Steven K. Vogel

JAPAN Remodeled

HOW GOVERNMENT AND INDUSTRY ARE REFORMING JAPANESE CAPITALISM

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Cornell University Press ITHACA AND LONDON

First published 2006 by Cornell University Press
First printing, Cornell paperbacks, 2007
Printed in the United States of America

Library of Congress Cataloging-in-Publication Data

Vogel, Steven Kent.
Japan remodeled : how government and industry are reforming Japanese capitalism / Steven Vogel.
p. cm.—(Cornell studies in political economy)
Includes bibliographical references and index.
ISBN-13: 978-0-8014-4449-4 (cloth : alk. paper)
ISBN-10: 0-8014-4449-7 (cloth : alk. paper)
ISBN-13: 978-0-8014-7371-5 (pbk. : alk. paper)
ISBN-10: 0-8014-7371-3 (pbk. : alk. paper)
1. Japan—Economic policy—1989– 2. Capitalism—Japan. 3. Industrial policy—Japan. 4. Corporate reorganizations—Japan. I. Title. II. Series.
HC462.95.V64 2006
338.952—dc22
2005032190

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Cloth printing 10 9 8 7 6 5 4 3 2
Paperback printing 10 9 8 7 6 5 4 3

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CORNELL STUDIES IN POLITICAL ECONOMY

edited by Peter J. Katzenstein

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To my mother

TABLES AND FIGURES

ACKNOWLEDGMENTS

I am grateful first and foremost to the many Japanese politicians, bureaucrats, business people, and others who agreed to be interviewed for this research project. They were extremely generous with their time and patient with my inquiries, and many graciously assisted with fact checking and updates. Many individuals facilitated the research in a myriad of ways, such as locating data resources, making introductions, and offering advice. Among these, Christina Ahmadjian, Geoffrey Bennett, Didier Guillot, Kōji Hirao, Takeo Hoshi, Keiko Hjersman, Yuki Ishimatsu, Gregory Jackson, Richard Katz, Jun Kayano, Nami Matsuko, Yoshio Nakamura, Toshiyuki Ōkubo, Naoko Sakaue, Yoshihiro Tajima, Kazufumi Tanaka, and Jirō Yoshida deserve special thanks. Christina Ahmadjian, Jennifer Brass, Clair Brown, John Cioffi, Christina Davis, Richard Deeg, Ronald Dore, Robert Fannion, William Grimes, Kenneth Haig, Roselyn Hsueh, Gregory Jackson, Peter Katzenstein, Kenji Kushida, James Lincoln, Gregory Linden, Robert Madsen, Jonathan Marshall, Yasuyuki Motoyama, Seio Nakajima, Keith Nitta, Gene Park, Hugh Patrick, T. J. Pempel, Ezra Vogel, Charles Weathers, John Zysman, and two anonymous reviewers offered helpful comments on earlier drafts. Many others read small excerpts to check for errors or misinterpretations. Kenneth Haig, Michiko Ishisone, Kenji Kushida, Keith Nitta, Jennifer Oh, Gene Park, Naoko Sakaue, Tetsuji Sugayoshi, and Masaya Ura provided superb research assistance. Robert Fannion collaborated on the German field research and gave useful feedback throughout the project. Yasuyuki Motoyama was a tireless partner for much of the research, and he and Iris Hui conducted the data analysis. James Lincoln has been an incredibly patient and generous mentor.

The Smith Richardson Foundation provided financial support, and Allan Song was instrumental in helping me to sharpen my proposal. I also benefited from financial support from the Center for Japanese Studies and the Committee on Research at the University of California, Berkeley. The Clausen Center for International Business and Policy at the Haas School of Business contributed to the purchase of data from the Development Bank of Japan. Roger Haydon of Cornell University Press guided the manuscript from submission through production; Ange Romeo-Hall oversaw the editing; and Kimberley Vivier edited it. Most of all, I thank Susan, Justin, and Ellie for their love, patience, and support. I dedicate this book to my mother, Suzanne Hall Vogel, who taught me—among many other things—that to understand Japan, you have to start by talking with some Japanese people.

