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Japanese Managerial Style as a Function of Real Economic Pressure and Successful Long Term Strategies
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The premise of my discussion is going to be that over the past twenty-five or thirty years, Japan has not revoked the laws of economics, and that basically Japanese management is a logical response to specific economic circumstances. We should not get caught up in the fact that Japan is different or that it is a cultural anomaly.

If we look at Japan shortly after the war, we basically see a country that had several million people coming in, so it had a large population with high unemployment. About 50% of the population had gone back to agriculture. It had a very weakened industrial base, but all of those people had to be fed. How was that going to be done? It did not take too much sense to realize that they were going to have to build up that base. The way they went about this was to use the light industry (manufacturing textiles and handicrafts) which was labor intensive, exported those goods, and used those exports to pay for imports. Actually, they did not have to export; they had to import because they needed food and raw materials. That was sort of a short-term solution. The government realized however, that in the long term, if they wanted to improve the industrial base and raise the standard of living, they would have to move out of light industry into heavier industry such as steel and shipbuilding. The reason they went into shipbuilding, of course, was that they had to import food and raw materials. If they had to buy and ship all of those goods, that would use up all of the foreign exchange, which they did not have. Shipbuilding uses a lot of steel, so those two things kind of held together. They also decided to develop coal because you can use that in steel and power, and finally, they developed fertilizers to improve food production. The reason why they wanted to develop fertilizers was because that was a way of getting the people out of agriculture and into industry. By raising the productivity of agriculture and helping to reduce the food import requirement, foreign exchange would also be saved. Japan was also helped out by the Korean War, as they started selling a lot of things to the Americans, which aided them in getting over the first economic hurdle.

After the Korean War, everyone was expecting a big drop in the economy, which did not occur. The reason it did not happen was because there was so much pent-up domestic demand that the economy just kept right on going. They continued to invest in steel, shipbuilding, power, and so on. In order to make this work, the Government set up all kinds of special incentives such as tax incentives, investment tax credits, and special loans at Government Banks. Besides offering special loans at Government banks, the city banks were encouraged to give loans. Thus, there were two sources for obtaining financial assistance. The reason why businesses had to borrow was because they did not have any capital left after the war. There had been a high rate of inflation, and all of the equity was basically wiped out. Therefore, the only place that they could go was to the Government or the banks. As a result, this led to the highly leveraged debt structure which we have seen in Japanese companies, particularly in heavy industry. So again, we see that this was management response to the circumstances that they had found themselves in. One of the consequences of this high degree of leverage was that it meant that most of their capital was debt capital. Because interest rates are tax deductible in Japan, this was actually a cheaper form of financing than equity capital. Further, if they were to have a down turn in the economy, normally interest rates would drop. With this high degree of leverage, their capital costs would also drop in the down turn, enabling them to price more aggressively to keep their markets. Then of course, when the economy picked up, the interest rates would tend to rise, and the companies could afford to pay for it because of the existing strong market. It is obvious why this structure was very attractive to firms. They also tended to maintain it, even when they did not have to anymore—in other words, when they could have gone out and tried to develop the equity market, and so on. In Japan, they also have the peculiar situation in which the stockmarket practice is such that people are issued their shares at par and they are paid a fixed rate of return against the par value. This has made equity financing even more expensive, encouraging the Japanese businessmen to keep their highly leveraged position.

