Inside the Castle Gates: How Foreign Companies Navigate Japan’s Policymaking Processes

By

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Abstract

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Multinational corporations (MNCs) are at the heart of today’s global economy, but their effects on the politics of advanced industrialized countries have not been studied systematically. This dissertation analyzes the case of Japan, a country most likely to reveal foreign MNCs’ influence. Japan developed for most of its history with an extremely low presence of foreign MNCs, but it experienced a dramatic influx from the mid-1990s, particularly in long-protected sectors at the core of its postwar development model of capitalism.

The dissertation explains an observed divergence in the political strategies of foreign MNCs in Japan—disruptive challenges to existing policymaking processes and norms of government-business interactions, versus insider strategies, in which MNCs worked within established organizations and prevailing modes of policymaking.

The core contention is that the corporate “clock speeds” of MNCs strongly shape their policy strategies. Clock speeds, the relative rate of change in aspects such as product introduction, product processes, and corporate organization, differs systematically across sectors. By analyzing policy cases within the banking and securities, insurance, telecommunications, and pharmaceuticals sectors, this study shows that MNCs with faster clock speeds tend to pursue disruptive strategies, while MNCs with slower clock speeds tend to pursue insider strategies.

This dissertation also shows how changes in Japan’s model of capitalism enabled the influx of foreign MNCs and expanded MNCs’ opportunities to exercise voice. Through an analysis at the national, sectoral, and firm levels over time, this study shows how Japan’s post-bubble political dynamics created new possibilities for foreign entry and voice. The new opportunities to exercise voice were taken advantage of by fast clock speed MNCs, while slower clock speed firms benefited from existing policy processes. The dissertation finds that MNCs can simultaneously influence policy processes along two different time horizons for cause and effect. While disruptive strategies act as exogenous sources of change, delivering shocks to existing arrangements and processes, insider strategies can lead to incremental, but potentially transformative, change over time.
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INTRODUCTION: Inside the Castle Gates

If you are confronted with a fortified castle, there are a number of strategies you might employ to gain access. You might bring a battering ram to break down the gates. You might try to lay siege. You might try diplomacy and bring an envoy from your own kingdom, and you might search for collaborators on the inside. Or you might employ trickery or attempt a stealthy entry through an unobtrusive side door.

Once inside, however, the game changes. You need new tools; a battering ram is no longer useful. Your objectives can change; a siege no longer makes sense, and diplomacy involves more than simply gaining access. Collaborators who helped you enter may no longer be unqualified allies. And trickery or continuing use of side doors becomes more risky, since you may be expelled.

From the perspective of many foreign multinational corporations (MNCs), Japan’s postwar political economy was the castle. While eager to absorb technology and expertise, Japan tightly restricted inward foreign direct investment (FDI). Even after the 1980s, when most formal policy restrictions had been lifted, Japan was an unusual market, with proprietary market conditions and distinctive economic characteristics. To gain market access and reshape the economic environment, some MNCs mobilized international pressure. Others used regulatory loopholes and Japanese allies to gain entry. Some enjoyed considerable success, but many failed. As a result, the image of the world’s second largest economy persisted as a fortress largely closed to foreign influence.

In the late 1990s, however, the castle gates opened. After a series of regulatory shifts, areas largely restricted to foreign entry, such as finance and telecommunications, were wide open. In fact, after a decade of slow or negative growth following the bursting of the economic bubble in 1990, parts of the castle had caught fire. In the late 1990s, crises swept through a number of previously protected sectors such as banking and insurance. Even in competitive manufacturing sectors, venerable firms such as Nissan were on the brink of collapse. Foreign firms were now invited inside the castle to put out the fire – to inject capital and management expertise to rescue Japanese firms. Foreign MNCs moved in quickly, taking prominent positions in core economic sectors. The largest influxes were in automobiles, banking, insurance, pharmaceuticals, securities, and telecommunications.

This influx led to developments unthinkable ten to fifteen years earlier. Nissan was revived by a management team from French automobile firm Renault, with a Brazil-born Frenchman of Lebanese descent as CEO. American private equity funds took control of several venerable but bankrupt Japanese banks. Foreign life insurers dominated new markets, and Western investment banks introduced radical new employment practices. Foreign pharmaceutical firms became some of the largest employers in the sector, and more than one nationwide telecommunications carrier was purchased by foreign firms.

This dissertation examines the effects of foreign MNCs on Japan’s political economy once they were inside the castle gates. Did they push Japan’s political economy further away from the distinctive institutions and policymaking processes that had characterized it for most of the postwar period? Did they drive Japan towards a global convergence of market practices? Did they undermine bargains at the core of Japan’s political economy such as long term employment? And did they pry open policymaking processes to outsiders? These are the broad questions this study poses.
MNCs in Japan: at the Intersection of Globalization and Institutional Change

The question of how foreign MNCs affected Japan’s political economy lies at the heart of scholarship on globalization and the evolving capitalist systems of advanced industrialized economies. MNCs are core drivers of globalization, but their mechanisms of influence on host countries differ from other globalizing forces, such as trade, portfolio investment, or international organizations. Their influence does not necessarily stem from an exogenous lowering of prices, the threat of capital flight, or mobilization of their home country’s government – mechanisms cited in other forms of globalization. Instead, MNCs can become political actors inside the host country, interacting with countries’ politics and policy processes. They have a broad range of options to exercise voice. By introducing new norms of behavior, they can deliver the equivalent of exogenous shocks. By joining existing arrangements and behaving as Japanese companies, however, they can also drive endogenous change.

While MNCs’ effects on the politics of developing countries have been studied, there is little systematic analysis of their influence on advanced industrial countries – where political systems and institutions are comparatively well developed and more complex.

Among advanced industrialized countries, Japan provides conditions most suited to study the effects of MNCs – conditions closest to that of a natural experiment. Its economy developed with a far lower presence of foreign MNCs than most others. Its politics and policymaking developed on the premise of repeated, long-term interactions among a stable set of actors, almost all Japanese. But beginning in the mid to late 1990s, foreign MNCs became significant players in a variety of industries. They became major employers, joined industry associations, and increasingly participated in government deliberation councils. Recent scholarship on systemic restructuring in Japan leaves the presence of MNCs as an endpoint.

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1 This dissertation follows John Dunning and his collaborators by defining Multinational Corporations as an “enterprise that engages in foreign direct investment (FDI) and owns or, in some way, controls value-added activities in more than one country.” John H. Dunning and Sarianna M. Lundan, Multinational Enterprises and the Global Economy, 2nd ed. (Cheltenham, UK ; Northampton, MA: Edward Elgar, 2008). The terms “corporations,” “enterprises,” and “firms” are used interchangeably.


3 This follows Albert Hirschman’s distinction between voice and exit. Albert O. Hirschman, Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States (Cambridge, Mass.: Harvard University Press, 1970).

The time is ripe to take it as the starting point in understanding not just how they influenced policy, but affected the very processes and institutions of policymaking.

As an extreme case of low MNC presence in its postwar development, the Japanese case is useful in broader scholarship on how advanced industrial countries change over time. In virtually all typologies, Japan is one of the paradigmatic “nonliberal” or “coordinated market” economies, along with Germany and France. The contrast is with “Anglo-American” or “liberal market” economies. As such, Japan is a “most-likely” case for change following an influx of MNCs introducing new norms and behavior. Process tracing in extreme cases is useful in revealing new mechanisms of influence. Mechanisms uncovered in this study can therefore contribute to scholarship aimed at understanding how various forms of capitalist systems evolve over time.

Institutions, regulations, and market dynamics can shape how firms exercise voice, and the effects of exercising particular types of voice. Therefore, to understand the effects of foreign MNCs on Japan’s policymaking, we must first understand the institutional, regulatory, and market conditions that enabled their entry. This is the topic of Part I of this dissertation, “Entering the Castle Gates.” Only by understanding the conditions enabling and facilitating the influx of foreign MNCs can we turn to Part II, “Inside the Castle Gates,” the political analysis of MNCs once they became prominent in key sectors.

**PART I: ENTERING THE CASTLE GATES**

Why did Japan’s economy have such a low foreign MNC presence during the postwar period, and why did an influx of MNCs occur in the late 1990s? What made the Japanese economy a fortress, and why did the gates suddenly open?

It is well known that the government’s strategic orientation driving Japan’s postwar rapid growth led an economy designed as largely closed to outside influence, particularly to foreign management control of domestic firms. I show that later, even after the strong strategic orientation waned, distinctive institutional features of Japan’s economy and restrictive sectoral regulatory structures persisted, hindering the entry and operation of foreign MNCs.

I contend that in the 1990s, major changes to Japan’s postwar model of capitalism reshaped the political economic conditions facing foreign MNCs, and this enabled the influx. The key transformations of Japan’s political economy included a demise of the strategic orientation of keeping Japan’s economy relatively closed (Chapter 2), changes to Japan’s distinctive institutions (Chapter 3), and major sectoral regulatory shifts and market transformations (Chapters 4, 5). The transformation was driven by political dynamics stemming from Japan’s languishing post-bubble economy of the 1990s.

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The Strategic, Developmental Castle: Outsiders Even When Inside

For much of the postwar period, Japan was remarkably closed to foreign MNCs. This was largely by government design, integrated into its strategy for pursuing economic growth in the early postwar period.\(^6\) Even after many of the policy restrictions were eased, Japan’s distinctive institutions and market conditions made it an exceptionally challenging environment to which foreign MNCs needed to adapt.

Japan’s postwar model of strategic economic development, as well as its clientelistic politics, required industrial sectors closed to trade and foreign management influence. Japan’s early postwar model of government-shaped rapid economic growth hinged on insulated core sectors. Japan’s centralized, bank-centered financial system that enabled the government to channel resources to targeted industries required banks to comply with government guidance. In the early postwar period, capital restrictions provided an effective tool to ensure compliance, precluding foreign participation. The manufacturing sectors deemed strategic were protected in their infancy from foreign competition and takeover. Later, a closed market enabled Japanese firms to charge higher prices domestically to finance their expansion into overseas markets.

Foreign MNCs, because they were competitors to Japanese firms and also potentially less likely to follow the government’s strategies, were systematically restricted.\(^7\)

The clientelistic power base of the Liberal Democratic Party (LDP) was also predicated on key sectors’ insulation from foreign MNCs. The LDP’s pork-barrel political machine, instrumental in its maintenance of power from 1955 until 2009, entailed channeling public works funds to industries such as construction and transportation.\(^8\) Infrastructure and employment provided by these industries, especially in rural areas, were exchanged for critical electoral and financial support. Large foreign MNCs in these sectors were a threat to common practices such as preferential project allocation, often through rigged bids and price collusion. Since the LDP’s local-level support also derived from small-medium businesses, large global MNCs, in areas such as large scale retail, were also restricted.

The overall strategic orientation of maintaining Japan’s closed political economy was sustained until the 1970s by strong capital controls, which included national restrictions on inward FDI and foreign MNCs. Even after the strongest national-level restrictions were lifted, however, foreign entry was hindered by distinctive institutional features that the Japanese political economy had developed – some designed to thwart foreign entry but mostly a result of political and economic considerations unrelated to foreign MNCs, as shown in Chapter 2 and Chapter 3.


\(^7\) As Pempel notes, in the 1950s, not only did Japan receive less US investment than any other industrialized country, but it even received less than comparative less attractive markets such as Columbia, Peru, and the Philippines. Ibid., 51. Japan continued to receive less foreign investment than all other OECD countries.

\(^8\) For example, see Brian Woodall, "Japan under Construction Corruption, Politics, and Public Works." (Berkeley, Calif.: University of California Press, 1996).
For example, *keiretsu* industrial groups, anchored by stable cross-shareholding that prevented hostile takeovers, hindered new entrants, foreign or domestic. The “main bank” system limited equity finance and prevented large bankruptcies that could enable foreign buyouts and rescues. The government’s “convoy” system of governing the financial sectors provided an implicit guarantee against the failure of financial institutions in exchange for their compliance with the government’s informal guidance. The social bargain of long-term employment created illiquid labor markets, hindering foreign MNCs’ abilities to attract high quality managers and white collar workers. Regulatory structures of “ex ante managed competition” in strategic sectors, which enabled the government to micromanage competition and shape firms’ business models through formal licensing authority and informal guidance, required extensive informal interpersonal networks with regulatory authorities. Outsiders had difficulty gaining information critical to competition, and Japanese branches of foreign MNCs had trouble justifying the cost of these informal networks to headquarters. Finally, proprietary Japan-specific dynamics of competition – what firms competed over – differed in many Japanese markets vis-à-vis major international markets. Particularly in closed and regulated markets, Japanese firms competed over volume and market share rather than profitability and price, and business models employed by foreign MNCs elsewhere did not give them automatic competitive advantages in Japan.

While some foreign MNCs succeeded in these conditions, they were mostly in non-strategic areas, such as food, beverages, and high end luxury brand goods, as well as in areas intrinsically dominated by global MNCs such as oil. Some foreign MNCs took advantage of Japan’s distinctive characteristics, but most were restricted access, faced difficulties, or were deterred from large-scale entry.

During this period, foreign MNCs’ political strategies were focused mostly on gaining market access. To this end, they mobilized *gaiatsu* – home government pressure – and exploited regulatory loopholes, sometimes with Japanese partners, to enter Japan. Once inside, however, in strategic sectors they were compartmentalized into particular market segments. Their ability to enter institutions to exercise voice through existing channels, such as industry associations and government deliberation councils, was limited. *Gaiatsu* was the primary policy tool at their disposal to influence policy.

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political reform, leading to a series of major regulatory changes. Manufacturing sectors, facing new global competitive challenges stemming from the Information Technology (IT) revolution, began to restructure. The LDP also abandoned its support base of small-medium businesses, opening the way to entry by global MNCs in areas such as large-scale retail.

Core tenets of the Japanese postwar model of capitalism began to shift. The strategic orientation towards foreign MNCs was largely reversed, leading to policies designed to enhance their ability to enter and operate in Japan, such as measures to facilitate M&A. Regulatory shifts in previously protected areas such as finance and telecommunications embraced greater openness and market-based competition. The “convoy” system was abandoned and main banks were weakened, leading to crises and bankruptcies that provided new opportunities for foreign entry. In a variety of sectors, the logic of regulation shifted from ex ante managed competition towards one of ex post market governance, accomplished through both deregulation and new regulations. This removed the compartmentalization that had limited foreign MNCs’ operations. It also reduced the importance of informal interpersonal networks in obtaining information critical to competition, decreasing the Japan-specific organizational costs for MNCs. As the new regulatory structures transformed the dynamics of competition in previously closed sectors, foreign MNCs enjoyed advantages over Japanese competitors with their global business models now effective in Japan. New labor practices, supported by regulatory shifts and judicial reinterpretation, increased the liquidity of labor market, making it easier for foreign MNCs to acquire high quality managers and employees.

In short, the 1990s saw a transformation in the broad institutional conditions, specific sector-level regulations, and underlying strategic orientation that had all aligned against foreign MNCs for much of the postwar period. The remaining restrictions were only in politically strategic sectors at the heart of clientelistic political support, such as construction and transportation. Overall, the castle gates were open, and foreign MNCs poured into previously

11 See *Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism*.
13 For an overview of many of these changes, see Schaeade, *Choose and Focus: Japanese Business Strategies for the 21st Century*.
14 They shifted according to Japan’s political logic, following a trajectory of change shaped by Japanese institutions, which acted as constraints as well as opportunities for institutional innovation. *Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism*, 7.
15 Deregulation mostly encompassed the removal of licensing requirements, sectoral compartmentalization, and regulatory barriers to entry. Re-regulation, the creation of new rules and organizations, was designed to regulate market-based competition *ex post*, such as strengthened antimonopoly authorities, supervisory agencies, and dispute resolution organizations. For the argument that liberalization, an increase in the level of competition, can be a result of deregulation, a relaxing of rules, combined with reregulation, and increase of rules, see Steven Kent Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries*, Cornell Studies in Political Economy (Ithaca, N.Y.: Cornell University Press, 1996).
restricted sectors, taking prominent market positions to a degree unthinkable a decade earlier (Chapter 1).

PART II: INSIDE THE CASTLE GATES – THE CORE ARGUMENT

How did foreign MNCs interact with Japan’s policy processes once the castle gates were open and they were inside? This is the core analytical question of this dissertation. To understand the influence of foreign MNCs on Japan’s politics and policymaking, it is most fruitful to focus on their intersection – the interactions between foreign MNCs and well-established policy processes in Japan.

Even at first glance, there is a notable divergence in the behavior of foreign MNCs towards existing policy processes. On numerous occasions foreign MNCs defied existing norms of government-business interactions and challenged prevailing processes. They ignored informal guidance, took advantage of regulatory loopholes, defected from long-standing industry organizations, and explored new avenues of policymaking. These were disruptive political strategies.

In most other cases, however, foreign MNCs tended to conform to existing norms of government-business interaction and followed typical policymaking procedures. They participated in informal consensus-building through interpersonal networks, they joined industry associations and influenced the latter’s preferences, and they shifted the balance of power among existing political actors. In short, they employed insider strategies.

The contrasting policy strategies imply different sets of mechanisms for influencing change. Disrupting existing norms and processes can trigger immediate responses, altering expectations and changing the norms and patterns of policy processes and government-business interaction. Insider strategies, however, suggest the possibility of a more subtle influence. While some effects can be immediately observed, others may drive gradual but transformative change. Disruptive strategies can be seen as exogenous shocks delivered by MNCs from within the economy, while insider strategies can contribute to endogenous change. Table 1 lists the divergent observed political strategies and their implied mechanisms of change.
Table 1. Divergent Political Strategies and Implied Mechanisms of Change

<table>
<thead>
<tr>
<th>Nature of Challenge</th>
<th>Examples of Actions</th>
<th>Implied Mechanisms of Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Disruptive</strong></td>
<td>• Ignore informal guidance&lt;br&gt;• Take advantage of regulatory loopholes&lt;br&gt;• Defect from long-standing industry organizations&lt;br&gt;• Probe new forms of government-business interactions</td>
<td>• Reduce ability for strategic policymaking&lt;br&gt;• Changed organization of interest aggregation&lt;br&gt;• Decrease stability of government-business relations</td>
</tr>
<tr>
<td><strong>Insider</strong></td>
<td>• Act as players in informal consensus building&lt;br&gt;• Using informal interpersonal networks to engage in informal negotiations&lt;br&gt;• Influence preferences of industry associations from within</td>
<td>• Change composition of economic interest groups&lt;br&gt;• Reshape domestic policy debates&lt;br&gt;• Decrease economic nationalism</td>
</tr>
</tbody>
</table>

So what causes the divergence of foreign MNCs’ political strategies? The most useful moments to examine are those in which MNCs faced potential windfall revenue by disrupting existing arrangements, or when they perceived policy-driven threats to their core business models or revenue streams.

I find that although the national origins and business models of foreign MNCs were diverse, there is an underlying regularity. I contend that the relative corporate “clock speeds” of firms strongly influenced their political strategies. Corporate clock speeds, explained more fully later, are the relative rate of change for firms or industries in aspects such as product introduction, production process, and corporate organization. Intuitively, the concept is easy to understand. For example, the world of Internet-related software services changes so rapidly that the name of the business category is itself unstable, with new products and services fundamentally reorganizing and redefining the market every few years. By contrast, the aircraft manufacturing sector moves quite slowly, with new product rollouts spanning not only years, but even decades. Several metrics are available to measure corporate clock speeds, but only a rough differentiation suffices for this study. (For details see Appendix A.)

My core contention is that firms with faster clock speeds were more willing to adopt disruptive strategies. They had relatively shorter time horizons, and their expected benefit from immediate windfall profits was greater than the potential longer-term repercussions (in some cases, even including expulsion from the country). Firms with slower clock speeds, on the other hand, were more likely to adopt insider strategies that conformed to existing processes and procedures. They had longer time horizons, with relatively less opportunity for windfall profits, and more to lose in the long term by taking risks in the short term.

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Clock speeds differ systematically across industries, with some within-sector variation. This study engages in a comparison across sectors, within sectors where possible, and across time. It examines issues and cases in which foreign MNCs were involved in policy processes. It takes the sectors in which foreign MNCs have made the deepest inroads since the mid-1990s, which include the financial sectors of banking, securities/investment banking, and insurance, and the non-financial sectors of automobiles, telecommunications, and pharmaceuticals. Table 2 presents an overview core argument, showing a range of clock speeds, industries arranged according to their relative clock speeds, and the range of political strategies.\footnote{The core argument presented here does not hinge on precise measurements of corporate clock speeds. However, several indications that can be used to measure clock speeds are presented in Chapter 6.}

\textbf{Table 2. The Core Argument – Clock Speeds Driving Diverging Political Strategies}

<table>
<thead>
<tr>
<th>Clock speed</th>
<th>Faster</th>
<th>Slower</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>Private Equity Funds</td>
<td>Investment Banking/Securities</td>
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<td></td>
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<td></td>
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<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political Strategy</td>
<td>Disruptive</td>
<td>Insider</td>
</tr>
</tbody>
</table>

The following sections show how the cases unfold across sectors with different clock speeds, grouped into fast, medium, and slow sectors. The cases also show that the divergence of policy strategies is not a function of the level of foreign management control in foreign-owned firms, levels of regulation in the sector, or the relative presence of foreign firms in the sector.

\textit{Fast Clock Speeds – Disruptive Challenges: Private Equity Funds, Investment Banks/Securities Brokerages}

Firms with the fastest clock speeds mounted the most disruptive challenges. They were concentrated in two sectors: private equity funds, and investment banking/securities. The time horizons of investment funds specializing in corporate turn-arounds are short, since they are expected to exit profitably in a few years at most. Especially when imminent windfall profits from large investments or the execution of exit options are at stake, they can be among the most willing of all firms to disrupt existing norms and processes.

Investment funds, facing the opportunity to realize windfall profits, challenged the norms of government-business interactions by ignoring strong government pressure and exploiting regulatory loopholes. A US investment fund purchased a failed Japanese bank and defied considerable informal government pressure. It refused to bail out an ailing department store chain, and shocked the government by executing a clause that allowed it to sell soured loans to the government. Another US-based fund sparked a controversy by using off-shore tax havens to avoid paying taxes in Japan, stonewalling the government’s efforts to collect taxes. The controversy was that these profits resulted from the turnaround of a failed bank, and the fund’s purchase had been subsidized by taxpayer money.
Comparisons between investment funds and across time strengthen the argument. Other investment funds that did not confront policy issues critically affecting their business models or ability to derive windfall revenues did not mount disruptive challenges. Moreover, the very firms that mounted disruptive strategies to derive windfall profits in the examples above found their time horizons lengthening after subsequent investments in smaller Japanese ventures. They became more focused on a steady stream of smaller activities and began to invest more heavily into becoming insiders.

Investment banks and securities brokerages also operate at fast clock speeds. Their products are not protected by patents or intellectual property and are easily emulated by competitors. Product cycles are rapid, and therefore firms are pressured into a constant search for new revenue drivers and windfall profit opportunities. Product development often occurs on traders’ desktops rather than as a process resembling traditional R&D, often with incremental updates and adjustments of algorithms on a daily and weekly basis. Employee turnover is high, and firms often poach individuals and teams from one another to gain expertise and product know-how.

Acting both as individual firms and as a group, foreign investment banks and securities brokerages were willing to disrupt Japan’s norms of policymaking. One defied norms of government-business interactions by refusing to testify when summoned by the National Diet (Japan’s Parliament) on the grounds that there was no legal obligation to do so – despite serving as the government’s primary advisor to sell a bank. Another exploited a regulatory loophole by utilizing aftermarket share trading to facilitate a controversial hostile takeover bid by a Japanese startup firm. Foreign securities brokerages moved in concert to defy the government’s attempt to orchestrate the creation of an industry-wide investor protection fund, finding a legal loophole and setting up their own separate fund. They also precipitated the demise of an industry organization by withdrawing their membership after discovering that participation was not mandatory.

Medium Clock Speeds – Disruptive and Insider Strategies: Insurance and Banking

Firms in the insurance and traditional banking sectors generally operate at slower clock speeds than do private equity or investment banking/securities. They adopted insider strategies, even when mounting acute opposition to proposed policy measures.

The clock speeds of insurers are generally slower than those of firms in the sectors above because their core businesses require longer time horizons and depend more on reputation and public trust. Traditional insurance products represent a trade between predictable payments now in return for protection from uncertain costs or liabilities in the future. Counterparty risk over

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20 Quarterly financial results are linked to bonuses potentially far larger than in any other Japanese corporate sector.
time matters to corporate customers, and the general public tends to be risk averse in choosing insurers, especially for policies that accumulate over time.  

Foreign insurers confronted with policy issues threatening their revenues worked from within prevailing policy processes to influence policy. When the government attempted to increase the private sector contribution of a policyholder protection fund, foreign insurers reshaped the political debate by mobilizing a large bloc of votes within the industry association. When the government proposed to increase the reserve requirements for variable annuities, a major growth area for foreign insurers, the latter worked through deliberation councils and industry association pressure to reach compromises.  

*Traditional banks* focused on corporate finance and retail operations also require relatively long-term relationships. Syndicated loans, for example (distinct from “main bank” centered group loans, as shown later), a growth area for foreign banks since the late 1990s, required Japanese banks as medium to long-term partners in extending loans.  

Banks demonstrated greater risk aversion and were less willing to be involved in disruptive challenges vis-à-vis faster clock speed firms. A foreign bank was the front-runner in purchasing a failed Japanese bank, but it withdrew from negotiations for fear of the exact issue over which the private equity fund caused a political firestorm. Banks concentrated their resources on becoming insiders, joining industry associations and stating their policy positions through longstanding lobbying organizations. Examining across time, historically, we see that only when they entered new growth markets such as securities and trust banking were they willing to partner with Japanese firms to exploit regulatory loopholes.  

A within-sector contrast is provided by the private banking and wealth management arms of banks. These organizations’ clock speeds were faster, with incentives and personnel almost equivalent to those of securities brokerages. Private banking operations, as well as securities brokerages, received far more numerous warnings from the government’s supervisory agency than did traditional banks. The private banking license of a major bank was even revoked after a government audit revealed numerous legal violations.  

**Slow Clock Speeds – Insider Strategies: Telecommunications and Pharmaceuticals**  

Industries in this study with slowest clock speeds consist of telecommunications and pharmaceuticals. With long time horizons for their investment and product pipelines, they adopted insider strategies.  

*Telecommunications* carriers require years to deploy new standards and network equipment. Both corporate customers and the general public have time horizons spanning multiple years, since they experience lock-in effects, particularly in wireless services, once they enter into a contract.  

Foreign managed telecommunications carriers behaved very much as insiders. In contrast with the initial attempts at market entry by foreign carriers and equipment firms in the 1980s, foreign managed carriers in the 2000s used insider strategies to obtain wireless spectrum allocation and operating licenses. They also participated in an effort led by a Japanese firm to

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21 The exotic financial products such as credit default swaps that led to the 2007-2008 crisis were an unregulated market segment, leading to little interaction between those activities and government regulation.  

maintain the status quo in the political balance of power between the major policymaking actors in the sector; this effort took the form of a lawsuit against the government.

Here too, within-sector comparisons strengthen the argument. Foreign carriers’ behavior as insiders stood in contrast to that of an aggressive Japanese newcomer to the sector. This newcomer deliberately operated at a faster clock speed, closer to that of finance and information technology (IT) services, and was willing to mount disruptive challenges. Another noteworthy contrast is provided by the far faster-moving industry of web-based services, operating on top of the telecom networks. In a similar issue over privacy concerns about digital images, while a (slower) foreign-owned carrier took an insider approach to the issue, a (faster) Silicon Valley startup firm that paid no attention to the issue. This led the latter into a public relations disaster and a regulatory backlash for the Silicon Valley startup firm – Google.

Pharmaceuticals firms have the slowest clock speeds in this study, requiring years of research and development (R&D), followed by months numbering in the double digits to complete clinical testing and obtain government approval to bring products to market. Reputation and customer trust is crucial as well, since doctors and hospitals partially risk their own reputations by prescribing a particular firm’s product. Pharmaceutical firms therefore tend to avoid disruptive strategies.

Foreign pharmaceutical firms pursued the most pronounced insider strategies. With arguably the greatest foreign MNC influence in the industry association compared to other sectors, multinational pharmaceutical firms worked within the industry association on issues affecting their core business models. Over time, the industry association’s policy positions came to mirror that of the foreign pharmaceutical lobby groups. Facing an acute policy threat, foreign MNCs orchestrated a coalition of interest groups opposed to the proposed policy. Most significantly, they even succeeded in embedding Japanese policy processes for clinical testing within international coordination efforts.

**Japan’s Transformation Creating Opportunities, MNCs Taking Advantage**

What is the relationship between the broad and pervasive changes to Japan’s postwar political economy during the 1990 that opened the castle gates (Part I), and these political strategies employed by foreign MNCs of different clock speeds (Part II)?

Put simply, the institutional and regulatory shifts created opportunities for corporations to experiment with new ways of exercising voice. Foreign MNCs with fast clock speeds took advantage of opportunities to mount disruptive challenges, while MNCs with slower clock speed made use of previously unavailable insider strategies.

The shift from an ex ante to an ex post mode of regulation entailed a greater reliance on legal rules rather than informal interpersonal networks. This lowered the stakes for opposing the government’s attempts at exerting informal authority, or exploiting loopholes, since competition was not shaped ex ante, and the government had less discretionary power at its disposal. For slower clock speed firms, industry associations that had barred foreign membership opened up, enabling them insider access to policy strategies. Many were quick to exercise their new clout, as seen above.
UNCOVERING MECHANISMS DRIVING CHANGE: MULTIPLE TIME HORIZONS ACTING SIMULTANEOUSLY

A picture emerges from the policy cases above, as well as others in Chapter 6, of one set of actors – MNCs – driving change through multiple mechanisms that operate simultaneously, but with different time horizons. These mechanisms are not necessarily obvious, and go well beyond the simple mobilization of home country diplomatic pressure – gaïatsu.

Firms in industries with faster clock speeds drove more disruptive change with easily observable, short time horizons of cause and effect. Firms in industries with longer time horizons spearheaded changes that unfolded at a slower pace, but were potentially no less transformative. (See Table 3, Table 4).

Table 3. Mechanisms of Influence with Short Time Horizons of Cause and Effect

<table>
<thead>
<tr>
<th>Mechanism</th>
<th>Disruptive/ Insider?</th>
<th>Example Cases (from Chapter 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shifting Norms of Strategic Government-Business Interactions</td>
<td>Disruptive</td>
<td>- Defying administrative guidance&lt;br&gt;- Aggressively exploiting regulatory loopholes&lt;br&gt;- Administrative litigation</td>
</tr>
<tr>
<td>Disrupting Industry Organizations</td>
<td>Disruptive</td>
<td>- Establishing parallel organization&lt;br&gt;- Precipitating collapse of organization through exodus</td>
</tr>
<tr>
<td>Shifting Power Balance Within Industry Associations</td>
<td>Insider</td>
<td>- Foreign MNCs created voting bloc within industry association, became major players in informal negotiations</td>
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</tbody>
</table>

Table 4. Mechanisms of Influence with Longer Time Horizons of Cause and Effect

<table>
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<th>Mechanism</th>
<th>Disruptive/ Insider?</th>
<th>Example Cases (from Chapter 5, 6)</th>
</tr>
</thead>
<tbody>
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<td>Shifting Industry Association Policy Preferences</td>
<td>Insider</td>
<td>- Industry Associations shifting from MNC-friendly positions over time</td>
</tr>
<tr>
<td>Altering Political Balance of Power Among Economic Actors through Market Performance</td>
<td>Insider</td>
<td>- Collapse of industry association after entry of major foreign MNC</td>
</tr>
<tr>
<td>Embedding Domestic Policymaking Within International Policy Coordination</td>
<td>Insider</td>
<td>- Pharmaceutical sector international clinical testing data usage</td>
</tr>
</tbody>
</table>

THE IMPACT OF MNCs ON JAPAN AND IMPLICATIONS FOR UNDERSTANDING CHANGE

What do these mechanisms imply for the role of MNCs in affecting policymaking in Japan? What was the overall impact of foreign MNCs? And what are the implications we can draw from this study for understanding MNCs and institutional change more generally?

Foreign MNCs had a two-pronged effect on policymaking in Japan. On the one hand, they broadened the range of political strategies available for firms in exercising voice. Where regulatory opportunities arose, fast clock speed foreign MNCs took advantage with disruptive strategies. Once disruptive actions were built into the expectations of the government and more risk averse firms, many of these actions were added to the less radical, if not completely condoned corporate behaviors.

On the other hand, foreign MNCs also became vested in existing policy processes and institutions of government-business coordination. As a result, they did not simply push Japan’s political economy away from the distinctive features characterizing it as a non-liberal, or coordinated market economy towards a liberal market, or Anglo-American model. Rather, they contributed to syncretism in Japan’s political economy – the combination and fusion of new and existing norms and practices. In short, while new norms and practices were introduced by fast clock speed firms, existing institutions and mechanisms of government-business policy coordination were simultaneously reinforced by slower clock speed firms.

24 Syncretism refers to the process of melding multiple different forms of beliefs or practices. Hybridization is a term often used to indicate the combination of new and old elements. I find the term syncretism to be more accurate, as it is often used in the context of cultural or religious combinations. To use an example from Japanese history, the writing system was adopted from China, but superimposed onto a fundamentally different language. While Chinese characters remained intact, and Japanese as a language survived, elements of the two were combined, as Japanese readings were added to Chinese characters and the Japanese language received thousands of new Chinese compound vocabulary terms. Thus, although often used for cultural or religious phenomena, the concept of syncretism aptly captures the coexistence and fusion of traditional (Japanese, or coordinated-market) and new (Anglo-American, or liberal market) elements of capitalism observed in Japan during its transformation from the mid-1990s.
An implication for policymaking in Japan is that the strategic capacity of the government is likely to have decreased. In the short term, the government faces the threat of foreign MNCs’ challenges if it attempts to informally manage economic activities against the MNCs’ wishes. In the short to medium term, any set of initially disruptive strategies are no longer disruptive; they are built into the government’s expectations, and more risk averse firms see them as part of the normal spectrum of options available. In the longer term, policymaking itself will be less amenable to strategic policies in areas involving large foreign MNC presences unless it serves the latter’s interests, since they are increasingly insiders in policy processes. At the same time, however, reformist governments do gain powerful corporate allies by enlisting foreign MNCs if the reform agenda supports the latter’s interests.

In the broader study of comparative politics, the Japanese cases presented in this study are useful when considering how advanced industrialized economies change over time. The role of MNCs in driving political and institutional change is under-explored in the existing literature. This study suggests that the very actors that can drive change by disrupting existing arrangements can also become strongly vested in existing arrangements. MNCs can therefore drive change not towards convergence, but towards hybrid systems, through the process of syncretism.

The exact form that disruptive and insider strategies take will differ according to the institutional and political configuration of host countries; domestic contexts shape the opportunities and constraints facing MNCs to exercise voice. However, regardless of the precise mechanisms available in each national context, this study points to the importance of multiple time horizons of different types of influence occurring simultaneously. MNCs can deliver immediate exogenous shocks, but they can also drive endogenous change by influencing policy processes over time as insiders. This study suggests that differentiating MNCs along clock speeds will be a useful first step; understanding the magnitude of each type of MNC yields hypotheses for the relative strength of each type of pressure, and the likely mechanisms of influence.

**OUTLINE OF THE DISSERTATION**

This dissertation unfolds in two parts. Part I, consisting of chapters 1 though 5, sets up the political analysis. Since the conditions for foreign entry and the options available to them in exercising voice are critical to understanding their ability to pursue disruptive and insider strategies, Part I covers Japan’s new regulatory and institutional context. Part II, consisting of chapter 6 and 7, is the core political analysis.

Part I asks the following questions. What is the extent of foreign MNC presence in Japan? What were the regulatory, institutional, and market contexts enabling the influx after decades of low MNC presence? Chapter 1 traces the rise of foreign MNCs in core sectors, touching on problems of existing measures and problems with data in assessing MNC presence. It suggests that the penetration of foreign MNCs in Japan is broader than commonly used indicators suggest, and shows it is deeper than many observers would expect.

Chapter 2 traces regulatory shifts at the national level. It shows how national regulations shifted away from strategically limiting the presence of foreign MNCs as part of the government’s developmental strategy towards embracing them in most areas. By tracing the historical political shifts over time, this chapter contends that the norms of economic nationalism
shifted decisively to embrace a greater foreign management presence in the economy after the bubble burst in the early 1990s.

Chapter 3 shows how institutional shifts to the core components of Japan’s political economy created an environment much more hospitable to foreign MNCs. It shows how the distinctive features of Japan’s economy, such as keireitsu industrial groups, long-term employment, and proprietary domestic dynamics of competition had hindered the operations of MNCs in Japan, exacerbating organizational tensions inherent in MNCs. Changes to many of these institutional features facilitated MNCs’ operations in Japan.

Chapters 4 and 5 are sector-level analysis, tracing the interactions between foreign MNCs, sectoral regulations, and market dynamics. They show how the regulatory shifts from ex ante managed competition to ex post market governance shifted the market dynamics, creating opportunities for foreign entry.

Part II is the political analysis. Chapter 6 presents the empirical cases supporting the core argument of this dissertation.
PART I

ENTERING THE CASTLE GATES:

REGULATIONS, INSTITUTIONS, AND MARKET DYNAMICS ENABLING
THE RISE OF MNCs IN JAPAN
CHAPTER 1: 
The Rising Presence of Foreign MNCs in Japan

In an ageing rural town along the inland sea, the opening of a convenience store chain in the mid-1990s was big news for the local community – especially for the youth. The town now felt more plugged into the metropolitan lifestyles seen on television. Almost a decade later, in late 2003, the local cellular phone store took down its sign and replaced it with a large, bright red illuminated billboard that read “Vodafone.” Nobody batted an eyelash. I marveled at how this rural area, which had seemed disconnected from even other parts of Japan not too long ago, was now within reach of a British telecom carrier.

The influx of foreign MNCs into Japan was dramatic. The rise in the mid to late 1990s was sudden, and the influx occurred in traditionally protected sectors. By the late 2000s, foreign MNCs had a broader and deeper presence in Japan’s political economy than most observers realize. This chapter presents an overview of the influx of foreign MNCs by examining national FDI data, sectoral market data, and significant illustrations.

In order to assess the impact of foreign MNCs on Japan, we must understand the degree to which foreign MNCs have entered Japan. This turns out to be a surprisingly challenging task. There is strong reason to believe that commonly used indicators understate the extent of foreign MNCs’ activities. Systematic studies documenting the recent influx of foreign MNCs into Japan have yet to be undertaken. Common indicators do show, however, the sharp rise of MNCs’ presence in Japan, concentrated largely in formerly protected sectors.

Cross-nationally, Japan still has among the lowest relative presence of MNCs compared to other advanced industrial countries, especially when comparing levels of inward FDI. I contend, however, that the penetration of MNCs in Japan’s economy is greater than FDI figures suggest. Moreover, foreign MNCs have been involved more deeply in Japan’s political economy than most observers realize.

Part of the problem lies with the inherent difficulty of measuring the market presence, employment, or capital footprint of foreign MNCs using inward FDI as a proxy. Another problem is that much of the foreign influx in Japan occurred in services sectors, an area particularly difficult to capture.

This chapter provides a more accurate picture of foreign MNC presence in key sectors than does previous scholarship, Japanese government data, or cross-national indicators. It begins with inward FDI data, which does capture the influx of foreign MNCs. It then notes the limitations of FDI in measuring MNC footprints, particularly with Japanese data. It proceeds to introduce sector-level market data not commonly seen in studies of MNCs. Finally, through several illustrations the chapter shows how deeply foreign MNCs have become involved in Japan’s political economy.

INWARD FDI FIGURES: CAPTURING THE SUDDEN INFUX

Data on inward FDI captures the influx of MNCs into Japan. Inward FDI stock as a proportion of GDP is the most commonly used proxy to determine the level of foreign MNC...
This measure has been used by scholars, industry lobby group, and governments as evidence of the low level of foreign MNC penetration in Japan. The Japanese government has even adopted it in its own policy goals; in 2003, Prime Minister Koizumi Junichiro announced his aim of doubling Japan’s stock of inward FDI in five years.

Until 1995, Japan’s level of inward FDI stock as a percentage of GDP never rose over 0.4%, having risen from 0.3% in 1980. Then, between 1996 and 2000, it doubled, from 0.6% to 1.1%. In the next two years, it doubled again to become 2.0% in 2002, reaching 2.8% in 2007.

Chart 1. Japan’s Inward FDI Stock as a Percentage of GDP (1980-2007)

Despite the rapid increase, Japan’s level of inward FDI stock as a proportion of GDP remains small compared to that of other advanced industrial economies. Between 1980 and 2000,

Definitions of FDI vary. It is defined by the International Monetary Fund (IMF) as involving a long-term relationship with a lasting interest, entailing significant influence on management of the enterprise. Their contrast is with portfolio investment, acquisition of securities or bank loans without direct management control, aimed mainly for financial gains. Ralph Paprzycki and Kyoji Fukao, Foreign Direct Investment in Japan: Multinationals’ Role in Growth and Globalization (New York, NY: Cambridge University Press, 2008), 11.


those of the UK, France, and Germany, rose from 12%, 4%, and 4%, respectively, to 35%, 22%, and 15%. During the same time period, that of the US quadrupled, from 3% to 13%.  

**THE LIMITATIONS OF FDI IN MEASURING MNC PRESENCE**

There is strong reason to believe, however, that FDI figures understate the level of foreign MNCs in Japan, and can be misleading for international comparison. The problems are twofold: use of FDI as a proxy for MNCs, and the reliability of data collected by the Japanese government.

Among the most serious problems of FDI figures to measure MNCs in general is that they do not capture capital raised in the host country. Inward FDI figures capture the initial transfer of funds by MNCs into the country. However, MNCs often raise additional capital within the country, taking out bank loans or listing the firm on a local stock exchange. Moreover, the initial investment may not take the form of capital. Intellectual property or know-how is often used in joint venture arrangements.

Reinvested earnings are also often omitted in many national statistics, including those of Japan. If MNCs repatriate profit abroad, it counts as a decrease in the FDI stock of the local country. However, if they reinvest the earnings in their local operations the FDI figures are not affected. Therefore, some of the most successful MNCs that invested over long periods to grow their operations are only counted for their initial investments from abroad.

There are a number of other problems with the data compiled by the Japanese government, used in cross-national statistics such as those compiled by the OECD. This has led many scholars and observers to conclude that FDI figures themselves are understated, and they almost certainly do not capture the full extent of MNC presence. Many of these scholars advocate alternate measures. However, lack of systematically collected, comprehensive data then becomes a serious problem, especially in making comparisons across time (See Appendix B for details and further discussion).

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28 When converted into dollar amounts, the relatively large size of Japan’s economy shows a smaller gap in the absolute amount of inward FDI.
29 John Dunning and his collaborators, in his decades of work on multinational enterprises, points out that FDI figures are notoriously uneven across countries. Dunning and Lundan, *Multinational Enterprises and the Global Economy*.
30 Ibid.
31 Ibid.
32 For Coca Cola and McDonalds, for example, which dominate their respective sectors in Japan, as well as firms such as IBM Japan, one of the largest foreign MNCs in Japan, it is not at all clear that profits are immediately repatriated. They are in Japan for the long run, and reinvest heavily in their Japanese operations to stay competitive.
THE INFLECTION POINT: SECTORS EXPERIENCING AN INFUX OF MNCs

Although inward FDI understates the presence of foreign MNCs, we can still observe the sectors that experienced the greatest inward FDI flows. The data shows an inflection point in the mid-1990s, with a sharp rise in inward FDI. According to the Ministry of Finance’s industry classifications, the sectors receiving the greatest inflows included chemicals, machinery, telecommunications, finance and services, and service. Mapped onto conventional industrial sectors, these include pharmaceuticals, automobiles, telecommunications, and finance and insurance (See Table 5).
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Source: Ministry of Finance
The sectors experiencing influx were all formerly strategic sectors from which FDI was intentionally limited for most of the postwar period. The financial sectors in particular were at the core of Japan’s postwar developmental state, in which the government directed financial resources towards particular strategic investment targets, shifting from heavy industries to high tech sectors over time.

There is also a notable contrast with the sectors in which FDI did not rise. These were sectors that remained the center of Japan’s clientelist, pork-barrel spending, which include food (agriculture), construction, transportation, and real estate.\(^34\)

In short, the mix of sectors in which FDI rose supports the idea that Japan’s postwar strategic developmental state was substantially dismantled, or at least it took on a very different form. At the same time, traditionally pork-barrel sectors remained closed.

**THE SHIFTING SECTORAL COMPOSITION OF HIGH INCOME MNCs**

An examination of the foreign MNCs with the top reported incomes over time reveals the shift of sectors in which MNCs grew significantly. The data, compiled from a private data company, is available for 1994, 1998, and 2002, although it is not complete.

There are two particularly noteworthy points. First, the level of income of the top firms rose substantially over the 8 years. For example, in 1994, Coca Cola Japan (top income) reported 5.6 billion yen with Tonen, an oil company (second) reporting 3.6 billion yen. In 2002, however, IBM Japan was at the top, earning 13.3 billion, and Coca Cola Japan in second place earned 12 billion. The sum total income of the top 20 foreign firms also doubled, rising from 45 billion yen in 1994 to 92 billion yen in 2002.

This increase occurred during years in which the Japanese economy stagnated, entered into recession, and underwent a banking crisis. Only since 2001 did an economic recovery occur, until the global financial crisis of 2007-2008. The growth of foreign MNCs’ incomes during these years illustrates the growth opportunities available in the Japanese market, as well as major instances of Japanese companies coming under foreign ownership and control.

The second noteworthy point from the data is the shift in composition of the top 20 firms ranked by reported income. In 1994, six oil companies were among the top 20 with only one financial firm. In 2002, no oil firms made it on the list, while two auto firms and two financial firms appeared. Firms in sectors such as software and telecommunications appeared for the first time as well. (See Table 6)

\(^{34}\) The other industries receiving little inward FDI in the chart, such as textiles and rubber & leather, were no longer major components of the Japanese economy by the 1990s. For characterizations of Japan’s dual political economy, with strategic “developmental” sectors managed by the bureaucracies on one hand, and the clientelistic sectors susceptible to political influence, see Woodall, "Japan under Construction Corruption, Politics, and Public Works." For the ties that bind these two parts of Japan’s political economy, see Steven K. Vogel, "Can Japan Disengage: Winners and Losers in Japan's Political Economy, and the Ties That Bind Them," *Social Science Japan* 2, no. 1 (1999). Masahiko Aoki calls this “bureaupluralism.” Masahiko Aoki, *Information, Incentives, and Bargaining in the Japanese Economy* (Cambridge: Cambridge University Press, 1988).
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<td>1.8</td>
<td>Pharma</td>
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**Total**: 45.2 65.9 91.8

Source: Teikoku Databank
SECTORS: FOREIGN MNCs BECOMING MAJOR PLAYERS

Now that we have seen the aggregate data, illustrating the sharp rise of FDI, and the sectors into which it flowed, let us turn to sector-level data. This sectoral data clearly shows the extent to which foreign MNCs became prominent players in their respective markets.

Sectoral market data, however, is neither fully systematic nor comprehensive. Although it is arguably the most important data in assessing the market impact of foreign MNCs, data is compiled by private companies, which rely on voluntary information disclosure. (For details, see the Appendix B). It is therefore incomplete, and is likely to understate the level of foreign market presences, since wholly owned subsidiaries and those not listed on exchanges are not obligated to disclose sales and revenue data. Even so, the sharp rise in core sectors is notable.

For each of the sectors, an additional indicator of the relative market positions of foreign firms is presented to illustrate their strength. These indicators differ across sectors. The data presented below, driven by availability, includes securities, insurance, automobiles, and pharmaceuticals.

Securities: From Wall Street to Minato Ward

In the securities sector, we clearly see the rise of foreign investment banks and brokerages. In 1995, there were no foreign firms among the top 20 securities firms ranked by sales volume. In 2000 there was one – Merrill Lynch ranked at 11th. By 2008, however, the number grew to four – Nikki Citi Holdings, a joint venture (3rd), Goldman Sachs (4th), Merrill Lynch (7th), Barclays Capital (13th). As a proportion of sales revenue among the top twenty, foreign firms accounted for 1.2% of the total in 2000, growing in 2008 to 20%. A more dramatic shift emerges if we look at the share of profits recorded by foreign firms as a proportion of the sum of the top 20. It grew from 4.6% to just over 60% in 2008. (See Table 7)
<table>
<thead>
<tr>
<th>1995</th>
<th>2000</th>
<th>2005</th>
<th>2008 (March)</th>
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<td>Sales</td>
<td>Operating Profit</td>
<td>Sales</td>
<td>Operating Profit</td>
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<td>224.2</td>
<td>15.1</td>
<td>Shinko</td>
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<td>Kokusai</td>
<td>88.1</td>
<td>7.5</td>
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<td>-18.1</td>
<td>Okazo</td>
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<td>-1.8</td>
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<td>Universal</td>
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<td>-4.2</td>
<td>Marusan</td>
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<td>-1.5</td>
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<td>Ichiyoshi</td>
<td>10.1</td>
<td>-0.8</td>
<td>Tokyo</td>
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Source: Teikoku Databank
In particular lucrative market segments, foreign investment banks were especially profitable. Data on the top advisory deals as early as 1996 show that despite a smaller number of cases, foreign investment banks dominated the market in terms of transaction sizes. Given that fees are based on size, this also shows foreign MNCs taking the most profitable deals. (See Table 6).

Table 8. Top Advisory Deals Involving Japanese Companies, 1996

<table>
<thead>
<tr>
<th>Rank</th>
<th>Financial Institution</th>
<th>Transaction Amounts (million USD)</th>
<th>Number of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Goldman Sachs</td>
<td>48,864</td>
<td>21</td>
</tr>
<tr>
<td>2</td>
<td>UBS</td>
<td>32,865</td>
<td>31</td>
</tr>
<tr>
<td>3</td>
<td>Merrill Lynch</td>
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<tr>
<td>4</td>
<td>Nikko Citigroup Securities</td>
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<td>32</td>
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<td>5</td>
<td>Nomura Securities</td>
<td>28,184</td>
<td>154</td>
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<td>6</td>
<td>Mizuho Financial Group</td>
<td>25,991</td>
<td>123</td>
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<tr>
<td>7</td>
<td>Daiwa Securities SMBC</td>
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</table>

Source: Nihon Keizai Shimbun

Insurance: Prudential Tower Towers Over the Prime Minister’s Residence

The growth and financial health of foreign insurers is also clear from sector-level data. In terms of income, two foreign firms were among the top 20 in 1995 – Aflac (15th) and Alico Japan (then part of the American Family group, 17th). By 2005, the number had grown to an astonishing 10 out of 20 – Alico (4th), Hartford (5th), American Family (6th), ING (9th), AIG Edison (15th), Aksa (16th), Gibraltar (17th), Prudential (18th), AXA (19th), AIG Start (20th).

The total share of income earned by foreign firms as a proportion of the top 20 rose from 2.5% in 1995 to approximately 25% in 2005. (See Table 9)

In perhaps the most visually symbolic demonstration of the ascent of foreign insurers, or foreign MNCs in general, can be seen in the skyline above the Prime Minister’s residence. The logo of Prudential is displayed prominently on the back of a skyscraper completed in 2002, which literally towers over the Prime Minister’s resident when viewed from one direction. The skyscraper, the Prudential Tower, was being built by a Japanese insurer that went bankrupt and was purchased by Prudential, which finished construction and opened the building with its name prominently displayed.

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Table 9. Top 20 Life Insurance Firms’ Policy Income, Operating Profits (Billions yen), Ranked by Policy Income

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</table>

Source: Teikoku Databank
The relative financial health of insurers is measured by their solvency margins, calculated by a formula designed to weigh the insurer’s risk divided by its ability to pay. As a crisis swept through the insurance sector in the late 1990s, the government mandated that firms publicize their solvency margins to allow outside observers to assess the health of insurers. Solvency margins from 1998 and 2000 reveal that foreign insurers were concentrated at the top of the list. (See Table 10)

Table 10. Life Insurance Solvency Margins (Risk/Ability to Pay)

<table>
<thead>
<tr>
<th>Rank</th>
<th>1998 Name</th>
<th>1998 %</th>
<th>2000 Name</th>
<th>2000 %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Prudential</td>
<td>1542.1</td>
<td>Manulife Century</td>
<td>6256.9</td>
</tr>
<tr>
<td>2</td>
<td>Sony</td>
<td>1429.1</td>
<td>Sony</td>
<td>1905.9</td>
</tr>
<tr>
<td>3</td>
<td>Nicos</td>
<td>1304.5</td>
<td>Prudential</td>
<td>1475.6</td>
</tr>
<tr>
<td>4</td>
<td>ING</td>
<td>1274.3</td>
<td>Credit Swisse</td>
<td>1336.1</td>
</tr>
<tr>
<td>5</td>
<td>Alico Japan</td>
<td>1240.6</td>
<td>American Family</td>
<td>1333.4</td>
</tr>
<tr>
<td>6</td>
<td>Daido</td>
<td>998</td>
<td>Alico Japan</td>
<td>1327.9</td>
</tr>
<tr>
<td>7</td>
<td>Taiyo</td>
<td>869.1</td>
<td>Orico</td>
<td>1295.5</td>
</tr>
<tr>
<td>8</td>
<td>Nihon</td>
<td>849.9</td>
<td>ING</td>
<td>1287.6</td>
</tr>
<tr>
<td>9</td>
<td>Sorix</td>
<td>838</td>
<td>GE Edison</td>
<td>1043.2</td>
</tr>
<tr>
<td>10</td>
<td>Fukoku</td>
<td>820.6</td>
<td>Orix</td>
<td>1015</td>
</tr>
<tr>
<td>11</td>
<td>Oiko</td>
<td>799.4</td>
<td>AXA</td>
<td>855.1</td>
</tr>
<tr>
<td>12</td>
<td>AXA</td>
<td>793.9</td>
<td>Taiyo</td>
<td>806.8</td>
</tr>
<tr>
<td>13</td>
<td>INI Himawari</td>
<td>763.9</td>
<td>Fukoku</td>
<td>779.3</td>
</tr>
<tr>
<td>14</td>
<td>Yasuda</td>
<td>727.2</td>
<td>Nihon</td>
<td>778.1</td>
</tr>
<tr>
<td>15</td>
<td>Aflac</td>
<td>711.5</td>
<td>Daido</td>
<td>757.6</td>
</tr>
<tr>
<td>16</td>
<td>Meiji</td>
<td>706.4</td>
<td>Saison</td>
<td>713.7</td>
</tr>
<tr>
<td>17</td>
<td>Asahi</td>
<td>688.8</td>
<td>Daichi</td>
<td>682.3</td>
</tr>
<tr>
<td>18</td>
<td>Daichi</td>
<td>662.1</td>
<td>Etna Heiwa</td>
<td>672.2</td>
</tr>
<tr>
<td>19</td>
<td>Sumitomo</td>
<td>589.5</td>
<td>Meiji</td>
<td>667.2</td>
</tr>
<tr>
<td>20</td>
<td>Heiwa</td>
<td>578.4</td>
<td>Yasuda</td>
<td>602.6</td>
</tr>
<tr>
<td>21</td>
<td>Mitsui</td>
<td>519.6</td>
<td>Sumitomo</td>
<td>551.3</td>
</tr>
<tr>
<td>22</td>
<td>Tokyo</td>
<td>478.7</td>
<td>Asahi</td>
<td>543.4</td>
</tr>
<tr>
<td>23</td>
<td>Saison</td>
<td>401.7</td>
<td>Mitsui</td>
<td>492.7</td>
</tr>
<tr>
<td>24</td>
<td>Chiyoda</td>
<td>396.1</td>
<td>AXA Group Life</td>
<td>464.7</td>
</tr>
<tr>
<td>25</td>
<td>Nihon Dantai</td>
<td>377.5</td>
<td>Aoba</td>
<td>377.6</td>
</tr>
</tbody>
</table>

Source: Teikoku Databank

Automobiles: Tie-ups With and Without Management Control

Automobiles, usually considered one of Japan’s most internationally competitive sectors, experienced a wave of foreign investment, much of it leading to foreign management control. With the exception of Toyota and Honda, almost all major manufacturers had significant levels
of foreign management or capital participation. Nissan, Mazda, and Mitsubishi Motors had foreign presidents in the early 2000s. The contrast with the industry’s postwar period of development (illustrated in Chapter 4), could not be more stark. (See Table 11, Table 12).

Table 11. Automobile Firm Tie-ups with Foreign Management Control

<table>
<thead>
<tr>
<th>Japanese Manufacturer</th>
<th>Foreign Partner</th>
<th>Tie-up Date</th>
<th>Nature of tie-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nissan</td>
<td>Renault</td>
<td>1999</td>
<td>Renault bought controlling stake of Nissan, took management control and installed foreign top management</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>Daimler Chrysler</td>
<td>2000-2005</td>
<td>Increased stake to controlling share, installed management</td>
</tr>
<tr>
<td>Mitsubishi Fuso Truck and Bus</td>
<td>Daimler Chrysler</td>
<td>2003</td>
<td>Spun out as wholly owned subsidiary of Daimler Chrysler</td>
</tr>
<tr>
<td>Mazda</td>
<td>Ford</td>
<td>1996-2008</td>
<td>Increased stake to controlling share, installed foreign top management</td>
</tr>
<tr>
<td>Nissan Diesel</td>
<td>Volvo</td>
<td>2007</td>
<td>Volvo bought shares from Renault, made it wholly-owned subsidiary</td>
</tr>
</tbody>
</table>

Table 12. Automobile Firm Tie-ups without Foreign Management Control

<table>
<thead>
<tr>
<th>Japanese Manufacturer (Subaru)</th>
<th>Foreign Partner</th>
<th>Tie-up Date</th>
<th>Nature of tie-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fuji Heavy Industries</td>
<td>General Motors</td>
<td>2000-2005</td>
<td>GM bought 21% stake, sold off completely in 2005</td>
</tr>
</tbody>
</table>

**Pharmaceuticals: Sales and Pipelines**

The presence of foreign MNCs in Japan’s pharmaceutical sector rose dramatically in the ten years between 1995 and 2005. More than other sectors, Japan’s pharmaceutical sector developed with a heavy reliance on foreign products as upstream inputs to Japanese firms’ product offerings (seen in more detail in Chapter 5). Even as foreign MNCs became major players in sales volume, many Japanese firms still depended heavily on them for their pipeline of new products.

In 1995, three foreign firms were among the top 20 sales. They included Banyu, purchased by Merck (13th), Ciba-Geigy (15th), and Pfizer (17th). By 2005, the number doubled to six out of 20, and their positions had moved up – Pfizer (2nd), Chugai, purchased by Roche in 2002 (7th), Novartis (10th), Banyu (12th), Glaxo SmithKline (14th), and Aventis (19th). The total

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share of foreign MNCs’ sales as a proportion to the total top 20 rose from approximately 9% in 1995 to 18% in 2005. (See Table 13)
Table 13.: Top 20 Pharmaceutical Firms, Sales and Operating Profits (billions yen), ranked by Sales

<table>
<thead>
<tr>
<th>1995</th>
<th></th>
<th>Operating Profit</th>
<th>2000</th>
<th></th>
<th>Operating Profit</th>
<th>2005</th>
<th></th>
<th>Operating Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sales</td>
<td></td>
<td></td>
<td>Sales</td>
<td></td>
<td></td>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>Takeda</td>
<td>602.0</td>
<td>91.8</td>
<td>Takeda</td>
<td>773.1</td>
<td>238.5</td>
<td>Takeda</td>
<td>784.8</td>
<td>356.7</td>
</tr>
<tr>
<td>Sankyo</td>
<td>410.2</td>
<td>87.0</td>
<td>Sankyo</td>
<td>417.6</td>
<td>94.0</td>
<td>Pfizer</td>
<td>385.3</td>
<td></td>
</tr>
<tr>
<td>Otsuka</td>
<td>369.6</td>
<td>27.5</td>
<td>Otsuka</td>
<td>351.5</td>
<td>30.2</td>
<td>Astellas</td>
<td>350.0</td>
<td>100.2</td>
</tr>
<tr>
<td>Yamanouchi</td>
<td>295.1</td>
<td>60.5</td>
<td>Yamanouchi</td>
<td>302.5</td>
<td>84.6</td>
<td>Sankyo</td>
<td>340.1</td>
<td>64.1</td>
</tr>
<tr>
<td>Eizai</td>
<td>253.6</td>
<td>40.2</td>
<td>Taisho</td>
<td>269.5</td>
<td>73.4</td>
<td>Otsuka</td>
<td>338.1</td>
<td>19.1</td>
</tr>
<tr>
<td>Taisho</td>
<td>220.9</td>
<td>61.9</td>
<td>Daiichi</td>
<td>261.4</td>
<td>59.1</td>
<td>Eizai</td>
<td>307.9</td>
<td>69.1</td>
</tr>
<tr>
<td>Shionogi</td>
<td>225.5</td>
<td>22.1</td>
<td>Eizai</td>
<td>258.6</td>
<td>61.6</td>
<td>Chugai</td>
<td>285.1</td>
<td>47.6</td>
</tr>
<tr>
<td>Daichi</td>
<td>217.3</td>
<td>42.8</td>
<td>Shionogi</td>
<td>215.9</td>
<td>24.1</td>
<td>Daiichi</td>
<td>259.9</td>
<td>56.3</td>
</tr>
<tr>
<td>Fujisawa-Yakuhin</td>
<td>219.3</td>
<td>22.2</td>
<td>Fujisawa-Yakuhin</td>
<td>207.8</td>
<td>18.0</td>
<td>Taisho</td>
<td>232.9</td>
<td>56.6</td>
</tr>
<tr>
<td>Tanabe</td>
<td>175.2</td>
<td>9.5</td>
<td>Tanabe</td>
<td>184.7</td>
<td>29.1</td>
<td>Novartis</td>
<td>232.2</td>
<td>34.6</td>
</tr>
<tr>
<td>Chugai</td>
<td>169.0</td>
<td>20.8</td>
<td>Chugai</td>
<td>181.2</td>
<td>28.5</td>
<td>Mitsubishi Welfarma</td>
<td>197.9</td>
<td>27.8</td>
</tr>
<tr>
<td>Sumitomo</td>
<td>149.8</td>
<td>8.2</td>
<td>Pfizer</td>
<td>170.1</td>
<td></td>
<td>Banyu</td>
<td>138.9</td>
<td>17.4</td>
</tr>
<tr>
<td>Banyu</td>
<td>130.8</td>
<td>22.1</td>
<td>Banyu</td>
<td>169.7</td>
<td>34.8</td>
<td>Shionogi</td>
<td>180.7</td>
<td>25.5</td>
</tr>
<tr>
<td>Dainippon</td>
<td>130.3</td>
<td>9.7</td>
<td>Dainippon</td>
<td>145.9</td>
<td>16.7</td>
<td>Glaxo SmithKline</td>
<td>170.7</td>
<td>23.1</td>
</tr>
<tr>
<td>Ciba-Geigy</td>
<td>136.3</td>
<td>11.4</td>
<td>Novartis</td>
<td>144.3</td>
<td></td>
<td>Tanabe</td>
<td>164.3</td>
<td>26.9</td>
</tr>
<tr>
<td>Ono</td>
<td>131.9</td>
<td>55.2</td>
<td>Ono</td>
<td>129.4</td>
<td>57.0</td>
<td>Dainippon</td>
<td>160.4</td>
<td>10.6</td>
</tr>
<tr>
<td>Pfizer</td>
<td>101.2</td>
<td>13.7</td>
<td>Sumitomo</td>
<td>125.9</td>
<td>28.7</td>
<td>Ono</td>
<td>144.1</td>
<td>61.2</td>
</tr>
<tr>
<td>Nihon Kayaku</td>
<td>108.3</td>
<td>7.3</td>
<td>Mitsubishi Welfarma</td>
<td>125.1</td>
<td>21.2</td>
<td>Sumitomo</td>
<td>142.3</td>
<td>26.6</td>
</tr>
<tr>
<td>Yoshitomi</td>
<td>101.6</td>
<td>12.9</td>
<td>Aventis</td>
<td>121.3</td>
<td></td>
<td>Aventis</td>
<td>122.2</td>
<td></td>
</tr>
<tr>
<td>Taiho</td>
<td>100.3</td>
<td>28.3</td>
<td>Nihon Kayaku</td>
<td>103.1</td>
<td>10.0</td>
<td>Fujisawa*</td>
<td>275.8</td>
<td>69.3</td>
</tr>
</tbody>
</table>

*(combined with Yamanouchi in April 2005 to create Astellas)

Source: Teikoku Databank
Due to the historical development of the sector, many of the products sold by Japanese firms are under license from MNCs. Moreover, the pipeline of new products sold by Japanese firms relies on foreign firms to a considerable extent, especially from firms that do not sell directly in the Japanese market. For example, in 2006, even after the expansion of foreign MNCs into sales activities, almost all major Japanese pharmaceutical firms relied heavily on foreign products in their pipelines. (See Table 14)

**Table 14. Foreign Products as a Proportion of Total R&D Pipeline (as of June 2006)**

<table>
<thead>
<tr>
<th>Firm</th>
<th># Foreign Drugs/Total in Pipeline</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Takeda</td>
<td>7/22</td>
<td>32</td>
</tr>
<tr>
<td>Astellas</td>
<td>12/23</td>
<td>52</td>
</tr>
<tr>
<td>Shionogi</td>
<td>10/12</td>
<td>83</td>
</tr>
<tr>
<td>Tanabe</td>
<td>7/9</td>
<td>78</td>
</tr>
<tr>
<td>Chugai</td>
<td>11/21</td>
<td>52</td>
</tr>
<tr>
<td>Eisai</td>
<td>6/12</td>
<td>50</td>
</tr>
<tr>
<td>Ono</td>
<td>3/14</td>
<td>21</td>
</tr>
<tr>
<td>Daiichi</td>
<td>6/28</td>
<td>21</td>
</tr>
</tbody>
</table>

Source: Deutsche Securities

**PROMINENT CASES OF FOREIGN FIRMS IN KEY AREAS OF JAPAN’S POLITICAL ECONOMY**

The involvement of foreign MNCs in Japan’s policy processes runs deeper than most observers might be led to believe. We now turn to an illustration of several areas in which foreign MNCs were involved in politically sensitive areas unthinkable a decade earlier.

**MNCs in Business Areas with Close Government Involvement**

First, we examine several areas in which foreign firms were hired or gained entry. Historical contrasts accentuate how much has changed.

Goldman Sachs became an advisor to the government in a sensitive, unprecedented sale of a failed and nationalized bank. This was the largest postwar bank failure, and rather than bringing in any of the major Japanese banks, the American investment bank was brought in as the politically neutral option. During most of the postwar period, major foreign financial institutions were considered anything but politically neutral; they were segmented into their own market segment to enable Japan’s strategic developmental policies to function through informal government direction of investment targets.

When Nissan was rescued by Renault, while there was much hand-wringing and trepidation expressed in the media, there was no government opposition and the new CEO was given virtually complete discretion in management control. The contrast between a GM’s rescue of Isuzu in 1971 was stark. At that time, a media frenzy ensued, and GM agreed to not raise its stake to over 49%, it limited the number of board directors it appointed to one third, and agreed that it would not control the appointments of president or chairman (see Chapter 5).
Morgan Stanley was hired by the Resolution and Collection Corporation, set up to resolve bad debt from financial and real estate institutions into which the government had injected public funds. The injection of public funds into financial institutions had caused a major political firestorm. Yet, the government’s hiring of a foreign firm to clean up the soured debt and profit from the transactions, caused no real controversy.

Vodafone purchased one of the three nationwide telecom carriers with no public backlash or government resistance. Vodafone had entered through one of the largest M&A deals in the nation’s history, enabled by a US investment bank and a team of US and British law firms. By contrast, in the late 1980s, government officials were extremely wary of allowing foreign firms to own and operate telecommunications network infrastructure. In both international and cellular services, they attempted to orchestrate the creation of firms that were Japanese owned and controlled, employing Japanese technology.

Finally, a financial exchange, Nasdaq, entered Japan. Financial exchanges were one of the final areas to be deregulated, and finance was a core element of Japan’s postwar developmental state. While Japan’s financial system had moved away from being predominantly bank-centered by the late 1990s, it would still have defied imagination in the late 1980s that a foreign financial exchange might be set up.

