Public & Industrial Policy Barriers to Independent Vertical Integration: Reflections of Keiretsu  
by John W. Bagby

I. INTRODUCTION

Keiretsu is a Japanese industrial organization form that has been both praised and criticized in recent years. Firms within a Keiretsu are linked in numerous ways. These links exist between firms in different industries and between firms that stand in vertical relationships. Japanese firms within Keiretsu tend to solidify their relationships through links and affiliations such as: cross shareholdings, interlocking directorates, social structures among top management, financial commitments, joint affiliation within commercial and investment banks, joint R&D activities, technology transfers, primary or exclusive customer supplier relationships, and unspoken social norms creating expectations for all employees to concentrate their purchases from Keiretsu members.

Observers recognized the strength of Keiretsu lies in supplying two kinds of assurance to its members. First, Keiretsu relationships create trust among vertical trading partners (e.g., suppliers, customers, manufacturers, assemblers) that the output of finished goods to consumers will be competitive against other major competitors in other Keiretsu or in other nations. Second, the Keiretsu provides the assurance of a safety net protecting member firms from bankruptcy during hard times and the downturn in the business cycle. These two primary assurances permit Keiretsu firms to move quickly into new markets, quickly update product offerings, quickly reflect price changes of raw materials components, or finished goods, and thereby maintain more flexibility than firms dealing at arms length within the chain of distribution. Keiretsu firms are more likely to weather recessions and changes in consumer preferences.

Keiretsu critics argue the industrial organization structure is a futile-like family of firms reminiscent of the late 19th century monopolistic trust. The absence of arms-length negotiation among all participants in the chain of distribution relegates through market forces only at the consumer level. Even then, particularly in Japan, consumers working for one Keiretsu are expected to purchase most of their goods only from producers within the Keiretsu. It is acceptable to make purchases from non-Keiretsu members only when no Keiretsu member produces that good or service. Similar unspoken expectations for restricting purchases and sales within the chain of distribution exist for all Keiretsu members. For example, suppliers are expected to forego sales of surplus production to competitors in other Keiretsu rather than make sales to a competitor. Customers are likewise expected to make exclusive of Keiretsu member supplies except under extraordinary conditions such as a suppliers inability to meet the demand. Keiretsu generally imply a lack of choice for buyers and sellers throughout the chain of distribution. This loss of liberty is inimical to most westerners.

Significant legal questions arise in the United States about the operation of Keiretsu. As the Japanese economy begins to spread worldwide, the applicability of the United States antitrust and takeover laws are drawn into question. keiretsu structures
arguably violate the prohibition against monopolization and restraints of trade under U.S. and E.C. laws. For example, Keiretsu vertical restraints permit the key Keiretsu firms, usually manufacturers, to exercise monopsony buying power over their suppliers solidifying oligopoly conditions and deterring potential entrants for disruptive competitors. Transactions between Keiretsu members also raise tax avoidance questions. For example, where raw materials and components are sold at nonmarket prices this shifts income and loss among members of the affiliated group.

This paper discusses the structure of Japanese firms within the Keiretsu industrial organization form. First, the history of Keiretsu is examined, followed by an examination of the business practices that characterize Keiretsu relationships. Next, the positive and negative effects of Keiretsu are explored with a view to promote the adoption of Keiretsu business practices that could sharpen American competitiveness internationally. Next, the potential legal impact of Keiretsu business practices are examined with particular emphasis of violations of the U.S. antitrust law. Finally, an analysis of the economic impact of Keiretsu and the process of constructing a U.S. variant of Keiretsu that would be acceptable under Western cultural norms is proposed.

II. WHAT IS KEIRETSU?

The Japanese manufacturing success miracle has been described as attributable to the so-called "complex Japanese distribution system." Recent studies have unraveled the mystery surrounding this distribution system and some Westerns are shocked to find that Keiretsu lies at the heart of a complex and potentially anticompetitive characteristic. Keiretsu, also known as Kigyo Shudan, is an umbrella term that describes various highly complex and interdependent relations. Keiretsus are futile families of firms with ambiguous boundaries that separate ostensibly independent firms which are in reality closely related. A single Keiretsu usually encompasses a large group of firms in different industries which maintain close relationships. These relationships are typically more social than legal structures. Nearly half of the top 200 Japanese firms are affiliated with a major Keiretsu.

Keiretsus grew out of the 10 major pre-World War II Zaibatsu. These were industrial combinations organized around major holding companies, the Nonsha. Zaibatsu controlled suppliers and customers vertically. The victorious allies in World War II concluded that the Zaibatsu holding companies were largely responsible for the rapid and intense military industrialization that permitted Japan's prewar imperialism. As a result the post-war occupation forces forced the Japanese to dissolve the Zaibatsu and installed Japanese antimonopoly laws patterned after the U.S. antitrust law. The large Zaibatsu were split up into smaller firms in the late 1940s. However, by the 1950s, many of the relationships in the old defunct Zaibatsu were reestablished. The post-war reconstruction of Japan required large amounts of capital for the rebuilding of Japanese industries so new groupings of firms were established around the
commercial banks. As the Japanese industrial machine intensified in the 1960s and 1970s, additional relationships and structures were established. This emerging Keiretsu provided capital to the expanding Japanese industries while simultaneously erecting barriers to foreign investors in Japanese firms, permitting the Japanese to retain control over their industry within Japan. Keiretsu is simply the latest in evolution in future forms from Zaibatsu and from the original Japanese futile form known as the "han."