Now, one of the other peculiarities that we have noticed in Japanese firms is the so called "permanent employment system." In this system, people are hired directly out of school, go to work for an organization, and remain with that organization for the rest of their lives until they retire. This, incidentally, only applies to very large firms, and of course most of the people in this

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room are either competing against or trying to attract very large firms to invest in their town or whatever. This is in fact, the kind of people you are dealing with. In numerical terms however, that only represents about 30% of the labor force. The rest of the labor force is not under the permanent employment system. The other 70% is very mobile, like what we might expect to find in the United States. This structure leads to a lot of flexibility because you have large firms with their permanent employment systems buying from smaller firms, all of whom have more flexibility in their employment systems. So, when the large firms get in trouble, the managers merely cut back on their orders from the small firms, and the people employed in the small firms are laid off. So, as can be seen, these large firms have an interest rate cushion and the labor subcontracting cushion described above. In addition, in the shipbuilding industry and in the steel industry, the whole labor force was not permanently employed. Many of them were so called “temporary employees,” which could be let go whenever needed. So there is a cushion there too. But from the perspective of the large firms, what they found was that the economy went along. The only time that it ever lagged was on an upward trend line, when the managers had to worry about issues related to balance of payments or prices, when the Government would cut down on money availability because imports were exeeding exports or prices were rising too rapidly. They went about this by raising interest rates, making capital less available, therefore putting the breaks on the economy.

The managers of large firms felt that such conditions were not going to last for very long. So, what were the advantages to them of having a permanent employment system? First of all, when this whole thing started to pick up again they would not have to go through the difficult process of trying to hire experienced workers again. In addition, from the managerial side, if the firms are growing with the trend line, let us say 10 to 15% a year, that means, in sixteen years they are quadrupling production. Therefore, within twenty-four years, the firms are going to be eight times as large, and that twenty-four years from now is now in terms of hiring. If they have this kind of employment system, and they want to have people who are trained to be managers in twenty-five years, they are going to have to hire a lot more people now than they need immediately down the road. So what this has meant, is that Japanese firms going through this cycle at the managerial level have had a lot of excess people in younger positions that they did not have jobs for. Therefore, they had the problem of what they were going to do with these people. They could not just have them sitting there twiddling their chopsticks! What they did with them was to give them a lot of staff work and have them do studies on what was happening in the economy. That worked out very well because, at the same time, they were trying to develop the market, managerial, and economic base. One thing they found at the end of the war, was that Japan was behind technologically with respect to the rest of the world. As a result, they started importing technology, particularly from the United States, and went into a lot of joint ventures. They took the bright young people directly out of Tokyo University and put them on doing those tasks to bring on new ventures, which turned out to be a nice benefit.

One thing that was very hard to understand for Westerners was why the Japanese always invested at such a high rate. If the tendency was to invest in anticipation of demand, they could get caught temporarily with excess capacity. Then to get rid of it, they would cut their price just to cover their interest cost which had declined. Then, they would export at this distressed price to some less developed country or eventually, the United States. That system worked out very well until the 1960's, when Japan started to get large enough that the rest of the world, particularly the United States, did not want to take all of their exports. The other countries started putting pressure on Japan for so-called voluntary marketing programs.

One can see though that there was a kind of logic on the part of the Japanese manufacturers to do this, and that it was pretty successful. What they found was that when they invested in anticipation of demand and dropped their price, their volume expanded both domestically and in the export market, lowering costs. Thus, they could use up their investment. As they were importing technology, every new investment was more productive. As a result, they would invest again with justification that as before, the price and costs would drop again. With this, they would kind of move down a curve, their prices would drop, and yet they had increased their volumes and lowered costs. Here we see the development of a cycle. They would invest, then they would use that investment to lower their prices. That would increase demand, which would increase productivity and bring down costs. What would eventually happen of course, was when they ran into a point where demand did not increase enough to justify that increase in investment, what is known in Japan as excessive competition. The Government would then intervene and put a floor under the price to lessen the competition. The companies did not have to go through that scenario too many times to learn that the Government was going to come in, implement a floor, and allocate production on the basis of market share. As a result, their normal management response was to start managing this investment/demand expansion cycle as fast as they could. What happened however in the early 1970's, was that the economy itself went into a real recession, many firms started to export at very low prices and demand did not go up. The Government had to come in with a number of so-called export cartels in several industries. Also, the rest of the world was in a recession. Among others the United States started getting upset by these exports. What the Government did then was to come in, put an export cartel on the situation, lower interest rates, and expect the latter to increase investment. Unfortunately, there was some break in the cycle at this time. The Japanese manager did not foresee that if he were to make an investment, he would get an increase in demand. Nevertheless, the Government continued to push this, but naturally every time they would try to get things started, it would not work. This is where Japan is now with this kind of structural economic change.

