CORPORATE STRATEGY

by Jesper Edman

Imitated or ignored?

Foreign Firms in Japan

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Inward foreign direct investment (FDI) has often been touted as a possible source of economic growth for Japan. For years, economists have argued that an influx of foreign capital and operations would have a positive effect, not only due to a direct increase in competition, but also as a result of the more indirect effects of knowledge spillovers from foreign firms to domestic competitors. To the extent that some foreign firms had superior techniques that enabled them to take market share away from indigenous Japanese firms, it was hoped that this competitive pressure would induce Japanese firms to emulate them, just as American and European companies have felt compelled to emulate the best practices of foreign firms coming to their soil.

Inward FDI into Japan is so low—standing at one-third the level of Korea and China, and one-tenth the level of OECD countries—that promoting it would seem to be a case of "low hanging fruit." Little wonder that the Abe Cabinet has set an official target of doubling inward FDI to ¥35 trillion ($330 billion) by the year 2020.

Sobering picture

Yet, a closer look at the impact in Japan of foreign firms—the *gaishikei*—presents a more sobering picture. While foreign firms have long operated in Japan, their presence and economic impact remains limited. Famous brands like Coca-Cola, Starbucks, and Apple are among the few exceptions. For many *gaishikei*, Japan remains a lucrative but highly segmented market. Foreign firms often operate on the fringes of their respective industries, foreign employment makes up a tiny portion of the total labor force and sales, and few non-Japanese companies are members of local industry associations. At issue here is not simply the low volume of FDI, but more fundamentally the interaction between foreign firms and local firms.

The invisible *gaishikei*

To begin with, let's consider competition. The entry of competitive foreign firms should spur domestic companies to cut costs and increase productivity lest they lose business. For this to happen, however, foreign firms must constitute a real threat to a domestic company's existing market share. In fact, many foreign companies—even the most globally successful—occupy very narrow (albeit lucrative) slivers of the Japanese market. Domestic incumbents—particularly large and powerful ones—have limited interest, or even awareness, of such niche incursions.

Consider the case of non-life insurance (e.g., health insurance or property & casualty). The market was deregulated in the 1990s, resulting in an in-flow of foreign firms from both Europe and the United States, including the likes of Skandia AFS and The Hartford. Observers at the time suggested such entry would serve as a wake-up call to the conservative Japanese insurance industry, and that the foreign firms would revolutionize both the distribution and form of Japanese insurance products. Twenty years on, Japanese incumbents continue to dominate the market, with foreign companies holding a combined market share of less than 6%, according to the General Life Insurance Association. While Japanese non-life insurance companies have indeed evolved significantly, these shifts have mainly come from the need to expand beyond Japan, rather than because of any increased competition in the domestic market. Within Japan, traditional distribution channels and products continue to hold sway.

The story repeats itself in industries as diverse as automobiles, retail, telecom, and chemicals, where foreign firms constitute marginal players. Foreign firms account for only 6% of total market share in Japan, with pharmaceuticals and services being the most prominent at 15% (see top figure). Note that any Japanese company in which a single foreign firm owns more than 10% is categorized as a foreign firm.by the Ministry of Economy, Trade and Industry (METI). If one included only majority-owned foreign affiliates, the market share of foreign subsidiaries in Japan would be far smaller than 6%.

When foreign firms increase market share, they often do so via new products, rather than by taking market share from Japanese incumbents. While this naturally benefits consumers, it doesn't necessarily put competitive pressure on domestic actors to improve innovation and creativity. The niches into which foreign firms enter are often ones that Japanese companies purposely ignore because they are seen as unprofitable or too risky (e.g., housing loans to contract-workers). With the exception of a few areas of direct retail (e.g., apparel), foreign firms do little to shake the competitive positioning of local industry.

Learning from the foreigners?

While the lack of direct competitive effects of foreign firms may be unsurprising, a more unexpected and arguably troubling aspect is the low level of learning and knowledge-transfer from foreign firms to domestic competitors. In most countries, by contrast, inward FDI generates knowledge spillovers to domestic firms, not only via technology, but also in terms of organizational practices, strategic capabilities, and human capital. These practices are frequently mandated by parent organizations in the home country; as a result, many gaishikei incorporate distinctly non-Japanese business practices, even when the majority of staff are local hires.

Given that shifts in both the domestic and international economy are putting Japanese companies under considerable pressure to renew their organizational strategies and capabilities, foreign firms would seem to be an ideal source of learning. In particular, gaishikei have introduced not only innovative products and services, but also many of the best practices that Japanese firms currently seek to adopt. These include proactive diversity strategies, more flexible organizational structures, rigorous corporate governance and risk management protocols, and performance-based human resource (HR) policies.

To date, however, these foreign innovations and practices have had limited influence on Japanese firms. The lack of influence is not simply a question of a lack of awareness and ignorance; Japanese companies often explicitly dismiss foreign innovations—be they products or practices—as unfit for the local market, and ill-matched to Japanese sensibilities.

