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From developmental state to the ‘New Japan’: the strategic inflection point in Japanese business

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Between 1998–2006, Japan’s political economy underwent a strategic inflection point, anchored on legal changes so profound that they are irreversible. These reforms sought to enable large companies to shift from the post-war priority on sales and market share toward a new focus on profitability. The arrival of powerful low-cost Asian competitors in assembled goods, and a drastic change in the shareholder structure in Japan brought the end of the ‘developmental state’ approach and necessitated repositioning into innovative, high-margin sectors. The congruence model posits that a successful shift in critical tasks requires a realignment of formal organization, people and culture. For Japan’s highly diversified companies, to compete as efficient innovators meant making clear choices what businesses to compete in, and then to restructure to focus on winning in those few businesses. For Japan as a country, the shift in formal organization came through a wholesale change in the underlying approach to law-making and regulation, as well as corporate law. The 1990s were not so much a ‘lost decade’ for Japan as one of renewal and repositioning.

Keywords: congruence model; ‘choose and focus’; Japan; political economy; profitability; strategic inflection point

Introduction

How can the ‘developmental state’ reconfigure once development has been accomplished and the competitive environment has completely changed? The rapid rise of Japan as an economic success story in the post-war period (1950s–1980s) made the country’s export-oriented growth policies a model for many other Asian nations. As Japan has struggled to revise its domestic political economy in response to global economic changes in the twenty-first century, we have gained insights into the processes of a country finding a new congruence that may also shed light on future tasks for other nations. The congruence model (Nadler and Tushman 1997, Tushman and O’Reilly 2002) hypothesizes that for an organization to be successful, an alignment of critical tasks, formal organization, people and culture is necessary. The tighter this alignment, the more successful the organization. Ironically, however, over time and with success, inertia and size also make the organization less likely to change effectively in response to disruptive technologies (O’Reilly and Tushman 2008). In the face of a major disruption, organizations must ‘unlearn’ and realign. It often takes a major crisis to increase willingness to change; it always takes strong leadership to orchestrate renewal; and it can take over a decade for the transition to be accomplished.

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This study argues that Japan underwent such a transformation between the years 1998–2006. The logic of the congruence model helps interpret Japan's 'lost decade' of the 1990s rather as one of reform and adjustment to the new global competitive environment. Staying with the business corollary, not only is Japan no longer a hungry 'startup', but the globalization of trade and the end of Japan's cost advantage in manufacturing high-quality consumer end products has rendered Japan's post-war growth strategy outdated. Thus, the critical tasks for twenty-first century Japan have to be redefined. During the post-war period, Japan's political economy was anchored on the idea of export-led growth by a set of champion industries and companies, picked and supported by a strong state system that relied on situational regulation by the bureaucracy to guide the allocation of resources. Described as a 'developmental state' system (Johnson 1982), or an 'iron triangle' set-up between the Liberal Democratic Party, bureaucracy and business, this system created strong vested interests as well as entry barriers for any type of competitor, in politics or business.

From the corporate perspective, what it took to 'win' in this industrial policy set-up was size, which was measured in sales and/or market share, as larger firms were granted easier access to government 'goodies' such as trade quotas (Abegglen and Stalk 1985). This created incentives for companies to diversify continuously, as any sale was a good sale regardless of profits. Over the four decades after WWII, Japan's largest companies morphed into unwieldy conglomerates, and investment and growth decisions were often predicated not on sound business strategy, but to scale with competitors.

A combination of factors reversed these incentives in the 1990s, in particular rising labor costs and a changing global trade regime. In the twenty-first century, facing competition by its Asian neighbors, Japanese companies have to win through higher margins based on higher rates of innovation and specialization in areas where others cannot compete. Japan's conglomerates with their large labor force, widespread 'also-run' business activities and slow bureaucracies can no longer match their Asian neighbors in mass-producing consumer end products (see Warner 2011). Globalization also coincided with the arrival of institutional and foreign investors in Japan that value profitability more than size. Moreover, the recognition that new firm entry was needed to push Japan to the next level of an affluent society cast doubt on the wisdom of ironclad business networks and running the economy on conglomerates. Deregulation and the rise of mavericks, such as in the retailing industry, were propelled by the arrival of imported goods on Japanese markets, which greatly changed the nature of competition within Japan.

The 1990s earned the nickname 'lost decade', for Japan seemed unwilling to embrace reform. One major reason why the country was slow to respond was inertia: the old system had served the country well and had created a resistance to change, perhaps due to an attitude of 'we have always done it this way' and an engrained culture of risk averseness and an unwillingness to stand out by doing some new and different. It was precisely because the system had worked so perfectly that it took so long to launch change and respond to the arrival of Taiwanese, Korean and Chinese competitors.

However, for those who saw the disruption in Japan's external environment, the 1990s became a period of transformation. The business catchphrase at the turn of the century was 'choose and focus' (*sentaku to shūchū*). This referred to a focus on the core business and the shedding of all activities that are not profitable or not central to the company's revised corporate strategy. Thus, companies needed to retrench, slim down, exit non-profitable businesses, spin off unrelated businesses, and lay off excess workers. Yet, Japan's business laws of the post-war years formed a straightjacket that did not allow for easy reorganization. It took the major crisis year of 1998 to trigger a wave of reforms aimed at

enabling Japanese firms to compete in a changed global economy through corporate repositioning.

This study chronicles this period of change from 1998–2006, and argues that the reforms were so deep and profound that they are irreversible. Therefore, this period marks a *strategic inflection* point for Japanese business. The reforms aimed at a ‘turn toward the market’ by rewriting literally all business laws, to afford companies greater liberties in strategy, and by increasing rights of shareholders and stakeholders, to heighten managerial accountability. The standing of politicians and the law and courts has increased, while that of the bureaucracies has greatly declined, as situational regulation through the ‘carrot-and-stick’ mechanisms of administrative guidance was phased out. Of course, laggards remained within business and government, as many preferred to hold on to the status quo. Vested interests are difficult to destruct in corporations, and even more so in countries. Old system vestiges and pockets of reform resistance notwithstanding, however, Japan’s reform period of 1998–2006 offers a remarkable case study of large-scale, country-based realignment.