**Foreign MNC Access to Policy Processes**

By the mid-2000s, foreign firms moved more directly into the Japanese government’s policy processes than ever before. Government deliberation councils, consultative bodies comprised of representatives from relevant interest groups and experts in the fields, play an integral part of Japan’s policymaking process. Foreign MNCs long complained that they were excluded from these deliberations councils. However, from the late 1990s, both firms and individuals employed by foreign MNCs were increasingly appointed to deliberations councils.

Foreign MNCs were represented in deliberation councils of the Ministry of Finance (MOF) and the Financial Supervisory Agency (FSA), split off from MOF in 1999. MOF was the former center of the developmental state, largely credited for allocating credit and investment to strategic target sectors. Employees of foreign MNCs were also included in deliberation councils attached to the Cabinet Office, a newly strengthened organization to facilitate greater policy coordination by the Prime Minister. MNCs were also represented on deliberation councils attached to the Japan Fair Trade Commission. During much of the postwar period, many foreign observers had criticized the JFTC for its relatively weak antitrust enforcement. Some charged that it allowed cartels and was negative towards foreign firms in general. Finally, even the Ministry of Economy, Trade, and Industry (METI), formerly MITI, included foreign MNCs in their deliberative councils. MITI had been at the center of much of postwar strategic efforts to enable Japanese companies to obtain foreign technology without incurring foreign management control. MITI had taken a central role in many of the private sector contracts and joint ventures allowing firms such as IBM and Motorola to enter Japan. Yet, by the late 1990s, MITI had repositioned itself to become one of the supporters of increased FDI. Employees of firms

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37 For details, see Toya and Amyx, *The Political Economy of the Japanese Financial Big Bang: Institutional Change in Finance and Public Policymaking*.

including JP Morgan, Merrill Lynch, McKinsey, AFLAC as well as MCI Worldcom, participated in deliberation councils.

Foreign firms also became prominent in many industry associations, also previously criticized by outsiders as a key venue for information exchange and government-business coordination. Banks such as Citibank and Manhattan Chase became permanent members of the banking association, and pharmaceutical firms such as Pfizer and Sanofi Aventis became standing board directors of the pharmaceutical manufacturers’ association – some of them foreigners. The Japan Automobile Manufacturers’ Association (JAMA), which had taken a position with MITI in the 1960s that entry of the US “Big Three” auto firms threatened the survival of Japanese auto firms, also embraced foreign management. In the early 2000s, all Mazda, Nissan, and Mitsubishi were all foreign controlled, with Suzuki and Isuzu with significant GM ownership.

Finally, foreign MNCs even became directly involved with the operation of political parties. The Democratic Party of Japan (DPJ), in opposition to the ruling LDP party, hired US public relations agent Fleishman-Hillard to help its campaign efforts.

CONCLUSION

The presence of MNCs in Japan’s economy grew rapidly, and reached further and deeper than most observers – and indeed many Japanese themselves – realize. This chapter has shown the influx of foreign MNCs into Japan beginning in the mid-1990s. Aggregate FDI reveals the sharp uptake of inward FDI flows beginning around 1995, with FDI stocks growing from less than 0.5% to GDP to almost 3% in slightly over a decade. This surge is particularly dramatic considering it had never risen above 0.4% for the previous 50 years in the postwar period, certainly not in the immediate prewar period, and although data is not available, probably not in the entire prewar era as well. That being said, inward FDI data understates the level of foreign MNC presence in Japan. However, it does capture the influx.

FDI data also captures the areas into which foreign MNC presences grew rapidly, which include automobiles, finance, telecommunications, and pharmaceuticals. Sector-level sales data from these sectors show the dramatic rise in MNC prominence over time. Aggregate income data captures not only a sharp increase in the incomes of foreign MNCs overall, but also the shifting sectoral mix of the highest income foreign MNCs.

Let us next turn to the conditions that kept the level of MNC presence in Japan’s economy so low for so long. We start with the national-level regulatory restrictions that were part of Japan’s postwar model of strategic growth.


CHAPTER 2:
The History of Japan’s Strategic Regulation of MNCs

Commodore Matthew Perry’s iron-plated “black ships” are arguably the image most deeply etched in the Japanese psyche as representing globalization. Perry’s black ships sailing into Tokyo Bay in 1853, with their powerful cannons overpowering Japan’s coastal defenses, was certainly traumatizing. The episode made it all too clear that Japan had no choice but to open up to the West, and that the path could be fraught with peril. So deeply has the image of Perry’s black ships been engrained in Japanese collective memory that, shortened to the convenient phrase kurofune raishu, it has appeared in media coverage of virtually every episode of major postwar entry of large MNCs into Japan.41

Japan’s strategic orientation towards MNCs was transformed in the 1990s. Until then, one cornerstone of Japan’s postwar political economy had been the insulation of core areas of Japan’s economy from foreign MNCs. During the postwar rapid growth era, the success of Japanese firms was equated with the health of the Japanese economy and the livelihoods of citizens. Foreign MNCs were considered a threat, not only to Japanese companies, but to the entire model of strategic development. Even as policy restrictions were eased, shifting from national-level capital controls to sector-level regulations, the strategic orientation of limiting MNC access remained.

In the 1990s, however, driven by almost a decade of scandals, decreasing employment, and stagnant growth, the strategic orientation was transformed. Confidence in the postwar Japanese model of capitalism was at an all-time low, and many disillusioned Japanese considered major domestic firms as part of the problem. Foreign capital and management expertise was now seen as part of solution to economic revival.

This shift in the perceived role of foreign MNCs was reflected in new policies. Driven by political pressure for reform, a broad set of policy initiatives in the late 1990s and early 2000s not only aimed to remove restrictions on inward FDI, but also strove to actively promote the entry of foreign MNCs. Even as foreign MNCs were taking major market positions in a variety of previously protected sectors, Prime Minister Junichiro Koizumi, in power from 2001 to 2006, spearheaded the most active push to accelerate foreign entry as part of his broader economic reform agenda. His policy drive included not only deregulation, but also a strengthening and revamping of the rules surrounding inward FDI to facilitate new forms of entry, such as mechanisms of M&A. With Japan’s historical efforts to strategically limit foreign economic influence dating back at least 400 years, this recent shift seems all the more remarkable.

This chapter traces the evolution of Japan’s historical policies towards managing inward FDI flows and the entry of foreign MNCs. It begins with the early history and traces the origin of the Japanese government’s capital controls and regulatory restrictions in the postwar era. It shows how the government was actually given its strongest policy tools by the Allied Occupation

41 The phrase kurofune raishu is so widely used, in fact, that it was even adopted for the marketing campaign in introducing an American female model of Filipino and Caucasian descent to Japan’s popular entertainment industry.
government, intended as temporary measures. It then goes on to trace the shift from national-level capital controls to sector-level restrictions as a result of international pressure, as Japan entered the global trade system in the 1970s. The increase of foreign MNC entry followed each incremental deregulation over the course of the postwar period as the gates gradually opened. The chapter then shows the shift in Japan’s strategic orientation towards foreign MNCs, setting the stage for the influx in particular sectors.

THE EARLY ORIGINS OF STRATEGIC MANAGEMENT (EARLY 1600S TO LATE 1800S)

Japan’s history of strategically limiting direct foreign economic influence has a long history – a history longer than the existence of the United States. It is perhaps unsurprising, therefore, that Japan’s path towards industrialization consciously and carefully limited foreign managerial influence within its domestic economy.

From its early history, despite the transformative influence of technology and culture from the Asian continent, Japan remained relatively isolated. Historical records show little direct sustained interaction between Japan and its neighboring civilizations. This is despite Japan’s heavy influence from the rest of Asia, including technology such as pottery, metals, and rice, as well as social and political elements including Buddhism and the written language. Before the 1600s, trading posts existed, but were limited to geographically peripheral regions. Historical records of Chinese traders in the Western island of Kyushu date from the twelfth century, and from the mid-1500s, Portuguese traders regularly visited western Japan. Then, from the early 1600s, the Tokugawa Shogunate allowed the Dutch and English to create trading posts on the island of Hirado.

Japan’s self-imposed isolation, sakoku, from the early 1600s is perhaps one of the more dramatic strategic rejections of foreign influence undertaken by a relatively small country. Beginning with a crackdown on missionary activity, the government strictly controlled the movement of foreigners and regulated trade. By 1616, Nagasaki and Hirado remained the only ports of Western access. The British East India Company closed its Japan office in 1623 for lack of profitability. In 1624 and 1639, respectively, the Spanish and Portuguese were expelled, leaving the Dutch the only remaining foreign presence in Japan. They were confined to Dejima, a small man-made island in Nagasaki.

The Tokugawa government strategically limited foreign contact for over two centuries until 1853, with the dramatic arrival of American Commodore Matthew Perry. While there had been a trickle of contact with American traders since the early 1800s, Commodore Perry’s iron-clad “black ships” arrived in what is now Tokyo Bay, demonstrating overwhelmingly superior firepower. The Tokugawa government was forced to negotiate opening the country to foreign access and trade. The US spearheaded a series of “unequal treaties,” in which Britain, France, and other Western powers gained tariff autonomy, extraterritoriality, and access to a number of ports cities, including Yokohama and Kobe – much closer to urban commercial

42 Of course, the current Japanese people, including the imperial line, are thought to originate in horse-backed invaders from the Asian continent. They replaced the indigenous Jomon population, and drove ancestors of the modern-day Ainu further and further north.
43 See Paprzycki and Fukao, Foreign Direct Investment in Japan: Multinationals’ Role in Growth and Globalization, 35.
centers than previous trade enclaves. However, perhaps remarkably, the Japanese government did succeed in maintaining a ban on foreign investments outside the designated ports.\textsuperscript{45}

The issue of how to deal with the foreign powers and the outside world became a central political debate. It eventually led to the Meiji Restoration of 1868, in which the Tokugawa government was overthrown in a largely peaceful transition of power.\textsuperscript{46}

As the new Meiji government rushed to modernize and industrialize Japan, it strategically attempted to limit foreign political and economic influence, even while aggressively studying and borrowing various political, economic, and social aspects of industrialized countries. The Meiji government dispatched missions to the US and Europe to understand and selectively borrow aspects such as constitutions, parliament, military, and other economic and social aspects to modernize Japan. However, at the same time, the Meiji leaders limited direct foreign control by eschewed foreign loans, fearing more subtle forms of foreign domination than the unequal treaties.\textsuperscript{47} From the early 1870s, the government actively purchased many foreign-owned facilities to maintain domestic control of the national economy, and it repaid the foreign debts of local provincial governors (daimyo) from before the Restoration. The government also prohibited local entities from taking foreign loans.\textsuperscript{48}

Over the next thirty years, as the Meiji government created institutions of a modern government, industrialized its economy, and renegotiated the “unequal treaties,” it continued to actively discourage foreign ownership of Japanese enterprises.

**DOMESTICALLY MANAGED INDUSTRIALIZATION (LATE 1800s – MID 1930s)**

From the late nineteenth century until the early 1930s, as Japan’s economy industrialized and grew, foreign technology and investments from abroad were critical in building the country’s technological and industrial base. The government took an active leading role in courting foreign skills and technology, but a major early function of the newly established government ministries was to limit direct foreign investment and management control.

The term *Wakon Yosai* (Foreign skill/technology, Japanese spirit) accurately framed the ideology governing Japan’s strategic reliance on foreign technology without control. Over the course of the 1870s, the government hired over 3000 skilled foreign engineers, technicians, and teachers to teach Japanese modern engineering skills and technical specialties. Private organizations hired another 2500 foreigners. These foreigners were sent home as soon as Japanese were deemed sufficiently trained.\textsuperscript{49}

In 1899, as a condition for renegotiating some of the provisions in the “unequal treaties,” Japan was forced to allow greater foreign investment. However, as soon as the government regained the right to set its own tariffs in 1911, it imposed import duties on a variety of products,

\textsuperscript{45} Paprzycki and Fukao, *Foreign Direct Investment in Japan: Multinationals' Role in Growth and Globalization*, 36.


\textsuperscript{47} Ibid., 95-99.


including industrial goods. These tariffs were raised after World War I, and again after the 1923 Great Kanto Earthquake.\(^5^0\)

Since the late 1800s, the Ministry of Finance had been actively channeling foreign capital away from direct investment. The government had relied heavily on foreign capital to finance the Russo-Japanese War (1899-1913), as well as to rebuild a devastated Tokyo after the 1923 Great Kanto Earthquake.\(^5^1\) The initial mandate of the Industrial Bank of Japan, established in 1900 and later well known for its role in providing long-term capital for major industrial projects, was to channel foreign capital investment to Japanese businesses as portfolio rather than direct investment.\(^5^2\) FDI was prohibited outright in sectors deemed strategic, including financial exchanges, insurance, and mining. It was also restricted in sectors such as banking, automobile manufacturing, aircraft, and machine tools.\(^5^3\) (It is worth noting that in the late 1990s, it was precisely many of these sectors in which foreign firms became highly prominent.)

The government was active in brokering the early major deals between foreign firms and Japanese industrialists, taking pains to ensure that foreign technology transfers entailed Japanese management control. The government spearheaded the creation of Japan’s industrial backbone, with officials actively courting foreign investment into particular sectors and pushing for joint ventures to avoid foreign managerial control. For example, officials from the Ministry of Communications visited Western Electric from around 1888, keenly interested in their telephone technology. NEC, later a centerpiece of Japan’s industrial landscape, was founded as a joint venture with Western Electric and Japanese industrialists, with the former initially holding a 54% stake. General Electric entered Japan in 1905 by creating a joint venture with Shibaura Electric, which later evolved into Toshiba.\(^5^4\) Technological tie-ups in the 1920s and 30s included those between Westinghouse and Mitsubishi Electric, Siemens and Fuji Electrical Machinery, Canada Aluminum and Sumitomo Metal, Otis Elevators and Toyo, Honeywell and Yamatake.\(^5^5\)

For multinationals, interest in directly investing in Japan grew until the 1930s. Japan became an attractive market in and of itself as it industrialized and grew economically, with a spike in demand after the 1923 Kanto Earthquake. FDI allured interest as Japan raised its tariffs on manufactured goods and components.\(^5^6\) Ford, General Motors, Victor Phonograph, Shell, IBM, and Nestle were among the large multinationals that entered Japan during this prewar period.

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\(^5^0\) Paprzycki and Fukao, *Foreign Direct Investment in Japan: Multinationals' Role in Growth and Globalization*, 37.


\(^5^3\) For a more comprehensive list, see Ibid.

\(^5^4\) Ibid., 27-41.


\(^5^6\) Paprzycki and Fukao, *Foreign Direct Investment in Japan: Multinationals’ Role in Growth and Globalization*, 37.
EXPPELLING FOREIGN FIRMS IN PREPARATION FOR WAR (MID-1930s - 1945)

From the 1930s until the eve of World War II, in the context of rising militarism, the Japanese government used a variety of policy tools to discourage, extort, and then appropriate the assets of foreign firms.57

As militarism and ultranationalist forces took hold of the government, it began imposing numerous firm and industry-specific restrictions. It exercised discretionary control over import licenses and foreign exchange permits to frustrate foreign firms’ attempts to build new factories, import components, and remit funds abroad.58 The government also explicitly promoted domestic manufacturers at the expense of foreign firms through subsidies, raising tariffs on goods such as imported auto parts, and imposing local production requirements. By the late 1930s, it also began pressuring foreign firms to sell their assets to Japanese partners. Some notable Japanese firms in joint venture arrangements, such as Shibaura (later Toshiba), which had absorbed significant amounts of technological know-how from GE, also began pressuring the government to force their foreign partners out of the joint venture.59 The government also pressure Japanese partners of joint ventures to become independent, such as Yokohama Rubber from B.F.Goodrich.60

By 1941, when war broke out in the Pacific after Japan’s Pearl Harbor attack, many foreign firms such as Ford and GM were only skeleton organizations, and the level of US investment in Japan had halved since 1930.61 After war broke out between Japan and the US, assets controlled by interests of the opponent were frozen in each country, the Japanese government seized the assets left behind, such as those of IBM.62

GIFTS FROM THE OCCUPATION (1945-1952): NATIONAL POLICY TOOLS OF FDI RESTRICTION

After Japan was defeated in 1945, the Allied Occupation authorities took control of the Japanese government. The Occupation government (the Supreme Allied Command Authority, SCAP) limited foreign entry by implementing specific policy tools intended as temporary measures to foster recovery of Japan’s economy. Ironically, these policy tools became the cornerstone of Japan’s postwar national restrictions of FDI at their strongest.

The Occupation authorities originally sought to dismantle major portions of Japan’s economy and industry to prevent the country from remilitarizing. Against the protests of many

58 For example, in 1936, it became clear that the government would not grant a license to Ford to build a factory, licensing only Toyoda (the forerunner of Toyota) and Nissan. In 1937, Ford’s Japanese operations were profitable, but it was denied the ability to remit profits outside of the Japanese “empire” (which included Korea, Taiwan, and Manchuria). Ibid.: 501-02..
61 Ibid.
US firms that had operated in Japan in the prewar period, SCAP barred almost all inward FDI. From around 1947, the US government shifted its stance towards Japan, concluding that an economically stronger Japan would serve as a bulwark against the spread of communism. The US refocused its efforts on reviving the Japanese economy, granting limited opportunities for inward FDI, but maintaining restrictions to protect the nascent Japanese recovery.63

SCAP promulgated two laws and instituted a process in which the Japanese government first evaluated inward FDI proposals before conferring with SCAP. The Occupation authorities’ intent was for Japan to remove these restrictions on inward FDI after it regained autonomy. The two laws were the Foreign Exchange Control Law (FECL) of 1949 and Foreign Investment Law (FIL) of 1950. Foreign investors were required to obtain permission to invest in Japan. Proposals were evaluated first by the Foreign Investment Commission, an organization set up within the Japanese government to which initial evaluation authority was delegated by SCAP. The commission consulted with the Foreign Investment Board to grant permission.64

In the immediate postwar years, multinationals that had been driven out of the country were allowed to return, and those whose assets were seized, such as IBM, recovered them. New firms such as Coca-Cola, as well as firms that had left, including Citibank, entered Japan initially to serve the Occupation troops.65 Other firms which had enjoyed strong competitive positions in Japan before the war, including Ford and General Motors, did not see sufficient potential in the Japanese market, and did not reenter. Overall, during the Occupation, most of the foreign investments were in oil, chemicals, and metals, sectors with prominent examples including Caltex (Nihon Sekiyu Seisei, Koa Sekiyu) and Shell (Showa Sekiyu), Asahi-Dow, Mitsubishi-Monsato Kasei, Nihon Zeon, and Nihon Light Metals.66

**THE HEYDAY OF FDI RESTRICTIONS (1955-1970s): DOMESTICALLY MANAGED RAPID GROWTH**

Japan’s postwar economic high growth era, growth of 10 percent per year between 1955 and the early 1970s, was the heyday of its national strategic policies of managing FDI. The government explicitly outlined its strategy of leveraging access by foreign multinationals to its domestic market in exchange for technology transfers, licensing, and tie-ups.

The main policy tools included the FIL, FECL, and direct restrictions on foreign ownership. These formal regulations were broad in scope, giving considerable discretion to the principal government actors. These actors included the Bank of Japan (BOJ), Ministry of Finance (MOF), and the Ministry of International Trade and Industry (MITI). The FIL placed foreign enterprises under the jurisdiction of MOF. The FIL approval process, however, gave influence to MITI and other government bodies, since approval was determined by the Foreign Investment Deliberation Council (a successor to the Foreign Investment Board established during the Occupation), comprised of MITI, BOJ, and other government ministry representatives.

The very language of the FIL codified Japan’s strategic orientation towards FDI. A clause stipulated that foreign investments must contribute to Japan’s international balance of payments

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63 Ibid., 105-11.
64 Ibid.
65 Ibid.
or be necessary to continue existing technological assistance contracts, and contribute to the development of Japan’s domestic industry. In practice, the government granted multinationals access to the Japanese market in exchange for entering into joint ventures with Japanese firms, license their technology to Japanese firms, or forego patent protection on certain products or processes.\textsuperscript{67} The government’s leverage was that foreign multinationals were interested in entering the booming Japanese market, but that the government had discretionary authority over remittance guarantees and unrestricted technology imports.

The FECL also codified Japan’s strategic attitude towards restricting FDI. In vague terms allowing for flexibility in enforcement, the law stipulated that the main criterion for approval was whether or not the foreign exchange transaction would benefit the Japanese economy. The FECL enabled MOF to control almost all foreign exchange transactions; unless a firm was preapproved under the FIL, all foreign exchanges required permission under the FECL.\textsuperscript{68}


Japan’s high growth era was clearly a period in which multinational firms were interested in the Japanese market, but were restricted from entering. As evidence, during a brief window of opportunity for multinationals to enter Japan without incurring FIL restrictions, a large number of firms established wholly owned subsidiaries.

Between 1956 and 1963, the government allowed multinationals to establish wholly owned operations in a form known as “yen-based” companies. Since multinationals were often forced into establishing joint ventures or disadvantageous technology licensing agreements under the FIL, the opportunity presented by wholly-owned yen-based companies was attractive. Despite the risk that the government would still use provisions in the FECL to block capital flows (profits, remittances, principal, interest) from the Japanese subsidiary to the overseas parent, as well transfers of capital, technology, and assets to the subsidiary, many multinationals considered it worth the risk.\textsuperscript{69}

Following the highly publicized entry of IBM into Japan as a wholly owned subsidiary in 1960, after lengthy and contentious negotiations with MITI over technology transfer agreements, major global multinationals entered Japan as yen-based companies. They included Exxon, Kaiser Aluminum, Scott Paper, Hoechst, and Olivetti, among others.

This window of opportunity for yen-based companies closed in 1963, when the government ceased approval. The government’s cited rationale was its impending “complete liberalization” after joining the OECD the following year.\textsuperscript{70}


\textsuperscript{68} Ibid., 159.


\textsuperscript{70} Encarnation, *Rivals Beyond Trade : America Versus Japan in Global Competition*, 59.
From National to Sectoral FDI Restrictions (1970s – 1980s)

From the late 1960s, Japan’s restrictions on FDI began to shift from direct, national-level restrictions to sector-level, and less direct measures. This shift was driven by Japan’s entry into the international trade system and pressure from its trading partners. Japan’s strategic desire to restrict FDI inflows, however, remained.

Japan joined the OECD and IMF in 1964, thereby incurring obligations to deregulate the flows of capital and foreign exchange. However, Japan retained most of its strict capital controls for the next two years, leading to protests from the US and European governments, and criticism from the OECD. Within Japan, the issue of liberalizing capital flows became a heated public debate, with most domestic actors urging caution and gradual change.\(^71\)

The Japanese government responded to this international pressure in 1967 by moving towards sectorally differentiated FDI restrictions. First, it created a “positive list” of industries in which approval would become automatic. One hundred percent foreign ownership was permitted in 17 industries with 50 percent ownership allowed in an additional 33. However, in practice, these “industries” were defined narrowly, and confined to business areas generally unattractive to multinationals (for example, they included “industries” such as soy sauce, wigs and geta, traditional Japanese wooden clogs).\(^72\) By 1969, despite multinational firms’ overall interest in the Japanese market, only four firms had submitted applications to enter businesses in the list.\(^73\)

The government continued to codify its strategic orientation towards FDI. MOF issued informal guidelines to foreign investors in a document titled the “Ten Rules for Foreign Investors.” MOF urged foreign investors to: invest in 50% ownership rather than 100%; ensure joint ventures appointed Japanese directors in proportion to the investment; avoid layoffs and factory closures, and; “cooperate with Japanese producers in the same industry to avoid ‘excessive competition’.”\(^74\)

Over the course of several years, restrictions were relaxed, except in those deemed strategic. From 1967 to 1969, the list of industries open to foreign investment up to 100 or 50% grew from 17 and 33, respectively, to 44 and 160. In 1970, it grew to 77 and 449. In 1971, 50%

\(^71\) Ibid., 65-66.
\(^72\) Mason, American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980, 202..
\(^73\) Encarnation, Rivals Beyond Trade: America Versus Japan in Global Competition, 68.
\(^74\) The full list, as cited in Mason, American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980, 326-27. reads:
1. Invest in industries where a fifty percent equity is automatically approved rather than in industries where a hundred percent is possible.
2. Avoid industries in which goods are produced mainly by medium to small factories.
3. Avoid restrictive arrangements with overseas parents companies or affiliates.
4. Cooperate with Japanese producers in the same industry in order to avoid “excessive competition.”
5. Contribute the development of Japanese technology.
7. Ensure that in a joint venture the number of Japanese directors reflects the Japanese equity percentage.
8. Avoid lay-offs and plant closures that might disrupt the Japanese labor market.
9. Cooperate in maintaining Japan’s industrial harmony and help in the achievement of her economic goals.
10. Avoid concentrating investments in any particular industry or industries.
foreign investment was permitted in all industries, and in 1973, the government shifted from a “positive list” of industries in which foreign investment was permitted, to a “negative list,” which allowed investment into all industries except those specified as restricted. The initial list of restricted industries contained 22, including computer manufacturing, integrated circuits, pharmaceuticals, and precision electric machines – strategic high tech sectors in which Japanese firms were deemed competitively weak. The government labeled these changes “complete liberalization.” By 1976, foreign ownership restrictions were lifted in 17 of the 22 industries. The remaining restricted sectors included petroleum refining, mining, leather manufacturing, and agriculture, forestry, and fishing. For acquisitions, firms were free to purchase Japanese firms, but the government required that foreign investors purchasing more than 10 percent stock of a Japanese company obtain consent of the target company.75 (See Table 15)

Table 15. The Deregulation of Restrictions on Foreign Ownership, 1967-1973

<table>
<thead>
<tr>
<th>Year</th>
<th>For Newly Established Firms</th>
<th>For existing firms in all industries</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Industries</td>
<td>Foreign ownership allowed</td>
</tr>
<tr>
<td></td>
<td>≤50% foreign ownership allowed</td>
<td>≤100%</td>
</tr>
<tr>
<td>1967</td>
<td>33</td>
<td>17</td>
</tr>
<tr>
<td>1969</td>
<td>160</td>
<td>44</td>
</tr>
<tr>
<td>1970</td>
<td>449</td>
<td>77</td>
</tr>
<tr>
<td>1971</td>
<td>All, other than those 100% allowed</td>
<td>228</td>
</tr>
<tr>
<td>1973</td>
<td>“Complete Liberalization” in principle except 22 industries (17 specified subject to delayed liberalization)</td>
<td>100% allowed in all industries except 22 specified</td>
</tr>
<tr>
<td>1974-1976</td>
<td>Liberalization of 17 specified industries</td>
<td></td>
</tr>
</tbody>
</table>


This extensive relaxing of FDI restrictions, however, did not entirely remove the government’s strategic capacity to restrict FDI. In sectors that the government deemed lagging in international competitiveness, it was able to continue formal protection. These included computer manufacturing, integrated circuits, pharmaceuticals, and precision electronic machines.

In 1980, the government abolished the FIL, including the Foreign Investment Deliberation Council tasked with granting the actual permission. Thereafter, foreign firms were required only to notify *a priori* rather than obtain government approval for specific investments.

The abolishment of FIL and relaxation of legal restrictions did not, however, lead to an influx of inward FDI. To some degree, formal legal restrictions were replaced with informal protection and barriers erected by the private sector. As we will see in the next few chapters, the overall institutional environment in Japan made it difficult for MNCs to operate. Japanese firms were able to utilize their advantages in this institutional context to increase the level of difficulty

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75 Ibid., 203-04.
for MNCs to penetrate the market. Numerous restrictions, direct and indirect, remained within the business laws of individual sectors. Moreover, specific market dynamics shaped by sectoral regulatory structures made it difficult for multinational firms to bring their core business models to Japan. As long as the strategic orientation continued, shifts in policy tools did not radically alter the opportunities available to foreign MNCs.

**INCREMENTAL MOVES TOWARDS FDI PROMOTION (1980s-2003)**

Beginning in the mid-1980s the Japanese government began to shift incrementally towards promoting FDI. However, it did not indicate a shift in the fundamental strategic orientation against foreign management influence in Japan’s domestic economy. The incremental policy shifts were driven by external pressure as trade debates with the US intensified. As we will see in the following chapters which take the analysis to a sectoral level, some of the incremental policy shifts did facilitate a degree of foreign expansion, but they were not the sweeping reforms that came in the 1990s, after the bubble burst.

From around 1984, the Japanese government began announcing measures to directly support inward FDI. These measures were driven by political leadership, part of Prime Minister Nakasone’s drive for economic and political reforms, which embraced the slogan of “internationalization.” The government-owned Japan Development Bank launched a “Loan Program for Promoting Foreign Direct Investment in Japan.” It offered low-interest, long-term loans to prospective foreign firms. Also in 1984, the Japan External Trade Organization (JETRO), whose original primary function had been to promote Japanese trade abroad, began to provide investment-related information to promote inward FDI.

In the late 1980s, as Japan’s economy grew rapidly (in what later proved to be a bubble) and the US slowdown and recession continued, the latter mounted increasing pressure on Japan to “open” its domestic market and reduce the US trade deficit. In 1990, following the US-Japan Structural Impediments Initiative (SII) negotiations, in which the US sought to foster structural change in Japan embracing greater US exports and firms, the Japanese government issued a “Declaration Concerning Openness to Foreign Direct Investment.” The following year, MITI set up a Council for Direct Investment to hear requests from foreign firms. Until the bubble burst, however, no stream of concrete policies emerged.

**THE POST-BUBBLE REALIGNMENT: TOWARDS INCREMENTAL FDI PROMOTION**

After Japan’s economic bubble burst in 1990-1991, the entire nation’s faith in the Japanese political and economic systems was deeply shaken.

Reputations plummeted as scandals erupted. Banks that had seemed poised to take over the world were exposed as simply riding the bubble, as their supposedly prudent investments and core strengths were exposed as speculation. Their assets plummeted in tandem with the stock market crash and end of the real estate bubble; the public saw the common practice of allowing borrowers to use the bubble-inflated market prices of stocks and real estate as irresponsible. Securities brokerages were found to have guaranteed their best customers profits, illegally cross-subsidizing from smaller customers and the general public. Vaunted Ministry of Finance

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officials were exposed as having been wined and dined by the bankers and brokerages they were tasked to oversee.

Manufacturers, once considered the vanguard of social stability, seemed to begin deserting the Japanese public. As the decade wore on and growth remained slow the widely publicized “hollowing out” of the manufacturing sector occurred, with manufacturing operations moving rapidly into Asia. Large firms, unable to rapidly cut the number of employees, drastically cut back the hiring of new college graduates, creating a “employment glacial period” for a generation of youth. Small firms, traditionally the ones bearing the brunt of economic pain during economic downturns, suffered.

Just as it seemed increasingly clear that major Japanese firms were no longer the vanguard of the Japanese public, a truly shocking scandal surfaced in the pharmaceutical sector. A Japanese pharmaceutical firm knowingly supplied HIV-tainted blood for transfusions, infecting several hundred victims, ranging from hemophiliacs to pregnant women. The regulator seemingly protected firms over citizens, with retired government officials serving on the board of firms that had engaged in a cover-up.

Finally, the banking crisis in the late 1990s almost a decade after the bubble burst, portrayed large Japanese banks as part of the problem rather than the solution. Opinion leaders and the general public seemed to have lost faith in the central tenets of the Japanese model of capitalism.

In this context, a series of incremental policies aimed at harnessing the benefits of foreign capital and management expertise began to appear. In 1992, the Foreign Exchange law was amended, simplifying the application procedures for direct investment. Later that year, the government passed the Import and Inward Investment Promotion Law, a package of tax incentives, credit guarantees, and a few other minor support programs.

In July 1994, the government established the Japan Investment Council (JIC) within the cabinet office. JIC was a cabinet-level council, headed by the Prime Minister with all the major ministers as members. The purpose of JIC was to promote inward investment by coordinating between ministries and disseminating information. It had been created on the basis of a Cabinet decision passed in March 1994, during the ten month period with the LDP out of power for the first time since 1955. (The LDP returned in a coalition government with the Japan Socialist Party (JSP) in June 1994.) An “Expert Committee” which included several prominent foreign participants, was created as part of JIC.

In 1995, JIC published a statement “Toward the Promotion of Foreign Direct Investment in Japan,” outlining its goals, including the promotion of deregulation, financial incentives, keeping better statistics on FDI, supporting JETRO in disseminating information, and others. This statement was followed by one in 1996 welcoming out-in M&A. Keidanren, the peak association for Japan’s industrial interests, issued statements in 1993 and again 1995 in support of foreign direct investment.

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78 METI, “History of Measures to Promote Foreign Direct Investment in Japan.”
79 See JIC website for the 1995 list members in the JIC Expert Committee [http://www5.cao.go.jp/e-e/doc/yearbook_ch1.html#ch1]
As the banking crisis loomed in the late 1990s, further measures were promulgated to improve the regulatory environment for inward FDI and to facilitate investments. One measure of the 1997 Cabinet measures for “The Action Plan for Economic Structural Reform” included improving the climate for M&A. The same year, the Japan Developmental Bank’s loan program was significantly expanded. By 2007, the bank reported it had extended 8 billion dollars in loans to 300 companies for 800 projects. Recipients included Daimler Chrysler, BMW, Volkswagen, Michelin, Bosch, Gilemeister Stihl, IBM, Motorola Eli Lily, Starbucks Coffee, and Toys ‘R’ Us.82

In 1999, the expert committee issued a report with seven recommendations, ranging from deregulation to better education facilities for children of foreigners working in foreign companies in Japan.

However, the interest in promoting FDI was piecemeal. Prime Minister Obuchi’s administration did pass several policies facilitating reform, but facilitating FDI was not a political priority. While the strategic orientation to limit MNCs had largely dissipated, the political leadership, especially under Prime Minister Mori began concentrating on massive spending on infrastructure and construction. As a result, the JIC remained inactive until 2003.83

**STRATEGIC FDI PROMOTION (2003-2006)**

The strongest political drive to increase inward FDI in Japan occurred under Prime Minister Koizumi. Several government programs strove to increase the level of inward FDI flows, and foreign owned firms were allowed to make political contributions – though the latter was designed less for foreign MNCs and more for large Japanese firms with a large proportion of foreign shareholders.

In a January 2003 General Policy Speech before the Diet, Koizumi declared his ambitious goal of doubling Japan’s stock of FDI in 5 years. Two months after the speech, the Japan Investment Council within the Cabinet Office announced an FDI Promotion Program. The five pillars of the program included: 1) improvements in the corporate environment, such as relaxing rules on joint ventures; 2) revising bureaucratic application procedures by creating a single entry point for foreign firms to interact with the government and translating laws and regulations into English and other languages; 3) improving the environment for employment and living by lengthening visas for skilled workers; 4) supporting national and regional measures to tie FDI for economic growth with aid to regions and utilizing Structural Reform Special Zones; and 5) disseminating information widely, both abroad and within Japan. In May 2003, Invest Japan offices were set up within JETRO as the main contact point for foreign firms entering Japan, with liaison offices in other major ministries and agencies.

In March 2006, Koizumi and the JIC set a new target for inward FDI, with a goal of attaining 5% of GDP by the end of 2010. Three months later, the JIC announced an FDI Acceleration Program (The Program for Acceleration of Foreign Direct Investment in Japan), with 74 measures covering three categories: regional investment promotion and assistance;

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improving the investment environment, such as rules surrounding M&A and improving the living environment for foreign residents; and disseminating information widely, with aid for regional governments in promoting themselves abroad.

In December 2006, the Diet approved the revision of the Political Campaign Law, submitted as a politician-sponsored bill. The law enabled majority foreign-owned firms listed on a public Japanese exchange for five years or more to make political contributions. The primary motivation behind the bill was to allow continuing political contributions by major firms whose shares were majority foreign owned, such as Sony and Canon (whose Chairman, Mitarai Fujio, was chairman of Keidanren, the peak business association). Although initially, the opposition Democratic Party Japan (DPJ) reportedly opposed the bill, it ended up gaining majority support from all major parties.  

**THE LOSS OF POLITICAL MOMENTUM, BUT NO REVERSAL**

The politically driven thrust to increase FDI waned after Koizumi left office in September 2006, and the ruling LDP-led coalition shifted to a more cautious approach toward reform. Moreover, the economy continued to grow steadily and the banking crisis had been largely resolved, with banks eliminating most of their non-performing loans. Given the recovery, pressure for further economic reform declined, and foreign MNCs were no longer viewed as critical to Japan’s economic growth or recovery as in the 1990s and early 2000s. Some of Koizumi’s successors even took the position of “mitigating the damage” from Koizumi’s market-oriented reforms as their political platform.

Some policy issues facilitating greater MNC access were delayed, though sometimes an inaccurate understanding of the issues nonetheless led to political action. For example, in 2006, a planned revision to the Commercial Code included a lifting of the ban on “triangle mergers,” which would allow equity share swaps between foreign MNCs not listed in Japan and Japanese firms. In the context of a widely publicized set of events in which an aggressive Japanese startup firm, Livedoor, mounted efforts at hostile takeovers of venerable Japanese broadcasters, fears of aggressive, large-scale hostile foreign takeovers were rekindled. (The president of Livedoor was eventually arrested and jailed for various counts of fraud.) A Diet debate resulted in a one year postponement of permission for triangle mergers, a position supported by the Keidanren. The extra year was to allow Japanese firms to implement “poison pills” guarding against potential hostile takeovers – a measure also enabled by the 2006 revision to the Corporation Law. Ironically, triangle mergers, even in the originally proposed form, could not be used for hostile takeovers.

Although the Diet session acceded to popular fear about hostile takeovers and postponed lifting of the ban on triangle mergers, the LDP did abandon a proposal to impose even more...

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85 Although equity swaps were commonly used in large M&A deals outside Japan, Japanese regulations had required that foreign firms wishing to use equity swaps had to be listed on the TSE. Paprzycki and Fukao, *Foreign Direct Investment in Japan: Multinationals' Role in Growth and Globalization*, 218-19.,
stringent shareholder approval requirements for triangle mergers. In fact, after triangle mergers were allowed in May 2007, there was no wave of hostile takeover bids, and only 10 percent of listed firms in Japan had adopted, or decided to adopt, poison pills.\(^{86}\) (Some even abandoned them in 2010.\(^\text{87}\)) In January 2008, Citigroup took advantage of its ability to engage in triangle mergers to make Nikko Cordial its full subsidiary – the largest inward M&A at the time. Nikko Cordial was already majority owned by Citigroup since early 2007, so this was hardly a hostile takeover.

The residual fear of aggressive foreign takeovers had been stoked by the actions of Steel Partners, an aggressive US hedge fund that acted as though scripted for the worst nightmares of Japanese fearing foreign influence. In a highly publicized case, Steel partners had attempted a hostile takeover of Bull-Dog Sauce in 2007, which held almost 30% of Japan’s market for condiment sauces. The sauce maker had not implemented any poison pill measures, but it moved to ask shareholders to issue special rights warrants to all shareholders other than Steel Partners, which had slightly more than 10% of its shares. Steel Partners took its case to the judicial system, filing for an injunction in the Tokyo District Court. The court did not grant the injunction, leading Steel Partners to sue Bull-Dog for discrimination. Shareholders approved the dilution of Steel’s shares, and Steel Partners was dealt a severe blow when the Tokyo High Court ruled not only that the move by Bull-Dog did not violate shareholder equality, but that Steel Partners was an “abusive acquirer” – essentially a green-mailer.\(^{88}\)

In a move following this, however, in 2009, Steel Partners managed to gain shareholder approval for its influence on the management of Aderans, a wig-maker. In a shareholder’s meeting, many of incumbent management’s proposals were defeated by shareholders, who approved Steel Partners’ candidates for the wig-maker’s board members.\(^{89}\)

Thus, although the cases of triangle mergers and Steel Partners’ bids for a hostile takeover aroused public fears of aggressive foreign takeovers, the trajectory was set, allowing foreign management participation and MNC entry. Triangle mergers did proceed, and Steel Partners did spearhead management changes at a large Japanese firm.

The JIC itself was dissolved in January 2008. A new “Expert Committee on FDI” was established under Ota Hiroko, the Economic and Fiscal Policy Minister under Koizumi’s successor, Abe Shinzo. FDI was an issue noted in the annual report of the Economic and Fiscal Reform Basic Policies for 2008, which outlines Japan’s economic growth strategies, including, for the first time, the aim of promoting FDI under the section of globalization. The report calls for revising “The Program for Acceleration of Foreign Direct Investment in Japan (FDI Acceleration Program)” promulgated in 2006, as well as comprehensively studying the regulations surrounding FDI. It also looks to clarify and sort M&A rules, as well as study tax reforms to reduce business costs, and promises to study how to speed up the approval of medical devices, as well as strengthen Japan’s overall stance on FDI promotion.\(^{90}\) However, the issue of increasing FDI was no longer a political priority.

\(^{86}\) Ibid., 219, Schaed, Choose and Focus : Japanese Business Strategies for the 21st Century, 122.
\(^{87}\) See, for example, “50 Companies Lower Takeover Barricades,” Nikkei Weekly April 19 2010.
When major issues arose, however, the political leadership continued to take a stance of enabling further foreign entry. In 2008, under Prime Minister Yasuo Fukuda, a policy issue arose over foreign ownership of airport shares, as a wave of privatization led to airports listing their shares on stock exchanges. The Ministry of Land, Transport, Infrastructure and Tourism (MLIT) attempted to submit a proposal to the Diet that would restrict the foreign ownership of airport stocks to less than one third of voting shares. MLIT’s state rationale was over security concerns, but many observers pointed to the high prevalence of retired MLIT officials employed by airports, often in advisory capacities. The Council for the Promotion of Economic Reform immediately publicized its opposition, and several LDP Cabinet members including the Finance Minister Yoshimi Watanabe and Chief Cabinet Secretary Yasuhisa Shiozaki argued that MLIT’s position contradicted the government’s stance of promoting inward FDI. Nonetheless, other elements within the LDP supported MLIT’s plan, reportedly agreeing to pass the legislation without alteration. This occurred at an awkward time for Prime Minister Fukuda, who had just issue a speech at the annual Davos Economic Forum in which he firmly committed Japan to being open to foreign investment. Citing this contradiction, the Fukuda administration postponed the issue, forgoing a debate in the Diet.

CONCLUSION

This chapter has shown how Japan’s strategic orientation towards MNCs was transformed in the 1990s. Japan has a long history of strategically limiting foreign access to its economy while aiming to benefit from technology and expertise from abroad. This strategic orientation was clearly manifested in Japan’s rapid industrialization in the late 1800s through early 1900s. In the postwar period, the Allied Occupation government provided Japan with powerful policy tools, intended for temporary use, but which the Japanese government used extensively after regaining sovereignty. As Japan’s economy grew and it reentered the international trade system, foreign pressure led to its relaxing of the strongest capital controls and restrictions on MNCs. Formal national-level restrictions were replaced by sector-level restrictions, however, with incremental easing through the 1980s in response to diplomatic friction with trading partners.

In the 1990s, widespread disillusionment with the model of Japan’s postwar political economy led to a transformation of the strategic orientation towards foreign MNCs. The health of the Japanese economy and society was no longer equated with the health of Japanese firms.

91 According to the Nikkei Shimbun, the Vice President of the company operating Haneda airport, 4 special advisors to Narita International Airport, the VP and two out of 14 other board of directors at Kansai International Airport, and 4 special advisors out of 16 board of directors to Chubu International Airport. "Koukuu Gyousei Heisasei Ni Hikan Nezuyoku [Strong Criticism Continues for Closed Airline Regulation]," Nihon Keizai Shimbun, February 19 2008.
92 Other critiques noted that the security argument was superfluous, since the Ministry of Defense issued a comment stating that legislation enabled it to take control of infrastructure, including airports, in the event of emergencies, and because national security concerns were outside MLIT’s purview. "Kuukou Gaishi Kisei Seifunai Ni Iron [Opposition within the Governemnt over Foreign Capital Restrictions of Airports]," Nihon Keizai Shimbun, February 2 2008. "Koukuu Gyousei Heisasei Ni Hikan Nezuyoku [Strong Criticism Continues for Closed Airline Regulation]."
Foreign MNCs were now considered critical to the solution rather than a potential problem. With a shift in the strategic orientation, sector-level regulatory shifts occurred (covered in Chapters 4 and 5), and the orientation of national-level policies shifted towards promoting inward FDI. A policy drive in the early 2000s incorporated the goal of increasing foreign MNCs as part of broader economic reforms. By the mid to late 2000s, the political enthusiasm for economic reform and embracing foreign MNCs waned due to the economic recovery and political platforms forged as a backlash to market-oriented reforms. However, on occasions when particular policy issues arose, they were resolved in the direction of enabling greater foreign access, and none of the existing policies were reversed.

By the mid to late 2000s, while foreign MNCs continued to enter a variety of sectors, media coverage no longer evoked cautionary references to Perry’s black ships. The strategic orientation that had lasted at least since Japan’s modernization in the late 1800s, had shifted.
CHAPTER 3:
The Effects of Japan’s Model of Capitalism on Inward FDI and Foreign MNCs

How did foreign MNCs interact with Japan’s distinct model of capitalism? How did elements of the model change over time, and how did these changes influence the conditions facing MNCs? These are the questions posed in this chapter.

I contend that during much of the postwar period, core elements of the “Japanese model” of capitalism rendered Japan a particularly difficult environment for MNCs to enter and operate. In particular, I argue that the distinctive features of the Japanese model of capitalism exacerbated organizational tensions and strategic dilemmas inherent to MNCs, such as the degree to which particular national operations could depart from core global business models and practices to fit local conditions.

However, substantial changes to these core elements of Japan’s model of capitalism during the 1990s and early 2000s rendered the environment much more hospitable to MNCs. Many of the organizational challenges and strategic dilemmas facing MNCs were reduced, facilitating their entry and expansion.

A debate in existing studies addresses reasons for the incredibly low level of MNCs and inward FDI in Japan – the reality until very recently. Many observers attribute the meager presence of MNCs to distinctive institutional features of Japan’s postwar economy. Others, however, blame countless strategic failures by MNCs to adapt to Japan’s social economic environment. Both lines of argument offer ample supporting evidence; management literature

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94 I follow Steven Vogel in characterizing the term “model” in Japan’s model of capitalism as “a constellation of institutions… linked together into a distinct national system of economic governance.” Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism, 8.
95 In some cases, following MNCs’ core business models to disrupt local practices can be an advantage. In other cases, without substantial modifications, the MNCs’ core business model will be ineffective. Ex ante, it is unclear which might be more likely to succeed – firms operate in an environment of pervasive uncertainty. In making these strategic decisions over time, power struggles and organizational tensions between headquarters and local operations can become a major challenge internally.
on Japan is full of foreign MNCs confronting difficulties that stem not only from regulatory restrictions, but also Japan’s core institutional environment; an abundance of strategic blunders by MNCs reveals their difficulty in adapting to local conditions.98

This chapter shows how Japan’s distinctive institutional features exacerbated challenges facing MNCs, but how these features also could provide opportunities for firms able to take advantage of them. Specific firm cases are used to illustrate the exact nature of dilemmas they faced.

I. THE DISTINCTIVE CHARACTERISTICS OF JAPAN’ POSTWAR POLITICAL ECONOMY

The core distinctive elements of Japan’s postwar political economy hindered the operations of foreign MNCs in Japan. Keiretsu industrial groups made it difficult for newcomers to enter the production networks and offer services to major firms belonging to keiretsu groups. Cross-shareholding among keiretsu firms was originally designed and encouraged by the government to thwart hostile takeovers, making it difficult for MNCs to purchase majority shares of Japanese firms. The main bank and “convoy” systems prevented bankruptcies and rescued troubled firms, reducing the targets for foreign acquisition. Long-term employment created illiquid labor markets, making it difficult for foreign MNCs to find high quality executives, managers, and staff. The importance of informal interpersonal networks in regulatory structures of ex ante management competition with the government and other firms, especially in highly regulated sectors, could be critical to competition. Newcomers had to invest into these relationships – a task that raised the operating costs for MNCs and was often difficult to justify to headquarters. Industry associations were a focal point of these informal networks, providing a conduit for the exchange of critical information between firms themselves and with the government. In most cases, foreign MNCs were excluded from these major industry associations in the highly regulated sectors deemed strategic. Proprietary Japan-specific dynamics of competition in many sectors rendered foreign MNCs’ global competitive strengths relatively insignificant in Japanese markets. Finally, norms of economic nationalism, widely held by elite politicians, bureaucrats, businessmen, and the broader general public, associated the success of Japanese firms with the good of the Japanese economy and society, forcing foreign MNCs into an uphill battle in entering and operating in Japan.

The Japanese institutional environment exacerbated organizational difficulties inherent to the operation of multinational firms. As recent studies on MNCs clearly show, it is not uncommon for MNCs to be fraught with organizational challenges and contradictory incentives among different levels of hierarchy, national units, and sub-national divisions.99 For MNCs

99 This scholarship goes beyond abstract theoretical conceptions of how MNCs take advantage of firm-specific resources or minimize transaction costs. For example, see Peer Hull Kristensen and Jonathan Zeitlin, Local Players in Global Games : The Strategic Constitution of a Multinational Corporation (Oxford: Oxford University Press, 2005). Cornelia Woll also points out the pervasive uncertainty under which firms operate in formulating and articulating their preferences. Cornelia Woll, Firm Interests : How Governments Shape Business Lobbying on Global Trade, Cornell Studies in Political Economy (Ithaca, N.Y.: Cornell University Press, 2008).
entering Japan, apart from regulatory restrictions on MNCs and foreign investment in many sectors, adjustment to the country’s economic environment required considerably Japan-specific adjustments and investments. The business models and core competencies developed by MNCs in global markets did not necessarily aid their efforts to enter and compete in Japanese markets. A common theme of business cases chronicling managers’ experiences was that they needed to “sell Japan to headquarters” and “sell headquarters’ plans to the Japanese.”

Some of the distinctive elements were created by design, while others evolved from larger political bargains or historical processes. For example, while cross-shareholding was encouraged by the government and adopted enthusiastically by firms to thwart foreign management control, long-term employment practices were the product of domestic political bargains – a response to militant labor disputes of the 1950s.

Table 16 presents an overview of the distinctive features of Japan’s political economy and how each impeded the operation of MNCs.

Table 16. Distinctive Features of Japan’s Political Economy Hindering MNCs’ Operations

<table>
<thead>
<tr>
<th>“Distinctive” Characteristics of Japan’s Political Economy</th>
<th>How the Characteristics Hindered MNCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Keiretsu Business Networks</td>
<td>Difficult for newcomers to enter production networks and business areas</td>
</tr>
<tr>
<td>Cross-shareholding</td>
<td>Reduction of M&amp;A targets</td>
</tr>
<tr>
<td>The Main Bank and Convoy Systems</td>
<td>Bank-based corporate finance, few bankruptcies or distressed targets for foreign acquisition</td>
</tr>
<tr>
<td>Long Term Employment</td>
<td>Difficulty for newcomers to find high quality management and employees</td>
</tr>
<tr>
<td>Importance of informal networks (ex ante managed competition regulatory structures)</td>
<td>Newcomers required to invest into entering networks</td>
</tr>
<tr>
<td>Industry Associations</td>
<td>Foreign MNCs barred from entry and receiving information, node of informal networks</td>
</tr>
<tr>
<td>Proprietary Japan-specific dynamics of competition</td>
<td>Multinationals’ core business models not directly applicable to Japan</td>
</tr>
<tr>
<td>Economic Nationalism</td>
<td>Limited government support for M&amp;A and foreign entry, less prestigious and accepted by public</td>
</tr>
</tbody>
</table>

These distinctive characteristics shifted in the 1990s, greatly facilitating the entry and operation of foreign MNCs. Keiretsu ties weakened overall, providing foreign firms and newcomers fresh opportunities to enter production networks and engage in business activities.

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100 See, for example, the memoirs of the first president of IBM Japan. Takeo Shiina, Gaishi to Ikiru: Ibm to No Hanseiki Watashi No Rirekisho [Living with a Foreign Firm: My Resume, Half a Century with Ibm] (Tokyo: Nikkei Business Bunko, 2001).
101 For a useful overview of many of the factors cited here, see Paprzycki and Fukao, Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization, 61-83.
with major firms. Regulatory changes rendered cross-shareholding an ineffective defense against hostile takeovers, and the unwinding of cross-shareholding in response to accounting reforms provided opportunities for foreign firms to purchase large blocs of previously unavailable shares all at once. The weakening of main banks and the demise of the convoy systems of regulation fueled waves of bankruptcies and crises in previously protected industries, opening opportunities for foreign MNCs to enter as rescuers. The decline of long-term employment and rising labor market liquidity, growing in tandem with a new market for headhunting firms, enabled foreign MNCs to attract executives, managers, and employees more easily than ever before. The regulatory shifts to ex post market governance in highly regulated sectors led to the declining importance of informal interpersonal relationships in competition, leveling the playing field for newcomers and foreign MNCs. The shift of propriety market dynamics towards that of global markets, propelled by the regulatory shifts towards ex post market governance, facilitated MNCs’ introduction of business models successful in other global markets. Particularly in IT-heavy services industries, these changes gave foreign MNCs advantages over Japanese firms, which struggled to adapt. Finally, the widespread disillusionment with Japanese companies and the Japanese “model” of capitalism in general led to a normative shift (as seen in Chapter 2) in which both the elite and general public increasingly accepted foreign firms as generally positive to the economy. (See Table 17)

Table 17. Shifts to Japan’s Distinctive Features Facilitating Foreign MNCs’ Operations

<table>
<thead>
<tr>
<th>Shifts to Japan’s Distinctive Characteristics</th>
<th>How the Changes Facilitated MNCs</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Open Keiretsu Ties</td>
<td>Increased opportunities to enter production networks, offer services, and enter into tie-ups</td>
</tr>
<tr>
<td>Unwinding of Cross-shareholding</td>
<td>Easier for M&amp;A, unwinding provided opportunities to acquire blocs of shares</td>
</tr>
<tr>
<td>Weakened Main Bank System and Demise of Convoy Systems</td>
<td>Corporate finance less bank-based, wave of bankruptcies in need of capital and management expertise</td>
</tr>
<tr>
<td>Increasing Labor Market Liquidity</td>
<td>Unprecedented ease of finding management talent and employees</td>
</tr>
<tr>
<td>Shifts from Ex Ante Managed Competition to Ex Post Competition Management</td>
<td>Declining importance of interpersonal networks in core business models. Increased information transparency.</td>
</tr>
<tr>
<td>More Open Industry Associations</td>
<td>Foreign MNCs allowed to join, gain more voice as insiders</td>
</tr>
<tr>
<td>Shifting dynamics of competition in highly regulated markets</td>
<td>Multinationals’ core business models more directly applicable to Japan</td>
</tr>
<tr>
<td>Post-bubble Disillusionment and Decline of Economic Nationalism</td>
<td>Government strengthened regulations enabling M&amp;A, normative shift of foreign MNCs as helpful to economic restructuring and reform</td>
</tr>
</tbody>
</table>
**KEIRETSU CORPORATE GROUPS**

Japan’s keiretsu business groups were widely cited as a barrier to entry for newcomers in a variety of markets, foreign and domestic alike. Keiretsu did, however, sometimes provide advantages to foreign MNCs that succeeded in becoming close to core keiretsu firms. As keiretsu groups became more open during the 1990s, with new webs of ties across traditional groups, new firms of all sorts, including MNCs, found it easier to enter. Moreover, more foreign MNCs were able to benefit from keiretsu networks as various Japanese markets grew receptive to new products and services that Japanese firms did not offer.

Keiretsu groups are best understood if disaggregated into horizontal and vertical groups. Horizontal groups consisted of anywhere from around 25 to 45 firms across several industries, clustered around financial institutions that served as main banks. Over 200 of Japan’s largest firms were members of the “Big 6” keiretsu. Vertical groups consisted predominantly of large manufacturers and their suppliers. The primary barrier that keiretsu groups posed to market entry by newcomers and foreign firms was high levels of intra-group trade. While keiretsu groups were by no means completely closed or necessarily collusive—often using outside firms to impose price or quality-based pressure on group members, they did, on the whole, put newcomers at a disadvantage. In services such as insurance, for example, keiretsu group companies often purchased life insurance in bulk from the insurer in their group. Therefore, one of the most common complaints of foreign MNCs until the mid-1990s was that keiretsu ties

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102 Schaeede distinguishes between two types of horizontal groups: three descendants of the prewar family-owned conglomerates, zaibatsu (Mitsubishi, Mitsui, Sumitomo), and three bank-centered groups (Fuyo, Sanwa, Daichi Kangyo). Schaeede, *Choose and Focus: Japanese Business Strategies for the 21st Century*, 89.


104 Japan’s Fair Trade Commission (JFTC) estimates of within-group procurement put average levels around 12% by value in 1981. These figures exclude financial institutions. Estimates from the Japan Fair Trade Commission, cited in Schaeede, *Choose and Focus: Japanese Business Strategies for the 21st Century*, 91-92. Many have criticized the JFTC for its lax antitrust regulation, which may lead to understated numbers. For example, see Kotabe and Wheiler, "Anticompetitive Practices in Japan Their Impact on the Performance of Foreign Firms."

105 As Clark and others point out, horizontal keiretsu groups companies did not necessarily tolerate higher prices from other members, but in times of crises, they were more likely to be involved in bailouts. Clark, *The Japanese Company*. For example, in the mid 1970s, when Mazda faced a crisis Sumitomo bank spearheaded a rescue plan, and the rest of the Sumitomo group, comprised of over 600 members at the time, reportedly aided the company by purchasing thousands of their cars every year for several years. Richard Pascale and Thomas P. Rohlen, "The Mazda Turnaround," in *Inside the Japanese System: Readings on Contemporary Society and Political Economy*, ed. Daniel I. Okimoto and Thomas P. Rohlen (Stanford, Calif.: Stanford University Press, 1988).

106 Employees were under some pressure to buy everything from cars to beer from group companies To illustrate, employees of Kawasaki Shipping, which carried Toyota cars, could not show up to a weekend golf course round with business partners in a Nissan. Employees of Nissan, part of the Fuji group, including Sapporo beer, could not fathom ordering Asahi or Kirin at company dinners and entertainment.
strategically hindered foreign market access\textsuperscript{107} – though some contended that these claims were exaggerated.\textsuperscript{108}

Vertical keiretsu were strong, long-term relationships between groups of suppliers and distributors for major manufacturers or other industrial firms. Newcomers, including startup firms, often found it difficult to enter supply networks of final producers.\textsuperscript{109} This became a point of contention in trade talks over Japan’s automobile industry in the 1980s and early 1990s, for example. For firms selling directly to consumer markets, distribution and retail networks, such as wholesalers, were often difficult to penetrate, since they were often organized along keiretsu groupings.\textsuperscript{110}

Keiretsu, however, could prove beneficial to foreign MNC in several ways. By allying with powerful Japanese firms within a particular keiretsu, foreign MNCs could gain powerful political backing in areas requiring government approval. MNCs’ alliance with powerful companies within keiretsu could also transform the Japanese rival firm within that keiretsu into an influential partner, providing the MNC with extensive cooperation along a variety of dimensions, and access to distribution networks. This relationship could act as a barrier to entry for subsequent foreign MNCs. And finally, an MNC providing services to a powerful firm within a keiretsu group often found it had immediate access to the major firms all at once.

\textit{Coca-Cola's Leverage with the Mitsubishi Group}

Coca-Cola’s experience in allying with Mitsubishi Heavy Industries to enter Japan provides an excellent illustration of these dynamics. In the immediate postwar period through the 1950s, Coca-Cola’s attempts to enter into the Japanese consumer market were met with a somewhat remarkably extensive set of regulatory restrictions. These included import restrictions, a ban from advertising in Japanese media, price floors, and luxury taxes.\textsuperscript{111} The major Japanese beverage companies Kirin, Sapporo, and Asahi worked through the industry association to lobby the Ministry of Agriculture (MOA) to delay issuing permission for Coca-Cola to sell to the general population (the company initially operated in Japan to serve US military personnel). However, Coca-Cola was able to enlist the help of Mitsubishi Heavy Industries to persuade MOA to allow it to enter. Mitsubishi’s interests were to supply bottling machinery to Coca-Cola – the latter had arranged an agreement between a major US producer of beverage equipment,

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\textsuperscript{107} Encarnation, \textit{Rivals Beyond Trade: America Versus Japan in Global Competition}, Jordan, "The Future of Foreign Direct Investment in Japan."
\textsuperscript{108} Weinstein, "Foreign Direct Investment and Keiretsu: Rethinking U.S. And Japanese Policy."
\textsuperscript{109} Kenichi Imai et al., eds., \textit{Venchaazu Infura Semeno "Seifutii Netto" Wo Tsukuru: The Infrastructure of Venture Companies} (Tokyo, Japan: NTT Shuppan,1998).
\textsuperscript{110} For an overview of these factors, see Paprzycki and Fukao, \textit{Foreign Direct Investment in Japan: Multinationals' Role in Growth and Globalization}, 43-44.
\textsuperscript{111} According to Dennis Encarnation and Mark Mason, in the immediate postwar period, the government viewed Coca-Cola as offering little technology while draining scarce foreign exchange and threatening Japanese beverage companies. They denied granting approval of an import license by a Japanese bottler to import syrup concentrate until 1956. In 1956, the bottling company was granted permission to import Coca-Cola syrup at the same time that Pepsi was allowed to enter. It also restricted Coca-Cola to advertise in domestic media, imposed price floors to prevent price wars, added levies, and limited to a number of designated outlets the sale of Coca-Cola products. Encarnation and Mason, "Neither Miti nor America: The Political Economy of Capital Liberalization in Japan," 34-35.
\end{flushleft}
George J. Meyer Company, and Mitsubishi immediately after the war. Mitsubishi Heavy Industries was part of the same Mitsubishi keiretsu as Kirin, the strongest firm opposing Coca-Cola’s entry. Mitsubishi Heavy Industries held a much stronger position within the keiretsu than Kirin, and it pressured the latter to reach an agreement with Coca-Cola, resulting in a bottling company in the Osaka area to serve Coca-Cola, jointly invested by Kirin (60%), Mitsubishi (30%), and Kirin’s wholesalers (10%). Mitsubishi Heavy Industries and Kirin also pressured the government, which in 1960 reached an agreement with other opponents to Coca-Cola to allow its entry, given a few conditions – including a 50 million yen payout to assist small-medium producers.112 In short, by allying with a powerful member of a keiretsu group, Coca-Cola not only received access to the keiretsu’s wholesale networks, but was able to transform a direct and formidable Japanese competitor into a staunch ally.

Once established, Coca-Cola’s distribution network became a barrier to entry for subsequent foreign firms. For example, Pepsi, though suffering from other problems with its international strategy as well, found it more difficult to enter and establish its own distribution and wholesale networks.113

Insurance: Aflac Benefitting from Keiretsu Group-Based Bulk Insurance

The insurance sector provides another example illustrating how keiretsu could benefit foreign entry. In the 1970s, when Aflac first began selling it, cancer insurance was not offered by any Japanese insurers. Major Japanese corporations were quick to become sales agents, offering Aflac’s new insurance products to their employees, and thus giving Aflac immediate access to the keiretsu group companies.114 Large corporations commonly offered life insurance products to their employees at favorable bulk rates, and these insurance policies were usually provided by keiretsu group companies. However, in the case of cancer insurance, since major Japanese insurers were not licensed to offer the product, Aflac was quickly able to make deep inroads.

Once large corporations had signed up as Aflac sales agents, this status also acted as an entry barrier for other insurers. As a result, even by the late 1980s, Aflac continued to hold over 90% of the cancer insurance market. It has even been argued that the large firms, interested in selling cancer insurance to their employees to gain commissions after the oil shocks of the early 1970s squeezed revenue, helped pressure a hesitant MOF to approve Aflac’s cancer insurance.115

112 Mason, American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980, 161-73. This compensation was part of a 100 million yen fund set up for this purpose, which received contributions from Coca-Cola’s Tokyo bottler, Kirin, and Pepsi. Encarnation and Mason, "Neither Miti nor America: The Political Economy of Capital Liberalization in Japan."

113 Mason cites a Japanese management specialist who contended that one reason that Pepsi did not fare as well as Coke (9% versus 90% market share in 1980 for Japan’s cola market), was that Pepsi’s Japanese bottling companies were regional financial institutions. Mason also notes that Pepsi established a larger number of smaller bottlers in Japan. This may have been a function of the relatively large size of bottler firms that Coke was able to access due to its ties with the Mitsubishi group. Mason, American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980, 319.

114 By signing up to become sales agents, the companies benefited from commissions on their sales.

More Open Keiretsu and Foreign Advantages

During the 1990s, keiretsu groups became more open, and foreign MNCs that were able to take advantage of the IT revolution to create new products and services benefited from access to keiretsu groups.

Overall, keiretsu groups became less cohesive and more open during the 1990s. The ratio of inter-group trading decreased, and mergers of major banks from different keiretsu were followed by new spinoffs and tie-ups between large manufacturers across traditional group lines. For example, Sumitomo and Mitsubishi banks merged, and the semiconductor divisions of Hitachi, part of the Fuyo group, and NEC from the Sumitomo Group, were spun out to create Elpida Memory in 1999. Mitsubishi Pharma’s merger with Tanabe also represented ties between former Mitsubishi and UFJ groups (2007) and Takeda and Kirin’s joint subsidiary created in 2002 linked the Sanwa and Mitsubishi keiretsu groups.

In sectors such as finance, insurance, and business services like accounting and consulting, large MNCs developed products and service offering that Japanese firms had not. As regulatory shifts enabled new business models and products in finance, and accounting reforms requiring greater disclosure and accounting, foreign MNCs found new opportunities to benefit from offering services to major keiretsu groups.

For example, as shown in more detail in the following chapter, the de-compartmentalization of banking, securities, and insurance led to new tie-ups. Major Japanese banks offered products from foreign insurers that their own groups companies did not. They also utilized the services of foreign brokerages to undertake activities such as quietly unwinding their cross-held shares. Large Japanese insurers entered into tie-ups with foreign insurers to offer a wider range of products. For example, a 2004 tie-up between Sumitomo Life and American Life gave the latter access to companies in the Sumitomo group.

Business services such as accounting and consulting for strategy and IT systems integration were also new areas in which foreign MNCs were able to rapidly gain Japanese corporate customers. Firms such as Accenture, KPMG, and PricewaterhouseCoopers became among the largest in their respective sectors (management consulting and accounting), and IBM Japan became a prominent systems integrator for small-medium firms in addition to large corporations. Even NTT DoCoMo, part of the generally conservative, former state-owned telecommunications firm NTT, hired McKinsey consultants to help formulate its Internet services business model in the mid-1990s.

CROSS-SHAREHOLDERING

Cross-shareholding, the web of reciprocal shareholding among keiretsu group companies, significantly reduced the number of targets for foreign acquisition. Although stable shareholders usually held only a minority of shares, this was effective protection against hostile takeovers because until 1999, regulations did not oblige minority owners to sell their shares to hostile bids, regardless of price. Regulatory shifts removed cross-shareholding as protection.

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117 Ibid.
against hostile takeovers, and accounting reforms pressured many firms to unwind their shares, creating opportunities for foreign MNCs to acquire the blocs of shares being sold.

The composition of stable shareholders for a major firm generally consisted of a large bank (the “main bank”), legally limited to holding 5% or less, a set of companies engaged in reciprocal shareholding totaling approximately 20%, and other stable shareholders comprising approximately 15% -- a total of approximately 40% stable shares.\(^{118}\)

The practice of cross-shareholding developed with government encouragement, and was designed explicitly to protect Japanese companies against takeovers by foreign firms in the early high-growth era. Facing the liberalization of several capital controls in exchange for entering the world trading system in the early 1960s, the government encouraged cross-shareholding. It revised the Commercial Code in 1966 to facilitate cross-shareholding by easing restrictions on Japanese companies issuing shares to third parties of their choice, while informally urging companies to adopt the practice.\(^{119}\) As a result, cross-shareholding among *keiretsu* business group companies increased almost twofold between the early 1960s and around 1974.\(^{120}\) It acted as an effective protection against foreign takeovers; as economists Ralph Paprzycki and Kyoji Fukao put it succinctly, “... by the time that foreigners were allowed to acquired Japanese companies... cross-shareholdings effectively prevented them from doing so.”\(^{121}\)

From the mid to late 1990s, however, cross-shareholding declined. Japan’s banking crisis, the continuing economic stagnation, and policy reforms drove the decline. The banking crisis of the mid-1990s put pressure on banks to sell low-yielding shares to maintain their BIS capital adequacy ratios, and accounting rule changes decreased the reported profitability of major firms, increasing the cost of holding on to cross-held shares.\(^{122}\) As a result, both banks and firms began unwinding their cross-shareholdings. In 1990, cross-shareholding accounted for 15% of all shares, but in 2002, this dropped to 7.2%. The proportion of stable shareholders fell from 43.1% in 1990 to 26% in 2002.\(^{123}\) Furthermore, while city banks and other banks accounted for 15.6% of share ownership on the Tokyo Stock Exchange in 1992, this dropped to 11.3% in 2000, and 5.3% in 2005.\(^{124}\)

Most importantly, a key rule change in 1999 rendered cross-shareholding ineffective

\(^{118}\) Jackson and Miyajima, "Introduction: The Diversity and Change of Corporate Governance in Japan," 4. The proportion of stable shareholders is a standard item in popular data compendia on Japanese companies, such as Toyo Keizai Kaisha Shikiho and Nikkei Kaisha Joho, which list the estimated percentage of non-crossheld shares, or “floating shares” for each company.