One of the most obvious examples is that of performance-based HR management. While performance-driven pay and promotion have been central to most foreign firms' HR policies for several decades, few if any Japanese companies have explicitly sought to adopt this approach. Even today—when the shrinking labor market and a need for securing global talent has made Japanese multinational firms acutely aware of the importance of changing their traditional HR practices—the vast majority continue to promote and reward based on age and seniority, even if they say for public consumption that they no longer do so. Similarly, while strategies to encourage diversity—e.g., in the form of more female and foreign managers—have begun to gain fledgling traction among domestic HR departments, few Japanese companies explicitly look to learn from their foreign competitors.

The lack of benchmarking of foreign practices has been detrimental to Japanese firms' human capital development. For example, while it's standard practice among foreign firms to search for talent globally, with English as the primary language, 70% of Japan's 150 largest companies do not offer English-language job information on their homepages. As a result, foreigners with an interest in working for Japanese companies are often stymied and discouraged from applying. In the financial services industry, the best and the brightest often leave domestic banks in favor of foreign rivals, once they recognize that the latter are willing to reward and promote them based on performance, rather than age and service. Similarly, talented female university graduates have often shown a preference for foreign firms—both in finance and other industries—based on the recognition that domestic companies offer limited opportunity for career advancement or work-life balance.

As Japanese companies wake up to the crucial importance of training and employing a diverse and global labor force, the lack of learning and imitation of foreign HR practices looks like a sorely missed opportunity.

Adopt, adapt, dilute

One of the ironies is of course that Japanese companies are famous for their ability to imitate and copy foreign products and practices. The 1980s were replete with stories warning of Japanese corporations' "adopt, adapt, adept" strategies, and their singular tack for improving upon anything the West could invent. Japanese companies do often adopt and adapt foreign introductions and innovations. In many cases, however, such adaptations result not in improved offerings, but rather in localized versions and translations. While these frequently fit well with Japan's existing domestic market structures and practices, they often have limited applicability outside the country.

Consider the case of loan syndication, a lending practice that was introduced to Japan in the mid-1990s by foreign financial entities like Citibank and Bank of America. Syndicated lending was initially seen as a significant innovation, one with the potential to replace Japan's traditional bilateral lending market—and its penchant for over-borrowing, bad loans, and poor-risk management—with a more efficient and competitive market-based lending format. While the major Japanese banks initially enthusiastically adopted syndication, over time they adapted the original foreign practice, such that by the early 2000s, a novel "Japanese-style" syndication market had emerged. This "translated" format lacked many of the key components of the initial introduction, including, for example, market-based pricing of fees and interest rates, third-party risk assessment, and open participation by a myriad of lenders. In effect, the Japanese version of loan syndication ended up sustaining and reinforcing the traditional lending system, rather than challenging and improving it. Similar results can be observed across numerous foreign-launched products and services, wherein Japanese incumbents' adjustments of the initial offering end up mitigating its impact and influence on local firms and practices.

It's important to recognize that such adjustments and adaptations to fit the local market are nothing new. Arguably, some of Japanese companies' greatest success stories stem from products that were adjusted to fit the Japanese market, and then exported abroad. The fuel-efficient cars that drove Japanese export success in the early 1980s were in no small measure developed to deal with Japan's vulnerability to the oil shocks of the 1970s. Sony's Walkman and Honda's Cub motorbike can similarly be seen as products that took shape in response to the distinct needs of Japan's crowded urban centers. Cars, cassette recorders, and motorbikes are, however, stand-alone products, which can be exported as single units and utilized in any country. By contrast, financial services, organizational practices, and other intangible systems and goods are highly context-specific, and linked to local cultures. In this case, the Japanese penchant for adapting foreign innovations to fit the local market arguably became a disadvantage, since it effectively dilutes the innovation's value for, and potential impact on, the local market.

Same Country, Different Worlds

Why haven't foreign firms been able to make a bigger impact on Japanese companies? Much of the problem derives from the silo-like division between foreign and Japanese companies within most, if not all, industry sectors. Foreign firms typically find it difficult to break into the dense inter-company networks and relationships that still characterize many Japanese industries. In many cases, foreign firms are under-represented in formal industry associations, not due to outright exclusion, but rather because of traditional practices and routines.

In one case, an industry association mandated that all CEO-level meetings be

Foreign subsidiary market share

Retail	2%
Telecom	6%
Machinery	4%
Chemicals	5%
Pharmaceuticals	14%
Services	15%
Automobiles	10%
Total	**6%**

Source: METI **Note:** This includes any Japanese firm in which a single foreign firm owns more than a 10% share; if only majority-owned foreign affiliates were included, the share would be much smaller held in Japanese, yet also banned the use of translators; as a result, foreign executives stopped attending. Because of this, non-Japanese entities often form their own exclusive foreign associations and networks, as exemplified by the International Bankers Association Japan, and the Foreign Non-Life Insurance Association of Japan.

Notably, there are clear exceptions to the rule. In industries characterized by global alliances (e.g., pharma), foreign firms play a disproportionately larger role in the industry association. As the table on pg. 7 highlights, this is also an industry where foreign firms have a larger share of the total market. In most cases, however, there is a clear separation between foreign and domestic firms.

