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# Zarządzanie finansami firm – teoria i praktyka

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## FINANCIAL STRUCTURE AND ORGANIZATION OF *KEIRETSU* – JAPANESE BUSINESS GROUPS

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**Summary:** *Keiretsu* business groups play a unique role in Japan's economy. In the postwar high-growth period, stable financial, capital, production, and personal relationships built trust, reduced transactions cost, and provided incentives for specific investments, and R&D activities among the companies within *keiretsu*. In the face of economic stagnation, financial deregulation and globalization, *keiretsu* groups are in transition. The objective of this paper is to examine financial structure and organization of *keiretsu* groups.

**Keywords:** business groups, *zaibatsu*, *keiretsu*.

### 1. Introduction

The objective of this paper is to examine financial structure and organization of business groups, often referred to as *keiretsu*, in postwar Japan. Japan was the only country outside Europe and North America which successfully industrialized before the Second World War. In the extraordinarily successful postwar period *keiretsu* became an essential factor in enhancing economic growth and structural upgrading as well as closing up productivity and technology gap between Japan and other developed countries.

The Japanese postwar *keiretsu* have been described in similar terms, yet, compared to business groups in other countries (for example, the Korean *chaebol*), the term “group” is misapplied in the *keiretsu* case. In general, *keiretsu* groups are defined as clusters of independently managed firms which were intertwined by a governance mechanism such as presidents' clubs, partial cross-ownership, and personal exchanges [Lincoln, Shimotani 2010, p. 128].

### 2. What are *keiretsu*

Economic literature on *keiretsu* quite often uses categories designed for the analyses of American or European corporations to describe their Japanese counterparts. It may lead, however, to evaluations and conclusions which are not always true. Ana-



lyzing Japanese corporations as single fully autonomous economic subjects is a frequently made mistake. Meanwhile, as *keiretsu* typology will reveal, the essence of Japanese corporations is the membership of business groups.

The most frequently presented division, particularly in the research on the system of corporation supervision, is the one into horizontal *keiretsu* (*Kinyu*) and vertical *keiretsu* (*Shihon*). Horizontal *keiretsu* are non-hierarchical groups of the main companies deriving from prewar *zaibatsu* conglomerates, (for instance *Mitsui*, *Mitsubishi*, *Sumitomo*, *Yasuda*), connected by credit relations with a common main bank (for instance *Dai-Ichi Kangyo*, *Fuji*), and providing other members of the group that are commercial partners or *joint-ventures* with preferences. Vertical *keiretsu*, on the other hand, are networks of subsidiaries operating within large corporations and subordinated to them by means of capital and long-term production-distribution relations (for instance *Toyota*, *Toshiba*, *Hitachi*) [Grabowiecki 2006].