\(^{119}\) Suginohara, "The Politics of Economic Nationalism in Japan: Backlash against Inward Foreign Direct Investment?."

\(^{120}\) Paprzycki and Fukao, *Foreign Direct Investment in Japan: Multinationals' Role in Growth and Globalization*, 42.

\(^{121}\) Ibid., 43.

\(^{122}\) Ibid.

\(^{123}\) Ibid.


\(^{124}\) Ibid., 13. However, cross-shareholding did not decline equally across the board. It was unwound mostly among firms that were less dependent on bank financing – for firms that were able or chose to raise funds from capital markets. For firms that continued to be dependent on bank financing – mainly less profitable firms – cross-shareholding was retained. Hideaki Miyajima and Fumiaki Kuroki, "The Unwinding of Cross-Shareholding in Japan," in *Corporate Governance in Japan: Institutional Change and Organizational Diversity*, ed. Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima (New York, NY: Oxford University Press, 2007).
protection against hostile takeovers; minority shareholders were now to sell their shares to a
hostile bidder once the latter established a majority position.\textsuperscript{125}

Explicit government policy also facilitated the unwinding of shares. As the
non-performing loans problem facing banks persisted through the late 1990s, in 2001 new
government regulations were enacted to facilitate the unwinding of bank shareholding. The
Banks’ Shareholding Restriction Law was passed in 2001, strengthening the restrictions on bank
ownership of shares. To support the sell-offs, the government even established a new
organization, the Banks’ Shareholding Purchase Corporation, which began purchasing
bank-owned shares in Feb 2002.

Foreign ownership of Japanese shares in general increased as a result of the unwinding,
although most was by foreign institutional investors making portfolio investments. In 1987, the
total foreign share of the aggregate market capitalization of the Tokyo Stock exchange was 5.3%,
which rose to 14.1% in 1999 and 28% in 2007.\textsuperscript{126}

\textit{Negotiating for Blocs of Stable Shares: Vodafone, British Cable & Wireless, Volvo}

Pressures on major Japanese firms to unwind cross-shareholding in the late 1990s
facilitated foreign entry. On several occasions, foreign MNCs were able to obtain large blocs of
shares by negotiating with a small number of actors. For example, as seen in the next chapter,
British telecom carrier Vodafone was able to purchase Japan Telecom by negotiating mainly
with the Japan Railway group companies. In a bidding war between British Cable & Wireless
and NTT over the international carrier IDC, the main counterparties included Toyota and a
trading company – both interested in maximizing profit from the sale rather than prioritizing
long-term relational considerations with NTT. Finally, Nissan Diesel, which was spun out of
Nissan – a result of Nissan’s new strategy under Renault-appointed management to substantially
unwind its crossheld shares – was purchased by Volvo in 2008.

\textbf{THE MAIN BANK AND CONVOY SYSTEMS: LIMITED OPPORTUNITIES FOR FOREIGN RESCUE}

The “main bank” system of corporate finance and governance, combined with the
“convoy system” of the banking sector limited the number of corporate and financial sector
bankruptcies, closing potential entry points for foreign MNCs. The main bank did, however,
ocasionally broker tie-ups between Japanese and foreign firms. As the main banks weakened in
the late 1990s, they were no longer able or willing to bail out as many distressed firms vis-à-vis
the high growth era. At the same time, the government’s abandonment of the convoy system led
to a wave of bankruptcies and crises in Japan’s financial sectors. Both the weakening of main
banks and the disappearance the convoy system contributed to the influx of foreign MNCs by
creating opportunities for them as rescuers and purchasers of distressed firms.

In the postwar rapid growth era, corporate finance was bank-centered, and main banks
provided “patient” capital, investing with long time horizons. In the system’s heyday, main
banks traded an implicit guarantee against letting borrowers fail in exchange for the threat of
sending in their own management to restructure firms in times of trouble. A paradigmatic and
often cited example is that of Sumitomo’s rescue of Mazda in 1975, when Sumitomo sent in its

\textsuperscript{125} Schaede, Choose and Focus : Japanese Business Strategies for the 21st Century, 95-100.
\textsuperscript{126} Ibid., 111. Citing data from the Tokyo Stock Exchange.
own employees to take control of the automobile firm, which had been hit hard by the oil 1971 shock.127 With main banks dominating corporate finance, opportunities for foreign control were limited. In times of strong performance, there was little financial need for firms to borrow from foreign banks or enter into financial relationships with foreign MNCs that could lead to management ties. In difficult times, main banks rescued ailing Japanese firms, reducing the possibility for foreign MNCs to purchase troubled Japanese firms.

Main banks could, however, aid in creating tie-ups between Japanese and foreign firms. For example, in 1971, when Isuzu solicited a significant investment from General Motors (see Chapter 5 for more details), it was acting upon the advice of its main bank, Daiichi Kangyo Bank.128 In 1979, Sumitomo bank was critical in forging the relationship between Mazda and Ford as well.

By the late 1990s, the main banks faced crises. Their non-performing loans reached epic proportions, jeopardizing their ability to maintain the 8 percent capital adequacy ratio mandated by BIS. Japan’s corporate finance system had also shifted towards capital markets, starting in the late 1970s, and accelerating through the 1990s. The effect was that main banks lost many of their best clients, who could raise funding more cheaply in capital markets, while banks’ most problematic clients, those that could not use capital markets, remained. Banks still held the majority of household savings, much of which did not go into stock markets, especially after the bubble burst in 1990s. Therefore, in short, main banks had lost many of their best borrowers, kept most of their worst borrowers, but faced the need to pay interest on massive amounts of household savings. This pushed them into ever-riskier investments, many of which became non-performing loans by the late 1990s.

In such condition, main banks in the late 1990s were increasingly unable to bail out their ailing borrowers. For example, in cases such as Nissan’s bailout by Renault, Nissan’s main bank was unable and unwilling to bail out the company, pushing it into the alliance.

The postwar “convoy” system of financial governance exchanged an implicit promise by the government to protect financial institutions against bankruptcy in exchange for the latter’s compliance with administrative guidance. Until the late 1990s, there had been no bankruptcy of a major financial institution in Japan’s postwar history. MOF had orchestrated the occasional merger of a weak financial firm. This was part of the government strategy to protect the financial system from outside influence and enable strategic investments into targeted sectors. The image of “convoy” was defensive—a fleet of ships moving at the speed of the slowest one.

In the late 1990s, coinciding with the banking crisis, the government abandoned the convoy system. While MOF did help orchestrate the mergers between the largest main banks to eventually create four mega-banks, other financial institutions were allowed to fail. Hokkaido Takushoku Bank was the first that the government allowed to fail, followed by the Long Term Credit Bank, Yamaichi Securities, and a wave of insurers.

These bankruptcies, as well as numerous other financial firms that were on the brink of collapse, allowed foreign MNCs to enter as rescuers. They were welcomed both for the capital

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127 Aoki calls this “contingent governance” exercised by the main bank system. Even if there were relatively few cases of banks actually replacing corporate management, both parties understood the rules of the game. Masahiko Aoki and Hugh T. Patrick, “The Japanese Main Bank System Its Relevance for Developing and Transforming Economies.” (Oxford [England] ; New York: Oxford University Press, 1994).

infusions they could provide, as well as the management expertise they were perceived to possess.

Regulatory structures shifting the core business models of banks themselves also provided opportunities for foreign expansion. As retail banking became comparatively less profitable than other forms of fee-generating businesses, and as the regulatory shifts to ex post managed competition proceeded, new business models became possible. Foreign financial institutions were often the ones introducing these new business models. Main banks began shifting from focusing on volume in their lending – since during the period in which interest rates and products were heavily regulated, volume was the only way to increase revenues – towards focusing on profitability. Pressure increased to pursue new fee-based businesses, leading to the development of areas such as syndicated loans. Foreign banks such as Citibank were first to spearhead this market segment, benefiting from expertise and experience they developed in other global markets. As seen in the following chapter, foreign securities firms and insurers pioneered and profited from new product offerings.

**LONG TERM EMPLOYMENT**

The long-term employment practices of large Japanese companies – so-called lifetime employment – rendered Japanese white collar labor markets highly illiquid. This was one of the most widely cited challenges for foreign firms entering Japan. The challenge was twofold: the lack of a well-developed market for mid-career hires; and the relative unwillingness of top university graduates to enter foreign firms.

For most of the postwar period, foreign firms, as well as new firms in general, faced uphill battles to attract high quality white collar employees. Foreign MNCs were on the disadvantageous side of one of the core tenets of Japan’s model of capitalism. Unlike cross-shareholding, long-term employment was the product of postwar political bargains rather than an explicit attempt to exclude foreign firms. University graduates competed for job offers from large corporations, considered most prestigious and secure. They were implicitly guaranteed a position (though certainly not necessarily the position they desired) in the core company or an affiliated company until retirement. In exchange, they received relatively low wages early on in their career, with seniority-based pay scales steadily increasing their income until near retirement.

The most prestigious employers were large Japanese corporations that offered this bargain. Small-medium firms, employing around 60% of the population (estimates vary) did not offer this bargain and were far less popular destinations for graduates from top universities. The practice of long-term employment was strengthened by several regulations and judicial cases that made it extremely difficult for companies to fire employees.

Foreign firms and new startup firms were traditionally outside this long-term employment structure. Foreign MNCs had short histories in Japan, they could not or would not

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129 Edman, "The Paradox of Foreignness: Norm-Breaking Mnes in the Japanese Banking Industry".
guarantee long-term employment, and the initial scale of their Japanese operations was small. It is easy to see how foreign MNCs could get caught in a vicious cycle. With headquarters unwilling or unable to commit to long term employment of its employees, graduates of top universities were unwilling to join. Staffed with management from third tier educational backgrounds or those forced out of major Japanese companies for one reason or another, the Japanese subsidiary of the MNC would suffer from ineffective salesforces, marketing strategies, or other organizational or personnel problems. Unable to turn a profit quickly enough, management from headquarters would send a new leader to head the Japanese office, who would then lay off large numbers of staff and management, frustrating subsequent efforts to further recruit top talent. Observers of the behavior of foreign MNCs in Japan find no shortage of cases following this scenario.

Moreover, lacking an active market for mid-career hires, foreign firms had difficulty finding employees who could be immediately useful in their operations. Most large Japanese firms had extensive on-the-job training, entailing months (and sometimes over a year) of training activities and job rotations before new graduates were put into positions with substantive working responsibilities. Moreover, many skills of managers from large Japanese firms were relatively firm or group-specific unlike those of managers in countries with more liquid labor markets. Other mid-career hires were considered mavericks, making dealings with business counterparties more difficult than otherwise. Foreign MNCs attempting to grow their businesses rapidly and requiring people with immediately useful skills had difficulty finding such workers.

If attracting top university graduates and mid-career hires were not challenging enough, people with highly developed English language skills and specialized intercultural abilities to interface between the MNC’s global operations and Japanese contacts were truly scarce. In sectors where informal interpersonal relationships with elite bureaucrats were critical for competition, as seen in the next section, this dearth of personnel with the appropriate mix of skills was an especially great challenge.

Executive talent was also difficult to find, since large Japanese corporations’ managers were predominantly homegrown, and by the time they rose through the ranks, many of their skills were most effective within the context of the firm or group. Executive headhunting was rare enough that in the mid 1980s, when Japanese banks were riding the economic bubble, Salomon Brothers and S.G. Warburg’s success in hiring high level managers from the prestigious Industrial Bank of Japan made headlines.

Despite challenges in finding new graduates, mid-career hires, and executive talent, some foreign MNCs were able to adopt long-term employment practices to their great advantage. IBM Japan, for example, successfully adopted Japanese corporate practices, complete with seniority wages and lifetime employment. This was facilitated by IBM’s overall employment strategy.

135 See, for example, Huddleston, Gaijin Kaisha : Running a Foreign Business in Japan.
until the 1990s, which was essentially the equivalent of Japan’s long-term employment with seniority wages. By the 1990s, IBM Japan was ranked as one of the top prospective employers by Japanese university graduates.

Long term employment in Japan began to decline starting in the 1990s. Some internationally competitive Japanese firms such as Toyota and Canon strengthened their commitment to long-term employment for a core group of workers, citing the competitive advantages they enjoyed from the practice. However, overall, long-term employment applied to a reduced set of core workers, as Japanese firms increased the proportion of temporary and non-regular workers.137

New regulations and court decisions facilitated the increased flexibility in employment arrangements. Several court decisions in the early 2000s overturned previous strictly applied standards for dismissal, and a revision to the Labor Standards Law in 2004 made it easier for firms to terminate employment when they deemed worker performance insufficient.138 The labor market became more liquid, spawning a large number of not only temp workers for basic office work, but also headhunting firms for management talent. As the executive of one foreign headhunting firm put it, in 1990 perhaps one out of ten cold calls would get answered at best, but by 2000, seven or eight out of ten were actively interested.139

These shifts in employment practices, combined with the increasing instances of corporations shedding capable workers due to extreme competitive weakness or collapse, played to the advantage of foreign firms. University graduates were less interested in long term employment, as the large Japanese industrial vanguard firms slowly reduced their workforce and froze hiring. Mid-career hiring became increasingly possible, facilitated by the development of headhunting firms. And executive talent became easier to find than ever before. For example, Vodafone succeeded in luring an executive from NTT DoCoMo, part of the former telecom monopolist NTT’s group, to become president of Vodafone’s Japan operations – the first time a former NTT group company executive took the helm of a foreign MNC. In another example, the collapse of Japanese financial institutions scattered former employees throughout the industry. The collapse of Yamaichi Securities in 1997, which had approximately 7700 employees at the time, sent most of them into the labor market, since Merrill Lynch employed only about 2000 of them.140 More than half of the employees of the Long Term Credit Bank also left the firm before it was bought and restructured by a foreign hedge fund, thereby providing foreign financial firms with experienced Japanese bankers.

The financial sectors arguably experienced the most extreme transformation of employee practices, driven by foreign MNCs. By offering Wall Street-style high salaries and bonuses to young workers, MNCs turned the traditional model of long-term employment and seniority on its head. Young graduates from top universities and mid-career hires were given astronomically high salaries by local standards, but enjoyed no job security. Wall Street norms of high turnover

139 This comment has been made in numerous public sessions by Sakie Fukushima, an executive of headhunting firm Korn/Ferry International.
and poaching of employees and teams prevailed, with employees moving frequently between Western investment banks.

The popularity of high-flying foreign financial firms attracted more top graduates than ever before, as they cited factors such as more responsibility given at a young age, less hierarchy, and higher pay as motivations. Even Tokyo University Law Department graduates, traditionally a source of MOF officials and other elite bureaucrats, experienced a rise in students heading to Western brokerages and consulting firms. In 2008, according to the Tokyo University newspaper, more law department graduates headed to foreign brokerages than to MOF and the FSA combined.\(^{141}\) Norms had shifted, and far from being a stigma, employment at a foreign financial or consulting firm was considered an appropriate career path for aggressive and talented youth, as well as particularly ambitious mid-career salarymen.

Finally, foreign MNCs gained a reputation as offering more opportunities for career-minded women vis-à-vis traditional Japanese companies. Indeed, many foreign MNCs explicitly targeted women as an underutilized source of talent, providing opportunities for rapid advancement.\(^{142}\) (For example, see the pharmaceuticals sector case in Chapter 5.) Here, foreign firms that departed from the norms of long-term employment, originally set up for a single (male) rice-winner family, enjoyed advantages.

**INDUSTRY ASSOCIATIONS**

Industry associations were a critical node of government-business coordination, aggregating business interests and exchanging information with the government. For most of the postwar period, many industry associations directly or indirectly excluded foreign MNCs from membership – one of the longstanding complaints of foreign MNCs. In the 1990s, many of the industry associations were restructured, opening themselves to foreign entry. In an interesting

\(^{141}\) For example, 25 graduates of the Tokyo University Law Department took their first job in Western financial firms in 2008, ten went to MOF and FSA."Todaisei Wa Gaishi Wo Mezasu [Tokyo University Graduates Aim for Foreign Firms]," *Nihon Keizai Shimbun*, March 4 2008.

\(^{142}\) For a discussion of recent development and survey results from company cases, see George Olcott, *Conflict and Change : Foreign Ownership and the Japanese Firm* (Cambridge, UK ; New York: Cambridge University Press, 2009).

### Employers of Tokyo University Law Department Graduates

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1997</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>MOF/FSA</td>
<td>13</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>METI</td>
<td>16</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>MIC</td>
<td>25</td>
<td>21</td>
<td>9</td>
</tr>
<tr>
<td>BOJ</td>
<td>8</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Mizuho</td>
<td>39</td>
<td>24</td>
<td>13</td>
</tr>
<tr>
<td>MUFJ</td>
<td>33</td>
<td>21</td>
<td>6</td>
</tr>
<tr>
<td>Nomura Securities</td>
<td>6</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Western Brokerages</td>
<td>4</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Western Consulting Firms</td>
<td>2</td>
<td>2</td>
<td>7</td>
</tr>
</tbody>
</table>

reversal, some industry associations that had been protectionist even became key facilitators of rapid foreign entry.

Japan has been characterized as a corporatist political economy, with peak associations representing major social interest groups – though excluding labor. Industry associations performed functions such as standard-setting, self-regulation, and information exchange among firms within the industry. They were a central node of information flows between the government and businesses, and they acted as the delivery mechanism for informal administrative guidance. They were also a key focal point for informal interpersonal networks, the topic of the following section.

Standard-setting was often used as a tool to strategically exclude foreign firms. A typical pattern would be for standards such as product specifications for licenses to be set explicitly to exclude foreign products, such as in the case of definitions of small automobiles as smaller than most US and European models. Another pattern was that standards would be set by the industry association after deliberations among members, with the specifications published just as member firms were ready to roll out their products, giving non-members no time to develop competing products before the first wave hit the market. A notable case of this was Japan’s proprietary PHS wireless technology. Domestic firms, under the strong guidance of MPT, set the standard, developed the products and networks, and published the standard just as they rolled out their services.

In many industry associations, especially those in protected strategic sectors such as banking, foreign MNCs were excluded. In others, even if they could join, foreign firms were unable to become full members. For example, in trust banking, despite winning the battle to receive approval and enter the market, foreign firms were initially not allowed to take positions of executive director and ordinary committee member of Trust Company Association of Japan. Even if foreign firms joined the association as full members, they were not given the right to vote. In another example, the banking peak industry association, the Federation of Bankers’ Association (Zenginkyo), was an aggregation of regional banking associations. Only banks that were members of one of the regional associations could join the national federation, but foreign banks had no regional association they could join, precluding them from the national associations.

Foreign MNCs often set up their own industry associations, such as the Foreign Banking Association or the Foreign Nonlife Insurers’ Association. These acted as lobby groups, but were not necessarily insiders. They did not have the power of standard-setting or self-regulation that the Japanese associations had.

In the late 1990s, as the presence of foreign firms increased, many industry associations reorganized their structures to allow membership of foreign firms. Zenginkyo, for example, directly accepted foreign banks, and the Life Insurance Industry Association was opened to

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145 Jeffrey L. Funk, Global Competition between and within Standards : The Case of Mobile Phones (Basingstoke: Palgrave, 2002).
146 "Lack of Opportunities, Personnel; Foreign Banks Fight an Uphill Battle to Win Pension Trusts."
foreign members. It therefore became the choice of foreign firms as to whether or not they wanted full membership. As a number of representatives from foreign firms explained, however, full membership often entailed substantial investments of funding and human resources, and after the regulatory structure shifted away from *ex ante* managed competition, full membership rather than associate membership in these associations did not necessarily yield returns commensurate with the cost.

Overall, industry associations themselves became less important to firms’ competitive strategies as the role of informal networks and informal information exchange decreased. The regulatory regime shifts that decreased the relative importance of licensing issued by the government on a discretionary basis decreased the role of informal information exchange, and will be discussed in the next section.

**Life Insurance Industry Association: From Hindering to Facilitating Foreign Takeovers**

In a fascinating development, the role of the life insurance industry association morphed from a cautious and somewhat exclusionary attitude towards foreign MNCs into one of welcoming and actively facilitating foreign entry. As a crisis swept through the sector, putting all member insurers at risk by straining the insurance policyholder protection fund, the industry association transformed its role.

The Life Insurance Industry Association (LIAJ) was put in charge of selling the assets of the first major postwar bankrupt life insurer, mid-sized Nissan Life. After Nissan Life’s bankruptcy in April 1997, LIAJ was tasked with managing the remaining contracts and finding a suitable buyer. It created a firm, Aoba, managed by the industry association itself, which did not sell new contracts, only processing and administering existing policies.

A disagreement among LIAJ members ensued over the sale of Aoba; many were hesitant to sell Aoba at too low a price, concerned that they would be in effect subsidizing a new competitor. In May 1998, the LIAJ gave permission to AIG to examine the books of Aoba, hiring Morgan Stanley as an intermediary. Six other insurers were interested, and LIAJ planned to hold an auction to select the buyer. The process dragged on, however, and seven months later, in December 1998, AIG dropped its bid. AIG had been the forerunner, promising to retain the terms of existing contracts and to not merge Aoba into its existing operations in Japan. In the interim, Aoba’s subscriber base had dropped in half, as the continuing hesitation of LIAJ led to the flight of risk-averse customers.

In February 1999, LIAJ announced that it would postpone selling Aoba altogether.

The subsequent bankruptcy of Toho Mutual Life in June 1999, with several other insurers on shaky financial ground, created a crisis for LIAJ, spurring it into action. The association’s fund to meet the liabilities of failed companies had been mostly drained by the collapse of Nissan Life. The majority of insurer-contributed funds in a new Insurance Policyholder Protection Fund, scheduled to come into effect that December, had already been set aside for Toho (An estimated 380 billion of 560 billion yen). The fund could not easily

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withstand another set of failures. The matter became even more urgent when an investigation revealed that Toho’s liabilities stood at 500 to 600 billion yen, twice the amount that it had reported when it collapsed.\footnote{“Liquidation Procedures Begin for Toho Mutual Life: Discussions of Takeover of Assets Focus on Joint Venture Ge Capital Edison,” *The Nikkei Weekly*, August 9 1999.}

LIAJ moved quickly resolve the stalled sale of Aoba, finding a buyer in September 1999—three months after Toho failed, and an incredible 29 months after the initial failure of Nissan Life. LIAJ chose French conglomerate Artemis, selling Aoba for 25 billion yen. The negotiations had actually broken down once when Artemis refused to pay LIAJ’s minimum price of 30 billion, but LIAJ, pressed for time, lowered its asking price.

Toho was sold in nine months. Before collapse, it had engaged in a tie-up with GE Edison Life, with the latter managing many of its policies. In March 2003, GE Capital Edison took over the remainder of Toho Mutual Life, with a 380 billion yen contribution from LIAJ’s protection fund.

When Chiyoda and Kyoei collapsed in October 2000, their respective foreign tie-up partners, AIG and Prudential, immediately offered sponsorship. Both were chosen by LIAJ to take over, with little debate or resistance within the association. In fact, the sale of Kyoei to Prudential was decided in a mere three days, on the condition that the bidder would not seek funds from the protection fund or the Japanese government.\footnote{This move was criticized by some, but a spokesman contended that asset deterioration would be rapid, and would become a burden for the Protection Corporation. “Kyoeiseimei No Shiensaki Kettei, Ireino Hayasani Hokano Kouho Fuman [Kyoei’s Aider Selected, Contenders Dissatisfied with Unprecedented Speed of Decision],” *Nihon Keizai Shimbun*, October 24 2000.}

Table 18. Time to Approval for Foreign Takeovers of Failed Japanese

<table>
<thead>
<tr>
<th>Name</th>
<th>Bankruptcy Date</th>
<th>Sale Date</th>
<th>Number Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nissan/Aoba</td>
<td>4/1997</td>
<td>9/1999</td>
<td>29</td>
</tr>
<tr>
<td>Kyoei</td>
<td>10/2000</td>
<td>10/2000</td>
<td>&lt; 1</td>
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\section*{INFORMAL INTERPERSONAL NETWORKS}

Informal interpersonal networks between firms, and between firms and the government were critical to the dynamics of competition and firms’ business models for much of the postwar period. As outsiders to these networks, foreign MNCs were historically at a disadvantage, and in some cases, justifying investments into interpersonal networks was a challenge that created friction between MNCs’ Japanese branches and global headquarters. With Japan’s regulatory shifts of the 1990s, however, these networks became less critical under the regulatory structures of \textit{ex post} market governance.

Webs of informal networks played a central role in Japan’s government-business linkages, critical to the government’s strategic capacity to manage the economy. The government-business relationship has been characterized as cooperation based on “reciprocal
the political economy dubbed a “network state” revolving around the dense information exchanges between elite bureaucrats and large corporations. Informal interpersonal networks were also a conduit allowing the government to implement administrative guidance through less formal means than via industry associations.

In many sectors, informal interpersonal networks were a critical component of corporate business strategies. This was especially the case in highly regulated sectors, where the government engaged in ex ante modes of managing competition. (The specifics of each sector will be introduced in the following chapter.) For example, the submission of an application for a product or business license was often the culmination, rather than the beginning, of lengthy and extensive informal negotiations. An application was not simply something to be filled out, but rather a device to enable government officials to gather information about the firm, which was expected to visit the relevant Ministry to receive guidance about how the application should be filled out. These ties were at the firm rather than the industry association level, since other members of the industry association were competitors.

Information on probable directions of policy, advance notice about policy changes affecting market competition, and the delivery of other important information to firms was often conveyed informally. Illustrating the importance of these informal networks, major Japanese banks devoted entire groups assigned to handle relationships with MOF bureaucrats. Known as MOF–tan, these employees were tasked with winning, dining, and cultivating relationships with MOF bureaucrats in the highly regulated banking industry, where any information obtained early could lead to a competitive advantage. Until after the bubble burst and such practices came under intense scrutiny, MOF–tan usually had substantial discretionary entertainment budgets at their disposal—quite pronounced during the bubble years. These types of divisions devoted to interpersonal relationships were quite difficult for foreign MNCs to justify to their headquarters. Although US aerospace firm Lockheed had been involved in arguably the largest bribing scandal in Japan’s history involving Prime Minister Tanaka Kakuei, this was involvement from outside the country rather than systematically organized division within companies operating in Japan staffed with relationship managers to the government. A prominent and repeated complaint lodged by the American Chamber of Commerce until the early 2000s was that these informal exchanges of vital information were not available to foreign firms.

Foreign MNCs in joint ventures often relied on their Japanese partners to provide access to the informal networks. For example, as Boehringer Ingelheim found out as it distanced itself from its partner Tanabe in the early 1980s, the firm reportedly had difficulty in obtaining information whenever the Ministry of Health changed its policies or administrative guidance. Boehringer was no longer an insider to the interpersonal networks, and Tanabe, though still a part of the partnership since it applied for approval of new products (until the law changed in the

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156 For more on Tanaka Kakuei, see Jacob M. Schlesinger, Shadow Shoguns: The Rise and Fall of Japan’s Postwar Political Machine (New York: Simon & Schuster, 1997).
mid-1980s allowed foreign firms to apply for clinical processes by themselves), was less and less willing to share information to its future competitor.\footnote{Nagami Kishi, \textit{Gaishi Kei Seiyaku Kigyou No Jidai [the Era of Upheaval, Foreign Pharmaceutical Firms]} (Tokyo: Nihon Noritsu Kyoukai Manejimento Senta, 1996), 27-29.}

Two other, more formal practices linked the government and businesses. They include \textit{shukko}, the temporary assignment of corporate personnel to the government, and \textit{amakudari}, the practice of private sector firms hiring former bureaucrats.\footnote{The precise role of amakudari is a topic of debate among scholars. Kent Calder argued that amakudari served to enhance the access of relatively disadvantaged firms to policy processes, such as regional, medium-sized, or less prestigious firms aiming for increased policymaking access. This included foreign firms; he notes that IBM, Texas Instruments, and Salomon Brothers hired a number of amakudari bureaucrats. Kent E. Calder, "Elites in an Equalizing Role: Ex-Bureaucrats as Coordinators and Intermediaries in the Japanese Government-Business Relationship," \textit{Comparative Politics} 21, no. 4 (1989). Ulrike Schaede argues that most amakudari personnel went to the largest 100 firms in Japan, finding that patterns of amakudari increased from the late 1970s to early 1990, systematically varying across sectors. She contends that highly regulated sector, where one might have expected larger number of amakudari bureaucrats, received relatively few because their trade associations could adequately represent their interests. She argues that sectors in which firms were unable to create a united front in lobbying were more likely to take amakudari personnel. Ulrike Schaede, "The "Old Boy" Network and Government-Business Relationships in Japan," \textit{Journal of Japanese Studies} 21, no. 2 (1995).} While shukko arrangements by foreign firms were exceedingly rare, MNCs did often seek former bureaucrats to serve as the president or chairman in tandem with an expatriate employee of the MNC. This was particularly true in the case of industries where informal ties mattered a great deal, such as pharmaceuticals.\footnote{There is clearly diversity among firms. Some are interested in the former bureaucrat’s informal networks rather than their management expertise. Many appointments of this nature can be found in foreign firms with ex-bureaucrats as chairman. Others sought bright, well-connected leaders who were intimately familiar with the industry. These former bureaucrats were put in the position of president, with real management responsibilities. However, precise data on the number of amakudari bureaucrats in foreign firms over time is difficult to obtain. At the source, the National Personnel Authority releases annual data documenting the placement of bureaucrats, but it underestimates the true extent of amakudari because it only includes cases that faced potential conflicts of interest. Bureaucrats that first moved to a public corporation or semi-private organizations were not included. Richard Colignon, and Chikako Usui, "The Resilience of Japan’s Iron Triangle: Amakudari," \textit{Asian Survey} 41, no. 5 (2001). Collecting data from the destinations – a survey of large Japanese firms – require access to databases that were beyond the financial resources for this study. Thomas W. Malnight, "Eli Lilly and Company (C): Japan," \textit{Harvard Business School Cases} 9-391-034 (1991).}

\textbf{Eli Lilly: Recruiting, Informal Networks, and Distribution}

The experience of US pharmaceutical firm Eli Lilly illustrates several of the challenges discussed so far. It faced challenges in hiring employees, coordinating with the government, managing informal networks, and making choices over distribution.

Eli Lilly had exported products to Japan from the beginning of the 20\textsuperscript{th} century. In the early 1970s, it entered into a joint venture with a Japanese partner. By 1984, 7\% of its total sales were from its Japanese operations, and at that time, changes to Japan’s regulatory framework allowed it to create a wholly owned subsidiary, which it did in 1985.\footnote{Thomas W. Malnight, "Eli Lilly and Company (C): Japan," \textit{Harvard Business School Cases} 9-391-034 (1991).}
First, a good relationship with the Ministry of Health and Welfare (MHW) was critical, since the MHW set the de facto price that pharmaceutical firms could get for their products. (It did so by stipulating the amount that would be reimbursed to the firm through the National Health Insurance (NHI) system, to be explained more fully in the next chapter.) Second, since price was rarely the final determinant in doctors’ selection of pharmaceutical products from a range of close substitutes (due to prices being set by the National Health Insurance reimbursement list), Japanese firms cultivated relationships with doctors and hospitals. They sent salesmen to major hospitals on a daily basis establishing a presence, running errands, and entertaining doctors after work and on weekends with golf. Eli Lilly was able to “rent” a number of employees from its joint venture partner for a few years, making them responsible for training mid-career hires who had experience in sales. Most of Eli Lilly’s mid-career hires came from other foreign firms operating in Japan, the main source of liquidity in Japan’s illiquid labor markets.  

In building a workforce from scratch, Eli Lilly also decided to recruit new college and university graduates. After finding that graduates from top schools lacked interest in a foreign firm without brand recognition in Japan, the company focused on middle-tier schools. However, the first year it attempted to recruit graduates, it found that other firms had already completed much of their recruiting by the time the “official” recruiting season began. In subsequent years, the company found that it had to offer higher salaries than other Japanese firms competing for the recruits because it did not offer a dormitory. Following local custom, Eli Lilly also paid commuting costs and modest meal allowances.

To bring its products to market, Eli Lilly needed to learn the Japan-specific requirements for conducting clinical trials, preclinical testing, and preparing applications to the Ministry of Health and Welfare. As a rule, only clinical data from tests on Japanese patients, conducted in Japan were permitted. In order to conduct clinical tests, however, close relationships with reputable doctors in major medical schools or hospitals was needed.

The distribution system was complex, but by creating a network of wholesalers, Eli Lilly was able to cope. It did introduce some different practices, but wholesalers, interested in cultivating a long term relationship, were amenable. Other aspects, such as the custom of paying doctors and medical testers in cash, did not meet the approval of global headquarters, and required compromises.

II. FOREIGN MNCs INTERACTING WITH JAPAN’S DISTINCTIVE INSTITUTIONS

Next we turn to a set of firm-level cases in which Japan’s distinctive characteristics interacted with MNCs’ strategies. These cases highlight the organizational and strategic challenges facing foreign MNCs. The cases also show the difficulty of assessing the motives of foreign MNCs entering a particular political economy – whether they enter to take advantage of the local environment seeking a “comparative institutional advantage” or if they believe their advantage is to disrupt aspects of the environment. Moreover, ex ante beliefs about particular

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162 Ibid.
164 Ibid.
MNCs’ strengths as understood by headquarters may not play out as expected due to independent strategy by the local leadership – sometimes for the better.

VARIETIES OF ENTRY STRATEGIES TAKING ADVANTAGE OF THE INSTITUTIONAL CONTEXT

In the cases below, the first three show different patterns of entry. Aflac, the insurer, took the existing regulatory structure as an advantage. Manpower, a temporary worker dispatch agency, exploited an area of regulatory ambiguity to provide its services. Toys’R’Us rode a wave of deregulation to disrupt established market practices to dominate its sector.

**Aflac: Regulatory Challenges, Informal Networks and Market Advantages**

Aflac entered Japan to take advantage of what it saw as a gaping hole in the product offerings of Japanese insurers, shaped by the regulatory structure. In clearing the initial hurdle of obtaining government approval, the efforts of an entrepreneurial Japanese leader committed to bringing Aflac to Japan succeeded beyond those made by headquarters. Once it obtained government approval, Aflac enjoyed the benefits bestowed upon it by the existing regulatory structure of ex ante managed competition, which provided the company with its own market segment, protected from large Japanese insurers.

Aflac entered Japan aiming at the niche market of cancer life policies. On the one hand, this segment had been completely ignored by Japanese firms due to strong social taboos associated with cancer. At the time, cancer was much feared, equated with certain and imminent death. Strong norms existed among doctors against telling patients that they had the disease – only family members were notified. At the same time, Japanese life insurance firms largely competed against each other on the basis of membership among their keiretsu groups rather than on differentiated products. Insurers, highly regulated, offered similar products, consisting of relatively simple lifetime accumulation products with payouts given out at the time of death. Specialized policies that paid out while the patient was still alive were virtually unheard. Given the prevailing norms about cancer, policies targeting the illness were beyond the scope of imagination for the major Japanese firms. This is precisely where Aflac saw a niche to be filled.\(^\text{165}\)

Once Aflac decided to enter Japan, however, the approval process was time-consuming and difficult, taking two years of preparation. First, there was a bureaucratic problem in establishing communication and building interpersonal networks. MOF had two divisions for insurance, life and casualty, with industry licenses (and therefore, firms in the market) segmented accordingly, and the appropriate category for Aflac’s cancer insurance was unclear. Even after accepting Aflac’s application, MOF was cautious and slow in granting approval. Although several newspapers, based on information from insiders close to the deliberations, carried stories that MOF approval was imminent, the approval was not forthcoming. The US headquarters, taking this delay as an indication that permission would be denied, decided to abandon the plan.\(^\text{166}\)


\(^{166}\) Kishi, Kenshou Gaishikei Kijyuu: Nihon Ni Okeru Seikou Senryaku [Evaluating Foreign Firms: Successful Strategies in Japan], 24-42.
At this juncture, the Japanese negotiator who had spent years preparing the application and visiting MOF took matters into his own hands. He took out a bank loan on his own after exhausting funds from the US headquarters, and continued the talks with MOF officials. MOF told him to reach an understanding with the Ministry of Health and Welfare (MHW), which was concerned primarily whether Aflac’s product would fit within Japan’s national health insurance system. (At the time, MHW was attempting to offer comprehensive health insurance coverage.) After a disagreement between several divisions within MHW, the ministry finally gave its approval.167

The next hurdle was to craft insurance contracts to be reviewed and approved by MOF. Informal interpersonal networks turned out to be of paramount importance. Sample contracts for MOF review were commonly drafted by prominent Japanese professors who were experts in the field, but Aflac found that they were all linked to existing Japanese insurers and therefore unavailable. In a creative solution, the Japanese in charge of setting up Aflac Japan visited Taiwan, which had a similar system of universities and insurance contracts as a legacy of Japan’s colonization. There they hired a Taiwanese professor to help draft the contract. Aflac finally submitted its application in late 1973.168

Following the logic of ex ante managed competition, the insurance sector was highly regulated, compartmentalized, and micromanaged by MOF. MOF turned its attention to the expected market performance of Aflac. MOF’s primary concern was whether or not cancer insurance would be a commercially successful product, since the ministry feared loss of face if it granted approval to a product that failed in the market. The Japanese in charge of setting up Aflac Japan used their informal interpersonal networks to sign up a sizable number of businesses as retailers of Aflac cancer insurance. These businesses were then mobilized to pressure MOF for approval of the application. Almost a year after submission, MOF approved the application.169

Once Aflac obtained approval in 1974, Japan’s highly regulated insurance market worked to the company’s advantage. Until 1984, Aflac enjoyed a de facto monopoly in offering a cancer insurance product, since no other insurer obtained a license for cancer insurance. Aflac’s market success was dramatic, with revenues rising from 420 million yen in 1974 to approximately 6 billion the following year, and over 42 billion in 1980. (by 2002, it was 832 billion). The company not only provided cash to patients diagnosed and treated with cancer, but also tailored its products to the Japanese market to conform to Japanese social norms surrounding cancer. It introduced options such as allowing an insured customer to have payments and correspondence delivered to a relative’s house if he or she did not want to learn of the diagnosis.

Aflac also moved to take advantage of corporate networks in addition to elite interpersonal networks. As seen in an earlier section of this chapter, Aflac’s niche product and strategy successfully took advantage of keiretsu groups, with a vast majority of companies listed on the Tokyo Stock Exchange purchasing its products.170 In plugging into elite networks, the company brought in a number of amakudari hires – former MOF and MHW bureaucrats who had been in charge of insurance, along with others from MOF and Japan Export Import Bank who were given Vice President positions. Moreover, Aflac hired division heads from major Japanese

167 Ibid.
168 Ibid.
169 Ibid., 24-42.
170 ACCJ, "Aflac."
firms such as Tokyo Life, Tokyo Marine and Fire, Tokyo Bank, TV Tokyo, and accounting offices.\textsuperscript{171} Even in the late 1980s, Aflac still enjoyed over 90\% of the cancer insurance market.\textsuperscript{172}

\textbf{Manpower: Exploiting a Regulatory Grey Area to Reveal Latent Demand}

Manpower, a US firm offering temporary workers (later known as dispatch workers), is a fascinating example of a firm that entered Japan using a regulatory ambiguity to provide services that filled a need created by Japan’s long-term employment system. Manpower first entered Japan in 1966. In contrast with Aflac, however, it was not offering a new type of existing service. Rather, it was selectively reinterpreting Japanese regulations to offer services without prior consultation with the government. According to Japan’s Employment Security Law, businesses were prohibited from supplying labor for other businesses, the only exceptions being the public employment security office and labor unions. Private job matching services required approval of the Ministry of Labor, and were limited to particular jobs, such as domestic helpers, nurses, department store food area workers, and the like.\textsuperscript{173} Therefore, strictly speaking, Manpower’s service of offering white collar office work could have been seen as blatantly illegal. Manpower carefully avoided the term “dispatch workers,” instead labeling its operations as “office work subcontracting.”

The Ministry of Labor, however, ignored Manpower's operations as they became quite popular, filling a gap in Japan’s relatively illiquid labor market. The company, fully aware of its tenuous legal position, did not engage in major advertising campaigns and expanded carefully. Manpower’s initial customers were foreign firms, but soon Japanese firms became their major clients, especially after the oil shocks of the early 1970s squeezed major corporations, which were unwilling to shed permanent workers but reluctant to expand their long term employment workforce.

Manpower actually sparked the development of an entire market in this area of regulatory ambiguity, as Japanese firms began offering competing services.\textsuperscript{174} This led Ministry-approved private job matching service providers to file a lawsuit in the public prosecutor’s office. (In addition, the Japan Communist Party’s newspaper, Akahata, vociferously protested that Manpower was illegal.) However, in 1979, the public prosecutor’s office ruled that Manpower’s business itself was not a problem, and in terms of the law, it was “grey, but extremely close to white” – in other words basically legal. The court also called for the quick implementation of a new law to erase any ambiguity. The Administrative Management Agency, also noting the rapid expansion of dispatch worker businesses, called for a new law. Reacting to

\textsuperscript{172} Ibid.
\textsuperscript{174} The included Man Friday, which commenced operations two years after Manpower, Century & Company (three year after Man Friday), Times, Temp Staff, Man Power Center, Japan Woman Staff, et cetera. Human Resources Business Forum, “History of Japan's Human Resources Dispatch,” http://www.jinzaibf.co.jp/data0307.html.
these pressures, the Ministry of Labor began a Dispatch Workers Business Problem Investigation Council.\footnote{Kishi, \textit{Kenshou Gaishikei Kigyou: Nihon Ni Okeru Seikou Senryaku [Evaluating Foreign Firms: Successful Strategies in Japan].}}

After a lengthy debate in which unions and some university professors voiced their opposition to the policy for fear that it would endanger lifetime employment, dispatch worker firms were legalized in 1986.\footnote{The Dispatch Workers Law, an abbreviation of the unwieldy Law for Securing the Proper Operation of Worker Dispatching Undertakings and Improved Working Conditions for Dispatched Workers.} In the interim, the president of Manpower’s Japan operations, Anthony Finnerty, personally toured Ministry of Labor officials to the US.\footnote{Kishi, \textit{Kenshou Gaishikei Kigyou: Nihon Ni Okeru Seikou Senryaku [Evaluating Foreign Firms: Successful Strategies in Japan].}} In 1984, eight of the larger Japanese dispatch worker firms cooperated to establish an industry association, the Japan Business Management Services Association.\footnote{Forum, "Dispatch."} Finnerty, who had studied Japanese since arriving in Japan, became the association’s first chairman. Notably, Finnerty did not attempt to mobilize the US government in applying pressure, nor did he approach Japanese politicians.\footnote{Kishi, \textit{Kenshou Gaishikei Kigyou: Nihon Ni Okeru Seikou Senryaku [Evaluating Foreign Firms: Successful Strategies in Japan].}}

\textit{Toys”R” Us: Introducing New Dynamics of Competition, Shifting Power Towards Retailers}

On the heels of deregulation that enabled large-scale retailers, major US toy retailer Toys“R”Us entered Japan with a strategy of disrupting local retail practices. By the late 1980s, Japan’s toy market was the second largest market in the world, following the US. It was also highly fragmented, dominated by small, local, mom-and-pop shops. The retail and distribution structure, not unlike that of many areas of Japanese retail, consisted of several tiers of wholesalers – a primary wholesaler that was often a subsidiary or affiliate of the manufacturer, and a secondary wholesaler acting as a regional distributor. The dynamics of competition did not revolve around prices. Manufacturers set “suggested prices,” for their products, selling them at a set discount to wholesalers. They also extended credit and generous payment terms, cushioning wholesalers in times of downswings in demand, in exchange for guaranteed distribution. Toy retailers then sold toys for the suggested retail price, in exchange for the ability to return excess inventory and receive credit from wholesalers.\footnote{Debora Spar, "Toys "R" Us Japan," \textit{Harvard Business School Cases} 796077 (1995): 3-5.}

Toys“R”Us proposed to buy directly from manufacturers and sell toys at discounted prices, bypassing the wholesaler network, and drastically reformulating the logic of competition towards price and scale.

The broader political context aided the efforts of Toys“R”Us. The US-Japan Structural Impediments Initiatives, which began in 1989 as a dialogue focusing on improving conditions for US exports and investment to Japan, pointed to the distribution system as a significant impediment to US firms. Around the same time, MITI was also interested in reforming the Large Scale Retail Law, which required builders of large stores to receive approval from MITI and a local board of consumers and retailers. This essentially provided local retailers the ability to severely delay and frustrate attempts to build large stores.
In partnership with Den Fujita, a bicultural Japanese businessman who successfully introduced McDonalds into Japan, making it the dominant fast food chain, Toys "R" Us attempted to enter Japan in 1991. Initial local opposition from areas in which it planned its first stores was predictably vocal, since, at 5000 square meters for its Niigata store, Toys "R" Us was proposing to create a toy store over 50 times larger than the average Niigata toy shop. A group of 520 small retailers created the Japan Association of Specialty Toy Shops to formulate market and political strategies to cope with the threat.\(^\text{181}\)

Once it began to expand, the US retailer grew dramatically. By 1995, Toys “R” Us was by far the largest toy retailer in Japan, with an approximately 15% market share, the first foreign retailer to reach a hundred billion yen in sales, with 64 stores in 1998.\(^\text{182}\) A report by Japan’s Fair Trade Commission in 1994 credited the store, along with other discount retailers, for increasing the level of competition in the industry, noting a shift of leadership towards retailers, with competition more based on price.\(^\text{183}\) By offering scale, the retailer had gone directly to manufacturers, and by removing wholesalers, they had shifted the terms of competition towards price rather than relational ties or credit. The entire balance of power between manufacturers and retailers had shifted.

Finally, the Japan Association of Specialty Toy Shops disbanded in 1999. With its membership decreased to 109 firms as a result of an exodus from the market and projected to shrink further, they gave up organized means to stem the tsunami.\(^\text{184}\)

**The Japanese Institutional Context Exacerbating Strategic Challenges**

The Japanese institutional context exacerbated the organizational and strategic dilemmas facing foreign MNCs. These challenges become extremely clear when we compare relatively similar MNCs that took contrasting strategies in entering and operating in Japan. Fast food and office supplies provide useful examples. While McDonald’s was a wild success, KFC’s fortunes declined as it followed headquarters more closely, and Burger King, which made fewest adjustments, was forced to exit the market a few years after entering. In office supplies, US competitors Office Max and Office Depot entered Japan around the same time in the late 1990s but took contrasting strategies. As a result Office Max exited within just a couple years, while Office Depot carved out a market position for a decade.

\(^{181}\) Ibid.: 9-11. It is worth noting that in a meeting of the Niigata Chamber of commerce, the consumer representative was in favor of approving the store, against the merchant representative. This is unlike some other prominent cases in which consumer representatives have voted against liberalization, such as in the case of agriculture Steven K. Vogel, "When Interests Are Not Preferences: The Cautionary Tale of Japanese Consumers.," *Comparative Politics* 31, no. 2 (1999).


\(^{184}\) "Nihon Gangu Senmonten Kai, Kameiten Genshou De Kaisan [Japan Specialty Toy Stores Association Disbanding Due to Reduced Membership]," *Nihon Keizai Shimbun*, June 27 1999.
**McDonald’s: Successfully Adapting Core Business Models**

McDonald’s was a runaway success in Japan. It dominated the restaurant industry, and was one of the largest MNCs in Japan according to income, as seen in Chapter 1. Much of its success is attributed to a departure from many aspects of its US business model. McDonald’s entered Japan in 1971, with a Japanese entrepreneur, Fujita Den as its joint venture partner. At the end of 1971, the chain had 5 stores with sales of two hundred million yen, growing in 2000 to 3598 stores and sales of 430 billion yen – the largest sales in its sector for 19 years. At the behest of Fujita, McDonald’s departed from its core US business model of opening suburban franchises, opening its first branch in the fashionable, high-end Ginza district of Tokyo. Fujita’s plan was to sell McDonald’s as a brand and a trendy Western fashion snack rather than to aim at becoming a substitute for traditional Japanese restaurants. He is even reported to have lobbied vigorously to alter the name to McDonald (makudo narudo) so it could be more easily pronounced in Japanese. The franchise added several Japan-specific menu items, and established a high profile training center for its part time hires in order to provide high quality customer services. Even as McDonald’s slid into a symbol of low wage work and shabby interiors in the US during the 1980s and 1990s, the Japanese chain continued to expand in both urban locations as well as in suburban outlets, and kept high standards of cleanliness and service.\(^{185}\)

**KFC’s Challenge: Global Standards Leading to Poorer Performance**

KFC, likewise, adapted to Japanese conditions such as the relative lack of space and the concentration of customers near major train stations. Mitsubishi spearheaded KFC’s entry into Japan as a joint venture in 1969. The head of the venture was an American, who had hired a Japanese deputy from Dai Nippon Printing after a chance meeting abroad. After initial market testing at a local department store, they discovered local differences in taste, such as Japanese disliking KFC’s mashed potatoes (they substituted French fries, departing from the standard US menu), and reduced the sugar content from company standard-set levels prescribed for coleslaw. The initial branches in Osaka and Kobe were exact replicas of US take-out stores, and performed poorly. Like McDonald’s, KFC’s Japan branch decided to locate stores near key stations on commuter train lines rather than in suburban shopping centers. In doing so, they reduced stores sizes to half of that required in KFC’s operating manual, with redesigned kitchens and equipment. Chicken piece “barrels” were reduced from 21 pieces to 12. By 1973, KFC had expanded to over 60 stores.

From the early 1980s, a new focus by headquarters to standardize international operations caused greater levels of friction. The American head of Japanese operations was quoted complaining of hurdles rates for real estate, operating instructions directly from American manuals, and television commercials that were inappropriate for the Japanese market.\(^{186}\) As a result, by 2000, KFC was no longer among the top 10 income Japanese restaurant chains.

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**Burger King: Strategic Failure to Adapt**

The experience of Burger King stands in stark contrast with that of McDonald’s and KFC in its early years. Burger King entered Japan in 1996 as a joint venture with Japan Tobacco. It had been in negotiations with the Seibu group from the early 1990s, but these talks had fallen apart.

Burger King’s poor choice of joint venture partner and its lack of adaptation to Japanese conditions are often cited in its failure. While it did focus on high density urban areas, Burger King required that the cooking equipment be identical to that used in the US. While McDonald’s had redesigned much of their equipment for smaller spaces, the large grills, already larger than those of McDonald’s, required more floor space in areas with high rental prices. The franchise also rolled out the same menu as in the US, with burgers that were significantly larger than those of most competitors, making no attempt to modify the product for local tastes. Of course, hamburgers themselves were not originally Japanese, but by the 1990s, virtually all other competitors offered additional items popular with Japanese. Since its joint venture was JT, it also failed to offer non-smoking areas, which were becoming increasingly popular in other domestic fast-food chains. Finally, an intense price war, during which McDonald’s lowered many of its hamburger prices, gave the impression that Burger King was overpriced, but in end, still offering fast food. As a result, Burger King withdrew from the Japanese market in 2001.

Reentering Japan in 2006, Burger King had a different joint venture partner (the Korean firm Lotte, which already operated a main stay fast food franchise). It developed several menus tailored to Lotte’s perception of the Japanese market, including different flavors (such teriyaki) and smaller burgers, and succeeded in achieving steady growth.

**Office Max vs. Office Depot – Adjusting to Japan’s Market for Office Supplies**

The experiences of Office Max and Office Depot provide an excellent contrast that highlights the importance of reading the local market. They both entered at a similar time, they had similar business models in their home markets, and faced the same Japanese market conditions. Yet, while Office Max exited in a few years, Office Depot remained for a decade.

Office Max entered Japan in November 1997 partnering with Jusco, a Japanese big-box supermarket chain focusing on suburban mega-stores. Following its US business model, Office Max was aiming to cultivate a market for small and home offices focused on suburban areas. It opened large stores in Japanese suburbs with essentially the same layout as in its US stores, with large boxes stacked high in warehouse-style shelves. Although it added approximately 3000 Japan-specific items, such as varieties of paper and writing implements, it kept the US base. Office Max discovered that the overwhelming proportion of demand for office products, even from small businesses, was closer to urban areas. Moreover, the market for home offices was far smaller than it anticipated, and some analysts contend that its warehouse-like layout was not popular with Japanese customers used to more refined interior decorations in the manner of

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187 Mitamura, *Gaishi No "Kigyo Senryaku" Ga Wakaru Hon* [Understanding the Corporate Strategies of Foreign Firms], 96-98.
188 Toshiaki Oh, "Baagaa Kingu Sha No Nihon Tettai No Haikei* [Context of Burger King’s Withdrawal from Japan]," *Inshoku Keiei* 2001.
prevailing writing and stationary stores. Office Max exited the Japanese market in January of 2000.\textsuperscript{189}

Office Depot also entered Japan in 1999. It opened its first store within a wholesaler building in downtown Tokyo, a similar size to that of the first Office Max store. It also adopted warehouse-style shelving. However, sales did not pick up, and it dissolved its joint venture with Deo Deo, a Japanese electronics chain concentrated in suburban areas. Office Depot then partnered with a major catalog retailer, and shifted to small urban stores. It opened branches in the most densely populated downtown areas such as Shinjuku, Shimbashi, and Shibuya, and focused on catalog sales. Over the course of the next decade, it expanded to 28 stores. While it suffered stiff competition in downtown areas, particularly after the sharp economic slowdown in early 2009, leading to its conversion to a mainly catalog order retailer, the chain did experience robust growth during the early to mid-2000s.\textsuperscript{190}

\textbf{CONCLUSION}

In this chapter we have seen how the distinctive institutions of Japan’s postwar model of capitalism interacted with foreign MNCs. Until the 1990s, they combined to create an environment that was particularly difficult for foreign MNCs to enter and operate. We saw how characteristics such as keireitsu networks, cross-shareholding, the main bank and convoy systems, long term employment, industry associations, and informal interpersonal networks combined to exacerbate organizational challenges facing MNCs. We then saw how shifts in the 1990s reduced many of these challenges. Through the corporate cases, we saw how different firms managed to use some aspects of Japan’s distinctive features to their advantage. However, other cases noted the challenge of doing so successfully.

Next we turn to sector-level analyses of the industries that experienced an influx of foreign MNCs. The institutional factors introduced in this chapter provide a backdrop for the specific regulatory and market contexts in the next two chapters.

\textsuperscript{189} Mitamura, \textit{Gaishi No "Kigyo Senryaku" Ga Wakaru Hon [Understanding the Corporate Strategies of Foreign Firms]}, 208-10.
\textsuperscript{190} Ibid., 212-16.

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CHAPTER 4:
MNCs and Japan’s New Financial System: Banking, Securities, and Insurance

The role of foreign firms in Japan’s financial sectors was transformed in the 1990s. The Japanese financial system itself had shifted from a bank-centered model at the heart of Japan’s postwar strategic development to a more financial market-centered model. Market dynamics changed, new products and new business models became possible, and new actors rose to prominence.

This chapter and the following take the analyses to the sectoral level. What was the sectoral context in which the influx of foreign firms occurred? To what degree did foreign MNCs drive the changes that enabled the influx? Did firms enter Japan to take advantage of existing arrangements, or to defy them? Answers to these questions not only set the stage for the political analysis of insider and outsider political strategies, but they also contribute to scholarship focused on understanding how advanced industrialized countries change over time.

Regulatory shifts over the course of the 1990s and early 2000s fundamentally altered the environment confronting foreign MNCs in the financial sectors. There, regulatory shifts were part of Japan’s shift away from its postwar developmental state. Several of the incremental regulatory shifts up until the 1990s were influenced by foreign MNCs, but the major changes in the late 1990s resulted from domestic politics – the political dynamics stemming from the bursting of the bubble economy, the prolonged economic stagnation, and the banking crisis. Foreign financial firms entered and expanded in Japan rapidly by taking advantage of the new regulatory structure that allowed their global products and competencies to be deployed in the Japanese market. Finally, the overall regulatory shifts from ex ante managed competition to ex post competition governance created new opportunities for firms to mount disruptive policy challenges (as seen in Chapter 6).

In this chapter I argue that until the 1990s, foreign firms gradually expanded their presence as the financial sectors were slowly deregulated as a result of foreign pressure combined with domestic reform agendas. From the late 1990s, regulatory shifts enabled new entrants, new markets, new services, and new business models. Foreign firms took advantage of these opportunities, growing rapidly and dominating the most profitable market segments. As foreign firms introduced new market activities and Japanese firms adjusted, the entire dynamics of competition in the sector – what firms competed over – shifted significantly, further advantaging foreign firms. As a result, by the mid-2000s, foreign MNCs had become an integral part of core areas of Japan’s financial sectors. This expanded their clout as insiders, and increased the impact of their disruptive strategies.

From Privileged Segmentation and Gaiatsu-Entry to the Gates Wide Open

The limitations of foreign access to the financial sectors were built into the regulatory structure. In both banking and securities, and insurance sectors, the Ministry of Finance (MOF) strongly managed competition. As the core of Japan’s postwar strategic development, the “developmental state,” MOF compartmentalized the sectors into different segments, restricted
market entry, and tightly managed firms’ business models through formal licensing authority and informal administrative guidance. MOF provided an implicit guarantee known as the “convoy” system that financial firms would be rescued, usually through government-orchestrated mergers, in exchange for tight control and cooperation with the government’s investment objectives. Foreign firms were compartmentalized in a particular segment, but protected from major Japanese financial institutions – an arrangement I call “privileged segmentation.”

In addition to the restrictions on foreign firms built into the regulatory structure, the prevailing dynamics of competition shaped by the regulatory framework did not advantage firms’ global competencies. Proprietary, Japan-specific dynamics of competition focused on achieving volume rather than profitability, and a variety of institutional factors, such as long term relations among keiretsu networks, and made it difficult for foreign firms to compete according to the logic of competition in the Japanese markets – as seen in the previous chapter.

The market entry strategies of foreign firms during the periods of “privileged segmentation” mostly took two forms. They involved gaiatsu, exerted through foreign governments, and taking advantage of regulatory loopholes, often with Japanese business allies. These entry strategies helped establish the “privileged segmentation” arrangements in some cases, and began to erode them in others – mostly as new entrants tried to enter the Japanese market, or as foreign firms attempted to move into more lucrative market areas.

The major regulatory shifts beginning in the mid-1990s and accelerating in the late 1990s with Japan’s Financial Big Bang reforms flung the gates wide open to foreign firms. No longer did they need to employ gaiatsu or exploit loopholes to enter Japan. With the removal of most direct restrictions on foreign operations, compartmentalization of the sectors, and licensing requirements, foreign firms were free to introduce new products and new business models. Large Japanese financial institutions were slow to adjust, due to organizational constraints such as long-term employees, long-term customer relations, their previous focus on volume, and their lack of experience with IT-intensive products and business models prevalent in global markets. This lag enabled foreign firms to carve profitable market niches, and to enter tie-ups to provide major Japanese financial firms with new products, enabling the MNCs to grow rapidly. Moreover, as Japanese financial sectors entered into crises in the late 1990s with a wave of bankruptcies and firms on the brink, foreign financial firms took advantage of M&A opportunities.

The chapter is divided into two sections: banking and securities, and insurance.

I. BANKING AND SECURITIES: TRANSITIONING AWAY FROM THE DEVELOPMENTAL MODEL

The transformation in the role of foreign financial firms in Japan was integral to a fundamental shift in Japan’s postwar economic model. During the heyday of the high growth era, when the government strongly shaped the investment allocations in the economy, the activities of foreign financial firms were tightly restricted and rigidly compartmentalized. Since the government’s ability to shape Japan’s investment profile hinged on its ability to informally manage a bank-centered financial system, the influence of foreign firms was kept at a minimum.

As Japan transitioned away from its strong, developmental, bank-centered financial system starting in the 1980s, however, opportunities for foreign firms increased. In most cases, they still needed to struggle – pound on the castle gates – by mobilizing gaiatsu or domestic allies, to enter and expand in profitable growth areas such as securities and trust banking.
In the 1990s, however, Japan’s postwar economic model was viewed as experiencing a full-blown crisis. Regulatory shifts reduced entry barriers and altered the dynamics of competition. As the banking crisis unfolded, the gates opened, welcoming foreign entry. Foreign financial firms entered and expanded en masse, aggressively introducing new products and services. Foreign entrants increased the complexity of the sector and realigned the relative strength of financial firms.

**The Early History of Foreign Banks in Japan (1860s-1930s): Establishing a Modern Banking Sector**

Foreign banks played a critical role in Japan’s efforts to industrialize and build a modern economy. From the mid-1800s through World War II, foreign banks were an integral part of Japan’s links with the international economy; they provided external financing for infrastructure, foreign currency services, and helped the Japanese government raise funds abroad. During this period, banks worked closely with the government, though they were not insiders in the political process.

The first wave of foreign banks that entered Japan in the early 1860s were mostly European banks emerging out of colonial ventures in Asia. Until the rise of Japanese banks in the 1890s, these European banks monopolized foreign exchange markets and dominated trade financing. They contributed to the Tokugawa and Meiji governments’ ability to purchase arms by providing loans and foreign currency. They also contributed to the Meiji government’s rapid construction of national infrastructure such as railroads by providing the expertise to allow the government to issue bonds. Finally, the Oriental Bank Corporation, a British colonial enterprise, was hired by the Meiji government to build and operate Japan’s first currency printing operation. The bank worked closely with the Japanese government, hiring foreign experts to train Japanese staff as it established modern currency operations.

International and domestic conditions led to a demise of the first wave of foreign banks. A second wave replaced the early colonial banks, which left Japan or went out of business by the turn of the century. Internationally, increased competition among colonial banks and the dynamics of Europe’s shifting power relations led to reduced profitability for many of the colonial ventures. Domestically, the rise of Japanese banks reduced foreign business opportunities for domestic business.

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193 Ibid., 52-64.

194 Figures are sparse, but in 1876, foreign banks held a total of 39 million dollars in assets, while Japanese banks held 35 million. By 1911, however, foreign banks’ held only 1.1% of the amount of deposits held by Japanese banks, and the total foreign bank lending amounted to 2.5% of that of Japanese banks. Ibid., 104.
The Japanese government gained regulatory authority over foreign banks in 1899, when it successfully renegotiated many of the “unequal treaties” with Western powers. Between 1899 and World War I (1914), the second wave of foreign banks entered Japan. Among the various American, German, and Chinese banks, a notable entrant included International Bank, the precursor to Citibank, the first American bank to enter Japan, in 1902.

This second wave of foreign banks facilitated Japan’s becoming a creditor nation after World War I, as its exports soared. Banks did so by issuing yen-denominated bonds from France, Russia, and Great Britain, which were purchased by the Japanese government. As the United States emerged as a major economic power, the American Express Bank (1917) and Park Union Bank (1919) set up operations in Japan.

As Japan moved towards militarization, foreign banks were generally interested in maintaining good relations with the government. The precursor to Citibank (International Bank was absorbed by National City Bank in 1916) was especially active in embedding itself in local arrangements, with other banks often following its lead. In 1923, National City Bank became the first foreign bank to begin promissory note transactions with the Bank of Japan (BOJ), and in 1937, it joined the Tokyo Deposit Interest Treaty. In 1938, it spearheaded foreign banks’ cooperation with BOJ’s efforts to concentrate foreign exchange reserves in the BOJ. During World War II, however, banks from the Allied countries were forced to cease operations.

After the war, foreign banks, mostly American, played an early role in reestablishing Japan’s financial links with the world. In 1946, immediately following surrender, with the Japanese government controlled by Allied Occupation government (SCAP), National City Bank applied to reopen its Japanese branches. By 1947, eight foreign banks were licensed to operate in Japan, though mostly restricted to dollar transactions involving the SCAP government and Occupation troops. From 1949, SCAP increasingly began to hand over portions of banking regulation to the Japanese government, culminating in the 1952 peace treaty, when Japan regained full sovereignty.

**FOREIGN BANKS IN THE EARLY POSTWAR PERIOD (1950 – LATE 1960S): PRIVILEGED SEGMENTATION**

In the early postwar period, coinciding with the heyday of government-led credit allocation into strategic industries, foreign banks were confined to a particular market segment. The market segment was privileged, however, in that it was protected from competition with the large Japanese banks—an arrangement I call “privileged segmentation.”

After Japan regained its sovereignty, the government established its postwar regulatory regime of ex ante, managed competition. MOF compartmentalized the sector into segments such as city banks, regional banks, and long term credit banks. It limited new entrants in each,

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195 The relative power of foreign banks in Japan was also influenced by international events, since the German bank suspended its operations, and the Russian Revolution undermined the position of the Russian bank.
196 Interestingly enough, a German bank actually opened a Japanese branch in 1943..
198 This is an integral part of what economist Yukio Noguchi has termed the postwar Japanese political economy as the “1940 system.” Yukio Noguchi, "The 1940 System: Japan under the Wartime Economy," *The American Economic Review* 88, no. 2 (1998).
controlled interest rates and branch licenses, and shaped investment destinations through a mix of administrative guidance financial incentives. This investment targeting was at the core of Japan’s postwar era of rapid economic growth. The government selected strategic targets for investment, defying Japan’s comparative advantage at the time – capital-light, labor-intensive industries such as textiles. Instead, it channeled investments towards more capital intensive but growth-driving sectors such as heavy industries of steel and shipbuilding, others such as petrochemicals, automobiles, and later, high tech sectors.

It was in this regulatory context that MOF limited foreign banks to particular market segments. In the early 1950s, these included trade financing and foreign currency-related activities. Later that decade, they expanded to include impact loans – medium-term foreign currency loans to Japanese firms. MOF actively protected the foreign banks from Japanese competitors, using administrative guidance to restrain the latter’s attempts to enter these segments. Since MOF restricted new entry into the foreign segments as well, the level of competition among foreign banks remained more or less steady, with the number of foreign banks in Japan only increasing from 12 to 15 between 1951 and 1967. Thus, although largely excluded from domestic policy processes, the foreign banks enjoyed their profitable market niches and did not actively press for change.


From the late 1960s, policy changes and external political pressure mobilized by new entrants eroded the arrangement of privileged segmentation. With Japan’s accession to the OECD and IMF, the Japanese government was under pressure to license more new entrants. As a result, the number of foreign banks more than doubled in seven years, from 15 in 1967 to 22 in 1971, and 33 in 1974. The increased level of competition among foreign firms in their market segment eroded the banks’ profitability

Another wave of foreign entrants mobilized gaiatsu pressure to gain entry into the Japanese market from the mid-1970s. The desire of Japanese banks to expand abroad starting in the early 1970s provided leverage for foreign banks, which lobbied their governments to demand reciprocal access into Japan. European governments in particular used this leverage, insisting on reciprocity when allowing access to Japanese banks. As a result, a deluge of foreign banks entered Japan in the 1970s, almost doubling the number of foreign banks between 1974 (33) and 1980 (64). (See Table 19, Table 20)

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199 A special but important early example was the financing of oil imports. In 1950, the three American banks were given exclusive rights to finance oil imports, which had been prohibited until then. Tatewaki, *Gaikoku Ginko to Nihon: Zainichi Gaigin Hyaku-Yonjunen No Kobo*, 160-61.