Previously, the Government had been pursuing what we would have called a classical economic policy, which says that basically investment is a function of interest rates. If you drop the interest rates by making money more available, people will invest. As a result, the economy will begin to grow again. If there is no investment from the private sector, then the only person who can provide investment is the Government.
1974 to 1976, the Government attempted somewhat half-heartedly to increase their public investment. Then, as soon as the economy started to pick up, they went right back into the previous policy of emphasizing private investment. The reason was that they were accustomed to managing the economy in that way. They were not willing to adopt what we might call a more Keynesian approach in which the Government comes in with massive public works to stimulate the economy. In order for the economy to function properly now, they would have to adapt their Government and business managerial styles to include this other approach.

In the domestic market, there is going to have to be more Government investment. There is however, a difficulty in implementing this. During the period when the Government was giving incentives for firms to invest, they were actually allocating resources from the Government sector to the private sector. As a result, the Government sector had kept itself relatively small. In actuality, it had declined as a percentage of GNP. Therefore, for the Government to come in and try to pick up the economy would result in a very large increase in the Government budget and in the budget deficit. Their problem was also compounded by the fact that during the previous period, in order to make the high rate of growth non-inflationary, they had encouraged savings. This resulted in a very high savings rate of about 35% of GNP.

If some of you remember your elementary economics, a high savings rate means a low marginal propensity to consume, which means that you have a rather low GNP multiplier. Therefore, for every dollar increase in Government expenditure, you do not get as much kick as if you had a lower savings rate. Therefore, people have been advocating that the Government do something to lower the savings rate. They thought it should be mostly done by increasing social services, social security and unemployment benefits which would decrease the uncertainty that the people saw in the economy and would improve the quality of life. The ministry of finance did not want to do this though, believing it would take a lot of flexibility out of the budget. They were not ready to face up to what seemed to be an emergent economic reality. In a sense, they were trapped by their previous successes.

Now, in industry itself, some changes are occurring as well. I mentioned that after the war, light industry had started off being the exporter of textiles, handicrafts and so on, because they were built on cheap labor. That was considered Japan's comparative advantage. As they moved into heavy industry, Japan had another advantage which was a cheap user-cost of capital. Of course, resources are allocated out of this traditional or light sector into the basic industry sector, the heavy-basic industrial sector grows rapidly on the basis of cheap capital. As a result, Japanese wages start going up and Japan becomes increasingly less able to compete with other countries such as Korea, Hong Kong and India in the traditional areas where investment and productivity gains have been less. So, the lighter industries start to phase out, and the Government helps them by giving them subsidies and so on. Again, the same thing has been happening with agriculture. This sector is now down to about 8% of the labor force and aging quickly. But the Government is assisting them through all kinds of programs such as putting restrictions on imports until they gradually reduce their numbers. Then come the recent currency revaluations. The people in agriculture and light industry are in more trouble and the Government has a real problem on its hands of what to do with them. In addition, those people in heavy industry can not find increased demand for their products either, and, as a result, their demand and growth starts to stagnate. Basic industries in general are still going to be very competitive since they have cheap capital and are continuing to modernize, while most of their foreign competitors are not. But the demand for their product is not growing, and they are under a lot of protectionist pressure from foreign countries. Therefore, the current growth is a result of the production of more sophisticated goods such as autos and machine tools. This is where the growth has been coming from since the late 1960's. Indeed, this is where Japan's current growth in exports is.

