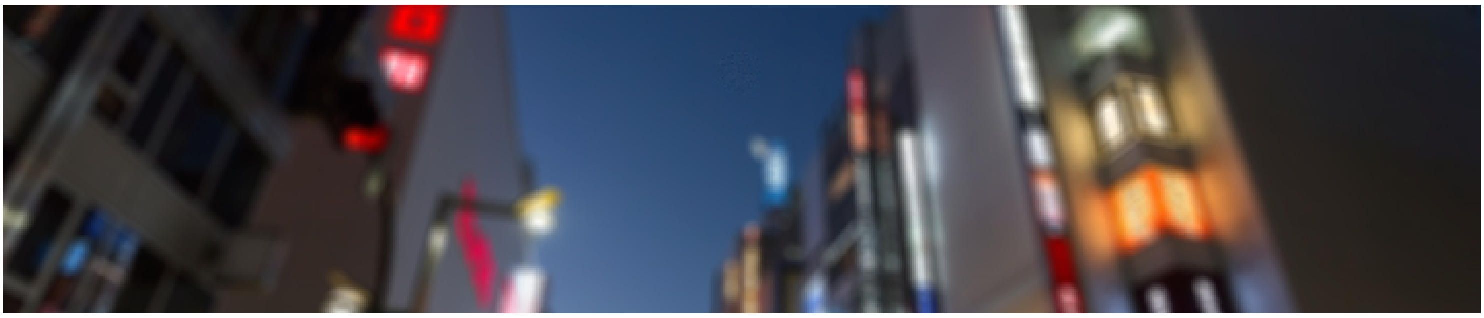
TOMORROW'S CHALLENGES



FROM SUMMIT TO PLUMMET IN JAPAN

GOVERNMENT SUPPORT OF BIG COMPANIES WAS ONCE GOOD POLICY, BUT IT IS NOW UNDERMINING THE ECONOMY

By IMD Professor Howard Yu – February 2015

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Along New York's fifth avenue at 59th street, the Apple flagship store is packed around the clock. A few blocks south stands a quiet Nintendo World Store. Tucked away in one corner is a collection of historic products, ensconced in museum-style glass cases: The 10,000-square-feet-space, with its sleek, stylish decor, was eerily quiet when I visited. If the Nintendo World Store exuded a sense of nostalgia, it was not alone, and with good reason.

According to *The Economist*, the five biggest Japanese electronics companies – NEC, Panasonic, Fujitsu, Sharp, and Sony – have lost two-thirds of their market value since 2000. Sony alone lost more than USD2 billion in 2014. Although economic malaise has plagued the land of the rising sun since the housing bubble of the 1980s, big Japanese firms seem to have since been sapped of their very vitality. What could have caused the long-term collective decline of a once vigorous industrial cluster?

Big firms disrupted only once

Harvard Business School Professor Clayton Christensen, who originally coined the now much popularized term "disruptive technology," once summarized the Japanese problem in a simple phrase: The big firm had been very disruptive in the past, but it played the disruptive game only once.

Concentrating on secondary markets and relying on greater economies of scale globally, firms like Toyota were able to sell products which were up to 20% cheaper than the competition, while buying time to refine their skills in marketing and distribution. Such learning opportunities are critical for any latecomer countries to move up the value chain in the global market.

In contrast to the popular belief that Japanese firms exhibited features of crony capitalism where direct competition was avoided, history showed otherwise: the Japanese government had encouraged fierce competition among domestic firms throughout its industrial development. Keiretsus – A Japanese term for a complex business groups with interlocking shareholding relationships and banking operations at their core – often entered the same industries with the subsidiary operations of other competing keiretsus. From heavy machinery, construction equipment, automotive, to electronics, Japanese companies fought hard to gain their share of the domestic market.

More importantly, however, was the export requirement that had been the hallmark upheld by policy makers whereby firms that successfully met export targets would be rewarded with preferential treatments such as tax concessions and low-interest financing. Less successful businesses were culled. The promising companies were turned into national champions with an explicit, expansive agenda. Fueled by growth, they eventually became the household names that we recognize today: Toyota, Honda, Canon, Nikon, Toshiba, Hitachi and so on.

The role of big companies and economic progress cannot be overstated. Many small or low-population countries like Belgium and Sweden got rich through big firms. But no large, populous country ever got rich by relying solely on foreign investment or an army of small companies. In Japan, then in Korea, Taiwan, and more recently China, international competitive companies were nurtured by the state.

Supporting big firms is an outdated policy

But what used to be good policy in the early stages of development later turned into a bureaucratic burden. Building new capabilities and transforming an organization is tough. Very few companies have been willing to undertake major changes, and still fewer have succeeded. And if a nation's economic prospects disproportionally depend on the success of a handful of large firms in the increasingly turbulent global market, policy makers are in fact betting the country's future on a few industry captains.

In the United States, when RCA, DEC, NCR, Westinghouse, Fairchild and the likes were increasingly under threat from rising Japanese counterparts, it wasn't the former wounded giants that fought back and restored the US economy to its former glory, it was the next generation of entrepreneurs hailing from Silicon Valley who heralded the internet age, which ultimately allowed the US to scramble back up to the leading position in the information technology sector.

In fact, overwhelming evidence from academic research suggests that when changes were incremental and continuous, large established organizations triumphed; but in the face of radical and discontinuous changes, the small, nimble, and agile players thrived while the large and well-established collapsed. In Japan, the venture capital industry – the engine that recycles human and finance capital – is markedly absent. The country even exhibits a strong bias in favor of large firms, as reflected in its current banking system and government regulations.

Support for more nimble firms is needed

Again, although nurturing big, internationally competitive companies was once considered to be good economic policy, it is now undermining the growth of the future economic engine. Sony, Toshiba, Sharp, and many others had been disruptive in the past, but the country relied too heavily on a single generation of successful companies, and, inevitably, they could only be disruptive once.

Break a dynasty and let a thousand bloom. This seems to be the policy of Silicon Valley, and so far, it has worked its magic. Maybe policy makers would be wise to pay attention.

Howard Yu *is Professor of Strategic Management and Innovation at IMD. His teaching and research activities focus on why and how some firms can sustain new growth while others cannot. He received his doctoral degree in management at Harvard Business School.*

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