Global strategy lessons from Japanese and Korean business groups

Howard S. Tu  
Associate Professor of Management,  
University of Memphis, Memphis, Tennessee

Seung Yong Kim  
PhD candidate in management,  
University of Memphis, Memphis, Tennessee

Sherry E. Sullivan  
Associate Professor of Management,  
Bowling Green State University, Bowling Green, Ohio

In the last decade, Asian countries have made great and rapid economic gains. As many Asian firms outperformed their US counterparts, some researchers began to speculate on whether the organizational structures of business groups—specifically, the Korean family-owned conglomerates called chaebols and the Japanese conglomerates known as keiretsus—were the causes of these economic gains. Chaebols and keiretsus are groups of independent companies operating in different markets with different products and services but under common administrative and financial controls. The groups depend on each other for leadership, human resources, and R&D functions, and are extremely important to the economies of their respective countries. The chaebols are credited with the rapid development of the Korean economy after the Korean War and the keiretsus are credited with the tremendous economic growth of Japan after World War II.

Although a number of researchers have examined these business groups, none have provided in-depth comparisons of them, especially in light of the recent Asian financial woes. Since June 1997, Asia has been enveloped in a severe economic crisis, with widespread bank failures and company bankruptcies. This crisis is unprecedented in a region where most of the governments were accustomed to operating in environments characterized by fiscal balance, low inflation rates, and low levels of unemployment.

In conducting a systematic comparison of these two groups, our aim here is to answer the following questions:

1. Why are most observers optimistic about Korea’s ability to recover quickly from the economic crisis, whereas few believe that Japan will be able to do the same?

2. What features of the Korean business groups permit them to respond faster than the Japanese groups during times of financial crisis?

3. What is the relationship between the government and these business groups?

To provide some insight into these two groups, we will examine and compare the ownership, structure, finance, and operation of these business groups. Based on this examination, important lessons for strategic international management are presented.
government influence, and cultural implications of the chaebols and keiretsus, as outlined in Figure 1.

Ownership and control

The stock of Korean chaebol member companies is heavily owned and controlled by the owners’ family members, whereas the controlling ownership in Japanese keiretsu members are spread among their affiliated companies. These differences in ownership have resulted in different management styles (autocratic versus collective) and focuses (shareholder versus stakeholder).

Chaebols

Chaebol ownership generally follows one of three patterns:

1. sole possession, whereby the founder or his family members and relatives own all affiliated enterprises
2. domination by the core company, whereby the founder or his family members and relatives own the core company, which in turn owns other affiliated enterprises
3. mutual possession, whereby the founder or his family members and relatives own the core company and/or some kind of foundation, which in turn owns other affiliated enterprises

Keiretsus

Keiretsu ownership operates under the close supervision and control of a family, which in turn is responsible to its head.

This highly converged ownership has two major effects on the managerial orientation of the chaebols. First, family members can exercise a great deal of influence on managerial activities. Because 31 percent of the executive officers of the top 20 Korean chaebols consist of the owners’ family members, agency costs can be avoided. As a result, chaebols are more likely to be oriented toward shareholders. This shareholder orientation, however, leans more toward the majority family shareholders than outside minority shareholders.

Second, chaebols usually have strong autocratic leaders who emphasize top-down decision making, one-sided top-down communication, and dauntless goal seeking. Such strong leadership, however, is not always effective, often resulting in an unbalanced decision-making structure in which more than 80 percent of the authority resides at the upper management level. Chaebols may often miss opportunities because opinions and information from outside top management typically are not sought.