A. Inter-market or Horizontal Keiretsu

The first of two forms of contemporary Japanese Keiretsu is generally known as the Inter-market or horizontal Keiretsu. These are formed around a bank or a general trading company as the nucleus of power. Most contemporary Inter-market Keiretsu encompass vertical Keiretsu as well. Inter-market Keiretsu have adopted the so-called one set principle "wan setto-shugi." This requires the Keiretsu to limit membership to only one major firm in each major industry. Thereby, there is no direct or limited direct competition between Keiretsu members. However, self-sufficiently is only a secondary Inter-market Keiretsu goal. Some Keiretsu members may retain relationships developed earlier with other firms in other Keiretsu groups, even though the one set principle may be violated.

Inter-market Keiretsu were patterned after the pre-war Zaibatsu and were a natural development after the post-war occupation. However, the 1970s oil shock weakened the solidarity of Inter-market Keiretsu. Much of the Japanese industrial infrastructure was already in place and the rising price of oil accelerated the reduced demand for capital investment. Therefore, Keiretsu member firms had a decreasing dependence on the lead bank as its main source of capital for new growth. Simultaneously, the Japanese securities markets became more efficient and therefore a cheaper source of capital. Since the 1970s, the influence of Inter-market Keiretsu has been reduced and replaced by strength within vertical Keiretsu.

Today, most Inter-market Keiretsu are concentrated around a nucleus firm, usually a general trading firm, Sogo Shosha. These firms were initially responsible for the aggressive establishment of international trade between Japan and other nations in the post-war period. General trading firms provide domestic and international wholesaling and distribution of goods produced in Japan and foreign goods exported to Japan. General trading firms also provide financial assistance to their Keiretsu members including: credits, loan guarantees, payment guarantees to suppliers, and other financial assistance. General trading firms usually involve less cross-shareholding than did the banks when they were the primary nucleus for Inter-market Keiretsu. General trading firms are largely responsible for the initial establishment of foreign trade relations, they manage off-shore transactions by establishing foreign subsidiaries, joint ventures, and the construction of productive capacity.
Examples of contemporary Inter-market Keiretsu include such well-known firms as Mitsubishi, Mitsui, and Sumitomo. These three large banking nucelli have their origins in the Zaibatsu and are the successors of these forms with a pre-war heritage. There are three large post-war Inter-market Keiretsu nucelli which include Fuio, BKB, and Sanwa. Smaller post-war Inter-market Keiretsu nucelli include Tokai and IBJ.

B. Vertical Keiretsu

The trend in Keiretsu development is away from Inter-market nucelli and towards vertical nucelli which are Keiretsu formed around a lead industrial or parent company. Contemporary examples of vertical Keiretsu nucelli sound like a who's who of major Japanese firms: Toyota, Nessan, Matsuhita, Hitachi, and Nippon Steel. These leading industrial firms are commonly referred to Dai Kigyo. Surrounding the vertical Keiretsu nucleus are affiliates and subsidiaries which function as suppliers and distributors for the output of the lead industrial firm. Effectively, these independent firms are actually captive satellites because nearly all their output supplies the lead firm and in the case of distributors, all their supplies are sourced from the lead industrial nucelli. Contemporary operations management and logistics concepts of just-in-time delivery are facilitated among members of the vertical Keiretsu because their production facilities are often located physically close to the lead firm. Vertical Keiretsu are particularly predominant in the auto and consumer electronics industries. Vertical Keiretsu may also be related to an Inter-market Keiretsu.

C. Conditions and Relationships Conducive to Keiretsu

To fully understand the impact of Keiretsu or to attempt to mimic its more useful characteristics, it is initially necessary to unbundle the Keiretsu conditions and relationships. These typically involve cross-shareholdings between Keiretsu member firms, interlocking directorates, interaction in presidential councils, interfirm sharing of personnel, and a wide array of other financial commitments.

1. Cross-shareholdings. A fundamental characteristic of Keiretsu has been cross-shareholdings known as "kabushiki mochiai." All member firms of a Keiretsu purchase shares in nearly all other member firms of that Keiretsu. Cross-shareholdings tie Keiretsu members financial interests as well as their product or service sales are tied. However, cross-shareholdings are more symbolic than real. Unlike in the U.S. where investment is a neutral commodity, in Japan cross-shareholdings signify a solidified relationship. Japanese firms may invest in their related Keiretsu members financial interests while recognizing these investments may bring in suboptimal returns. This stands in stark contrast to most U.S. securities investment decisions where optimizing return is the primary criteria.