Berkeley, California S. V.

CONTENTS

1 THE JAPANESE MODEL AND INSTITUTIONAL CHANGE

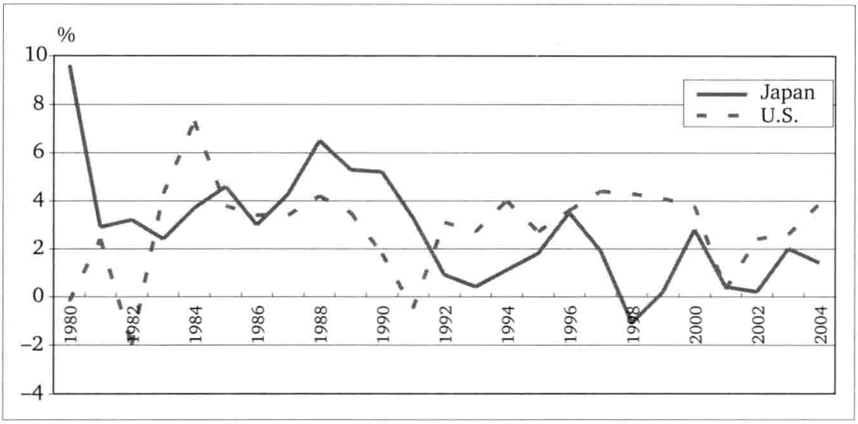
Once upon a time, would-be reformers from around the world looked to Japan for lessons. Japan had somehow discovered how to balance competition and coordination in a modern economy. It fostered cooperative relations between government and industry, between financial institutions and manufacturers, and between labor and management. The Japanese model delivered tangible signs of success: rapid economic growth, a rising standard of living, booming exports, technological leadership, and financial power. Japan performed well across a broad range of social indicators, with high educational achievement, excellent health standards, low crime rates, and little income inequality. By the 1980s, even the modest Japanese had developed a certain confidence and pride in their economic system.

Japan's economic miracle did not fizzle out quietly but erupted in a moment of market euphoria in the late 1980s—now referred to simply as "the Bubble"—in which investors poured money into real estate and stock markets. When the Bubble finally burst in 1991, Japan descended into a prolonged economic slump. As the Nikkei stock index plunged, economic growth faltered, and recovery failed to materialize, experts and amateurs alike rushed forward with a daunting array of theories to explain Japan's plight and to offer prescriptions for revival (see Chapter 2).

Many government officials, business executives, and opinion leaders simply concluded that the Japanese economic model had gone terribly wrong. They questioned the very institutions that had been credited with Japan's past success: a powerful bureaucracy guiding the economy, close government-industry ties, "lifetime" employment, the main bank system, and dense interfirm networks. Reform advocates declared that Japanese government and industry would have to fundamentally alter their ways. The government should liberate the economy, and companies should sever long-term ties with workers, banks, suppliers, and other firms.

Despite popular perceptions to the contrary, Japanese government and industry translated this collective reform frenzy into action. The government lowered interest rates, increased and decreased public spending, lowered and raised taxes, coddled and cracked down on ailing banks, liberalized financial

FIGURE 1. *GDP Growth in the United States and Japan, 1980–2004*



Source: International Monetary Fund, World Economic Outlook Database.

flows, eased labor standards, revised corporate law, lifted the ban on holding companies, privatized special public corporations, and revised the pension system. Just for good measure, the government also reorganized itself. Meanwhile, Japanese companies sold off subsidiaries, spun off divisions, switched supply sources, moved production overseas, renegotiated loan repayment schedules, introduced merit-based wage systems, reorganized their boards of directors, and experimented with stock options and share buybacks.