Features | Chaebols (Korea) | Keiretsus (Japan)
--- | ---: | ---: |
Ownership and control | • Family owned | • Cross-stock ownership
• Family-oriented | • Stakeholder orientation
• Strong autocratic leadership | • Collective leadership
Structure | • Unrelated, vertically integrated structure | • Either horizontally diversified or vertically integrated
• Government does not allow groups to own banks | • Banks are core group members
• Expansions based on family moods and government policies | • Expansions based on MITI’s long-term plans and group’s strategic planning
Finance | • Internal goals dictated by government’s goal agenda | • Internal goals dictated by own financial institution’s long-term returns
• Cross-debt-payment guaranteed loans | • Capitalized by using internal banks and financial institutions willing to take higher risks
Government influence | • Enforcement of industrial policy through direct grants and subsidies | • Supportive of industrial policy through research subsidies
• Cause of undisciplined growth and overcapacity in some industries | • Competition reduced by support of weaker firms and “no lose” strategy
Culture | • Wha enables quick decisions and ability to sell or liquidate unprofitable units | • Wa requires time to reach consensus

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Keiretsus

Japan’s keiretsus have benefited from the practice of “cross-stock sharing,” whereby member companies own some stocks of other member companies. This practice is
a symbol of commitment and mutual obligation to the
group. It is also a means of sharing risks and preventing
hostile takeovers. However, with the risk to individual
members reduced, the original intention of the practice as
a reinforcement of group loyalty has been forgotten by
some members.

Because the ownership of individual firms in a keiretsu
is spread among affiliated companies without a major
owner, leadership tends to be collective rather than auto-
cratic. Moreover, the individual firms are concerned more
with stakeholders’ interests than with those of share-
holders. The member companies tend to collude and do
what they consider to be in their own best interests rather
than work toward increasing the total value of the group.
This practice of cross-stock ownership seems to serve as a
means of promoting self-interest rather than as a means
of controlling group behavior.

Ownership factors: Implications
of the Asian crisis

In response to the recent financial crisis, chaebols have
acted much more quickly than the keiretsus. As soon as
the Korean government decided to accept the Interna-
tional Monetary Fund (IMF) loan, chaebol leaders read-
justed their investment priorities, focused on maintaining
a stable cash flow, and increased efforts to downsize com-
panies through wage freezes or layoffs.

The Japanese keiretsus have also been under a great deal of
external pressure to reform. According to Bremner (2001),
the IMF has threatened to send a team of auditors to make
sure Japan’s banks are using acceptable practices in making
their loans. Unfortunately, the keiretsus lack strong leaders
who can pull the group members together and bring them
through the crisis. Mitsubishi CEO Minoru Makihara, in a
comment that well represents the leadership problems
keiretsus are experiencing, said:

Twenty years ago, there were powerful leaders in
the group. People are now more concerned with
their own problems. The Friday Club crowd hates
to embarrass underperforming colleagues in pub-
lic. We never raise topics related to the manage-
ment of individual companies. (Bremner, Thorn-
ton, and Kunii 1999)

Structure

Chaebols and keiretsus differ in their organizational
structures. Whereas the chaebol has more of a con-
glomerate structure, keiretsus are either horizon-
tally diversified or vertically integrated. Moreover, a keir-
etsu always has a bank or group of banks as one of its
three core firms, whereas a chaebol is prohibited by law
from owning or controlling a bank. This difference in
structures is a result of environmental and historic forces.

Chaebols

As shown in Figure 2, the organizational structure of the
chaebols is a result of their diversification strategy. Chae-
bols consist of a number of independent groups of
vertically integrated firms. The industries these
groups are involved in are completely unrelated to
each other, with their only common link being their
ownership. Internal trading among member compa-
ies is quite high. In 1998, chaebols’ internal trad-
ing was 28 percent of their total business transac-
tions. Unlike keiretsus, the chaebols do not have an
internal financial institution because Korean law
prohibits any business group from owning or con-
trolling its own banks.

Chaebols have been criticized for expanding in an
“octopus leg” style. Expansion is often determined
by kibun (“personal feelings and moods”) or by fam-
ily rivalries. For example, a chaebol may enter a new
industry just because other chaebols are doing so.