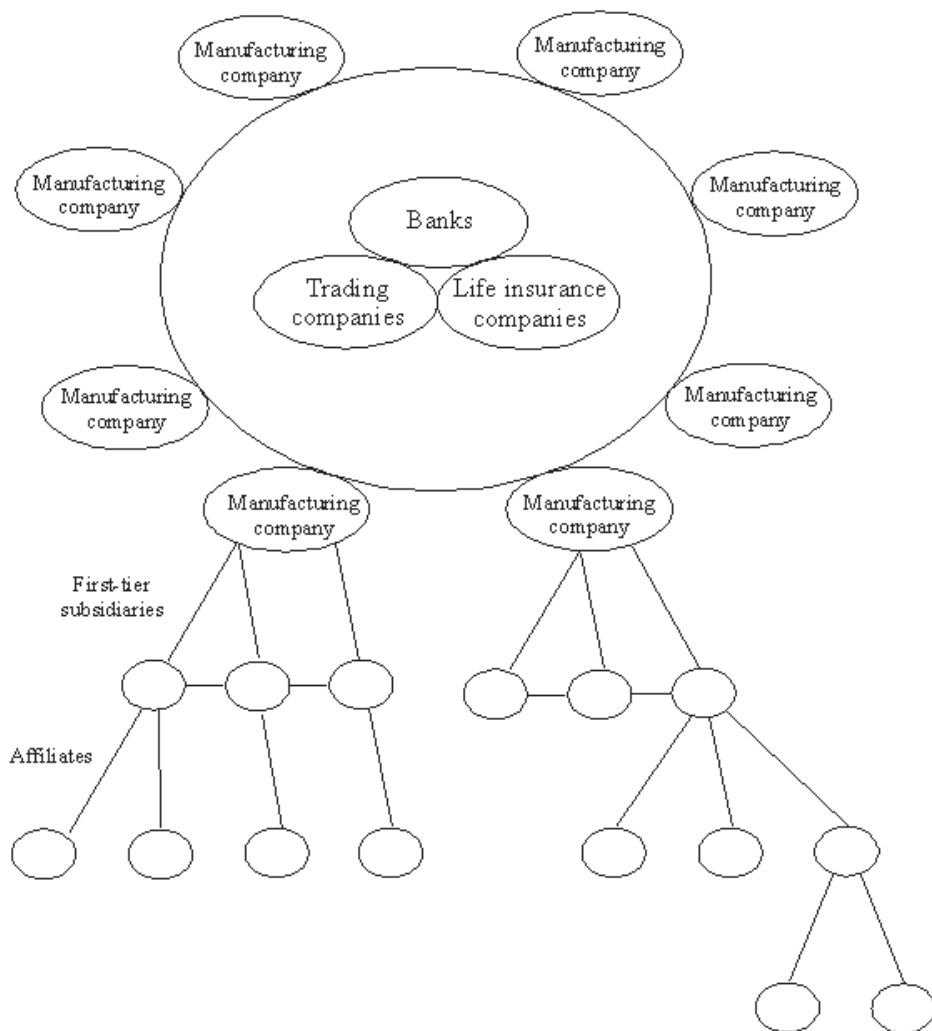
The division into horizontal *keiretsu* and vertical *keiretsu*, however, does not fully reflect the character of the relations occurring in both types of the analyzed structures. The term *Kinyu keiretsu*, in other words financial *keiretsu*, suggests that the main binder of the group's companies are financial relations. Actually, however, although the position of the city bank and, in consequence, the importance of credit relations and the main bank system are crucial here, production and trade relations are of great significance as well. Whereas, in the case of *shihonkeiretsu*, the term *shihon* means "capital", which, in consequence, suggests a dominant role of capital relations. A distinct feature of this type of *keiretsu*, however, is the production and distribution relations between the main subject of the group and the network of subsidiaries. However, capital relations, although extremely important, play a role analogous to the one they played in horizontal *keiretsu*. They are not, therefore, a distinguishing feature differentiating this type of *keiretsu* from the alternative form. What is more, they are characteristic of both types of corporate groups [Majewski 2007].

Horizontal *keiretsu* were formed around a large city bank being the group's main bank. They also include general trading companies (*Sogo Shosha*), life insurance companies (*Kanji Gaisha*) and other financial institutions, large industrial companies and a network of subsidiaries (see Figure 1). Such groups bear some of the most famous names in Japanese industry – *Mitsui*, *Mitsubishi*, *Sumitomo* and differ from the vertical *keiretsu* in scope, number and structure.

Where the vertical *keiretsu* operates within an industry, broadly defined, the horizontal *keiretsu* consists of firms from virtually every major industry in the economy, with especially strong representation in the key industries of the postwar high-growth period that was the era of its greatest strength (heavy industry, petrochemicals, materials processing, and banking and trading) [Gerlach, Lincoln 2004; Flath 2005].

While virtually every large Japanese firm heads a vertical *keiretsu*, there are only six horizontal *keiretsu*, which were formed in the 1950s. Three are direct descendants of the prewar *zaibatsu* (*Mitsui*, *Mitsubishi*, and *Sumitomo*), and three were

formed at the initiative of banks and also have their roots, less directly, in the prewar *zaibatsu* (*Fuji*, *Sanwa*, and *Dai-Ichi Kangyo*).