Cross-shareholdings reveal another important difference between debt and equity in Japan and debt and equity in
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the West. For example, in the United States creditors expect a fixed return and can be expected to throw the debtor into bankruptcy or at least reorganization if loans go into default. U.S. equity represents the residual claims in the firm which receive a variable return stream: High returns in successful times, low or no returns in unsuccessful times. By contrast, Japanese debt and equity relationships are reversed. Japanese bank loans more resemble equity because lenders are much more flexible about repayment. For example, if a Japanese Keiretsu firm reached a financial exigency most creditors would be willing to restructure the loans. Japanese creditors commonly defer interest or principal repayments, reduce outstanding principal balances and willingly roll over loans to provide the borrower with flexibility to meet cash flow problems. In return for this flexibility, creditors expect to actively participate in management. By contrast, Japanese equity holders demand relatively fixed dividend payments and are expected to be inactive in their control of management. Therefore, Japanese corporate democracy is a mere pretext as exemplified by Boone-Pickins difficulties in becoming a member of the board of directors of the Koito Corporation despite his substantial 25% common share ownership in that company.

Cross-shareholdings creates a stable shareholding group known as "Antei Kabunshi." Between 60 and 80% of all shares listed on the Tokyo stock exchange represent cross-shareholdings among Keiretsu member firms. This clearly facilitates the deterrence of hostile take-over threats. All Keiretsu members identify closely with each others financial successes. The stability of equity permits lower dividend payments and a lower cost of equity capital than would exist in Western markets. It also means that Japanese Keiretsu member firms are less disciplined by the market for corporate control. So long as reliable access is maintained to bank loans, Keiretsu member firms may pursue long-term strategies with lesser short-term market discipline. This phenomena has been described as "patient capital." Japanese firms are not the prisoner of present value stock evaluation techniques like are used in the United States which reward shareholders with higher stock market prices only when the firm's cash flows are high in the projected near term. This phenomena also explains the vast difference between price earnings multiples prevalent in the Japanese market as opposed to those in Western markets. Average price earnings multiples in the United States are in the 15-20 range and have been as high as 35 among Japanese firms until early 1992 when the Japanese market began a precipitous fall reflecting more reasonable multiples.

2. Interlocking Directorates and Presidential Councils. More direct communication of policies affecting the entire Keiretsu are possible through personnel connections among all Keiretsu firms. These personnel connections include interlocking directorates in which many of the same personnel sit on the boards of several Keiretsu member firms. Interlocking directorates facilitate communications of
policy directives between firm's upper managers to discipline all Keiretsu members to adopt and strive for the group goals.

While interlocking directorates form an important symbolic connection among firms. A more efficient effective forum for the discussion of group policy occurs in the presidential councils known as "sacho-kai." Typically, monthly meetings are held among 20 to 50 key presidents of Keiretsu member firms. These meetings exclude representation of minor Keiretsu members and typically represent various coalition constituencies including some shareholders, some lenders, some trading partners, and presidents of the larger or lead firm members of the Keiretsu group. Presidential councils substitute for the United States style board of directors as the primary policymaking forum for each constituent firm and for the Keiretsu group.

Presidential councils are not a legal structure but instead an informal social grouping which influence R&D, investment, production, pricing, and new product decisions by members. Presidential councils approach decision making in the classic oriental style of consensus where their influence is brought upon member firms out of decisions negotiated through internal politics.

Typically, presidential council meetings are dominated by an exchange of views on current economic and financial matters and on projections about the future competitive environment with other Keiretsu and with firms in other nations. Presidential councils discuss issues such as joint research and development, the solvency of member firms, the optimal placement of key and talented personnel, labor problems, public relations, charitable activities, and they resolve disputes among members. Members of Japanese presidential councils and Keiretsu observers from within the group's membership, generally deny vigorously the presidential councils are active in policymaking. However, it has long been suspected that these councils resemble similar structures in the pre-war Zaibatsu. Therefore, presidential councils probably provide more than a simple discussion forum by providing decisions binding on the whole Keiretsu.

3. Interfirm Personnel Sharing.

Keiretsu further solidify their relationships by sharing key personnel or by providing employment security for workers laid off from depressed Keiretsu members. Typically, staff members from the large leading industrial firms will serve as top officers or directors in smaller member firms. This permits the influences from a presidential council decision making to percolate down into the policy set for all Keiretsu member firms. It also assures overall Keiretsu strength and conformance of policy by all member firms to the Keiretsu group's goals. Keiretsus further assure their success by adopting a revolving door policy with high ranking government officials. Japan has long embraced the setting of industrial policy through a central government agency. The Ministry of International Trade and other key regulatory agencies retain close
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contacts with firms they regulate. This permits close coordination of industrial policy among all competing Keiretsu and closely identifies regulators financial interests by perpetuating the survival of Keiretsu members regulated by these government agencies. Inter-firm personnel sharing assures policy conformance from the level of government through lead industrial firms down to smaller member Keiretsu firms and it perpetuates the lifetime employment security system.