The perception

Such industry-level segregation suggests to many Japanese senior managers that foreign firms are qualitatively different. As a result, all-too-many of these managers ignore or actively dismiss foreign organizational strategies and practices, suggesting they are un-Japanese and incompatible with the local culture. As one manager explained to me, “We don’t really look at the foreign firms …they’re just different from us.” This is despite the fact that most employees at foreign firms are themselves Japanese.

The distinction between foreign and Japanese companies, and the lack of interaction between them, is further reinforced by the labor market. One of the most common pathways for knowledge spillovers—labor mobility between firms—is effectively closed in Japan, as the number of senior managers or engineers that leave foreign firms for Japanese companies is exceedingly small. Moreover, even on those rare occasions when individuals do transfer into Japanese firms, their knowledge and experience are rarely leveraged, simply because there are few structures and systems in place to actively learn from mid-career transfers.

Perhaps the biggest challenge, however, is the mental imagery of the foreign firm, as evidenced most obviously in the term *gaishikei*. The term identifies foreign firms as outsiders, belonging to a different category unto themselves. The term is often underpinned by the press, which regularly makes use of not only *gaishikei*, but at times also the epithet *kurobune*, or “black ships,” a direct allusion to Commodore Matthew Perry’s steamships that forced Japan to end its self-imposed isolation in the mid-1800s.

Ignoring innovations by *gaishikei*

Such broad categorizations serve to reinforce the notion that foreign firms’ practices are inherently different from those of Japan. In many cases, novel innovations and practices introduced by foreign firms are simply ignored by the general press. For example, Prime Minister Abe recently made headlines when he suggested Japanese firms should offer “equal pay for equal work” as a way of reducing wage discrimination against non-regular workers (mostly part-timers and temporaries) who now make up nearly 40% of the labor force. In fact, the Swedish furniture retailer IKEA introduced such a scheme last year, yet this received little attention in the media.

Clumping all foreign firms under the term *gaishikei* also obfuscates important differences among them. In particular, the term *gaishikei* is often associated with the finance industry, specifically the high-risk, high-reward culture of investment banking. Because of this, foreign firms are frequently viewed as offering low job-security, even when they operate in relatively staid industries like medical devices and apparel retail, or hail from European countries with strong employee protections. Many university graduates face pressure from parents to avoid foreign firms due to these images. The result is a two-track labor industry, where foreign companies tend to operate in a separate universe, with limited local attention.

Naturally, there are exceptions. A prime example is Coca-Cola, which occupies a dominant position in the Japanese beverage industry and has close relationships with Japanese bottlers and retailers. Tellingly, Coca-Cola has a long history in Japan, having entered with the occupation after World War II. Perhaps it’s not surprising that many younger Japanese believe Coca-Cola to be a Japanese company. The implication is that the foreign firm’s position is often a function of time; it takes years, if not decades, for the gaishikei to establish a reputable and trusted presence. Few foreign firms can boast of Coke’s track record; as a result, many subsist on the fringes of the local market.

***Gaishikei* no more**

Ending the artificial division between *gaishikei* and locals would be beneficial to both sides. How can this be done? A simple but still powerful first step would be for official Japan—and ideally also the press—to refrain from categorizing firms by nationality. While all governments seek to promote and protect their own firms, few developed nations make such an explicit distinction between the foreign and domestic as Japan. Refraining from using the *gaishikei* moniker would not only signal greater openness; it would also encourage consumers and suppliers to evaluate partners based on their qualitative merits, rather than the location of their headquarters. There are potential benefits for the Japanese government too: making less of the firm’s nationality might help reduce the hand-wringing that inevitably arises when iconic brands like Sharp and Nissan are acquired by non-locals.

Recruiting Japanese staff

Removing the *gaishikei* moniker also requires that foreign firms take a more active role in promoting themselves, particularly in recruitment. The *Nikkei* recently re-leased its annual special report on top-ranked firms among new graduates. In the 20-page report, which lists the top 10 to 20 employers across all major industries (300 in total), I could only find two foreign firms: McKinsey and Accenture. Foreign firms are conspicuously absent in the elaborate but crucial hiring system that Japanese university graduates pass through. Although many of my students speak excellent English, few are considering foreign employers, mainly, it seems, due to a lack of information. By proactively courting new grads, foreign firms can not only raise their profiles, but also help debunk some of the myths and stereotypes that graduates may still have about the *gaishikei*.

In the short-term, such actions can improve the attitudes of potential recruits. Over the longer haul, a greater understanding of foreign firms can promote more inter-company hiring and tie-ups, generating learning and innovation on both sides.

To many foreign firms, Japan remains a semi-closed market, frustratingly difficult to tap into. Conversely, many Japanese firms view foreign companies as inherent “outsiders” whose innovations and practices have limited applicability to the local market. As a result, many of the potential fruits of collaboration and learning that come with FDI remain unrealized.

Changing this requires a mental shift in the way firms, customers, regulators, and the media classify organizations based on their nationality. Ditching the *gaishikei* nomenclature and mentality would be an important first step.