Theory and hypotheses: congruence model

The congruence model (Nadler and Tushman 1997, Tushman and O’Reilly 2002) hypothesized that for effective implementation of a given strategy, four key organizational elements have to be fully aligned: (1) the recognition of what it takes to ‘win’, that is, the translation of corporate strategy into executable critical tasks; (2) a formal organization that incentivizes and rewards employees toward these tasks; (3) employees selected and/or trained for ability to accomplish these tasks efficiently and effectively; and (4) a corporate culture that sets strong norms and values toward these tasks. If any one of these elements is not fully aligned, the company will operate at suboptimal levels. For example, if the goal is to be a leading innovative company, yet corporate culture disallows taking action and people are rewarded for risk averseness (not making mistakes), the company will most likely fail. If a company’s success is predicated on employees making extra efforts to save costs through teamwork (helping wherever there is a need), yet if employees are not selected or trained for being team players, the company will not fare as well as it otherwise might.

Studies for the US have shown that the most successful companies stand out for purposeful alignment and constant efforts at maintaining this alignment (Southwest Airlines, IBM, Wal-Mart). This stance is a recipe for success, unless things suddenly change. New technological innovations – such as the arrival of telephony, the semiconductor, or the internet – cause punctuated equilibria that disrupt otherwise incremental growth. Whereas a good strategic alignment can be modified at the margin to respond to incremental change, a disruption of the equilibrium path typically demands a reformulation of critical tasks, which in turn requires reorganization of rewards, people and culture. The challenge is that the tighter alignment, and thus the more successful the organization in the previous setting, the more difficult the renewal and repositioning, as engrained best practices and success habits have to be altered (Harreld *et al.* 2007)

For companies, such punctuations are typically subsumed under the header ‘disruptive technologies’; for entire industries or economies, they cause ‘strategic inflection points’ (Burgelman and Grove 1996). A strategic inflection demarcates a point in time when the balance of forces shifts completely, away from previous structures to new ways of doing things, and therefore fundamentally alters the ways in which companies compete.¹ For an inflection to be strategic, it has to be irreversible.

The congruence model is typically employed to identify performance gaps in a single corporation. However, this is also helpful in guiding analysis at the much higher level of country strategy. For Japan as a country, the arrival of South Korea, Taiwan and, eventually, China as *bona fide* competitors in high-quality mass production pulled the rug away from under the post-war period strategy of large-scale manufacturing groups. Japan's success in the post-war period (1950s–1980s) was based on the strategic goals of fast export-led growth and technological catch-up with the West. This was translated into the critical tasks of: (a) government policies to support the growth of leading companies in strategic industries, to be executed by a strong bureaucracy; (b) controls of technology imports, research activities, and other corporate activities; and (c) incentives for companies to grow and employ workers on a long-term (lifetime) basis to focus government efforts on infrastructure growth policies by reducing the need to build a large-scale social security system. The idea was to catch up through hard work in producing high. Employees were rewarded for working long hours, doing precisely as told, and not causing a disruption. One result was the world's leading manufacturing system in terms of product quality and value of the twentieth century.

In organizational terms, the biggest heritage from the post-war era was a set of incentives that drove companies to grow, at any cost. Between the 1960s–1980s, when domestic markets were shielded from most foreign influence, corporate competition was primarily for access to desired items that the government controlled. Access to industrial policy allocations (trade quotas, raw materials, technology licenses) was based on industry rankings by firm size, measured in sales. Access to talent was also based on size, as the largest companies had the first-round pick of university graduates, and working for a large company was the predominant aspiration. Main banks also competed for size and supported company expansion; they were willing to tolerate very high debt levels as size was also an insurance against bankruptcy, because the lifetime employment system made companies 'too big to fail'. Size made corporate managers important players in the political economy (Fletcher 2012). Thus, aggressive growth was expected by stakeholders, supported by shareholders (other firms and banks), and pushed by government policy (Schaeде 2008, chap. 3).

Empirical studies of Japan's post-war industrial organization confirm this trend towards increasing diversification among large Japanese firms (see Goto 1981, Yoshihara *et al.* 1981, Fukui and Ushijima 2007). Onto four decades of continuously rising diversification, the bubble economy from 1987–1991 added exuberant, unrelated diversification – be that by steel companies into semiconductors and amusement parks, shipbuilders into finance, or construction firms into golf courses. Rampant unrelated diversification ultimately challenged organizational capabilities. When the bubble burst, Japanese companies found themselves with what came to be called the 'three excesses' of equity, capacity, and labor.

Research on the performance consequences of diversification for the United States has shown that whereas strategic diversification around the core competence of a company may well improve performance, unrelated diversification will decrease performance over time (Palich *et al.* 2000). As studied in a large body of research, the United States underwent a shift from diversification to focus in the 1980s (cf. Schaeде 2008, chap. 4). Major triggers for refocusing included: increased uncertainty and volatility through globalization, and a new understanding that large conglomerates were too slow in their adjustment to competitive changes; a new regulatory stance by the Reagan Administration's antitrust team that allowed within-industry consolidation; the arrival of the efficient market hypothesis in finance that shifted the previous emphasis on risk

diversification through a given company toward specialization by the company and diversification of investment portfolios; the emergence of institutional investors that hunted for profit, and of a new type of financial intermediaries such as leveraged buyout funds that specialized in bust-up deals; and the arrival of corporate raiders who increased the threat of hostile takeovers and triggered voluntary restructuring as a preemptive move. Finally, excessive diversification posed great challenges to organizational design and management: the larger the organization, the more likely are internal resource allocations are subjected to opportunism, bureaucracy, corporate politics and similar obstacles of human nature that undermine the initial efficiency consequences of the multi-product firm (Williamson 1975, 1985). Business units that should have been shut down were not, due to vested interests, and new businesses in unrelated areas were opened to reward successful managers.