**Figure 1.** Structure of *keiretsu*

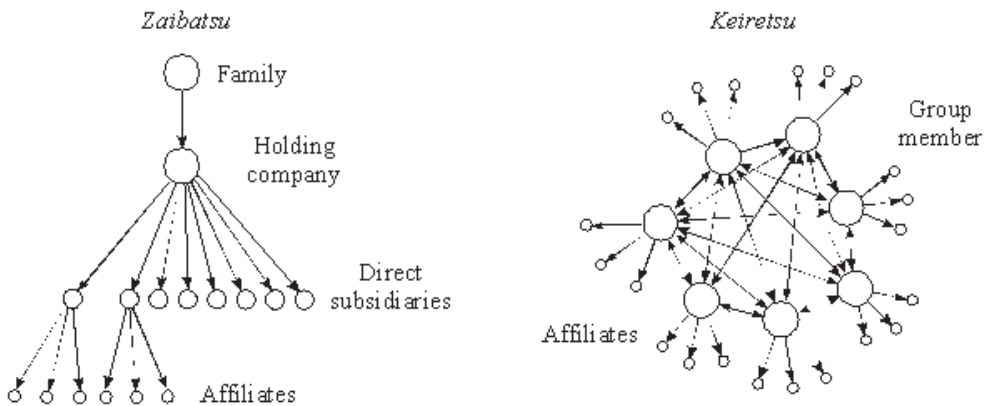
Source: own study.

The horizontal *keiretsu* are much less tightly coordinated than the vertical *keiretsu*. Whereas the vertical *keiretsu* has a pyramidal structure of shareholding and of personnel transfers (from core company to first-tier suppliers, from first-tier to second-tier, and so on), the horizontal *keiretsu* is characterized by cross-sharehol-

ding among various member companies, and personnel movements are much more limited, concentrated at the level of the board of directors. The flows of goods are also more limited: according to Japan's Fair Trade Commission, the average horizontal *keiretsu* firm relies on other members of its group for approximately 13% of purchases (a much lower level than in the vertical *keiretsu*) and 15% of sales. The principal coordination mechanism is the president's club, a regular meeting of the top managers of the group companies. It is mirrored by sets of parallel (and less frequent) meetings of functional managers (finance, personnel, R&D) [Okabe 2002].

### 3. Processes of *keiretsu* formation

The prewar conglomerates *zaibatsu* are crucial to the understanding of the postwar horizontal *keiretsu*. The former had far greater structural similarities to the postwar horizontal *keiretsu* than to the corporate groups that have developed in most economies outside the Western societies, especially, but by no means exclusively, in Asia: they were family-controlled conglomerates with a formal coordination mechanism, the holding company, which was largely family-owned (Figure 2). It held significant blocks of shares in the most important companies in the group, appointed top executives of the top-tier member companies, and allocated resources for new industrial companies within the group. And like the corporate groups in many countries, their formation was linked to and encouraged by government policy. The "old" *zaibatsu* (including *Mitsui*, *Mitsubishi*, and *Sumitomo*) spread their reach across industries in the sell-off of state-owned enterprises in the 1880s; the "new" *zaibatsu* of the 1920s and 1930s were heavily involved in the expansionist policies of the government in Taiwan, Korea, Manchuria, and China [Morikawa 1992; Lynn, Rao 1995].



**Figure 2.** *Zaibatsu* vs. *keiretsu*

Source: [Yonekura 1985, p. 64].

The close links of the *zaibatsu* to the military state and their dominant role in the wartime economy led the American occupation authorities to target the *zaibatsu* for dissolution as agents of Japanese militarism and imperialism. General MacArthur said in 1948, describing the *zaibatsu*: “*The world has probably never seen a counterpart to so abnormal an economic system. It permitted exploitation of the many for the sole benefit of the few. The integration of those few with government was complete and their influence upon government policies inordinate, and set the course which ultimately led to war and destruction*” [Tsuru 1993, p.73]. One mechanism for attacking the *zaibatsu* was the purge of top managers, which affected virtually all companies in the Japanese economy; another was the confiscation of shares held by the designated *zaibatsu* families. Another, specifically targeted at the *zaibatsu*, was the prohibition of the use of the famous *zaibatsu* company names (for several years *Mitsui* and *Mitsubishi*, for example, were banned from the mastheads of Japanese companies) and the forced break-up of key companies. *Mitsubishi Heavy Industries*, for example, was divided into three separate regional companies; the *Mitsui* trading company was broken into over a hundred separate entities. However, another mechanism, more lasting in its effect, was legislation that outlawed holding companies, which in one blow eliminated the key element of the vertical control structure of the groups. This prohibition lasted until the late 1990s, when the Diet finally passed legislation to make holding companies legal.

