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Discussion Paper No. 2022-E-18

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IMES Discussion Paper Series 2022-E-18
December 2022

The Digital Transformation (DX) and the Financialization of Japan: A Case Study of Private Equity

Ulrike Schaede*

Abstract

This paper argues that Japan is experiencing an increase in "financialization" – a process of marketization where the primary focus in all transaction is on the immediate monetary value earned. Left unregulated, excessive financialization can erode the core architecture and health of an economy. Japan's financialization will be further accelerated by the interrelated forces of the digital transformation (DX), societal and employment system changes, and the need for corporate reinvention and repositioning. To showcase the difficulty of finding a balance between the positive discipline of the market and the dangers of excessive short-termism, this paper introduces Japan's emerging private equity (PE) market. Corporate need for a new market for spinouts and carve-outs meets global investors eager to find alternative investments. Together, they create new pressures for short-term financial results, even for companies not targeted by these investments, thus increasing financialization overall. The paper introduces recent U.S. proposals on regulating the PE industry to ensure long-term value creation while reining in financial schemes that are detrimental to the health of companies and the economy. As Japan shows signs of increasing financialization, it may warrant attention to the current discussion regarding the PE industry in the U.S.

Keywords: Japan; financialization; marketization; private equity; digital transformation; corporate reorganization
JEL classification: G30, L10, K20

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This paper was prepared while I was a Visiting Scholar at the Institute for Monetary and Economic Studies (IMES), The Bank of Japan, Tokyo, in January-March 2020. I am grateful to the many Japanese PE managers who were willing to share their insights for this paper, and the IMES staff for providing a rewarding research environment. The views expressed in this paper are those of the author and do not necessarily reflect the official views of the Bank of Japan. I am solely responsible for all errors that remain.

1. Introduction

In January 2022, Japan's Prime Minister Fumio Kishida announced that Japan would embark on a "New Capitalism", one that balances market forces with social well-being. [1] How exactly this would be shaped was uncertain at the time of this writing. And while the proposal did not use the word "financialization", it could nevertheless be read as a call to tone down the market-oriented language of Kishida's predecessors, in particular Prime Minister Shinzō Abe.[2] The reform programs of "Abenomics", rolled out between 2012-2020, brought a myriad of changes intended to impose the discipline of market mechanisms on Japanese business. With the slogan "Japan is Back", Abenomics aimed to increase Japan's global competitiveness and attract global investors to Tokyo, by pushing Japanese companies to pursue business strategies that increase profitability, stock prices, and therefore returns on investment.[3] Domestic reformers and institutional investors joined U.S.-trained neo-classical economists in calling for increases in capital efficiency and a stronger role of the market for corporate control.[4] The Abenomics reforms were widely celebrated as necessary antidotes to the slack, inefficiency, and long-term suboptimal performance of many Japanese companies.

Indeed, many Japanese companies of all sizes had over the years lost their competitive edge and puttered along – sometimes using a concern for stakeholders such as employees and suppliers only as an excuse for poor performance. Characterized by low profitability, many listed companies had fallen into a cost-cutting mode. A series of shocks and crises – the 1998 banking crisis, the long period of zero-level interest rates, the 2008 global financial crisis, and the 2011 Great Tohoku Earthquake, tsunami and nuclear disaster – had also led many CEOs to grow cash reserves, either as a "rainy day" stash or for lack of clear vision during such uncertain times. These cash holdings depressed the average ROE for Japan's listed companies. Financial analysts viewed them as "capital-inefficient", and recommended stock buybacks, for no other purpose than to lift ROE and the stock price.[5] Others saw the absence of market mechanisms to guide and discipline corporate strategy as the root cause of the problem, and recommended

[1] "Policy Speech by Prime Minister KISHIDA Fumio to the 208th Session of the Diet, January 17, 2022", https://japan.kantei.go.jp/101_kishida/statement/202201/_00009.html

[2] For example, the original speech included a review of the system of quarterly disclosure, higher wages, and more investments into innovation, rather than stock buybacks and dividend payouts.