A very similar scenario played itself out in Japan in the 1990s. Globalization undermined the previous advantages associated with size; the arrival of foreign investors in Japan during the 1990s banking crisis (including institutional investors and private equity and hedge funds) shifted managerial attention toward profitability; and the large flagship concerns of the Old Japan were bogged down by politics, vested interests, and an inability to react to the new challenges of the 1990s. As a result of encrusted structures and restrictions on laying off workers, restructuring or reorganizing, the average profitability of Japanese stock exchange-listed companies showed a continuing decline. Figure 1 shows the unweighted average of several profitability indicators for 1414 companies listed on the Tokyo Stock Exchange without interruption between 1980–2009 (author's calculation based on Nikkei Needs data, unconsolidated, 1980–2009). Return on assets declined from an average of 10% in the 1980s to approximately 3%; operating profit and ordinary profit (operating and ordinary income, respectively, over revenues) fell from an average of 7% to 3.5%; and return on equity, showing high variation over time, has hovered below the 5%

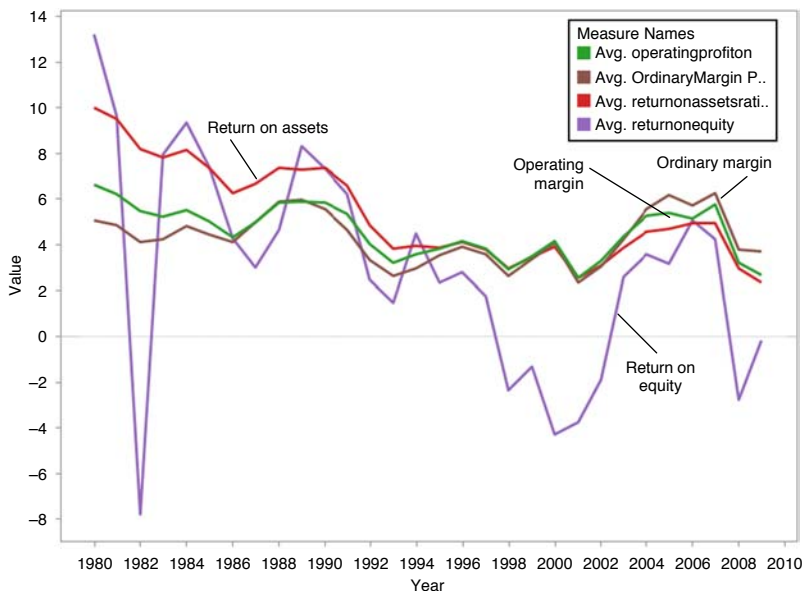


Figure 1. Average profitability data by listed Japanese companies, 1980–2009. Note: ROE data for 1982 are an outlier due to a reporting inconsistency. Source: Constructed from the Nikkei Needs database, unconsolidated, for 1414 companies listed in all 30 years.

line since the 1990s. In international comparison, these are dismal numbers. About one quarter of all listed companies earned no profits at all during the 2000s, even though the years 2003–2007 marked the longest boom period in Japanese record-keeping history. Japan had stopped growing, and it stopped being successful at what it was doing. The strategic goal of the post-war period developmental state was no longer accomplishable. The crisis of the 1990s forced Japan toward strategic repositioning.

Applying the congruence model to the situation of Japanese companies, and of Japan's economy overall, *we can hypothesize that for change to result in a new viable system, it needs to occur at a number of levels.*

- First, to survive against Asian competitors, Japanese companies have to reposition strategically into higher margin sectors, that is, they have to focus on technological leadership. This requires a reformulation of critical tasks toward innovation, risk-taking and individual contribution.
- Second, this means employees (and at the higher level, companies) have to be rewarded for the true contribution they make, not just for being there or being large. This requires people (and companies) to think on their own feet, as opposed to walking lockstep toward the previous goal of export-led growth or 'also-run'.
- Finally, culture (norms and values) need to shift to an emphasis on individual contribution, variety and risk-taking. For companies with over 100,000 employees such a shift can easily take a decade; for a country it may take a generation.

In what follows, I argue that the 1990s laid the groundwork for precisely this transition. Because this transition is far from being completed, this contribution discusses the accomplishment made, as of 2011, in the first step, strategic refocusing. An analysis of changing employment patterns, and the societal shift toward individualism, performance pay and growing income differentials, as well as individual career paths and work-life balance are left for further research.

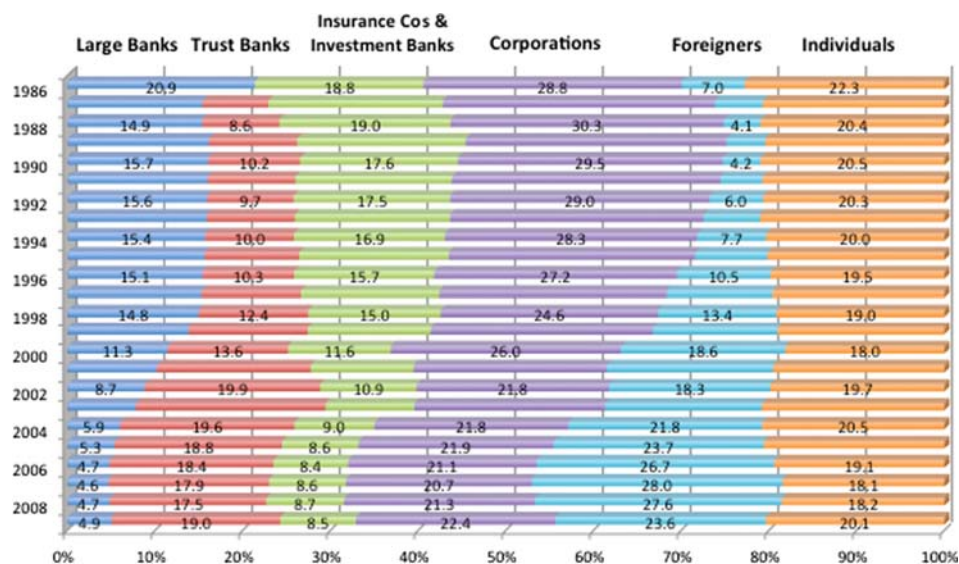


Figure 2. Ownership percentages, by type of investor. Source: TSE (2009); in percentage of total market capitalization, as of March each year.

The 1998 tipping point

Performance struggles by Japan's largest companies were exacerbated by three events that came together in the 1990s: globalization, the banking crisis, and social distress. Thus, the 1990s became a decade of repositioning and renewal, for the crisis was exploited by Prime Ministers Hashimoto (1996–1998) and Koizumi (2001–2006) to push for fundamental reforms in the corporate sector.