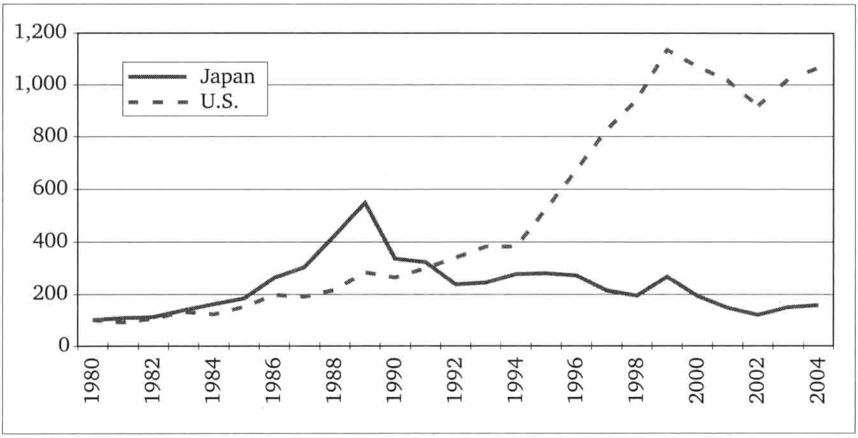
As the United States and Japan traded places—with the Japanese economy languishing and the U.S. economy resurging—U.S. government and business leaders looked less to Japan as a model, and Japanese leaders looked more to the United States as a model (Figures 1 and 2).[1] Japanese government officials grew more reticent about touting the merits of their economic model in bilateral talks and multilateral forums, and their American counterparts grew more confident in insisting on the superiority of the U.S. model.[2] Japanese corporate executives became less assertive in transferring their practices to their U.S. business partners, and U.S. executives became more aggressive in imposing their standards on their Japanese business partners.[3] The Japanese

1. See Grimes 2002.

2. By the mid-1990s, for example, the Japanese government became less active in promoting Japan's own experience as a model for developing countries, and the U.S. government grew bolder in promoting liberalization on a global scale through multilateral initiatives on telecommunications and financial reforms.

3. See Chapter 6 for detailed case studies of U.S. companies transferring practices to their Japanese partners.

FIGURE 2. *Major Stock Indexes in the United States and Japan, 1980–2004 (1980 = 100)*



Sources: Nihon Keizai Shimbun; Dow Jones.

government embraced the U.S. government's rhetoric of privatization, deregulation, and globalization, and the private sector hailed American industry's focus on flexibility, core competence, and shareholder value.

Yet a funny thing happened on Japan's way to the U.S. model: it never got there. As government officials and industry leaders scrutinized their options, they selected reforms to modify or reinforce existing institutions rather than to abandon them.[4] This in itself should come as no surprise. After all, Japan preserved considerable institutional continuity through more dramatic upheavals after the Meiji Restoration and World War II.[5] Japan could not preserve its old system in the new environment, but it could not replicate the American one either.

The tricky part is to specify *how* Japan is changing. This book seeks to do so by carefully analyzing government and private-sector reforms. Political scientists tend to focus on the "macro" level of politics and policy whereas business experts address the "micro" level of corporations and strategy. Yet we cannot understand government reforms without investigating how private-sector institutions and corporate strategies drive support for and opposition against reform proposals, and we cannot understand corporate restructuring

4. See Zeitlin and Herrigel 2000, especially 1–50, for a theoretical discussion of "Americanization" that stresses selective adaptation and creative modification rather than the wholesale adoption of the U.S. model.

5. Westney 1987, Noguchi 1995.

without examining how policy reforms generate new options and foreclose others. This book describes and explains patterns of institutional change in Japan through the extended use of the comparative case method: systematically comparing across countries (Japan versus the United States and Germany), across policy issues (labor market reform versus financial reform, for example), across industrial sectors (automobiles versus retail), across companies (Toyota versus Nissan), and across time (Seiyu before and after allying with Wal-Mart).[6]