201 As the oil shocks caused international credit to tighten, Japanese firms began having difficulty raising funds, leading banks to accelerate their expansion abroad. Ibid., 19-22.
Table 19. Number of Foreign Banks and Branches in Japan – Decade Averages, 1904-1970

<table>
<thead>
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<th>Decade</th>
<th>Avg # Banks</th>
<th>Avg # Branches</th>
</tr>
</thead>
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<td>13</td>
</tr>
<tr>
<td>1911-1920</td>
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<td>34</td>
</tr>
<tr>
<td>1961-1970</td>
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<td>35</td>
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Table 20. Number of Foreign Banks and Branches in Japan, 1970-2003

<table>
<thead>
<tr>
<th>Year</th>
<th># Banks</th>
<th># Branches</th>
<th>Year</th>
<th># Banks</th>
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<td>82</td>
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<td>1989</td>
<td>83</td>
<td>121</td>
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</tbody>
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Source: Ibid.

Despite the increased foreign bank presence in Japan by the late 1970s, their political influence within the Japanese system was limited. Their political strategies varied, their actions lacked unity. While some wished to create an industry association that could lobby MOF directly, others feared that MOF would use such an association as a vehicle for repressive administrative
Large American banks took the view that their own channels of communication with MOF better served their particular positions; they preferred to go it alone. Some banks wanted to lobby their home governments to pressure Japan. The majority, however, either were not interested, or did not know how to become involved in Japanese political processes. The Japanese banking industry association at the time also prohibited foreign entry.

A great deal of the external government pressure on Japan on behalf of banking was not actually the direct result of bank lobbying. Broader trade balance, currency, and balance of payment concerns by the US and European Commission pulled banking into the debate. The end result was a setback to foreign banks’ market positions. In 1978, the Financial Institutions division of the EC Commission and a US Congressional task force came to Tokyo and met with MOF and BOJ. Though not responding to direct lobbying by US banks, the “Jones Report” published by the US task force contended that Japan’s regulatory treatment was discriminatory towards American banks, therefore inhibiting broader US exports. The US Congress and Treasury went further, adding calls for revaluation of the yen. The Japanese government responded by allowing foreign testimonials in the newly created Financial System Review Council. This deliberation council was primarily focused on domestic financial reform issues, but it did call upon representatives of firms such as Bank of America and Deutsche Bank to testify about their regulatory treatment. The banks contended that tacit discrimination did indeed occur. The council’s final report, however, noted that there was no discrimination, and that the foreign governments’ criticism was simply a function of the falling profitability of foreign banks.

Ironically, this call for equal treatment by foreign governments led to regulatory shifts that ended some of the protection of foreign market segments. MOF ended the administrative practice of prohibiting Japanese banks from entering the market for impact loans. Aggressive small Japanese banks immediately entered, reducing foreign banks’ share of the impact loans to less than 50% by 1981. Not all deregulation hurt foreign banks though, since the relaxation by MOF and BOJ of branching and retail deposit restrictions allowed foreign banks into the consumer finance market – a market segment with lower prestige than mainstream retail deposits.

Despite losing privileged access to select markets, protection of foreign banks did not end entirely. The new Banking Law of 1981 formalized some measures of preferential treatment, exempting foreign banks from strict capital/asset limits and from government bond underwriting obligations, while granting generous CD limits. The Japanese government formalized the principle of reciprocity, enabling increased foreign access in exchange for furthering the strategic goal of promoting Japanese banks’ overseas expansion.

As the removal of protection and increased competition decreased the profitability of foreign banking operations, foreign financial firms shifted their attention to areas offering greater potential profits. In attempting to enter these new areas, foreign firms mounted political strategies of gaiatsu and exploited regulatory loopholes.

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204 Ibid., 28-34.
205 Ibid., 37-39.
POUNDING ON THE CASTLE GATES: SECURITIES AND TRUST BANKING (MID-1980s)

Securities and investment management (trust banking) became the new areas that foreign financial institutions sought to enter from the early 1980s, as their focus moved away from banking. Partnering with Japanese firms, they used gaiatsu and exploited regulatory loopholes to pry open the markets.

In the securities market, challenges to the regulatory regime by foreign banks, combined with gaiatsu that leveraged Japanese firms’ desire to expand abroad, resulted in the removal of tight restrictions on foreign entry.

Citibank spearheaded the initial foreign entry into Japan’s securities market with a challenge to the regulatory regime. In 1983, Citibank gained control of the Tokyo branch of a London stock brokerage, Pickering. This violated Japan’s Securities and Exchange Act, which prohibited banks from engaging in securities market activities. After three months of internal debate, MOF approved the deal on an “exceptional basis.”\(^{206}\) The approval occurred during the time in which yen-dollar exchange rates were being renegotiated, culminating in the Plaza Accord of 1985, in which the five governments of the US, Japan, France, Great Britain, and West Germany agreed to devalue the dollar – a particularly sensitive international political juncture that may have precipitated a more conciliatory stance. Regardless, MOF’s approval encouraged others, both foreign and domestic, in attempts to pry open the gates further.

At about the same time, the overseas expansion of Japanese banks and securities brokerages provided the impetus for foreign firms to mobilize gaiatsu to enter Japan. In 1984, Sumitomo Bank purchased a Swiss securities firm, crossing the line between banking and securities, which was strictly prohibited in the Japanese market. Although harboring misgivings, MOF granted permission. This led Swiss and German banks to immediately request reciprocal entry to Japan’s securities market. MOF denied permission, however, leading the European banks to appeal to their home governments. The same year, there were a series of regulatory entanglements arose, with Japanese securities firms attempting to enter Great Britain’s banking sector. These developments led to several bilateral talks between MOF, Britain, and Germany in 1985. In the end, MOF granted permission to most foreign financial firms wishing to establish branches in Japan.\(^{207}\)

The castle gates had, in effect, opened. Japan experienced a flood of foreign entry, with the number of foreign securities firms increasing from 9 in 1984 to an astonishing 44 by 1987 (See Table 21).\(^{208}\)


\(^{208}\) Ibid., 57-58.
In trust banking, a partnership between foreign and Japanese financial firms took advantage of a regulatory loophole to open the market to new entrants. Trust banking seemed attractive the massive amount of assets held in Japan’s corporate pensions were managed by a handful of trust banks and life insurance companies, whose investment opportunities were limited by regulations. In the early 1980s, entry into trust banking was strictly controlled, and foreign firms (along with other Japanese financial institutions) were prohibited access. Morgan Guaranty and Nomura Securities took the lead in fighting to open the gates. The two used a regulatory loophole in the market segmentation, proposing to MOF that they enter trust banking via a new joint venture. Citibank, Chemical Bank, and Bank of America quickly followed their lead, partnering with Japanese firms to propose establishing new joint venture trust banks. MOF, fearing the potential loss of its control over interest rates, and uneasy about letting securities firms into the trust banking business, informally rejected these proposals. Incumbent Japanese

BOJ released a position paper around this time, contending that there was no legal basis to prohibit US banks from entering independently, but that the effects on the trust banking market should be carefully considered. It took a cautious stance against joint ventures involving Japanese securities firms, since this was tantamount to breaking down the separation between banking and securities.

trust banks, claiming that the sector was not strong enough to withstand increased competition, applauded this stance.²¹⁰

Rejection by MOF led the American banks to lobby the US government. The Treasury department pressured MOF, noting that Japanese banks were permitted to engage in trust banking in the US, contending that American firms should enjoy reciprocation. After continual meetings between MOF and interested parties in 1984, a compromise was reached. MOF licensed a small number of foreign banks to establish trust bank operations. In doing so, MOF retained the restrictions on Japanese securities firms and banks from entering the business, to the advantage of the new entrant foreign firms and incumbent Japanese trust banks. The ministry announced it would issue eight licenses, but nine foreign banks applied, and MOF’s desire to avoid further political wrangling led it to license all nine in 1985.²¹¹

THE CASTLE GATES WIDE OPEN: Deregulation and New Opportunities for Entry in Securities

In the 1990s, the opportunities facing foreign financial firms interested in the Japanese securities market shifted dramatically. Deregulation lifted most of the regulatory restrictions. It was driven by the political and bureaucratic leadership as part of a broad set of reforms to Japan’s financial regulatory framework. Leaders’ concern had shifted from foreign firms as a threat, introducing “excessive competition” to the detriment of Japanese firms, to foreign firms as part of the solution to revive the Japanese economy and recover its position as a center of global finance. In addition to lowered entry barriers, performance crises by Japanese firms provided new opportunities for foreign firms to enter into partnerships and tie-ups with the major Japanese firms, and to absorb personnel and grow organically.

The Financial Big Bang reforms considerably lowered the formal entry barriers into securities-related market areas. First, after 1998, new entrants into the securities business were required only to register with the government rather than apply for a license. Moreover, requirements that securities firms specialize in particular areas were lifted. Several foreign brokerages took advantage of this deregulation to enter the securities market, including Charles Schwab, Signa International, American Express, Bank One, and others.²¹² Second, the segmentation between banking and securities was relaxed. From 1999, banks were allowed to enter securities markets through subsidiaries, and the seven major Japanese banks proceeded to do so.²¹³

Stock exchanges themselves were also subject to deregulation, to the point that a foreign firm could spearhead the establishment of a whole new stock exchange. In 1998, the requirement

²¹¹ In this decision, Pauly argues that MOF used gaiatsu (the US as a scapegoat to foster its own agenda), to prevent politicians from intervening in banking policy, and that they were convinced that foreign control of the market would be limited. (Ibid, ———, Regulatory Politics in Japan: The Case of Foreign Banking, 50-54.) The nine banks included Morgan Trust Bank, Japan Bankers Trust, Chase Manhattan Trust & Banking, Cititrust and Banking, Chemical Trust Bank, Manufacturers Hanover Trust Bank, Union Bank of Switzerland, Credit Suisse Trust and Banking, and Barclays Trust & Banking.
that securities trading could only occur within specified exchanges was lifted.\footnote{\textit{Tdb Report: Gyoukai Doukou 1999-1 \[Tdb Report: Industry Developments 1999-1\] (Tokyo, Japan: Teikoku Data Bank, 1999), 19.}} New markets, such as Over-The-Counter (OTC) trading, became possible. In 1999, during the US high tech boom, Nasdaq announced that it would enter Japan, forming a partnership with Softbank in June of that year. The following year, Nasdaq Japan began operations as part of the Osaka Stock Exchange.\footnote{Nasdaq eventually pulled out the joint venture in 2002, and the Osaka Securities Exchange took over its operations, renaming the market Hercules. Nasdaq had entered Japan shares of its technology companies were high, and it expanded into international markets. By 2003, it had withdrawn from all its European ventures as well.} The announcement by Nasdaq that it would enter Japan spurred competition among exchanges; the Tokyo Stock Exchange (TSE) rushed to open a similar market for start-ups and new businesses. The TSE moved quickly, rolling out its competing exchange, named Mothers, half a year before Nasdaq Japan commenced its operations.

Performance crises of Japanese firms gave foreign firms new opportunities to expand their market presences in Japan. Much of foreign securities firms’ expansion from the late 1990s was achieved through mid-career hires and college recruits. However, the collapse of Yamaichi Securities, one of Japan’s “big four” brokerages, provided an unprecedented opportunity to expand rapidly by absorbing displaced personnel. Yamaichi was the smallest of the “big four” Japanese brokerages, but was involved in an accounting scandal. It had illegally hidden massive losses and become insolvent. In 1997, Yamaichi reached an agreement with MOF to voluntarily cease operations and file for bankruptcy – a move that shocked the nation, with a memorable press conference in which the president of Yamaichi shed tears in apologizing to the employees and their families. Merrill Lynch, interested in aggressively expanding into retail operations, used this opportunity to expand rapidly. Aiming at Japan’s massive household assets, which earned little interest in domestic banks, Merrill purchased 33 of Yamaichi’s retail branches and hired about 2000 of the approximately 7500 Yamaichi employees. Revealing a shift in the norms toward foreign firms, the media mostly portrayed the US investment bank as a savior for employing many of the Yamaichi employees, in the context of rising unemployment as a major societal concern.\footnote{Over the next few years, however, Merrill Lynch was unable to make the enterprise profitable, deciding to close all but two branches by the end of 2002. Merrill Lynch lost an estimated 900 million dollars over four years, but despite closing most of its branches, reported that it retained 80% of its client assets – in effect, focusing on the top tier wealth Lawrence White, ”Asia: Is Japan Still a Tough Nut to Crack?,” \textit{Euromoney} 2007.}

In 1999, Salomon SmithBarney created a joint venture with Nikko Securities, a major Japanese player experiencing serious financial difficulties. The new joint venture, Nikko SalomonSmithBarney, was reincorporated as Nikko Citigroup in 2003, focusing on middle-size firms...
deals. Nikko Citigroup became quite successful, recording 59% of the market in equity underwriting in 2000.\textsuperscript{217}

In 2007, Citigroup purchased a controlling share of the brokerage Nikko Cordial Group, the third largest of the remaining big three, for approximately 11 billion dollars. Nikko Cordial’s reputation had been damaged in a scandal the previous year when an accounting manipulation scandal came to light – even producing talks about forcing it to delist from the stock exchange. Combined with its Nikko Citigroup operations, focused on corporate clients, this gave Citigroup a position in both retail and corporate securities.

**NEW BUSINESS MODELS – REGULATORY CHANGES ADVANTAGING FOREIGN FIRMS IN SECURITIES**

Regulatory shifts in the 1990s significantly realigned firms’ business models. The resulting dynamics of competition, aligned the terms of competition in Japan’s securities market more closely to those of global markets. Realignment advantaged foreign firms in Japan, who could utilize their business models, products, and market know-how in the Japanese market.

Until 1994, the commissions charged by securities firms in Japan for trades were strictly regulated. Just as regulated interest rates shaped banks’ business models, commission fee regulations for securities firms, combined with regulations limiting their product range, pushed business models towards achieving volume. The large securities firms amassed a large number of branches, with massive sales forces. Branching licenses, granted by MOF on a discretionary basis, were therefore critical to competition, MOF enjoyed strong leverage to compel firms to comply with its informal guidance.

The deregulation of commission fees had immediate effects on firms’ business models. The first deregulation, in 1994, only applied to trades greater than 1 billion yen. Even so, over the following three months, commission fees for these large trades dropped by half.\textsuperscript{218} In 1998, fees for over 50 million yen were deregulated. The effects were exemplified by Daiwa Securities, the second largest firm, whose commission revenue dropped by a quarter just in the following month.\textsuperscript{219} The final deregulation in 1999 removed all restrictions on commission fees. A 2001 survey conducted by the Japan Securities Dealers Association, polling the 200 largest brokerages, showed an average decline of 20% in fees from 1999 (40% for trades via phone and fax), with a decline of over 70% since the initial deregulation.\textsuperscript{220}

Multinational securities firms were less reliant on commission income than were Japanese firms, since the deregulation of brokerage fees in the US and UK occurred in 1975 and 1986, respectively. (In the US, after deregulation, firms’ proportion of income from commissions

\textsuperscript{217} This figure is by Thomson Financial Securities Data, cited by Ani Hadjian, "Nikko Salomon Logs a Stellar First Half in Japan, Which Leaves Rivals Frothing: Hat Trick in Equity, Debt and M&a Has the Talons out in Tokyo," *Investment Dealers Digest*, June 26 2000.

\textsuperscript{218} According to survey by the Japan Securities Dealers’ Association (JSDA), the commission rates trades over 1 billion yen dropped from 0.075% to 0.038% Shinhua Liu, "Commission Deregulation and Performance of Securities Firms: Further Evidence from Japan," *Journal of Economics and Business* 60, no. 4 (2008).

\textsuperscript{219} Ibid.

fell from an average of 50% in 1975 to 16.5% in 1995.\textsuperscript{221} Therefore, as Japanese brokerages, hindered by the costs of large retail branch networks, struggled to shift their business models, foreign firms were able to introduce products and business models developed in other markets into Japan. This was also facilitated by further measures that were part of Japan’s Financial Big Bang reforms, allowing new products such as derivatives and short selling in Japanese financial markets.

The advantages enjoyed by foreign firms that became effective in the Japanese market included the following. They had greater familiarity with products such as convertible bonds, quickly topping the list of trades and issuances. They were able to leverage their global footprints and experience in multiple markets to aid Japanese firms in raising equity finance abroad. Their program trading algorithms were widely deemed superior, with great flexibility and speed. With their advanced computer systems capable of conducting large basket trades (trades involving a portfolio of multiple shares and bonds) that Japanese firms could not, even major Japanese securities firms increasingly placed orders with the foreign firms. As foreign institutional investors expanded their investments into Japan, finding many shares to be undervalued, foreign firms’ global scale and close relationships with institutional investors worldwide played to their advantage. Their research analysts also offered data and evaluations to institutional investors, not traditionally a service provided by Japanese brokerages.\textsuperscript{222}

As a managing director from the securities branch of a European bank put it, foreign investment banks had advantages in: product innovation; an industry-wide rather than national perspective; better technology (IT systems); faster execution of deals; and risk appetites in different places – Japanese firms were much more aggressive towards highly rated firms, while foreign firms used their own methodologies. The main disadvantage of foreign firms was their lack of long term relationships with major Japanese investor firms.\textsuperscript{223}

The regulatory shifts that realigned business models and dynamics of competition in Japan’s securities market came on the heels of a marked ebb in the reputations of domestic securities firms and the regulatory agency, MOF. The major domestic securities firms’ reputations had dropped precipitously by the late 1990s. They had already been tainted after the bubble economy collapsed in 1991, when they were found to have guaranteed institutional investors profits with cross-subsidies from smaller clients and retail customers. Brokerages were also accused of fostering “churning” – advising customers to engage in unnecessary buying and selling to earn commission fees, since commission rates had been regulated and comprised a major source of income. Scandals in the late 1990s involving payoffs to organized crime in shareholders meetings led to further disenchantment and distrust.\textsuperscript{224}

The relative advantage of foreign firms over domestic firms in business models and competencies is clearly revealed in their contrasting financial performance. (Despite the subprime bubble that led to a full-scale crisis among US firms in 2008, the advantages foreign


\textsuperscript{222} Basket trades involve placing a complex mix of orders for various shares at the same time. They were often used in the late 1990s to make it difficult to detect that major shareholders were unwinding their shares. An obvious concentrated sale of particular shares would signal the market that a major shareholder was unwinding, leading to speculation that could drive down shares, reducing the value of shares that a firms was attempting to unwind.

\textsuperscript{223} Interview with investment banker who wished to be anonymous. Tokyo, Japan.

firms enjoyed during the 1990s and early 2000s were not limited to exotic derivatives and sub-prime-related products.) In 1996, Japanese members of the Japan Securities Dealers’ Association experienced a 40% decrease in operating profits compared with the previous year, while that of foreign securities firms grew a whopping 21 fold.225 In 2000, the total operating income for the 238 domestic firms dropped 23%, reflecting a 45% drop in commission revenues, while that of the 50 foreign firms rose 33%, with revenue increasing by 44%.226

We now turn to trust banking and investment advisory services, which started as a distinct market but melded into securities-related markets as deregulation broke down barriers between market segments and as the sector became increasingly complex.

**TRUST BANKING AND INVESTMENT ADVISORY SERVICES**

The Financial Big Bang reforms removed the barriers isolating trust banking and investment advisory services from other financial sectors. Both foreign and domestic firms were permitted to offer services, and foreign financial firms faced particularly lucrative new opportunities.

After prying open the gates through regulatory loopholes and gaiatsu in the 1980s, foreign trust banks had struggled after an initial few years of profitability. The trust banking industry as a whole had been hit by the bubble bursting in 1991, and foreign trust banks had suffered as well. In 1992, for example, five of the nine foreign trust banks booked losses, with the total combined pretax losses reaching approximately 1.6 billion yen. The losses were attributed to a drop in commission income and declines in stock and real-estate prices.227

By the late 1990s, however, low interest rates and the banking crisis led to an inflow of Japanese savings assets into foreign trust banks, which had exposure to overseas markets and offered dollar-denominated investment trusts. Between 1998 and 1999, while the overall volume of corporate pension funds entrusted to the major Japanese trust banks shrank by approximately 1%, the nine foreign trust banks logged a combined increase in corporate pension fund assets of almost 30%.228 In the first half of 1998, the total assets held by foreign trusts increased by approximately 40%.229 A particularly successful dollar-denominated investment trust developed by LTCB Warburg took in 50 billion yen in its first week.230

Deregulation facilitated the entry of new firms. In 1998, regulations over new entrants shifted from an approval to registration system. The response was immediate – five of the seven new entrant trust banks were foreign.

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Deregulation also facilitated tie-ups between Japanese financial firms and foreign financial firms offering investment advisory services. In 1999, the Ministry of Health and Welfare removed most restrictions on the asset mobilization for welfare pension funds. This allowed each fund to select its own investment advisory firm and considerably broaden the range of investment products and destinations. Funds seeking higher returns rushed to find higher yielding investments overseas creating demand for tie-ups between Japanese financial institutions seeking the expertise of foreign trust banks and investment advisors.

Japanese banks, trust banks, insurers, and even securities firms were among those that sought partnerships with foreign firms. For example, Sumitomo Bank and Daiichi Kangyo Bank created tie-ups with Templeton and JP Morgan, respectively. Sumitomo Trust Bank became partners with Chase Manhattan. Japan’s largest life insurer, Nihon Seimei entered into a tie-up with Deutchebank, Yasuda Life with PaineWebber, and Yasuda Fire and Marine with Signa International. New joint ventures began appearing as well, including Prudential-Mitsui Trust Investments, Nomura BlackRock Asset Management, Meiji Dresdner Asset Management, and others.

By late 2004, a survey showed that foreign institutions took 26.5% of all shares of funds managed by domestic investment trusts, investment advisers, and pension funds, totaling 147 trillion yen. This was equivalent to the share held by the six largest Japanese trust banks. The share had risen by over 10 points from March 2000, and in 1998, the share had been approximately 7% (up by 80% since 1997).

In summary, the regulatory environment, market opportunities, and dynamics of competition facing the foreign financial firms from the late 1990s was starkly different from that of the early 1980s, when foreign firms actively attempted to pry open the castle gates. The gates were open, and foreign firms found their core competencies gained in other markets to be competitive advantages in the Japanese domestic market. We now turn to a new set of players that became active in the late 1990s – private equity and investment funds.

**INVITED INSIDE THE CASTLE TO PUT OUT THE FIRE: PRIVATE EQUITY AND INVESTMENT FUNDS**

The banking crisis of the late 1990s and the government’s abandonment of the convoy system created unprecedented opportunities for foreign investment funds. While equity investment had risen considerably during the 1990s, several foreign private equity and investment funds took a step further to take management control of Japanese banks. Four failed banks were sold to investment funds – two former long term credit banks and two regional banks. The investment funds, though raising some political concern and alarm in society, were largely regarded as saviors; they injected much needed capital and contributed management expertise to turn around the unprofitable organizations.

The first bank sold to a foreign investment fund was the Long Term Credit Bank (LTCB), a venerable financial institution that had supported Japan’s postwar recovery and growth. It had, however, outgrown its regulatory structure-shaped business model and failed to successfully transition to new business models. As a long term credit bank, it had been forbidden

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231 These figures were calculated by Cerulli Associates, a Boston-based research firm based on data from the Investment Trusts Association, the JSDA, the Japan Securities Investment Advisers Associations, and other sources.
to take retail deposits; its core function had been to extend long term loans in return for exclusive rights to issue bank debentures. The liberalization of bond and equity markets in the 1970s had made this function obsolete, and its plans to reinvent itself as a Western-style investment bank in the mid-1980s were jettisoned in favor of pursuing easy profits from the bubble economy in the late 1980s. After the bubble burst, LTCB was saddled with a large and growing portfolio of nonperforming loans. Despite restructuring, downsizing, and an attempted tie-up and buyout deal with Swiss Bank Corporation and Sumitomo Bank, LTCB was unable to recover or sell itself off. Even after a government injection of 170 billion yen in early 1998, it became insolvent, and was nationalized in October of that year.\footnote{Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism, 179-81. The government had agreed to grant “Cancellation rights” by which the bank could sell back loans to the government for three years if the value dropped by over 20 percent.}

While the government preferred to sell LTBC to a bank rather than an investment fund, they were open to selling it to a foreign firm. They were keen to avoid sustaining the convoy system approach, in which they would have facilitated a takeover by Dai-ichi Kangyo Bank or the Industrial Bank of Japan, major banks with historically close ties to LTBC. Among the bidders, the one deemed most serious was Ripplewood, a Texas-based investment fund with powerful political connections that included Bill Clinton and the chairman of the Mitsubishi Corporation.\footnote{Other bidders included American Bank JP Morgan, French financial firm Paribas, which the government deemed as not serious bids. Mitsui Trust was the only interested domestic firm, but it was weak and troubled, and its bid was interpreted as its inability to say no to the government’s probe about whether or not it was interested. Gillian Tett, Saving the Sun: A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown (New York: HarperBusiness, 2003), 149-53.} Former chairman of the US Federal Reserve Paul Volker was an advisor to Ripplewood, meeting with senior LDP politicians including former Prime Minister and then Finance Minister Kiichi Miyazawa, head of Japan’s Financial Supervisory Agency Hakuo Yanagisawa, and governor of the Bank of Japan Masaru Hayami.\footnote{Ibid., 145-55.} LTBC was sold to Ripplewood Holdings in March 2000 for approximately 121 billion yen. Renamed Shinsei Bank, the restructured bank began operations in June 2000.

The second bank to be sold off to an investment fund was Nippon Credit Bank (NCB), the smallest of the three long term credit banks. NCB was also nationalized in 1998 after a series of scandals and a failed government bailout.\footnote{In 1997, when NCB, the smallest and weakest of the three credit banks, teetered on insolvency, the government orchestrated a bailout. A senior MOF official in the Banking Bureau summoned around 40 executives from banks and insurance companies to the ministry and urged them to save the financial system from instability by purchasing newly issued shares of NCB. MOF committed itself to inject funds as well, giving the companies an estimate of 700 billion yen of risky loans held by NCB. 34 financial institutions ended up contributing a total of 210 billion yen, with MOF injecting 80 billion yen. This MOF-orchestrated bailout became a political scandal the following year when NCB became insolvent. The government nationalized NCB in December 1998, resulting in a total loss for the firms that contributed to the bailout. Contention revolved around the revelation that NCB had understated the level of its bad loans by almost 60%, with the actual levels closer to 1.12 trillion rather than 700 billion yen. Contributors to the bailout accused the government of misleading them, and the DPJ seized the political initiative, taking an active role in investigating the government’s involvement during sessions of the Diet’s Budget Committee. The MOF Banking Bureau chief at the time, as well as leaders of bailout participants were summoned to hearings. In these hearing, the MOF Banking Bureau director confirmed}
firms in 2000, led by Softbank and supported by trading firm Orix, and others. The consortium renamed the bank Aozora, and it began operations in September 2000.\footnote{The first president appointed by the Softbank consortium on September 4, 2000 committed suicide just over two weeks later. Tadayo Homma was a former Bank of Japan official and he was found on September 20th in an Osaka hotel room with a suicide note. "President's Suicide Leaves Burdened Bank," \textit{The Nikkei Weekly}, September 25, 2000 2000.}

In 2002, however, the largest Japanese investor, Softbank, decided to sell its share in the bank, having incurred heavy losses when the IT bubble burst in 2001. In a private sector bidding, Cerberus, a politically well-connected US investment fund, won over others including GE Capital, Germany’s Hypovereins Bank, and Sumitomo Mitsui Banking Corporation.\footnote{Some contended that SMFG’s bid was urged by the government in the first place. "Editorial: Aozora Bank Deal Worrying," \textit{The Daily Yomiuri}, April 15 2003.} While a revision of the Banking Law in 2002 gave FSA the final say in equity interests in banks of 20\% or larger, it did not block the investment by Cerberus.\footnote{"Strict Fsa Rules Stymie Aozora Bank Suitors," \textit{The Nikkei Weekly}, June 17 2002, "Foreigners Eye Shares in Aozora," \textit{The Nikkei Weekly}, January 14 2003.}

The sale of Aozora to a foreign investment fund had political support. While some LDP members raised their concerns, reformist Prime Minister Koizumi and Heizo Takenaka, the economic reformer appointed by Koizumi to take charge of financial, economic, and fiscal policy, had no qualms. Takenaka actively encouraged foreign participation in Japan’s banking sector reforms; he contended this would provide better assessments of bad loans while focusing on profitability. In his view, foreign firms were valuable allies in reforming Japan’s financial system – he was, to extend the castle metaphor, “inviting them in to put out the fire.”

Two failed regional banks, Tokyo Sowa Bank and Kofuku Bank, were sold to US private equity funds Lone Star and a partnership led by WL Ross & Co, respectively. Initially,
Tokyo Sowa was to be sold to a set of investors led by WL Ross & Co in July 2000.\textsuperscript{239} In December of that year, however, WL Ross canceled the purchase due to concern over his firm’s liability in a lawsuit filed against the bank’s former management; the investors had failed to reach an agreement with the government concerning provisions against potential losses from the lawsuit.\textsuperscript{240} In January 2001, Lone Star won the bid against Shinsei Bank, Orix, and the Cerberus Group. Loan Star had promised a long-term commitment, and the government deemed its bid would require less public money (The Deposit Insurance Corporation would inject approximately 700 billion yen into the bank, with Lone Star capitalizing the bank to at least 40 billion yen).\textsuperscript{241}

Kofuku Bank, a second-tier regional bank based in Osaka, became insolvent in May 1999, and was placed under government management shortly thereafter.\textsuperscript{242} It had sunk in scandal, with the management eventually arrested for illegal unsecured loans. In May 2000, a partnership led by WL Ross & Co, which had created a fund called Nippon Investment Partners, was chosen to purchase the bank. It invested 30 billion yen while the government absorbed approximately 730 billion yen of the bank’s bad loans in exchange for guarantees that the bank would retain approximately half of its 2000 employees and 81 of its 123 branches.\textsuperscript{243}

**NEW MANAGEMENT, NEW BUSINESS MODELS AT FOREIGN-REFORMED BANKS**

Under the new management installed by the private equity and investment funds, the banks drastically altered their business models.

Shinsei Bank departed sharply from its own past practices as well as the predominant norms of Japanese banking. Strategically, Shinsei Bank reoriented itself away from relational banking, which had prioritized volume over revenue. The new management team was led by Masamoto Yashiro, whose previous careers included a foreign oil company and Citibank, restructured the traditional centralized, hierarchical corporate structure by flattening and decentralizing it. New employees and teams were brought in to build retail banking and invest banking arms, many from other foreign financial firms operating in Japan such as Citigroup, Lehman Brothers, and Bear Stearns. The traditional, centralized IT system from Fujitsu was

\textsuperscript{239} W.L. Ross had managed a private equity fund under Rothschild in the late 1990s, and left in 2000 to set up his own fund, WL Ross & Co.


\textsuperscript{241} The Financial Supervisory Agency had given the bank one week to submit a recovery plan, including drastically scaling-down business, raising capital (its capital adequacy ratio was 0.5%, well below the 4% required for domestically operating banks. Kofuku bank had asked the FRC for 60 billion yen of public funds. Makoto Sato, "Kansai Bank Handed Deadline to Reform," *The Nikkei Weekly*, May 17 1999. The scandal broke when it was revealed that FRC chairman Hakuo Yanagisawa, along with two other prominent LDP politicians, had received political donations between 500,000 and 1 million yen from the former president of the bank "Kofuku Bank Donated Money to Frc Head," *The Daily Yomiuri*, September 11 1999. Tokusuke Egawa, the former president, was already facing charges for extending illegal unsecured loans to a real estate company owned by his family. Three Egawas, the former president, former vice president Benji Egawa, and former managing director, Tokuaki Egawa, were arrested, as were the presidents of the real estate company. "Kofuku Bank Ex-Executives Rearrested," *The Daily Yomiuri*, October 7 1999.

overhauled by a team of Indian IT specialists who adopted a modular server architecture, replacing Fujitsu terminals with low cost Dell PCs. Yashiro demanded better risk assessment and monthly revenue data, which LTBC had neither quantified rigorously nor collected frequently.\textsuperscript{244}

Culturally, Shinsei departed from longstanding Japanese norms and banking practices. It implemented a two-tiered compensation scheme. “Permanent staff” enjoyed higher job security but lower pay, while “market staff,” mostly mid-career hires and foreigners, received higher pay in return for lower job security. Women were allowed to apply for and given managerial posts, a departure from previous norms. Almost one hundred Indian staff, mostly to revamp the IT system, and who spoke little or no Japanese, began appearing in the workplace. The bank also hired a consultant to build bridges between corporate relationship managers and product specialists; the former were tasked with explaining to longstanding clients how Shinsei was shifting to a price-based model based on risk assessment, and the latter focused on promoting particular products and making quick deals.\textsuperscript{245}

The second most drastic shift occurred at Tokyo Star Bank, the former Tokyo Sowa Bank resuscitated by Lone Star. Installing a young American as president, Tokyo Star Bank jettisoned previous operating manuals, replaced the IT system using primarily Indian engineers located in Tokyo and Bangalore, and shifted workflows (PCs, email, and spreadsheets were introduced to all employees for the first time.) Branches were reorganized to provide a consumer-friendly space, and some new products, such as deposit-linked mortgages, were introduced.\textsuperscript{246} Tokyo Star Bank took mid-career hires for foreign currency deposits and investment trust operations, in which it lacked expertise, and introduced outside personnel in marketing and public relations departments. It also introduced performance-base salaries.\textsuperscript{247}

Kofuku Bank, renamed Kansai Sawayaka Bank by WL Ross & Co, transitioned away from the standard practices of regional banks, which had emphasized historical ties with customers. The bank, began operations in February 2001, and with the help of the Boston Consulting Group, it focused on retail loans to small-medium businesses in the Kansai area. It partnered with a consumer loan company and became the first mainstream bank in the region to offer unsecured loans at higher interest rates (5-14%) – a niche previously reserved for the consumer finance market segment.\textsuperscript{248} It reduced the number of branches and implemented new employee incentives such as stock ownership and stock options.\textsuperscript{249}

The reforms at Aozora, most of them before Cerberus took over, were significant, but less dramatic than those undertaken by Shinsei or Tokyo Star. Aozora’s restructuring relied on ties with its owners and established partners: in overhauling and operating its IT system, Aozora contracted Hitachi, with which it had a longstanding relationship; Aozora launched an online

\textsuperscript{244} Tett, Saving the Sun : A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown, 197-204.

\textsuperscript{245} Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism, 182-83.

\textsuperscript{246} Tim Clark and Carl Kay, Saying Yes to Japan : How Outsiders Are Reviving a Trillion Dollar Services Market (New York: Vertical, 2005), 44-46.

\textsuperscript{247} "Foreign Funds Changing Regional Banks," The Nikkei Weekly, September 2 2002.

\textsuperscript{248} "Kansai Sawayakai Bank Focused on Unsecured Loan Business," The Nikkei Weekly, April 15 2002.

consultancy on M&A run jointly with Softbank Orix, and Tokio Marine & Fire. Aozora also formed ties with California-based Silicon Valley Bank, specializing in startup firms. The turnaround in performance of these banks was significant. In most cases, the foreign owners exited at a substantial profit.

Shinsei recorded net profits of 61 billion yen in 2002, the same year that Japan’s largest banks recorded major losses. Shinsei went on to list itself on the Tokyo Stock Exchange in February 2004, in an IPO that raised 220 billion yen for the Ripplewood-led investors, which sold one third of their stake – a significant return on their initial 121 billion yen investment. After its IPO, Shinsei’s profits continued to grow, driven by its investment banking division, until the global financial crisis of 2007-2008.

Tokyo Star Bank earned approximately 11 billion yen in its fiscal year ending March 2003, a 60% rise from the previous year. The year before that, in the fiscal year ending 2001, the bank had written off over 200 billion yen in losses. The bank went public in October 2005, reportedly giving Lone Star over 230 billion yen in profits. Tokyo Star was then acquired by a Japanese investment fund, Advantage Partners, who bought out Lone Star’s remaining 68% stake for slightly over 250 billion yen. Given Lone Star’s initial investment of 40 billion yen, this was hailed as a successful exit.

Finally, the exit option of WL Ross & Co was to sell Kansai Sawayaka Bank to the Bank of Kansai in 2003 for an undisclosed sum.

CONCLUSION: BANKING AND SECURITIES

Japan’s banking and securities sectors were transformed during the 1990s, with regulatory shifts providing the opportunity for foreign financial firms to rise to prominence in the sector. The regulatory shifts were the final stage in Japan’s transition away from its postwar model of rapid growth, with its strategic capacity centered on the banking system. During the rapid growth era, foreign banks, which potentially threatened the ability of the government to exert its influence, were compartmentalized in a privileged market segment. Over time, as Japan’s strong strategic orientation was gradually weakened, partly due to Japan’s entry into the international trade system and partly due to the development of global non-bank financial markets. During this period – the 1970s and early 1980s – foreign MNCs entered newly liberalized Japanese financial markets such as trust banking and securities, through strategies of gaiatsu and exploiting regulatory loopholes with Japanese partners.

In the 1990s, the regulatory overhaul following the bursting of the bubble economy, Japan’s prolonged economic stagnation, and looming banking crisis, led to a vast opening of

opportunities for foreign firms. The regulatory shift towards ex post market governance, centered on the Financial Big Bang reforms, enabled new entrants, new business models, new services, and new products. Foreign financial firms’ business models and technologies became competitive in the Japanese market. Moreover, the government’s abandonment of the convoy system provided takeover targets for private equity funds.

II. INSURANCE: THE RAPID TRANSFORMATION OF MAJOR PLAYERS

Insurance, also a key part of Japan’s postwar strategic model of development, was transformed in the 1990s. Regulatory shifts towards ex post competition management, combined with demise of the convoy system and the breakdown of compartmentalization from other financial sectors, led to vast new opportunities for foreign insurers. As new regulations enabled new entrants, new business models, and new insurance products, foreign insurers were quick to seize substantial portions of the market while their Japanese counterparts struggled to adjust. Moreover, government’s abandonment of the convoy system led to a wave of bankruptcies and crises, providing foreign insurers with unprecedented opportunities for M&A and expansion.

The history of foreign involvement in Japan’s insurance sector followed a broadly similar trajectory to banking and securities, but with two major exceptions. These exceptions are useful in assessing the relationship between firm strategies and regulatory change.

The broad similarities between insurance and the banking sector included the importance of foreign insurers in the inception of the sector in the late 1800s, and the ex ante managed competition regulatory structure in the postwar period. The insurance sector was also near the core of Japan’s strategic postwar development policies. Insurers held massive assets, which were tightly regulated, both formally and informally, to invest in particular targeted areas of the economy.

A major difference was that a small number of foreign insurers carved their own privileged market segment in the 1970s by introducing a new class of products that were not offered by domestic firms. In a sense, they capitalized on a gap in product offerings by Japanese insurers – a gap resulting from the sectoral regulatory regime that limited firms’ product offerings and business models.

The new foreign insurance products, however, did not undermine the existing regulatory structure. Instead the government simply created an extra compartment into which the new products fit. The foreign insurers were restricted from entry into the other segments, while major Japanese insurers were prohibited to enter the foreign segment. This arrangement lasted until the late 1990s, when the Financial Big Bang reforms dismantled much of the regulatory apparatus of ex ante managed competition.

The second major difference was that when the convoy system was abandoned in the late 1990s, a crisis swept through the sector, leading to a wave of bankruptcies. Since Japan’s insurance market was still the second largest in the world in terms of assets,255 and deregulation of investment options promised lucrative new business models, foreign insurers swooped in with a series of M&As.

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255 At one point in the late 1990s, Japan had almost 40% of the global total share of life insurance premiums. By 2005, however, this shrank to approximately 19% by 2005, still in second compared to the 26% held by the US. Mitsumasa Okamoto, Gyokai Kenkyu Shirizu: Seiho Sonpo [Industry Analysis Series: Life Insurance, Casualty Insurance] (Tokyo: Nikkei Bunko, 2006), 28-29.
Thus, although the entry of foreign insurers in the 1970s reorganized market dynamics, the regulatory framework remained intact. In the late 1990s, regulatory shifts driven by domestic politics opened up new market opportunities – in the form of new business models and the availability of bankrupt or near-bankrupt firms – which precipitated a major influx of foreign insurers. In short, firms followed regulatory shifts.

Even as the overall insurance market in Japan declined, the market share held by foreign firms (as measured by income from premiums) rose from less than 5% in 1997 to approximately 25% in 2004, and almost a third in 2005. In new market areas, such as variable annuities, which did not exist prior to 1999 but grew to become an approximately 80 billion dollar market by 2005, multinationals enjoyed almost 60% of the market share (75% including joint ventures).

**EARLY HISTORICAL ORIGINS – MEIJI TO WWII (LATE 1800S – 1945)**

Foreign firms participated in the inception of Japan’s modern insurance industry, but they operated in a realm largely independent of the government. Japan’s insurance sector was minimally regulated in its inception.

As Japan became involved in international trade from the late 1800s, foreign insurers created the first casualty insurance market. They began by selling fire insurance policies for storage buildings in trading ports such as Yokohama. By 1881, an astonishing 72 foreign casualty insurance firms were offering their services. The insurance sector was booming, and the first Japanese insurers such as Tokyo Marine and Fire, founded in the early 1880s, also began to grow rapidly.

Japan’s life insurance market developed shortly after the casualty insurance market, but since targeted the domestic market, foreign insurers had a negligible presence. Japan’s first modern life insurers – modern in the sense that they based their operations on mathematical probabilities – began operations in the 1880s. Meiji Life (1881), Teikoku Life (1888), and Nihon Life (1889), were among the prominent early firms that continued to be major players over a century later.

After an initial period of prosperity in the 1890s, a major crisis swept the insurance sector, leading to the creation of Japan’s insurance regulatory structures. Intense competition had led to increasingly risky investments, and a wave of bankruptcies swept the sector around the turn of the century. This initial boom and bust prompted government intervention, precipitating the Insurance Business Law of 1900, which formally established the policy framework of licensing and price controls. The sector was compartmentalized, with life insurers prohibited from offering

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259 During the Sino-Japanese War of 1894-95, the number of life insurance firms proliferated. Ibid., 18-20.
casualty insurance, and vice versa. Prices and products were subject to *ex ante* government approval, aimed at preventing the type of competition that had led to bankruptcies.\textsuperscript{260}

**POSTWAR RAPID GROWTH WITH RESTRICTED BUSINESS MODELS (1950s-1970s)**

During the postwar rapid growth era from the 1950s until 1970s, the Japanese insurance market grew swiftly, accumulating vast assets in a tightly controlled market. Foreign firms did not enter until the 1970s.

World War II decimated Japanese insurers, but government-led restructuring efforts enabled them to start afresh. By the 1970s, an astonishing 90 plus percent of the population was estimated to have life insurance policies.\textsuperscript{261}

Firms’ business models were strongly shaped by the regulatory structure, leading to competition based on volume rather than price or product differentiation. MOF strictly restricted entry into the insurance sector, and insurers were limited to offering products similar to each other, such as life insurance policies that paid lump sums upon death. Price restrictions led to little differentiation for consumers in products such as auto insurance. On the investment side, insurers were also strictly limited in their options to investment their assets. For example, in the early 1980s, MOF issued administrative guidance limiting attempts by Japanese insurers to set up overseas investment operations.\textsuperscript{262}

As a result, insurer investments had low risk profiles with similar returns across firms. Therefore, competition revolved around achieving volume. Insurers mobilized large sale forces to canvass corporations and households,\textsuperscript{263} and keiretsu networks were important in gaining sustainable blocs of corporate subscribers, known as “group insurance.”

The insurance sector was one of the core elements of Japan’s postwar financial system that enabled the government to strategically allocate resources. The tightly restricted financial markets in the postwar high growth era, combined with relatively weak public pension and welfare systems created incentives for the general population to buy life insurance. Regulations over the insurers’ investments and the relative underdevelopment of financial markets meant that the government could use the insurance sector as the second banking sector, channeling the massive assets of life insurers towards strategic domestic sectors.


Foreign insurers began entering Japan’s insurance market in the early 1970s, with Alico Japan, part of the AIG group, and American Family (Aflac), entering in 1973 and 1974,

\textsuperscript{260} The postal life insurance system, which would later become the largest insurance company when privatized in the mid-2000s, had its origins in 1916. Since the early life insurance market served only the high income population, the government instituted a public life insurance system, (based on the Kan i Seimei Hoken Law). Ibid.

\textsuperscript{261} Casualty insurers had also experienced rapid growth as automotive insurance became popular. Ibid., 18-20, 26, 103.


\textsuperscript{263} Even after shrinking its salesforce, in 2005, Nippon Life employed 53,000 door-to-door sales staff known as “bicycle ladies” to canvass households Paprzycki and Fukao, *Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization*, 164.
respectively. They were able to take advantage of the compartmentalized market by offering products that fell into neither the traditional life nor casualty insurance categories. For example, after much preparation, Aflac received MOF approval to offer cancer insurance. MOF had harbored significant reservations about approving the product, since cancer was a taboo subject in Japanese society at the time – doctors would commonly not inform patients if they were diagnosed. MOF officials were also cautious because they considered the failure of a product, having given their approval, as a risk to themselves.

Cancer insurance turned out to be quite popular, and MOF created a new industry segment, that of “third sector” products that were neither life nor casualty insurance. Foreign insurers were restricted into this segment, but protected from entry by the large Japanese insurers, as well as new foreign firms. Like banking, foreign insurers enjoyed “privileged segmentation,” offering products such as cancer and hospitalization insurance – products that paid out while the patient was alive, while Japanese life insurers were restricted to offering classic life insurance products that were essentially death benefits. Unsurprisingly, the foreign firms were not major political drivers of change to end compartmentalization.

**INCREMENTAL DEREGULATION (MID-1990S – LATE 1990S)**

In the 1990s, external pressure from the US, combined with MOF’s plans for reform, led to the deregulation of prices and products and a breakdown of compartmentalization. While foreign firms favored the deregulation of prices and products, they actively lobbied the US government to pressure the Japanese government to slow down the full removal of compartmentalization.264 The Clinton administration’s Framework talks advocated deregulation of Japan’s financial markets, which MOF was willing to deliver since it followed MoF’s own long-term agenda for reform.265 All parties agreed on major deregulation in areas such as product approval, prices, and market-facilitating policies to support insurance brokers. The US-Japan Insurance Pact reached in late 1994 also promised to address several common complaints raised by foreign firms; the Japanese government promised to increase foreign firms’ access to information, with increased clarification of MOF’s permission and licensing procedures, and for MOF to heed input from foreign firms when reforming insurance regulation, such as inviting them to deliberation council meetings.

Included in the pact was also a stipulation about the timing of deregulation the compartmentalization of the sector. The agreement stipulated that the Japanese government would not “radically change” conditions in the third sector until liberalization in the life and nonlife sectors were sufficient. In effect, it promised that Japanese insurers would not enter the third sector until liberalization of the other sectors was deemed sufficient.

This issue of the timing and sequencing of dissolving sectoral compartmentalization flared up as a bilateral dispute in 1996, when MOF proposed to allow Japanese firms to enter the

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third sector through subsidiaries. The foreign insurers already in Japan lobbied the Clinton administration, which vigorously opposed this deregulation until further liberalization of the life and non-life sectors.

The final agreement, reached in December 1996, largely supported the US positions. It limited Japanese insurers’ entry into the third sector for five years, while deregulating prices in casualty insurance, which enabled foreign insurers to introduce new pricing such as discounts, and new products such as policies via mail order. This final agreement was reached in the context of Prime Minister Hashimoto’s plans for the financial Big Bang reforms, which promised sweeping reforms, deregulation various financial products and removing barriers between banking, securities and insurance by 2001.

The removal of restrictions on new entry into the insurance sector, combined with a crisis that swept through the Japanese life insurance industry, opened the gates to an influx of foreign entry.

As the Japanese government abandoned its “convoy” approach to keep insolvent firms afloat in exchange for strict regulation, a wave of bankruptcies occurred between 1997 and 2001. The sector had been in an overall decline, partly due to the post-bubble economic slump, with the number of life insurance subscribers peaking in 1994. Arguably more serious was the fact that insurers were stuck with investment portfolios that yielded less than their “guaranteed return rates” promised to insurers, due to the restricted investment targets and the low interest rate adopted by the government attempting to stimulate the economy. Most of the Japanese life insurers’ insolvencies led to foreign takeovers, beginning with Nissan Life, the first insurer to go bankrupt, Toho, Chiyoda, and Kyoei. (See Table 22).

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266 This was part of MOF’s plan for incremental to consolidate the three laws governing the insurance sector: the Insurance Business Law, the Law Concerning the Control of Insurance Soliciting, and the Law Concerning Foreign Insurers, into a new Insurance Business Law. For the various options raised in banking and securities, see Ibid. The negotiation over insurance occurred at the same time, according to the same logic.

267 Schoppe, Bargaining with Japan: What American Pressure Can and Cannot Do, 59. The US government contended that Japanese government’s plan to allow Japanese firms to enter the third sector constituted a “radical change” to the sector, violating the 1994 agreement. The Japanese government’s position was that it had already liberalized the life and non-life insurance sectors sufficiently, allowing it to deregulate entry into the third sector – just as spelled out in the 1994 pact.

268 ACCJ Welcomes U.S.-Japan Insurance Pact. 1996. Jiji Press Ticker Service, December 17. The responses of Japanese firms were mixed: casualty insurers, who would be subject to increased competition within the sector in addition to that from foreign firms were vocal in the opposition, while life insurance companies, facing saturation and welcoming the opportunity to expand into casualty insurance, were quiet. US-Japan Insurance Pact Angers Nonlife Insurers. 1996. Asia Pulse, December 17

Table 22. Bankruptcies and Foreign Takeovers in Life Insurance

<table>
<thead>
<tr>
<th>Company</th>
<th>Date of Bankruptcy</th>
<th>Total Assets (billion yen)</th>
<th>Buyer (or Sponsor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nissan Life</td>
<td>April 1997</td>
<td>2.2</td>
<td>Aoba Seimei (Artemis)</td>
</tr>
<tr>
<td>Toho Life</td>
<td>June 1999</td>
<td>2.7</td>
<td>GE Edison Life (GE Capital)</td>
</tr>
<tr>
<td>Dai Hyaku Life</td>
<td>May 2000</td>
<td>1.7</td>
<td>Manulife</td>
</tr>
<tr>
<td>Taisho Life</td>
<td>August 2000</td>
<td>2.2</td>
<td>Azami Life (Daiwa Life, Softbank)</td>
</tr>
<tr>
<td>Chiyoda Life</td>
<td>October 2000</td>
<td>3.5</td>
<td>AIG Star Life (AIG)</td>
</tr>
<tr>
<td>Kyoei Life</td>
<td>October 2000</td>
<td>4.6</td>
<td>Gibraltar Life (Prudential)</td>
</tr>
<tr>
<td>Tokyo Life</td>
<td>March 2001</td>
<td>1.1</td>
<td>T&amp;D Financial (Daido, Taiyo Life)</td>
</tr>
</tbody>
</table>


In selling off insolvent Japanese insurers, a notable shift occurred in the role of the industry association. As seen in Chapter 3, the Life Insurance Industry Association shifted from delaying the sale of the remnants of Nissan Life, to actively facilitating the rapid sale of subsequent bankrupt or struggling insurers. After the initial trepidation, foreign insurers were perceived as rescuers to help put out the fire, rather than plunderers intent on liquidating assets.

As regulations on foreign entry were relaxed, multinational insurers began entering Japan rapidly. As seen in Table 5, of the major foreign insurers operating in Japan in 2009, most entered after 1996, most between 1998 and 2002 (See Table 23).

The market share of foreign insurers grew rapidly as well. As measured by income from premiums, the combined market share held by foreign insurers rose from less than 5% in 1997 to 35% in 2004. This growth occurred even as Japan’s overall insurance market shrank after 1996. In a development laden with symbolism, Prudential completed a 38 story office tower in 2002 which, partly due to its location on relatively high ground, looked down upon the Prime Minister’s residence and gained prominence in the skyline near the National Diet building.

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Table 23. Dates of Entry for Foreign Life Insurers in Japan

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Postwar Entry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alico Japan (American Family)</td>
<td>1973</td>
</tr>
<tr>
<td>Aflac</td>
<td>1974</td>
</tr>
<tr>
<td>ING Life</td>
<td>1986</td>
</tr>
<tr>
<td>Prudential Life</td>
<td>1987</td>
</tr>
<tr>
<td>Zurich</td>
<td>1996</td>
</tr>
<tr>
<td>AXA</td>
<td>1998</td>
</tr>
<tr>
<td>PCA Life</td>
<td>1998</td>
</tr>
<tr>
<td>GE Edison</td>
<td>1999</td>
</tr>
<tr>
<td>Manulife*</td>
<td>1999</td>
</tr>
<tr>
<td>Cardif Assurance Vie</td>
<td>2000</td>
</tr>
<tr>
<td>Hartford</td>
<td>2000</td>
</tr>
<tr>
<td>Gibraltar (Prudential)</td>
<td>2001</td>
</tr>
<tr>
<td>AIG Star</td>
<td>2001</td>
</tr>
<tr>
<td>MassMutual Life</td>
<td>2001</td>
</tr>
<tr>
<td>Mitsui Sumitomo Metlife</td>
<td>2002</td>
</tr>
<tr>
<td>Credit Agricole</td>
<td>2007</td>
</tr>
<tr>
<td>Allianz</td>
<td>2008</td>
</tr>
<tr>
<td>SBI AXA Life</td>
<td>2008</td>
</tr>
<tr>
<td>Prudential Financial Japan Life</td>
<td>2009</td>
</tr>
</tbody>
</table>

* note: Manulife entered as a joint venture in 1999, became a fully owned subsidiary in 2001

Source: Foreign Members of Life Industry Association of Japan, company homepages

ADVANTAGES INSIDE THE CASTLE: REGULATORY CHANGES AND NEW PRODUCTS

Under the new regulatory structure, with insurers allowed to offer new products and pricing schemes, foreign insurers were at an advantage. They could introduce products from other markets into Japan and Japanese firms were eager to engage in tie-ups in order to offer products that they themselves could not.

Deregulation of prices enabled foreign insurers to introduce new pricing models and engage in price competition. For example, as soon as differential pricing for auto insurance according to risk-levels was permitted from 1997, American home insurance Zurich and others move quickly to offer such price differentiations based on models derived from their home operations.271

A new product that became a major growth driver for foreign insurers was variable annuities – essentially mutual funds with some level of insurance guarantee. Although nonexistent before 1999, the market grew to become approximately 4 billion dollars in 2002, and an astonishing 80 billion dollars by 2005.272 Hartford was a leader in this market, and other foreign firms were quick to offer variable annuities products. For example, Alico Japan offered

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products in which changes to the length of maturity could be tied to varieties of what was being insured, and ING Life offered discounts according to blood pressure. Hartford’s variable annuities enabled policyholders to get dividends as early as one year after joining, and Alico Japan offered US-dollar denominated cancer insurance repaid the entire sum upon maturity, regardless of whether or not the policyholder developed cancer.\textsuperscript{273} The almost zero percent interest rates offered by banks, combined with poor performance in the overall stockmarket in the late 1990s and early 2000s led to interest in annuities, marketed as relatively low risk.\textsuperscript{274}

After 2002, when deregulation enabled insurance products to be sold at bank windows, demand for foreign insurance products further increased. The growth of variable annuities accelerated, and foreign firms dominated this new market (See Table 24).

### Table 24. Assets in Variable Annuities as of September 2005

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Company</th>
<th>Assets (millions USD)</th>
<th>Market Share (%)</th>
<th>Number of Policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Hartford</td>
<td>24,830</td>
<td>30.6</td>
<td>308,000</td>
</tr>
<tr>
<td>2</td>
<td>Mitsui Sumitomo Metlife</td>
<td>11,760</td>
<td>14.5</td>
<td>114,000</td>
</tr>
<tr>
<td>3</td>
<td>ING</td>
<td>11,612</td>
<td>14.3</td>
<td>158,000</td>
</tr>
<tr>
<td>4</td>
<td>Sumitomo</td>
<td>6,752</td>
<td>8.3</td>
<td>190,803</td>
</tr>
<tr>
<td>5</td>
<td>Manulife</td>
<td>5,262</td>
<td>6.5</td>
<td>78,000</td>
</tr>
<tr>
<td>6</td>
<td>Mitsui Life</td>
<td>4,546</td>
<td>5.6</td>
<td>141,000</td>
</tr>
<tr>
<td>7</td>
<td>AIG (Alico Japan)</td>
<td>3,915</td>
<td>4.8</td>
<td>51,000</td>
</tr>
<tr>
<td>8</td>
<td>T&amp;D Financial</td>
<td>3,525</td>
<td>4.3</td>
<td>42,000</td>
</tr>
<tr>
<td>9</td>
<td>Tokio Marine and Fire</td>
<td>3,259</td>
<td>4</td>
<td>40,000</td>
</tr>
<tr>
<td>10</td>
<td>Nippon Life</td>
<td>2,277</td>
<td>2.8</td>
<td>28,202</td>
</tr>
<tr>
<td>11</td>
<td>Dai-ichi Life</td>
<td>2,268</td>
<td>2.8</td>
<td>47,412</td>
</tr>
</tbody>
</table>


**EXPANDING TIE-UPS: "SUPPLY CHAINS" IN INSURANCE**

Tie-ups with Japanese firms was another mechanism by which foreign insurers increased their market presence. After the deregulation of products, foreign firms enjoyed a new demand for tie-ups from Japanese insurers eager to offer their products. Since the deregulation of products enabled foreign insurers to introduce new products to the Japanese market before domestic firms could develop competing products, the latter began seeking tie-ups with foreign firms. For example, in 2001, Scandia and Daiwa Life, and American Family and Dai-ichi Mutual Life, entered into such relationships. In 2004, Sumitomo Life and American Life began selling each other’s products.


\textsuperscript{274} The subsequent burst of the subprime-fed bubble originating in the US in 2008 revealed that many of these products were not without their risks, however. Interest in the products plummeted, and several firms withdrew from the market.
The lifting of segmentation between life and casualty insurers, as well as between banks and insurers, benefitted foreign firms, which could increase their sales channels. Examples of tie-ups between life and casualty insurance include that between Aioi and AXA. Banks such as Mizuho Bank began selling Hartford products, and Shizuoka bank sold AXA products. This movement continued, with tie-ups in 2007-2008 between insurers such as Gibraltar and Credit Agricole and banks Shinsei and Resona, respectively. Alico Japan became an exclusive supplier for Mizuho Bank for life insurance policies, and its products were also sold by the Bank of Tokyo-Mitsubishi UFJ, Sumitomo Mitsui, and Resona Holdings.

Finally, on the investment side, deregulation drove links between Japanese life insurers with vast portfolios seeking higher returns, and foreign financial firms. Until 1996, administrative guidance by MOF tightly restricted the investments allowed by insurers, limiting them mostly to loans. This led to the plethora of tie-up between Japanese insurers and asset management arms of foreign financial institutions, as covered in the previous section. Examples include the 2003 tie-ups between Mitsui Life and American Express Financial Advisors, and Meiji Yasuda and Ariantz Dresner Asset Management.

Overall, the competitive performance of foreign insurers continued until the crisis of 2007-2008, in which the damage was not from Japanese market per se. In 2000, although domestic interest saw their revenues decline, foreign insurers and new entrants performed well. Even after Japanese firms were allowed into the third sector in July 2003, foreign insurers continued to grow, even as the overall insurance market shrunk.

**Japanese Insurers’ Scandals Increasing the Social Legitimacy of Foreign MNCs**

In contrast with foreign private equity firms, most foreign insurers were not regarded with suspicion and were widely accepted. The reputations of longstanding firms such as Aflac and Alico, which had been built over time, are likely to have contributed to their image. In 2004, a survey conducted by the Nikkei Financial Daily found AFLAC had the top marks overall. They were followed by new entrant mid-size insurer Sony (2nd) and another foreign firm, Alico (3rd). Other foreign firms were ranked highly, with low rates of contract cancellations. The major domestic life insurers were middle to lower. The survey was based on five categories: credit

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276 Ibid., 18.
standing; financial heath; business stability: earnings power and; growth potential, for the 18 largest life insurers out of 41 firms. Moreover, Japanese consumers had faced years of poor payouts and decreasing expected returns by Japanese life insurers.

At the same time, similar to the case of securities, a series of scandals severely damaged the reputation of large domestic insurers. In late 2005, the FSA discovered the Meiji Yasuda had systematically denied payouts. The FSA punished Yasuda by freezing their new policy issuances for two weeks, and prohibiting them from offering new products for some time. In response, the chairman, president, and nine top officials resigned. In early 2007, the FSA announced that after investigations, 38 firms had underpaid their policyholders in an incredible 1.3 million cases, totally 96.4 billion yen.

CONCLUSION: FOREIGN FINANCIAL FIRMS AND JAPAN’S FINANCIAL SYSTEM TRANSFORMATION

The increased opportunities for foreign financial firms in Japan’s financial sectors stemmed from the transformation of Japan’s financial system. While the financial system was at the core of Japan’s postwar model of development, foreign firms were compartmentalized and segmented, with their market access strictly limited.

However as Japan began to transition away from the strong strategic developmental policies of channeling capital to targeted industrial sectors, financial markets were gradually liberalized. Foreign MNCs played a limited but important role in the incremental liberalization, applying gaiatsu and cooperating with Japanese firms to take advantage of regulatory loopholes to pound on the castle gates in areas such as securities and trust banking.

In the 1990s, however, as the Japanese government swept away many of the regulatory vestiges of the strategic developmental era, foreign MNC faced a broad array of opportunities to introduce new products and services. They took advantage of these opportunities to rapidly expand their market presence as Japanese firms struggled to shift their business models and core competencies. Foreign MNCs as a whole were profitable through the 1990s and 2000s, even as their respective sectors were shrinking or unprofitable in the aggregate.

Demise of the convoy system also created opportunities for M&A and expansion – most dramatically in the case of investment funds taking control of the first failed Japanese banks of its postwar history, and a large swath of its insurance market. Moreover, through tie-ups with Japanese firms interested in offering foreign products, foreign firms were able to gain market presences beyond their direct market shares.

The Regulatory and Market Drivers of Entry: No Black Ships

The financial sectors provide a valuable first cut in assessing the relationship between regulatory reforms and the influx of foreign MNCs. Global finance is often depicted as an


This case, however, was not one in which foreign financial firms were prying open the sector. Instead, domestic regulatory shifts responding to political pressure for reform, triggered by prolonged economic stagnation, provided conditions that enabled foreign entry, expansion, and profitability. The picture it portrays is not one of simple inevitability, with global financial firms moving into the Japanese market with superior products and business models as Perry’s Black Ships had once sailed into Tokyo Bay with superior firepower.\footnote{For financial reforms in the early 1990s, Steven Vogel shows how MOF orchestrated an incremental de-compartmentalization of the sector at its own pace. Vogel, "The Bureaucratic Approach to the Financial Revolution: Japan's Ministry of Finance and Financial System Reform."} Only after domestic regulatory shifts, occurring at a timeline dictated by domestic political developments, did foreign MNCs enter en masse and take advantageous market positions. In short, the foreign financial firms were not the modern day equivalent of Perry’s Black Ships – they did not appear in Tokyo Bay according to a timeline dictated by a foreign power rather than the Japanese government.

We next turn to the non-financial sectors that experienced major influxes of MNCs.
CHAPTER 5:
MNCs in Japan’s Non-Financial Sectors: Automobiles, Telecommunications, and Pharmaceuticals

This chapter asks the same questions as the previous chapter, but for the slower clock speed sectors of telecommunications, pharmaceuticals, and automobiles. What was the sectoral context in which the influx of foreign firms occurred? To what did degree did foreign MNCs drive the changes that enabled the influx? Did firms enter Japan to take advantage of existing arrangements, or to defy them? Here too we are also interested in the implications for how advanced industrialized countries change over time.

These three sectors played different, less central roles in the Japanese government’s postwar strategic development compared to those of the financial sectors. Yet, they were all protected from MNCs at some point, and the overall pattern of foreign entry was roughly similar. In all three cases, regulatory shifts, combined with changes in market dynamics, opened opportunities for foreign MNCs. While restrictions remained, foreign MNCs pursued entry strategies of gaiatsu and cooperation with Japanese partners. When restrictions were lifted and when market dynamics shifted to foreign firms’ favor, MNCs expanded rapidly.

The government deemed automobiles and telecommunications strategic industries in the early postwar period as it sought to build up the industrial and technological capacities of Japanese firms. Japan’s pharmaceutical sector was strongly shaped by the government in the immediate postwar period to facilitate the quick recovery of a malnourished population ravaged by the wartime devastation.

In automobiles, the regulatory structure shifted earlier than in the other sectors. The sector reveals the importance of market dynamics – not simply regulatory shifts – in enabling an influx of foreign MNCs. In other sectors, the market shifts occurred immediately following regulatory shifts, but the two decades separation between deregulation and market shifts in the automobile sector reminds us that regulatory shifts alone were insufficient.

MNCs were instrumental in establishing Japan’s automobile industry in the prewar period, but foreign entry did not occur in any significant scale until the 1970s. The government strongly managed the sector from the 1950s through 1970s, actively orchestrating partnerships between Japanese firms and smaller European firms to obtain technology. Foreign MNCs exerted gaiatsu, but did so in the context of attempting to lower Japan’s import barriers for their products rather than to enable direct investment. By the 1980s, the government was no longer protecting or micromanaging competition in the sector, but it was not until the 1990s that market forces weakened a number of major Japanese competitors. As the Japanese automobile firms faced crises, the foreign influx ensued.

The foreign auto firms that entered Japan did so to take advantage of Japanese firms’ technology, products, and production know-how, useful to their global strategies. There was less emphasis on accessing the Japanese market for its own sake.

A comparison of three different cases of foreign MNCs gaining management control of Japanese automobile firms reveals the challenges facing MNCs in formulating strategies and sustaining complex organizations after entry. Such comparison reinforces the point that market challenges facing MNCs in Japan no longer necessarily stem from regulatory factors or peculiar market conditions in areas that are relatively less regulated.
Japan’s telecommunications sector experienced an influx of foreign MNC entry after regulatory shifts in the late 1990s. However, in contrast to other sectors, in which Japanese firms experienced crises, the bursting of the IT investment bubble in 2001 weakened global telecom carriers while leaving Japan’s domestic market relatively unscathed. As a result, one wave of global MNCs withdrew from the Japanese market due to economic factors exogenous to Japan – illustrating the point that increased MNC presence can lead to greater economic vulnerability to exogenous economic shocks. The largest foreign MNC in cellular services exited from the Japanese market largely due to particularistic dynamics of competition within the Japanese market. As a counterpoint to the relatively unregulated automobile sector, cellular services remained highly regulated, with policy-shaped market dynamics creating a distinctive domestic cellular market. Although the policies were not explicitly or implicitly, formally or informally aimed at hindering the operation of MNCs, the foreign carriers were unable to take advantage of the Japanese market as it evolved along its own trajectory.

The entry strategies of MNCs first consisted of gaiatsu, with mixed degrees of success, at the moment of initial market liberalization, when competition was introduced into the sector in the mid-1980s. As in the case of automobiles, the most vocal gaiatsu in the 1980s was mobilized over trade issues, with foreign MNCs attempting to get their cell equipment to Japanese carriers.

The telecommunications regulatory structure following the 1985 liberalization was one of ex ante managed competition, and foreign MNCs were confined to particular market segments. In the mid to late 1990s, the regulatory structure shifted towards ex post competition management, and the removal of regulatory restrictions on foreign entry led to an influx of foreign carriers. As noted above, an exodus of foreign carriers occurred a few years later, first due to exogenous shocks, and then due to market dynamics in the domestic cellular sector. By contrast, in other areas where market dynamics favored foreign MNCs such as cable television and Internet hardware, MNCs continued to expand.

In contrast with the other sectors, Japan’s telecom sector did not experience an acute crisis. MNCs entered Japan to access the profitable market, and to obtain technology and services useful in their global strategies.

In pharmaceuticals, the presence of MNCs grew over a longer time period, responding to incremental regulatory shifts, and accelerating in the 1990s. The pattern of entry, unlike that in other sectors, followed the supply chain downwards. Global MNCs began by providing raw materials and licensing products, gradually expanding into sales and marketing. The pharmaceutical sector reveals that market deregulation per se is not prerequisite to an influx of foreign MNCs. Instead, shifts in market dynamics, such as an increase in the level of formalization in standards of operation (e.g., sales) and clinical testing, favored foreign MNCs, facilitating their expansion.

Global pharmaceutical firms did not engage in prominent gaiatsu strategies. Instead, from early on, they expanded to the degree that the regulatory structure allowed, beginning with joint ventures and gradually increasing their independence. They were, however, involved in shifting the policies that changed the market dynamics towards those favoring MNCs – insider strategies, as we will see in Part II.