Globalization and new owners

Globalization occurs at four different levels: in manufacturing as separate from finance, and flowing out of an economy ('in-out' foreign direct investment, for example) as well as flowing in ('out-in'). Japanese manufacturing had begun moving abroad in full speed during the 1980s, when globalization was discussed in terms of how the location of manufacturing elsewhere affected domestic industries, and this trend continued into the twenty-first century. However, until the 1990s, domestic markets remained relatively shielded, both in manufacturing and finance.

In the 1990s, however, globalization hit Japan's domestic markets with full force. By 2004, the import penetration ratio in manufactured goods had doubled from the previous 7% of total sales to 13% (CAO 2004, figure 3-2-1). Suddenly, price competition reached intermediate product markets, just as a shift to global parts procurement threatened previously tight-knit subcontractor relations.

In financial markets, in 1998 the old 'Foreign Exchange and Foreign Trade Control Law' was replaced by a new 'Foreign Exchange Law' that liberalized cross-border financial transactions and removed most of the remaining barriers to investment in Japanese companies. This facilitated entry for foreign equity funds and other investors that had developed an appetite for assets sold by Japanese banks cleaning up their bad loans, with fire sales of golf courses, hotels and office buildings. Figure 2 shows that the percentage of foreign ownership in companies listed in the first section of the Tokyo Stock Exchange (TSE) more than quintupled, from 5% in 1991 to 28% in 2008. More than 50 of the leading TSE-listed companies had foreign ownership exceeding 50%. The fact that a significant portion of foreign investments were sourced from within Japan only underscores that strategies pursuing higher return on investment had become popular, at the expense of the post-war period of long-term stable intergroup shareholdings.

At the same time, the share held by trust banks – institutional investors that act as custodians for investment funds, pension funds, and so forth – doubled from less than 10% to 19%. Trust banks include investment and pension funds as well as so-called 're-trusts', wholesale investors that administer corporate pensions and other large-scale funds. In other words, these are newly emerging institutional investors that compete, in the final analysis, through higher returns on investment. Thus, Japan's combined share of institutional investors interested in superior corporate profitability increased from about 20% in 1996 to 47% in 2006. No Japanese manager could afford to ignore this new investor category.

Banking crisis

The collapse of Japan's bubble economy (1987–1991) caused a serious banking crisis in the mid-1990s. Scandals that had begun at commercial and investment banks engulfed the bureaucracy in 1995. In 1997, another round of widespread bank accounting fraud eventually revealed the true extent of the non-performing loan crisis and the abysmal

situation of the financial system (Hoshi and Kashyap 2001, Amyx 2004). Bank failures began in 1995 and culminated, in November 1997, in the collapse of a first-tier bank and a leading investment bank. And while the Asian financial crisis of 1997 did not hit Japan directly, it caused great losses for Japanese banks actively involved in Asian trade finance and investment.

In rapid succession, more trouble came to the fore. In September 1998, the collapse of Japanese Leasing, a subsidiary of the Long-Term Credit Bank, with debt of ¥2.2 trillion (almost \$20 billion) was the biggest failure of a Japanese firm to that date. A month later, the government nationalized LTCB and another specialized long-term credit bank that had been main contributors to the post-war growth plan (later sold to foreign funds and restructured into Shinsei and Aozora Banks). The banking crisis was so severe that between March 1998 and March 1999, the government had to infuse ¥9.3 trillion (about \$90 billion) into the largest banks (Hoshi and Kashyap 2001, Takeuchi 2003). A revision of the antitrust restriction on holding companies allowed large banks to merge, and major consolidation reduced the number of leading banks from 13 to four.

Long planned by former Prime Minister Hashimoto, 1998 also was also the year of the financial 'Big Bang'. This reform package brought a revision of almost all laws relating to the financial industry, in particular accounting and disclosure. Mandatory consolidated reporting meant that banks and corporations could no longer hide their non-performing loans in undisclosed subsidiaries, and cross-subsidization within diversified companies also had to be declared. It is difficult to exaggerate the implications of this reform, for it invalidated the financial advantage of building large conglomerates. A company's core and affiliated

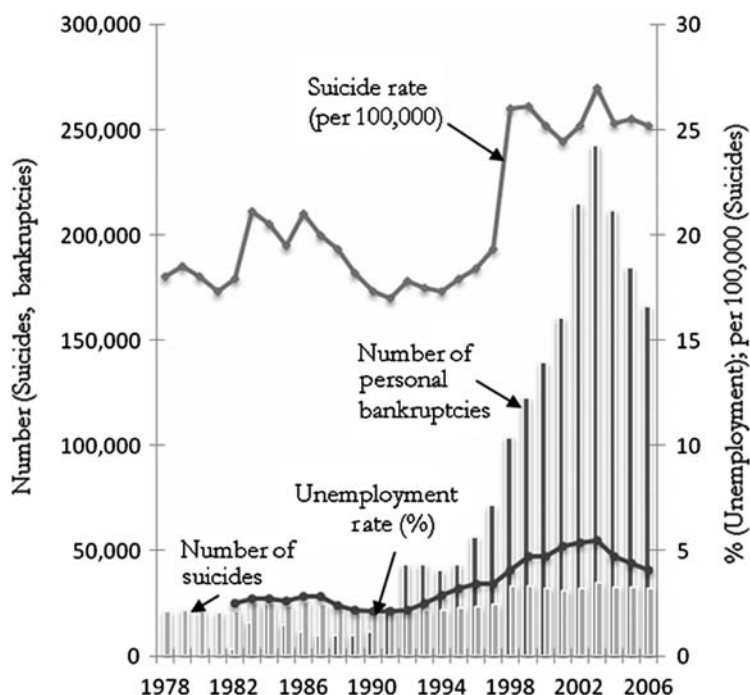


Figure 3. Unemployment, personal bankruptcy, and the suicide rate, 1955–2004. Sources: www.stat.go.jp/data/roudou/2.htm, <http://www.npa.go.jp/toukei/index.htm>, <http://www.courts.go.jp/search/jtsp0010?>

businesses and their separate performances were now regularly reported, finally allowing a meaningful evaluation and comparison of the financial health of Japanese companies.