Now, one of the interesting things about these new more sophisticated industries from a management standpoint, is that they grew initially the same way that basic industry did, by borrowing a lot of money, thus having a high degree of leverage and low capital costs. They did not need as much capital on a continuing basis however, and therefore decreased their leverage as they grew. Here we see each individual firm responding to the economic realities which they found for their industry and product. These new industries are not capital intensive businesses, they are more technology or marketing intensive businesses. Therefore, they did not need that capital long-term and started putting it back into the system. They are not borrowers, at least the more successful ones. Now, the less successful firms are borrowers, as that is the only way that they can maintain their market and competitive position. The decision therefore rests in the Japanese banks as to how long they want to fund the third or fourth level producer in these new industries. But the impact on the country as a whole has been to increase savings while decreasing investment, exacerbating the Government's reflation program.

The other side of the picture is that light and basic industrial companies traditionally have used the trading companies, as these industries are basically raw material processors. The trading companies have invested in mining and raw material production overseas and have imported raw materials for these industries to produce further. Since the capital of the basic industries in particular was all going into plant and equipment, the trading companies really provided the working capital and the distribution capital that the industry required. This is the same thing that they did in the light industry when they imported wool and cotton, and exported cloth. Now, the big difference from light and basic industries of the new firms, who also started using the trading companies, is that later on, they actually acquired the distribution capabilities themselves, especially for serving larger markets. This is seen in companies like Toyota and Nissan who have their own distribution systems in the United States. They are looking for places to put their excess capital in the world. For instance, Toyota has a joint venture with General Electric where they are selling home appliances and prefabricated homes through their dealers in Japan. This is done because they are using the same kind of financing structure to sell these other big ticket items as for cars.

Then we have one more group of industries, the high
technology firms, which are having a hard time because the basic industries and sophisticated manufacturers are still basically very competitive. As a result, with flexible exchange rates, they are causing the yen to appreciate. They are making it more difficult for these very new high technology firms to catch up with the low cost producers in the United States (computers or semi-conductors). Before other Japanese industries were able to do that because the United States producers were not quite as responsive and aggressive and the yen was constant. But now, IBM and firms like that are not so sleepy and the yen is rising. That is, United States competitors tend to be very price aggressive and a rising yen aids this. So, the very new industries are having a difficult time catching up. The Government's response to this situation has been to subsidize them directly in certain kinds of technology to bring forth the proper managerial response.

If we look towards the future a bit, one of the things that everybody is interested in is Japanese foreign investment, and the fact that they are borrowing foreign exchange reserves. Here again, the individual response of the Government and the four industry sectors (traditional, basic sophisticated manufacturers, high technology) is different according to the situation in which they find themselves. If we look at light industry, which was the first one to go overseas, the people who basically took or forced that overseas was the trading company. The trading company did not really care if they were importing cotton from the United States and then running it through a Japanese or some other country's mill to be exported back to the United States or elsewhere. They could just as easily have made that a Korean mill and there probably would not have been much change in the business. So, we began to see Japanese investment, usually in the area of joint ventures, moving into various areas, and both large and small Japanese firms were involved. That was the first stage of investment.

Then, we began to see the second level of investment as the basic industries began to feel that the future was in some way against them. They were under a lot of pressure from the Government because of pollution. We began to see them revising their strategies and starting to view themselves as people with a lot of knowledge in their industry instead of simply producers of steel or whatever. They started moving towards engineering and production of equipment, and building steel mills in Brazil or wherever. So, in another stage of investment, we began to see trading companies and the heavy manufacturers beginning to sell whole plants to the LDC's (Less Developed Countries) with the idea that these plants would produce the lower product grades, which could then be brought back to Japan to be used, upgraded or sent elsewhere. This procedure of course, was a good strategy because of rising costs and because it took some of the export protectionist pressure that was being placed on Japan and put it on the Koreans, the Brazilians or others. It also helped upgrade Japan's industrial structure.