III. EFFECTS OF KEIRETSU

The impact of Keiretsu on Japanese society, Japanese industrial performance, and on other nations are quite varied. Keiretsu arguably maintains consistency with Japanese culture that permits the rigid Japanese work ethic and has contributed to the tremendous Japanese industrial success worldwide. The following sections discuss the apparent Keiretsu benefits to Japanese companies and the promise of Keiretsu's style benefits should other nations adopt certain Keiretsu characteristics.

A. Keiretsu Benefits to Japanese Firms

Keiretsu's style closeness among related firms arguably increases the flexibility of the lead industrial firm to compete effectively against other Keiretsu lead firms and in international markets. The timeliness of production changes and shipping from suppliers reinforces this competitiveness. Confidential assistance between firms assures technological compatibility and product quality. These advantages are secured through joint ventures and research and development activities. Keiretsu members learn new technology and refine their production processing by engaging in joint R&D ventures with the leading technology firms within their Keiretsu group. Technology transfer between the technology leaders and smaller suppliers typically unable to invest in R&D assure the production of state-of-the-art components. Lead Keiretsu firms need not worry their suppliers will use this technology for a competitor, because the Keiretsu grouping ties them into exclusive relationships. Such relationships are difficult in the United States where suppliers often fell to various assemblers. In the U.S. an assembler would be reticent to share state-of-the-art technology with a supplier for fear the information would leak to a competitor. Two U.S. examples illustrate this point. First, Microsoft as the primary designer of microcomputer operating systems, is often exposed to new technology from unrelated software and hardware companies. It has long been suspected that Microsoft uses its access to these proprietary trade secrets to enlighten its own software and hardware manufacturing subgroups. So if an independent word processing firm exposed a new program to Microsoft to enable the word processor to work well with Microsoft's upcoming new version of DOS, the word processing company might fear Microsoft would share the innovation with its own in-house word processing group: Microsoft Word. A similar problem occurred between Ford and one of its suppliers of windshield glass. The supplier had developed a cheaper and more effective method to
produce windshield glass. Ford attempted to misappropriate the proprietary know-how in producing the windshield glass to bring the production in-house and deprive the glass manufacturer of its own proprietary information. However, Ford was unsuccessful in producing the glass in the new way, solidifying its relationship with this glass supplier. However, this incident exemplifies the strength of Keiretsu in developing trust among suppliers and customers.

The relation among Keiretsu members: suppliers, customers, distributors, and lead industrial firms reinforces their tendency to purchase and sell within the Keiretsu group. In some instances, this tendency is actually strong pressure to support Keiretsu members products and services exclusively. With suppliers and distributors exclusively tied to a lead industrial firm, these members of the distribution chain have little alternative but to sell for and through the lead industrial firm. This loss of transaction liberty brings benefit primarily to the lead industrial firm. For example, suppliers are expected to provide just-in-time deliveries of components substantially reducing inventory carrying charges incurred by non-Keiretsu style competitors. These exclusive relationships also permit flexibility in changing product designs to suit the lead industrial firm. For example, a consumer electronics firm like Sony adopts a product marketing strategy of frequent model changes. Its suppliers can be encouraged to respond with high quality changed components on very short notice. Consumer electronics firms in non-Keiretsu style supply relationships would probably be unable to match these quick product change cycles. In addition, non-Keiretsu style industrial firms have justifiable misgivings about a supplier sharing the lead firm's proprietary technology with other customers. However, in a Keiretsu, this problem never arises because suppliers sell to no competitors. The indentured servant status provides tremendous benefit to the lead industrial firms because suppliers and distributors are entirely beholden. In return these peripheral firms are given some assistance during business downturns and assurance of their survival thereafter. Without the assurance of confidentiality, this symbiosis would be impossible. It also contributes to stable performance, steady growth, and steady profit performance of the lead industrial firm and less fluctuation in the fortunes of the smaller peripheral firms.

A final major advantage to the Keiretsu style affiliation is a strong takeover protection. Keiretsu members are expected to jointly act as a group in protecting any potential takeover target. This "security council" coordinated activity was evident in the attempt Boone Pickens made to takeover Koito, the electrical supply member of the Toyota Keiretsu group. Despite Boone's large share of Koito stock, he was unable to secure a seat on the Koito board. After numerous frustrating attempts to publicize the closed nature of Keiretsu relations in Japan, Boone eventually abandoned his takeover threat. When Getty Oil was sold to Texaco, Mitsubishi readily purchased Getty's holdings of 50% of Mitsubishi Oil. Such actions
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exemplify how Keiretsu members are quick to absorb any potential influential big blocks of member firm's stock to retain control in the group.