The groups reemerged during the 1950s: the old names reappeared once the occupation ended, the dismembered companies merged again, and a formal group identity was created through the presidents’ clubs. The coordination structure was, however, of necessity very different from the prewar pattern. The family ownership of the prewar period had been thoroughly eradicated, but even in the 1920s and 1930s professional managers had been developed to occupy key administrative positions. A more radical change was the associational character of the group, by which was meant apparently stable grouping without any hierarchical control system.

Economic analyses of the development of the horizontal *keiretsu* have stressed the advantages of group membership in the environment of the 1950s and 1960s. The group bank played a key role, not only in providing loans directly but also in mobilizing other financial institutions to make financing available to the group companies. The trading company was also a key player, particularly in the 1950s, when foreign exchange controls were stringent and knowledge of international markets was scarce within the management ranks of the member companies, especially after years of war, and occupation.

In the postwar high-growth period, the group provided a kind of mutual insurance system, in which the interlocking shareholding protected member companies both from any threat of takeover by foreign companies trying to enter the Japanese market by acquisition and from pressure from equity markets. In times of crisis, group firms could be counted on to step up and help: when *Mazda* was on the brink of bankruptcy in the mid-1970s, for example, not only did its group bank, *Sumitomo*, intervene to provide a new CEO and financial guidance for the company’s turnaround, but

*Sumitomo* group-company employees were urged to place orders for *Mazda* vehicles, with substantial financial inducements to do so [Rohlen 1983, p. 219-264]. The shielding of member companies from shareholder pressures is reflected in a study by I. Nakatani comparing matched pairs of group-member companies and independent companies in the 1980s: he found that group companies had lower growth rates and lower profitability, but greater returns to employees and greater stability in performance across the fluctuations of the business cycle [Nakatani 1984, p. 227-258]. These explanations for the persistence of the horizontal *keiretsu* groups, which are grounded on attributions of economic rationality, can be augmented by institutional explanations that emphasize the importance of the historical legacy of interpersonal networks and shared identity within the *zaibatsu* groups. Only the groups in which these features were strongly entrenched made the transition to the postwar system. By the end of World War II, there were about eighty *zaibatsu* groups in Japan; despite all the advantages postulated by the economic analyses, there are only six horizontal *keiretsu* groups in postwar Japan, and their number has not changed since the 1950s [Lynn, Rao 1995, p. 55-80].