Expansion may also occur as a result of the govern-
ment’s industrial policies. By following such a pol-
cy, chaebols often enter a new business that is in its
infancy. The instability of suppliers and uncertain
demand prevent economies of scale and cause tre-
mendous opportunity costs. This forces the chaebols
to integrate vertically according to the needs of the
particular business. When government policy caused
sporadic supply and higher prices in imported steel, Hyundai Motor Corporation decided to invest in the steel industry to guarantee a reliable supply of raw materials. Similarly, it is quite common for a chaebol to enter a new industry for the purpose of cementing its relationship with officials who are championing a special government program. Thus, the diversification of chaebols is often based on reactive responses to government policy or political reasons rather than on strategic planning.

**Keiretsus**

Unlike chaebols, keiretsu expansion is carefully thought out and strategically planned. These groups have two types of organizational structures. Vertical keiretsus operate in only one industry and are completely vertically integrated. Horizontal keiretsus operate in more than one industry, but the industries are highly related to each other. The two structures are mutually exclusive.

There are mixed reports concerning the internal trade among member companies of a keiretsu. Some estimate that 30 to 50 percent of a keiretsu firm’s contracts are with other member companies, with vertical keiretsus having a higher percentage of internal trade than horizontal ones. Overall, the rate of internal trade among member firms is much higher in keiretsus than in chaebols.

Japan has no law prohibiting keiretsus from owning any financial institution. Typically, one of the three core firms in a keiretsu is always a bank or a group of banks (see Figure 3) whose responsibility is to provide low-interest loans and take care of any other financial needs of the member firms. At the same time, these banks also participate actively in cross-stockholding of other members.

**Structure: Implications of the Asian crisis**

Since the Asian economic crisis, groups in both Korea and Japan have been under great pressure to restructure their organizations by disposing of nonperforming business units. Because the chaebols have unrelated business units, it is easier for their owners to identify the nonprofitable ones and dispose of them. The chaebols use a process called “the Big Deal” to put blocks of business units on the market for trade to other chaebols. Although the government played an important role in the introduction of this process, many chaebols have recognized it as an opportunity to renovate their group structure as well. The Big Deal serves as a market in which business units are bought and sold. If there is no buyer for a specific business whose performance has been poor, then the business will be put on a “workout list” and it will either eventually drift to another chaebol or be closed down. While the Big Deal allows chaebols to get rid of their nonprofitable and non-core business units, it also permits some chaebols, such as Hyundai and Kumho, to expand and strengthen their primary business units through the purchase of similar units from other chaebols. The end result is that the restructured chaebols have become more vertically integrated with a narrower focus on a few core business areas.

Because keiretsu structure is designed for synergy, it is more sensitive to industrial downturns. Even before the onset of the financial crisis, some keiretsus were already affected by the slowdown in the Japanese economy. A few have finally disposed of some of their nonprofitable units. Japan’s largest steelmaker, Nippon Steel, sold its semiconductor subsidiary to United Microelectronics, the Taiwan-based wafer foundry group. Similarly, Yamaichi sold its retail network of failed brokerage houses to Merrill Lynch, while Travelers acquired 25 percent of Japan’s third largest broker, Nikko. Other keiretsus have restructured by cutting back secondary business units and seeking strategic alliances with foreign companies or other keiretsu companies. Moreover, there have been mergers and acquisitions between Japanese financial companies themselves. These types of business activities were unimaginable before the recent financial crisis.

Unfortunately, because of the synergy of their business units, the keiretsus cannot dispose of large blocks of their operation without affecting the overall performance of the group. In most instances, outsourcing must be found or developed to replace the functions of their displaced units.
As a result, the restructuring process is slow, painful, and often ineffective.

Finance

Both chaebols and keiretsus focus their interests on market share and sales volume. However, their interests originate from different sources. Although chaebols are more shareholder/family-oriented, their interests in market share and sales volume are dictated by their government’s economic goals. In contrast, keiretsus’ interests in market share and sales volume are dictated by their own financial institutions’ focus on long-term returns rather than short-term profits.