B. Adaptable Aspects of Keiretsu

Western firms may find the Keiretsu style exclusivity and attendant loss of liberty to be inimical to Western culture. However, on closer examination, Keiretsu relationships have numerous advantages. Even if Westerners are unwilling to adopt wholesale the characteristics of Keiretsu, they lead to structural advantages which may not be equaled. Therefore, it behooves Western firms to analyze the components of Keiretsu relationships with a view to mimicking the most efficient and effective of these characteristics. For example, many U.S. firms have adopted just-in-time inventory yielding tremendous cost savings. This Keiretsu component requires coordination and cooperation among suppliers and customers that mimic Keiretsu characteristics. At the heart of most Keiretsu relationships, lies a form of "trust" among vertical trading partners. Even where a fundamental and embracing trust is unlikely, it is possible to construct contracts and relationships among Western suppliers and customers that approximate this trust through levels of "assurance."

The centerpiece of efficiency for Keiretsu relationships is a set of assurances for the lead industrial firm. To maintain competitiveness, the lead firm must be assured of raw material and component supply as well as certainty about the distribution of finished products. First, suppliers must provide technical compatibility and sophisticated component parts that work precisely with the lead firm's designs. Suppliers must have the technical capability, manufacturing capacity, and technical resources to make expeditious technological changes. Where this technology is provided by the lead industrial firm, there must be absolute assurance the technology will not be used to supply a competitor. This creates a difficult balance because suppliers capable of attaining short design cycles probably have excess technical design capacity that must be withdrawn from supplying the lead firm's competitors. This problem becomes particularly acute where the technologies are developed primarily by the supplier. On balance, the more the lead firm relies on the supplier's knowhow to provide an update highly technical components, the supplier will have an incentive to capitalize on its technological prowess. Therefore, captive component supplier will be least disruptive when the majority of technology is provided by the lead firm. The lead firm must maintain control over its competitor's access to innovative and efficient suppliers, strongly suggesting these will continue to be exclusive relationships.

The second major area of lead firm assurance involves the timing, quality and quantity of components supplied. Japanese Keiretsu have been characterized by high product quality derived from high component quality with very low reject rates by the lead firm. The lead firm expects exact satisfaction of its quantity demanded fulfilled within very short time frames to
reduce inventory costs and exactly match input and output quantities. These "exclusive requirements" contracts are not unknown in Western supply relationships, but are the predominant mode of Keiretsu firms.

Supplier assurances are less demanding than those for lead industrial firms, yet nevertheless important to the maintenance of successful Keiretsu relationships. Component and raw material suppliers will generally require the lead firm purchase a sufficient quantity of the supplier's output to exhaust its capacity. While many Western firms are familiar of this form of "exclusive output" relationship, these predominant in Japanese style Keiretsu relationships. Suppliers must also be assured that payment for their output is stable and their cash flow covers all non-avoidable expense. To the extent the lead firm cannot provide such assurances, other suppliers may become uneasy and "jump ship." Suppliers also need assurance that their key personnel and innovations will not be misappropriated by the lead industrial firm. This assurance is apparently violated regularly in Japanese Keiretsu and is the primary source for insecurity about Keiretsu relationships among Westerners. Japanese lead Keiretsu firms regularly exchange personnel and will appropriate innovation to the extent necessary to assure their supplies from alternative suppliers. The Ford glass example discussed earlier, exemplifies how this problem may generally be viewed as insurmountable among Western firms. Suppliers confront another important dilemma because it may be impossible for a supplier to serve two competing customers where one is a technological leader. Keiretsu style suppliers must work closely with their customers to assure technical and quality compatibility. If technology is provided by one competing lead firm and the supplier maintains confidentiality by refusing to share this technology with another customer, this breaches the essential assurance and trust with the technological laggard. This problem is alleviated in Japan somewhat by intervention from MITI and by other joint R&D ventures among competitors. However, Western antitrust laws are still perceived to prevent much technology sharing among competitors. As a result, the prospect of Western suppliers holding close relationships with two or more competing firms is severely compromised by the technology confidentiality requirement. Western style Keiretsu may ultimately be limited to captive suppliers because of this problem. However, as uncertainty is reduced concerning joint R&D activities or American governments adopt industrial policies, Western supply firms may be unable to supply more than one lead firm. Additionally, where these technologies are patented or otherwise protected intellectual property, supplier may be justified in legally restricting the output from advanced technology to a particular customer without violating the confidence or fiduciary duty owed to other customers. Congressional recognition of this problem resulted in the National Cooperative Research Act of 1984 which extends the rule of reason to joint R&D ventures.

Nearly all other incidents of Keiretsu provide generic vertical assurance that
solidify customer and supplier assurance or could be supplied in some other manner. For example, cross-shareholdings, common control, interlocking directorates and officers, all contribute to the assurances discussed above. Most other Keiretsu factors contribute to financial stability which could be obtained by other means. For example, capital infusions, common capital providers, financial forbearance during hard times, and the general community of interest in Keiretsu members financial performance could be acquired in Western economies where takeover threats diminish. Such situations have existed in most of Western Europe and are beginning to occur in the United States and United Kingdom as a result of reaction to the perceived damage of the hostile takeovers during the 1980s.