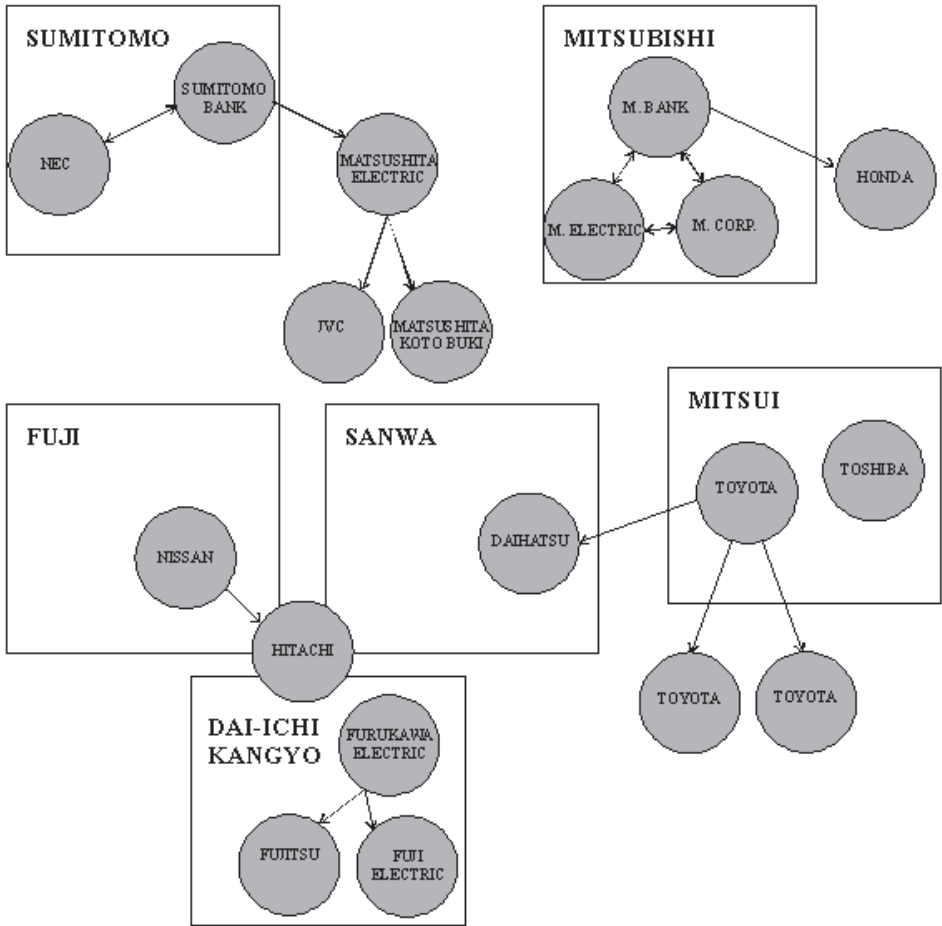
On the other hand, it is possible to argue that the horizontal *keiretsu* had an effect on the Japanese economic system well beyond the confines of their own groups, in the form of the role of the main bank. The role played by the *zaibatsu* banks of the prewar years evolved in the postwar *keiretsu* into a central role in mobilizing loans from other financial institutions and, as noted above, holding the legally permitted maximum of 5% of shares outstanding and acting as a monitor on the performance of management. Other banks which were not involved in the horizontal *keiretsu* emulated the key elements of this role in acting as the main banks for their largest and most important customers.

The vertical *keiretsu* is a fundamentally different type of group from the horizontal *keiretsu* which was previously described. In contrast to a relatively loose relation of different size and different branch enterprises which occurs in the horizontal *keiretsu*, vertical *keiretsu* is of a tight pyramidal relation character with clearly centralized executive managers. An apex core company holds controlling shares in the first tier of key subsidiaries. Each holds controlling shares in its subsidiaries, which hold controlling shares in yet another tier of subsidiaries, and so on. Moreover, it is characterized by a high degree of branch specialization.

Some vertical *keiretsu* derive from prewar industrial *zaibatsu* which avoided dissolution, for instance *Shibaura Manufacturing Works* (now *Toshiba*) or *Hitachi*, other developed their activity in the 1960s.

Vertical *keiretsu*, for most companies, is composed of two types of subsidiaries: *Kogaisha*, which are firms created by the core company, usually by spinning off a division, department, or factory from its own organization, and *Kanren Gaisha*, which is a formerly independent firm that has developed a long-standing relationship, usually as a supplier, with the core company, and has been brought into the group. Either type of group firm can belong to another category: the consolidated subsidiary, in which the core company owns a set proportion of the equity. This is a category created by

internationally accepted accounting standards, in which the performance data from such subsidiaries must be consolidated with the data from the owning company in the formal reports required of publicly listed companies. Companies differ in the extent to which the core company owns a controlling share of their group firms. Some, like *Hitachi*, *Sony*, and *Suzuki*, own actuarially significant stakes in over 80% of the companies in their groups; for others, like *Toshiba*, *Sanyo*, or *Toyota*, fewer than 20% of their group companies are consolidated [Westney 2001].



**Figure 3.** How horizontal and vertical *keiretsu* interconnect

Source: [Gerlach, Lincoln 2004, p. 22].