[3] "Japan is Back", Policy Speech by Prime Minister Shinzo Abe at the Center for Strategic and International Studies (CSIS), Friday, February 22, 2013; https://japan.kantei.go.jp/96_abe/statement/201302/22speech_e.html

[4] For example, many reformers called for cleaning up so-called "zombie firms" (e.g., Caballero et al. 2008). This term referred to "dead firms walking" thanks to forbearance and continued lending by their banks, even though they seemed to lack a viable business model. However, defenders of these practices pointed to the value of saving companies with large current employment and potential future growth perspectives (e.g., Schaede 2020).

[5] For example, in 2015 Third Point assumed an ownership stake in FANUC, one of Japan's most profitable companies, and demanded dividend payouts and stock buybacks. No sooner had the management performed these measures did the fund leave with a hefty capital gain, but no other value creation; see Esty/Kanno (2016). As of 2022, it appeared that these cash reserves allowed many Japanese companies to weather the COVID-19 pandemic of 2020 onward with comparatively fewer layoffs and bankruptcies than seen elsewhere.

reforms to allow interventions by major shareholders, including hostile takeovers. Corporate governance reforms were seen as key to help Japan overcome the stagnation of the "lost decades" between the 1990s and 2010s (e.g., Hoshi/Kashyap 2011; Team Shift the Curve 2014; Toyama 2020).

Yet, these calls for capital efficiency and reforms toward the market have also pushed Japan toward "financialization", i.e., a primary focus on the monetary value of, and immediate returns to, each transaction. In contrast to traditional previous business norms anchored in long-term trade relations, relationship banking, and forbearance implicit in the main bank system, the turn to the market has necessarily also brought a new "deal culture". In this culture, all transactions are assessed in terms of returns on investments, which can be more accurately determined for the short-term. Deal makers have a much lower tolerance for long-term investments in a company's value creation, such as through employee training or large R&D spending, which can take a long time before they yield returns. Rather, they prefer high labor mobility and open innovation, as they allow "the market" to determine resource allocations.

Financialization has become a large research topic in the United States and Europe, especially since the 2008 Global Financial crisis. In corporate governance, financialization means an embrace of the "maximizing shareholder value" (MSV) doctrine over all other outcomes of corporate activity (Lazonick/O'Sullivan 2000). In corporate restructuring, it calls for getting the best and fastest deal in any merger and acquisition, even if that necessitates drastic cost-cutting and layoffs. In employment relations, it means that a good job is one that pays more. In personal life, a good neighborhood is one where housing prices increase the fastest, and a good friendship is one that is useful in getting ahead (Davis 2009). In many countries, including Japan, these trends have met significant enthusiasm. A higher "economic metabolism" is hoped for, and there is a growing willingness to part with traditional norms of long-term relationship building, obligation, commitment, and trust, all in favor of fast, return-oriented, efficient deals (Dore 2008).

The main fuel of financialization is the "bandwagon effect", i.e., people start doing something because everybody else is doing it. In the United States, colloquially this is known as FOMO: the "fear of missing out". In order not to fall behind, people (in their role as employees, managers, investors, savers, etc.) trade stability for liquidity, and continually take higher risks to climb up in status and rankings. The negative effects of these trends have crystallized in the U.S. and Europe, in particular after the 2008 Global Financial Crisis. Not only has job insecurity jumped and worker loyalty declined as the companies attract talent with higher pay but also views employees as fungible. Corporate strategy dictated by finance has also increased activist investor interventions, layoffs, and corporate sell-offs, which eventually may erode a country's, industrial strengths. And because the insiders understand the risks better than those who jump on the bandwagon later, a clearer separation of winners and losers has emerged, which is clearly visible in growing income inequality (e.g., Epstein 2005; Lazonick 2009a, b; Lazonick/Shin 2020; Lowenstein 1991).

