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Japanese business: Time to take the brake off?

The Japanese economy may be the second largest in the world, but it struggled in the 1990s and early 2000s. And while economic pain might have resulted in structural reforms elsewhere, that has not happened in Japan.

In his latest book, *Changing Japanese Capitalism: Societal Coordination and Institutional Adjustment*, INSEAD Affiliate Professor Michael A. Witt likens the process of institutional change in Japan to driving a car with the parking brake on. You can still drive the vehicle, but the engine has to work harder than it would do, if you didn't have the brake engaged.

The brake is the coordinated character of Japan: changing the ways of doing business there involves a lot of mutual consultation and information exchange about possible steps and their practical feasibility, until a consensus about a course of action emerges. The high levels of social networking in Japanese business are a key element in these coordination processes.

Coordinated processes, which we also see in Continental European countries, are prone to getting stuck if no consensus emerges. Unlike in many other nations, however, the inertia of the Japanese process is exacerbated by three factors.

One is that the system did well for a long time and still has legitimacy in the minds of many people. "It has a lot of stabilisers built in that allow people to continue to see the system as legitimate even when it's actually suffering," Witt says.

A second element is the relative absence of deviant behaviour. "(What) really sets Japan apart from many of the industrialised countries is that in many of the industrialised countries – if the ways of doing things do not really reflect the needs of companies, if they inflict economic pain on people, if labour regulations make a company uncompetitive, if it means you can't get a job because companies can't afford you or if taxes are completely unreasonable, at least by commonly held social standards – people start opting out of the system," Witt says. "The astonishing thing about Japan is that this happens at a comparatively low level, actually a very low level indeed."

This is related to a third point, namely the country's highly networked structure. While it allows companies to coordinate their strategies with other firms and related actors in the system, it also makes it "relatively easy to keep tabs on what everybody's doing." This is a source of conformity pressures and so discourages people from opting out.

In need of an afterburner?

In all, Witt believes these factors are effectively holding back institutional adjustments and therefore economic growth in Japan as well. "Now while in many countries you see the opting out processes being a power boost or afterburner in a jet engine, this kind of afterburner's not present in the Japanese case. So getting the power that's needed to get a certain result is much higher than you'd need if the processes were structured in a certain way, for instance, leaving more freedom to individuals and firms to devise their own rules, as would be the case in many Anglo-Saxon states."

Witt says there is a clear correlation between growth and the level of coordination within an economy: "We see that countries with high levels of coordination tend to be the same countries that have shown relatively low economic performance in the recent decade or so."

Of the limited institutional change evident in Japan, part of it is linked to selling off distressed financial firms to foreign companies. This, Witt argues, has led to changes in corporate governance along Anglo-Saxon lines, at least for some firms. However, these companies are viewed as being outside the 'regular realm' of Japanese business. "They're in Japan but they are seen as foreign affiliates, which is precisely what they are. So there may be some impact but I believe it will be relatively limited. More interesting perhaps, is the question of the sale of financial assets, in particular shares by Japanese financial institutions, and a lot of these shares seem to have landed in the hands of foreign shareholders." The reason this is significant, he says, is that traditionally, the Japanese are not very active in putting pressure on management to produce shareholder value, unlike their counterparts in Anglo-Saxon countries.

Corporate governance

"It's a system that puts employees and society first. Shareholders are basically one stakeholder group among many and traditionally not a very important one. Now what's happened in recent years is that because the ownership by foreign shareholders has gone up considerably, there's been increasing pressure on Japanese firms to reform along the lines of American firms and be more concerned with shareholder value. The interesting thing is – typically what happens once you have more than 30 per cent foreign shareholders – this is seen as the 'tipping point' when companies start having to implement reforms in terms of corporate governance structure."

He adds, however, that it's not clear yet what the overall effect on the rest of the Japanese business system will be. "Despite this increase, we see only very limited impact on corporate governance structures—a very, very small number of firms seem to have implemented far-reaching reforms. And even in those cases, it's not clear to what extent those reforms were done by form only, in order to give investors the impression their concerns were being taken seriously, while in reality the objective was mostly to maintain the core objectives of the Japanese firm undisturbed, mainly employees and society first."

Against this backdrop, even a reform-minded political leader like Junichiro Koizumi was unable to make much headway. Witt says this was mainly due to Koizumi focusing his attention on reforming the political system, rather than the way Japan conducts business. "His accomplishments in terms of economic or business-related reforms are very limited and they were also not (in line with) his objective."

Japan 'will not sink in the Pacific'

Witt concludes his book by saying that Japan is placing "a highly risky bet about the Japanese business system on an uncertain expectation of renewed tranquility." It's a bet that could go sour.

He says he expects Japan to continue performing 'relatively poorly' as it contends with issues such as an ageing population. "Japan will not sink in the Pacific," Witt says, but it will face increased international competition and rapid technological change in the years ahead.

For a system that works well "under conditions of predictability and calm" that's likely to spell trouble. "Now if the expectation of Japan is that this is a temporary thing, for instance, all this technology we're seeing is just a function of the current transition to the next industrial age and we know normally these transitions take 50 years, the present one started around 1970 so maybe we can tough it out until 2020 and then things will become calmer again and then we … will just take it from there and return to the former days of glory. The problem with this line of thought, and it may well happen this way, is there's no guarantee it will happen."

If, however, the pace of change or 'environmental turbulence' remains high, "then staying the course is a very problematic approach."

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