SOUTH KOREA AND TAIWAN, like many other countries, have a trade deficit with Japan. Why? Because they are dependent on Japanese inputs — mostly components and materials, but also highly specialized steel — to produce their own products. If Japan were to sink into the ocean tomorrow, Samsung would be unable to build high-class LCD TVs, Apple could not produce a single iPhone and Boeing and Airbus would have to halt airplane production. The notion that Japanese companies have “lost it” reflects a 20th-century mindset that ignores the realities of today’s global supply chains.

Perhaps the best — though by no means singular — example of this is the high-end consumer electronics industry, including flat panel displays, cell phones, DVD players and digital cameras. According to Japan’s White Paper on Manufacturing 2006, the combined global market share of Japanese companies for these end products stood at around 25 percent in 2005. This is why many believe that competitors from South Korea and Taiwan have outdone Japan. After all, Japanese companies used to rule that market.

MOVING UPSTREAM
But wait! According to the same data, in “midstream” products that feed into these gadgets, such as semiconductors, circuit boards or laser heads, Japanese companies combined account for roughly half of world market share. And in upstream products, such as advanced adhesives and resins needed for semiconductor production, and the polarizers that make a flat panel display viewable in sunlight or produce true black, Japanese companies own more than 66 percent of the world market. And more than half of the global market for the advanced machinery needed to make semiconductors or LCD panels belongs to Japanese firms.

This new role is highly desirable, given the “smiley curve of profits.” This is a U-shaped curve that depicts the various steps of production for a product category on the x-axis, and profit margin on the y-axis. In electronics, the low point of the “U” is product assembly. When you buy a new TV, the real money is made either upstream (in the materials and components that differentiate the product), or downstream (in this case, the retail store).

Over the last decade, Japan’s leading companies have strategically repositioned themselves to move away from the low point, and toward the upstream part of the “smiley” curve. Those that have already accomplished this transition have emerged as more profitable and differentiated. This change took a decade, and in some industries is still under way. Nor was it easy, and it took some companies too long to realize that the previous cost advantage they enjoyed in the mass production of high-quality household products has moved elsewhere. Margins in the assembly stage are too thin for a high-cost nation. Moving upstream, where technology leadership is less contested and margins are much higher, is the correct strategic repositioning for Japanese firms.

STRATEGIC INFLECTION
The 1990s are often referred to as Japan’s “lost decade.” In reality, things had gotten so bad that Japan’s leading companies were forced to change
aggressively. Even reluctant reformers were pushed toward change when the non-performing loan crisis, and in particular the 2002 Financial Reform Program, made banks more aggressive in their attempts to restructure unprofitable firms. As banks pushed their borrowers to sell off marginal business units to recoup losses, some companies proactively began to look for new business opportunities to return to profitability. In the process, large firms became leaner, and the spun-off business units were by definition more focused.

Just as this new market for corporate assets developed, the 1998 revision of the Foreign Exchange Law removed previous limitations on foreign investments in Japan. In the 15 years between 1995 and 2010, foreigners increased their share of ownership at the Tokyo Stock Exchange from about 8 percent to 28 percent. In contrast to the previously dominant stable shareholders, these new investors were interested in profits and the soundness of the business model, and began to exert pressure on companies to move into high-margin activities.

In the 1980s, Jack Welch declared General Electric’s strategy in a nutshell as “Be No.1 or 2, otherwise fix, sell or close.” This is precisely what leaders of Japan’s largest companies decided to do in the late 1990s. The most prominent business catchphrase in Japan in the early 21st century was “sentaku to shūchū,” which I have translated as “choose and focus.”

In their attempts to close down non-core subsidiaries, sell off non-profitable businesses and acquire spinouts from their competitors to dominate a core business segment, companies faced insurmountable restrictions in the Commercial Code. In response, between 1998 and 2006, Japan revised the Commercial Code annually, in order to facilitate reorganization and restructuring. Adjacent laws, such as the Labor Standards Law, were also amended. In 2006, a new Corporation Law replaced the old Commercial Code, and in 2007 Japan introduced its version of the Sarbanes-Oxley Act (known as J-Sox) to increase shareholder rights commensurate with the new liberties granted to management. Somebody who has not looked at the legal environment of doing business in Japan for a decade will hardly recognize the new setting.

These legal revisions and shifts in shareholder structure — and therefore managerial incentives — marked a strategic inflection point in Japanese business. In reaction, some 75 percent of the Nikkei 500 firms engaged in at least one measure of reorganization — defined as exiting a business line, acquiring a business for consolidation or implementing a new organizational structure. In comparison, during the refocusing wave in the United States in the 1980s, about 50 percent of Fortune 500 firms were estimated to have slimmed down. Japan’s “choose and focus” wave was truly remarkable.

**New Japan Leadership**

The strategic repositioning has led to new technological relevance for Japanese firms in two ways. First, large firms have refocused. For example, Panasonic has exited the market for both blow dryers and semiconductors. The company now
focuses on four business areas, of which one is high-end electronics products, under the slogan “ideas for life.”

Second, the newly focused firms now need to purchase inputs that they previously may have built in-house. By exiting many component categories, they have made room for innovative, mid-sized firms to expand. These young, new multinationals — such as JSR, Ibiden, or Nitto Denko — are easily overlooked, as they are not (yet) household names. Meanwhile, many large firms replaced yesterday’s businesses with tomorrow’s, such as Fujifilm Holdings or Shin-Etsu Chemical. These companies bear only scant resemblance to what they were two decades ago. Toray and Teijin are no longer stuffy textile companies; they are now materials companies. Together, they control 70 percent of the global market in carbon fiber, and are leaders in a variety of environmental membranes and pharmaceutical skin patches.

The emergence of new industry hierarchies is perhaps the most important result of “choose and focus.” People who feel that Japan has “lost it” base their observation on the track record of companies that were the export leaders of the 20th century. Some of these may indeed have “lost it,” while others are still undergoing the refocusing turnaround, a process that can easily take a decade. But the exciting rise of new companies with distinct capabilities and the successful switch of others into new industries have counterbalanced the decline of the laggards. Market share is not necessarily their primary goal. The New Japan companies are aiming for profit. These new strengths play out in important product categories that often remain invisible unless one actively looks for them. A preoccupation with companies that are household names will yield a misleading evaluation of Japan.

**Implications**

It is still too early to judge how the strategic refocusing will materialize into long-term profits. It may take some time for the results to be reflected in macroeconomic numbers, as many laggards are still structuring their turnaround. But it is important to realize that Japan’s strategic inflection between 1998 and 2006 was not predicated on one event or based on one law or one politician. It was triggered by a confluence of factors — crisis, globalization, push from within and social change — and therefore is irreversible at its core.

To assume that corporate Japan is unchanged could be a recipe for failure. And relying on trade statistics that emphasize end products to evaluate the economic prowess of the country completely ignores the current reality.

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