Chaebols

Chaebols’ financing strategy is closely linked to the government’s support policy and the legal environment. The government has provided financial resources through the preferential allotment of grants, foreign loans, and the disposal of government-vested properties (land, government-owned power supplies, lower taxes, and so on). It usually awards the largest share of resources to companies with the biggest market share and total sales. So the chaebols are always desperately seeking ways to increase their market share and total sales, with little consideration for profitability.

Although chaebols can raise some of their capital by issuing stocks, it is not an attractive alternative. The high cost relative to the risky Korean economy and the possible loss of control for family owners make issuing stocks to the public unappealing. For capitalization, chaebols prefer to use a “cross-debt-payment guarantee” strategy whereby group member companies use their own equity to guarantee payments and secure loans from outside banks to support the financial needs of other members. This strategy also creates strong bonds among group members for three reasons: (1) if a loan is defaulted, the guaranteeing company is liable; (b) it encourages trading among group members as a form of support for weaker units to prevent them from defaulting on their loans; and (c) it leads to a concentration of power at the top of the management hierarchy, which is necessary to prevent a total collapse of the entire group from any domino effect resulting from a member firm’s bankruptcy.

The legal environment in Korea has also affected the organizational characteristics of chaebols. Until recently, the groups were not allowed to own any bank stock, and their investment in insurance companies and security firms was restricted by law. By controlling financial channels, the government prevented the chaebols from dominating the capital market.

Keiretsus

The financial strategies used by keiretsus are also related to government policy and the legal environment. Japan’s supporting policy toward an industry usually takes the form of research and development. The government sponsors various projects to develop new technologies through encouraging basic research. The most famous example of such sponsorship is the VLSI semiconductor technology development project (1976–1980). Jointly funded by government (¥30 billion) and industry (¥42 billion), the project contributed greatly to the strength of the semiconductor industry in Japan. In addition to considering the viability of a keiretsu and its investment efforts, the government also appears to consider industrial balance among the business groups when disbursing resources. One example is how Japan’s Ministry of International Trade and Industries—MITI—assigns the automobile Voluntary Export Restraint (VER) quotas to the country’s eight automakers.

In contrast to Korea, Japan has few legal restrictions on its keiretsus regarding investments in financial institutions, including bank, security, and trust fund management firms. This has resulted in most keiretsus having a major bank or banking subgroup in their leading core network. Under the antitrust laws, which prevent keiretsus from having a central holding company structure, the existence and position of these financial institutions actually serve most of the functions of a holding company. The institutions support their group members by providing low-interest loans, investing in member stocks, and providing other financial support as needed.

Because of these internal financial sources, keiretsu members do not need to use high-risk financing strategies to obtain capital. In addition, Japanese banks are generally more willing to assume riskier loans for member companies. Banks in the keiretsus encourage member firms to focus on long-term return strategies such as market share and sales maximization rather than short-term profit maximization. Banks also encourage member firms to use more capital through expansion of output levels in order to increase their own profitability. Although each group’s own banks and financial organizations are responsible for the viability and expansion of the group, the failure of any of these financial institutions will have a detrimental impact on the whole business group.

Finance: Implications of the Asian crisis

Both chaebols and keiretsus use their own method of capitalization and avoid traditional sources such as public stock issuing. According to the IMF’s 2001 annual report, the Korean economy is recovering faster than Japan, and the chaebols are outperforming the keiretsus in their contribution to national recovery from the financial crisis.
Korea is under an IMF mandate to cut down on cross-debt-payment guarantees. Through the effort of the Big Deal, such guarantees among the top five chaebols’ subsidiaries dwindled 70.3 percent in the fourth quarter of 1998, from 21.3 trillion won (the Korean currency) down to 6.2 trillion won. The IMF report clearly indicates that Korean chaebols have “improved their capital structure and profitability.”