MNCs entered the Japanese pharmaceutical market primarily to sell to the Japanese market, the second largest in the world, rather than to take advantage of technologies or production know-how. By the late 1990s, technological shifts a global of wave of M&A had rendered Japanese firms quite small, with relatively weak R&D capabilities, thus providing impetus for foreign entry.
I. AUTOMOBILES: THE TEMPORAL SEPARATION OF REGULATORYSHIFTS AND MARKET DYNAMICS

The relationship between foreign MNCs and Japan’s automobile industry usefully illustrates the role of market dynamics in enabling foreign entry. Despite the removal of regulatory restrictions on foreign MNCs by the early 1980s, it was not until the late 1990s that crises at several major domestic firms provided the opportunity for significant foreign entry.

Since the 1970s, Japan’s auto industry has been one of its most successful, globally competitive industries. Government regulation and foreign MNCs were instrumental in its inception, and the early postwar period was characterized by MITI’s strong industrial policy. This policy took the form of infant industry protection and preferential credit allocation. In the 1950s, MITI also brokered strategic alliances between Japanese firms and smaller European auto firms (rather than the US Big Three, which were considered threats) to obtain technology and production know-how. Compared to the other sectors in this study, the government’s micromanagement of competition in the auto sector was less successful, and it was abandoned earlier. In the 1980s, as Japan’s stronger firms gained strength from domestic and global markets, weaker players began entering into capital tie-ups with MNCs. In the 1990s, however, bleak economic conditions within Japan pushed several major Japanese auto firms into crises, paving the way for a surge of inward investment.

The three major tie-ups – Renault and Nissan, Ford and Mazda, and DaimlerChrysler and Mitsubishi Motors – reveal the organizational challenges in managing complex MNCs. The Renault–Nissan represents the paradigmatic case of a successful turnaround by foreign management, departing from Japanese norms in some ways by altering practices, but conforming to broad social bargains by avoiding mass layoffs. The Ford–Mazda relationship was also successful, though less dramatic and much less well publicized. The lack of publicity, however, was not for lack of dramatic slogans, since it adopted the phrase “change or die” at one point. DaimlerChrysler-Mitsubishi was widely considered a failure, with relatively little restructuring and serious safety cover-up scandal by Mitsubishi leading to DaimlerChrysler pulling out of the relationship.

INCEPTION OF THE SECTOR: FOREIGN DOMINATION, GOVERNMENT SUPPORT (1910-1920s)

From its inception, the Japanese automobile sector was dominated by the American firms that pioneered the mass production of automobiles – Ford and General Motors. While the Japanese government was interested in cultivating domestic producers, especially for military purposes, strong demand for automobiles and trucks led to the direct entry of Ford and GM into Japan.\(^\text{287}\)

Japanese demand for automobiles and trucks grew rapidly after the 1923 Great Kanto Earthquake. The government reduced duties on imports of finished autos and components, and

\(^{287}\) In 1918, interest from the military led to government support for truck production. The Japanese government passed a law providing subsidies to truck manufacturers as well as certified users. Under this policy, three firms, Tokyo Gas and Electric, Ishikawajima Shipbuilding, and Kaishinsha, obtained authorization for truck production. Until then, the only automobiles in Japan, mostly cars, were imported by individual and companies (an estimated 4500 vehicles at the time). Michael A. Cusumano, The Japanese Automobile Industry: Technology and Management at Nissan and Toyota (Cambridge, Mass.: Council on East Asian Studies, Harvard University Press, 1985), 15.
the Tokyo Metropolitan government went so far as to import trucks directly. The number of registered vehicles doubled in a year, from 13,000 in 1923 to 24,000 in 1924. This strong demand led Ford and General Motors to establish subsidiaries and assembly facilities for knock-down vehicle sets – 1925 in Yokohama for Ford, and 1927 in Osaka for GM. By 1931, the two companies had established nationwide sales networks, selling 100,000 vehicles that year. Between 1926 and 1935, the combined market share of Ford, GM, and other foreign firms exceeded 95 percent. In the market for tires, Goodrich entered into a joint venture with Baron Furukawa to establish Yokohama Rubber. Goodrich provided much of the capital and engineering skill, with management left to Furukawa.

**THE RISE OF MILITARISM: FOREIGN EXPULSION (1930s-1945)**

In the early to mid-1930s, as the Japanese government grew increasingly militaristic, waves of ultra-nationalism began shaping the domestic automobile industry through heavy-handed intervention. The military proposed expulsion from Japan of Ford and GM, and despite MCI’s protests over damage to trade relations, the military prevailed. In 1936, the government passed the Automobile Manufacturing Enterprise law, drafted by military officers and adopted by the increasingly military-dominated Cabinet. The law required that manufacturers producing more than 3000 vehicles obtain government licenses. Licensees were exempt from various taxes and import duties on machinery and materials, but were required to maintain at least 50% Japanese ownership, with a majority of Japanese as board of directors. The Ministry of Commerce and Industry (MCI, predecessor to MITI/METI) was given discretionary authority to approve producers’ business plans, regulate the attempts of manufacturers to merge or dissolve, and directly oversee any operations involving military production.

From the mid-1930s, the Japanese government proceeded to expel the foreign manufacturers. In 1936, MCI mandated a ceiling on the production levels of Ford and GM. It raised import duties on finished products, components, and knock-down sets, and revised foreign exchange regulations making it difficult for them to pay for imported parts. In late 1939, Nissan, Toyota, and Ford signed an agreement to invest in a joint venture, but military intervention

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288 Ibid., 7, 15-16.
289 Wilkins, "American-Japanese Direct Foreign Investment Relationships, 1930-1952." Despite the booming demand for automobiles during the second half of the 1920s, Japanese manufacturers were struggling. Even in 1931, only 436 automobiles were manufactured domestically, and most Japanese firms which had attempted to enter the industry had exited the market or gone bankrupt. The major industrial conglomerates such as Mitsui, Mitsubishi, and Sumitomo were unwilling to enter the industry despite some pressure from the military and Ministry of Commerce and Industry (MCI, predecessor to MITI/METI). In 1931, an MCI deliberation council comprised of university professors and officials from MCI, the military, MOF, and the Ministry of Home Affairs had issued a recommendation that local producers merge and concentrate on market segments for smaller vehicles to avoid competing against larger imports. Ishikawajima created the Isuzu brand by spinning out its automobile division and absorbing Kaishinsha, and Nissan, incorporated in 1933, entered the small car and truck markets, but neither was able to attain substantial scale. Cusumano, *The Japanese Automobile Industry: Technology and Management at Nissan and Toyota*, 16.
nullified the deal.\textsuperscript{291} Later that year, Ford and GM closed down their operations and left Japan.\textsuperscript{292}

\section*{The Immediate Postwar Period: Government Rescue (1940s-Early 1950s)}

The Japanese government played a critical role in re-establishing the Japanese automobile industry and supporting Japanese firms. In the immediate postwar period, the Japanese government fought to reestablish the domestic automobile industry earlier than the Occupation Authorities intended. SCAP had banned automobile production immediately after the war as part of its attempt to demilitarize and de-industrialize Japan. (SCAP did allow the production of trucks immediately after the war, but deemed passenger cars unnecessary for the immediate recovery.) MITI’s automobile section actively lobbied SCAP to resume production around 1947.\textsuperscript{293}

In the late 1940s, however, Japanese auto manufacturers faced an acute crisis. They suffered from a combination of US military surplus vehicles sold on the market, and the severe deflationary measures imposed on the Japanese economy in 1949. Despite some internal dispute over whether to support the firms, MITI’s push in their favor carried the day, and the government offered direct support through the BOJ and also arranged for bank loans from the Japan Development Bank (JDB) and the Industrial Bank of Japan (IBJ). Nissan, Toyota, and Isuzu survived only with this support.\textsuperscript{294}

\section*{Constructing the Fortress: MITI’s Industrial Policy of Protection, Promotion, and Tie-Ups (1950s-60s)}

The heyday of MITI’s industrial policy towards the Japanese automobile industry began in the late 1940s, lasting until around 1970. MITI’s strategy was to segment the market, protect it from foreign competition, and nurture Japanese firms. In contrast to policy in the financial sectors where the government attempted to isolate firms almost entirely from international competition, MITI saw early tie-ups with foreign automobile firms as critical for Japanese firms to gain expertise. The government was also less successful in micromanaging automotive competition.

MITI divided the market into different segments, drawing on its ability to grant automobile manufacturing licenses, allocate foreign exchange, and set import taxes to restrict

\begin{itemize}
  \item After they left, Toyoda and Nissan took 85\% of the market. Cusumano, \textit{The Japanese Automobile Industry: Technology and Management at Nissan and Toyota}, 17.
  \item Kawahara, \textit{The Origin of Competitive Strength: Fifty Years of the Auto Industry in Japan and the U.S}, 9.
  \item In fact, support for Japanese automobile manufacturers was not an initial government priority. BOJ and the Ministry of Transportation were in favor of eliminating restrictions on automobile imports and allowing foreign firms to take over the market for passenger cars. However, MITI’s view was that a domestic auto industry could stimulate growth and technological progress in other sectors, including machinery and steel. MITI prevailed, and it used policy tools at its disposal including low-interest loans, tax privileges, and exemptions from import duties to support domestic manufacturers. Cusumano, \textit{The Japanese Automobile Industry: Technology and Management at Nissan and Toyota}, 19.
\end{itemize}
imports. MITI’s primary targets for industrial development were the “Big 5” domestic auto companies, consisting mostly of firms that had been licensed under the prewar Motor Vehicle Manufacturing License Act. These included Nissan, Toyota, and Isuzu, along with Hino Motors (an offspring of Isuzu), and Mitsubishi Heavy Industries, which had produced military vehicles during the war. A second set of manufacturers specialized in small cars and three-wheeled vehicles – Toyo Kogyo (later to become Mazda), Daihatsu, Fuji Heavy Industries (later to become Subaru), Suzuki, and Mitsubishi. This second group received less support than the Big 5.

In 1948, MITI drew up a 5 year production plan, and in 1950 an equipment rationalization schedule and a plan for the “Big 5” to create a low-cost automobile. Not all of these targets were successful, however. Some, such as the production plan, were too ambitious, and others, such as the low-cost car, contradicted market incentives to the point that manufacturers refused to follow MITI’s guidance. Through the 1960s, MITI attempted to consolidate the sector by orchestrating mergers between manufacturers. Its attempts grew from its fears that “excessive competition” in the domestic market would leave all the firms lacking resources to compete internationally. These consolidation attempts did not succeed.


296 In 1948, MITI produced a five-year production plan that proved far too ambitious, and failed implementation. In 1950, MITI produced an equipment rationalization schedule for the industry, but the effort lagged behind market developments; major firms were already modernizing their programs. In 1955, MITI announced plans to develop a “people’s car” to be developed by 1958. It instituted a contest, stipulating the cruising speed, maximum speed, maximum engine size, fuel efficiency, and maximum manufacturing costs. Cusumano, *The Japanese Automobile Industry: Technology and Management at Nissan and Toyota*, 21. In this plan, MITI would test prototypes and select a winner firm, investing capital to support its production and manufacturing costs. MITI’s “people’s car” conception led to a major public debate within the auto industry as well as among opinion leaders and academic circles. The “Big Five” opposed the plan due to the potential prospect of new competitors entering the passenger car market. Genshichi Asahari, president of Nissan and chairman of the Automobile Manufacturers Association was also opposed, quoted as saying that cheap cars were not only impossible to build, but also unnecessary, directing people instead to buy used cars. The industry association filed a formal objection, and none of the firms agreed to participate in the plan. An underlying fear of the automobile firms was that a low-cost passenger car would be outcompeted by three-wheeled vehicles, exceedingly popular in the low end market, and manufactured by a different set of firms than the auto manufacturers. ———, *The Japanese Automobile Industry: Technology and Management at Nissan and Toyota*, 21. In fact, three-wheel vehicle truck production was greater than that of 4 wheel vehicles until 1957. Kawahara, *The Origin of Competitive Strength: Fifty Years of the Auto Industry in Japan and the U.S.*, 10. MITI eventually shelved the “people’s car” plan, but this attempt to shape the market had the unintended consequence of thrusting automobile and three-wheel manufacturers into the same passenger car market. Cusumano, *The Japanese Automobile Industry: Technology and Management at Nissan and Toyota*, 21.

297 By the mid-1960s, there were a large number of competitors in Japan’s automobile market, leading to MITI concern over “excessive competition” in the domestic market possibly weakening the industry against foreign competitors as markets gradually opened up. Seven domestic firms manufactured both cars and trucks – Nissan, Toyota, Isuzu, Hino, Mitsubishi, Prince, and Toyo Kogyo. Six firms built small cars – Toyo Kogyo, Daihatsu, Fuji Heavy Industries, Suzuki Honda, and Mitsubishi. This prevented any firm from attaining economies of scale. On the one hand, MITI faced pressure from European countries and the IMF to lower import restrictions. At the same time, MITI worried that domestic manufacturers, unable to attain scale, would be wiped out by foreign competitors. It exerted informal guidance pressuring firms to specialize in one type of vehicle,
MITI did succeed, however, in its plan to harness the technology and expertise of foreign firms by orchestrating a series of tie-ups with domestic firms. This plan was targeted at the Big 5 Japanese manufacturers and relatively smaller foreign automobile manufacturers. MITI’s concern was that Japanese automobile firms’ experience was in trucks rather than cars, placing them at a severe disadvantage in competition against foreign car manufacturers. It issued guidance for domestic manufacturers to become knock-down kit assemblers for European manufactures for a few years, then switch to assembling domestically produced components. This led to several tie-ups: Nissan with the British firm Austin in 1952, and in the following year, Isuzu with Rootes, another British firm, Hino with Renault, and Mitsubishi with Willy-Overland, an American firm. All four tie-up contracts prohibited the Japanese partner from exporting their cars.\(^{298}\) Three of the four contracts ended in 1960 (1958 for Mitsubishi), though some were extended; the tieup lasted 7 years for Nissan, 12 years for Isuzu after an extension, 11 years for Hino after an extension, and 10 years for Mitsubishi after an extension. Toyota was the only Big 5 manufacturers that chose to avoid a partnership.\(^{299}\) (See Table 25)

### Table 25. Tie-ups Between Japanese and Foreign Automobile Firms (1950s-1960s)

<table>
<thead>
<tr>
<th>Japanese Auto Firm</th>
<th>Nissan</th>
<th>Isuzu</th>
<th>Hino</th>
<th>Mitsubishi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Partner</td>
<td>Austin</td>
<td>Rootes</td>
<td>Renault</td>
<td>Willy-Overland</td>
</tr>
</tbody>
</table>

MITI’s plan for tie-ups enabling domestic producers to gain expertise was combined with its protection of the domestic market. MITI used foreign exchange allocations, combined with a value-added tax of 40 percent, to reduce imports. Japan’s imports of automobiles fell from 45% in 1951 to 23% in 1954, and 9% in 1955, finally reaching 1% of new auto sales in 1960.\(^{300}\)

MITI also protected the domestic manufacturers from imports though the 1960s and most of the 1970s through duties differentiated by car size. Although it lifted duties on small cars, it defined the specifications for small cars as smaller than that of most American and European cars, with larger cars incurring a duty of at least 34 percent. Commodity and weight taxes on all autos after the early 1950s also penalized the purchase of large cars. Inspection regulations raised costs of foreign exports to Japan; until 1983 revision, customs agents inspected every imported such as minicar, sports car, etc, but the small car manufacturers, Toyo Kogyo, Fuji, Mitsubishi, and Daihatsu objected strongly, as this would have capped their growth potential – MITI was forced to abandon the idea. Moreover, Honda, which had specialized in motorcycles, entered the market in 1963, despite MITI’s efforts to dissuade it from doing so. In 1963, MITI was unable to persuade Honda not to enter the 4 wheel vehicle market. MITI then tried to promote consolidation of the domestic sector, but was ultimately unsuccessful. Prompted by a recession in 1965, Prince merged with Nissan in 1966, but this was the only full merger. Toyota took a majority share of Hino in 1968 and Daihatsu in 1969, and Nissan took a majority share of Fuji in 1968, but since none of the companies competed directly with the firms they bought into, the level of competition did not decrease. Cusumano, *The Japanese Automobile Industry : Technology and Management at Nissan and Toyota*, 22-23.

\(^{298}\) Mitsubishi was allowed to export within Asia.


\(^{300}\) Ibid., 7.
vehicle rather than a sampling from a batch, and only agents registered in Japan were permitted to file import applications.  

**Gaiatsu from the US Big Three**

By the late 1960s, the American “Big Three” auto firms began to apply pressure to establish operations in Japan, but were unsuccessful. The Japanese government restricted them from establishing wholly owned factories, setting a ceiling for equity investment into existing Japanese auto firms at 7%. In the late 1960s, executives from the Big Three, aided by the US State Department, conducted numerous meetings with Japanese firms and government officials to press for direct entry. The Japanese government, however, maintained the position that the domestic auto industry was fragmented and weak, requiring time for rationalization and consolidation. The Japanese Automobile Manufacturers’ Association fully backed the government position.


The Japanese government’s regulatory restrictions hindering foreign entry were removed in the early 1970s. Most of the explicit government protections were removed – partly due to external political pressure, and partly because Japanese firms as a whole were becoming internationally competitive, especially following the oil shocks which created demand in the US for small, fuel-efficient Japanese cars. As soon as explicit protection was removed, the Big Three US auto firms moved in immediately, purchasing minority ownership and capital tie-ups.

In 1970, MITI lifted foreign investment restrictions into Japanese automobile companies. In 1972, it decreased duties on all car imports to 8 percent, down from over 30%, and duties were eliminated entirely in 1978. The Big Three moved in quickly to engage in capital tie-ups with Japanese firms, to some degree in reaction to overtures by the weaker Japanese firms.

In 1970, Chrysler was involved in creating Mitsubishi Motors as a joint venture. Mitsubishi Heavy Industries (MHI) invested 85%, with Chrysler putting in 15%. MHI required technology and overseas distribution, but was unwilling to join Toyota or Nissan. Expecting government opposition, Mitsubishi had quietly approached Chrysler in 1968, proposing a 35% equity stake for the latter. Chrysler agreed to the plan; in its view, this was the only way the government would allow it to enter Japan. The Japanese government, surprised by the plan, abandoned its efforts to consolidate Japanese manufacturers.  

Chrysler provided access to export markets, selling Mitsubishi-built cars in the US under the Dodge and Plymouth brands. Chrysler had initially planned to increase its share to 30%, but it experienced a management crisis and shelved plans to do so. In 1985, after Mitsubishi became increasingly competitive, Mitsubishi and Chrysler cancelled the basic contract of their joint venture, with Mitsubishi Heavy Industries decreasing its share to 50% and Chrysler to 10%. Mitsubishi Motors was listed on the stock exchange in 1988, and Mitsubishi

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301 Ibid., 24-25.
303 Ibid., 234-35.
Heavy Industries dropped its shares to less than 30%, but was still the largest shareholder. The two companies were invested in a joint venture for production in the US (Diamond-Star Motors), announced in 1985, beginning operations in 1988.\(^{304}\)

In 1971, GM purchased 34.2% of Isuzu, which built trucks, buses and automobiles. Isuzu had been facing a potential financial collapse after negotiations with other Japanese manufacturers failed. Arguably the weakest Japanese automobile firm to begin with, Isuzu had failed to retain alliances with Fuji Heavy Industries (attempted at MITI’s urging), and Mitsubishi (Mitsubishi moved away from Isuzu to ally with Chrysler in 1969). Furthermore, negotiations with Nissan had failed, since Isuzu feared becoming a Nissan subsidiary, and Nissan’s truck division had also raised opposition. GM sent four executives to the board of Isuzu. Through the tie-up, Isuzu gained access to US markets as some of its trucks and vehicles were sold by Chevrolet. Isuzu also expanded into global markets in the 1980s as a partner of GM, with joint ventures in countries including the Philippines, Indonesia, Tunisia, and Egypt. Isuzu became a major supplier and R&D contributor to GM, and in the mid-1980s, Isuzu became a beneficiary of GM’s global telecommunications network.\(^{305}\)

This initial investment by GM into Isuzu created a media frenzy in Japan. The chairman of GM, in a statement to the Japanese press, promised GM would not take management control of Isuzu. In the agreement, GM agreed to not increase its share above 34.2% for five years, with a permanent ceiling of 49%. The agreement stipulated that GM would not control appointments of the president or chairman, and it was limited to sending one third of the total number of board appointments, with limited proxy powers.\(^{306}\)

In 1979, Ford acquired 24.5% of Mazda. Mazda had been rescued by its main bank, Sumitomo Bank, after experiencing a financial crisis in the mid-1970s.\(^{307}\) After the bank sent in new executives, the company had become profitable again from 1976, and Sumitomo Bank played the role of agent in Ford’s investment in Mazda. Ford licensed the production of small trucks to Mazda, and the latter distributed Ford’s products in Japan. In 1980, Ford sent three executives to Mazda’s board of directors, including one senior manager – though their roles consisted of monitoring and reporting to Ford rather than engaging in specific management tasks at Mazda.\(^{308}\) By the late 1980s, the two companies had co-developed several products, and Ford gained manufacturing expertise from Mazda through outsourcing some of its development.\(^{309}\)


\(^{307}\) Mazda was famous for its technological feat of successfully producing the rotary engine, based on a German design that had nobody had succeeded in commercializing. However, the rotary engine was not fuel efficient, and the oil shocks hit the company extremely hard.


In 1981, GM purchased a small stake (5.3%) in Suzuki. Suzuki had the largest market share of minicars in Japan, but only about 5% of the automobile market at the time. GM and Suzuki jointly developed a number of small cars sold in the Japanese market, and in the US through the Chevrolet division. Even as Suzuki’s domestic car sales decreased by the mid-1980s, its production increased by over 40% due to the increase of exports. In 1986, GM and Suzuki built a plant in Canada as a 50-50 joint venture. From 1988, Suzuki imported GM’s Chevrolet and Pontiac brands to Japan.

In sum, the demise of regulatory restrictions led to foreign auto firms moving in to take minority equity stakes in the smaller, relatively weak Japanese auto firms. While production tie-ups of various sorts were pursued and some executives were sent from the foreign MNCs Japanese auto firms for the most part retained managerial autonomy.

**Tie-Ups with Management Control (Late 1990s-)**

Market developments took a dramatic turn in the mid to late 1990s, leading to a major foreign influx that entailed foreign management control. As economic stagnation slowed the growth of Japan’s overall automobile market, several firms were thrown into increasingly dire financial straits. Foreign auto firms entered Japan to turn around major Japanese auto firms to a degree unthinkable a decade earlier. The turnaround of Nissan by Renault was the most dramatic, accompanied by an equally dramatic shift in public opinion. The new CEO, Carlos Ghosn, was initially greeted in the Japanese press with much trepidation, but his reputation morphed into that of hero and management guru. Ford’s restructuring and reorienting of Mazda was also dramatic, though much less publicized vis-à-vis that of Nissan. DaimlerChrysler’s abandonment of troubled Mitsubishi Motors highlights the difficulties of managing large and diverse multinational operations.

**Renault and Nissan: The Paradigmatic Revival**

Nissan’s turnaround under the management control of Renault is widely considered within Japan as a paradigmatic case of rescue and turnaround of a Japanese company at the hands of foreign management. In 1999, Renault purchased a 37% stake in Nissan for approximately $5.4 billion.

Nissan faced an acute crisis by the late 1990s, teetering on the edge of bankruptcy. Its crisis stemmed from factors including aggressive product and dealer expansion in the US, miscalculations of dealer valuation in the US, poor differentiation among its products, high debt, and damage inflicted by depreciation of the yen. It recorded losses for six of the seven years until 1998. Its main banks, Fuji Bank and Industrial Bank of Japan, weakened themselves, announced they would not engage in a bailout of Nissan. After unsuccessful talks with DaimlerChrysler and Ford, Nissan entered into negotiations with Renault, which was willing to undertake a massive capital injection, in return for complete management control. Renault sent

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310 Badaracco, "General Motors' Asian Alliances."
311 Manufacturers’ difficulties were compounded by a strong yen, which raised the price of exported cars and components.
312 Heller, "An Inquiry into the Role of Interfirm Relationships in Recent Organizational Change Initiatives in Japanese Automobile Firms."
Carlos Ghosn, a Brazilian born Frenchman of Lebanese descent, who became Nissan’s president in 2000, and CEO in 2001.

Ghosn restructured Nissan extensively. Supplier chains were reorganized and the overall number of suppliers was reduced from 1145 in 2000 to 595 in 2002. Nissan closed a major manufacturing plant, working with unions to offer early retirement or transfers to other plants. The entire Nissan group workforce was reduced by approximately 15,000 people, and the company headhunted a new chief designer from Isuzu – in an unprecedented move to hire away top talent at this level from a competitor. Nissan also sold assets such as real estate to repay its debts. By sharing product development elements like vehicle platforms with Renault and combining purchasing operations, Nissan reduced its procurement costs by 20%. In overseas operations, Renault and Nissan shared plants. In 2002, Nissan reached its performance targets a year early—it had become profitable, and eliminated its interest-bearing debts to zero.

With the dramatic but successful reforms he spearheaded without resort to mass layoffs, Carlos Ghosn’s image in the Japanese press changed from that of a dreaded cost-cutter to a savior whose lack of social constraints and obligations, combined with vision and execution, enabled the dramatic turn-around.313

**Ford and Mazda: A Major Turnaround Under the Radar**

In 1996, Ford expanded its tie-up with Mazda, taking a greater level of management control than ever before. By the mid-1990s, Mazda had entered another financial crisis due to factors including overexpansion of dealers in the domestic market and its lack of hit products. Mazda logged operating losses for three consecutive years, from 1993 to 1996. It sought a deeper relationship with Ford to revive its fortunes, and with Sumitomo Bank once again calling upon Ford to save the company, the bank invited Ford to examine Mazda’s books in late 1993. Ford, satisfied with what it saw, and considering its ongoing tie-up with Mazda a success, agreed to a joint declaration of a closer strategic relationship.314 Ford doubled the number of its executives in Mazda’s board, and in 1996, injected capital in exchange for greater management control. Ford increased its stake to 33% (for an estimated $480 million), and Mazda agreed to receive a Ford executive as its CEO—the first Japanese firm to have a foreign CEO. Several other Ford executives were dispatched to Mazda, as were groups of midlevel engineers and managers.315

Mazda essentially became a firm under the Ford umbrella, relatively independent as an organization, but with strong links between the two. The Ford executives dispatched to Mazda had specific managerial responsibilities, bringing a focus on improving asset utilization and cash flow-oriented decision making. They spearheaded a reorganization of the company, and Mazda’s

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315 Many of the executives later took positions in Ford’s global operations. The first Ford executive was Henry Wallace. Other, such as Mazda’s CFO, Bob Shanks, was later moved to Ford’s European operation. Todd Zaun Neal Boudette, Norihiko Shirouzu, "Mazda Serves as School for Executives at Ford; Japan's Cutthroat Competition Means Designs Must Be Churned out Quickly," *The Wall Street Journal*, August 28 2003.
production plans were frozen and examined by the new Ford-dispatched management. The number of subsidiaries was cut in half between 1999 and 2000 (34 to 17), and cost cutting measures such as expense reductions and exchange rate exposure hedges were pursued. Mazda rebranded itself, and internal divisions were shifted around, including the creation of a new marketing division. A major voluntary retirement program led to a reduction of over 2000 personnel – part of a reform plan with the dramatic slogan of “change or die.” English was also adopted as the primary internal language for top-level meetings. After several years without new products while Mazda reorganized and reoriented itself, in 2002, a slew of new products was released, and the firm immediately returned to profitability.316

Mazda retained its independence as an organization, giving room for both autonomous organizations to compete and learn from the other. Senior management of Ford and Mazda apparently interacted as equals, unlike the case of other firms in the Ford group such as Volvo and Jaguar/Land Rover, which were wholly owned by Ford. In some cases directors from Ford reportedly acted on behalf of Mazda against the wishes of Ford.317

Overall, under Ford management, Mazda received a much needed capital injection, and Ford management implemented some production techniques it learned from Mazda’s operations.318 Ford’s contributions to Mazda included expertise in styling, international marketing and finance, while Ford learned aspects of supplier management, particularly in quality and delivery.319

**DaimlerChrysler and Mitsubishi Motors: Difficulty and Failure**

Mitsubishi Motors was also in crisis in the late 1990s, and DaimlerChrysler (the result of a de facto acquisition of Chrysler by Daimler in 1998), purchased a controlling stake of 33.4% in 2000. Unlike Nissan and Ford, however, the merger was considered a failure, and DaimlerChrysler pulled out in 2004.

Mitsubishi Motors’ crisis in the late 1990s, like that of Nissan, was acute. More reliant on Asian markets than its competitors, Mitsubishi was hit harder by the effects of the 1997-1998 Asian Financial Crisis. Sales plummeted, and in 1997, Mitsubishi Motors recorded its largest loss ever. A restructuring program was implemented in late 1997, which restored the company to profitability the following year, but its sales did not grow, and its interest-bearing debt totaled 1.7 trillion yen by the end of 1999.320

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316 Heller, "An Inquiry into the Role of Interfirm Relationships in Recent Organizational Change Initiatives in Japanese Automobile Firms."
318 Phil Martens spent three years as Mazda before becoming Vice President of product development at Ford, tasked with speeding up development after experiencing Mazda’s rapid product creation system in Japan’s competitive domestic market. Neal Boudette, "Mazda Serves as School for Executives at Ford; Japan's Cutthroat Competition Means Designs Must Be Churned out Quickly."
Chrysler, facing difficulties of its own, had divested itself from Mitsubishi in the early 1990s. It sold its shares of the US Chrysler-Mitsubishi joint venture, and decreased its share of Mitsubishi to less than 3 percent in 1992. The following year it sold off its remaining shares.

For DaimlerChrysler, Mitsubishi was not its first choice of a Japanese auto firm. DaimlerChrysler had been rebuffed by Honda, and internal opposition ruled out Nissan. DaimlerChrysler paid approximately $2.5 billion for its 33.4% stake in Mitsubishi Motors, sending a president and executive management team. In stark contrast with Renault’s management team, the DaimlerChrysler executives failed to stage a dramatic turnaround of Mitsubishi. Mitsubishi recorded losses in 2003, and it experienced a major scandal the following year. In 1994, it was revealed that Mitsubishi Motors management had been engaging in a serious defect cover-up scheme lasting over a decade. The scandal was a culmination of other smaller cover-ups that had resulted in fines and recalls. Refusing Mitsubishi’s request for a new capital injection, DaimlerChrysler divested itself in 2005. As part of the exit deal, it acquired 85% of Mitsubishi’s truck division, spinning it out as Mitsubishi Fuso Truck and Bus.

The DaimlerChrysler-Mitsubishi Motors case reveals the organizational challenges of integrating the operations of diverse multinational operations under a single management umbrella—especially for a product as complex as automobiles. Analysts have contended that DaimlerChrysler executives never received the full support of Mitsubishi employees, and did not set clearly defined goals. They were unable to muster sufficient support from the DaimlerChrysler headquarters, with the DaimlerChrysler-installed Mitsubishi president lacking a direct line of report to the CEO of DaimlerChrysler. Other contributing factors may have been the lack of a sufficient sense of crisis, with the implicit possibility of a Mitsubishi keiretsu group bailout – which is indeed what happened after DaimlerChrysler exited. Analysts have pointed to problems with communication internally, and the relative lack of Mitsubishi executives’ involvement in decision-making, combined with a sense that DaimlerChrysler managers were working in their own interests rather than those of Mitsubishi.

This case reminds us that organizational challenges exist not only in entering the market, but operating successfully within it after entry.

**Further Foreign Firm Action in Japan’s Automobile Market: Entry and Exit**

Finally, a few further developments in Japan’s auto industry suggest how MNCs are changing the sector, and how global forces can affect the domestic sector via MNCs.

The entry of MNCs has facilitated the reorganization of the sector, entailing a marketization of firms – in the sense that they can be bought, split apart, and sold – more than ever before. As Nissan divested itself of its keiretsu relationships, it decided to sell off Nissan Diesel. In 2006, Volvo had purchased 13% of Nissan Diesel from Nissan, and in 2007, it moved

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321 Shortly before the merger, the Transportation Ministry’s investigation revealed that Mitsubishi had engaged in cover-ups, and had secretly repaired defective vehicles, since at least 1977. It was later fined 4 million yen by a Tokyo court, and Mitsubishi issued a recall, which cost it approximately 5 billion yen.


323 Ibid.
to acquire the remaining shares (it had raised its stake to 19% in the interim). Paying approximately $1.06 billion, it made the truck company into a wholly owned subsidiary.

The sudden exit of GM from its investments in Japanese firms created shockwaves in the sector, especially among firms into which the company had invested. GM’s exit demonstrated how factors relatively unrelated to the Japanese market could precipitate major exogenous shifts in MNCs’ strategies in Japan. In the mid to late 2000s, facing higher gas prices and a collapse in demand for its core revenue-driving large vehicles, GM confronted a financial crisis. As its need to raise operating capital became acute, in 2005, GM suddenly sold off all of its shares of Fuji Heavy Industries (Subaru), much to the surprise and shock of the latter. The following year, GM sold its entire 49% stake in Isuzu – a stake it had held since 1999 when it raised it level of ownership. Also in 2006, GM lowered its 20% stake in Suzuki to 3%, selling of the remaining shares in 2008.

GM’s exit led to a realignment of capital holdings and relationships among Japanese auto firms, while opening the door for further foreign ownership. Toyota purchased a large proportion of GM’s stake in Fuji Heavy Industries, cultivating deep production ties with the company. Toyota also became a major shareholder of Isuzu, integrating many of its operations with Toyota’s Hino truck division. Isuzu did, however, retain some of its GM tie-ups without a capital ownership relationship. Suzuki entered into a partnership with Volkswagen, leading to a 20% investment by the latter in early 2010.

**CONCLUSION: AUTOMOBILES**

The case of Japan’s automobile industry illustrates how regulatory shifts alone were insufficient for an influx of MNCs. Only when market dynamics shifted, over a decade after formal and informal regulatory restrictions were removed, did MNCs face opportunities for major entry. The objective of entry for many of the MNCs, however, was not simply access to the Japanese market. They were in search of firms that complemented their global product lines, with potential to enhance their production technology and know-how.

Tie-ups between major Japanese auto firms and foreign MNCs that rescued them reveal the inherent challenges in managing complex MNCs. While Nissan and Mazda’s fortunes were revived by Renault and Ford, respectively, DaimlerChrysler experienced serious difficulties with Mitsubishi Motors. In contrast to arguments suggesting that outside management necessarily improves efficiency, we see that foreign buyouts are neither inherently a panacea, nor necessarily even helpful to domestic corporate restructuring.

Finally, the abrupt exit of GM due to problems mostly in its North American operations, reshuffled the ownership and alliance structure of the Japanese auto industry. This suggests that with greater foreign MNC presence, overall market volatility will increase, since exogenous factors can realign MNCs’ global strategies, affecting even host countries that would be otherwise unaffected directly – precisely one of the rationales for limiting foreign access during the developmental period. Next we turn to the case of telecommunications.
II. TELECOMMUNICATIONS

Foreign firms’ interactions with Japan’s telecommunication sector followed a broadly similar pattern to that of other sectors – regulatory restrictions compartmentalizing MNCs, followed by policy shifts that enabled an influx. Unlike other sectors, however, MNCs’ business models were not decisively successful vis-à-vis Japanese firms, and their entry was not precipitated by a domestic crisis. Instead, the bursting of the global IT investment bubble in 2000-2001 reduced the strength of MNCs in global markets, leading many to leave Japan. (The Japanese carriers’ relatively low exposure to international markets left them relatively unscathed.) In short, the MNCs left Japan due to external market conditions rather than market dynamics within Japan.

The telecommunications sector is complex, straddling several areas including services, hardware, and other value-added services such Internet services provision. In this study we are primarily concerned with the area of services provision, in which carriers are the main actors. Carriers must, by definition, have a presence in the economy to provide services, while equipment providers can have a market presence based on trade rather than direct operations. Carriers are almost always more highly regulated than equipment manufacturers in any country, and while equipment firms were involved in prominent cases of gaiatsu, these were trade debates over market access. Since MNCs interested primarily in trade can become involved in policy debates over the regulatory framework for services due to the latter’s influence on choices of equipment procurement, this section includes some political strategies of equipment manufacturers as well.

The overall pattern of foreign entry unfolded as follows: during the initial market liberalization of the mid-1980s, foreign MNCs mobilized gaiatsu strategies to enter. For a decade, the Ministry of Posts and Telecommunications (MPT) regulated the sector with the logic of ex ante managed competition, closely resembling how MOF’s historical governance of the financial sectors. A decade later, MPT shifted its regulatory framework towards that of ex post market governance. Restrictions on foreign entry were lifted, as was compartmentalization of the sector. A surge of foreign MNCs entered the sector, reorganizing several markets and introducing new technologies and business models. However, unlike financial sectors, Japan’s telecom sector did not experience a crisis, and the core business models of foreign carriers were challenged at a global level with the advent of the Internet. Combined with particularistic dynamics of competition in Japan’s mobile sector, foreign telecom carriers did not enjoy the sustained, profitable presence that did financial firms.

HISTORICAL DEVELOPMENT: THE NTT MONOPOLY AND “FAMILY” EQUIPMENT PROVIDERS

Foreign firms had virtually no role in Japan’s postwar telecommunications market until the 1980s. The operation of telecommunications infrastructure and services in Japan, like that in most other countries, was originally conducted by the government, followed by state-owned monopolies. For most of the postwar period until 1985, when the sector was partially liberalized, domestic and international telephony were monopolized by state-owned carriers Nippon Telegraph and Telephone (NTT) and Kokusai Denshin Denwa (KDD), respectively.

The monopolies procured equipment from a stable set of suppliers known as the “NTT family.” Established during the initial industrialization of Japan in the early 1900s, the major “NTT family” firms, including NEC, Hitachi, Fujitsu, and Oki, competed against one another for
allocations of NTT’s procurement budget. As a key part of Japan’s developmental strategy, the focus of telecommunications was to build the technological competency of Japanese electronics firms, with NTT subsidizing the R&D efforts of the manufacturers. For most of the postwar era, NTT procured its equipment from this closed set of suppliers.

Motorola’s attempt to export equipment to Japan precipitated the first thrust of MNCs’ gaiatsu strategies to enter Japan, albeit over trade issues in this case. In the late 1970s, Motorola was interested in selling pagers to NTT. Finding NTT initially unresponsive to its overtures, Motorola lobbied the US government. The US government subsequently charged that NTT’s failure to disclose its procurement procedures or specifications was a violation of GATT Article X.

In 1980, NTT clarified its procurement procedures, though its performance and design criteria favored products manufactured domestic firms. Moreover, since NTT’s procurement shares were determined by quality rather than price competitiveness, this eliminated a major competitive advantage of Motorola. Nonetheless, in 1981, Motorola did receive a modest contract of $9 million for 60,000 pagers. Gaiatsu, in this case, enabled Motorola to join the closed group of NTT family firms, rather than open up the procurement procedures.

LIBERALIZATION: THE REGULATORY SHIFT TO “CONTROLLED COMPETITION” (1985)

The critical juncture opening the opportunity for foreign MNCs to enter Japan’s telecommunications services market occurred after 1985, when competition was introduced. A major result of the political battle leading up to the partial privatization and liberalization of the sector was MPT’s success in gaining vast regulatory authority over the sector. With its new policy tools, MPT compartmentalized the sector, orchestrated new competitors, and regulated price changes. This new regulatory structure that emerged in 1985 has been labeled “controlled competition,” and it espoused the logic of ex ante managed competition in the financial sectors.

The new regulatory structure restricted foreign firms from owning infrastructure and offering domestic services. The restrictions were built into the laws governing the sector – the NTT Law, KDD Law, Telecommunications Business Law, and Radio Law. The Telecommunications Business Law, which governed the activities of new competitors, divided carriers according to whether or not they owned infrastructure. “Type I” could own infrastructure, while “Type II” carriers were limited to leasing infrastructure from others. Foreign equity ownership of Type I carriers was capped at less than one third, while there were no restrictions on foreign ownership of Type II carriers.

Type II carriers were subdivided into “General Type II” carriers, which operated solely in local areas, and “Special Type II” carriers, which could operate across prefectural lines. Until

326 Vogel, Freer Markets, More Rules : Regulatory Reform in Advanced Industrial Countries.
327 MPT also compartmentalized the sector according to the scope of business. Services were divided into local, long distance, international, and mobile, and MPT’s administrative guidance prohibited firms from engaging in more than one business area.
these divisions were abolished in 1998, foreign carriers were confined to registering as Special Type II carriers, which were more heavily regulated than the General Type II designation.

Foreign investments into NTT and KDD were initially prohibited upon their privatization. From 1985 until revisions in 1992, the NTT Law and KDD Law explicitly prohibited foreign equity ownership. After 1992, foreign ownership was subject to a ceiling of 20%.

**The Entry of Global Carriers in the “Special Type II” Market Segment**

Global carriers entered the Japanese telecommunications market immediately after the regulatory shift, though they were limited to the “Special Type II” market segment. The initial focus of global carriers such as AT&T, British Cable & Wireless, and France Telecom was on providing international telecommunications to multinational corporations operating in Japan. For example, AT&T JENS, a majority AT&T owned joint venture with a variety of Japanese partners such as KDD and Fujitsu, first began offering private corporate networks services from the mid-1980s.

As data communications became more important in firms’ global operations, multinational telecom carriers’ competitive advantages lay in connecting leased lines in Japan to their international grids. Even if they used leased lines within Japan, global carriers could offer “virtual private networks,” essentially multiple users sharing common infrastructure provided by the carrier, but in such a way that user experiences were the equivalent of owning their own private lines. To this end, some partnerships were formed between Japanese and foreign firms to provide global services, such as that between AT&T, KDD, and others in 1993, known as the WorldPartners global alliance. Moreover, as the Internet began to emerge in the early 1990s, and MPT authorized carriers to offer Internet services in 1992, majority foreign-owned firms such as AT&T JENS began offering Internet services to large enterprises.

In the less regulated area of equipment, foreign firms entered as well, though through trade rather than direct investments.

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328 The dynamics of competition shaped by the regulatory structure of controlled competition further benefited foreign firms. Since MPT approved price decreases for KDD and Type I carriers, they all moved to lower prices gradually, and in lock-step fashion. As a result, their prices for international services remained higher than in many other countries, providing benefits to foreign carriers. Thus, the business strategy of offering voice services over leased lines was not a legitimate business strategy in the US, since international calling rates were low, but the high rates in Japan made this a rational strategy. Takahiro Yamada, "American Telecommunications in Japan," in *Winning in Asia, U.S. Style: Market and Nonmarket Strategies for Success*, ed. Vinod K. Aggarwal (New York, NY: Palgrave Macmillan, 2003), 152.

Despite paying for interconnection and leased lines, the company’s rates were still approximately 80% less than that of KDD at the time. The service, AT&T @phone, charged 33 yen per minute for calls to the US, compared with 450 yen for 3 minutes by KDD. "At&T Jens Ga Intaanetto Denwa Saabisu Wo Kaishi: Kokusai/Kokusai Tomo Ni Saabisu Wo Teikyou [at&T Jens to Begin Internet Telephone Service: Both Domestic and International Services Offered]," Impress, http://internet.watch.impress.co.jp/www/article/970805/atphone.htm.

329 MNCs opportunities were concentrated in areas in which Japanese firms were relatively weak. By the mid-1980s, Northern Telecom had become a major international player in providing digital switches, as telecommunications networks worldwide transitioned from analog to digital switching equipment. The company became the first non-Japanese company to become a major supplier of switches to NTT. In
POUNDING ON THE CASTLE GATES: LIBERALIZATION AS AN OPPORTUNITY FOR ENTRY IN COMMUNICATIONS EQUIPMENT, SATELLITE, INTERNATIONAL, AND MOBILE SERVICES (1980s)

In the areas outside the “Special Type II” market segment, in which foreign MNCs were excluded from the beginning, foreign firms employed gaiatsu to attempt entry. The market segments included international telephone service, satellite, and mobile telephony, although the latter two concerned trade more than direct investment. Foreign firms enjoyed varying degrees of success, and in all cases, MPT initially planned to license fewer carriers than those that expressed interest. MPT was particularly hesitant to license firms with high levels of foreign ownership.

International Services: Pounding on the Gates with Domestic Support

In international telephony services, MPT intended to license one competitor to KDD, a Japanese firm. However, strong gaiatsu pressure mounted by British Cable & Wireless through the British government, combined with general pressure from the US, led to MPT’s approval of an additional international carrier that had a significant level of foreign influence.

The Japanese entrant, Nihon Kokusai Tsushin (ITJ), was created in 1986 by a consortium of Mitsubishi Trading Company, Mitsui Bussan, Sumitomo Trading Company, and Matsushita (each with 17% of the shares). ITJ’s plan was to use KDD’s infrastructure, purchasing the rights to use it in perpetuity. A potential foreign entrant emerged in the form of Kokusai Digital Tsushin (IDC), also formed in 1986. The majority shareholders were the trading company C. Itoh and British Cable & Wireless, with 20% each, followed by Toyota and Pacific Telesys International (PTI, a US West coast-based firm spun out of AT&T), with 10% each. IDC had the maximum level of foreign investment allowed, 33%, and it planned to use Cable & Wireless’ underwater cable from Europe to Hong Kong, building a new transpacific cable to Japan. In short, it would avoid KDD’s infrastructure entirely.

MPT argued that one firm was sufficient to maintain a balance between supply and demand, and it was hesitant to license two carriers. The Supply-Demand Adjustment Clause in the Telecommunications Business Law granted the ministry discretionary authority in denying licenses to potential entrants. MPT could cite expected imbalances in the estimated supply and demand of telecommunications services as the grounds for denial, although the clause did not stipulate how the ministry would determine projected supply and demand. In 1986, an MPT study group published a report contending that Japan should strive to maintain the reliability of international communications, and that a level of national autonomy should be retained. The study group’s estimate suggested that the entry of the two new carriers would create an

1988, its market share for digital switches was a modest 0.6%, with Hitachi at 26.1%, Oki at 25.5%, NEC at 25.0%, and Fujitsu at 11.8%. but by the early 1990s its share had expanded to an 8% share of the market for central office switches. (NEC, Fujitsu, Hitachi, and Oki had 39%, 26%, 19%, and 16%, respectively.) Martin Fransman, Japan's Computer and Communications Industry: The Evolution of Industrial Giants and Global Competitiveness (New York, NY: Oxford University Press, 1995), 100.


Ibid., 102-18.
oversupply of network capacity. MPT also feared that Cable & Wireless’ plan for a new undersea cable would render KDD’s new backbone, slated to commence operations in 1988, underutilized.

Keidanren joined the debate in 1986, supporting the entry of two new carriers. The previous year it had submitted an opinion paper to the government requesting new entrants into international communications in order to lower communications costs for Japanese companies. Toyota, Matsushita, NEC, and Sony were among the 40 companies that signed this opinion paper. In 1986, Keidanren produced its own supply-demand estimate, projecting demand growth to be faster than that of the MPT study group.

MPT was interested in merging the two new competitors, and, somewhat surprisingly, Keidanren became a mediator in the process. However, talks collapsed in 1987 after Keidanren’s proposed plan put the share of Cable & Wireless at less than 3%, eliciting the reaction from C&W that this could only be thought of as a joke.

Foreign governments began reacting to the debate. The British government set up a meeting between the UK government’s Department of Trade and Industry and MPT, and sent a letter from British Prime Minister Thatcher to Japanese Prime Minister Nakasone expressing dissatisfaction that C&W was meeting resistance from MPT to enter the Japanese market. The US government, though not coordinating directly with the British government, applied pressure through the State Department to Japan’s Ministry of Foreign Affairs, MPT, and the Japanese embassy in the US. The US contended that the attempt to reduce the share of a foreign firm to under 3% was illegal, and constituted an abrogation of the MOSS agreement.

In the end, a compromise for consolidating the two companies could not be reached, and both companies applied for licenses. MPT granted both, and each began services in 1989. After 1991, both firms became profitable, and between them, took slightly over 25% of the total market share, leading to price decreases in international communications services along the way.332

**Satellite Telecommunications: Pounding on the Castle Gates to no Avail**

With liberalization of Japan’s telecommunications sector, another area that opened up to new competitors was satellite communications.333 In 1985, three consortia expressed an interest in entering the sector. Each involved Japanese trading companies, and each proposed to buy or lease US equipment. One firm had a 20% investment from Hughes Communications, a leading American manufacturer of satellites, although the focus of Hughes was more to sell satellites than operate the service334

Since the early 1980s, the US government had been pressing Japan to purchase US satellites, and it became one of the issues in the 1985 MOSS talks. MPT was interested in consolidating the potential entrants into one carrier, since it deemed that a total of 206 transponders – the sum of all three firms’ proposals – exceeded potential demand. MPT also

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332 Ibid.
333 This section draws heavily from Ibid., 75-87.
334 The consortia, all formed in 1985, included: Japan Communications Satellite (JS-SAT), with 20% investments by C.Itoh, Mitsui Trading Co and Hughes Communications; Space Communications (SCC), 75% owned by Mitsubishi Trading and 25% by Mitsubishi Electric, proposing to use Ford Aerospace communications satellites; and Satellite Japan (SJC), with investment from Sony (30%), Nissho Iwai (23%), Marubeni (22%), planning to use satellites from RCA Astro Electronics.
pointed to the US experience in which financial difficulties by some satellite firms led to a degradation of service quality. The prospective entrants argued that demand would expand with applications such as video, and the US satellite manufacturers lobbied against application of MPT’s supply-demand adjustment clause. At one point, Keidanren even put forth a consolidation plan, but questions within Keidanren about the rationale for its play such a role resulted in a shift in personnel, dissipating the plan. Since Japan had allocated a different bandwidth for satellite communications than the US, the US government also lobbied for Japan to change its spectrum allocation.

MPT’s deliberation council on telecommunications businesses argued in its overall liberalization plan that a total of five new competitors to NTT and KDD should receive licenses, two of which could be satellite carriers. Although the specific basis for how the deliberation council arrived at this number was unclear, MPT followed its recommendations, granting two licenses for satellite communications. The carrier led by Sony and Nissho Iwai, slated to use satellites manufactured by RCA Astro Electronics, was not licensed. (An MPT official was quoted as having made the decision on the basis of estimated demand elasticity, and in the spirit of the Telecommunications Business Law.) Further US pressure through the MOSS talks and from the USTR in 1986 to obtain approval for the third satellite carrier was unsuccessful, and MPT denied the request.335

**Cellular Services: Pounding on the Castle Gates to Divide the Market**

In cellular services, Motorola mobilized gaiatsu to pressure the Japanese government to license an addition carrier that had pledged to use its equipment.336 Motorola and the US government viewed liberalization of Japan’s telecommunications sector as a critical opportunity to advocate the adoption of cellular standards developed in the US, which would enable American firms to access the Japanese market and reduce the trade deficit.337

In short, Motorola succeeded in its efforts to get a Japanese firm that had pledged to use its equipment an operating license and spectrum allocation. When it found that the geographic area allocated to this new carrier excluded the Tokyo Metropolitan area it applied further pressure through US diplomatic channels, in the context of escalating US-Japan trade wars, an incredible private sector solution ensured that a different cellular firm would adopt Motorola’s equipment to construct an entirely separate network.338

335 In her analysis, Suda argues that the lack of domestic support was a likely factor in the lack of success by the US in getting the third satellite carrier, Satellite Japan (SJC), approved. Suda, *Tsushin Gurobaru-Ka No Seijigaku : "Gaiatsu" To Nihon No Denki Tsushin Seisaku* [the Politics of Globalization in Telecommunications : "External Pressure" On Japanese Policies], 75-87.
336 This section draws heavily upon Ibid., 96-102.
337 After the AT&T breakup in 1982, demand for equipment surged, and the communications equipment trade gap between the US and Japan widened, with Japan exporting over 11 times the value it imported.338 For details, see Kenji E. Kushida, "Wireless Bound and Unbound: The Politics Shaping Cellular Markets in Japan and South Korea," *Journal of Information Technology and Politics* 5, no. 2 (2008). MPT helped orchestrate the creation of a new carrier, Nihon Ido Tsushin (IDO), backed by Toyota, NEC, and a few other major Japanese firms. The company intended to deploy a cellular standard developed by NTT, J-TACS, with equipment procured from the NTT family firms. Another firm, however, also sought to enter the market. DDI was interested in competing against NTT by using Motorola equipment, and therefore the TACS standard. According to Motorola Japan’s vice
REGULATORY SHIFTS OPENING THE GATES: FOREIGN ENTRANTS RESHAPING THE CABLE INDUSTRY (1993-)

The cable broadcasting sector, a market adjacent to telecommunications, but which increasingly merged into the latter in the mid-2000s, demonstrates how regulatory shifts led to an immediate foreign influx. The lifting of restrictions on foreign investment and easing of geographic compartmentalization led to consolidation and reorganization of the sector as the result of foreign entrants.

Until 1993, MPT restricted competition and prohibited foreign ownership of cable operators. The operations of cable broadcasters were geographically limited to a single region, such as town, village, or ward. In exchange, they were given local monopolies. According to MPT’s original vision, the primary purpose of cable providers was to retransmit terrestrial broadcast signals—a public service in areas lacking adequate reception of terrestrial broadcasting signals. MPT also saw cable broadcasters as a medium to provide some local programming on local events.

president, DDI had estimated that by avoiding NTT’s patent usage fees and NTT “family” provided equipment, DDI could reduce its costs to less than a half or a third.

The ideal scenario for MPT was a merger or joint venture between IDO and DDI employing the NTT standard, though they were not opposed to its adoption of the TACS standard to use Motorola’s equipment. However, each firm was wedded to its standards strategy, and the question of which party would exert more control was difficult to resolve. MPT opened bids for licenses in 1986, but neither firm applied. By January 1987, MPT gave up trying to consolidate the firms, shifting its efforts to divide the market geographically between the two companies to enable both to enter. In February 1987, MPT announced that an agreement had been reached between the two carriers over the geographic distribution of markets. The agreement was reached informally, and while MPT maintained its public stance that the agreement was reached between the two private actors, several IDO and DDI employees maintained that MPT had essentially told them what to do.

This compromise allowed DDI to enter the market, but the uneven division of geographic regions led to another round of gaiatsu initiated by Motorola. It turned out that although DDI had received a license and spectrum for particular regions, it was excluded from the largest market, the Tokyo metropolitan region, and was overall approximately half that of IDO.

Motorola mobilized further US pressure, leading to letters of protest from the USTR and Department of Commerce. In the follow-up meetings to the MOSS talks in March 1987, the US criticized the exclusion of Motorola from the Tokyo metropolitan region, and the US Secretary of State George Schultz indicated to Prime Minister Nakasone that the geographic distribution was robbing Motorola of an opportunity for fair competition. At one point, Motorola itself even went so far as to demand that a new carrier be licensed using Motorola equipment. MPT, however, was unwilling to yield, claiming that the geographic division was decided by private sector actors, and that it was unwilling to impose its will on this private sector solution.

The solution to this conflict came from domestic Japanese firms. In a fascinating turn of events, IDO, already committed and invested in NTT’s standard and equipment, decided to deploy an entirely new, redundant network using Motorola equipment. Toyota, the major shareholder of IDO, had actually forced this decision. In the context of escalating trade friction with the US, Toyota feared retaliatory moves by the US aimed at Japan’s automobile exports. IDO’s management opposed Toyota’s plan, but had few alternatives, especially in the face of Toyota’s threat to withdraw its guarantee of the loans needed by IDO to build its networks.
In 1993, during the brief period in which the non-LDP coalition held power, MPT began to deregulate and de-compartmentalize the cable market. It ended local monopolies by allowing external ownership of local cable companies, and foreign entities were allowed up to 33% equity ownership of cable companies.

Foreign firms immediately took this opportunity to enter Japan, forming joint ventures with Japanese partners. The American cable operator Tele-Communications International (which later became Liberty Media) partnered with Sumitomo Trading Company to create a 40/60 joint venture, Jupiter Telecom (J:Com), and Time-Warner joined Toshiba and trading company C.Itoh to create Titus Communications.339

J:Com moved particularly aggressively in purchasing and entering into tie-ups with local cable providers. It integrated them into a national network, soon becoming the largest cable provider in Japan. J:Com drove the consolidation of Japan’s fragmented cable market, even eventually absorbing its competitor, Titus in 2000. By March 2008, as the proportion of Japanese households with cable television service reached 42%, up from just under 15% in 1997, J:Com’s market share was the largest, approximately 37% of the total.340

**THE CASTLE GATES OPENING: REGULATORY SHIFTS, NEW OPPORTUNITIES, AND THE FOREIGN INFLUX (LATE 1990S-)**

The major regulatory shift in Japan’s telecommunications sector from *ex ante* managed competition to *ex post* market governance occurred over several years in the mid to late 1990s. Restrictions on foreign firms were mostly removed, leading to an influx of multinational telecom firms entering Japan.

MPT dismantled much of its policy apparatus by removing the compartmentalization, largely deregulating pricing, and mostly liberalizing foreign investment. Specifically, foreign ownership restrictions into Type I carriers were removed, most carriers were no longer required to submit their pricing plans for approval, and MPT issued a statement that firms were not limited in the scope of their business (previously limited to one area). A few years later, the categories themselves were removed.341

The shift partly reflected changing views within the ministry on the merits of freer competition – in part a reaction to the advent of the Internet and the Japanese firms’ rapid decline in international equipment markets. Neither external pressure nor corporate lobbying were the main drivers.342

Japan’s deregulation of foreign investment occurred in 1998, after it entered into the World Trade Organization (WTO) Telecommunications Agreement in 1997. Even before the WTO negotiations, Japan was ready to deregulate inward foreign investments. Many within

MPT recognized that the new competitors to NTT were having difficulty competing against NTT’s overwhelming size, reach and financial resources, and that foreign capital could help facilitate more competition. The Japanese government was also interested in opening its domestic market to gain easier access to international markets; in entering the US, KDD had waited 403 days to receive approval from the FCC. (Foreign investments of over 25% into the US telecommunications service market required approval from the FCC, determined by whether the home country gave competitive opportunities for US firms. As a result of the negotiations, limitations on foreign investment in NTT were maintained on the grounds of national security, much like similar limits in France, Canada, Germany, and Great Britain.  

The 1998 deregulation enabled foreign firms to own infrastructure-owning (Type I) carriers, and an influx of foreign firms ensued. In 1998, US carrier Worldcom became the first foreign carrier to register as a Type I operator, followed by Global One and Pacific Gateway Exchange. These firms primarily focused on laying trans-Pacific fiber optic networks.

In 1999, British Cable & Wireless became engaged in a new pattern of market entry – a bidding war against a major Japanese firm over the takeover of a smaller company. The smaller company, IDC, was a Japanese international carrier, and British Cable & Wireless pitted itself against NTT in seeking to buy the firm. British Cable &Wireless prevailed, indicating the willingness of IDC’s stable shareholders, which included Toyota and a trading company, valued the British firm’s higher price premium offer over considerations that it was a foreign firm, or NTT’s considerable relational networks and clout in the sector. The new joint venture, Cable & Wireless IDC, announced plans to build its own fiber network in Japan, entering international and domestic services in 1999 and 2000, respectively. MPT, which had held serious reservations about similar plans a decade earlier, had shifted its position to the point that expressed no public concern.

Foreign firms quickly took prominent positions in several market areas, although overall, NTT continued to be the overwhelmingly dominant player. In the realm of Internet Service Providers (ISPs), US firm PSINet purchased Japanese ISPs Rimnet and Tokyo Internet, becoming the second largest competitor to NTT for business users. In 1999, British Telecom and AT&T purchased shares of Japan Telecom, one of the largest competitors to NTT. By mid-2002, 25 carriers had registered as infrastructure-owning Type I carriers.

Foreign firms also benefited from new market opportunities opened up by MPT’s relaxation of its sectoral compartmentalization, combined with technological advancements surrounding the Internet. For example, when MPT allowed firms to offer voice services over leased lines on top of Internet protocols from mid-1997, AT&T JENS was first to market offering international telephony with its Internet services. After MPT allowed the owners of leased infrastructure to connect to NTT’s local switches, AT&T JENS began offering bundled Internet and international services to households. J:Com, the foreign-managed cable company, 

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343 At the time, the British government retained special shares of British Telecom, France imposed a 20% foreign ownership ceiling on wireless carriers, Canada limited direct inward investment into its carriers to less than 20% with portfolio investments to 46.7%, and the German government was required at least two thirds of Deutsche Telecom. Suda, Tsushin Gurobaru-Ka No Seijigaku : “Gaiatsu” To Nihon No Denki Tsushin Seisaku [the Politics of Globalization in Telecommunications : "External Pressure" On Japanese Policies], 147.

also expanded its business scope by offering telephone services in 1997, followed by Internet services in 1999. By March 2008, as the proportion of Japanese households with cable television service reached 42%, up from just under 15% in 1997, J:Com’s market share was the largest, approximately 37% of the total. Through 2009, the company’s profitability continued to increase.

Highlighting the importance of regulatory shift in the carriers segment, a transformation in the far less regulated market of network equipment was driven primarily by technological change. The intersection with the Japanese market was less about direct investments and more about trade, but the dominance of Cisco Systems occurred as the Internet suddenly took over the world of data networking from the mid-1990s. In the Japanese market, sales of routers in Japan grew from 55 billion yen in 1995 to 202 billion yen in 2002. Cisco’s market share between 1999 and 2001 was estimated at over 80% for high end routers and over 70% for mid-range routers.

As several industry participants noted, the Japanese Internet Service Providers would have been happy to buy equipment from the Japanese firms with which they had longstanding relationships, but they had no other option – despite being appalled at the manufacturing defects occasionally found in Cisco equipment (recall NTT family firms competed for NTT’s procurement orders on the basis of quality rather than price).

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347 The protocols underlying the Internet, TCP/IP, were based on a fundamentally different set of principles from traditional telephone circuit equipment, as well as data communications equipment until then. The sudden popularity of the Internet surprised telecommunications equipment providers around the world; they had been preparing for a different set of data communications protocols. From the mid-1990s, Cisco Systems, a Silicon Valley startup firm, along with its smaller competitor Juniper Networks, moved quickly to dominate the rapidly expanding market of Internet equipment worldwide. By the early 2000s, they enjoyed approximately 80% of the global market for Internet routers and switching equipment.
349 The Japanese firms were not the only ones to be blindsided by the Internet. Existing global hardware manufacturers, ranging from Lucent in the US to Nortel, Ericsson, and others, were left behind as well. Second, Cisco’s overwhelming market share in Japan is almost entirely absent from inward FDI figures due to its production system. In the 1990s, Cisco was one of the leading adopters of extensive outsourced manufacturing.
THE LIMITS OF FOREIGN ENTRY AND EXPANSION IN TELECOM: THE IT BUBBLE BURST AND THE GLOBAL INTERNET DISRUPTION

In contrast with the financial sectors, foreign MNCs’ business models were not decisive advantages in the Japanese market. More seriously, the core business models of global telecom carriers themselves were severely undermined by the advent of the Internet, which eroded the profitability of their communications operations. The shift to providing Internet services did not make up for the declining revenue from providing long distance and international communications. The impact of the Internet in lowering communications prices hit global carriers in the late 1990s, just as they were entering Japan.

Compounding the problems of the global carriers was the bursting of the IT investment bubble in 2000-2001. The bubble had fueled bidding wars for wireless spectrum in Europe, as well as investment races to create fiber optic infrastructure around the world. As the bubble burst, it became clear that there was a global abundance of fiber infrastructure. As stock prices plunged, it also became clear that carriers’ massive payments for wireless spectrum would suppress their ability to invest in the actual networks. Making the situation worse was the revelation of serious fraud committed by Worldcom – a major force in driving down communications prices that eroded the revenue of its competitors. By the time that Worldcom went bankrupt in 2002, it was clear that global carriers had not only faced fundamental challenges from the advent of the Internet, but that they were competing against low prices set by a fraudulent company.

The major global carriers began exiting Japan in the wake of the bursting of the bubble. Just as in other markets, their core business models of providing private data networks and international service to major corporate firms had become radically less profitable with the advent of the Internet. Worldcom, now bankrupt, withdrew from Japan, and AT&T and British Telecom sold their stakes in Japan Telecom. In 2004, British Cable & Wireless sold its stake in Cable & Wireless IDC.

Thus, the bursting of the IT bubble was an exogenous shock leading multinational carriers to exit Japan. Their exit was not the result of closed Japanese markets or discrimination towards foreign firms, nor was it purely the result of unusual traits of the Japanese market making it difficult for multinationals. In fact, even after the bubble burst, Japan’s cellular market offered opportunities for major foreign entry.

ACCESS TO THE HIGH-END SERVICES MARKET, BUT CHALLENGED BY “GALAPAGOS-LIKE” MARKET DYNAMICS

In 2001, in the largest M&A deal in Japan’s history up until that point, British telecom carrier purchased Japan Telecom, one of NTT’s major competitors. Unlike other sectors, Vodafone’s entry was not triggered by performance crises of Japanese firms, but rather, the desire of Vodafone to acquire technology and a market position in Japan’s profitable cellular market.350

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350 The Average Revenue Per User (ARPU), a common measure of market profitability, in the cellular sector in Japan was higher than that of other developed countries through the mid-2000s.
Japan Telecom was the owner of J-Phone, one of the three major cellular carriers and a front-runner in introducing popular cellular Internet-based services. J-Phone had enjoyed several years of strong performance and a rapid increase in subscribers due to its pioneering introduction of handset features such as color displays, and services such as camera-embedded handsets linked to mobile web services capable of emailing pictures. Vodafone, in the midst of an aggressive expansion into global markets, was particularly interested in J-Phone’s cellular Internet platform.

In September 2001, Vodafone acquired management control of Japan Telecom after gaining majority ownership. It had purchased the shares owned by BT and AT&T earlier that year, and had convinced Japan Telecom’s stable shareholders, particularly companies in the Japan Railway group, to sell their shares. Vodafone proceeded to reorganize the company under a holding company, and sold off the landline businesses of Japan Telecom to Ripplewood, the US investment fund.

The US investment fund then proceeded to demonstrate a new type of business opportunity now possible in Japan’s telecommunications sector. In a matter of months, Ripplewood turned around to sell Japan Telecom to Softbank, the aggressive upstart firm introduced earlier which had been instrumental in bringing Nasdaq to Japan and which had purchased the failed Nippon Credit Bank. Ripplewood made a substantial profit of about 90 billion yen in the process.351

The sale to Softbank was significant, since it was not obvious that Japan Telecom’s stable shareholders would have sold their shares directly to Softbank, often viewed by large established firms as suspiciously radical; Softbank was the first Japanese new entrant to buy rather than build a nationwide network.

To return to Vodafone – it took full control of J-Phone, renaming it Vodafone in October 2003. Vodafone then successfully implemented the technology and know-how of J-Phone’s cellular Internet services and camera phone in its European operations, introducing it as VodafoneLive! The company quickly became the largest European cellular Internet service provider at the time.352

Despite its success in “harvesting” the service and technology from Japan’s cellular market, Vodafone exited Japan in May 2006. It had lasted slightly less than five years. Vodafone’s global financial performance had declined sharply, and it underwent a management shakeup, which resulted in a realigning of its global investment and market priorities. Vodafone’s operations in Japan had become difficult to sustain profitably, largely due to the proprietary trajectory in which Japan’s cellular market dynamics propelled the sector.

Put simply, the Japanese cellular industry was evolving rapidly along its own course of development. In doing so, it became an ill fit for Vodafone’s global strategy. Led by the NTT DoCoMo and KDDI, the other two wireless carriers, Japanese carriers surged ahead of global markets to offer third generation (3G) cellular services. Competition among the carriers hinged on introducing proprietary but sophisticated cellular services that were tightly coupled with

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352 Kontentsu kakumei no kishu tachi: Nihonhatsu no jouhou saabisu kaishi. 2003. *Nihon Keizai Shimbun*, October 6, 3. By the end of 2004, Vodafone had introduced Vodafone Live! in 21 countries, mostly Europe, with over 28 million subscribers (Vodaphone website <http://www.vodafone.com>). At about that time, i-mode was offered in nine countries with only 3 million subscribers, through local carriers licensing the technology from DoCoMo (NTT DoCoMo website <http://www.nttdocomo.com/presscenter/facts/index.html>).
handset offerings, such as music players, infrared data transfer capability, electronic commerce-enabling chips, GPS links, and double cameras for video chats – in short, services and features proprietary to the Japanese market.\textsuperscript{353}

In this domestic market context, Vodafone’s global strategy for 3G networks and handsets, which moved more slowly than the Japanese market, and its reluctance to invest in Japan-specific services, alienated the general public. Vodafone’s 3G network was deployed later than those of its competitors, with inferior coverage. Its handset offerings struck users as a step backwards in terms of features and usability, since Vodafone introduced global models to replace the Japan-specific models offered by J-Phone.\textsuperscript{354} As users began to leave Vodafone for other carriers, it became even more difficult for the company to make investments into infrastructure. As seen in Table 26, the number of new subscribers dropped precipitously after Vodafone took over J-Phone.