In the mid-1990s, scandals involving ministry officials led to first revisions of administrative guidance that placed stricter limits on personal connections between firms and ministries. In 1998, the Ministry of Finance was stripped of most of its supervisory role in the financial sector. In its stead, the newly created Financial Services Agency (FSA) soon became a prime example of how regulatory processes had begun to change. For the first time, the 1999 'Inspection Manual' introduced a detailed and binding rulebook on bank inspections. In defining what constituted a 'non-performing loan', the FSA wiped out decades of banks' convenient self-reporting. The banking crisis afforded the FSA heightened authority, as banks were facing failure and the government's capital infusion had triggered public scrutiny.² In 2002, Prime Minister Koizumi issued an aggressive program for structural change, based on financial system reform and the clean-up of non-performing loans by 2004. This was indeed accomplished, as the ratio of non-performing loans at major banks declined from 8.4% in 2002, to 2.9% in 2005. Even though problems remained at the smaller banks, by 2006 the loan portfolios of Japan's major banks had improved and profits had resumed.

Social crisis

Unprecedented social crisis in the late 1990s showed that post-war period policy tools had been rendered ineffective in addressing the new economic hardship and social suffering. In 1998, indicators of social distress all hit new record highs, including unemployment, bankruptcies by small firms, homelessness, crime, divorce rates, child abuse, and suicides (see Figure 3). Remarkably, these social indicators were directly related to economic hardship. A US–Japan comparison of the relation between economic data (growth, unemployment) and private distress (personal debt, bankruptcy, suicide) showed a much more direct association for Japan than for the US (Schaele 2006). This was attributed to the fact that during the post-war period Japan had little need for comprehensive government programs of unemployment support, public assistance and poverty relief. During the years of post-war economic growth, building a system of long-term unemployment insurance was not considered necessary given the system of lifetime employment, and the working poor had usually been able to find jobs. Families were expected to be the first and last resort for people in need but in the 1990s, families often found themselves unable to help. For Japan, one of the most affluent countries in the world that prides itself of social stability and security, these shocking events increased the general willingness to embark on drastic change.

Japan's strategic inflection, 1998–2006

As the domestic crisis increased eagerness to 'do something', and external changes and the continuing recession required that 'something be done', a window of opportunity for true reform in the business sector opened up. Between 1998–2006, Japan underwent changes in laws and regulation, regulatory processes, and domestic and global competition so fundamental that these define a strategic inflection point.

Regulatory change: post-remedy regulation and 'leave it to the market'

Even though Prime Minister Koizumi made postal privatization his major platform – and later was evaluated based mainly on that one initiative – it is in denouncing risk

socialization, and not intervening in the bankruptcies of a number of large failing firms, that he made his mark with the reforms ‘toward the market’. His line ‘leave to the private sector what the private sector can do’ (*minkan ni dekiru koto wa minkan ni yudaneru*) became the core message of the 2002 Financial Revival Program, and his relentless insistence convinced business that they could no longer sit and wait for the government to bail them out (Koizumi 2002). Throughout the post-war period, companies had hedged against failure by asking for approval from the regulating ministry, to count on that ministry for support should the investment run afoul. This exchange of information was private and closely-held, greatly empowering the ministries. Koizumi’s new stance curbed this informal decision-making, transferring the discussion of business decisions to companies and their shareholders, and leaving ministries with open and transparent regulatory decision-making powers. As one official of the Ministry of the Economy, Trade and Industry (METI) put it in an anonymous interview in 2007, ‘It is no longer fun to be a METI official.’

One foundation for this shift ‘toward the market’ through privatization, deregulation, and clear corporate accountability was the 2001 government reorganization. In addition to a streamlining of ministries to reduce the size of government and clarify responsibilities, this reform concentrated decision-making power in the Prime Minister’s Office. A strong prime minister – such as Koizumi between 2001–2006 – could now pull reform deliberation away from the ministries and into his own discussion group, the Council on Economic and Fiscal Policy (CEFP), thus curtailing the role of ministries in the policy-making process. During the post-war period, ministry-based deliberation councils (*shingikai*) had played an important role in reinforcing the power of the various ministries and their vested industry interests (Schwartz 1998, von Staden 2012). A council’s final report was often written by bureaucrats and frequently turned into law. Under the new system, the Prime Minister, who is also a member of the CEFP, can choose to pull a policy deliberation away from the ministry to open it for broader discussion, thereby overriding vested interests.

Situational regulation was further reduced with the 1998 revocation of controls over foreign trade through the new Foreign Exchange Law, and the phasing out of a series of specialized industry laws. The post-war system had placed great emphasis on entry regulation, whereby the regulator (the ministry in charge, which was also tasked with protecting and nurturing an industry) decided which companies were allowed to engage in what business activities. Process regulation – the monitoring of firms once they were ‘in’ – had been left to informal agreements, implemented through frequent contacts between companies and ministries (Schaeде 2000, 2003). An important tool of informal regulation was administrative guidance, which allowed for situational application as it rested on a carrot-and-stick mechanism. Those who cooperated were rewarded whereas mavericks were punished. In addition to entry licenses and permits in the ministries’ discretion, until the 1980s the Ministry of Economics, Trade and Industry greatly relied on trade controls to evoke business cooperation in informal *quid pro quo* regulation. Removing these controls deprived the ministries of their most powerful carrots.

These changes were followed by a series of other new laws that shifted the regulatory focus away from the actor (an industry or company) and toward the action itself (a market or transaction). This de-personalized the act of regulation and undercut the value of personal relations among businesses and bureaucrats, which had been the core of ministerial power in the post-war period. The post-war period informal regulatory processes, based on the fact that a ministry in charge of nurturing an industry was also tasked with its regulation, was undermined by a shift to legal processes and a turn to the courts.

This transition came with a fundamental reorientation in Japan's legal philosophy. Japanese corporate law, as it existed through the 1990s, dated back to nineteenth century Civil Law logic of 'pre-regulation': if not explicitly spelled out in a law, an activity was not allowed. For corporations, the law outlined most corporate activities *ex ante* and imposed detailed restrictions on management, while also reducing the threat for managers to be held liable by shareholders. However, the inherent limitations had become too much of an obstacle for reform, and in 2001 the Ministry of Justice announced a reorientation toward a 'post-remedy' approach, as used in Common Law countries, under which everything is possible unless it is specifically prohibited (Ministry of Justice 2001). Corporate law was to be the test case for this new approach to law-writing.