It’s clear that trust and assurance is a most important feature in solidifying vertical relationships. Technology owners must maintain the exclusivity in relations with suppliers and customers. This makes the name brand assembler or lead industrial firm the most central figure in the Japanese style Keiretsu and therefore most likely to exert vertical pressures both up and down the chain of distribution.

C. Keiretsu Disadvantages

Japanese style Keiretsu relationships are not costless. Participants are deprived of their free will and choice among suppliers and customers. This loss of independence and liberty probably costs all firms in the Keiretsu group certain opportunities and higher profit margins from unused capacity and foregone sales. This inability to take full advantage of profit opportunities is much like an insurance premium paid into the Keiretsu group to obtain Keiretsu benefits. For example, lead firm pressures on suppliers to lower prices so the lead firm can maintain competitiveness is an exaction in return for the assurance the lead firm will continue making purchases. Pressures on suppliers to expand capacity quickly often require borrowing from the Keiretsu lead bank at higher than market interest rates. In both cases, the premiums paid or profits foregone are equivalent to an insurance premium for the supplier’s survival. Profit maximization is available only for the lead firm because pressures on both suppliers and distributors to reduce profit margins funnel the higher returns to the lead firm.

Costs of Keiretsu relationships are born by society and entities outside Keiretsu trading group as well. Non-Keiretsu firms encounter severe barriers to entry, making it difficult to break into the affiliated trading group. This externality has been cited by Western companies as a major disadvantage of the Keiretsu form. For example, U.S. firms have great difficulty establishing supply relationships with Keiretsu member and lead firms. The small but growing number of successful U.S. suppliers to Japanese lead firms often cite delays of up to two years before regular supply relations are established. While some of this delay may be due to the Japanese consensus style of supply and negotiations, the expectations inherent in Keiretsu style relationships
for a long term relations is also a factor. Keiretsu induced barriers to entry are allegedly responsible for the underutilization of suppliers by Japanese transplant lead industrial firms operating in the U.S. (e.g., Toyota, Nissan, Sony, Panasonic). Much of the rhetoric and pressure in the U.S. against Japanese style Keiretsu transplants in the United States center around this issue.

IV. ANTITRUST BARRIERS TO KEIRETSU

Western critics of Japanese style Keiretsu commonly site that these affiliated trading groups are cartels. This strongly suggests that illegal restraints of trade or monopolization accompany some aspects of Keiretsu relationships. On its face, the description of common Keiretsu relations suggest that threats and discipline by lead industrial firms are anticompetitive practices and exert monopolization within Keiretsu groups. Contracts and practices that prohibit suppliers from selling outside their Keiretsu channel potentially violate U.S. and Japanese antitrust law.

As the Japanese economy has grown and there are numerous viable competitors in each industry, the Keiretsus have evolved from horizontal or Inter-market s into vertical structures. The one set principle suggest that horizontal anticompetitive action is less likely in the more modern forms of Japanese Keiretsu. This means that Keiretsu are probably most vulnerable to allegations of vertical restraints of trade up and down then the distribution. Under U.S. law, the classic analysis of prohibited vertical restraints of trade focuses on a lead firm and its pressures down the chain of distribution through its distributors. While such pressures exist in Japanese style Keiretsu relationships, is alleged to provide pressure up the distribution chain towards suppliers. Therefore, the traditional U.S. vertical restraint of trade analysis is somewhat inappropriate to applications on Japanese Keiretsu. Nevertheless, the following sections review the standard against vertical restraints of trade with emphasis on the application to Japanese Keiretsu relationships. This includes the standard vertical restraints of trade like: (1) exclusive dealing, (2) resale price maintenance, (3) concerted refuses to deal, (4) price discrimination, (5) exclusive distributorships, and (6) time.

A. Exclusive Dealing

Exclusive dealing generally describes restrictions in supply contracts that require the buyer to resell only the seller's profits. Exclusive dealing is therefore generally a downstream political restraint preventing distributors and retailers from selling other supplier's products. The Clayton Act in Section III prohibits exclusive dealing when it tends to create a monopoly or substantially lessens competition. It should also be illegal under the Sherman Act as a form of monopolization. Exclusive dealing forecloses competition by other suppliers and can create monopolization where there are few alternate distributors or retailers in that region. Exclusive dealing is subject to the rule of reason because of efficiency in the chain of distribution. For example, exclusive dealing relationships can reduce selling costs,
secure a supply source for the distributor or retailer, and can work to attract other competitors to establish exclusive dealing relations with alternate distributors or retailers. Under the widely-used quantitative substantiality test, exclusive dealing is found illegal only where an adverse effect on competition from a substantial dollar volume of the market is foreclosed by this buyer's exclusive requirement contract. For example, in Standard Oil versus the United States, the exclusive dealing relationship was found illegal because $58 million worth of trade representing 6.7% of the market constituted a quantitatively substantial amount of foreclosed competition.