The core company of the vertical *keiretsu* itself contains both corporate headquarters and a range of business divisions. The core company of the *Toyota* group, for example, produces most of the company’s models of autos and trucks; *Matsushita*

*Electric* contains over forty business divisions producing a wide range of products, from office equipment to home appliances. The core company in the group concentrates on high-value-added manufacturing (usually but not exclusively final assembly) and R&D for the core businesses of the group. The group companies engage in one of three types of activities: the manufacture of components and subassemblies (or in some cases lower-value-added final products); sales and distribution; and quasi-related businesses.

The horizontal and vertical *keiretsu* were portrayed above as quite distinct from the intercorporate network. In fact, the two are highly intertwined, as depicted in Figure 3. The *Toyota* group is a vertical *keiretsu* linked mainly to the *Mitsui* horizontal *keiretsu*, as is *Nissan* within *Fuji*, *NEC* in *Sumitomo*, *Furukawa* in *Dai-Ichi Kangyo*, and so forth. By the same token, where vertical *keiretsu* span horizontal *keiretsu*, they thereby tether them together. *Toyota* is a *MitsuiNimoku-kai* member, and most *Toyota* group companies deal with *Toyota's* primary banks, *Mitsui* and *Tokai*. *Daihatsu*, however, is a *Toyota* affiliate that uses *Sanwa* as the main bank and maintains a seat on *SanwaSansui-kai*. Prior to a bailout by *Toyota* in the 1960, *Daihatsu* was a separate automaker aligned with the *Sanwa* group [Gerlach, Lincoln 2004].

The size of this network creates the overall impression, that “the whole of Japan is one big *keiretsu*”, in which a few indefinable, apparently boundless edifices have the capacity to directly influence Japan’s economy and even to indirectly influence society, while the “traditional sector” of the national economy, described by general theories of clearly identifiable definable legal rights, price paradigms, identical organizational structures and power hierarchies, becomes less and less significant [Kensy 2001, p. 218].

#### 4. Conclusions

In the face of powerful forces of combined with economic stagnation financial deregulation and globalization, *keiretsu* groups have “withered away” so they no longer constitute a significant topographic of the Japanese economic landscape, despite having been one from the 1950s to the early 2000s. *Keiretsu* groups have to make a transition:

- from indirect finance (bank loans) to more diversified and direct borrowing from capital markets (bonds, commercial papers) [Ito *et al.* 2005],
- from insider type of corporate governance based on the main bank system and cross-shareholding relations to more market oriented open type governance [Patrick 2004],
- from subcontracting system to new forms of relationship between large companies and SMEs (modular and integral architectures) [JSBRI 2005],
- from life-time employment and seniority promotion systems to the more flexible merit-based system [OECD 2005],



- from companies in a manufacturing assembly and R&D-driven industries (automobiles and consumer electronics) to high-tech service-oriented and *ICT*-driven companies [Ozawa 2005],
- from general trading companies (*Sogo Shosha*) as intermediaries in foreign trade to develop own production facilities and sales organization abroad by Japanese transnational corporations [UNCTAD 2004],
- and finally, – from the mix of formal and informal (norms, practices and shared beliefs) rules that govern Japanese companies toward more formal, greater transparency and disclosure (Commercial Code, Antimonopoly Law, International Accounting Standards) law and market-oriented system [Milhaupt, West 2004].

However, the current transformation of *keiretsu* structures is moving toward weakening and even erosion of the institutional complementarities existing among the corporate finance and governance system, including the main bank system, cross-shareholding, and business transaction system.

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## STRUKTURA FINANSOWA I ORGNIZACJA JAPOŃSKICH GRUP KAPITAŁOWYCH KEIRETSU

**Streszczenie:** Grupy kapitałowe *keiretsu* odgrywają szczególną rolę w gospodarce Japonii. W okresie przyspieszonego wzrostu stabilne relacje finansowe, kapitałowe, produkcyjne i personalne budowały zaufanie, redukowały koszty transakcyjne działalności, a także pobudzały do inwestycji i stymulowały działalność B+R przedsiębiorstw należących do struktur *keiretsu*. W warunkach globalizacji, deregulacji finansowej i globalizacji grupy *keiretsu* podlegają przemianom. Celem artykułu jest analiza struktury finansowej i organizacji grup *keiretsu*.

**Słowa kluczowe:** grupy kapitałowe, *zaibatsu*, *keiretsu*.