Japan has been under a great deal of internal political pressure to improve its economy by restructuring the banking system and revitalizing the corporate sector. Even with most of the required legislation in place and the recent announcement of mergers among major banks, Japanese bankers are still reluctant to cut off the financial support of keiretsu members. The IMF reports that banks in Japan are still slow in improving the “quality assessments and provisioning practices” of their loans. Bad loans are emerging as fast as old ones are written off. Overcapacity in corporate Japan is still a common problem, and FY2000 financial results showed weaker operating profits.

In sum, the Japanese economy is still struggling to recover from Asia’s financial crisis. A moderate recovery in 2000 has given way to renewed weakness. There is now a broad consensus that sustained recovery will not be achieved until the roots of Japan’s economic problems are addressed.

The role of government influence

The Korean and Japanese governments have both had a heavy hand in the planning and development of their respective countries’ industries. Thus, they have molded the structures of their largest business groups, the chaebols and keiretsus. In both countries, influence has come through industrial planning and subsidization.

Chaebs

Although the chaebols were thought to be built by self-made founders, many of them were actually developed by various support plans initiated by the Korean government. The government played an important role not only in encouraging the growth of chaebols but also by indirectly influencing what industry the groups would expand into. For instance, when the focus of the government’s Five-Year Economic Plan shifted from one industry to another, the chaebols also shifted their business focus. The government’s indirect influence has caused undisciplined investments and explains why the top five chaebols have very similar organizational structures and overlapping business units.

In addition, the eagerness of the government to become involved in new industries has created unnecessary competition among chaebols. For example, the government supported the Samsung group’s entrance into the automobile industry despite the presence of two other chaebols, Hyundai and Daewoo, already involved in manufacturing passenger cars. The resulting strong competition in the Korean market caused Samsung’s financial problems at its beginning production in 1998.

Despite some of the problems the Korean government has produced, it can also be given credit for the success of most chaebols. Officials generally have a strong influence over which groups will get government financial support and subsidies, and the chaebols will compete to be in the good graces of these officials.

Keiretsus

The present structure of keiretsus is the result of historic events and Japan’s industrial policy. After World War II, zaibatsus, the large business groups that dominated the Japanese economy, were dismantled by US occupation authorities. The United States introduced antitrust laws in Japan that were very similar to its own. These laws are still in effect and forbid the existence of any central holding company. MITI served as a coordinator of the restructuring of postwar Japan and encouraged the development of the keiretsus. One reason Japanese industries are able to compete successfully in the world market is MITI’s strict guidance.

MITI also plays a participating role in Japan’s industrial policy. Unlike Korea’s government policy of directly encouraging investments in selected industries with no disciplinary expansion control, the Japanese government has focused its subsidies in the form of research and growth development. Its goal is to develop “planned competition and growth with no losers.” For instance, the Japanese VER program in the auto industry resulted in the government intentionally giving more favorable consideration to weaker manufacturers when assigning quotas. Similarly, the VLSI semiconductor technology develop-
ment project produced more than 1,000 government-owned patents, which Japan licenses not only to the companies that participated in the project but also to nonparticipating companies. On the other hand, MITI also plays an important role in deciding which companies will be allowed to participate in which industries. In sum, the Japanese government is focused on reducing competition among groups, promoting better planned growth, and creating a “no loser” mentality.

**Government influence: Implications of the Asian crisis**

When the Korean government realized it could not deal with the financial crisis on its own, it sought assistance from the IMF. But the IMF was willing to help only if Korean businesses reduced the cross-debt-payment guarantee among members of the same business group. In anticipation of the government’s call for management and industrial restructuring in exchange for the IMF loan, the chaebols reassessed the value of their subsidiaries. As a result of this quick response, cross-debt-payment guarantees decreased 70 percent in one year. Moreover, the government reduced competition among major chaebols by requiring businesses to rid themselves of excess capacity.