How the Japanese Model Shapes Its Own Transformation

To understand how the Japanese economic model is changing, we must first recognize that the existing institutions of Japanese capitalism are shaping their own transformation. Market systems are embedded in a complex web of laws, practices, and norms. The process of liberalizing markets—just as much as the process of constraining markets—involves the transformation of these laws, practices, and norms. Liberal reformers sometimes contend that if only the government would pull back, then markets would flourish. Yet governments must create and foster the institutions that sustain market competition. Some authors imply that the Japanese model is more embedded in societal institutions than the U.S. model.[7] Yet an American-style external labor market is not less embedded than a Japanese-style internal labor market; an American equity-based financial system is not less embedded than a Japanese credit-based system; and an American antitrust regime is not less embedded than a Japanese corporate network (*keiretsu*). Scholars have stressed that the historical transition to market society in western Europe, the creation of market institutions in developing countries, and the transition to a market system in post-Communist countries all entail a complex process of building market institutions.[8] Yet few have extended this logic to the more modest transition from one type of market system to another. For Japan to shift toward the U.S. model, it would not simply have to dismantle existing institutions but also create new ones, and a full conversion would involve changes at all levels of the system: laws, practices, and norms. So long as Japan does not make a full conversion, therefore, the legacy of earlier institutions powerfully influences the trajectory of change.

6. On the comparative case method, see Lijphart 1971 and 1975, George 1979.

7. Crouch and Streeck 1997. Hall and Soskice (2001, 64) also suggest that it should be easier for coordinated market economies to become more like liberal market economies than vice versa.

8. Polanyi 1944, North 1981, Chaudhry 1993, Cohen and Schwartz 1998, Fligstein 2001, World Bank 2002.

To illustrate this point, let us engage in a brief thought experiment: What would it take for Japan to shift to a U.S.-style liberal market system, with active external labor markets, a market for corporate control, and the free market entry and exit of firms? Table 1 presents selected examples of the types of changes that would be required. In the employment system, for example, Japan lacks an external labor market for "permanent" employees (*shain*) at large corporations in the sense that companies do not buy and sell these employees' labor on the free market. Employers do not ordinarily poach workers from other firms, and employees do not move from one company to a competitor. The government cannot simply legislate a change in these practices. To cultivate such a market, the Japanese government would have to reduce legal restrictions on dismissal, disseminate more information to employers and workers, cultivate organizations to match employers with workers, promote portable pension plans, and expand unemployment insurance. It would have to revise financial regulations, accounting standards, and corporate law to encourage firms to be more responsive to shareholders and less beholden to their workers. Companies would have to renegotiate their compacts with their workers and redesign their systems of employee representation. Employers would have to become less loyal to their workers, and workers would have to become less loyal to their employers. And sufficient numbers of employers would need to be looking for workers, and workers for new employers, to provide adequate liquidity in the market.

We can think of institutional change as occurring when an exogenous shock pushes actors to reassess the balance between the costs and benefits of the status quo. But institutional change is a function of the level of this shock plus the incentives and constraints built in to the existing system. For our purposes, the forces for change outlined below comprise the exogenous shock, and the Japanese model itself constitutes the incentives and constraints that shape the response to this shock. This means that even when the shock is big enough to impose change, existing institutions still shape the substance of change. In the Japanese case, these institutions leave an especially heavy imprint owing to the stability of the actors. In politics, the same economic ministries collaborate with the same ruling party to dominate the policy process, so the primary arena of decision making is unlikely to shift, for example, from the bureaucracy to the judiciary or from the national government to local authorities. In business, few large firms exit the market and few new firms rise to challenge them, so change comes via the incremental reform of existing firms rather than their replacement by new firms with radically different practices. Therefore, outside forces—such as foreign governments demanding policy reforms or foreign companies bringing new business

TABLE I. *What Would It Take to Turn Japan into a Liberal Market Economy? Selected Examples*