The regulation of exclusive dealing is not well applied to Japanese style Keiretsu. Given the typical upstream restraints to suppliers exclusive dealing restrictions have an inverted coercion task. Nevertheless Keiretsus with strong downstream control could solidify and strengthen their group’s competitiveness by establishing exclusive dealing relationships with key dealers. For example, if retailers or distributors with established locations or customer networks were tied to a particular Keiretsu, exclusive dealing relationships would create a barrier to entry by other lead industrial firms to sell through those favored outlets. Exclusive dealing relationships would tend to provide an incentive for competing industrial firms to establish new retail and wholesale distributors with their own exclusive dealing relationships in order to compete in those geographic markets. Exclusive dealing relationships also limit the growth of the Keiretsu to the growth of any wholesale distributor or retailer within that exclusive dealing relationship. A mild form of exclusive dealing is usually legal in the United States. The so-called "adequate representation" clauses requiring distributors or retailers to maintain minimum inventories, provide minimum shelf space, make minimum advertising expenditures, and provide minimum technical, sales, and service expertise can provide sufficient assurance to the supplier of the resellers efforts. This can be accomplished without resort to such exclusive relationships. As the Japanese relax their anti-discount store laws and multiple competing brands are carried, this aspect of Japanese style Keiretsu may subside.

B. Exclusive Distributorships

Exclusive distributorships invert the coercion upstream from distributor or other reseller to a supplier. When the retailer has the sole right to sell goods produced by a particular manufacturer or sold through a particular distributor, this is known as a "exclusive distributorship." Effectively a geographic monopoly over that manufacturer's brand is established. Exclusive distributorships are often promoted as essential to prevent free riding. For example, low priced discounters have thin profit margins and are less able to provide expensive technical expertise in sales, service, and inventories of parts or new products. By contrast, the high priced, high cost service-oriented retailer has higher profit margins permitting larger expenses for promotion, service, adequate inventories, parts, and sales expertise. If low priced
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discounters proliferate in selling the same products as the high priced retailers, eventually consumers will use the expertise of the high priced retailer but make actual purchases from the discounter forcing the high priced retailers out of business. Exclusive distributorships are justified on the basis of reducing the free riding aspect that low priced discounters have on the sales expenditures of high priced retailers.

Exclusive distributorships, however, eliminate competition for a particular brand within a geographic region. This can nearly eliminate intra-brand competition in favor of inter-brand competition. Eventually, the price structure of all competitors in the industry will rise higher than if price competition within and among brands is vigorous. Japanese style Keiretsu can be enhanced by exclusive distributorships because this reinforces the community of interest within the Keiretsu chain of distribution and it enhances competition only with other Keiretsu.

C. Customer or Territorial Restrictions

Suppliers restrictions on resellers from selling to particular customers or within particular regions are considered customer or territorial restrictions. Such restrictions reduce intra-brand competition and allegedly strengthen inter-brand competition. They provide a minimum incentive to other resellers by offering monopoly profits and tend to favor some distribution channels over others. They are considered illegal when they tend to limit competition and have no legitimate economic or business objective. Therefore, the rule of reason applies to customer territorial restrictions. In both Schwinn and Continental TV versus Sylvania, the territorial restriction was tested by this rule of reason. In Japanese style Keiretsu, such restrictions probably proliferate. The threat of continued relations with a particular supplier continue unless certain customers or territories are ignored by the reseller. This permits the distribution network for the lead industrial firm to be strengthened in pieces and prevents the growth of large and powerful potentially insurgent retailers or distributors downstream from the lead industrial firm.

D. Resale Price Maintenance

Another vertical device to discipline downstream resellers is resale price maintenance. This is the manufacturers insistence that the reseller charge a minimum, list, or manufacturers suggested resale price. Also known as vertical price fixing, the practice tends to support high cost retailers, restrict the expansion of discounters, and limit the aforementioned free rider problem. Some observers argue that retail price maintenance is actually a disguised price fixing scheme by resellers. Under this theory, distributors or resellers band together to coerce the manufacturer or supplier into fixing a minimum list price so that all participating resellers may obtain abnormally high profits.

While most of the U.S. application of resale price maintenance has been to minimum prices, it probably also applies to maximum prices or other missing
Constraints. Keiretsu upstream from the lead industrial firm are usually to hold down prices. These customer induced price limitations are less likely to violate the spirit of the prohibition against resale price maintenance because competition to supply the lead industrial firm is limited or nonexistent. Downstream retail price maintenance in Keiretsu varies according to competitive pressures, sometimes setting a floor to protect resellers and other times setting a ceiling to assure all production is eventually sold.

E. Concerted Refusal to Deal

U.S. antitrust laws use a concerted refusal to deal as a method to enforce other vertical price and non-price restrictions. This discipline assists in maintaining resale price maintenance. However, it is illegal to actively harass downstream resellers into following a resale price maintenance scheme. Any illegal monitoring rather than simple refusal to deal is prohibited. The shunning activity of Keiretsu members against disruptive suppliers or distributors is similar to a concerted refusal to deal. Concerted refusals to deal in Keiretsu generally force compliance with exclusive dealing, exclusive distributorship, and price discrimination schemes. They are not designed to support a price floor as is typical in U.S. practice.