Table 26. New Cellular Subscribers for Japan’s 3 Major Carriers (thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>NTT DoCoMo</th>
<th>KDDI</th>
<th>J-Phone/Vodafone</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>6,762</td>
<td>584</td>
<td>1,805</td>
</tr>
<tr>
<td>2001</td>
<td>5,451</td>
<td>1,428</td>
<td>2,149</td>
</tr>
<tr>
<td>2002</td>
<td>3,285</td>
<td>1,560</td>
<td>1,706</td>
</tr>
<tr>
<td>2003</td>
<td>2,601</td>
<td>2,509</td>
<td>1,451</td>
</tr>
<tr>
<td>2004</td>
<td>2,179</td>
<td>2,782</td>
<td>437</td>
</tr>
<tr>
<td>2005</td>
<td>2,452</td>
<td>2,812</td>
<td>-94</td>
</tr>
<tr>
<td>2006</td>
<td>1,848</td>
<td>5,655</td>
<td>380</td>
</tr>
</tbody>
</table>

Source: Telecommunications Carriers Association

The key point was that Vodafone did not face xenophobia on the part of Japanese consumers. Nor was it subject to other barriers making entry difficult. Handsets were provided by the popular Japanese equipment manufacturers such as NEC and Sharp, in addition to global firms Nokia and Motorola. The Japanese firms were themselves interested in accessing Vodafone’s global market reach. Rather, it was a case in which Japan’s proprietary market dynamics disadvantaged Vodafone’s global strategy in the Japanese market.

It is also noteworthy that in exiting Japan, Vodafone contributed to a major structural shift in the domestic market. Softbank, which had already purchased the nationwide networks of

\textsuperscript{353} The introduction of number portability accelerated this trend, as Japanese carriers rushed to introduce value-added services to increase the lock-in effect, in which consumers could keep their mobile numbers when changing carriers, but would not be able to carry over other contents, such as downloaded games or songs. I have called the overall dynamic of competition in Japan’s cellular market developing rapidly, but in its own proprietary direction, “leading without followers.” Kenji E. Kushida, "Leading without Followers: Innovation, Competition, and the Political Economy of Japan’s Telecommunications Sector," \textit{BRIE Working Paper} 184 (2008).

\textsuperscript{354} Vodafone’s initial 3G handsets were limited to two models compared to 8 or 9 by its competitors, and they were widely criticized as performing lower than high-end 2G models in attributes such as battery life and coverage. Vodafone also initially offered two handsets for its 3G service until late 2004, when it introduced 7 new models, four of which were provided by global firms including Nokia, Motorola, and Sony Ericsson. The global models, however, while offering global roaming, were perceived as moving backwards in terms of user interface and features.
Japan Telecom, ended up purchasing Vodafone’s cellular operations from Ripplewood, making it one of the three major Japanese cellular carriers—the first time a newcomer bought rather than built its own network infrastructure. Moreover, Vodafone exited via the largest leveraged buyout to date at the time, a mechanism unavailable a few years earlier, and enabled by foreign investment banks. Moreover, Vodafone’s exit was not entirely a failure, since it raised a similar amount to what it had paid to enter and invest in its Japanese operations.  

**INVESTMENT FUND AS WIRELESS CARRIER: WILLCOM AND CARLYLE**

The purchase of another Japanese mobile carrier by US private equity fund Carlyle illustrates the degree to which the deregulation of foreign investment enabled foreign firms the freedom to enter the market, despite the proprietary dynamics of competition.

In mid-2004 US private equity fund Carlyle gained management control of DDI Pocket, a wireless carrier operating a largely Japan-specific variant of conventional cellular technology. The cellular substitute technology, known as Personal Handyphone System (PHS) was the product of MPT’s industrial policy deployed in the mid-1990s as a cheaper, technologically simpler alternative to conventional cellular services. PHS services helped push Japan’s cellular sector along its proprietary trajectory. Between 1995, when PHS debuted, and around 1997, cellular carriers, responding to the competitive threat from PHS, improved their network coverage, dramatically miniaturized and added features to their handsets, and lowered prices. The PHS market peaked in 1997, declining thereafter. Of the three PHS carriers, two eventually exited the market, but DDI Pocket continued to grow. The company had hoped that cellular competition would move towards price-based competition, which would give it a competitive advantage with low prices. Instead, however, the advent of Japan’s commercially successful cellular Internet services shifted the market towards data transmission.

By 2001, DDI pocket, which had become part of the KDDI group—the major competitor to NTT—had shifted its focus to providing flat-rate data coverage, mostly for business users to connect their laptops. Its PHS network provided faster data transmission speeds than cellular services at the time, and DDI Pocket was in the black. In 2004, after KDDI began offering flat-rate data plans for its primary cellular handsets, it decided to sell DDI Pocket to avoid cannibalizing business areas.

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355 Kushida, “Leading without Followers: Innovation, Competition, and the Political Economy of Japan’s Telecommunications Sector.”

356 The original vision was for PHS to be used as a cordless phone at home, becoming a wireless public telephone outside. The low price of deploying infrastructure and handsets that were technologically simpler than cell phones allowed PHS carriers to offer lower prices and higher performance than cellular services from 1995 to around 1997. An MPT estimate projected that PHS services would overtake cellular services by the late 1990s. ———, “Wireless Bound and Unbound: The Politics Shaping Cellular Markets in Japan and South Korea.”


358 Some contend that DDI Pocket’s operating costs were lowered as a result of equipment manufacturers Kyocera and Sanyo attaining greater scale—beneficiaries of PHS deployments in a number of Chinese cities, including Shanghai. Ibid.
Carlyle, which had already invested in Japanese DSL providers such as eAccess, acquired a 60% stake of DDI Pocket for a reported 220 billion yen. It renamed the business Willcom, and deployed several board members. Willcom then introduced a new service pricing plan that amounted to a shift in the prevailing business models of mobile carriers. It became the first wireless carrier in Japan to offer free unlimited calls between subscribers of its own service. Combined with early offerings of smart phones optimized for sending emails and editing word processing documents, Willcom’s subscriber base grew from 2.9 million at the time of Carlyle’s acquisition to approximately 4.7 million by July 2007.

As will be seen in Chapter 6, Willcom went on to receive spectrum allocation from the government to operate next-generation PHS services. Before Carlyle exercised an exit option, however, intensified competition in Japan’s cellular market began to undermine Willcom’s advantages and squeeze its revenue. Cellular carriers’ 3G networks surpassed those of Willcom, new entrants such as Softbank began offering free in-network calls, and a new entrant, eMobile, began offering cellular-based high speed data services. By 2009, sales began to fall, and Carlyle injected further funds, reshuffling management.359

**MOBILE VIRTUAL NETWORK OPERATORS**

Finally, foreign firms, as well as all other newcomers to the cellular sector benefited from the government’s strengthening of regulations requiring infrastructure-owning carriers to lease out their networks. Known in the mobile context as Mobile Virtual Network Operators (MVNOs), the new regulations allowed new entrants to lease mobile network capacity from existing carriers to offer their own services and brands. Walt Disney Japan took advantage of this, entering into an MVNO arrangement with Softbank to offer a service, DisneyMobile. The company commenced services in March, 2008, offering plans similar to those of Softbank, but bundling fee-based features offered on other carriers, such Disney ringtones, mobile website subscriptions, and character handsets.

**CONCLUSION: TELECOMMUNICATIONS**

The telecommunications sector illustrates how regulatory shifts enabled an influx of foreign MNCs. In the first instance of market liberalization, some foreign MNCs saw opportunities for entry, but against a cautious MPT that was just establishing an ex ante managed competition regulatory structure, the MNCs needed to mobilize gaiatsu. After the regulatory shifts, however, as MPT shifted toward the regulatory structure of ex post competition management, the castle gates were open. An influx of carriers in cable, telecommunications, and wireless services ensued. The shift over the course of a decade, from MPT’s extreme caution regarding foreign-owned international services providers to raising little concern about Vodafone or Carlyle taking control of vast national infrastructure, is nothing short of remarkable. It reveals the extent to which norms underlying the regulatory shifts had changed.

A useful lesson from the telecommunications sector is that major foreign MNCs do not possess superior business models or internal competencies when entering Japan. Telecommunications is an extreme case in which global carriers’ core business models were

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threatened even as they entered Japan, and they faced severe financial difficulties from the
bursting of the global IT bubble shortly thereafter. Many exited Japan due to these exogenous
factors rather than characteristics of the Japanese telecom market. Others, including Vodafone
and Carlyle, experienced unexpected conditions in Japan’s proprietary dynamics of competition
in its cellular market.

Vodafone’s exit from Japan, however, revealed new functions that the new domestic
market could perform. The carrier was able to enter and exit the market using standard M&A and
leveraged buyout techniques, leaving having likely turned a profit. Ripplewood’s purchase and
subsequent sale of Japan Telecom, which was undoubtedly highly profitable, showed that such
deal-making was now possible in the once-highly protected and carefully managed sector.
Moreover, the investment banks involved in these deals of historical (to Japan) proportions also
 gained substantial commissions. Finally, the involvement of MNCs in the sector ended up
providing an unlikely newcomer with nationwide infrastructure – a development also
unthinkable a decade earlier.

III. PHARMACEUTICALS: INCREASED REGULATION FACILITATING FOREIGN ENTRY

The experience of foreign MNCs in Japan’s pharmaceutical sector reveals that
deregulation is not the only type of regulatory shift that can reshape the dynamics of
competition to favor MNCs. In Japan’s pharmaceutical sector, a strengthening of regulations,
mostly in the 1990s, which increased the level of formalization in areas such as clinical testing
and sales practices, played to MNCs’ strengths.

Foreign pharmaceutical firms were instrumental in the creation and development of
Japan’s pharmaceutical sector, but in the early postwar period, they faced regulatory restrictions
limiting their role to that of upstream suppliers. Incremental regulatory shifts in the 1980s,
accelerating in the 1990s, removed restrictions on MNCs’ operations and reshaped market
dynamics in their favor. While some shifts, such as rules that decreased the power of wholesalers,
were partly the result of US-Japan trade talks, many of the regulatory shifts, such as the
restrictions on informal ties between doctors and pharmaceutical firms in sales activities, were
the result of domestic political forces, following a series of scandals.

Japan pharmaceutical sector was not at the core of the country’s national-level
developmental strategies in the manner of finance, or to some degree, automobiles and
telecommunications. However, in the prewar and postwar periods, the industry was shaped by
concrete policies that targeted the rapid acquisition of capabilities for manufacture and
distribution of much needed pharmaceutical products – especially in the immediate aftermath of
World War II. These policies resulted in an industry structure entailing a large number of
small-medium producers weak in R&D capabilities.

By the 1990s, a series of technological revolutions in the global production of
pharmaceuticals (the so-called “biotech” revolution) radically increased R&D costs, driving a
major consolidation of global pharmaceutical firms. As a result, by the late 1990s, Japanese
pharmaceutical firms on the whole were dwarfed by the major MNCs, which were more
interested in moving directly into markets in Japan than in licensing their products. The influx of
MNCs was therefore partly a function of the overall weakness of Japanese pharmaceutical firms
in global competition. The influx took the form of M&A, the dissolution of joint ventures, and
the expansion of firms already present.
The Japanese market remained lucrative, the second largest in the world. Its size was not due simply to rapid aging of the population, but to political factors. Despite tightly regulated prices, the political strength of the doctors’ association retained incentives for the latter to prescribe extravagant quantities of pharmaceutical products.

**HISTORICAL ORIGINS: STRATEGIC PROMOTION FOR DOMESTIC PHARMACEUTICAL PRODUCTION**

From the inception of Japan’s modern pharmaceutical sector, foreign firms provided much of the upstream supply of products. Government policies from the early 20th century shaped the dynamics of competition, leading to a domestic industry comprised of a large number of small-medium firms focused on bringing foreign products into the domestic market.

Until World War I, Japan imported most of its pharmaceuticals from Germany. With the advent of that war and Japan’s alignment against Germany, those imports ceased. Prices skyrocketed, and the Japanese government reacted by spearheading domestic production. In 1915, it passed a law subsidizing the entry of firms into the pharmaceutical business. At the same time, another law essentially declared German patents void. These policies worked as intended, precipitating an influx of small medium firms manufacturing the German drugs, and relieving the acute drug shortage and price spikes. This industrial composition of a large number of small-medium domestic firms focused on bringing in foreign products, rather than developing their own, continued during the inter-war period, and was further strengthened by government policies following World War II.

In the immediate post-war period, government policies – though this time by the Allied Occupation authorities – strengthened the presence of small-medium firms in Japan’s pharmaceutical industry. Ravaged by the war-time devastation, Japan faced an acute need for penicillin, as tuberculosis and other diseases attacked the malnourished population. SCAP arranged for an American firm to bring in penicillin cultures and provide basic manufacturing know-how. It granted a large number of penicillin manufacturing licenses (around 80) to Japanese firms. As a result, a multitude of firms from disparate industries, such as sake, miso, soy sauce, beer, milk, chemicals, and textiles, entered the pharmaceuticals business.

Thus, by the 1950s, Japan’s pharmaceutical sector had over a thousand small and medium firms that imported bulk ingredients from foreign producers, combined them locally, and sold the resulting products in the domestic market. The vast majority did not possess their own R&D capabilities, but were simply responding to the policy-shaped market environment of great demand for a large variety of products in low volume, with relatively easily obtainable raw materials and recipes.

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INITIAL POSTWAR FOREIGN ENTRY: FROM PARTNERSHIP TOWARDS INDEPENDENCE
(1940s-1980s)

Multinational pharmaceutical firms were interested in entering the Japanese market from the 1950s, but they were hindered by direct restrictions on foreign entry, combined with proprietary market dynamics that developed from the 1960s.

From the 1950s through most of the 1960s, regulations forced multinational pharmaceutical firms to enter Japan in the form of (often multiple) joint ventures, or through licensing agreements with Japanese firms for distribution and sales. The national-level FECL, in place until the mid-1960s, required all foreign firms to obtain permission to enter. In applying for permission, in many cases firms such as Pfizer were told by regulators that Japan’s shortage of foreign currency necessitated that their entry be granted only on the condition that they manufacture domestically.363 Pfizer entered by creating a joint venture with Tanabe in 1953, and with Daito in 1955.364 Ciba (now part of Novartis), which had been exporting to Japan from 1870 through the early 1900s through Takeda, entered in 1952.365 Other entrants in the 1950s included Schering, Lederle, and Roussel, followed in the 1960s by Sandoz, Bristol Myers, Hoechst, and Merck.

The dominant business model for multinationals during this period was to find suitable Japanese partners to whom they would license products, leaving sales and marketing activities to them. For domestic firms, the dominant business model was to identify foreign products to license to import or manufacture themselves. Thus, many Japanese pharmaceuticals firms were originally distributors importing foreign products and specializing in marketing and sales efforts.366

From the mid-1960s, Japan’s pharmaceutical market grew rapidly. In 1970, sales were one trillion yen, double that of 1965, and by 1980, it had grown to four trillion yen.367 In this context, as restrictions on them were progressively lifted, foreign firms quickly moved in to the market.

In 1967, as part of the liberalization on foreign investment, a condition for Japan’s 1964 entry to the OECD and IMF, restrictions on foreign ownership of pharmaceutical firms were partially lifted to allow 50 percent ownership. Many prominent multinationals entered in this period, creating joint ventures and contracting sales to domestic firms.368 This was still a lucrative arrangement for domestic firms, whose competitive strategies did not rest on costly R&D investments. Moreover, until 1976, in the absence of a patent law protecting

363 Ibid., 175.
364 Ibid., 174.
365 Kishi, Gaish Kei Seiyaku Kigyou Gekidou No Jidai [the Era of Upheaval, Foreign Pharmaceutical Firms], 115-17.
368 Noguchi, Yoku Wakaru Iyakuhin Gyokai [Understanding the Pharmaceutical Industry], 46-47.
pharmaceutical manufacturing processes, Japanese manufacturers were able to reverse-engineer foreign products and use a slightly modified process to produce essentially the same product.\(^{369}\) In 1975, the foreign investment ceiling in pharmaceutical firms was raised to 100 percent, and the number of foreign entrants increased rapidly, with over 300 companies engaging in direct investments.\(^{370}\) In 1983, a revision of the Pharmaceutical Affairs law lifted the regulation that prohibited foreign firms from applying for clinical testing. The revision induced many multinationals to expand their own operations to manufacture, distribute, and market their products.

**Proprietary Market Dynamics: Hinder ing Foreign Operations (1960s-1980s)**

As in finance and telecommunications, Japan-specific regulations created proprietary market dynamics, disadvantaging multinational firms as well as new entrants until the late 1980s. The main factors creating these market dynamics included Japan’s national health insurance system, the role of doctors in dispensing drugs, and clinical testing requirements, all resting on dense informal interpersonal networks.

*Japan’s NHI Scheme and the “Doctor’s Margin”: Shaping Proprietary Business Models*

Japan’s National Health Insurance (NHI) scheme, requiring universal coverage, put the government in charge of mandating a uniform fee schedule for all healthcare providers – in effect setting the prices that pharmaceutical firms could charge for their products. Implemented in the early 1960s, the fee schedule determined the prices that doctors and hospitals could charge for each procedure, as well as the amount of reimbursement from health insurers for each pharmaceutical product sold to patients.\(^{371}\)

The role of doctors as both prescribers and dispensers (roles often separated in other countries) meant that when doctors prescribed a particular medication, the consumer was charged the fee set by the NHI schedule, and the doctor was reimbursed that same amount from the NHI. This dual role was lucrative for doctors and hospitals, which fought a series of political battles to retain this dual capacity.\(^{372}\)

\(^{369}\) Neimeth, "Japan’s Pharmaceutical Industry: Postwar Evolution."

\(^{370}\) Reich, "Why the Japanese Don't Export More Pharmaceuticals: Health Policy as Industrial Policy."

\(^{371}\) Japan’s national healthcare regime with universal coverage grew out of the socialist and conservative parties competition for power in the early to mid-1950s, before the LDP was firmly entrenched in power. Both sides called for universal coverage, with legislation passed in 1958. John Creighton Campbell and Naoki Ikegami, *The Art of Balance in Health Policy: Maintaining Japan's Low-Cost, Egalitarian System* (Cambridge ; New York: Cambridge University Press, 1998), 107-08.

\(^{372}\) The politics of healthcare reform illustrate the strength of the Japan Medical Association – the industry association of doctors – in shaping major policy issues. During the Occupation, SCAP was interested in separating prescription from dispensing, and MHW, supported by the Federation of Health Insurance Associations introduced several bills promoting the functional separation. However, in a political battle in 1954, JMA opposed furiously, including deploying sound trucks around Tokyo and staging a “sitting to the death” protest in front of the Diet building. The JMA eventually prevailed, enabling doctors to retain the ability to both prescribe and dispense medicines. Thomas, *The Japanese Pharmaceutical Industry : The New Drug Lag and the Failure of Industrial Policy*. See also Naoko
This combination of NHI reimbursement fees and doctors’ roles as both prescribers and dispensers led to the following market dynamics. Pharmaceutical firms sold medications to doctors at a discount – lower prices than the NHI reimbursement price received by doctors. Doctors and hospitals pocketed the difference between their discounted purchases and government-mandated reimbursement, known as the “doctor’s margin,” which became a major revenue source.

Put differently, the government set the retail price for drugs charged by doctors (who both prescribed and dispensed the products), but the wholesale prices at which they procured drugs was determined by competition among pharmaceutical firms. The doctor’s margin was the difference between their selling price and procurement cost.

The doctor’s margin as a revenue source created a strong incentive for Japanese doctors to over-prescribe medications. While this was a serious problem in and of itself, it was also a growth-driver for the pharmaceutical industry, by the 1980s making Japan the second largest pharmaceutical market after the US.  373

Pharmaceutical companies competed against one another to receive procurement orders from doctors, and developed a variety of strategies that went beyond price-based competition. Their sales practices were highly labor intensive, resulting in disadvantages for foreign firms, as well as new entrants in general. Salesmen canvassed hospitals and doctors, cultivating close personal relationships with doctors. It was not uncommon for salesmen to take doctors out for meals or golf and run personal errands for them. Until restrictions were placed on distribution of samples, firms also commonly included large numbers of sample medicines along with doctors’ orders.

Wholesale distribution networks became a critical component in the interactions between pharmaceutical firms and doctors, further disadvantaging foreign firms and new entrants. The distribution system was extremely complex and fragmented, a very large number of small-medium wholesalers and few national-level players. Many wholesalers were linked tightly to particular pharmaceutical companies, increasing multinational firms’ reliance on domestic firms for distribution and sales.

**Pricing: Innovations Unrewarded and “Knock-offs” Supported**

The NHI pricing schedule, which determines the reimbursement levels of pharmaceutical products, advantaged domestic firms producing products that were very similar to major existing drugs – generics and other products differing only slightly from existing drugs. Products introduced by foreign firms therefore commanded little, if any, premium over generics and similar products introduced by Japanese firms. The situation continued until revisions in the price schedule in 1992. Moreover, since the price schedule kept the prices of older products high, Japanese firms in the domestic market did not face a rapid plummet in prices as soon as patents expired – as in many other developed countries. As a result, foreign firms had little competitive

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373 It is well known that Japanese doctors tend to over-prescribe drugs to patients. For example, see Campbell and Ikegami, *The Art of Balance in Health Policy : Maintaining Japan's Low-Cost, Egalitarian System*, Thomas, *The Japanese Pharmaceutical Industry : The New Drug Lag and the Failure of Industrial Policy*. 

advantage over “knock-offs” produced by Japanese pharmaceutical firms which concentrated their efforts on the labor intensive sales practices and reverse engineering, rather than R&D into innovative products.\textsuperscript{374}

\textbf{Clinical Testing and Approval: The Primacy of Informal Networks}

Japan-specific standards and data requirements for clinical testing became another significant hurdle for direct foreign operations in Japan. From 1965, the government began a strict program of clinical trials approval, largely in response to an event known as the “thalidomide tragedy” of 1961. This event was part of a worldwide tragedy in which thalidomide administered to pregnant women caused a large number of birth defects; the possibility of the drug’s affecting unborn children had not been tested. In response, in 1967 the government implemented the Basic Policies of Drug Manufacturing Approval.

Critical to the development of the industry, Japan’s new pre-clinical and clinical trial standards differed from those in the US and Europe, and required that the data be generated in Japan. These requirements were not necessarily designed to be strategically protectionist. Rather, they reflected the bureaucratic prerogative of the Ministry of Health and Welfare (MHW) to minimize the risks from pharmaceuticals.\textsuperscript{375} The standard mantra for MHW officials was that “when the Ministry of Finance makes a mistake, people lose money, but if we made a mistake, people die – it is our fault.”\textsuperscript{376} While the Japan-specific requirements raised the costs for all multinationals, those already operating subsidiaries and laboratories in Japan were less affected.\textsuperscript{377}

Firms’ success with clinical testing procedures often hinged on close relations with key doctors. Due to the ready availability of patients, pharmaceutical firms relied on university hospitals and large private hospitals to conduct clinical trials, and in such organizations, key senior doctors were highly influential. Not only did they control resources internal to the hospital, but they also determined assignments of new doctors to particular hospitals, creating hierarchical webs of influence throughout the industry.

Cultivating relationships with these key doctors was critical, but enormously resource intensive. For salesmen (almost always men), the common industry saying for the critical university hospitals was “wait for 3 hours, meet for 5 minutes.” Multinational firms entering Japan were therefore in an environment in which a labor-intensive sales force focused on relational ties was critical in obtaining product approval. They faced large sunk costs to play this game, raising the attractiveness of partnering with Japanese firms. These market dynamics also increased internal organizational challenges, such as global headquarters’ unsympathetic view of large discretionary budgets for salesmen in their Japanese operations.\textsuperscript{378}

\textsuperscript{374} Paprzycki and Fukao, Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization, 177.
\textsuperscript{375} One contributor to the requirement for using Japanese subjects for clinical trials aimed at the Japanese market was concern over diiodohydroxyquinolin. The compound caused severe side effects that seemed to occur only in Japanese patients, but in retrospect, were probably due to the way it was used. Neimeth, "Japan's Pharmaceutical Industry: Postwar Evolution," 5. Also see Mikanagi, Japan's Trade Policy: Action or Reaction?
\textsuperscript{376} Interview, former Ministry of Health and Welfare official. Tokyo, June 2006.
\textsuperscript{377} Neimeth, "Japan's Pharmaceutical Industry: Postwar Evolution."
\textsuperscript{378} For example, see the case of Eli Lilly. Malnight, "Eli Lilly and Company (C): Japan."
The clinical trial approval process, conducted by the MHW, also required informal interpersonal networks with government officials. In contrast to agencies such as the US Food and Drug Administration, which hired physicians and conducted clinical testing in-house, MHW acted as a facilitator, allocating the actual testing work to university professors. Applicant firms and the professors had no direct contact, and no venue existed for applicants to provide further explanation or information. Rejected applications did not include formal communications or explanations regarding the Ministry’s directives, examiners’ opinions, nor the ultimate reasons for the rejection. In such cases, informal networks were the only avenue for firms to learn the source of the problem. This put multinational firms with weaker networks at a disadvantage, while their Japanese competitors could gain access to the crucial information—again, pushing multinationals towards partnerships.  

**Regulatory Shifts: Lifting Foreign Restrictions and Reorganizing Markets (Late 1980s – 1990s)**

From the 1980s and accelerating through the late 1990s, a series of incremental regulatory changes altered the dynamics of competition within Japan’s pharmaceutical sector. The regulatory shifts were less dramatic than the Financial Big Bang, and were aimed at solving specific, narrower problems rather than an overhaul of the industry, but their combined effect significantly reshaped business practices and business models in the domestic sector over time. Multinational firms were the largest beneficiaries of these regulatory shifts and new market dynamics. In short, the importance of large sales forces to maintain informal relationships with doctors and hospitals declined, the wholesale and distribution networks consolidated, the NHI fee schedule was revised to favor new products, and clinical testing requirements moved towards globalized standards and practices, allowing externally gathered data.

**Pricing: Towards Rewarding New Products**

From the 1980s, MHW began aggressively cutting the overall reimbursement prices of pharmaceuticals in a manner that favored new products over “knock-offs” and older ones. This favored multinational firms, which tended to offer new products.

The reduction of pharmaceutical reimbursement prices was the result of the politics of Japan’s broader healthcare sector. MHW’s primary interest was to lower overall government healthcare expenditures. The political drive to expand healthcare coverage to the elderly in the 1970s, combined with the propensity of doctors to prescribe large quantities of medications (a result of several political battles won by the doctors’ association enabling them to continue both prescribing and dispensing drugs), had led to a sharp rise in the government’s healthcare expenditures by the 1980s. In the context of Prime Minister Nakasone’s aggressive efforts to

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379 Kishi, Gaishi Kei Seiyaku Kigyou Gekidou No Jidai [the Era of Upheaval, Foreign Pharmaceutical Firms], 136-41.
380 The actual prices charged to doctors by pharmaceutical firms were the wholesale prices, but the basic levels were set by the reimbursement price in the NHI fee schedule.
381 A “free” medical care for the elderly, spearheaded by a progressive governor of Tokyo, spreading to other areas, led to the national government to establish a major new program in 1972. Campbell and Ikegami, The Art of Balance in Health Policy : Maintaining Japan's Low-Cost, Egalitarian System, 108-11.
balance the budget and reduce government expenditures, pressure arose to cut doctors’ fees and pharmaceutical prices. However, the strength of the Japan Medical Association, the doctor’s association, made the first option politically difficult, leading to MHW’s solution of reducing pharmaceutical prices. With base prices at 100 in 1980, they fell to 53 in 1989, decreasing the pharmaceutical portion of the government’s total healthcare budget from 40% in 1981 to 30% in 1987. MHW continued to lower prices, with decreases of 10% every year in 1996, 1997, and 1998, with another 7% in 1999, 6% in 2002, and 4% in 2004.

From 1996, as MHW reduced prices, it also began to significantly shift the relative weight, reducing the prices of older products, and “knock-offs.” more rapidly. This disproportionately hurt small-medium Japanese pharmaceutical firms with few R&D resources – firms whose products had been protected by high reimbursement prices even after their patents had expired. For example, Eizai and Daiichi Tanabe relied on older products for almost 40% of their sales, Chugai for 30%. For mid-sized firms Mochida, Kyorin, and Kissei, reliance on older products was above 70%. By the mid-2000s, the prices for generics and other knock-offs were reduced to 15 to 70 percent of the original product, averaging about 50%.

This brought the market dynamics of Japan’s pharmaceuticals market closer to those of the US and other global markets. Multinational firms were accustomed to competing in markets in which prices plummeted anywhere from 40 to 80% as soon as patents expired and a flood of generics entered the market.

Sales: Reshaping the Wholesale and Distribution Market

A series of government policies led to consolidation of Japan’s pharmaceutical distribution system. In 1989, as part of the US-Japan bilateral Structural Impediments Initiatives, the Japanese government moved to reform the practice of wholesale prices being set between doctors and pharmaceutical firms. From 1992, after the Japan Fair Trade Commission weighed into the issue, pharmaceutical firms were prohibited from engaging in price negotiations with doctors. Instead, wholesalers were to become the exclusive price negotiators with doctors. As a result, pharmaceutical firms’ sales practices of providing extensive non-medicine services to doctors began to decline, lowering the overall density of informal relational networks with wholesalers.

As wholesalers became the main negotiators with hospitals and doctors, they came under increased price pressure, especially after MHW’s rounds of reimbursement price reductions through the 1990s. With doctors and medical institutions demanding lower prices

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385 Paprzycki and Fukao, Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization, 177.
387 Noguchi, Yoku Wakaru Iyakuhin Gyokai [Understanding the Pharmaceutical Industry], 84-88.
from wholesalers to preserve their own margins in the face of reimbursement price reductions, smaller wholesalers were at a bargaining disadvantage. This sparked a major consolidation of wholesalers from around 1999. By 2007, the membership of the Japan Pharmaceutical Wholesalers Association shrank from 486 in 1985 to 129, and the 129 members were largely comprised of four major wholesalers and their subsidiaries.\footnote{\cite{Paprzycki2004}}

**Decline of Informal Relations: Scandals and Sales Professionalization**

A major scandal involving close informal ties within the pharmaceutical sector decreased the role of interpersonal networks, and fueled a move towards increased professionalism in standards of sales practices.

In 1996, a major scandal broke, involving close ties between MHW and pharmaceutical firms. The scandal involved HIV-tainted blood used in transfusions, infecting a large proportion of hemophiliacs and some pregnant women, causing an estimated 2000 deaths of hemophiliacs and their families. The Minister of Health and Welfare, Kan Naoto, had spearheaded an investigation in 1996, leading to the discovery that MHW had overruled the recommendations of its internal study group in 1983 and 1985 and allowed continuing use of untreated blood for transfusions, despite the availability of treatment processes. Executives and former presidents of Japanese pharmaceutical firm Green Cross, some of whom were former MHWM officials, were arrested. Several other firms, including US firm Baxter, which had followed MHW guidelines but had continued to provide HIV-tainted blood, reached private settlements with families.

Informal relations between doctors and pharmaceutical firms were also cast in a negative light. In 1997 the industry association, the Japan Pharmaceutical Manufacturers’ Industry Association (JPMA) implemented a standardized testing and accreditation system for pharmaceutical firm employees tasked with sales to doctors – Medical Representatives, or “MRs” as they were known. After this, many university and general hospitals prohibited non-accredited salespeople from soliciting staff doctors.

Increased professionalism of sales forces, occurring simultaneously with growth in Internet usage, provided advantages to multinational firms. Quick to implement IT systems and get on board with the Internet as a medium for contacting doctors – busy doctors often sent queries to multiple firms late at night – foreign firms were able to provide rapid specialist responses to such queries.\footnote{\cite{Paprzycki2004}}

**Revision of Clinical Testing: Towards Global Standards**

Japan’s clinical trials procedures began to shift towards international standards beginning in the 1980s. The drivers of change included bilateral US-Japan pressure and lobbying from within Japan, as well as a worldwide movement to “harmonize” clinical trials procedures among developed countries.

\cite{Paprzycki2004}

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\cite{Paprzycki2004} Overall, multinationals are credited with rapidly implementing IT systems that enabled fast responses by specialists, with extensive data to draw upon, including dates and names of hospitals and doctors visited by MR as well as content of conversations. "Gaishikei Ga Tainichi Kousei Wo Kakeru Iyakuhin Bijinesu Gekihen No Shougeki [the Shock to Pharmaceutical Businesses Caused by Foreign Firms on the Offensive in Japan]," *Shukan Datamondo* 2002.
1983, a revision of the Pharmaceutical Affairs Law allowed foreign firms to apply for clinical testing directly. While this enabled foreign pharmaceutical firms to operate independently in the Japanese market without Japanese partners, foreign firms protested mandatory continuation of existing partnerships with Japanese firms for licensing and distribution agreements. These issues were mostly settled in the MOSS talks, resulting in the dissolution of partnerships and movement of foreign pharmaceutical firms into downstream activities, as shown later.\(^{390}\)

An international organization aimed at standardizing clinical testing procedures, the International Conference on Harmonization (ICH), included Japan as a core participant, pushing it in the direction of revising its clinical testing procedures. Founded in 1990, ICH brought together the industry associations and regulatory agencies of pharmaceutical manufacturers from Europe, the US, and Japan.\(^{391}\) A series of meetings over several years led to tangible results – notably an agreement in 1997 that came into effect in 1998 enabling the limited use of clinical test results conducted abroad in Japanese approval processes. Known as the “bridging” method, firms were able combine data primarily gathered abroad with certain types of domestic data to fulfill clinical testing requirements. A rapid growth of overseas testing occurred; in 1993, 18% of clinical trials were held overseas, while in 2000, the figure had risen to 2000, according to a survey conducted by JPMA.\(^{392}\) In 2004, the Pharmaceutical Law was revised, simplifying the clinical approval processes and further relaxing the rules on data requirements.

The relaxation of previously stringent data requirements for clinical trials substantially altered the dynamics of clinical testing practices. After the 1998 deregulation, a market developed for outsourced clinical testing, conducted by firms known as “Contract Research Organizations (CROs).” After the 2004 revision, firms increasingly moved testing outside of Japan, both directly and through CROs.\(^{393}\)

Growth of the market was rapid, accelerating after the 2005 Pharmaceutical Law revision. Sales of the industry totaled 15.6 billion yen in 2000, employing approximately 1700 people, growing four-fold to 61 billion yen sales in 2004 with almost 5700 employees, and reaching 113 billion yen by 2009 with almost ten thousand employees. (See Table 27). With the proportion of foreign firms employing CROs almost constant at approximately 30%, the rapid growth of this industry represents a major reduction in the internal organizational investments necessary for foreign firms to engage in the clinical testing procedures.


391 Members include the EU, the European Federation of Pharmaceutical Industries and Associations (EFPIA), the US Food and Drug Administration (FDA), the Pharmaceutical Research and Manufacturers of America (PhRMA), Japan’s Ministry of Health, Labor, and Welfare (MHLW), and the Japan Pharmaceutical Manufacturers Association (JPMA).


393 After the 2004 revision, a collaboration between university hospitals to coordinate in clinical testing was announced to speed up testing procedures. Six major state universities agreed to simplify clinical testing procedures, with a single application, and testing allocated to the hospital strongest in the area. Participating universities included Tokyo University, Chiba, Tsukuba, Tokyo Medical and Dental, Niigata, and Gunma Universities. Previously, firms had been required to ask particular hospitals to conduct the tests. ”’Tie-up to Spur Faster Drug Approval; 6 Universities Agree to Share Skills to Speed up Testing of Foreign Medicines,” *Daily Yomiuri*, June 20 2006.
Table 27. Total Sales and Employment of Japan CRO Association Member firms

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales (Billions yen)</th>
<th>Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>15.6</td>
<td>1736</td>
</tr>
<tr>
<td>2001</td>
<td>24.1</td>
<td>2786</td>
</tr>
<tr>
<td>2002</td>
<td>38.9</td>
<td>3611</td>
</tr>
<tr>
<td>2003</td>
<td>50.1</td>
<td>4620</td>
</tr>
<tr>
<td>2004</td>
<td>61.4</td>
<td>5688</td>
</tr>
<tr>
<td>2005</td>
<td>71.0</td>
<td>7050</td>
</tr>
<tr>
<td>2006</td>
<td>83.1</td>
<td>7487</td>
</tr>
<tr>
<td>2007</td>
<td>95.5</td>
<td>8297</td>
</tr>
<tr>
<td>2008</td>
<td>102.5</td>
<td>9027</td>
</tr>
<tr>
<td>2009</td>
<td>113.0</td>
<td>9838</td>
</tr>
</tbody>
</table>

Source: Japan CRO Association

THE RAPID GROWTH OF MNCs: (1990s -- )

By the late 1990s, terms of competition within Japan’s domestic pharmaceutical sector – pricing, sales and distribution, and clinical testing – had shifted significantly, facilitating the expansion of multinationals into the downstream activities of sales and distribution.


As a result of these global mergers, the gap in scale between Japanese firms and global multinationals widened. By 2001, the relative global sales and R&D capabilities of the largest multinationals, such as Pfizer, Glaxo SmithKline, and Merck, dwarfed that of major Japanese firms – to say nothing of medium-sized Japanese firms. (See Table 28)

The surge of foreign firms into the Japanese market took the form of their exiting from historical partnerships to engage in downstream activities themselves, expanding their sales forces and personnel through mid-career and new graduate hires, and though M&A.
Table 28. Sales and R&D investments of Top Global, Top Japanese, and Mid-sized Japanese Firms (billions yen)

<table>
<thead>
<tr>
<th>Top Global firms (global basis)</th>
<th>Sales</th>
<th>R&amp;D investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pfizer</td>
<td>3320</td>
<td>630</td>
</tr>
<tr>
<td>Glaxo SmithKline</td>
<td>3250</td>
<td>500</td>
</tr>
<tr>
<td>Merck</td>
<td>2780</td>
<td>320</td>
</tr>
<tr>
<td>AstraZeneca</td>
<td>2090</td>
<td>350</td>
</tr>
<tr>
<td>Aventis</td>
<td>2040</td>
<td>340</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Major Japanese Firms</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Takeda</td>
<td>1005</td>
<td>100</td>
</tr>
<tr>
<td>Sankyo</td>
<td>549</td>
<td>82</td>
</tr>
<tr>
<td>Yamanouchi</td>
<td>481</td>
<td>65</td>
</tr>
<tr>
<td>Eizai</td>
<td>432</td>
<td>55</td>
</tr>
<tr>
<td>Shinogi</td>
<td>422</td>
<td>31</td>
</tr>
<tr>
<td>Fujisawa</td>
<td>341</td>
<td>57</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Medium-sized Japanese Firms</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banyu</td>
<td>180</td>
<td>21.1</td>
</tr>
<tr>
<td>Dainippon</td>
<td>164</td>
<td>13.1</td>
</tr>
<tr>
<td>Ono</td>
<td>133</td>
<td>28.3</td>
</tr>
<tr>
<td>Santen</td>
<td>89</td>
<td>12.1</td>
</tr>
<tr>
<td>Tsumura</td>
<td>75</td>
<td>4.5</td>
</tr>
<tr>
<td>Kaken</td>
<td>73</td>
<td>5.3</td>
</tr>
<tr>
<td>Mochida</td>
<td>63</td>
<td>8.4</td>
</tr>
<tr>
<td>Kyorin</td>
<td>62</td>
<td>6.0</td>
</tr>
<tr>
<td>Kissei</td>
<td>60</td>
<td>13.0</td>
</tr>
<tr>
<td>Nikken Chemical</td>
<td>55</td>
<td>4.0</td>
</tr>
<tr>
<td>Zeria</td>
<td>54</td>
<td>4.0</td>
</tr>
<tr>
<td>Nippon Shinyaku</td>
<td>51</td>
<td>7.0</td>
</tr>
<tr>
<td>Torii</td>
<td>46</td>
<td>0.4</td>
</tr>
<tr>
<td>Fuso</td>
<td>44</td>
<td>2.1</td>
</tr>
<tr>
<td>Tomiyama</td>
<td>28</td>
<td>4.9</td>
</tr>
<tr>
<td>Hokuriku</td>
<td>25</td>
<td>2.6</td>
</tr>
<tr>
<td>Teikoku Zoki</td>
<td>22</td>
<td>4.4</td>
</tr>
<tr>
<td>Nihon Kemifa</td>
<td>18</td>
<td>2.1</td>
</tr>
<tr>
<td>Sawai</td>
<td>17</td>
<td>1.6</td>
</tr>
<tr>
<td>Nichiiko 日医工</td>
<td>13</td>
<td>0.7</td>
</tr>
<tr>
<td>Wakamoto</td>
<td>10</td>
<td>0.8</td>
</tr>
</tbody>
</table>


EXIT FROM PARTNERSHIPS AND ORGANIC GROWTH

Many multinationals decided they no longer needed to rely on Japanese partners for sales channels. Several major firms had moved into sales activities on their own since the 1980s, but movement accelerated in the late 1990s. For example, in 1985, Ciba-Geigy, which had been contracting sales to Takeda and Fujisawa, began selling independently. Also in the 1980s, Bayer
separated from Takeda, Sund from Sankyo, and SmithKline Beecham from Fujisawa. By the early 2000s, most foreign firms had shifted to selling their own products themselves.\textsuperscript{394}

The dissolution of partnerships was highly detrimental to medium sized firms. For example, in 1998, after Pharmacia dissolved its partnership with Sumitomo Seiyaku, the latter’s sales dropped by a quarter the following year.\textsuperscript{395} In 1993 Astra raised its stake in a joint venture with Fujisawa Pharmaceutical from 51% to 90% to exert more control, and Zeneca dropped partner Sumitomo Chemical in 1995.\textsuperscript{396}

Multinational firms also moved to expand their domestic sales forces. For example, between 2000 and 2001, Pfizer hired over 600 people, followed by another 600 in 2002. Many of these new employees were mid-career hires from Japanese pharmaceutical firms.\textsuperscript{397} In a stark contrast to the entire history of the industry until the late 1990s, by 2000, foreign firms sported the largest presence of salespeople in the industry. In 2000, the size of sales forces representing Pfizer, Merck, Glaxo SmithKline, Novartis, and Astra Zenaka equaled or exceeded that of the largest Japanese firms, Takeda, Sankyo, and Yamanouchi. (See Table 29)

Table 29. Number of Salespeople (“MR”s), Top Foreign and Japanese Pharmaceutical Firms

<table>
<thead>
<tr>
<th>Top Foreign Firms</th>
<th>MRs</th>
<th>Top Japanese Firms</th>
<th>MRs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pfizer</td>
<td>1700</td>
<td>Takeda</td>
<td>1350</td>
</tr>
<tr>
<td>Banyu (Merck)</td>
<td>1476</td>
<td>Sankyo</td>
<td>1240</td>
</tr>
<tr>
<td>Glaxo SmithKline</td>
<td>1300</td>
<td>Yamanouchi</td>
<td>1300</td>
</tr>
<tr>
<td>Novartis</td>
<td>1300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Astra Zeneca</td>
<td>1300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beringer Ingelheim</td>
<td>600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pharmacia</td>
<td>700</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Not only were foreign firms growing rapidly in size, but also in revenue. In 2000, despite little growth in Japan’s overall pharmaceuticals market, multinationals fared well: for example, revenue at Novartis rose 8% over the previous year, Roche by 10%, Pfizer by 2%.\textsuperscript{398}

\textsuperscript{394} Noguchi, \textit{Yoku Wakaru Iyakuhin Gyokai [Understanding the Pharmaceutical Industry]}, 46-47.
\textsuperscript{395} "Gaishikei Ga Tainichi Kousei Wo Kakeru Iyakuhin Bijinesu Gekihen No Shougeki [the Shock to Pharmaceutical Businesses Caused by Foreign Firms on the Offensive in Japan]."
\textsuperscript{396} "Drugs Firms in Japan; Softly, Softly," \textit{The Economist} 1993.
\textsuperscript{397} "Nippon Kouryaku Faizaa Hahiru: Mr Tsugitsugi Hikinuki, Uriagedaka Mokuhyou Kokunai Toppu [Pfizer Rushes to Capture Japan, Hires Away Mrs, Aims for Top Sales in the Domestic Market]," \textit{Nikkei Sangyo Shim bun}, June 11 2002.
\textsuperscript{398} "Foreign Firms Shine in Drug Market: Hit Products, Mergers Help Them Grab More of the Pie; Rivals Struggle as Prices Fall," \textit{The Nikkei Weekly}, March 27 2000.
GROWTH VIA M&A

Foreign pharmaceutical firms also engaged in M&A-driven growth in the Japanese market. Unlike banking, securities, insurance, or automobiles, domestic pharmaceuticals did not face acute crisis ushered in by the late 1990s. In fact, as whole, compared to sectors such as automobiles and consumer electronics, the pharmaceuticals sector sported relatively high value added (calculated as sales divided by the sum of operating profit, labor cost, depreciation, financing costs, borrowing costs, leasing costs), low dependency on bank loans (lending divided by total assets), and relatively high equity ratios. (See Table 30)

Table 30. Value-added, Equity Ratio, Lending/Assets Ratios Across Selected Japanese Sectors, 2002

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value added %*</th>
<th>Equity Ratio</th>
<th>Lending/Total Assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharma</td>
<td>17.8</td>
<td>71.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Autos</td>
<td>6.8</td>
<td>30.9</td>
<td>30.6</td>
</tr>
<tr>
<td>Consumer Electronics</td>
<td>Negative</td>
<td>29.3</td>
<td>24.5</td>
</tr>
</tbody>
</table>

* Value added % calculated as sales divided by sum of operating profit, labor cost, depreciation, financing costs, borrowing costs, leasing costs.

Source: Ibid.

Instead, foreign M&A into Japan’s pharmaceutical sector consisted mainly of medium-sized firms purchased by large global firms seeking domestic sales and wholesale distributions networks. The earliest such move was Merck’s purchase of Banyu in 1983, but the wave of major buyouts begin in 1998, such as Beolinger Ingelheim’s purchase of SS Pharmaceutical and Roche’s purchase of Chugai. These were not bailout purchases, since the Japanese firms sported reasonably strong sales and wholesale networks, but were relatively weak in R&D. Joining multinationals represented strategic management decisions on the part of the Japanese firms as well. As a result, rather undergoing replacement of management by personnel from the foreign buyer, many, including Banyu and Chugai, were able to negotiate relative managerial autonomy for their Japanese operations. (See Table 31)

Table 31. M&A Activity in Pharmaceuticals

<table>
<thead>
<tr>
<th>Multinational Firm</th>
<th>Japanese M&amp;A Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983 Merck</td>
<td>Banyu</td>
</tr>
<tr>
<td>1998 BASF (Germany)</td>
<td>Hokuriku Seiyaku</td>
</tr>
<tr>
<td>Akzo Nobel (Netherlands)</td>
<td>Kanebo’s Pharma divison</td>
</tr>
<tr>
<td>2000 UCB (Belgium)</td>
<td>Fujirebio</td>
</tr>
<tr>
<td>Boelinger Ingelheim (Germany)</td>
<td>SS Pharmaceutical</td>
</tr>
<tr>
<td>2001 Schering (Germany)</td>
<td>Mitsui Pharmaceutical</td>
</tr>
<tr>
<td>Abbott Laboratories (US)</td>
<td>BASF/Hokuriku Seiyaku</td>
</tr>
<tr>
<td>2002 Roche</td>
<td>Chugai</td>
</tr>
</tbody>
</table>
CONCLUSION: PHARMACEUTICALS

Foreign MNCs’ involvement with Japan’s pharmaceutical sector highlights the role of regulatory shifts that reorganize the dynamics of competition in the sector, facilitating foreign entry and expansion. In spite of significant deregulation of restrictions that had hindered foreign firms, such as the inability to directly apply for clinical testing procedures, it is striking that much of the regulatory shift consisted of strengthening regulations. Informal negotiation between wholesalers and doctors was prohibited, salesforces were professionalized, clinical testing relied less on informal interpersonal networks, and new regulations enabled the outsourcing of clinical testing.

MNCs entered Japan primarily to access its domestic market, moving downstream as regulations shifted. Once key factors shifted to facilitate MNC direct operations in Japan, the sector witnessed a wide spectrum of patterns of entry – dissolution of joint ventures and partnerships, M&A, and growth through hiring new graduates and mid-career employees. Although a crisis did not sweep through Japan’s pharmaceutical sector in the same manner as in other sectors in this study, technological shifts and global consolidation in the sector weakened the competitive position of Japanese firms, particularly in R&D. Global pharmaceutical firms grew to become among the largest firms in Japan’s pharmaceutical sector.

CHAPTER CONCLUSION

The careful and close examination of relationships between foreign MNCs and Japan’s automobile, telecommunications, and pharmaceutical sectors allows us to address the broader questions posed at the beginning of the chapter. The answers, when taken along with those of the previous several chapters, are critical to understanding the conditions enabling the influx of MNCs, and more broadly, the transformation of Japan’s model of capitalism.

The influx of foreign firms was enabled by shifts in regulatory structures and market dynamics. Both were necessary to facilitate the rapid expansion; not only the removal of direct restrictions on foreign MNCs, but the dynamics of competition – what firms compete over – mattered in their relative ease of introducing global business models and adapting to Japanese market conditions. The gap in timing between the regulatory shifts and changes in market dynamics in the case of automobiles demonstrates this most clearly. The case of telecommunications, however, reminds us that MNCs’ global business models do not necessarily give MNCs advantages in Japan’s market where market developments follow a proprietary, though competitive, trajectory. The pharmaceutical sector then reminds us that regulatory shifts to reshape market dynamics did not necessarily entail deregulation – a formalization of processes and new regulations, part of the transition to a ex post market governance mode of regulation, was often critical as well.

The regulatory shifts were driven by domestic political dynamics. Except for a few cases in which trade talks involving Japan and its trading partners led to domestic policy adjustments, and the embedding of Japan’s clinical testing procedures within the international policy coordination efforts, MNCs were not the drivers of the regulatory shifts enabling their entry and expansion. MITI in the 1970s, MPT, and the MHW all proceeded with regulatory shifts according to their own logic. The overall political context of the mid to late 1990s, in which ex ante managed competition was abandoned in the financial sectors, with intellectual support for Japan’s traditional model waning, channeled attention towards market-based
competition to revive the Japanese economy. However, the regulatory shifts were not spearheaded or strongly coordinated by the political leadership as a cohesive policy. They were not connected to the overall national policy goals to facilitate FDI as seen in Chapter 2. Indeed, Prime Minister Koizumi’s target to double inward FDI was announced in 2003, after much of the influx covered in the preceding chapters had already occurred.

In the sectors dealt with in this chapter, we see that MNCs entered Japan for different reasons; in automobiles and telecommunications (particularly for Vodafone) carriers were interested in technology or production know-how from Japanese firms that would be useful for their global strategies. In pharmaceuticals, it was Japan’s domestic market that attracted MNCs. Since the automobile and wireless telecommunications sectors were shaped strongly by policies, and were embedded in Japan’s national institutional context, these cases more closely resembled a movement by MNCs to take advantage of domestic “comparative institutional advantages” offered by Japan. Yet, the opportunities were based more on concrete market developments than on deeper institutional factors, and none of the MNCs are likely to have self-identified their entry strategies as taking advantage of factors that ran deeper than the new market opportunities.

This concludes Part I of this study, analyzing the context in sectors that experienced the most dramatic influx of foreign MNCs. We have examined the national regulatory, national institutional, and sectoral levels, illustrated concretely by company cases. This examination leads to Part II, which concerns the effects of MNCs on Japan’s policy processes once they entered.
PART II

INSIDE THE CASTLE GATES:

THE POLITICAL STRATEGIES OF FOREIGN MNCs IN JAPAN
CHAPTER 6:

Political Strategies Across Sectors: Clock Speeds Shaping Responses

This chapter presents the core empirical cases of foreign MNCs’ policy strategies. It examines the major issues involving foreign MNCs in each of the sectors experiencing a dramatic increase in presence of foreign firms—banking and securities, insurance, telecommunications, and pharmaceuticals. By showing the regularity in variation across sectors, as well as within the fast-moving financial sectors that provide many issue cases, the chapter provides evidence that firms’ clock speeds strongly shape their divergent political strategies; when confronted with policy-created threats or revenue opportunities, those with faster clock speeds tend to mount disruptive challenges, while those with slower clock speeds tend to pursue insider strategies. Before delving into the details of each sector, the chapter will first review the core argument and explain how each set of sector issue cases is used to build the argument.

The core argument of variation across sectors is shown below, in Table 32. The top two rows align sectors along their relative clock speeds. The third row lists the main policy issues cases presented in the chapter, cases in which firms faced windfall profit opportunities, or perceived threats to their core business models or revenue streams. The fourth row shows their responses, which fall along the spectrum of disruptive versus insider strategies, indicated in the bottom row.

Table 32. The Core Argument – Variation Across Sectors

<table>
<thead>
<tr>
<th>Clock speed</th>
<th>Faster</th>
<th>Slower</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>Banking (investment funds)</td>
<td>Pharma</td>
</tr>
<tr>
<td>Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telecom</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pharma</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Selected Policy Issue Cases

- Shinsei’s put option contract with the government
- Lone Star’s use of tax loophole
- Creation of parallel foreign Investor Protection Fund
- Collapse of Tokyo Stock Exchange members’ assn
- Recapitalization of Policyholder Protection Corp by private sector
- Capital reserve ratio increases for variable annuities
- Administrative litigation over interconnection fee raise
- Standard setting for next generation wireless
- Proposed increased frequency of pharma price list
- Clinical testing time lag vis-à-vis other OECD nations

Policy Strategy Response

<table>
<thead>
<tr>
<th>Policy Strategy Response</th>
<th>Challenge policy process as individual firms</th>
<th>Challenge policy process as group of foreign firms</th>
<th>Challenge as insiders as group of foreign firms</th>
<th>Challenge as insider, building coalitions, shifting preferences</th>
</tr>
</thead>
</table>

Political Strategy

<table>
<thead>
<tr>
<th>Disruptive challenge</th>
<th>Insider Challenge</th>
</tr>
</thead>
</table>
The core argument linking firms’ clock speed with their political strategies is strengthened by within-sector comparisons where possible (See Table 33). The banking sector provides variation in clock speed. Most sectors provide cases that allow a comparison between issues that pose a significant threat or opportunity, versus those that do not. And some sectors provide issue cases that can refine the argument by demonstrating the conditions under which it holds, such as characteristics of the policy threat or opportunity.

### Table 33. Issue Variations Within Sectors

<table>
<thead>
<tr>
<th>Sector Variation</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
<th>Telecom</th>
<th>Pharma</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clock Speed</td>
<td>O</td>
<td></td>
<td></td>
<td></td>
<td>Δ</td>
</tr>
<tr>
<td>Threat/Opportunity</td>
<td>O</td>
<td>O</td>
<td>O</td>
<td>O</td>
<td></td>
</tr>
<tr>
<td>Border/conditions</td>
<td>O</td>
<td>O</td>
<td>O</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The principle cases across sectors unfold as follows. The financial sectors, which have the fastest clock speeds, are where the most disruptive challenges occur. The banking sector provides an important clock speed variation within the sector, investment fund-owned banks with a short time horizon, and traditional banks focused on corporate finance and retail banking, with considerably longer time horizons. While investment fund-owned banks mounted notable systemic challenges, traditional banks were demonstrably more risk averse, focused on insider strategies. Moreover, among investment fund-managed banks, those facing the greatest policy-created opportunities for windfall profits engaged in the most disruptive behavior, and after logging windfall profits, lengthened their time horizons, yielding an increased focus on insider strategies.

The securities sector, which includes investment banking for the purposes of this analysis (since the same company usually engaged in both) is also characterized by extremely fast clock speeds. Without intellectual property protection, product cycles were rapid, with high proportions of revenue derived from new products expected to generate high profits for as little as a few weeks before being copied by others. Firms experienced rapid personnel turnover, driven by large bonuses often determined by performance on a quarterly basis. On many occasions, individual investment banks were willing to mount disruptive challenges by exploiting regulatory loopholes. On significant policy issues, securities firms moved a group to undermine informal government pressure, defying well-established norms of government-business coordination.

The insurance sector, with relatively slower clock speeds than those of investment fund-managed banks, securities firms or investment banks, tended to prefer insider strategies – both to challenge and to support policy initiatives. Although some insurers relied heavily on tools of high finance, such as variable annuities, the majority of insurers’ business operations were devoted to cultivating and retaining corporate and business customers for more traditional insurance products. Therefore, the combination of limited opportunities for windfall profits and the need to establish trust with business networks and individual households produced longer time horizons. Insurers worked within industry associations in key policy issues, even when
opposing particular policies, but following established norms of government-business interactions.

The clock speeds of *telecommunications* carriers are considerably slower than those of the financial sectors. Investments into infrastructure take years, especially for networks employing new standards. Carriers create lock-in effects for customers, both corporate and consumer, lengthening their time horizons to capture users at transitional junctures. Foreign carriers pursued insider strategies, joining standard-setting processes as insiders. Even in a notable case of administrative litigation, foreign firms participated by following the lead of a domestic firm, rather than mounting a challenge themselves.

Finally, the *pharmaceuticals* sector, with the slowest clock speed, relies almost exclusively on insider strategies. With years of R&D followed by lengthy clinical test procedures, pharmaceutical firms have the least potential for windfall profits through means other than blockbuster products. As such, their time horizons are longer, leading them to pursue strategies of embedding themselves deeply into existing policy networks and processes as insiders.

**I. Fast Clock speeds: Investment Funds, Banking, Consumer Finance**

The lineup of cases in the banking sector is shown in the table below (See Table 34). They are composed of three sections: investment funds and investment fund-managed banks; traditional retail banks; and the consumer finance industry. Investment fund-managed banks, with short clock speeds mounted disruptive challenges when faced with opportunities for windfall profits. Traditional banks with slower clock speeds and longer time horizons were more risk averse. The consumer finance industry reveals important limits to the ability of firms to mount disruptive challenges – the “space” provided by legal loopholes or informal authority not grounded in formal legislation.

**Table 34. Cases within the Banking Sector**

<table>
<thead>
<tr>
<th>Clock Speed</th>
<th>Sector Segment</th>
<th>Policy Threat/Opportunity?</th>
<th>Policy Strategy</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Faster</td>
<td>Investment Fund-Managed Banks</td>
<td>Yes</td>
<td>Disrupt</td>
<td>-Shinsei’s put option -Lone Star tax loophole</td>
</tr>
<tr>
<td></td>
<td></td>
<td>No</td>
<td>Insider</td>
<td>-Aozora (Cerberus) -Kansai Sawayaka (NIP)</td>
</tr>
<tr>
<td>Slower</td>
<td>Traditional Banks</td>
<td>Yes</td>
<td>Insider</td>
<td>-Postal Privatization -Citigroup Private Banking Suspension</td>
</tr>
<tr>
<td></td>
<td></td>
<td>No</td>
<td>Insider</td>
<td>-Joining industry associations</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conditions Case</th>
<th>Sector Segment</th>
<th>Principle Illustrated</th>
<th>Issue Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Finance</td>
<td>Limits of Ability to Mount Disruptive Challenge</td>
<td>-Regulatory change and judicial case eliminating regulatory ambiguity</td>
<td></td>
</tr>
</tbody>
</table>
THE FASTEST CLOCK SPEEDS: THE INVESTMENT FUNDS

As noted in Chapter 4, when Japan’s banking crisis deepened in the late 1990s, four major takeovers of Japanese banks by investment funds occurred. In the first and largest takeover, Ripplewood led a group of investors in purchasing the remnants of Long Term Credit Bank (LTBC) after the latter was declared insolvent and nationalized. The bank, reorganized and revived, was renamed Shinsei Bank. The second takeover was of Nippon Credit Bank (NCB), another failed long term credit bank. NCB was first sold to a coalition of Japanese firms led by Softbank and revived as Aozora Bank, but was later sold to US investment fund Cerberus. A failed regional bank, Tokyo Sowa Bank, was sold to the Lone Star Fund and revived as Tokyo Star Bank. Finally, an investment fund set up by W.L. Ross and several US pension funds (named the Nippon Investment Fund) purchased another regional bank, Kofuku Bank, to create Kansai Sawayaka Bank. Each fund reorganized the business models, business practices, and organizational structures of its banks; the banks departed from traditional relational banking, installed new IT systems, restructured employment systems, hired new specialists, and introduced new products.

The investment funds were focused on purchasing the Japanese distressed assets, reorganizing them, and exiting at a profit. Most had various investments in real estate and other troubled firms, but the banks represented their largest investments in Japan. The funds’ time horizons were short – less than five years to realize a profit – and an exit strategy to realize windfall profits was an integral part of their business models.

Among the funds, Ripplewood faced the greatest opportunity for windfall profits, responding with a disruptive challenge to the government. Lone Star pushed the hardest to take advantage of a regulatory loophole to minimize taxes paid to the Japanese government from its bank turn-around. The other investment fund-managed banks did not face similar policy-created opportunities or threats, and did not disrupt prevailing patterns of government business relations. It is worth noting that over time, after Ripplewood and Lone Star benefited from their windfall profits, their time horizons lengthened as the size of their investments decreased, and the firms increased their efforts to become insiders in policy processes.

Disruptive Challenges: Ripplewood and Shinsei Bank

Shinsei Bank, with Ripplewood-appointed management leadership, launched arguably the most dramatic disruptive challenge to the government by a foreign firm in Japan. Shinsei’s challenge was two-fold. First, it defied norms of a Japanese “main bank” by allowing a major debtor to collapse. Then it followed through on a contract with the government which enabled it to sell soured loans to the government.

In reorganizing LTBC into Shinsei Bank, the new Ripplewood-appointed management executed a massive turnaround in the bank’s strategy. It shifted away from relational banking, introducing new practices such as modeling the estimated risk of debtors and charging differential interest rates according to these estimations. It hired new employees with experience in other areas of finance, and created a two-tiered employment system: one offered higher pay and lower job security, while the other offered the traditional higher job security in exchange for lower pay. Ripplewood appointed as the new bank president a Japanese with previous experience...
heading the Japanese branch of a multinational oil company and building Citibank’s Japanese retail operations.

In this context, in the summer of 2000, Sogo, a department store chain with roots from the 1830s, came to Shinsei asking for debt forgiveness of 98 billion yen. This amounted to approximately half the company’s outstanding debt to Shinsei, and was part of a broader restructuring plan spearheaded by Sogo’s other main bank, the Industrial Bank of Japan – a typical main bank- led restructuring scheme. Shinsei, however, refused to participate in the concerted bail-out of Sogo, in effect sealing the retailer’s fate. The government applied informal pressure to Shinsei, but had no formal authority to force the bank to act. Shinsei, however, faced significant losses if Sogo went bankrupt and defaulted on its loans.

At this point, to avoid incurring non-performing loans from Sogo, Shinsei ignited a political firestorm by exercising a controversial clause in its contract with the government. This clause, inserted during the negotiations for the sale of the failed and nationalized LTBC to Ripplewood, gave Shinsei the right to sell bad debt to the government – in effect, a “put” option on soured loans. This put option had been inserted by Bank of Japan officials as a solution to two problems: reducing the risk of LTBC’s asset portfolio, and avoiding political involvement. (This put option was a creative application of the concept of a “cancellation right” which fit within existing the existing legal framework, enabling BOJ officials to avoid involving political leadership through an attempt to pass new legislation.) Specifically, the put option enabled Shinsei to sell loans back to the government during its first three years if the loan value dipped more than 20 percent. Moreover, in the final days of negotiations, the government allowed Ripplewood to backtrack on its original pledge to protect all borrowers in the event that extending particular loans threatened to create losses for the bank.

The Sogo case brought all these issues to the fore. According to the terms of Shinsei’s contract with the government, if the bank forgave some of Sogo’s debt, it would forfeit the rest of its put option on that debt. Since Sogo was widely regarded as insolvent due to rash investments during the bubble period, it was clear that a bailout and restructuring would take time. Ripplewood’s cost-benefit calculation was relatively short term. Where others – as we will see – were likely to have given more weight to their reputational costs and long-term relations with the government, Ripplewood was under pressure from its investors to turn around Shinsei as quickly as possible. Thus, since the government had already assured Ripplewood that Shinsei would not need to commit to all its debtors, and since its contract stipulated it could sell soured debt to the government, but would forfeit the opportunity to do so if it forgave a portion of Sogo’s debt, Shinsei went ahead and exercised the put option. It returned approximately 200 billion yen (2billion USD at Y100=1USD) to the government (specifically, the Deposit Insurance Corporation).

The government was put in a difficult position. Bailing out Sogo with public funds, in the wake of unpopular capital injections into banks, was politically unpalatable. However, allowing Sogo to fail would cause a social shock, since the chain employed over 10,000 employees, with another 40,000 people employed by mostly small-medium suppliers. This was just as rising unemployment was becoming an increasingly political issue. BOJ officials had apparently not anticipated that Shinsei would exercise the put option, and many in the ruling

399 Tett, Saving the Sun : A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown, 208-10.
400 Ibid., 159-60, 70, 208-10.
Liberal Democratic Party (LDP) were surprised and unhappy that the BOJ had agreed to such a clause.

As the press learned of the situation, media coverage portrayed all parties in a negative light. Shinsei was seen as a threat to Japan, and investment funds such as Ripplewood were portrayed as vultures, opportunistically preying upon Japanese firms and taxpayer money. Policymakers were blamed both for insufficient reforms, initially causing the problems, as well as the costs of reform if those reforms entailed corporate collapses and unemployment. The largest political opposition, the Democratic Party of Japan (DPJ), which had won a large number of seats against the LDP that summer, used the issue to attack the LDP. They raised connections between Sogo’s chairman Mizushima, the criminal underworld (yakuza), and LDP politicians. They also drew attention to Mizushima’s large salary (by Japanese standards) and the suicide of an LTCB banker tasked to monitor Sogo’s finances.401

The political firestorm intensified when participants were summoned to Diet hearings. Officials from the Financial Supervisory Agency, the Financial Reconstruction Commission, and the President of Shinsei were called to testify. In the testimonies, politicians criticized Shinsei’s payments of several billion yen to Ripplewood for “advisory” services while the government still owned a third of the bank – though this was not illegal.402

When the Diet committee called upon Goldman Sachs, which had been hired by the government as the advisor to the LTBC sale, to testify, the investment bank mounted a surprising challenge. Reportedly acting on the advice of its lawyers who advised Goldman’s leadership that the Diet had no power to force them to testify without evidence of wrongdoing, Goldman executives chose not to appear. This exacerbated politicians’ accusations that the investment bank had been negligent in advising the government by failing to warn them about the put option in the contract.403 This sentiment was a factor in the sale of the other failed bank, NCB, to a Japanese firm-led consortium.

In the end, there was little the government could do. Sogo went bankrupt, and Shinsei continued to follow its business model of abandoning its role as a “main bank.” It terminated lending to many small companies deemed too risky, and allowed some notable larger firms to fail.404 Between April and June of 2001, it returned another 100 billion yen to the government.405

Shinsei continued to defy the government’s informal guidance. In December 2001, the FSA issued a “business improvement order” to Shinsei on the grounds that Shinsei was not honoring its commitment to extend loans to small companies. The FSA went so far as to stipulate four companies to which Shinsei was to extend loans. Shinsei, however, pointed to the stipulations in its contract absolving it from obligations to make such loans.406

By 2005, Ripplewood, which had paid 121 billion yen for LTBC, had delivered approximately 270 billion yen to its investors.407 An IPO in 2004 raised 230 billion yen, and by

401 Ibid., 210-12.
402 Ibid., 212-18.
403 Ibid., 211-12.
404 Nihon Building failed, Daiichi Hotels and Life declared bankruptcy, and Seiyo, real estate group, collapsed. Hazama and Kumagai Gumi, two construction companies asked for debt forgiveness.
405 Tett, Saving the Sun: A Wall Street Gamble to Rescue Japan from Its Trillion-Dollar Meltdown, 234-36.
the end of the put option contract, Shinsei had returned over 1 trillion yen of its non-performing loans to the government.  