As Milhaupt and Pistor (2008) argue, the practical differences between common and civil law applications are not nearly as stark as typically characterized. In reality, codes are insufficiently specific, making the courts' interpretations powerful in shaping corporate rules. Rather, the critical difference between pre- and post-regulation lies in the incentives they offer to invest in legal innovation, and the access they provide to lawmaking. A corporate example of this is stock options. In the US with a common-law approach, a company can freely issue a right, written as a simple document; the financial, accounting and legal ramifications of this document are to be decided by the courts later. Thus, the company has just influenced law design. In contrast, civil law systems used to have no room for a stock option, so companies could not just introduce them; rather, they either had to develop functional equivalents (such as perquisites), or they had to lobby politicians to rewrite the law.

Japan's switch to post-remedy adjudication was cemented in easier access to the courts, by streamlining court processes, reducing fees, and helping courts specialize in certain areas such as bankruptcy. Both have resulted in a new demand for law in Japan. What this means is a shift away from centralized lawmaking as well as away from post-war informal problem resolution – both between regulators and companies, and among companies – and towards a larger circle of participants and therefore a market for ideas and innovation in the legal process.

Corporate change: reorganization and restructuring

The biggest challenge faced by proactive companies that aimed to address the 'three excesses' of the bubble economy – equity, capacity, and labor – and adjust to the new global competitive environment was a lack of structure for the processes of corporate reorganization. The tipping point of 1998 had brought to the fore the need for large companies to 'choose and focus' in order to compete more nimbly against rising competitors in Asia. 'Choose' meant the identification of core businesses in which to compete and 'focus' meant concentrating corporate resources in these few business segments, and exiting all non-core activities – be that through shutting down business units, spinning them out into independent small companies, or selling them off to competitors or hedge funds.

Beginning in 1997, Japan began to revise the Commercial Code annually for a decade, until, in 2006, the new Corporation Law (*Kaisha-hō*) superseded previous laws regarding company creation, restructuring, and corporate governance. Related laws such as those on labor, finance, taxation, and bankruptcy were also amended at a rapid rate. Reflecting the new legal philosophy of post-remedy adjudication, these revisions increased managerial flexibility and choice but also brought new regulations toward a level playing field, particularly in the form of transparency and accountability. In the decade following 1998, Japan literally revised every single law pertaining to commerce, and in the process

succeeded in clarifying and concretizing the legal situation. As a result, somebody who knew Japan well in the 1980s but has not looked since might not recognize the new legal environment (for a list of legal changes in this period, see Schaeде 2008, pp. 34–35).

While these laws enabled change, new accounting rules pushed for reorganization beginning in 2000. In particular, mandatory consolidated accounting raised the cost of carrying non-performing subsidiaries, which suddenly reduced profitability data, forcing a move to refocusing even in slow reformers. Moreover, companies had to report mark-to-market valuations (as opposed to book or purchase prices) of their assets. Whereas those who had acquired assets in the early post-war period could report a windfall gain by switching to present values, most companies had bought shares and real estate during the bubble period. If they did not want to report huge losses, they needed to sell these off. Beginning in 2001, mark-to-market valuation also applied to cross-shareholdings, which contributed greatly to the unraveling of cross-shareholdings (Schaeде 2008, chap. 5).

Pressure on banks to clean up non-performing loans increased demand for easier ways ‘out’, such as through bankruptcy-based restructuring and outright liquidation. In the post-war period, banks had addressed business failures by working out informal debt restructuring that left the loans on the books, to be covered by loss reserves taken from bank profits. The goal was to save the company and recoup the loans in the long run, all the while maintaining employment; the government had been very supportive of such rescue operations. However, several large-scale bankruptcies in the late 1990s were a harbinger that the government had revised its stance on the ‘too-big-to-fail’ rule, and Koizumi’s end of business risk socialization greatly affected turnaround strategies. Moreover, most banks could no longer afford to bail out failing clients, as bank profits were too slim to cover loss reverses. The main bank system of old, with its quasi-automated rescue function for all clients, had come to an end (Hoshi *et al.* 2011).

Instead, in order to clean up their non-performing loan portfolio expeditiously, banks switched to direct bad-loan disposals, whereby the bank suffers a one-time extraordinary loss, then initiates bankruptcy procedures or a turnaround event, and sells off non-core assets. To facilitate such actions, the 2000 Civil Rehabilitation Law (*Minji saisei-hō*) replaced a clumsy and rarely used law of 1927 to design new bankruptcy procedures for corporations and individuals. In 2003, the revised Corporate Reorganization Law (*Kaisha kōsei-hō*) allowed ‘Chapter 11’-type turnarounds adjudicated in courts. Moreover, a 2001 Guideline for Out-of-Court Workouts addressed bank-led workouts by stipulating how debt forgiveness should be organized in cases with multiple lenders but uncertain claims (Takeuchi 2003, Higashino 2004a). In 2004, the old Liquidation Law (*Hasan-hō*) was revised to simplify legal procedures for shutdown and fair distribution of assets.

To facilitate reorganization and increase speed in liquidation, court reforms allowed banks and companies to file a reorganization petition with a court in Tokyo or Osaka even if the failing firm or its lenders are located elsewhere. These two district courts established special reorganization departments to handle bankruptcy cases promptly and efficiently. Data by Teikoku Databank show that bankruptcy procedures skyrocketed with the adoption of these measures. In the period between April 2000 and March 2005, a total of 86,972 bankruptcies were reported (with liabilities of ¥73 trillion), the vast majority of which were under the Corporate Reorganization Law (see Takagi 2003).