LABOR

GOVERNMENT POLICY	CORPORATE BEHAVIOR
Laws • Labor market reform • Changes in case law doctrine • Corporate governance reform • Pension reform • Lift holding company ban	**Practices** • Lay off workers when necessary • Do not favor new graduates over midcareer hires • Shift from seniority to merit-based pay • Introduce stock options
Norms • The government should not use regulation to preserve employment.	**Norms** • Companies should not preserve employment at the expense of profits.
Net Result: An Active External Labor Market	

FINANCE

GOVERNMENT POLICY	CORPORATE BEHAVIOR
Laws • Financial reform • Banking crisis resolution • Corporate governance reform • Pension reform • Lift holding company ban	**Practices** • Sell off cross-held shares • Banks make lending decisions and price loans on the basis of risk • Corporations choose banks on the basis of price • Banks stop lending to insolvent firms
Norms • The government should not protect banks or manipulate financial markets.	**Norms** • Companies should maximize shareholder value.
Net Result: A Market for Corporate Control	

COMPETITION

GOVERNMENT POLICY	CORPORATE BEHAVIOR
Laws • Strengthen antitrust policy • Regulatory reform • Bankruptcy law reform • Strengthen social safety net	**Practices** • Choose business partners on the basis of price and not relationships • Do not cooperate or collude with competitors • Banks refuse to bail out failing firms
Norms • The government should not try to protect companies from failure.	**Norms** • Companies should not favor long-term business partners.
Net Result: Free Market Entry and Exit	

practices—play an especially important role in institutional change. Having lost confidence in their own institutions since the 1990s, Japanese government and business leaders are especially susceptible to this outside influence.

In addition, the complementarity (interaction) among the different components of the economic system conditions the trajectory of institutional change.[9] Masahiko Aoki stresses that national systems of economic governance incorporate complementary labor, financial, and political systems. The Japanese financial system, with patient capital channeled to firms by banks, for example, complements the Japanese labor system, with long-term employment stability and strong labor-management collaboration at the firm level. Japanese firms can uphold their employment guarantee to workers in a downturn because they are not subject to shareholder pressures for short-term returns.[10] This means that the evolution of the Japanese labor relations system is shaped not only by the existing institutions of the labor market but by the distinctive institutions of the financial market as well. Moreover, actors are likely to be cautious in tampering with one element of the system for fear that it will negatively affect other parts. For example, firms might be reluctant to embrace new financial strategies—such as courting international investors or listing on a foreign stock exchange—that could undermine their labor relations systems.

The existing institutions of Japanese capitalism do not simply act as friction, impeding fuller liberalization or convergence on the U.S. model. These institutions shape the trajectory of change in a much more active way: they enable other types of institutional innovation. The Japanese government and industry can build on their existing ties, for example, to forge new public-private partnerships to facilitate adjustment to changing market conditions (Chapter 4). Or company managers and labor union leaders can use existing channels of communication to design new pacts to preserve employment and enhance productivity (Chapter 6). One could view Japan as doubly constrained: it cannot maintain its existing economic system owing to the forces for change, and it cannot converge on the liberal market model owing to the logic of its existing institutions. Yet these dual constraints are themselves major drivers of institutional innovation.

9. Paul Pierson (2000) describes this dynamic in terms of increasing returns: the probability of further steps along a given path increases with each move down the path because the relative benefits of these steps over other options increase over time. So once a critical institution, such as a collective bargaining system or a main bank system, takes hold, it is reinforced over time by complementary laws, regulations, norms, and procedures, as well as by the entrenchment of supporting political interests.

10. Aoki 1988.

The Japanese Model

Before shifting to the model of institutional change, let us briefly review the core features of the postwar economic system before 1990 and outline the forces driving change. For present purposes, we can define the Japanese model as a constellation of institutions (including political institutions, intermediate associations, financial systems, labor relations systems, and interfirm networks) linked together into a distinct national system of economic governance. Japan was similar to other coordinated market economies (CMEs) such as Germany and different from liberal market economies (LMEs) such as the United States in that it fostered long-term cooperative relationships between firms and labor, between firms and banks, and between different firms.[11] These relationships combined to produce relatively stable networks of business relationships (*keiretsu*), including horizontal industrial groups and supply and distribution networks.[12] The bureaucracy played a critical role in protecting industry from international competition, promoting industry through an active industrial policy, managing competition in sectoral markets, and establishing and maintaining the framework for private-sector coordination. Industry associations served as important intermediaries between the government and industry, especially in industrial sectors with a large number of firms.[13] Here we focus particularly on the core "micro" institutions of the Japanese model: the "lifetime" employment system, the main bank system, the corporate governance system, and supplier networks.