**Disruptive Challenge: Lone Star’s Offshore Tax Haven**

While Shinsei’s challenge consisted of adopting new norms and following a contract to the letter, the challenge posed by the Lone Star Fund was based on its use of a regulatory loophole. It used offshore tax havens to maximize profits from its investments, the largest of which was from Tokyo Star Bank. Although Lone Star was not the only foreign firm found to be using similar tax havens, its purchase of what was, in effect, a partly taxpayer recapitalized bank, rendered the issue the most politically contentious.

The failed Tokyo Sowa Bank was sold to Lone Star in early 2001. Since the sale occurred after the political debate surrounding Shinsei, Lone Star was not given a similar “put” option for non-performing loans. Lone Star installed new management, restructured the bank’s organization and realigned its business model to focus on retail operations and to offer specialized services and products. Beginning operations in June 2001 as Tokyo Star Bank, the new bank became profitable by March 2002. In 2005, Lone Star exercised part of its exit strategy by listing the bank on the Tokyo Stock Exchange, raising 90 billion yen for 30% of its shares. Lone Star completed its exit strategy in late 2007, selling the remaining shares to a Japanese investment firm, Advantage Partners, for approximately 250 billion yen. Given its original investment of 40 billion yen, Lone Star’s investment and turnaround of the bank was a resounding financial success. These large profits became the center of political contention.

The Japanese government’s investigations into Lone Star’s tax practices began in 2003. In addition to Tokyo Star Bank, Lone Star had invested in a number of other smaller financial firms, golf courses, and other real estate deals since the late 1990s.

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409 The Financial Reconstruction Commission in charge of selling Tokyo Sowa had initially picked US private equity fund WL Ross & Co in July 2000. However, In December of that year, however, WL Ross, led by investor Wilbur Ross, canceled the agreement due to fears about liability over a lawsuit filed against the bank’s former management. It had failed to agree with the government on provisions against the potential loss "Tokyo Sowa Bank Hunts for New Buyer."
410 As Kim Clark and Carl Kay have documented, Lone Star installed Todd Budge, an American, as president – the foreign leader of a Japanese bank. Budge reorganized the bank by creating greater job flexibility. He replaced the antiquated IT system with an open architecture network hiring Indian engineers in Tokyo and Bangalore, and modernized employees’ use of computers by introducing email and Excel to employees, most of whom had not previously had their own PCs. He reorganized branches to be more consumer friendly, and introduced new products such as deposit-linked mortgages Clark and Kay, *Saying Yes to Japan : How Outsiders Are Reviving a Trillion Dollar Services Market*, 44-46.. To enter new areas such as foreign currency deposits and investment trust operations, the bank hired mid-career employees (which it had not done previously). Outside talent was hired for marketing and public relations as well, and Budge introduced performance-based salaries "Foreign Funds Changing Regional Banks."
412 Before Tokyo Sowa, Lone Star had invested in a number of other smaller nonbank financial firms and retailers, such as Minebea finance, Nomura Finance, and retailer Victoria. Between 2001 and 2003, its main investments were in small regional financial credit unions and golf courses. "Nihon De Ichi Oku En
Taxation Bureau contended that the Lone Star Fund had failed to report almost 40 billion yen of taxable income between 1997 and 2003. It ordered the fund to pay approximately 13 billion yen in back taxes, including a penalty. Lone Star countered that it had no actual business operations in Japan; lawyers conducted the transactions and the Japanese unit searched for prospective purchasers, but did not directly involve itself in investment activities. Lone Star took refuge in a loophole provided by the US-Japan Income Tax Convention, which stipulated that the Japanese government could only tax income on foreign corporations if the latter had “permanent facilities” in Japan, such as branches and offices. The taxation bureau, on the other hand, contended that employees in the Japanese operations were, in fact, assessing assets, collecting claims, and engaging in other business activities; therefore, their Tokyo operations constituted de facto facilities. They also accused Lone Star of purchasing loss-making Japanese firms, extending them financing, and then receiving returns on the financing while continuing to list the Japanese firm as loss-making.

The issue of Lone Star’s taxes became politicized in 2006, when the Tokyo Tax Bureau calculated that the fund failed to declare another 14 billion yen earned from Tokyo Star Bank. At issue was the Bermuda-based investment firms used by Lone Star, and its re-selling of non-performing loans from Tokyo Star Bank in 2002 and 2003 through firms in Japan and Ireland. The tax bureau gave Lone Star a notification of tax evasion, but Lone Star contended that it was not liable. Since the fund did not have assets in Japan, there was no way for the Japanese government to collect the taxes.

This issue came up in a National Diet subcommittee meeting, but the debate did not move beyond criticizing the use of tax havens for government-facilitated profits.

The Tokyo Tax Bureau then targeted Tokyo Star Bank. In 2005, it contended that the bank had failed to declare approximately 19 billion yen in income, and it levying a 7 billion yen additional tax. However, Tokyo Star Bank, then still majority owned by Lone Star, fought back, filed for an investigation by the National Tax Tribunal, an organization set up to investigate such taxation issue. The Tax Tribunal nevertheless denied the request for an investigation. Lone Star exited in late 2007 before the issue was resolved, but in January 2008, immediately after being bought out by Advantage Partners, Tokyo Star filed a lawsuit in the Tokyo District Court. As the court began to gather information, in May 2008 the tax bureau reversed its position. It found that the additional taxation was the result of incorrect calculations, and it returned just

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415 Lone Star claimed it did not have a Japanese operational base, while the tax authorities deemed the money as to be “income from asset management,” liable to tax regardless of location, rather than “income from business activities” not subject to declaration if there is no base in Japan. "Firm Failed to Declare 14 Bil. Yen in Earnings," *The Daily Yomiuri*, April 1 2008.
under 8 billion yen to the bank (including approximately 1 billion yen of interest, calculated at what some considered an extremely generous 4%).

While the Tokyo Star Bank issue was resolved, the tax bureau continues to maintain the position that Lone Star evaded taxes, while Lone Star contends otherwise. The tax authority, however, has no options at its disposal.

No Challenge/Windfall Opportunity, No Disruption: Aozora and Kansai Sawayaka

In contrast to Ripplewood and Lone Star, which mounted disruptive challenges, Cerberus and the W.L. Ross-led Nippon Investment Partners did not challenge the government. This was partly the result of differences in strategy, but also because they were not confronted by similar issues that presented windfall revenue opportunities or threats to their revenue.

The sale of the failed and nationalized Nippon Credit Bank (NCB) occurred in the midst of the political contention surrounding Shinsei and Ripplewood. As a reaction, the government selected a group of Japanese investors which had also expressed interest, over Cerberus. After tough negotiations, and with some hesitation, the government authorized the same “put” option granted to Shinsei for NCB’s buyers.

The bank, renamed Aozora, took a less aggressive approach than did Shinsei in restructuring its operations and exercising the put option. The president of Aozora stated that he would not hesitate to use the put option to serve the interest of shareholders, but added that since 93 regional banks were part of the consortium that had purchased Aozora, the bank would be careful to avoid forcing borrowers into bankruptcy. He promised to consult with the regional

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417 The political debate that erupted over whether Softbank could get the same clause as Ripplewood was actually substantial. Negotiations began in July 2000, when the Diet called in BOJ officials and Shinsei’s president for testimonies over Shinsei’s challenge to the government. Making matters worse for the government was a political scandal involving the chairman of the Financial Reconstruction Commission, a career bureaucrat, slated to explain the necessity of the “put” option. The career bureaucrat had received cash and benefits from Mitsubishi Trust & Banking corporation and was forced to resign after criticism from the DPJ "Frc Image Dealt Blow by Kuze's Predicament," The Daily Yomiuri, July 30 2000, Stephanie Strom, "Finance Official Quits in Latest Blow to Japan's Government," The New York Times, July 30 2000.

418 Aozora’s restructing was less radical than Shinsei’s, relying on the ties with its owners and established partners. In overhauling and operating its IT system, Aozora contracted Hitachi, with which it had a longstanding relationship, Aozora launched an online consultancy on M&A run jointly with Softbank Orix, and Tokio Marine & Fire, and it formed ties with California-based Silicon Valley Bank, specializing in startup firms "Aozora Bank Forms Ties with Silicon Valley Counterpart.", "Aozora Bank Taps Hitachi for Accounts System Work.", "Bank Launches Online Consultancy on M&a, Funding.". As an illustration of how difficult it can be to restructure entrenched corporate practices, it should be noted that the first president of Aozora appointed by the Softbank consortium on September 4, 2000 committed suicide just over two weeks later. Tadayo Homma was a former Bank of Japan official and he was found on September 20th in an Osaka hotel room with a suicide note "President's Suicide Leaves Burdened Bank.".

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banks during the process.\textsuperscript{419} By May 2002, Aozora had sold off 49 bad loans worth 144.5 billion yen for 106.8 billion (compared to Shinsei’s 1 trillion yen by February 2003).\textsuperscript{420}

A sudden shift of Softbank’s strategy following the burst of the dot-com bubble led it to sell Aozora in the summer of 2002. Having incurred heavy losses in its IT-related investments, Softbank sought the capital to concentrate on investments in its broadband business.\textsuperscript{421} GE Capital, Germany’s Hypovereins Bank, US investment fund Cerberus group, and Sumitomo Mitsui Banking Corporation launched bids for Softbank’s share of Aozora. Some conservative LDP members feared that a foreign owner would use the put option more aggressively, and the FSA was more interested in selling Aozora to a major Japanese bank. However, the reformist political leadership in the Koizumi administration won, and the government did not exercise its recently acquired legal capacity to veto Softbank’s sale to Cerberus.\textsuperscript{422} Cerberus did not exercise the put option aggressively as some had feared, and listed the bank on the Tokyo Stock Exchange in November 2006.

Kofuku Bank, a second-tier regional bank in Osaka, was sold to Nippon Investment Partners (NIP), a fund spearheaded by investor W.L. Ross and several major US pension funds, in 2000. Kofuku’s bankruptcy and sale had been mired by corruption and scandal.\textsuperscript{423} The sale price was approximately 24 billion yen, but the deal did not include the “put” option given to Shinsei and Aozora. The bank did, however, receive a 12 billion injection of public funds. Other stipulations included the requirement to retain half of its 2000 employees and 81 of its 123 branches. The bank was reorganized and a new business model was implemented, aided by Boston Consulting Group. A new employment scheme was implemented, involving performance-based pay, employee stock ownership, and stock options. The revived bank, Kansai Sawayaka Bank, began operations in February 2001. Two years later, NIP successfully exited its

\textsuperscript{420} "Aozora Expresses Fear over Foreign Investment." \textit{The Japan Times}, May 30 2002.
\textsuperscript{421} Some contend that the Ministry of Finance also pressured Softbank to sell the bank, rejecting Softbank’s vision of using the bank to finance a network of Internet-related firms.
\textsuperscript{422} In April of that year, the Banking Law had been revised, strengthening the government’s power in the sale of banks. In the revision, FSA was given a final say on equity interests of 20% or larger in banks – in effect, the authority to screen the “quality” of prospective major shareholders of banks "Strict Fsa Rules Stymie Aozora Bank Suitors.".
\textsuperscript{423} Kofuku became insolvent in May 1999, and was placed under administrators appointed by the Financial Reconstruction Commission. The Financial Supervisory Agency had given the bank one week to submit a recovery plan, including drastically scaling-down business, raising capital (its capital adequacy ratio was 0.5%, well below the 4% required for domestically operating banks. Kofuku bank had asked the FRC for 60 billion yen of public funds. However, it was put under government management, and its management team was arrested Sato, "Kansai Bank Handed Deadline to Reform.". Some political suspicion was raised when it was revealed that FRC chairman Hakuo Yanagisawa, along with two other prominent LDP politicians, had received political donations between 500,000 and 1 million yen from the former president of the bank. Tokusuke Egawa, the former president for extending illegal unsecured loans to a real estate company owned by his family. Three Egawas, the former president, former vice president Benji Egawa, and former managing director, Tokuaki Egawa, were arrested, as were the presidents of the real estate company "Kofuku Bank Donated Money to Frc Head.", "Kofuku Bank Ex-Executives Rearrested.".

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investment when another local bank, the Bank of Kansai, bought 80% of NIP’s shares – investors earned an estimated profit of 5.8 billion yen.\(^{424}\)

Thus, unlike Shinsei and Lone Star, the two firms Cerberus and NIP, meeting neither policy-created opportunities for windfall profits nor threats to their core business models, mounted no disruptive challenges.

**Clock Speed Slowdown: Investment Funds After Windfalls Becoming Insiders**

As a secondary comparison, it is worth noting the behavior of the investment funds Ripplewood and Lone Star after they logged windfall profits. The investment funds continued their presence in Japan after their bank turnarounds with smaller investments. With lower stakes, however, their time horizons lengthened, reducing incentive to mount disruptive challenges. Tellingly, they hired former government officials to strengthen informal networks, signaling intent to avoid further “misbehavior.” The former government officials were not hired explicitly to curry favor with policymakers or make specific demands on bureaucrats. Rather, the understanding was that occasional lunches with former colleagues and subordinates reinforced the notion that the funds would generally not create difficulties for the ministries and government. In return, the government would not harshly target the funds.\(^{425}\)

Therefore, as their time horizons lengthened after initial windfall profits, even the investment funds that had mounted disruptive challenges increased their investments to become insiders in the prevailing interpersonal networks between government and business.

**Slower Clock Speeds: Traditional Banks**

Compared to investment funds, traditional retail banks had longer time horizons. As seen in Chapter 4, the largest retail banks such Citibank and Chase Manhattan had been operating in Japan for decades. While they used regulatory loopholes to expand their presence in Japan, notably in the establishment of trust banking and securities operations, once the regulatory regime shifts of the late 1990s allowed them to become insiders, they invested resources to do so. A number of issues demonstrate the contrast with faster clock speed firms.

First, JP Morgan’s decision regarding LTBC, before it was purchased by Ripplewood, provides a telling contrast between traditional banks and investment funds. JP Morgan was one of the early potential buyers of LTCB. However, upon learning of the put option possibility, it abandoned the deal, considering the potential risk to reputation too great.\(^ {426}\)

Second, the case of Citibank’s private banking shows how larger firms with a wider range of activities face potentially higher costs as repercussions for politically risky strategies. From the early 2000s, the Financial Services Agency (FSA), which had just been split off from the Ministry of Finance was shaping itself as the driver of a strong *ex post* regulator. It began aggressively investigating and enforcing punitive measures against financial institutions, both foreign and domestic. In 2004, the FSA handed out one of its harshest punishments by revoking Citigroup’s license for private banking for wealthy clients. It cited systemic problems with

\(^{424}\) ACCJ, "Kansai Sawayaka Bank (Ks Bank)," *FDI Case Studies*, http://www.accj.or.jp/doclib/fdi/1069040587.pdf.

\(^{425}\) The funds did not grant permission to quote or cite details of the personnel involved.

Industry participants widely note that this was a warning signal – irregularities of various forms could be found in most firms if the FSA looked hard enough, and the FSA demonstrated its willingness to terminate firms’ operations. It created a disincentive for large, established firms to engage in politically risky behavior. For banks engaged primarily in corporate and retail lending, such as Citibank, which did not face the opportunity for windfall profits or pressure to exit, these constraints were perceived as real.

A 1999 reorganization of the Japan Bankers’ Association, the peak banking industry association, enabled membership of foreign banks. Citibank, Chase, and JP Morgan, the largest of the foreign banks, moved quickly to join as permanent members.

Finally, the issue of privatizing the postal system illustrates the limits of firms’ influence on policy, and the broader conditions under which disruptive strategies might even be contemplated. The privatization of Japan’s postal savings system created the largest financial institution in Japan, representing a major competitor to all banks. The privatization was at the core of then-Prime Minister Koizumi’s election in 2003. Despite opposition by financial institutions, Japanese and foreign alike, there was little they could do, as Koizumi conducted the election focusing all other political issues around this privatization.

Japan’s postal savings system, by far the largest Japanese financial institution in terms of deposits, was long at the center of Japan’s “developmental” state. With higher interest rates than conventional banks were allowed to offer until the 1980s, and with branches all over the nation, it was the largest deposit collector. Political control of the investments from these savings, the Fiscal and Investment Loan Program, allocated pork-barrel projects throughout the nation, providing the basis for the LDP’s long-lasting power.

After Prime Minster Mori’s historically low approval ratings in the early 2000s brought the LDP to the brink of an electoral rout, Koizumi Junichiro was elected as head of the LDP. His strategy was to keep the party in power by pledging to undermine the old basis of its power – pork barrel allocations of depositor investments gathered from the postal savings system. When he dissolved the Diet in 2005, he made postal privatization the central issue – a metaphor for forward-looking reforms representing a clean break with the past. Postal privatization split the opposing DPJ, some of whom were former LDP members with vested interests, and the party was unable to articulate a clear platform to counter Koizumi’s simple binary framing of issues.

Foreign banks opposed postal privatization, since it would create a massive retail bank with branches all over the nation. Through organizations of foreign MNCs, including the American Chamber of Commerce and other industry groups such as the European Business Council in Japan and the International Bankers Association, they published statements and papers opposing privatization. Their argument was that privatization would create an unfair playing field in favor of the new bank. At the same time, they backed the Japan Bankers’ Association’s opposition of the privatization – large Japanese banks were opposed for the same reason. The effect, however, was negligible. Koizumi’s campaign led to a landslide electoral victory, and the privatization proceeded.

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The politically spearheaded collapse of Japan’s lucrative consumer finance industry illustrates an important condition required for firms to mount disruptive challenges to the government in the first place. It shows that in order for firms to defy existing rules and processes, they must have the regulatory opportunity to do so. As we have seen in the case of postal privatization, if an issue is part of broader, electorally critical political dynamics, firms may have little influence. This case shows that if firms’ business models are curtailed through laws and the judicial branch, there is also little they can do to resist or mount a challenge. In other words, for revenue-threatening policy changes that are highly political, and involve rule changes or the judicial branch, firms have no room to defy informal rules and norms.

The distinction between banking and consumer finance is that the latter’s customers are generally high-risk borrowers, with firms charging high interest rates. In the late 1990s, regulatory shifts to Japan’s consumer finance market had increased the industry’s attractiveness to foreign firms, while simultaneously easing their entry.

To set up the case, we must first briefly review the nature of Japan’s consumer finance industry. Japan’s consumer finance was an odd market, long separated from mainstream retail banking by MOF, with firms’ business models relying on a legal and regulatory ambiguity. This regulatory ambiguity enabled consumer finance firms to charge higher interest rates than conventional banks, becoming far more profitable than conventional retail banking in the late 1990s. Deregulation measures, part of Japan’s Financial Big Bang Reforms, enabled consumer finance firms to use a variety of new means to raise capital, including issuing commercial paper, debt, convertible bonds, and bonds. Since foreign financial firms enjoyed competitive advantages in precisely these means of raising capital, they moved quickly to enter the market segment.

Traditionally, the consumer finance market was stigmatized by the Japanese public due to its long history of ubiquitous small loan sharks with ties to organized crime. Mainstream banks were not involved in the market, partly due to informal guidance by MOF. The sector’s historical development entailed a pattern of public scandals followed by a lowering of maximum interest rates. Maximum interest rates fell from approximately 180% to 110% in 1954. The US firm Associates was among the first foreign firms entering the market in 1979. In the 1980s, a legal “gray zone” was established when the government passed the Money Lending Business Law, which allowed lenders to charge more than the Interest Rate Restriction Law. Lenders could follow instead the maximum interest rate stipulated by the Investment Control Law. This latter rate was reduced from 73% to 55% in 1986 and 40% in 1991. Even after the maximum interest rate was lowered to 29.2% in 2000, it was still the most profitable segment of the banking sector.

A wave of foreign entry occurred in the late 1990s, mostly as pure market transactions – a contrast to the politically leveraged, gaiatsu-enabled entry strategies in the securities and trust

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428 In fact, in the 2003 tax investigation by the Tokyo Tax Bureau, introduced in the Lone Star case above, a consumer finance firm under the Citigroup umbrella was accused of understating its income by 50 billion yen, owing 10 billion yen in taxes.
banking markets (as introduced in Chapter 4). GE Capital Services acquired Tokyo-based Koei Credit in January 1998 and Osaka-based Lake in November of that year, merging the two in 2000 and renaming it GE Consumer Finance.\footnote{Ge Capital Merges 2 Consumer Finance Subsidiaries,} In 1998, Associates International, which had by then been in Japan for two decades, expanded by purchasing 90% of DIC Finance. Citigroup entered the market in September 2000 when it bought the US parent company of Associates, Associates First Capital, which currently had the fifth-largest consumer finance company in Japan.\footnote{Citigroup Extends Global Reach with Associates Deal}

Foreign firms’ market presence exceeded the direct size of foreign-managed or foreign-owned consumer finance firms. Deregulation had enabled consumer finance firms to raise funds through means such as issuing convertible bonds and securitized debt, but the “big four” Japanese consumer finance firms lacked this expertise. Foreign financial firms such as brokerages eagerly extended their services to the big four (which actually enjoyed a lower default risk than banks) to secure funds.\footnote{For example, the Financial Times reports that in 1999, Citibank and Merrill Lynch arranged securitized finance of approximately 100 billion yen and 20 billion yen to Shokkoh, and Nichiei, respectively. The two firms were later embroiled in the media scandal revealing illegal debt collection tactics practiced by these firms towards small businesses, leading, among other things, to over 300 lawsuits against Nichiei. Gillian Tett, “Loan Sharks Seek Their Pound of Flesh: Gillian Tett on the Shocking Tactics Used by Some Debt Collectors in Japan,” The Financial Times, November 15 1999.}

**The Policy-driven Collapse of Japan’s Consumer Finance Market**

From 2006, the combination of a court ruling and popular pressure contributed to a strong political push to reduce the profitability of consumer finance operations. The nature of the reforms left firms little room for defiance of the government.

In January 2006, a Supreme Court decision, which overturned the decisions of lower courts, ruled against a subsidiary of Aiful, one of the big four consumer finance firms. It ruled that the main justification for allowing firms to charge the higher interest rate was that interest payments were optional. However, unsurprisingly, the court found that the actual industry practices did not treat interest payments as optional. It found that firms routinely threatened debtors that the latter would be forced to repay the remaining balance if they fell behind in interest payments.\footnote{The judge also noted that there was something wrong with the consumer finance industry enjoying record profits while suicides by debtors increased. Shohei Ide, Sarakin Hokai: Guree Zon Kinri Teppai O Meguru 300 Nichi Sennsou [Destruction of the Loan Sharks: The 300 Day War over Removing the Grey Zone Interest] (Tokyo: Hayakawa Shobo, 2007), 23.}

The court ruling was also a blow to the FSA because it contended that the administrative measures allowing simplification of loan application processes were illegal.\footnote{Ibid., 14-25.}

After political debates involving lobbying by the consumer finance industry association, a split within the LDP, and bureaucratic maneuverings around the publication of a deliberation council report, the Diet passed a new bill in December 2006.\footnote{Ibid.}
The new Money Lending Law, replacing the Money Lending Business Law, was sponsored by the FSA rather than by politicians. Previous amendments had all been politician-sponsored, reacting to waves of negative press and public outcries. The new bill decreased the maximum interest rate from 29.2% to 20% and imposed lending limits. Several measures aimed directly at loan shark activity. It barred persistent day-time debt-collection activities, such as visits and calls to borrowers’ homes, workplaces, and relatives. Lenders were also prohibited from taking out suicide insurance coverage on borrowers.

In the meantime, during most of 2006, the FSA cracked down on several lenders. In April, it punished Aiful, one of the big four, for illegal debt-collection methods by ordering a three-day suspension of operations. In October, it penalized GE Consumer Finance for similar offenses, and in December, it imposed the harshest penalty on Sanyo Shinpan Finance, suspending business for 12 days on grounds that employees had falsified documents.

Compared to traditional banking, the consumer finance industry had weaker ties to the government. These weaker ties stemmed from several factors: the industry’s postwar separation from mainstream banking until the late 1990s; the private company origins of the major consumer finance companies; and the significant differences in corporate structures and business practices. To illustrate the latter points, for example, in 2005, Forbes showed that three of the six richest Japanese were presidents or founders of the top consumer finance firms, Takefuji, Aiful, and Acom. This sharply contrasted with the top management of major Japanese banks, who were not, as individuals, paid such vast sums. Corporate finance was traditionally dominated by a large number of firms, many of which were essentially loan sharks with ties to organized crime for handling debt collection. Unlike traditional banks, they were not prestigious employers, and typical employment arrangements were strictly performance-based, with solely commission-based salesmen. As the major consumer finance firms grew in size and consciously shed their image as shady loan sharks, they made efforts to enter respectable business society. They began to employ retired bureaucrats, and the industry association made political contributions, though at a much smaller scale than other segments of finance. They also began listing themselves on stock exchanges, and some joined Keidanren.

However, in 2003, a major scandal with Takefuji, the largest firm, weakened the industry’s image. The chairman and founder was arrested for wiretapping a journalist critical of their debt collection methods, reviving the latent image of consumer finance firms as gangsters in corporate guise.

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436 Ide, Sarakin Hokai: Guree Zon Kinri Teppai O Meguru 300 Nichi Sennsou [Destruction of the Loan Sharks: The 300 Day War over Removing the Grey Zone Interest], 47.  
437 While the Asahi newspaper reported that since 1980, 23 people from MOF had post-retirement positions in five firms, with positions of chairman or auditor in 2007. Among them were former banking bureau chiefs and financial investigators. Between around 2005 and 2007, five BOJ retirees, including former members of the policy board, went to the big four. An arm of the industry association had contributed funds to politicians, (about 19.5 million yen between 2003 and 2005) and through the purchase of party tickets. Moreover, the section within FSA dealing with consumer finance was one of the smaller, with about 20 people, compared to the two banking division, the insurance division, and the securities division. Ibid., 11, 87-88.  
The American firms that had invested significantly in the consumer finance industry used a mix of insider strategies, including external government pressure, to attempt influencing the policy process, but they were ultimately unsuccessful in doing so. American industry associations, including the Financial Services Roundtable and Managed Fund Association, as well as the US Treasury department, lobbied the FSA and Japan’s ambassador to the US. The ACCJ contended that the lower nominal interest rates in Great Britain, France, and Germany’s consumer finance industries understated various fees and that Japan’s de facto interest rates were lower. GE Consumer Finance gave their position and distributed reports in a government deliberation council, and US senator Richard Shelby, a Republican from Alabama, reportedly visited Japan as well.

In 2006, a final agreement between the LDP, FSA, Ministry of Justice, and the LDP’s ruling coalition partner Komeito, was reached behind closed doors. The LDP, initially cautious about damaging the industry, had eventually taken the position that its public image would be enhanced by confrontation of firms often portrayed as loan sharks. Moreover, an influx of young LDP politicians (known as the “Koizumi children”) who had been elected in September 2005 as part of Prime Minister Koizumi’s strategy to revamp the party, had no vested interests in the industry. A compromise plan from the FSA had proposed that the new, lower interest rate would kick in two years after the law change, in 2009. The new law, which came into effect in 2009, capped the amount of interest charged on consumer loans (20% for less than 100,000 yen, 18% for less than 1 million yen, 15% for more than 1 million yen).

Even before the new law was enacted, the effective removal of the “grey zone” interest rates and lenders’ obligation to repay interest collected from borrowers, past and current, led to an exodus of foreign firms from the market. In 2007, GE closed approximately 60% of its branches and cut 400 of its 2600 employees through voluntary retirement. At the same time, CitiFinancial, the consumer lending arm of Citigroup, announced it would close 80 percent of its branches. The industry continued to shrink rapidly.

Thus, the consumer finance case illustrates the limitations for firms attempting to mount challenges to the government. Despite the clear threat to their core business models and the relatively fast clock speeds of foreign financial firms, leading to the high likelihood of a systemic challenge, the nature of the policy reforms left firms no room to take such action. The legal change backed by a judicial ruling that removed regulatory ambiguity gave firms no opportunity to mount disruptive challenges. Moreover, since the issue became significantly

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439 The Financial Services Roundtable (100 of the largest integrated financial services companies in the US), the Financial Services Forum (CEOs of the 20 largest financial institutions in the US), the Managed Funds Association (representing over 1000 financial industry professionals), sent letters and opinion papers to the head of Japan’s FSA, as well as the US Treasury and Japanese Ambassador to the US. Michiy o Nakamoto, "Us Industry Chiefs Urge Tokyo to Reconsider Consumer Loan Plans," Financial Times, August 23 2006, Ide, Sarakin Hokai: Guree Zon Kinri Teppai O Meguru 300 Nichi Sennsou [Destruction of the Loan Sharks: The 300 Day War over Removing the Grey Zone Interest].

440 Ide, Sarakin Hokai: Guree Zon Kinri Teppai O Meguru 300 Nichi Sennsou [Destruction of the Loan Sharks: The 300 Day War over Removing the Grey Zone Interest].

441 Ibid., 123-57.

politicized, with both the political leadership and bureaucracy aligned against corporate interests, insider strategies had little effect.

**Fast Clock Speeds: Securities/Investment Banking**

The policy issues cases in the securities/investment banking sector are shown in Table 35 below. When confronted with policy-created windfall opportunities or threats, firms tended to mount disruptive challenges.

These disruptive challenges were undertaken by individual firms, or as the concerted actions of foreign firms acting as a group. Significant individual disruptive actions included Goldman Sachs’ refusal to testify before the Diet concerning actions it undertook while acting on behalf of the government, and Lehman Brother’s exploitation of regulatory ambiguity that enabled an off-exchange hosting M&A by an aggressive Japanese start-up firm. Disruptive actions by foreign firms acting in concert – observed to this magnitude for the first time in these cases – included defying strong government pressure to create a private sector-funded protection fund, and withdrawing from an association set up to make political donations.

By contrast, in major policy issue cases that did not directly create major windfall opportunities or pose a threat, securities houses and investment banks took insiders positions, working through existing industry associations and prevailing policymaking processes. The paradigmatic case is the liberalization of securities products sold at banks, which promised an expansion of opportunities, but not windfall revenue.

The securities sector also provides an issue case in which foreign firms went to great lengths to avoid unduly antagonizing business partners, thereby following the government’s administrative guidance. Brokerage activities, which are aided by longer-term relations with large Japanese firms, banks, and Japanese institutional investors, must balance the opportunity for windfall profits with the negative perception of untrustworthiness and opportunism. When an error committed by a trader in Mizuho Securities led to windfall profits for foreign brokerages at the expense of Mizuho, the largest recipients voluntarily returned their windfall profits in an effort coordinated by the FSA, by contributing to a new industry fund.
Table 35. Securities/Investment Banking Sector Cases (Relatively Short Time Horizon)

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<thead>
<tr>
<th>Threat/Opportunity</th>
<th>Policy Strategy</th>
<th>Cases</th>
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<tbody>
<tr>
<td>Yes</td>
<td>Disrupt</td>
<td></td>
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<tr>
<td></td>
<td>(as individual firm)</td>
<td>- Goldman’s refusal to appear in Diet</td>
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<tr>
<td></td>
<td></td>
<td>- Lehman’s off-exchange hostile M&amp;A facilitation</td>
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<td></td>
<td></td>
<td>- Securities Investor Protection Fund</td>
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<td></td>
<td></td>
<td>- Tokyo Stock Exchange Members’ Organization</td>
</tr>
<tr>
<td>No</td>
<td>Insider</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>- Liberalization of securities sold at bank windows</td>
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**Boundary Case**

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<thead>
<tr>
<th>Issue</th>
<th>Policy Strategy</th>
<th>Issue case</th>
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<tbody>
<tr>
<td>Opportunity for windfall profits</td>
<td>Insider (great lengths to show themselves as responsible firms)</td>
<td>- Windfall profits from Mizuho trading error returned</td>
</tr>
</tbody>
</table>

**Individual Disruptive Challenges (and Their Limits)**

On arguably the most politically high-profile issues involving foreign firms in the securities sector, the foreign investment banks took notably disruptive stances to existing policy processes. The first case, in which Goldman Sachs defied the Diet’s orders to testify, has been introduced in Chapter 3. It is worth reiterating that this was a notable act of defiance, since the government had hired Goldman as its advisor for the politically sensitive task of selling off the nationalized Long Term Credit Bank. Yet, Goldman refused to appear at the Diet session, citing the government’s lack of legal coercive power.

In a second case, Lehman Brothers capitalized on regulatory ambiguity to play a critical role in facilitating a controversial hostile M&A. In early 2005, Lehman assisted Livedoor, an aggressive Japanese Internet start-up firm, in taking control of a venerable broadcasting corporation. (The president of Livedoor was later arrested and found guilty of violating securities law and falsifying the company’s accounts). Lehman’s role was to take advantage of a loophole in securities regulations to aid Livedoor in quietly acquiring a large portion of the target company’s shares. Securities rules required that acquisition of greater than a third of a public company be conducted through tender offers open to all shareholders. However, Lehman and Livedoor circumvented this regulation through after-hours acquisitions on an off-exchange system operated by the Tokyo Stock Exchange. Although Livedoor’s bid eventually failed, Lehman’s role was brought up in political debates over how far to reform Japan’s economic system in introducing “Anglo-American” elements.

The risks and limits to firms’ taking advantage of regulatory loopholes were illustrated by the FSA’s punishment of parts of the Credit Suisse group. Since its creation in 1998, the FSA,

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anxious to show itself a strong regulator, had conducted numerous audits on foreign as well as domestic firms. For the most part, it imposed fines for legal infringements such as underreported taxes and illegal trades.444

In 1999, however, a series of infringements by the Credit Suisse group led the FSA to hand out the harshest punishments at the time. After an investigation, FSA charged 5 firms in the Credit Suisse group with illegal schemes and attempts to mislead investigations. FSA enacted sanctions, prohibiting the group from dealing in Japanese government bonds, and barring Japan’s public pension, insurance, and postal banking systems from using the group’s trust bank. For the Credit Suisse Financial Products Bank, which specialized in derivative products, the FSA rebuked the firm’s license entirely. An ensuing criminal investigation by the Police Agency, which raided the house of the (Japanese) Tokyo branch manager, led to a four month jail sentence. In 2001, the Tokyo District Court imposed a 40 million yen fine on the parent firm, Credit Suisse First Boston.445

This action raised the stakes for firms with longer time horizons. As one industry participant put it, exploiting regulatory loopholes could generate windfall profits, but firms needed absolute assurance that their actions were legal. Several participants noted that larger firms engaged in a wider variety of activities, such as European commercial banks, were naturally more risk averse than specialized investment banks such as Goldman Sachs or Lehman Brothers.446

**Concerted Disruption: Securities Investor Protection Fund**

The government’s attempts to create a fund for protection of securities investors from the bankruptcy of brokerages – the Securities Investor Protection Fund – led to a concerted disruptive challenge by foreign firms. The challenge disrupted the government’s standard operating procedures of policy implementation: forging an informal consensus and delegating implementation to the industry association through administrative guidance.

MOF’s attempt to create a protection fund in the securities industry was sparked by the deepening financial crisis of the late 1990s. In 1997, a set of bankruptcies shook the sector. Sanyo, a medium-sized brokerage became the first listed securities firm to collapse in the postwar period. It was mired in debt, creditors refused to bail it out, and other brokerages refused to absorb it. This was the juncture at which MOF departed from the “convoy system” of an implicit bailout guarantee. Later that year, Yamaichi Securities, Japan’s oldest and fourth largest securities house, failed suddenly. This truly shocked the nation; it was possibly the most dramatic “sudden death” of a venerable, prestigious company, giving the population at large an acute sense of the severity of the financial crisis.


446 (Interview notes, 2006)
MOF was keen to revamp and strengthen the protection fund for securities investors. Officials saw it as part of a broad shift from ex ante competition management (including preventing failures before they occurred) to ex post regulation (setting up institutions to protect consumers when failures did occur.) MOF envisioned a fund analogous to deposit insurance for banks. The existing fund was optional, and MOF sought a more comprehensive, mandatory institution.

Following standard modus operandi, MOF attempted to implement its vision through the Japan Securities Dealers’ Association (JSDA). Compared to direct regulation of firms, this approach required no Diet approval, allowing MOF to avoid political involvement. JSDA was to design and mandate membership into the new fund.

Foreign firms were concerned about this plan from an early stage. They were unwilling to shoulder the cost of bailing out failed Japanese firms – especially small-medium brokerages such as Sanyo, with opaque accounting practices. In April 1998, Goldman Sachs and nine other foreign firms, including three European banks, sent opinion papers to JSDA outlining their concerns. They contended that: 1) MOF was unclear about how it derived the proposed fund size of 50 billion yen; 2) losses from the collapses of Sanyo and Marubeni were far greater than this amount; and 3) MOF’s explanations concerning the causes of these firms’ collapse were insufficient.

In late June, this group of ten firms was joined by fourteen others in voicing their displeasure. The group, now including Barclays Capital, Dresdner, ING Bearing, Societe Generale and other smaller firms, sent letters to JSDA and MOF. The foreign firms noted their support for an investor protection fund, but wanted new requirements on members – that brokers separate customers’ accounts from their own, and that capital adequacy ratios be monitored.

In August 26, 1998, foreign firms sent statements to members of the committee charged with setting up the investor protection fund (these included 17 JSDA members, including one European and two American firms, with the committee headed by the vice chairman of JSDA, who was chairman of Shin Nihon Securities). The foreign firms reiterated their concerns about separation of customers’ and brokers’ accounts and minimum capital ratios. They contended that the issues covered by the fund establishment committee were too narrow, failing to address these broader, more fundamental issues.

Nomura, the Japanese industry leader, also expressed reservations about the fund. At one point it even considered withdrawal from the committee.

The FSA, spun out of MOF, was nervous about mandating brokerages to separate their accounts, fearing a wave of bankruptcies among small-medium brokerages. Despite moving towards an ex post mode of regulation, officials were uneasy over possibly disruptive action. To mitigate the danger, the FSA issued informal guidance for large firms to aid small-medium firms’
liquidity. In November 1998, it also issued strong requests to the principal industry associations in banking and trust banking in preparation for implementation of new reporting requirements the following April.\textsuperscript{451}

In the meantime, the foreign firms discovered a loophole in the government’s plan to implement the investor protection fund. While fund membership was mandatory, nowhere did it stipulate that only one fund could exist. Foreign firms therefore decided to create their own parallel fund. They did so on the grounds that the initial fund carried potentially large and unknown risks, including: 1) ambiguity as to the extent of fund responsibility in the event that a bankrupt firm had not separated their books properly; 2) some concerns about the financial status of the Securities Deposit Guarantee Fund – the previous fund; and 3) uncertainty over the new fund’s responsibility for repaying bailout funds from the BOJ to Yamaichi Securities.\textsuperscript{452} Further stoking foreign firms’ concern was MOF’s initial plan to raise the level of coverage by the fund from 10 million yen per person to their full portfolio amount by March 2001.\textsuperscript{453} MOF initially expressed discontent with this plan for a parallel fund. In media interviews, officials suggested the possibility of denying approval for the second fund. MOF continued to be publicly critical of the proposed parallel fund until mid-November 1998, just before the fund was to come into effect on December 1.\textsuperscript{454} Moreover, the foreign firms acted against the preferences of the industry association, JSDA; the JSDA chairman had issued a strongly worded critique of their actions.\textsuperscript{455}

At the last minute, just days before the deadline, MOF accepted the second fund. It gave up the hope of compromise, and lacked the legal power to reject the second fund.\textsuperscript{456} Thus, MOF approved foreign firms’ creation of the Securities Investor Protection Fund, parallel to the original Japan Investor Protection Fund. The first chairman of the foreign-dominated fund was a


\textsuperscript{452} "Shouken No Toushisha Hogo, Kokunai, Gaishi 2kinin Ninnka, Ookurashou -- Taishutsu Ruuru Miseibino Daishou [Mof Approves the 2 Securities Investment Protection Funds (Foreign, Domestic) -- the Cost of Not Creating Rules for Exit]," \textit{Nihon Keizai Shim bun}, November 28 1998.


\textsuperscript{454} ""Shoukenban Yokin Hoken Kikou" No Toushisha Hogokikin Mondai Gaishi Dokuji No Kikin Mitomezu [The "Deposit Insurance for Securities" Investor Protection Fund Problem, Approval for Foriegn Firms' Own Fund Not Given]," \textit{Sankai Shim bun}, November 12 1998.

\textsuperscript{455} He contended that there had to be one rather than two funds, making the analogy of a collective village fire brigade – “It’s not right to say that one won’t go to a particular area because it burns more easily. While we do need to decrease the chance of fires, saying that we won’t go there if it burns is questionable.” Half a dozen small foreign securities firms did indeed join the Japanese association."Hogokikin Mondai De Gaishikei Wo Hihan -- Katou Seiichi Nihon Shoukengyo Kyoukai Kaichou [Kato Seiichi, Chairman of the Japan Securities Dealers' Association Criticizes Foreign Firms over the Protection Fund Issue]," \textit{Mainichi Shim bun}, November 19 1998.

\textsuperscript{456} "Shouken Toushisha Hogo Kikin, Ookurashou Ikou, 2001nen "Kokunai" To Gappei -- "Gaishi" Sousetsu Younin [Mof Approves the Creation of A "Foreign" Securities Investment Protection Fund, Intended to Merge with The "Domestic" One in 2001]."
Kosei Securities, a medium sized Japanese broker, was the only Japanese firm to join the foreign fund. The Japan Investor Protection Fund had 241 members, comprised of Japanese financial institutions, and the Securities Investor Protection Fund, with 51 foreign institutions.

The limitations of MOF informal authority in the face of concerted action by foreign firms was further illustrated during talks of merging the two funds. MOF had granted permission for the second fund on the condition that the two would be merged by April 2001. However, in March 2001, the foreign-dominated Securities Investor Protection Fund decided, in a general meeting, to postpone merging with the Japanese fund for at least a year. The issue was foreign firms’ perception of insufficient monitoring for Japanese brokerages in separating their accounts. The chairman of the foreign-dominated fund also pointed out that while securities firms were legally required to join a protection fund, the fund lacked the ability to evaluate or deny membership.

In 2002, the issue was finally resolved. The Japan Securities Dealers’ Association ordered that its members receive external oversight of their assets, satisfying the main concern of foreign firms. In the context of a nascent recovery from an impending banking crises and rising stock market prices, foreign firms agreed to merge their deposit insurance association.

Concerted Disruption: Precipitating Industry Association Collapse at the TSE

During a time of shrinking profits, a coordinated move by foreign firms undermined a longstanding Japanese industry organization. This was a disruptive challenge, revealing a mechanism of foreign influence never before seen in Japan. The organization was the Tokyo Stock Exchange (TSE) Participants’ Association, and the issue occurred over a political donation fund, once a significant funding pipeline between the securities industry and politicians.

The TSE Participants’ Association aggregated political contributions from securities firms. JSDA, the larger industry association, was classified as a self-regulating association and therefore prohibited from making political donations. For several decades, the recipients of donations on behalf of association members had been determined by the big four Japanese firms – Nomura, Daiwa, Nikko, and Yamaichi – behind closed doors. After a series of scandals in the 1990s, other routes for political donations had been closed, leaving the TSE Participants’ Association as a major aggregator of funds. In 2000, it contributed 100 million yen, 95 million in 2001, and 75 million each in 2002 and 2003 in addition to 10 million yen worth of party ticket purchases. These amounts ranked just below the contribution levels by major industry

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459 "Intabyuu Tsugawa Shouken Toushisha Hogokikin Rijichou Ni Kiku, Daiichi Kikin Tono Gappei Miokuri [Interview with Tsugawa, Chairman of the Board of the Securities Investment Protection Fund, About Postponing the Merger with the First Fund]," Nikkin, April 27 2001.
460 "Kokunai Kei to Gaishi Kei No “Toshishahogokikin” Togo E Ugoku [Moving Towards a Merger between the Japanese and Foreign Investor Protection Funds]."
associations – the Japan Automobile Manufacturers’ Association and the Japan Iron and Steel Federation.\textsuperscript{462}

The increasing foreign market presence in TSE trading proportionally increased foreign firms’ obligatory contributions to the association. The association collected fees from individual firms according to their share of trading on the TSE, and by 2003, foreign firms accounted for approximately 35\% of the association’s 1.1 billion yen annual revenue. This was greater than the 25\% contributed by the major Japanese firms. Yet, the foreign firms felt there was little difference in their actual influence. Some observers understood the situation to be one in which older small-medium firms possessed disproportionate influence.\textsuperscript{463}

Foreign members of the TSE Participants’ Association caused its demise by withdrawing from the organization. In September 2003, Morgan Stanley, discovering that membership in the TSE Participants’ Association was not mandatory, decided to withdraw. This was unprecedented. The association had 107 members at the time, 21 of which were foreign. No firms had withdrawn from the organization (or its predecessor) since its inception in 1957, other than for mergers and bankruptcies.\textsuperscript{464} JP Morgan, Merrill Lynch, and Goldman Sachs, joined by medium-sized Japanese firm, Kosei, followed suit in November.\textsuperscript{465}

The actions of foreign firms precipitated an exodus, as other Japanese firms began withdrawing as well. By the end of the year, the association had fallen into financial distress. By March 2004, the association had taken the position that firms could stipulate the destination of their donations. However, by mid-2004, facing a major budget shortfall, it decided to abandon donations altogether, and at the end of June, the association itself was dissolved.\textsuperscript{466} A coordinated withdrawal from a voluntary organization, while always a possibility, had never been acted upon in this way, or in this magnitude.

\textbf{Avoiding Excess Opportunism Against Private Sector Competitors: the Mizuho Error}

An episode revolving around a trading error by a Japanese securities firm revealed the concern of foreign securities firms about their reputation as “responsible” members of Japan’s corporate community – even at the cost of forgoing windfall profits.

In late 2005, a Mizuho trader committed a trading error of colossal proportions. On December 8, for shares of J-Com, a cable company that was newly listed that day, the trader reversed the entry into his computer terminal for the number of shares and the share price. Instead of selling one share at 610,000 yen, the trader offered to sell 610,000 shares at 1 yen.

Critical failures, both procedural and with the IT system at the Tokyo Stock Exchange (TSE), compounded the problem. The trader’s mistake occurred in the Mothers exchange, an

\textsuperscript{463} Ibid.
\textsuperscript{464} Ibid.
\textsuperscript{465} "Toshi Torihiki Sankasha Kyoukai Gaishi Dattai, Zaiseinen Ni [Withdrawal by Foreign Firms Puts Tokyo Stock Exchange Participants’ Association in Financial Difficulties]." Nikkei Kinyu Shimbun, November 21 2003.
exchange within the TSE designed for smaller companies in the image of the American NASDAQ exchange. Such an order – selling far greater numbers of shares than the number outstanding (14,500) – should never have cleared. However, TSE had not installed upper limits to the number of shares sold. Its concern had been that such limits would slow transaction speeds to unacceptable levels.

A software error in the trading system compounded the problem. When the Mizuho trader attempted to cancel the trade, the cancellation was denied by the Mothers exchange. A bug in the trading system, built by Fujitsu in 2000 when the Mothers exchange debuted, had kicked in at the worst possible time. Unable to cancel the sell order, Mizuho became the selling party to a vast number of purchase orders through the remainder of the day. TSE did not suspend trading of J-Com stock after learning of the situation, and Mizuho did not reveal the error until after trading hours.467

For this single error, Mizuho booked a loss of 40 billion yen. The amount approximated a year’s worth of operating profits. Since far greater numbers of stock were sold than existed, the Japan Securities Clearing Company, set up by the TSE, enacted the unusual measure of cash clearance. Mizuho was to pay cash to purchasers in lieu of the stock. The cash clearance measure also immediately revealed the monetary gains of all parties who had bought the improbably low-priced shares.468 Foreign firms dominated the gains. The UBS group, profiting the most, had purchased 38 thousand shares, translating to a 12 billion yen profit. Credit Suisse First Boston, Morgan Stanley, Nikko Citigroup, and Lehman Brothers were among the others. Many of the orders had originated from abroad. These firms claimed that most of the purchases had been conducted by automated software trading programs that kicked in before human intervention halted the purchases (see Table 36).

468 Since it was impossible to complete all trades by the December 13 deadline, with more stock purchases having been made than those in existence, the Japan Securities Clearing Company, set up by the TSE to clear securities transactions, imposed a cash payment to shareholders in lieu of delivering stock. This was the first time since 1950 that such a measure had been imposed. "(Q&a)"Jittai No Nai Kabu" Seiri, Mizuho Shouken Gohacchu De Kyousei Kessai [(Q&a) Sorting Out "Stocks without Form," Compulsory Cash Settlement for Mizuho's Erroneous Order]," Asahi Shimbun, December 14 2005.
Table 36. Top 10 Amounts Returned by Firms from Mizuho Trading Error

<table>
<thead>
<tr>
<th>Firm</th>
<th>Million yen</th>
</tr>
</thead>
<tbody>
<tr>
<td>UBS</td>
<td>12,000</td>
</tr>
<tr>
<td>Credit Suisse First Boston</td>
<td>3,338</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>1,146</td>
</tr>
<tr>
<td>Nikko Cordial (Citigroup)</td>
<td>1,020</td>
</tr>
<tr>
<td>Tokai Tokyo</td>
<td>410</td>
</tr>
<tr>
<td>Lehman Brothers</td>
<td>390</td>
</tr>
<tr>
<td>Nomura</td>
<td>340</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>253</td>
</tr>
<tr>
<td>Okazo</td>
<td>240</td>
</tr>
<tr>
<td>Ando</td>
<td>204</td>
</tr>
<tr>
<td>Daiwa Securities SMBC</td>
<td>200</td>
</tr>
</tbody>
</table>

Source: Nihon Keizai Shimbun

The revelation of these windfall profits led to a Japanese media frenzy and a government inquiry. Some media outlets portrayed the foreign firms as predators preying on a hapless Japanese firm. The FSA Minister Kaoru Yosano stated in a press conference that “it was not a pretty thing” for brokerages to knowingly bid for nonexistent shares. The FSA summoned executives from the securities firms for hearings. At the TSE, the president and executives resigned over the procedural and IT system failures.

Losses suffered from erroneous orders were not entirely uncommon. Yet this was an exceptionally large loss. For example, in 2001 UBS Securities Japan had lost 16.2 billion yen through a similar error during the IPO of Dentsu (It sold 610,000 shares for 16 yen each rather than 16 shares for 610,000 yen.) – though there had been no public outcry.

Facing a public relations disaster, UBS and the other foreign firms declared they would return their windfall profits. This was despite the lack of any legal coercion, although the FSA reportedly summoned executives from the banks to press them to voluntarily return their profits. Indeed, some banks publicly announced that they preferred the creation of new rules.

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469 “Shinkokin, Shouken 50sha Ga 209 Oku [50 Securities Firms Contribute 20.9 Billion Yen to New Fund],” Nihon Keizai Shimbun, February 15 2006.
472 According to an FSA study, in 2005 0.0026% of trades, or 14318 errors, occurred. 89% of the 222 securities firms experienced such errors. Of these instances, 667 trades exceeded 100 million yen, but the Mizuho case was the only one with more than 100 million yen in losses. "Kabu Gohacchuu Shoukaigaisha 9 Wari De [Erroneous Stock Trade Orders at 90 Percent of Securities Firms],” Nihon Keizai Shimbun, March 16 2006.
473 Hyuga, "Ubs to Return Money from Tokyo Trading Error."
474 "President of Tokyo Stock Exchange Resigns."
mandating return of the funds, as they feared shareholder litigation over voluntary relinquishment of profits.\textsuperscript{475}

Lacking clear rules on handling the returned profits, JSDA, the industry association, set up a special new fund in early 2006. It collected total contributions of 21 billion yen (approximately half of what Mizuho lost) from 50 firms.\textsuperscript{476} Although the initial purpose was to research and invest into technologies and strategies to deal with major natural disasters or catastrophic system failures, the money sat in the fund for over two years, as members could not agree on how to use the funds; the major exchanges had already invested to improve their trading systems.\textsuperscript{477} The TSE also fined Mizuho 10 million yen for the error.\textsuperscript{478}

This case illustrates the boundaries of systemic challenges when securities firms confronted opportunities for windfall profits. While counterfactuals are not always useful, it is probably safe to conjecture that an offshore-based investment fund would have been less likely to cooperate in voluntarily returning windfall profits – especially over tens of billions of yen. Securities firms, with a broader range of businesses and longer time horizons, however, were concerned about reputational costs and long-term interactions with the government.

**II. MEDIUM CLOCK SPEEDS: INSURANCE**

Insurers, with relatively slower clock speeds than investment funds or securities brokerages and investment banks, pursued insider strategies when challenging government policies. The cases are outlined in Table 37.

In issues threatening their revenue, insurers mounted challenges as insiders. Over the issue of private sector contributions to the life insurance policyholder protection fund – similar to the securities policyholder protection fund introduced earlier – foreign firms’ insider challenges consisted of shifting the balance of power in informal negotiations and exerting power through formal voting within the industry association. They also opposed an increase in reserve requirements for variable annuities, but in neither case did they mount disruptive challenges. In issues they supported, such as the liberalization of insurance products sold at banks, insurers’ insider strategies consisted of supporting the government by weakening industry opposition.


\textsuperscript{476} "Mizuho Gohacchuu Rieki Henjou 50sha 209oku Ni Hangaku Ga Kikin Kyoshutsu He [Profits Returned from the Mizuho Error, Half to Become the Basis for a Fund, 20.9 Billion Yen from 50 Firms]," \textit{Yomiuri Shimbun}, February 15 2006.

\textsuperscript{477} In late 2006, the JSDA established an internal organization to figure out how to use the funds. "Jeikobu Kabu Gohacchu Rieki Henjou No Kikin, Tsukimichi Kimaranai [Difficulties in Determining Uses for the Profits Returned from the Erroneous Order for J-Com Stock in the Fund]," \textit{Nihon Keizai Shimbun}, December 13 2006.


\textsuperscript{478} Kanako Takahara, "Tse Keeps Nishumuro at Helm, Fines Mizuho Unit," \textit{The Japan Times}, March 23 2006.
Another policy issue reveals an important limit to insider strategies in general – that firms must be given the opportunity of becoming insiders. Unlike in the life insurance segment, with a prominent foreign presence, the foreign presence in casualty (or non-life) insurance was relatively low. The non-life insurance industry association, unlike the life insurance industry association, was not revised to allow foreign insurers to join. When the government raised the level of casualty insurers’ financial liability for earthquake insurance, foreign casualty insurers found themselves left out of the process, and did not have the opportunity to mount insider challenges.

<table>
<thead>
<tr>
<th>Policy Threat/Opportunity?</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Insider Challenge</td>
</tr>
<tr>
<td></td>
<td>- Recapitalization of Life Insurance Policyholders Protection Corporation</td>
</tr>
<tr>
<td></td>
<td>- Increased reserve requirements on variable annuities</td>
</tr>
<tr>
<td>No</td>
<td>Insider Support</td>
</tr>
<tr>
<td></td>
<td>- Liberalization of insurance sold at bank windows</td>
</tr>
</tbody>
</table>

**Boundary Case**

<table>
<thead>
<tr>
<th>Principle Demonstrated</th>
<th>Issue Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>The limits of insider challenges: gaining insider status</td>
<td>- Earthquake insurance for casualty insurers</td>
</tr>
</tbody>
</table>

**LIFE INSURANCE POLICYHOLDERS PROTECTION CORP (LIPPC)**

Foreign firms mounted an insider challenge to alter the balance of power in informal government-industry consensus building over a policy issue involving the Life Insurance Policyholders Protection Corporation (LIPPC). Foreign insurers’ increased market presence also gave them another insider mechanism of influence – greater formal power within the industry association, which affected the industry association’s preference-formation process.

Recapitalizing the LIPPC became a major issue in 2001, after a wave of bankruptcies hit the sector in 1999 and 2000. LIPPC had been funded by a mix of private and public money – 560 billion yen from insurers and 400 billion yen guaranteed by the government. By October 2001, only 20 billion yen of the insurers’ contribution remained. Although the government’s portion was untouched, the FSA was hesitant to use it. The FSA required Diet approval to dip into this portion, but since a bankrupt insurer was unlikely to threaten the entire financial system, Diet members were reluctant to support a politically unpopular injection of taxpayer money. Moreover, the government’s portion of LIPPC funding was scheduled to expire in March 2003.

The political issue developed as the FSA’s wishes to have insurance companies recapitalize the fund clashed with those of unwilling insurers. Especially given the overall decline in the traditional life insurance business and the government’s shift towards ex post
regulation, many major insurers were unwilling to subsidize the rescue of weaker firms. The five major Japanese life insurers went so far as to publicly state their opposition.\(^{479}\)

In this context, foreign firms became significant power players in informal consensus-building. The insurance industry association was split. Several major domestic players, as well as the foreign firms, were opposed to more private contributions. Medium-sized firms, which could not afford to antagonize the FSA, were the main initial supporters. The FSA needed to create an informal consensus, and set about doing so by contacting individual insurance firms. It eventually convinced Meiji and Yasuda, set to merge the following year, to alter their positions and support the FSA.\(^{480}\)

Informal consensus-building was critical in this case because the formal decision was made by a vote within the industry association. During its creation, LIPPC had adopted a formal structure of weighted votes. After LIPPC was strengthened and reorganized in 1998 – the previous fund having been depleted by the bankruptcy of Nissan Life – major insurers, who shouldered most of the financial burden, had insisted on this weighted structure. The number of votes was determined by the firm’s level of contribution, a function of its size.\(^{481}\)

Foreign insurers, mainly Alico Japan, under the AIG umbrella, had voiced misgivings during the inception of the LIPPC. But in 1998, before the major influx of foreign firms, there was little that could be done, since membership was compulsory. Warning against LIPPC’s ambiguous maximum financial liability and opposing membership of insolvent firms, Alico Japan boycotted the opening meeting.\(^{482}\)

However, by 2001, the influx of foreign firms gave them considerable clout in the industry association. Approval of additional private funding contributions required a majority vote of 41 or more out of 81 total votes. In 2001, foreign firms’ rapid market share growth gave them control of 21 votes. Moreover, they were effectively a voting bloc rather than individual firms with diverging preferences; the US Life Insurance Association, the American Chamber of Commerce in Japan, and the European Business Council all issued statements opposing the private refunding of LIPPC. The Nihon Keizai Shimbun provides a snapshot of the distribution of votes at the time (See Table 38):
Given the opposition by most major domestic firms, this bloc of foreign firm votes was significant in the FSA’s efforts to reach a compromise. Small-medium firms were easier for FSA to prevail upon. The FSA ended up drastically reducing the level of private sector contributions it requested, from 340 billion yen to 100 billion yen. (Given the 22 billion yen balance at the time, this amounted to an additional contribution of 78 billion yen.)

Finally, despite continued opposition by major Japanese insurers such as Nihon Life and foreign insurers, the measure passed. FSA’s lobbying of Meiji and Yasuda and other smaller firms had been decisive. Although in this case, the foreign firms ultimately failed in their objectives, they demonstrated a new mechanism of influence. In building an informal coalition in support of its position, the FSA was forced to work much harder than it otherwise would have. It became clear that foreign insurers were a significant bloc of actors, and their preferences could differ from those of the medium-sized insurers they replaced.

**VARIABLE ANNUITY RESERVE REQUIREMENTS: THREATENED, BUT INSIDER RESPONSE**

The establishment of reserve requirements in 2005 for the fast-growing variable annuities market also reveals how foreign insurers tended to pursue insider strategies, even when their core revenue streams were threatened by an emerging policy issue. The market for variable annuities, first appearing in 1999 and growing to 80 billion dollars in 2005 (see Chapter 4), did not have regulations stipulating reserve or capital requirements for the guaranteed portion of returns promised by variable annuity products. Each firm was able to determine its own specific methodology to calculate risk and reserves for its variable annuity products.

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485 "Seiho, Tsuka Kyoshutsu Wo Shoudaku: Futan Waku, 1sen Oku En Iji, Hogokikousoukai [Life Insurers Accept Additional Expenditures: Support Level Remains at 100 Billion Yen]."
In mid 2004, FSA announced that it would implement uniform reserve requirements for variable annuity products beginning the following fiscal year. The recommendation included stipulation by the regulator of valuation assumptions, which were relatively conservative. The proposed regulations, in effect, increased the level of capital reserves firms were required to hold. Moreover, firms with a larger proportion of variable annuities as their total product portfolio incurred larger increases to their capital reserve requirements.\(^{486}\) In short, the foreign firms that had grown most rapidly by selling variable annuities would be hit the hardest. Some in the Japanese media viewed this measure as a ploy orchestrated by domestic insurers, which were suffering declining sales as foreign firms grew rapidly, buoyed by the deregulation that enabled them to sell their products at bank windows. Since domestic insurers were well capitalized and diversified, foreign insurers, especially those more dependent on variable annuities than on other products, would potentially need to reevaluate their Japan strategies—selling low-priced products with low capital reserves by using proprietary risk-management models and reinsurance schemes.\(^{487}\)

In response to this policy proposal, foreign MNC insurers, which had been using insider strategies such as publishing policy papers to advocate lower reserve requirements,\(^{488}\) strengthened their argument that Japan should adopt the methodology used in the US. Through foreign industry associations such as the American Council of Life Insurers, European Business Community, and the Canadian Life and Health Insurance Association, the MNCs published reports and policy position papers, and participated in formal and informal deliberation council meetings to provide information on various calculation methods for reserve rations of variable annuities.\(^{489}\) In essence, two choices were on the table—a “contingent reserve” methodology that employed calculations known as scenario testing, and a “standard method” formula that would be issued by the government based on solvency margin ratios.\(^{490}\)

In the end, the government allowed both methodologies, enabling insurers to choose between the two to calculate reserve requirements.\(^{491}\) However, the overall reserve requirements did, in effect, increase for foreign MNCs for which variable annuities comprised the bulk of revenue. The policy discussions leading up to the decision were extensive, including organizations such as The Institute of Actuaries in Japan, which provided detailed reports on the


\(^{488}\) American Council of Life Insurers, European Business Community, and Canadian Life & Health Insurance Association, "Establishing Appropriate Reserve Requirements for Variable Annuities in Japan."


\(^{490}\) For details on the methodologies, see Ino, "Variable Annuity Market in Japan: The Sun Also Rises."

technical aspects of the benefits and drawbacks of each methodology. The actual negotiations were largely informal, however, and the issue did not spill over into the public sphere or media. Yet debates were intense, as noted by the outgoing chairman of the industry association of life insurers in his farewell speech in June 2005.492

The new regulations went into effect in April 2005, and many firms (including Japanese firms) found it necessary to redesign and pre-price their products. Several foreign insurers found the need to recapitalize their Japan operations, and a number of insurers including AKSA, Credit Suisse (March) and Prudential (October) suspended sale of particular types of variable annuities with low monthly fees.493 The following year, MNCs such as Hartford, which relied primarily on variable annuities, saw their profits drop as they adjusted their products and strategies.

In sum, although the issue of establishing new reserve requirements for the rapidly growing variable annuities markets was a potential threat to the core revenue streams of insurers, their strategies were to work through existing policy processes – insider strategies.

LIBERALIZATION OF INSURANCE SOLD AT BANKS

As a counterpoint to issues threatening foreign MNCs, the liberalization of insurance products sold at banks benefited them while threatening major domestic insurers. In this case, foreign firms became allies of the government, weakening the industry’s ability to resist the government’s plans.

In 2004, a policy debate occurred over whether to continue stripping away the compartmentalization between banking and insurance. Banks were permitted to sell insurance products on a limited scale from 2001. The list of permitted products was then expanded in 2002. According to the original plan, the list of permitted insurance products was to expand in 2005, culminating in complete liberalization in 2007.

The removal of compartmentalization aided most foreign firms, but imposed significant transition costs on major Japanese firms. For foreign firms, with specialized products and relatively small sales forces and fewer retail branches, enlisting banks to sell their products in effect gave them massive sales channels. New entrants and medium firms shared these benefits. However, for major domestic insurers with massive numbers of salespeople (and long term employment norms that did not allow them to downsize quickly) as well as their own retail networks, sales of their products by banks would become a competitive disadvantage. They had relatively little to gain compared to the banks, since their own sales force, rather than those of banks, would be rendered redundant, and banks would also receive revenue from commissions. The insurance industry association was split on the issue. The chairman, a post that rotated among the “big four” (Nihon, Daiichi, Meiji Yasuda, Sumitomo – formerly the big five before the Meiji Yasuda merger), explicitly stated that the industry association opposed immediate liberalization, urging the government to proceed with caution. In testimony at FSA’s deliberation council, he warned that the FSA’s concept of “one stop shopping” at banks would

493 The particular types of variable annuities suspended were those that paid out upon the death of policyholders. "Seiho No Hengaku Shuushin Hoken Hanbai Teishi Aitsugu: Sekini Junbikin Tsumimashi De [Life Insurers Continue to Stop Selling Variable Lifelong Insurance with Increased Reserve Requirements],” Nihon Kogyo Shimbun, October 7 2005.
incentivize bank salespeople to leverage their loans against small-medium businesses to force them to buy particular insurance products, pocketing the commissions. However, foreign firms such as Manulife, Prudential, and PCA, as well as some medium-sized firms publicly announced their support of moving ahead with the liberalization on schedule.

Given the rapid growth of foreign firms and the overall decline of traditional life insurance, the big four insurers mustered intense political resistance to FSA’s plans. They convinced the LDP’s Insurance System Reform Promotion Diet Members’ Alliance to adopt a position opposing complete liberalization. This reportedly led the FSA to briefly consider gradual liberalization over several more years. However, in the end, the reformist Koizumi administration moved ahead with the wave of deregulation in 2005 as scheduled.

Earthquake Insurance: Exclusion From Industry Association, Lack of Information

A brief comparison with the case of the Japanese government increasing non-life insurer’s burden of earthquake reinsurance reveals the limitations of insider strategies. It is a simple point, but this case clearly shows the dynamic at work: foreign MNCs require the opportunity to become insiders in order to pursue insider strategies.

In early 2007, foreign non-life insurers were chagrined to learn that FSA intended to raise the level of private sector contributions to Japan’s earthquake reinsurance system. The earthquake reinsurance system guaranteed government support for private insurers’ earthquake insurance in the event of catastrophic earthquake damage that exceeded their ability to pay. The government had increased the level of reinsurance payments in 2005 after increased public concern about a major earthquake hitting Japan, following a strong 2004 earthquake in Niigata Prefecture, and the massive earthquake and tsunami in the Indian Ocean. FSA’s proposal in 2007 was to raise the non-life insurers’ liability coverage from 5000 billion yen to 6000 billion. The issue was that while FSA had been reportedly negotiating with the General Insurance Association of Japan since August 2006, the foreign insurers claimed they were only informed of the plan in May 2007. Unlike in the life insurance industry segment, where foreign life insurers’ market shares had grown rapidly, the presence of foreign firms remained relatively modest. And while the industry association for life insurers was increasingly influenced by foreign insurers from within, as seen above, the General Life Insurance Association had not been reformed to allow membership of foreign insurers. Foreign non-life insurers, such as AIU of the US and Allianz of Germany, offering automobile and fire insurance, were represented by the Foreign Non-Life Insurance Association of Japan. Consequently, the reinsurance issue brought a

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496 "Hoken No Ginkou Mado Han Zenmen Kaikin: Seiho No "Hangeki" Gekika, Seijika Mo Makikomu [Liberalization of Insurance Sales at Banks: Life Insurers' Resistance Becoming Extreme, Involving Politicians]."

reappearance of the type of information gap that had ceased to exist almost a decade earlier in
the life insurance segment, and that recalled historical protests by foreign firms over denial of
insider status. Foreign insurers were surprised to learn about the negotiations, and the FSA told a
press interview that “it was not aware that the information had not been relayed to the foreign
insurance groups.”

In short, insider strategies are only possible when MNCs are allowed to
come insiders. As shown in Chapter 4, reforms to the industry associations and the decrease of
sectoral regulatory restrictions were prerequisites for many of the insider strategies pursued by
foreign MNCs in the 2000s.

III. MEDIUM-SLOW CLOCK SPEEDS: TELECOMMUNICATIONS

The cases in the telecommunications sector, with a relatively slower clock speed than
that of the financial sectors, line up as follows (see Table 39). In cases when confronted by either
threats or opportunities, foreign-managed firms adopted insider strategies.