Short of shutting down a non-profitable business unit, companies could spin it out or sell it off. Between 1998–2000 laws were rewritten to facilitate mergers and acquisitions (M&A), as well as spin-offs. New stock swap and stock transfer systems allowed companies to sell off parts of the organization or merge with another firm through a stock swap. Companies were allowed to repurchase their own stock (to reduce excess equity

generated during the bubble period), and a 2001 revision lifted restrictions on what companies could do with their own 'treasury stock', including allowing stock swaps to acquire other companies. In addition to deregulating stock options, the introduction of new stock categories and new rules on transactions offered unprecedented flexibility in refinancing, compensation, corporate restructuring, and takeover defense. Together with the lifting of the ban on holding companies in 1997, this opened new venues for companies to reorganize. Subsequent reforms offered a new set of deals in terms of asset transfers, leveraged or management buyouts and takeovers (Hashimoto 2002, Higashino 2004a, 2004b). New rules on internal oversight made members of the Board of Directors liable for mismanagement and increased pressures to attach clear responsibilities to business units. Companies can now think strategically about their business portfolio – which business units to keep, which to spin off, and which to close down – and then execute these strategies in completely new ways.

As part of its Revival Program, the Koizumi government also began to revise labor rules. Prior to 2000, a spin-off or transfer of operations required the consent of labor, yet workers often resisted because in Japan smaller companies tend to pay significantly lower wages. In addition, around 2000, the courts softened their stance on what constituted a 'fair' dismissal of a regular employee, by allowing that one of four conditions (as opposed to all four) was sufficient grounds: the company was in distress, the person to be dismissed was incompetent, part-time workers had already been cut, and the unions had agreed. Previously, fulfilling all four conditions meant, for example, that a company had to be facing bankruptcy before it could let go of ineffective workers; now companies could reduce employees for proactive adjustment measures, to prevent bankruptcy (Schaeede 2008, chap. 9). While it is still difficult to dismiss workers in Japan, it is no longer impossible. This shift undermined previous expectations of work relations and began a long-term change in the social contract between the government, companies and employees that is likely to extend for a generation.³

New legislation also aimed to open the door for hostile takeovers. These had long been hindered by cross-shareholdings and a lack of rules regarding minority owners. New rules beginning in 2000, which were further revised and codified in the Corporation Law of 2006, allow for a 'squeeze-out' in which minority owners must submit their stakes if the takeover is offered at a fair price. In contrast to other countries, the threshold where such a squeeze-out can begin in Japan may in some cases be as low as 66% of ownership, even though 85% may be the more usual boundary (Nakayama 2010). Suddenly, the Old Japan horizontal business groups (*keiretsu*) where each member owned a small stake in each other no longer offered reliable protection against raiders. This further undermined the logic of cross-shareholdings. To allow companies to search for different measures of protection – similar to those granted in the US and Europe – the Ministry of Justice and METI released a Takeover Guideline in 2005 that validated a 'poison pill' (a mechanism that makes a hostile bid prohibitively expensive) in the form of new warrant issues that dilute the raider's stake (Milhaupt 2005, CVSG 2006). This Guideline was incorporated into the new Corporation Law of 2006, and it clarified the rights of owners in defense situations by giving shareholders a choice to issue a *carte blanche* for such mechanisms, or to insist on ratification each time new defense schemes are introduced.

One concern at the time was that Japanese firms would use the new hostile takeover guideline to formulate a plethora of defense mechanisms. However, whereas a poll of June 2006 revealed that 27% of listed companies were considering the introduction of such measures – by October 2007, only some 10% of listed firms had in fact adopted poison-pills (*Nikkei* 19 June 2006, 15 October 2007). Perhaps most importantly, the possibility of

hostile takeovers in and of itself pushed management towards ‘choose and focus’. In addition to pressure to maintain stock price and market cap at a high level, the best defense against a hostile takeover is to do by oneself what an incoming raider would do to an underperforming company: replace ineffective management, revise the business model, and improve performance. Thus, the mere threat of a hostile takeover greatly increased managerial discipline.

In 2007, the new Financial Instruments and Exchange Law (FIEL, *Kinyū shōhin torihiki-hō*) greatly revised regulations on corporate disclosure, internal auditing and compliance, in addition to governing financial transactions and disclosure associated with takeover bids. Perhaps the biggest contribution of this law to the strategic inflection point was to further push for transparency and managerial accountability. First, it made quarterly earnings reports statutory for all listed companies. Second, it contained a section referred to as ‘J-SOX’ – the Japanese version of the US Sarbanes-Oxley Act that prescribes internal controls and independent audits, including liability of members of the board of directors (FSA 2006, Konishi and Shimizu 2006).

Other legal revisions in line with ‘leaving it to the market’ included reforms of antitrust (to enforce cartel rules more forcefully), intellectual property rights, and company formation rules in an effort to spur venture activities (Schaeде 2008). At the end of the decade-long process, the legal and financial setting within which Japanese companies operate had completely changed. The new settings undercut previous sources of power (such as personal networks, access to regulators, and company size), and demand a new skill set of management leadership, clear strategic positioning, and the pursuit of long-term profit.

Implications

As Figure 2 showed, whereas in the 1980s some 75% of shares at the Tokyo Stock Exchange were held by stable, friendly shareholders such as banks and corporations, by 2008 almost 50% of shares were owned by institutional (including foreign) investors. For better or worse, these new investors are much more short-term oriented than the previous stable shareholders: they will buy high-performing stocks that raise their return on investment over that of other funds but they are likely to sell low-performing stocks, thereby depressing a company’s stock price and increasing the threat of a takeover. To impress these investors, Japan’s leading large conglomerates embarked on a slimming-down diet. While an easy first step to increase profitability was to simply exit non-profitable businesses, the most aggressive reformers, such as Panasonic, completely reorganized their core businesses and shed hundreds of subsidiaries.

This refocusing on the core businesses occurred through three main measures: (a) reorganizing the company to create clear profit and loss centers around the core businesses; (b) strengthening the core by consolidating with (acquiring) competitors; and (c) exiting non-core businesses. During the refocusing wave of the 1980s in the United States, it was estimated that about half of the country’s Fortune 500 firms engaged in at least one of these activities (Markides 1995). To evaluate the extent of Japanese refocusing, Schaeде (2008) counted activities in these three categories by Japan’s Nikkei 500 firms during 2000–2006. During that period, 75% of Japanese companies declared at least one act of corporate reorganization, consolidation, or exit. One third of Japan’s leading firms adopted multiple measures of ‘choose and focus’, such as turning the company into a holding (to focus the business units as stand-alone companies), merging non-core units with a competitors’ entity, or selling off or shutting down activities no

longer considered relevant. Thus, just in terms of simple numbers the Japanese refocusing wave of the early 2000s was perhaps even larger than that in the US in the 1980s.