In contrast, Asia’s economic downturn caught the Japanese government by surprise. During the initial part of the crisis in 1997, real estate values in Japan nose-dived. Most banks refused to readjust those values in their loan portfolios in an effort to avoid recalling the loans of their member firms. Once businesses began to fail, banks were stuck with the real estate the businesses used as loan collateral. Today, on paper, many Japanese banks are bankrupt, which has caused further economic depression in the country.

Despite the fact that the Japanese government is under a great deal of pressure to improve the economy, it is reluctant to force banks to reevaluate and restructure their loan portfolios because it may cause the collapse of some keiretsus. Further, because its subsidies are in the form of research and planning, the government does not have the direct financial clout to bring reluctant group businesses into line.

**Culture**

Both chaebols and keiretsus emphasize the idea of harmony. However, the groups have different interpretations of the word and enact it differently.

**Chaebols**

*Wha*, or harmony, in Korea is interpreted by business leaders as a form of “sharing pain” under extreme situations. Because the power structure of chaebols is concentrated in the upper management levels, leaders tend to be very autocratic. This strong, autocratic culture permits chaebol managers to react quickly to a crisis and sacrifice unprofitable business units without major resistance. The principal of *wha* also allows managers of negatively affected business units to accept their sacrifice as part of sharing the pain.

**Keiretsus**

*Wa*, or harmony, in Japan is influenced by the government’s “no loser” policy. Member companies are more concerned with such stakeholder values as maintaining good relationships among member companies and supporting each other’s survival than with such values as profit and return on investment. Because of this no-loser mentality, no business unit will be singled out for poor performance. Often, more profitable units withdraw from the evaluation and criticism of other group members and concentrate on pursuing their own best interests. The keiretsus’ collective leadership is based on group responsibility and may help reduce corporate corruption. However, such leadership is slow to react in a crisis.

**Culture: Implications of the Asian crisis**

In contrast to the Korean culture, Japan encourages a participatory communication system and consensus decision-making, again making it slower to respond to a crisis. The cultural belief in *wa* and the country’s no-loser policy have also made many keiretsus reluctant to dispose of nonperforming units. Instead, many keiretsu affiliates have gone their separate ways. Sumitomo Life, Japan’s third largest life insurer, borrowed ¥165 billion (US$1.46 billion) from companies in a different keiretsu while other affiliated companies of Sumitomo’s keiretsu were unable to obtain financial support. In addition, both Toyota’s and Hitachi’s requests for assistance to their own member banks have been turned down. Takashi Kiuchi, one of Mitsubishi Electric’s managing directors, declared, “The keiretsu system now seems to be largely a fiction” (Bremner et al. 1999). Insiders of many keiretsu member
companies have said that they will look outside the group for alliances and new opportunities. If these trends continue, the mighty keiretsus may end up disintegrating into many smaller groups.

The reasons for the successes and failures of international firms are usually extremely complicated. It would be naive to believe that these reasons can be streamlined and simplified into a few direct factors, or to announce that one form is better than another. Obviously, under different environmental conditions the outcomes can be completely different—as evidenced by the extremely successful performance of the keiretsus in the 1970s and ’80s. So we have examined and compared the business groups of Japan and Korea in light of the current Asian financial situation to investigate their reactions to the crisis and to provide some insight into understanding their organizational characteristics as well as their strengths and weaknesses.

As summarized in Figure 1, factors including ownership, structure, finance, government influence, and culture have given the Korean chaebols the upper hand in coping with the Asian crisis. Strong autocratic leadership has helped them respond and adjust quickly to the unexpected, volatile nature of this economic downturn. Both chaebols and keiretsus have altered their structures in response to the new environment. The chaebols have taken the opportunity to solidify and expand their core business units and to become more vertically integrated, whereas the keiretsus have succeeded only in the limited disposal of some nonperforming units. The Japanese government’s financial incentives and subsidies have been more effective in pressuring the chaebols to reform. Meanwhile, the Japanese government’s “no loser” approach to planning and subsidies may be more effective in supporting its industries in global competition, but has not been effective in influencing the keiretsus in a crisis situation that calls for discipline and sacrifice.

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