The labor relations system combined a grand bargain of wage moderation and few strikes in exchange for employment security with firm-level pacts that promoted labor-management cooperation. Labor unions were organized primarily at the enterprise level, rather than at the sectoral level, facilitating cooperative agreements between management and labor. Large Japanese firms developed channels to incorporate labor into the management process and to enhance communication between managers and workers. They cultivated the loyalty of their core workers by offering long-term employment, by tying wage increases primarily to seniority, and by offering firm-specific benefit programs such as nonportable pension plans. They fostered internal labor markets by encouraging personnel transfers within the firm or the corporate group while impeding external labor markets by restricting most hiring to recent graduates. With lower turnover, Japanese firms had a greater

11. Hall and Soskice 2001.

12. Gerlach 1992, Lincoln and Gerlach 2004. The Japanese originally differentiated the horizontal industrial groups (referring to them as *kigyō shūdan*) from other corporate networks, but they now employ the term *keiretsu* for the horizontal groups as well.

13. Representative works on government-industry relations include Johnson 1982, Samuels 1987, Okimoto 1989, Hiwatari 1991, and Schaede 2000.

incentive to invest in training their workers. At the same time, they retained considerable flexibility with a starkly tiered system of permanent employees, who enjoyed job security and full benefits, and nonregular workers, who might work full time but did not enjoy the same level of wages, benefits, or security.[14]

The financial system centered on bank lending rather than capital market finance. The government actively directed the allocation of credit through public financial institutions and private banks. The government insulated the market from international capital flows, segmented financial institutions into distinct niches (securities houses, insurance firms, and various types of banks), and heavily regulated the financial sector to prevent both market entry and exit. Meanwhile, firms maintained long-term relationships with their "main" banks. The main banks would provide their clients with a stable line of credit at favorable rates, monitor the clients' performance, and aid the clients in the case of financial distress. The firms, in turn, would conduct a large and consistent share of their borrowing and transaction business with the main bank.[15] Firms and their main banks often shared ties to a common industrial group—also known as a horizontal *keiretsu*—such as the Mitsubishi, Mitsui, Sumitomo, Daiichi Kangyo, Sanwa, and Fuyo groups. Companies within these groups tended to engage in preferential business relationships and to cross-hold each other's shares. In this way, they kept a large proportion of their shares in stable hands, insulating them from outside shareholders and all but eliminating the risk of hostile takeover. Japanese managers practiced "stakeholder" governance in the sense that they viewed workers, banks, suppliers, and distributors as members of a corporate community, and they considered the interests of this broader community in making management decisions. Corporate boards were typically composed of a large number of career executives, with little or no input from outsiders.[16]

Japanese manufacturers cultivated extensive supply networks, also known as vertical *keiretsu*. Assemblers remained loyal to their suppliers in exchange for supplier efforts to control costs, maintain quality, develop products to specification, deliver supplies in a timely fashion, and provide superior after-delivery service. Assemblers collaborated closely with their core suppliers on research and design, and they often cemented these relationships with cross-shareholdings. Toyota incorporated this approach to supply-chain management into its "just-in-time" lean production system, which emerged as the

14. Koike 1988, Aoki 1988, Ariga et al. 2000.

15. Aoki 1988, Aoki and Patrick 1994, Aoki and Dore 1994.

16. Teramoto 1997, 32–36; Itami 2000; Inagami 2000; Dore 2000, 23–48; Itō 2002; Jackson 2003, 263–67.