Of course, not all Japanese companies were eager reformers. Many laggards remained, even among the large Japanese household names, and cultural reasons were often cited to explain their unwillingness or inability to move beyond a mere lip service of 'choose and focus'. One common obstacle was the long-standing HR practice of appointing to the president position of a subsidiary those managers that were not promoted into top ranks at the mother company. These presidents of subsidiaries were often classmates of the managers at the mother company, and given limited mobility in Japan's executive labor market, it was allegedly difficult to close down businesses run by classmates. Thus, while some large companies charged ahead and completely repositioned, others stumbled along, often faring exceedingly poorly.

The plurality in how Japanese companies have reacted to the strategic inflection point can be explained with the help of the congruence model, applied to both the corporate and country level. The most basic insight is that the transition from an existing alignment to a new one is a time-consuming process. Even though Figure 1 above showed a strong upward trend in average profitability of listed firms for the early 2000s, so far systemic empirical studies of the effects of 'choose and focus' have found either no increase in average profit indicators, or remained ambiguous (Asaba 2006). This is not surprising. First, average profit data may be misleading, as for every proactively refocusing company there was at least one slow mover. More importantly, these studies used data only until 2002, and better results can be expected from future research. This is because true organizational renewal entails more than simply spinning off non-profitable business units. In order to translate strategic repositioning and new critical tasks into results, formal organization, people and culture have to be realigned, and for large organizations this process can last well over one decade.

Another insight gained from the application of the congruence model is that strategic positioning alone will not bring true change, and not all companies may appreciate this or go at it at the same pace. The first step, of course, must be the identification of new critical tasks. With the possible exception of a handful of industries, for most Japanese manufacturing companies the assignment can no longer be to mass-produce high-quality end products. Rather they must compete in upstream components and materials that earn higher margins, and feed into intermediate products made in Taiwan and South Korea, which in turn feed into end products assembled in China. The only way for Japanese manufacturers to earn profits in competition with Asian countries is through technology leadership and constant innovation. This insight has led competitive companies to change their human resource management practices: rewards had to shift from working hard to working efficiently and effectively; people had to be selected for individual talent as opposed to not making mistakes; and culture had to change to speed and risk-taking. The celebrated turnaround president of Panasonic, Kunio Nakamura, described the changes in his company as akin to a 'cultural revolution'. A full evaluation of Japan's 'choose and focus' wave will have to be based on data after 2010.

Finally, the application of the congruence model to Japan as a country reveals that an even longer wait is necessary, as a repositioning here may require a generational change. For Japan, the critical tasks have shifted from fast export-led growth and catching up with the West, to building structures that support a rapidly ageing society and a shrinking workforce, at a time when government debt exceeds 200% of GDP. Rather than interfering with corporate strategies, like the erstwhile developmental state used to do, the new government role is to build a level playing field that supports innovation and new company

formation while refocusing on societal tasks. The country culture has to shift away from expecting government to socialize risk, and toward a system that supports individual effort and variation, be that in career or pension planning. Given the shrinking workforce, people have to be more efficient to earn the revenues needed to support the country, and rewards in society are shifting towards career differentiation, work-life balance, and a new appreciation for risk and return. Japan's society will adjust to these new tasks much more slowly than even the largest companies, but it is already apparent that the next generation of workers is undergoing this change. Voices that doubt the glory of the fabled 'salary-man' work ethic have become louder; societal and family structures are changing; and the lockstep motion of Japan's society, perhaps always exaggerated, is visibly breaking open. This is not easy, as underscored by the vivid discourse within Japan of the increasingly 'unequal society' (*kakusa shakai*, the growing differential between the rich and poor) of the early 2000s. As of 2010, even though at the corporate level the strategic inflection point has irreversibly occurred, it may take Japan as a country another decade to make this transition.

Conclusions

The stronger the alignment between critical tasks, formal organization, people and culture, the more successful is the organization, yet the more difficult it is to change. In the 1990s, global shifts in the competitive environment and the replacement of Japan as the world leader in mass-manufacturing high-quality consumer goods by China, Taiwan and South Korea brought an end to the 'developmental state' model. In the twenty-first century, Japan must compete through technological leadership. To enable Japan's companies to 'choose and focus' on innovation in materials and components, the country as a whole needed to realign (see Warner 2011). The legal system, regulatory processes and incentives for people and companies in the political economy have been overhauled. Corporate ownership structures and business networks have changed. What it takes to win in the New Japan is fundamentally different from what it took in the post-war period, and it requires a shift to new motivations, processes and strategic approaches, for individuals, corporations and the country as a whole. The 1990s were not a lost decade for Japan but a painful realignment away from old, successful habits toward new and still emerging processes.

As of 2010, Japan is still in the progress of repositioning, both at the corporate level and as a country. The reforms of the 1990s and early 2000s have allowed forward-looking companies to change into new world competitors. These companies are world leaders in electronic components and input materials that other Asian companies cannot mimic. According to one study, even though Japan has relinquished its erstwhile dominant position in high-end consumer electronics end products, Japanese companies combine to a dominant world market share in components needed to make those products (METI *et al.* 2005). As of 2010, the contribution to overall economic activity by these leading firms was still fairly small. To unleash the energy that exists in Japan's entrepreneurial firms, the country as a whole has to find a new alignment.

Notes

1. In mathematics, an inflection point is reached when the first derivative (the slope of the trajectory) becomes zero, and the second trajectory (the rate of change) reverses its sign.
2. The FSA published inspection results on the internet, including the difference with the banks' own claims. Initially, the 15 largest banks understated non-performing loans by 36% (five banks

underreported by more than 50%). Yet, by 2002, average underreporting had declined to 5.5%. See FSA Sept 16, 2004, press release, available from: www.fsa.go.jp/news/newse/e20040916-1.html

3. By 2008, 80% of Japan's listed companies had switched to performance pay and promotion, and perhaps half of these used promotions as outright incentives to attract and retain talent. See Schaede (2008) for an analysis of changing employment practices in the context of Japan's strategic inflection point until 2008.

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