The next investment that we can begin to see, is that having to do with more sophisticated machinery, auto production, ball bearings, and so on. They are also starting to export plants, but their reason is a little different. They are trying to protect their export markets because of protectionist pressures in Europe and the United States. Auto producers are under a lot of pressure to set up plants even though Japanese production is still competitive. Also, they are beginning to see that certain kinds of things, like certain parts or certain products on the lower end of their product line can be produced cheaper some place else. For example, in order to maintain their competitive position, they may move their black and white television production to Taiwan or elsewhere. Again, you can see that each management approach is applying itself to the problems that they are confronting.

I would say that the Government is basically encouraging these industrial trends. They are offering subsidies to get firms out of light industry and are not giving them protection in terms of quotas or higher tariffs. Their pollution control laws are certainly as stiff as ours, and their restrictions on plant sitings are very strict. The key difference, however, is that they are not trying to penalize these people. They force them to meet guidelines and will not allow them to grow any more. Yet, they are not penalizing their current cost structure because, unlike the United States, in terms of their mandated costs they are allowed a tax and/or low cost credit offset. That is, they can often expense such costs and Japanese banks can make loans at very low interest rates for pollution. So again, the Government has made an effort not to penalize firms. But these industries are not growing. The Government is also certainly encouraging plant exports through things such as special programs under the Export-Import bank, and special kinds of insurance programs against possible non-payment by some of these less developed countries and so on. Naturally, in certain areas like aluminum, which is not so much a benefactor of cheap capital, but of their previous access to cheap energy (which is no longer cheap), they are definitely making an effort to scrap a large percentage of the plant which is now economically obsolete. But for the basic industries this is rare. Generally, they are just maturing.

In the area of more sophisticated goods, of course, the Government is encouraging them to invest overseas to the extent to which these people want to. This will help to reduce exports and take some pressure off of the yen. This is now of interest to Japan, particularly since they are trying to strengthen the very technologically advanced industries. A more stable yen would be beneficial to them.

As for the high technology area where Japan sees itself moving, my own feeling is that it is going to be hard for them to get out of their current concentration in the two areas of basic industries and more sophisticated manufacturers where they are currently so competitive. The reason for this is that the successful firms in these areas are simply too strong and almost too capable in terms of their management and their ability to respond to the economic and business situations in which they find themselves. In addition, they have the real options of upgrading their domestic business and industries overseas.

In summing up, the current situation is that the Government has a problem in managing the new situation because the traditional light industries and the more sophisticated manufacturers are not really investing much domestically at all. As I have said, they have a pretty high cash flow and are actually putting money back into the system. They are basically net savers from
the economy's perspective. The basic industries are using money but not at the rate that they used to. They are using money mostly for modernization, for overseas investment, or for pollution. Finally, the higher technology sector, though investors, cannot absorb large amounts of capital because these industries are more people and knowledge intensive. So, the first three sectors are now severely dropping the amounts of capital that they are using and the fourth sector cannot pick up the balance. Yet, the high savings rate is continuing. In fact, the high savings rate is exacerbated by the current economic uncertainty.

The Government is therefore going to have to pick up the slack by increasing its own investment in terms of public works. It is also going to have to try to lower the savings rate. Up until now, they have been picking up the slack in savings in terms of acquisition of foreign exchange. That is basically foreign investment by the Government. In fact, to this extent they have been promoting or subsidizing the export growth, which the rest of the world has increasingly resisted. However, now with the appreciation of the yen, exports have not increased in volume, but export value has gone up. They are thus not getting for their export subsidy any real increase in physical demand which might increase either their demand for labor or capital. There is then really no alternative for the Government but to increase its domestic public investment and to expand its social services.

I guess that I would be rather optimistic in looking at this situation, unlike Gary Saxonhouse this morning. In the past, what we have seen is that both the Government and Industry have responded to economic realities in terms of their management styles. I do not see why that fact should change in the future.