Table 39: Telecommunications Sector Cases (Relatively Long Time Horizon)

<table>
<thead>
<tr>
<th>Threat/Opportunity</th>
<th>Policy Strategy</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Insider (join Japanese firms)</td>
<td>- Administrative Litigation</td>
</tr>
<tr>
<td></td>
<td>Insider</td>
<td>- Next Generation Wireless Spectrum Allocation</td>
</tr>
<tr>
<td>No</td>
<td>Insider</td>
<td>- Vodafone</td>
</tr>
</tbody>
</table>

An interesting within-sector contrast is with a Japanese-owned but fast clock-speed firm,
Softbank. Softbank, which has appeared several times in this study for its involvement in
financial sectors, purchasing the failed bank NCB to revive it as Aozora, and to partner with
Nasdaq to introduce a new stock exchange to Japan, self-identifies as a fast-moving firm. Unlike
traditional telecom carriers, its interest in infrastructure services was to provide a platform for its
portfolio of online services. With a faster clock speed than traditional carriers, Softbank
aggressively mounted disruptive strategies, both in market activities, and in obtaining wireless
spectrum.

PARTICIPATING IN JAPANESE-DRIVEN DISRUPTION: ADMINISTRATIVE LITIGATION

Once they took major market positions in the telecommunications sector, participation in
the sector’s first case of administrative litigation was the furthest that foreign MNCs pushed
the Japanese government. Spearheaded by KDDI, the major competitor to NTT, the lawsuit was
consciously designed to send a strong signal to the government of the industry’s willingness to
use the judicial branch as an arena of policymaking.

Ibid. In this article, an FSA official is quoted as saying that the ministry does not talk to individual
companies, and would not exclude foreign firms from talks to domestic firms. This suggests that the issue
was an oversight, but further first-hand interviews are necessary to determine intent.
The lawsuit arose in July 2003, when a group of five telecommunications carriers sued the Minister of Information and Communications (MIC) – the first lawsuit of its kind in the sector. The group of companies waging the lawsuit included KDDI, Japan Telecom, Poweredcom, Cable & Wireless IDC, and Fusion Communications. The issue was interconnection fees charged by NTT for access to its network. The lawsuit, led by KDDI, was in direct response to MIC’s revision of its Administrative Ordinances to allow NTT to raise its interconnection rates. This was the first time the government had approved an increase in these rates. The lawsuit demanded that MIC retract the approval of NTT’s interconnection rate increase for the 2003-2004 fiscal year. The symbolic importance of the press conference announcing the lawsuit was captured in the seating arrangements – two foreigners, Phil Green of Cable & Wireless and William Morrow of Japan Telecom were among the five company presidents in a row at the table.499

The problem was a provision in the Long Run Incremental Cost (LRIC) formula adopted by MIC to determine NTT’s interconnection rates. The provision stipulated that if NTT East and NTT West’s communications traffic dropped by over 15 percent, its costs would be recalculated. This recalculation led to the increased interconnection rates. The payment scheme in the provision stipulated that competitors would make a first payment to NTT for the current fiscal year based on previous years’ traffic, and an additional payment the following year if traffic was found to have fallen by more than 15%. In 2003, this amounted to an approximately 5% rise in interconnection fees.

The lawsuit had five charges: 1) procedural, on the basis that the ministry ignored the recommendation of its deliberation council, 2) unfair pricing, since some portions of the cost calculations lacked sensitivity as to whether or not communications actually occurred, and did not take NTT’s efficiency gains into account, 3) violation of the Telecom Business Law, since LRIC as a pricing scheme was not stipulated, 4) anti-trust violations, for setting NTT East and NTT West’s prices equal to each other, and 5) violation of the principles of contract, since a priori agreed upon rates were revised ex post.

In the press, firms instigating the lawsuit complained that MIC repeatedly met with NTT management behind closed doors, without allowing access to other carriers. The lawsuit was widely seen within the industry and among observers as a conscious move to shift norms of government-business interactions in the industry.500 NTT’s competitors were clearly signaling that the era of carriers obeying discretionary ministry decisions was over, and that in exchange for the demise of the government’s implicit guarantee against failure, industry participants were willing to take greater risks to obtain policy outcomes in their favor against NTT.501

The strong backlash against MIC’s approval of NTT’s interconnection rate hike came from the apparent reversal, and the potential shift in political dynamics underlying telecom

500 Some note that a particular KDDI manager, formerly a MPT (predecessor of MIC) official, was behind KDDI’s lawsuit. This manager had advocated new avenues of policymaking from the time he had been in MPT.
501 “Setsuzokuryou No Gyousei Soshou, 5sha Ketsudan No Naimaku [the Administrative Lawsuit over Interconnection Fees, the inside Story of the 5 Firms’ Decisions],” Nikkei Communications, August 8 2003.
policymaking that this implied. For the two decades after NTT’s privatization in 1985, there had been a balance of power between the LDP, representing NTT management, and the opposition party, aligned with NTT’s labor union. MIC was able to play these forces against one another, sometimes using US pressure for market opening and liberalization to bolster its case in pressing for reforms.

However, as NTT itself weakened due to consumer shifting to mobile phones and the company’s falling behind in Internet access markets, NTT’s management and labor united in pressuring politicians. Moreover, turmoil in US telecommunications markets – namely the collapse of WorldCom and the burst of the tech bubble – ended US pressure on Japan’s telecommunications policies.

Just before the litigation, MIC had gone further in siding with political forces sympathetic to NTT. In May 2003, the Upper house got MIC to agree to “reconsider fiber unbundling obligations” for NTT – the obligations which forced NTT to lease out its fiber infrastructure at lower prices to competitors. This flew in the face of several years of MIC’s increasingly strengthening regulations over NTT to lease out its infrastructure at low prices, thereby contributing to Japan’s rapid development of high speed broadband markets. Many speculated that NTT had succeeded in getting both LDP and opposition politicians on its side.

In this context, the lawsuit was also seen as a warning to NTT by competitors that the industry was willing to introduce a new policy actor into the arena telecommunications policymaking – the judicial branch. This would reduce the overall discretion of informal political agreements.

The lawsuit was eventually dismissed two years later. However, the tentative proposal to “reconsider” fiber access was not taken up by MIC, and no further political pressure was apparent. As one media report put it, “although it is unlikely that the NCCs will win, this lawsuit can be an impetus for change in reforming the discretionary administrative practices and collusion behind closed doors.”

Informal interviews with current and former MIC officials and industry participants suggest that this was indeed the case.

While the administrative litigation itself was a disruptive challenge to the norms of telecom policymaking, the role of foreign MNCs was actually that of insiders. Spearheading the lawsuit themselves would have represented a systemic challenge, but MNCs followed the clear lead of the second largest firm in the sector. They became part of a coalition to influence the balance of power among policy actors.

**Normal Times, Insider Strategies**

Even during periods without policy issues that constituted threats or opportunities, foreign telecom carriers pursued insider strategies. Vodafone, the foreign MNC with by far the largest presence in Japan between 2001 and 2006, did not mount any particular disruptive challenge in its political strategies. This is not to say that its market strategies did not contain disruptive elements. For example, Vodafone raised eyebrows with its market strategies, hiring a high level manager from its dominant competitor, NTT DoCoMo as its Japanese president, the

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503 (Interview notes, 2008)
first such high profile headhunting in the industry. It also attempted to disrupt the market practices in the domestic handset market by introducing global handset models to the Japanese market and promising Japanese manufacturers access to its global markets. However, it also joined deliberation councils and the industry association. In various conversations with MIC officials, none could identify any case, except the lawsuit, in which Vodafone acted like anything other than a domestic firm.

**WILLCOM’S INSIDER STRATEGY: NEXT GENERATION WIRELESS LICENSE**

Willcom, the operator of a technological alternative to cellular services known as Personal Handyphone System (PHS), (introduced in Chapter 5), pursued an insider strategy to obtain wireless spectrum allocation for its next-generation services. US private equity fund Carlyle had purchased a 60% majority ownership of the company, then named DDI Pocket, for approximately 220 billion yen in 2004, when it was spun out of KDDI. Carlyle approved the appointment of a Japanese president from within the company, and three of the eleven board directors were sent by Carlyle.

In early 2007, MIC announced that it would allocate business licenses for 2.5 GHz spectrum, to provide high speed data services for use in next generation mobile services. In contrast with previous rounds of spectrum and license allocations, during which the ministry engaged in *ex ante* informal consensus building to match the number of applicants with the number of licenses issued, MIC announced that it would adopt what is known as a “beauty contest” approach to allocation. Rather than an auction, given the escalation of bids in Europe, which MIC viewed as potentially harmful to carriers’ ability to invest in the actual services, the idea was that MIC would choose the winners according to its own criteria. The one major condition in applying for the spectrum was MIC’s stipulation that existing operators of third-generation (3G) services were not allowed to apply on their own.

Thus, four applicants, each aligned with an existing carrier, applied for two licenses. Willcom was one of them. The other applicants included: Akka Wireless, backed by NTT DoCoMo; Open Wireless Network, whose main investors included eAccess, Softbank, and Goldman Sachs; and Wireless Broadband, whose largest investors were KDDI (32%), Intel (18%), and several other major Japanese firms.

The status of foreign MNCs as insiders in this round of spectrum allocation was in stark contrast to that of the mid-1980s, when competitors were first licensed. In the mid-1980s, Motorola had struggled to obtain nationwide service licensing for DDI, the carrier using its equipment (DDI), but in 2007, Intel was a major partner in one of the applicants, which intended to deploy its WiMax technology. Moreover, each of the applicants had the backing of a large financial firm, such as Akka Wireless’s backing by Tokyo Mitsubishi UFJ bank, and Goldman Sachs financial backing of the Open Wireless Network consortium. Willcom was majority owned by Carlyle. In short, three of the four applicants had substantial foreign involvement – but this fact was such a non-issue that it was virtually never mentioned in the media.

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505 MIC’s “Policy Study Group on the Effective Use of Radio Waves” had decided in 2004 to forego auction mechanisms for spectrum allocation based on the extremely high prices in the European 3G auctions in 2000, which had led to prices of up to 150 times the initial expectations. The auctions were regarded to have been victim to excessive speculation, and were considered to have weakened carrier’s capital expenditure budgets for building infrastructure, delaying the deployment of 3G in Europe.
In fact, ironically, since the original PHS service was a product of the ministry’s industrial policy, and Willcom intended to deploy a next-generation PHS service, it was labeled as the firm offering “indigenous, Japan-born technology.” Most observers therefore anticipated that among the applicants, Willcom would be a premier choice. For Carlyle, since the ability of Willcom to obtain a license and spectrum for its next-generation services was critical to raising the value of the firm and reaping a profit upon exit, its presentation of Willcom as the firm promising to deploy indigenous Japanese technology was a clear insider strategy.

In late December of 2007, MIC allocated the licenses; Willcom, KDDI, and Intel-backed Open Wireless Group were the winners. Criticized in the past for lack of transparency in the allocation process, MIC adopted a point system, the results of which were revealed after the decision. The winners scored highest in the categories of early date for expected commencement of services, availability of base stations and locations to install base stations, and equipment procurement. Willcom received the highest scores for infrastructure investment, capital procurement, and profitability, since the technological underpinnings of its base stations enabled low cost, and the firm was deemed capable of funding most capital costs through revenues from its existing operations, which were growing rapidly at the time.506

The contrast between Willcom (and Intel)’s insider strategies in obtaining wireless spectrum and licenses could not have been stronger vis-à-vis that of Softbank, introduced in the next section.

Further evidence that Carlyle had a relatively long time horizon in Willcom appeared in August 2009, when Carlyle increased its investment in the carrier in exchange for a management shake-up. By early 2009, Willcom’s competitive position, strong as recently as 2007, had eroded considerably. Its pioneering flat-rate data services, free within-network calls, high data transmission speed, and relatively sophisticated Internet-enabled handsets were emulated, incorporated, and in some ways, surpassed by the major cellular carriers. When the financial crisis of 2007-2008 hit, Willcom had to shelve its plans to conduct an IPO – Carlyle’s intended exit strategy. After failing to conduct an IPO and as loss of subscribers began, Willcom was unable to raise capital for its investments into next generation networks. At that point Carlyle injected approximately 5 billion yen of capital in September 2009, also decreasing the board size from 11 to 9, and increasing the number of Carlyle appointees from three to five.507 It was unusual for investment funds such as Carlyle to increase their investments after several years.508

**SOFTBANK’S DISRUPTIVE STRATEGY IN OBTAINING WIRELESS SPECTRUM**

The behavior of Softbank, a fast clockspeed firm notable for its willingness to disrupt the status quo, pursued disruptive strategies to obtain wireless spectrum, stood in sharp contrast to that of Willcom.

Since the allocation for 3G wireless spectrum in 2000 had been a “beauty contest” in which MIC had chosen winners without a publically disclosed methodology, the founder of

507 "Willcom Changes Top Commander for Crucial Wireless Data Battle."
508 The Nikkei Weekly also notes that Carlyle was known for investing in firms longer than other buyout funds and raising their corporate value over time. "Carlyle Boosting Willcom Stake in Bid to Save Investment," The Nikkei Weekly, March 30 2009. This resonates with their investment in US automobile firm Chrysler, for example.
Softbank, Son Masayoshi, who wanted to enter the market, mounted a series of four different challenges. He eventually succeeded, but gave it up when his firm successfully purchased Vodafone’s Japanese operations when the MNC exited the market.

Son’s first attempted informal lobbying to MIC. In 2000, when the 3G spectrum was first licensed, each of the three carriers (NTT DoCoMo, KDDI, and J-Phone) received 20 MHZ. However, it was discovered that KDDI’s spectrum, adjacent to that of PHS, caused conflicts with PHS services. MIC therefore had allocated a small portion of spectrum as a buffer – but to keep competition fair, it designated equivalent portions of spectrum to be kept unused in DoCoMo and J-Phone’s allocation. Son, discovering this spectrum left unused for no real technical reason, lobbied the minister of MIC and repeatedly visited the ministry, attempting to convince them to allocate this spectrum to him. In December 2003, MIC went so far as to call for public comments on the issue, but in March 2004, it rejected Son’s efforts. Incumbent carriers, unsurprisingly, strongly supported MIC’s stance.509

Softbank’s second disruptive challenge was to mobilize a media campaign to attack the ministry. In August 2004, MIC had announced that it would be reorganizing the spectrum, allocating some of the 800 MHz band spectrum to new 3G services. Son took a confrontational and unprecedented tactic of posting a full page advertisement in Japan’s major daily newspapers – twice. In these ads, he called for users to voice their opinions to MIC and demand lower cellular service prices. He also held a press conference criticizing MIC’s lack of transparency in its decision-making processes for spectrum allocation. When MIC opened a web-based public comment forum on the issue – a standard procedure it had adopted since the late 1990s – it was inundated with over 30,000 comments, almost a thousand times more than the normal number of responses. Most of them called for Softbank to be allowed entry. By 2004, Softbank had successful lowered Japan’s broadband prices by introducing a price war for DSL,510 and consumers were interested in its promise to radically lower cellular service prices. At the end of September 2004, MIC announced a compromise; it would open a new frequency, 1.7 GHz. However, Son was not placated, insisting that 800 MHz, a bandwidth more suited for cellular service and used by incumbent carriers, was what he wanted.

Son’s third attack was to file a lawsuit against MIC in October 2004. Following the lawsuit mentioned above, it was only the second time the ministry had been sued. Softbank called for an injunction against the allocation of the 800 MHz spectrum, calling for new, open methods for assigning spectrum. Softbank criticized the lack of transparency in the existing procedures, involving MIC and incumbent carriers negotiating behind closed doors, couple with incumbent carriers taking post-retirement amakudari bureaucrats.

Son’s fourth attack came in the form of mobilizing gaiatsu. He flew to the US, visiting chairman of the FCC at the time, Michael Powell to ask for the FCC to put diplomatic pressure

on Japan. The FCC declined, but MIC was well aware that Son was attempting to mobilize gaiatsu as well. From MIC’s point of view Son’s disruptions were unwelcome and opportunistic. Son had seemingly switched positions when demanding the 800 MHz spectrum, since his previous efforts had been focused on lobbying for MIC to license TD-CDMA, a separate 3G technology that had yet to be commercialized anywhere in the world. In December 2004, MIC convened a study group to consider the possibility of spectrum reallocation for the 800 MHz bandwidth. The following month, MIC rejected the wish of new entry to the 800 MHz bandwidth, proceeding instead in allocating spectrum at the 1.7 GHz bandwidth. Three entrants – Softbank, eAccess, and IP Mobile, were granted licenses.

**Willcom and Google: Different Time Horizons, Different Approaches to Privacy**

The contrasting approaches of Willcom and Google to privacy issues surrounding the capture of images highlights the different sets of logic driving these two firms with very different clock speeds – Willcom moving at the speed of a telecom carrier, and Google reshaping the very structure and usage of the Internet.

After obtaining the license, Willcom actively involved firms and academics to study how its base stations could be leveraged for value-added services. Willcom planned to open its 160,000 base stations around the nation to third parties to install cameras or sensors, for services such as traffic monitoring or other uses. Since the widespread installation of cameras or sensors was likely to raise issues of privacy and usage rights, Willcom invited interested parties to begin discussing policy and regulatory issues. In the first meeting, thirty entities, ranging from firms to local governments and organizations, participated.

Willcom’s approach is in stark contrast with Google’s approach to Google Street View in Japan. Google is a fast clock speed firm with a short corporate history and rapid introduction of new products and services, even doing away with the notion of incremental upgrades by offering many of its services as “perpetual Beta.” Google took the opposite approach from Willcom in dealing with generating images that potentially raised privacy issues. From mid-2008, Google began deploying its fleet of cars with 360 degree cameras mounted on the roof to collect digital images for creating bird’s-eye views of streets in its Google Maps. This caused an acute media frenzy about potential privacy violations, touching off public policy debates, particularly in local governments and among some groups of lawyers. Concerns included images of

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511 NikkeiCommunications, ed. *Fuunji Tachi Ga Makioskusu Keitai Denwa Houkai No Jokyoku: Shirarezaru Tsushin Sensou No Shinjitsu [the Opening Tune of the Destruction of the Cellular Phone Order, Brought About by Adventurers: The Truth of the Telecommunications Wars Revealed].*

512 Softbank eventually returned this bandwidth when they acquired Vodafone’s Japan operations, and IP Mobile filed for bankruptcy after failing to raise sufficient funding to cover the costs of its proposed infrastructure.


514 These included local governments such as Machida City and Suginami Ward in Tokyo, a city in Nara, and the Niigata Lawyers Association. “Guuguru "Sutorito Byuu" Zenkoku Kara Kisei Motomeru Koe, Purabashii Kenen Kakudai [Voices from around the Country Calling for Restrictions on Google "Street View": Privacy Concerns Spreading],” *Sankei Shimbun*, February 8 2009.
laundry lines, individual faces, and car license plates captured clearly and put on the web. As a result of the public outcry, Google lowered the height of its cameras, replacing older images. While concern was raised in other countries as well, Japan was the only country where Google lowered its camera height.

A deliberation council within MIC concluded that Street View itself did not violate Personal Information Protection Law, although it warned that the legality would depend on the material photographed. MIC also demanded that Google take into consideration privacy concerns for the secondary use of images as, such as users violating the security of homes pictured. Swift opt-out actions were recommended, and Google was ordered to give localities advance notice.

IV. Slow Clock Speeds: Pharmaceuticals

In pharmaceuticals, the slowest clock speed sector in this study, MNCs pursued insider strategies over time. The policy issues themselves were slow moving, and since the effects of foreign MNCs are more difficult to isolate, given their longer time horizon, assessing their independent effect on policy is difficult. Yet, over time, as foreign MNCs became ever-larger market actors, industry positions tended to converge to their preferences. Regardless of their effects, however, it is very clear that pharmaceutical firms pursued insider strategies of several varieties. They include some of the most subtle and significant strategies, such as embedding Japan’s domestic pharmaceutical policy process within international coordination efforts.

In an immediate threat – the government’s initiative to increase the frequency of pharmaceutical price decreases – foreign pharma firms worked closely with several other actors to facilitate building a powerful coalition to oppose the plan. For the longstanding issues of improving the comparators (to be explained fully later) used in the clinical testing process, and the increased use of generic products, foreign firms worked from within the industry association and existing policymaking processes. For their long-held goals of reducing approval time for new drugs and gaining permission to use foreign clinical testing data in Japan, foreign MNCs helped embed the Japanese policy process in international coordination efforts.

Table 40. Telecommunications Sector Cases (Relatively Long Time Horizon)

<table>
<thead>
<tr>
<th>Threat/Opportunity</th>
<th>Policy Strategy</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes (immediate)</td>
<td>Insider</td>
<td>- Slowing Down Reimbursement Price Decreases</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Reducing Approval Time for New Drugs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- International Clinical Testing Standards - - Leadership Positions in Industry Association</td>
</tr>
</tbody>
</table>

INDUSTRY ASSOCIATION PRESENCE

As seen in chapter 5, penetration of foreign firms in Japan’s pharmaceutical sector was deep. Foreign firms were among the top in sales and employees, many Japanese firms depended on products licensed from MNCs, and MNC pipelines of new products supported many of the pipelines of Japanese firms.

Foreign pharmaceutical firms’ presence in the domestic industry association, the Japan Pharmaceutical Manufacturers’ Association (JPMA) was also the most extensive of all sectors examined in this study. In 1985, among the 34 officers from 31 firms in the association, only two were from foreign firms: Banyu, which had been bought by Merck in 1983, and the joint venture Daito Pfizer. By 2007, there were 41 officers from 38 firms, but 10 of those firms were foreign MNCs. Moreover, four of the ten foreign firms were permanent officers of the association, and more startlingly, four of the representatives were not Japanese.\(^{516}\) JPMA is notable for having at least one foreign member from the early 1990s – earlier than in the other sectors. An official at JPMA who wished to remain anonymous noted that industry participants often grumbled that foreign firms had two industry associations to work for them – the Japanese JPMA as well as the US industry association PhRMA, which had local offices in Tokyo.

**Resisting Increased Price Revision Frequency: Building a Coalition of Domestic Support**

In an immediate issue that threatened the core revenue streams of foreign pharmaceutical firms, the government proposed more frequent decreases in the reimbursement price of pharmaceutical products included in the National Health Insurance (NHI) system price schedule. In response, foreign firms mobilized the insider strategy of making considerable efforts to build a consensus among a variety of actors in order to create a coalition opposing the proposed government policy.

As seen in Chapter 5, throughout most of the postwar history of Japan’s pharmaceutical sector, the price schedule in the NHI system determined price levels for pharmaceutical products. Then beginning in the 1980s and accelerating through the 1990s, a move to contain overall healthcare costs led to decreases in pharmaceutical reimbursement prices (See Table 41). Foreign MNCs, facing lower selling prices for some of their products vis-à-vis other markets such as the US, had a longstanding interest in keeping product price levels in the NIH as high as possible.

<table>
<thead>
<tr>
<th>Year</th>
<th>Price Cut (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>6.6</td>
</tr>
<tr>
<td>1996</td>
<td>6.8</td>
</tr>
<tr>
<td>1997</td>
<td>4.4</td>
</tr>
<tr>
<td>1998</td>
<td>9.7</td>
</tr>
<tr>
<td>2000</td>
<td>7.0</td>
</tr>
<tr>
<td>2002</td>
<td>6.3</td>
</tr>
<tr>
<td>2004</td>
<td>4.2</td>
</tr>
<tr>
<td>2006</td>
<td>6.7</td>
</tr>
</tbody>
</table>


In 2006, the expert committee appointed by the Ministry of Health, Labour and Welfare (MHLW) responsible for the NHI price schedule, the Central Social Medical Insurance Council (Chuikyo), announced that it would shorten the cycle of price revisions from two years to one...
year. This was a direct threat to the revenues of pharmaceutical firms in general, but particularly MNCs, whose products tended to lose value more rapidly than domestic knock-off products.

Multinational pharmaceutical firms had long employed external pressure from the US and European governments to oppose the regular decrease in pharmaceutical prices. However, they were unsuccessful, since domestic politics surrounding the government’s medical expenditures favored the more powerful Japan Medical Association (JMA), which represented doctors. To decrease medical expenditures, the government consistently chose cuts in reimbursement prices for pharmaceutical products over cuts to doctors’ fees.

In response to the 2006 announcement, foreign pharmaceutical firms mobilized to build an alliance between various industry groups opposing increased frequency of price revisions. PhRMA and the European Federation of Pharmaceutical Industry Association were able to create a joint front with key Japanese industry associations. These included the Federation of Pharmaceutical Manufacturers Association of Japan (though increasingly influenced by the ever-greater MNC presence in its membership), along with the Federation of Japan Pharmaceutical Wholesalers Association, and the Japan Generic Drug Wholesalers Association. These actors all opposed price decreases for their products.

More critically, the foreign pharmaceutical firms were able to enlist the powerful JMA to oppose annual price revisions as well, although on slightly different grounds. JMA’s many general practitioner members – doctors operating small-medium sized clinics rather than large hospitals – tended to order pharmaceuticals in small quantities. Frequent price revisions or other forms of disruption to price stability disproportionately raised their transaction costs, since the timing of purchase would directly affect the cost of pharmaceutical products.\(^{517}\)

The issue of annual price schedule revisions was also raised in the U.S.-Japan Regulatory Reform and Competition Policy Initiative, an annual bilateral set of requests by the US Trade Representative.

The outcome was abandonment of the MHW proposal for annual price revision, and retention of the bi-annual revision schedule. Thus, by assisting the creation of an alliance of actors opposed to an increased frequency of price revisions, foreign MNCs employed an insider strategy to oppose a revenue-threatening policy issue.

**Comparators and Generics: Aligned with Government Interests**

Foreign MNCs saw their policy preferences enacted in two related issues, that of “comparators” and the use of generic drugs. In both cases, policy changes advantaged new products (and therefore R&D) in pricing over older products and knock-offs. The changes were in the direction favored by foreign pharmaceutical firms for decades, a direction that gradually became the industry association’s position.

“Comparators” are used to establish the price for new drugs in Japan’s NHI price schedule. When firms develop new drugs, after clinical trials are completed, deliberations take place within the Central Social Medical Insurance Council to determine the pricing of the product. To establish a list price for a new product, the panel uses a similar existing product as a benchmark; this is the comparator. As a PhRMA member expressed the dissatisfaction of

\(^{517}\) See, for example, "Opposition to Japan's Once-Yearly Nhi Drug Price Revisions Strengthens," *Pharma Marketletter*, September 11 2006. Verified by numerous informal conversations with lobbyists and industry participants.
MNCs, the problem with using comparators in this way is that since new products are by definition improvements on older products, the comparators are not really substitutes. The core issue was that the government selected comparators as much as 15 years old. Therefore, the comparator had undergone up to 7 or 8 rounds of price decreases, in some cases declining to half its original value.

The use of comparators, particularly older products, fit the politics of price decreases in the healthcare sector. MHLW’s incentives to keep healthcare expenditure costs down entailed keeping price levels as low as possible for medical procedures, pharmaceutical products, or both, and pharmaceutical firms were the politically weaker of the two. Therefore, MHLW’s position was in direct conflict with that of MNCs, which had long advocated rewarding innovation by setting higher prices for new innovative products. In effect, the relatively low price for new products through the use of older comparators also helped support small-medium Japanese firms, whose older or knock-off products were priced relatively favorably vis-à-vis those of MNCs that had engaged in far greater R&D expenditures.

In December 2007, MHLW took steps towards positions that multinationals had been advocating. It committed to using comparator drugs that had been on the list for less than 10 years, and which were not competing with generic products (which would have lowered their price). MHLW also agreed to a “Foreign Price Adjustment” (FPA) rule, taking into consideration the most recent foreign drug price data available for new products introduced to the NHI price schedule.

The increased use of generic pharmaceutical products was also a step that foreign MNCs had long advocated, since it rewards new products – their forte – by lowering the price of older products under competition from generics. A longstanding complaint of foreign pharmaceutical firms had been that the NHI price schedule allowed old products, on which small-medium firms with little R&D capability depended on disproportionately, to remain in the Japanese marketplace longer than in other markets. Elsewhere, these older products came under intense price pressures since generics flooded the market as soon as their patent protection expired. In short, in the Japanese market, older products, and therefore the large number of small-medium firms, along with large Japanese pharmaceutical firms that benefited from licensing agreements with foreign MNCs dating from decades earlier, had been shielded from price competition from generics since the price schedule for old products kept their prices artificially high.

In March 2008, MHLW changed the rules for prescription, facilitating the adoption of generics in Japan. In previous prescription forms, doctors were required to check a box

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518 Interview with PhRMA representative, August 2008.
520 Aided by measures in the early 2000 to mid 2000s, such as minor financial incentives for doctors to prescribe generics, and for pharmacists to dispense them, the industry had already been growing rapidly. Specifically, in 2002, 20 yen per prescription was given to doctors for prescribing generics, with 120 to pharmacists. In 2006, 20 yen per prescription was given to doctors for allowing a prescription to be filled with generics. Osamu Saigusa, "Japan's Healthcare System and Pharmaceutical Industry," Journal of Generic Medicines 4, no. 1 (2006): 28. According to an annual report by the industry association, Japan Generic Medicines Association, with 40 members, sales in the generics industry rose from approximately 300 billion yen in 2003 to 400 billion yen in 2007. http://www.jga.gr.jp/
stipulating that generic products could be used; the default option was for non-generic products. This form was changed so that unless doctors checked a box stipulating that a new drug should be used, generics would be prescribed by default.\textsuperscript{521} In 2009, generics grew to an estimated 9.4\% of sales in the pharmaceuticals market.\textsuperscript{522} up from 5.2\% in 2004.\textsuperscript{523}

**Shortening Clinical Testing Approval Times: Embedding Policymaking in International Policy Processes**

Arguably the most critical issue for foreign firms in the pharmaceuticals sector was the time and high cost required for conducting clinical testing in Japan in order to bring products to market. A longstanding complaint for MNCs was that Japan’s clinical testing process was slow, and often required extensive informal ties with key doctors and the government to facilitate its function. The effect was to raise costs of bringing drugs to market to several times the level of other markets. It was in this area that foreign MNCs seem to have had the greatest insider impact on regulatory policy by facilitating the embedding of Japan’s clinical testing regulations into an international organization.

As noted in Chapter 5, the International Conference on Harmonization (ICH), founded in 1990, was an international forum that brought together industry associations of pharmaceutical firms and regulatory agencies of Europe, the US, and Japan. Through several meetings over the course of the decade, ICT participants agreed on standards for clinical testing data interoperability among member countries.

The creation of ICH was not driven by governments, but rather by the global pharmaceutical firms. Some observers contended that the ICH represented the industry’s success in entrenching their interests with national regulators, blocking access to policy processes by other actors such as consumer organizations, patients’ associations, and the broader medical and scientific communities. Such commentators argued that the clinical testing standards of several national regulators were safer before adoption of ICG agreements, and that information was more accessible before uniform ICH standards were adopted.\textsuperscript{524}

As the ICH talks progressed, Japan began accepting more foreign clinical testing data, and the government attempted to enhance the efficiency of clinical testing. As a result, the speed of approvals increased dramatically. For all applications, the average number of months until approval hovered around 40 months in 1991 and 1992, 34 months in 1993-1994, and decreasing to approximately 20 in 1995 and 1996; the time halved in four years (See Table 42).

\textsuperscript{523} Saigusa, "Japan's Healthcare System and Pharmaceutical Industry."
Table 42. Pharmaceutical Product Approval Times (1991-2001)

<table>
<thead>
<tr>
<th>Year</th>
<th>All Applications</th>
<th>Priority Applications</th>
<th>Regular Applications</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total # applications</td>
<td>Average # Months for Approval</td>
<td>Total # applications</td>
</tr>
<tr>
<td>1991</td>
<td>34</td>
<td>39.8</td>
<td>5</td>
</tr>
<tr>
<td>1992</td>
<td>29</td>
<td>41.3</td>
<td>4</td>
</tr>
<tr>
<td>1993</td>
<td>44</td>
<td>33.5</td>
<td>15</td>
</tr>
<tr>
<td>1994</td>
<td>33</td>
<td>33.9</td>
<td>6</td>
</tr>
<tr>
<td>1995</td>
<td>24</td>
<td>20.2</td>
<td>12</td>
</tr>
<tr>
<td>1996</td>
<td>46</td>
<td>19.1</td>
<td>19</td>
</tr>
<tr>
<td>1997</td>
<td>33</td>
<td>15.6</td>
<td>15</td>
</tr>
<tr>
<td>1998</td>
<td>35</td>
<td>17.6</td>
<td>10</td>
</tr>
<tr>
<td>1999</td>
<td>29</td>
<td>20</td>
<td>4</td>
</tr>
<tr>
<td>2000</td>
<td>23</td>
<td>22.7</td>
<td>14</td>
</tr>
<tr>
<td>2001</td>
<td>13</td>
<td>7.8</td>
<td>12</td>
</tr>
</tbody>
</table>

Source: Japan Pharmaceuticals Manufacturing Association

Through the process of decreasing approval times, the US pharmaceuticals industry association, PhRMA, which has a branch in Japan, worked closely with the American Chamber of Commerce in Japan, the European Business Council’s Pharmaceuticals Committee, and the Japanese industry association, JPMA. The foreign participants were generally satisfied with the level of cooperation.525

LIMITATIONS OF PHARMACEUTICALS’ INSIDER STRATEGIES: BROADER POLITICS OF HEALTHCARE

Although the insider strategies of foreign MNCs were successful overall, in that their policy preferences became policy or were adopted by the industry association, there were some limitations. While they were successful in slowing down the pricing re-evaluation, foreign firms did not achieve all of their goals.

They had wanted industry representation on the Chuikyo Drug Pricing Expert Subcommittee, which determined prices for the NHI price schedule. More specifically, they wanted a US industry participant expert. In short, they wanted to deepen their level of insider embedding into policy processes.

The foreign firms did have reason for optimism. They had considered it a success in the late 1990s when industry pressure created a Committee on Drug Benefits under the Medical Insurance Council with two industry representatives as official members. JPMA created a working group to support the members, and both US and European organizations were invited to send representatives to this working group.

525 A 1997 White Paper published by the American Chamber of Commerce in Japan characterized the process as “generally good cooperation.”
In 2007, however, foreign firms’ demand for industry representation on Chuikyo, part of the bid to oppose the increased frequency of price revisions, was denied.\textsuperscript{526} Still, in some measure of limited success, in February 2008, Chuikyo agreed to allow drug manufacturers—including foreign MNCs—to make presentations at initial meetings of the drug pricing subcommittee.\textsuperscript{527} They had made it inside the castle.

\textsuperscript{527} ———, "Seventh Report to the Leaders on the U.S.-Japan Regulatory Reform and Competition Policy Initiative."
Conclusion

Japan has moved a long way from being a castle, largely closed to foreign direct investment and management control of firms within its economy. A quote from a 1985 report on foreign acquisitions in Japan is telling:

…most of the acquired companies were relatively weak in terms of their financial position, products or technology and were in industries considered non-strategic in a consensus between government and industry. None were strong firms in industries vitally important to Japan’s economic success. Thus, historical acquisitions have not been threatening to Japanese control in key industries.528

By 2000, most of the influx of foreign MNCs had occurred in the very sectors which had been considered strategic to Japan’s model of strategic postwar development. Many of the acquired firms had been strong firms vital to Japan’s rapid economic growth. The sectors in question, particularly finance, were still vitally important to Japan’s economic success. However, foreign capital and management expertise were now part of the solution rather than a threat. For M&A, many of the acquired companies were indeed weak, bankrupt, or facing a crisis. Yet, some offered world-class technology and production expertise. The castle gates were not only open, but the walls were being taken down as well, with the country embracing a new model of integration into the global economy for its future growth and prosperity.

Let us now return to the questions raised in the beginning of this study. What were the effects of foreign MNCs on Japan’s policy processes once they had entered en masse? What can we learn from this study about MNCs as drivers of globalization? And how does this contribute to our understanding of how Japan’s distinct model of capitalism is evolving?

The Effects of MNCs on Japan’s Policy Processes

The first question – the effects of foreign MNCs on Japan’s policy processes – is a question about how foreign MNCs exercised their voice in its political economy. In all national contexts, the range of options available for actors to exercise voice is shaped by the opportunities and constraints provided by the political, institutional, and regulatory environment. In the case of Japan, which had an extremely low presence of MNCs in core sectors until recently, we must therefore differentiate between the changes that facilitated the influx of MNCs from the potential effects of MNCs after gaining prominence in the economy. In other words, to what degree were MNCs’ observed mechanisms of influence simply a result of the changes enabling them to enter and expand in Japan, and to what degree were the mechanisms spearheaded by MNCs themselves? Part I of this dissertation addressed this question by examining in detail the interactions between foreign firms and Japan’s institutional, regulatory, and market environments at the national and sectoral levels.

The Castle: Limiting Foreign Voice

Put simply, for most of Japan’s modern history until the 1990s, foreign MNCs’ options for exercising voice were extremely limited. They were outsiders, especially in core strategic sectors, and their political strategies were mostly restricted to gaiatsu and exploiting regulatory loopholes – both of which often required strong Japanese partners to succeed.

For most of Japan’s history, foreign capital and management control were restricted by design. As seen in Chapter 2, even as the policy tools changed over time, Japan’s strategic orientation to limit foreign management control remained throughout its modern history until the 1990s. Insulating core areas of the economy from foreign influence had been a cornerstone of Japan’s postwar “developmental,” or “mercantilist” political economy of its rapid growth era, when the government channeled resources towards industries targeted for growth. The success of Japanese firms was equated with the development of the Japanese economy and health of the Japanese populace.

Distinctive characteristics of Japan’s political economy at the national level created an environment particularly difficult for foreign MNCs, as shown in Chapter 3. Characteristics such as keiretsu, cross-shareholding, the main bank and convoy systems, long term employment, industry associations, and the importance of informal interpersonal networks to competition all hindered the entry and operation of foreign MNCs. Although not all of these elements were designed explicitly to thwart foreign entry, they created significant hurdles for Japanese new entrants as well as foreign MNCs. Foreign MNCs, however, faced the additional dilemma of how to formulate their Japan strategy – namely, given Japan’s distinctive characteristics, how much to depart from their core business models successful elsewhere and how much to invest into Japan-specific factors. With a relatively small number of successful foreign MNCs in Japan, their market clout was limited, reducing their ability to become policy insiders.

Finally, as seen in Chapters 4 and 5, sector-level restrictions often limited foreign MNCs’ access to core parts of highly regulated Japanese markets. With regulatory structures of ex ante managed competition, the government compartmentalized sectors, orchestrated the entry of new entrants, and micromanaged competition through licenses and informal guidance. In these sectors, foreign MNCs were often limited to a particular market segment – often “privileged” in the sense that large Japanese competitors were kept out, and therefore sometimes quite lucrative, but nonetheless limited.

The Castle Gates Open: New Opportunities for Voice

Changes in the 1990s, however, created an array of new opportunities for foreign MNCs to exercise voice in Japan – both through existing channels and in new ways. Political, regulatory, and institutional shifts transformed market dynamics and facilitated foreign entry, enabling MNCs to take large portions of markets previously closed to foreign entry. The same shifts also enabled them to become insiders in existing policy processes and provided opportunities for them to challenge prevailing norms of government-business relations.

The transformation of Japan’s strategic orientation was a major driver in providing foreign MNCs opportunities to enter Japan and become policy insiders. After pervasive disillusionment with Japan’s postwar political economic model following the bursting of the
bubble, a series of corporate and government scandals, languishing economic growth, and restructuring by major Japanese firms, MNCs came to be regarded as part of the solution to Japan’s economic problems rather than a threat, as seen in Chapter 2. Foreign MNCs were invited inside the castle, serving in government deliberation councils and put in previously unthinkable politically sensitive roles, such as assisting with the sale of bankrupt financial institutions.

Changes in many of Japan’s distinctive national institutions led to an environment far easier and more advantageous for foreign MNC entry, as shown in Chapter 3. The weakening of main banks and the government’s abandonment of the convoy system gave rise to waves of bankruptcies and distressed firms available for foreign purchase. The opening of keiretsu and unwinding of cross-shares opened new avenues for foreign entry and expansion. Shifting employment practices created a more fluid labor market, providing foreign MNCs with access to a growing market of mid-career hires for executive talent, managers, and staff-level employees. Particularly in finance, Wall Street-style salaries offered by foreign financial firms at a time of doubt about the sustainability of long-term employment promises by major Japanese firms became a socially acceptable path for top university graduates.

Regulatory shifts at the sector level, particularly in previously closed industries, enabled new market dynamics; this not only allowed unprecedented levels of foreign entry, but also often gave MNCs competitive advantages by making their global business models competitive in Japanese markets, as seen in Chapters 4 and 5. With the transformation of regulatory structures from ex ante competition management to ex post market governance, new entrants, new products, and new business models became possible. MNCs had a new edge over Japanese firms that struggled to adapt. Foreign MNCs’ growing market clout in a variety of sectors increased their ability to exercise voice as insiders in policy processes.

The logic of ex post market governance also expanded the range of MNCs’ abilities to exercise voice. MNCs could aggressively take advantage of regulatory loopholes and defy informal government guidance, spearheading disruptive political strategies. On the one hand, the new regulatory structures opened the door to business strategies that could yield windfall profits, increasing the incentive for firms to adopt disruptive strategies. On the other hand, the costs of mounting disruptive strategies decreased radically, since the government had less discretionary authority to manage competition. The government’s market-oriented rationale behind the new regulatory structures also gave foreign MNCs more justification to defy informal attempts by the government’s to influence their behavior.

In sum, the major changes to Japan’s postwar model of capitalism during the 1990s that enabled the foreign influx also provided foreign MNCs with new possibilities to exercise voice – both within existing channels, as well as through new avenues. A greater range of possibilities, however, does not automatically lead to actors taking advantage of them. In this case though, foreign MNCs with the fastest clock speeds utilized the new possibilities to their fullest extent by mounting disruptive strategies. Foreign MNCs with slower clock speeds demonstrated a variety of strategies to exercise voice from within existing channels.

**Foreign MNCs’ New Voices: Disruptive and Insider**

Foreign MNCs with the fastest clock speeds were most aggressive in taking advantage of the new possibilities for expanding the range of voice. Their disruptive policy strategies were a manifestation of their exercising voice in new ways. Fast clock speed firms, when faced with
potential windfall profits or policy threats, could potentially derive the greatest benefits from
mounting disruptive challenges, while they faced the largest costs for not doing so. Larger
Japanese firms had slower clock speeds, and most new Japanese firms did not have the size or
clout of foreign MNCs.

There were several disruptive challenges that fast clock speed MNCs mounted to
exercise their voice in policy processes. They shifted the norms of strategic government-business
interactions by defying administrative guidance and aggressively exploiting regulatory loopholes.
Shinsei’s refusal to bail out Sogo, its exercise of the put option in its contract with the
government, Loan Star’s use of the tax loophole, Goldman Sachs’ refusal to testify in the Diet,
and Lehman Brothers’ use of off hours trading to execute a major share purchase, were among
the prominent examples noted in Chapter 6. The participation of foreign carriers in the
administrative litigation against MIC was also intended to explicitly shift the rules of the game in
government-business interactions in the sector.

Foreign MNCs also showed that when their interests were aligned as a group of foreign
firms, they could spearhead concerted movements that challenged prevailing norms of
government-business coordination. We saw this dynamic with the securities brokerages
establishing their own parallel shareholder protection fund, and the exodus from the TSE
industry association that led to collapse of a particular member group.

As insiders, foreign MNCs gained voice within existing channels of
government-business coordination. While the mechanism of exercising voice itself was not new,
the rapidity with which a group of new entrants became prominent actors was unprecedented.
Foreign MNCs shifted the balance of power within industry associations. As seen in the
insurance sector, as foreign insurers’ market presence grew dramatically within the span of a few
years, they became critical actors in informal negotiations as well as when formal voting
procedures were invoked in the association.

We also observe the rising presence of foreign MNCs eliminating the potential for
industry associations to take strong stances against foreign competitors. While normative shifts
within industry associations – sometimes occasioned by necessity – aided the entry of foreign
firms, associations in sectors such as automobiles, telecommunications, and pharmaceuticals that
were once anywhere from unenthusiastic to hostile towards foreign entry during the postwar
period, had foreign MNCs as core participants by the mid-2000s. In the case of insurance, we
saw how the industry association even shifted its role from slowing foreign entry to actively
facilitating their rapid entry.

Another mechanism we observed for foreign MNCs to enhance their voice was to
weaken the opposition by outperforming them in markets. We saw the most extreme case of this
in the retail sector, when Toys’R’Us decimated local small-medium retailers, causing their
industry association, which had slowed the MNCs’ entry, to disband entirely. In other sectors
such as securities and insurance, the change in relative market power led to a decreased ability of
industry associations to take unified positions on matters that split the preferences of foreign
MNCs from those of major Japanese MNCs.

Finally, we observed the subtle but transformative mechanism of influence exerted by
foreign MNCs in the embedding of domestic policymaking within international policy
coordination processes. In the cases reviewed in Chapter 6, this revealed itself only in the
slow-moving pharmaceutical sector, but preliminary evidence suggests that in other
slow-moving areas, particularly those involving standards, similar patterns are likely to be
observed.
Overall, these new mechanisms of foreign MNCs to exercise voice in Japan’s political economy are likely to reduce the strategic ability of the government to shape markets through informal means. While industrial promotion activities can be accomplished through formal measures such as subsidies and regulation, there is less room for selective interpretation in the implementation of policies.

The Japanese political economy is also unlikely to regain the ability, nor the inclination to exclude foreign MNCs. Once open to MNCs, it is improbable that industry associations and markets could or would reorient themselves towards keeping foreign influence at bay.

**Greater Susceptibility to Exogenous Shocks: Global Financial Crises and Bailouts**

An increased foreign presence also puts Japan at greater risk of exogenous shocks delivered through foreign MNCs. The most severe shock came in the 2008 global financial crisis, when Lehman Brothers suddenly went bankrupt, AIG teetered on the brink of collapse, and financial markets were thrown into turmoil. Many of the revenue drivers of foreign financial firms, such as variable annuities, became unprofitable, leading many of these firms to exit the market, at least for the time being. Shinsei Bank, the most heavily involved in credit default swaps and a large counterparty to Lehman, became the worst performing bank in 2009, even provoking the FSA to issue an operations improvement order for Shinsei to improve its internal risk controls.

Other than the direct counterparty damage from the Lehman Bankruptcy and uncertainty for the future of AIG subsidiaries in Japan (initially expected to be sold, but then retained), direct damage to Japan’s financial sector from the crisis was relatively light. Japanese financial institutions still held major assets, and their exposure to the subprime mortgage-based financial products were limited. The majority of Lehman divisions were absorbed by Nomura Securities, which offered retention bonuses to keep the expertise of Lehman employees. And as Wall Street firms rebounded after the US government bailouts, their Japanese operations quickly became profitable again.

In this case, the economic damage to Japan came in early 2009, when it became clear that demand for Japanese products had plummeted. A steep drop in Japanese exports, back to 1970s levels drove the economy into a quarter of sharp recession. Japan was spared the worst of the financial crisis, largely due to its banking system not participating in much of financial market activity that caused the global financial crisis – foreign MNCs did not deliver the shock from this crisis.

Previous shocks delivered through MNCs were less severe. The bursting of the global IT investment bubble in 2000-2001 led to an exodus of foreign telecom carriers, though the largest foreign MNC to enter the sector, Vodafone, did so after the exodus. In the mid to late 2000s, as the US auto firms, facing high oil prices, were driven to the brink of bankruptcy, GM’s sudden exit from its Japanese capital tie-ups created a shock to its partners. A rapid realignment in the sector followed, but the effects were not necessarily negative.

The trajectory of an increased MNC presence, though, undoubtedly opens the Japanese economy to greater susceptibility for such exogenous shocks in the future. National bailouts of MNCs headquartered in their economies, such as the US government and AIG or the Big Three auto firms, can more easily influence development of the respective industries in Japan.
IMPLICATIONS FOR UNDERSTANDING MNCs AS DRIVERS OF GLOBALIZATION

This study suggests that as drivers of globalization, MNCs can exert influence on host advanced industrial countries through multiple mechanisms that operate simultaneously, but with different time horizons. While the specific mechanisms for MNCs to exercise voice depend on the institutional and regulatory context of the host country, this study does suggest that one set of actors – MNCs – can deliver both disruptive and insider strategies. While disruptive strategies and some insider strategies have short time horizons of cause and effect, other forms of insider strategies can have longer time horizons.

We can take this logic a step further to suggest that, since corporate clock speeds influence whether firms adopt disruptive or insider strategies, the relative mix of clock speeds of new MNCs will affect the mix of strategies experienced by the economy. The mix of strategies in turn affects the relative time horizons at which change occurs.

In terms of change, the mix of disruptive and insider strategies also has implications for whether economies will converge or remain distinct in the fact of globalization. While some firms find it to their benefit to mount disruptive strategies, which can drive change by altering the expectations of actors, others find insider strategies more suited to their needs. As long as firms are interested in insider strategies, they are vested interests in keeping the existing channels of exercising voice active – for example, they would not be interested in seriously undermining the power of industry associations if they enjoy greater clout within them. In the debate over whether globalization is driving convergence or whether distinctive features will remain, this study therefore suggests that the entry of MNCs can actually strengthen vested interests in existing institutions of government-business coordination, which can be distinct across countries. Differences are therefore embedded, even as the presence and influence of foreign MNCs as drivers of globalization increases.

At the same time, the responses to disruptive strategies may be national in character, affected by political dynamics that can differ across countries. In some countries, disruptive strategies may cause a backlash, narrowing the range of activities allowed by MNCs and limiting their penetration into core areas of the political economy. In others, the same strategies may be hailed as beneficial to the political economy by broadening the range of strategies available to domestic firms as well – once built into actors’ expectations, strategies that were once disruptive are no longer so.

A Simple Model of Firms’ Political Strategies Confronting Threats/Opportunities

From this study of Japan, we can also propose a simple predictive model of firms’ political strategy responses when confronted with a potentially threatening policy issue, or with a policy-related opportunity to gain windfall profits. This is not necessarily the decision process within the firms themselves, since the logic from their perspective can differ according to their clock speed. For example, the obvious response for a firm with fast clock speeds to challenge a policy issue may not occur to a firm with much slower clock speeds with a ten-year product pipeline. Yet, their responses are likely to fall along the regularity of relative clock speeds.

If a policy issue does not arise, or if it is not perceived as a major threat to firms’ core businesses, firms have little incentive to mount a challenge. (Their perception, of course, is not perfect. They may misread the situation, be blindsided by stealthy reform, or be subject to unexpected policy outcomes or consequences.)
Foreign MNCs’ default political strategy, absent a threatening policy issue, is to become insider in the policy process. The level of investment into becoming an insider depends on the firm’s internally derived perception about the value of investing in industry associations, interpersonal networks, and other activities, combined with opportunities to make those investments. Some decide to invest heavily, while other prefer to keep a low profile. (See Figure 1)

**Figure 1: A Simple Model of Firms’ Political Strategies**

If a policy issue is perceived a sufficient threat to challenge, then the firm faces a range of political strategy choices. At the most disruptive end, it can choose to challenge the policy process on a solo basis through independent actions, such as defying common norms of government-business relations or typical policy processes. Or it may join other firms – foreign, domestic, or both – and mount a concerted challenge to existing processes or organizations. At


530 Barriers to entering these domestic policy organizations and networks were long a complaint of foreign firms operating in Japan, but since the late 1990s, policy and organizational changes have enabled unprecedented entry. As one manager put it, the formal and informal barriers to entry have almost disappeared, but core industry association members incur significant investments of time and personnel. Many foreign firms do not see enough gain to justify full membership and participation in endless meetings and committees.
the other end of the spectrum, it can choose an insider strategy, including but not limited to: working through normal policy processes to alter the balance of power among interest groups, build coalitions, or mobilize informal interpersonal networks.

Our study of Japan suggests that there are limits to firms’ ability to mount disruptive challenges. For example, it is easier to defy government attempts to influence behavior if they are exercised through informal means. If the policies are anchored so firmly in both law and judicial rulings (such as in the case of consumer finance in Japan), with no readily available loopholes, then MNCs have little room to defy the government. Moreover, when confronting policy issues that are embedded in major political positions (such as in the case of Prime Minister Koizumi’s postal reforms, which were central to his election campaign), then the voices of foreign MNCs, let alone corporate actors in general, may be swept away by politics. In other words, when firms confront political issues so large that their voices are unlikely to produce their preferred outcomes, they may not raise their voices much – but this is not an indication that they do not have preferences, or that their voices are always ineffective.\footnote{Cornelia Woll’s framework relates corporate political interests to their preferences and strategies. In her framework, 1) corporate identities shape their interests, 2) firms’ causal beliefs shape their preferences, and 3) opportunities and constraints from firms’ strategic environments shape their strategies Woll, Firm Interests : How Governments Shape Business Lobbying on Global Trade, 34-36.}

\section*{Syncretism in the Transformation of Japan’s Political Economy}

Finally, we come to the question of the role MNCs are playing in transforming Japan’s political economy. This study, by focusing on MNCs, has highlighted more change than continuity. It does not, therefore, claim to give a perfectly balanced answer to the age-old question of how much Japan really is changing. However, it is manifestly clear that significant transformations have occurred in a broad swath of industries at the core of Japan’s postwar rapid growth era.

Recent scholarship has shown that Japan’s political economy has been transforming itself in important ways from the 1990s onward. For example, Steven Vogel finds that the Japanese model is transforming itself to become more selective, with companies reevaluating the costs and benefits of their long term relationships, more differentiated, with greater variety in corporate practices, and more open, with an increased foreign presence.\footnote{Vogel, Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism.} Ulrike Schaede sees a “strategic inflection point” from the mid-1990s through the mid-2000s, in which regulatory shifts and market conditions caused major firms to pursue a strategy of choosing and focusing on core areas.\footnote{Schaede, Choose and Focus : Japanese Business Strategies for the 21st Century.} Masahiko Aoki and his collaborators find an increasingly hybrid system, with new practices and firms alongside new practices and firms, with the emergence of a new hybrid organizational form of Japanese corporations.\footnote{Aoki, Jackson, and Miyajima, eds., Corporate Governance in Japan.} These studies flag the entry of foreign MNCs as an endpoint – the beginning of their influence on Japan’s political economy. This study takes foreign MNCs as the starting point in examining their influence.

My core contention regarding the influence of MNCs on Japan’s overall model of capitalism is that they are pushing Japan’s political economy in two directions simultaneously, driving a process of syncretism. New practices are being introduced and employed side by side with older practices. While some MNCs seek to disrupt existing practices in several domains –
market strategies, corporate organizations, and policy processes -- other derive substantial benefits from existing practices. For example, while Toys’R’Us disrupted prevailing retail networks to transform the sector, Coca Cola and P&G benefit from strong links to their wholesale networks. While Wall Street investment banks introduced new employment practices, those such as PricewaterhouseCoopers, IBM Japan, and Shinsei Bank adopted hybrid systems.

Syncretism does not lead to convergence. Like Christianity entering new societies and retaining native religious symbols, or Buddhism introduced to Japan with various Buddhas mapped onto preexisting Shinto Deities, new norms and practices introduced by foreign MNCs affect existing arrangements. However, foreign MNCs are affected by Japanese arrangements as well. MNCs can become vested in mechanisms of exercising voice that are particularly useful in the Japanese context. As we saw in the case of Ripplewood, while foreign firms may mount disruptive challenges when facing the opportunity for windfall profits, they can begin to invest in existing arrangements in the longer term. As the presence of MNCs increases in Japan, the presence of Japan may increase in global MNCs as well. A generation of managers and executives in Japan operations are beginning to trickle into the board rooms of MNCs with operations in Japan. Perhaps the most extreme, though non-Japanese, example is Carlos Ghosn, appointed as CEO of Renault itself after reviving Nissan.

A convergence of regulatory structures does not necessary yield similar outcomes -- whether in markets or political strategies. As the trajectory of change in Japan continues along a course influenced by its institutional, regulatory, and market contexts, the policy strategies of foreign MNCs contribute to a broader set of mechanisms of coordination. However, despite taking advantage of opportunities to mount disruptive challenges and insider strategies, their vested interests in insider strategies preclude a wholesale abandonment of existing arrangements. With much room for foreign MNC growth in many of the slower clock speed industries not included in this study, the likelihood of future foreign entry becoming increasingly vested in insider strategies is high.

Thus, we can be specific about predictions about the trajectory of Japan’s development by considering the relative weight of fast-moving versus slow-moving foreign entrants, and immediate versus long term mechanisms of influence. Slow-moving mechanisms of influence may increase the range of possibilities over time to exercise voice by affecting future regulatory changes. Fast clock speed firms are likely to take advantage of the new opportunities to their fullest. Yet, the presence of slow clock speed firms will ensure that the process of change is one of syncretism rather than convergence.

MNCs are in Japan to stay. Like the Vodafone sign in rural Japan, they will become increasingly invisible as part of the landscape. They are already a legitimate career option for many Japanese. They will become even more deeply embedded as insiders over time, but some faster moving firms will mount disruptive challenges on occasion. The Japanese political economy, once an impregnable castle, is transforming into a more open city-state -- still retaining some walls, but no longer a fortress. It is more interdependent, vulnerable to exogenous shocks, but irreversibly committed. Bridges are built and roads are paved, increasingly allowing influence in both directions. While images of black gun ships from the West will continue to occupy a special part of the Japanese psyche, they can be safely relegated to the realm of history and culture rather than contemporary political economy.
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APPENDIX A: CLOCK SPEEDS

The notion of corporate clock speeds originates from management literature on “industry clock speeds.” The term was coined in the late 1990s with the observation that different industries evolve at different speeds. Intuitively, the concept is easy to understand. For example, the world of Internet-related software services changes rapidly, with new products and services reorganizing and redefining the market every few years. By contrast, the aircraft manufacturing sector moves quite slowly, with new product rollouts spanning decades. Boeing introduces new products once or twice a decade, and its latest major redesign, the 787 Dreamliner, is taking over a decade to bring to market. In another example, Intel, in a relatively fast clock speed industry, expects a billion dollar semiconductor fabrication plant to become obsolete in only a few years, while in automobiles, a slower clock speed sector, a billion dollar factory can still be useful after 20 years.

Several metrics are available to measure corporate clock speeds. Charles Fine, who coined the term in the mid-1990s, points to: 1) the speeds of product introduction, measured by new product introduction rates or product generation intervals; 2) changes in business processes, potentially measured by capital equipment obsolescence and; 3) the rate of organizational changes. A 1999 quantitative study analyzing business units in the electronics industry measured: 1) the fraction of total revenue derived from new products as an indicator of product innovation; 2) the total duration of product life cycle, and; 3) the rate of decline in prices of input materials. For example, see Table A-1, and abridged version from Fine’s original conception.


536 Fine, Clockspeed : Winning Industry Control in the Age of Temporary Advantage.


538 Fine, Clockspeed : Winning Industry Control in the Age of Temporary Advantage, ———, "Industry Clockspeed and Competency Chain Design: An Introductory Essay".

539 Mendelson and Pillai, "Industry Clockspeed: Measurement and Operational Implications."
Table A-1: Sample Clock speed Measurements from Fine (1998)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Product Tech Clock Speed</th>
<th>Organizational Clock Speed</th>
<th>Process Tech Clock Speed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fast Clockspeed Industries</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Personal Computers</td>
<td>&lt;6 months</td>
<td>2-4 years</td>
<td>2-4 years</td>
</tr>
<tr>
<td>Semiconductors</td>
<td>2-3 years</td>
<td>5-10 years</td>
<td>10-20 years</td>
</tr>
<tr>
<td><strong>Medium Clockspeed Industries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automobiles</td>
<td>4-6 years</td>
<td>4-6 years</td>
<td>10-15 year</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>7-15 years</td>
<td>10-20 years</td>
<td>5-10 years</td>
</tr>
<tr>
<td><strong>Slow Clockspeed Industries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft (commercial)</td>
<td>10-20 years</td>
<td>5-30 years</td>
<td>20-30 years</td>
</tr>
<tr>
<td>Shipbuilding</td>
<td>25-35 years</td>
<td>5-30 years</td>
<td>10-30 years</td>
</tr>
</tbody>
</table>


Challenges in Measuring Clock Speeds in the 21st Century: The IT Revolution and Services Transformation

Measuring clock speeds has become more difficult since the original conception was put forth in the late 1990s. Advances in Information Technology (IT) tools and their implementation, has affected the very notions of products and sectors. The fast-moving industries are affected disproportionately by advances in IT, which include IT-related industries themselves as well as the heaviest users such as finance.\(^4\)

Product/service rollouts have become less distinct, with online Internet services increasingly in a state of “perpetual beta,” constantly updated. Google, for example, does not publish distinct version of its search engine, email, or web-based word processing or spreadsheet applications. They are updated on the fly, making product and process speeds difficult to measure.\(^5\) In industries such as financial services, in which IT investments are the heaviest

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\(^5\) In contrast with traditional software, with major updates to software version followed by minor updates, such as with Microsoft’s Windows operating system, globally dominant services such as Google’s Gmail remained in beta for five years after its introduction, and it will be continue to be updated on the fly. In the five years it was officially in beta, Google added several new features to Gmai1, reorganized its core software architecture, and modified its offerings to enable corporations and universities to use it. Gmail is no longer official designated as in “beta,” but it acknowledges that the label is relatively meaningless in a world of constant updates, humoring users with the option of reinstating the word “beta” on the logo if they choose. Keith Coleman, "Gmail Leaves Beta, Launches "Back to Beta" Labs Feature,” http://gmailblog.blogspot.com/2009/07/gmail-leaves-beta-launches-back-to-beta.html.
among all industries, the notion of “products” also poses a measurement problem. Many complex instruments such as particular types of derivatives or collateralized debt obligations undergo constant modifications and do not emerge as distinct product offerings. Extremely high speed trading, which drove the revenues of investment banks after the 2007-2008 financial crisis, is not a distinct product, but rather a set of algorithms supported by new, unprecedented magnitudes of computational power. What we do know, however, is that in financial sectors and online services, clock speeds are among the fastest, and accelerating.

Traditional sectoral boundaries are becoming blurred. For example, telecommunications equipment manufacturers producing cellular handsets (Nokia, Motorola) now compete with computer manufacturers (HP, Dell), with functionality that pits them against makers of digital cameras (Canon, Minolta). Categories are therefore less stable in IT-related, fast-moving sectors. Finally, products and services are increasingly intertwined. This leads to the necessity of the conception to encompass not only products in the traditional sense, but services – such as finance – as well. The conception of industry clock speeds, which emerged in the late 1990s along with an attempt at empirical measurements, is therefore due for an update.

Fortunately for this analysis, a relatively rough differentiation of clock speeds suffices. The argument does not hinge on a slight difference according to precise measurements. This dissertation also augments the notion of clock speeds by broadening its application. This dissertation expands the scope of the concept’s applications from industrial product sectors to services sectors such as securities, banking, and insurance. To do so, it draws upon the notion that the concept of production can encompass not only products, but services as well, since investments into building IT systems capable of delivering services such as those by financial firms or Google are industrial in scale – on the order of billions of dollars of investment.

542 In the absence of systematic studies, anecdotal evidence is the only recourse. For colorful illustrations, see, for example, John Hintze, "Nyse Fines Credit Suisse for Algo Run Amok," Securities Technology Monitor(2010), http://www.securitiestechnologymonitor.com/news/-24504-1.html, Timothy Lavin, "Monsters in the Market," The Atlantic(2010), http://www.theatlantic.com/magazine/archive/2010/07/monsters-in-the-market/8122/. According to Andrew Sorkin, a US financial firm created a “shadow group” to study the business model of a profitable product group it had acquired, in case the group left, and it even went so far as to hire PricewaterhouseCoopers to build a covert computer system to track the group’s trading activities to able to reverse engineer their products. Sorkin, Too Big to Fail : The inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis--and Lost. It is also quite common for one firm to study and reverse engineer the products of others.


544 Ibid. Data centers built by firms such as Microsoft and Google in the late 2000s reach 500 billion dollars per data center, with several coming online every year.
APPENDIX B: CONSIDERATIONS ON FDI DATA

FDI figures as reported by governments around the world are problematic, with national idiosyncrasies rendering precise comparisons inaccurate.\textsuperscript{545} The shortcomings of FDI data from Japan are as follows. For data from the Japanese government, different sources report different numbers, each with critical omissions. For example the Bank of Japan’s (BOJ) figures, the most internationally comparable, cover all investments and additional working capital above 5 million yen, but do not break them down into industries. The Ministry of Finance’s (MOF) statistics only record investments subject to the Foreign Exchange Law, omitting inflows less than 30 million yen – potentially up to a third of foreign firms – among other problems.\textsuperscript{546} These data sources were revised and improved in 2004, but introduced a new problem of data comparability over time. Data from the Ministry of Economy, Trade and Industry (METI) is based on voluntary surveys with response rates below 50%, omitting key sectors such as finance, real estate and insurance. There are also other limitations.\textsuperscript{547} Data compiled by private firms, such as the Toyo Keizai Gaishikei Kigyo Soran and Teikoku Databank, rely on public disclosure and survey data, but many major foreign firms do not publicly report or voluntarily disclose financial data. A comprehensive source, the Establishment and Enterprise Census, compiled by the Statistics Bureau in the Ministry of Internal Affairs and Communications (MIC) covers all firms with compulsory data collection, including data on foreign ownership. However, this census is published only occasionally, with the 2007 version covering only 1996 and 2001.\textsuperscript{548}

There is also the question of what to measure: sales revenues, profits, market share, employees, or something else. Economists Kyoji Fukao and Ralph Papyrizki contend that employment share is the best measure of foreign presence. Using the Establishment and Enterprise Census, they calculate FDI levels according to the share of employment. Even accounting for different foreign ownership levels, they find Japan’s FDI levels to be higher than measures recorded by the Japanese government or international statistics from the OECD or

\textsuperscript{545} Dunning and Lundan, \textit{Multinational Enterprises and the Global Economy}.

\textsuperscript{546} MOF data only records inflows, omitting outflows. Paprzycki and Fukao, \textit{Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization}, 13. It also omits reinvested earnings, a notable drive of increased US FDI stock according to US accounting methods. Before 1985, MOF data did not include loans and the acquisition of unlisted stocks. MOF figures of FDI stocks were recorded in nominal dollar investments. Since the strengthening of the yen from 360 yen per USD in the early 1980s to 100 yen per USD in the 1990s, this would yield a constant recorded stock of FDI despite an actual four-fold increase if adjusted for exchange rates. Weinstein, "Foreign Direct Investment and Keiretsu: Rethinking U.S. And Japanese Policy." In 1996, Weinstein estimated that the FDI stock in Japan may have been 10 to 12 times higher than reported levels.

\textsuperscript{547} Nonetheless, it was this METI data from the late 1980s that became the basis of US-Japan Framework Talks in the mid-1990s under the Clinton administration. The popular citation was that foreign firms in Japan only accounted for 1% of Japanese sales, while foreign firms’ sales accounted for 10% of all sales in the US. This figure is cited in Graham and Krugman (1993), and the first Clinton/Tyson \textit{Economic Report of the President}. Weinstein, "Foreign Direct Investment and Keiretsu: Rethinking U.S. And Japanese Policy," 3.

\textsuperscript{548} Paprzycki and Fukao, \textit{Foreign Direct Investment in Japan : Multinationals' Role in Growth and Globalization}, 13.
UNCTAD.\textsuperscript{549} Others, such as James Abegglen, with extensive experience observing the Japanese economy and running foreign MNCs in Japan, contend that sales as a total percentage of the total market is preferable.\textsuperscript{550} Both suffer the data limitations noted above.

\begin{footnotesize}
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\item \textsuperscript{549} They find that the share of employment by foreign affiliates, of using a 33.4\% ownership ratio, as does METI’s figures, is barely above 1 percent in the 1997, but if it is considered at 20\% or more held by one firm, the employment shares is 2.75\% in 2001. This figure, while still low, is actually almost half that of the US in 1997, with the only US figures available capturing 10\% or more as foreign owned – therefore capturing proportionally more than Japan at 20\% or more single owner. The employment share for manufacturing calculated in this way yields figures higher than do METI, OECD, and UNCTAD. Although the share of services is low as well, at 2\% in 2001, this is only slightly less than the US in 1997, at 4.31. Ibid., 26-30.
\item \textsuperscript{550} Abegglen, 21st-Century Japanese Management : New Systems, Lasting Values.
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