F. Price Discrimination

The 1936 Robinson-Patman Act outlawed price discrimination that was the original target of Interstate Commerce Commission regulation and the populist sentiment that gave rise to the Sherman Act in the late 19th century. By the mid-1930s the Populist sentiment had turned anti-chain store so price discrimination is viewed as the classic monopsonist or oligopsonist power. When sellers charge different prices for goods of like grade and quality to different buyers, an illegal price discrimination arises if it substantially lessens competition or tends to create a monopoly. Price discrimination can occur only where buyers or sellers have market power and there is imperfect information. Price discrimination is not illegal in services which explains the proliferation of the practice in the airlines and hotel industry. Robinson-Patman applies only where like commodities sales are made at different prices in interstate commerce within a fairly contemporaneous time.

Price discrimination may occur in Keiretsu where lead firms have market power to dictate different pricing structures from suppliers who may also supply other lead firms. The presence or absence of perfect information is irrelevant in Japanese style Keiretsu price discrimination because most lead firms are unwilling to shop around for alternate suppliers.

In one case alleging the damaging impact of Keiretsu style price discrimination, the Automobile International Association (AIA) has made a super 301 petition to declare the practice unfair. The Japanese transplant auto makers prescribe price discrimination for parts supplied to them from their suppliers. Original equipment automobile component parts.
manufacturers are prohibited from selling through any distribution network except authorized dealers. Sales outside the dealer network are permitted only in limited quantities and at higher prices than sold to U.S. auto dealers of Japanese brand cars. This is clearly a buyer induced price discrimination that tends to support the dealers and reinforce them as Keiretsu members. Thereby profits from all after-market parts sales are retained within the Keiretsu reinforcing its power and weakening non-Keiretsu distributors. This creates a barrier to entry into the parts supply market for original equipment for parts. The super 301 petition alleges the Japanese charge higher home market prices to cross subsidize lower prices in the U.S. market putting further pressure on non-Keiretsu member distributors. Such activities probably violate the super 301 prohibition against dumping. U.S. suppliers are compliant with this scheme and forego higher profits to maintain the Keiretsu's cohesivity. Maximum resale price maintenance has been necessary to discipline this cartel and restrict entry by potentially disruptive nonmembers.

G. Tying

Keiretsu organizations probably indulge in tying relationships in which buyers must purchase generic products available elsewhere in order to get a desirable product. Keiretsu approached the U.S. equivalent in franchising by requiring the purchase of most products from within the Keiretsu system. However, while tying may be essential to product uniformity and protection of the trademarked goods or services in a franchise, these needs are weaker within the Keiretsu. Keiretsu members generally must accept group discipline, loss of liberty, and thereby refuse to deal outside the group to qualify for membership benefits, loans, assured customers, and other financial protections.

H. Horizontal Effects of Vertical Relationships

Despite the predominance of vertical relationships that characterize Japanese style Keiretsu, there are horizontal impacts on the competitive structure of the Japanese economy. The proliferation of strong Keiretsu tend to limit the number of competitors in any market under the one set principle to a few competitors limited by the number of successful, strong Keiretsu groups. The mere existence of affiliated trading groups and their general refusal to deal with suppliers from outside the group, solidifies the monopsony market power over purchasing from member suppliers. Japanese style Keiretsu does not violate the Clayton Act, Section 8 prohibition against interlocking directorates. Interlocks are illegal under U.S. law only between competitors where an agreement communicated by the common director would violate the antitrust laws. Indeed, it is widely believed that vertical interlocks strengthen groups and make them more responsive to the needs of suppliers and customers. In addition, the limited pool of qualified director talent also strongly suggests non-enforcement of vertical interlocks. Keiretsu cross shareholdings are usually of low percentages which would not constitute majority control.
Therefore, while cross shareholdings reinforce vertical relationships, they are below the threshold that might constitute a merger under U.S. law. Therefore, cross shareholdings would probably never trigger analysis of vertical mergers even though an argument might be made. Keiretsu relationships approximate the control found in a vertical merger. Japanese Keiretsu practice of cross subsidization among member firms erects barrier to entry for competitors particularly among suppliers. For example, when the Keiretsu provides temporary employment for a financially troubled supplier, restructuring of loans, or direct financial support, the supplier is protected from insolvency where an independent supplier would otherwise fail. Therefore, Keiretsu practice of "propping up" troubled members deters new entry by alternative competitors. In sum, most Japanese Keiretsu style vertical relationships are not directly illegal under U.S. law, yet they impose a horizontal effect which tends to create solidified oligopoly and oligopsony conditions which erect barriers to entry by other firms and deprive most Keiretsu member firms of liberty. Arms length negotiation and bargaining among Keiretsu suppliers and customers is rare, frustrating the natural equilibrium tendencies found in perfectly competitive markets.
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