This trend of "transactionalization" and deal orientation is also worth noting in Japan, as will be shown below (Exhibits 5 and 6). This paper argues that three forces combine to explain this increase and further push Japan toward financialization: (1) the *digital transformation (DX)*, which brings the digitization of trade and finance with immediate, borderless transparency; (2) shifts in demography, society, and *labor markets* with a much higher emphasis on skills and specialization to allow high labor mobility and more transactional, pay-oriented work relations; and (3) shifts in *corporate strategies* toward corporate reinvention and new processes of innovation; this necessitates trades in corporate assets and a financial market for such deals. The paper uses the example of the rise of the private equity (PE) industry in Japan, which addresses all three aspects: it helps companies reposition for competing in the DX; it helps corporate reorganization to respond to labor market shifts; and it allows for the easy trade of corporate assets for the implementation of strategic change. However, by its very purpose and business model, PE is a contributor to financialization because it brings the commoditization and trade of corporate assets. Because PE privatizes and marketizes dead-or-alive decisions for companies, it offers a great solution to a stagnating sector. But in the hands of aggressive short-term fund investors it may cause a healthy company's or sector's demise. What is more, the mere existence of a new market discipline greatly increases the financialization of the entire economy, so even healthy sectors may be negatively affected. Thus, the rise of PE shows how difficult it is to balance the positive efficiency gains from market-based deals with the threats from detrimental financial schemes that serve to enrich only a small group.

In the United States, which has a much longer experience with leveraged buyout funds (i.e., private equity), new regulations are now being discussed, with the goal to preserve the industry's beneficial aspects while curtailing potential damage to the economy. While the digital transformation cannot be stopped, the financial markets can be regulated, the employment system can be restructured, and corporate strategies can be incentivized for long term growth rather than short-term profit generation. As Japan discusses the creation of a "New Capitalism", the interaction between the three factors of the DX, labor pressures, and corporate strategy shifts, and the bandwagon they create, should be considered. A consistent plan of a more balanced capitalism will benefit from incorporating and attenuating the trends of financialization.

The paper proceeds as follows. Section 2 introduces research on "financialization" and its background in the United States and Japan, as well as a framework that connects the three current trends of the digital transformation, employment changes, and the necessity of business reinvention. Section 3 offers an overview of the PE industry, and why it is prone to lead to financialization, at least in the ways in which it is currently structured. Section 4 presents

Japan's current situation of private equity as an industry. Section 5 highlights recent regulatory initiatives to rein in PE in the U.S. and the EU. Although some of these may be specific to the legal systems there, directionally they may prove helpful for Japan as well, in terms of what can be done to structure incentives and rules for long-term value creation. Section 6 concludes on the outlook for Japan.

2. What is Financialization?

Traditionally, economics textbooks have used the term "financialization" (*kinyūka*) to describe a country's transition to a stage where the tertiary sector (services) contributes more to GDP than the primary and secondary sectors (agriculture and manufacturing). Since the 1980s, academic research has added a new meaning and further nuance to this term. In addition to (1) a *new regime of wealth accumulation*, which is seen as driving income inequality, "financialization" now also refers to a (2) shift in *corporate strategy-making* in the interests of shareholders over all other stakeholders, and (3) even a shift in *everyday life* decision-making toward expressing and assessing all aspects of household and living, including marriage and child education, in monetary terms first. Van der Zwan (2014) defines this shift as "the web of interrelated processes – economic, political, social, technological, cultural – through which finance has extended its influence beyond the marketplace and into other realms of social life". Financialization also challenges existing notions of the role of the state in the political economy because it places the emphasis of policymaking simply on creating "the right" markets, while delegating the regulation of economic actors to these markets (van der Zwan 2014). As Engelen (2008:118) put it, "something has radically changed in contemporary capitalism".

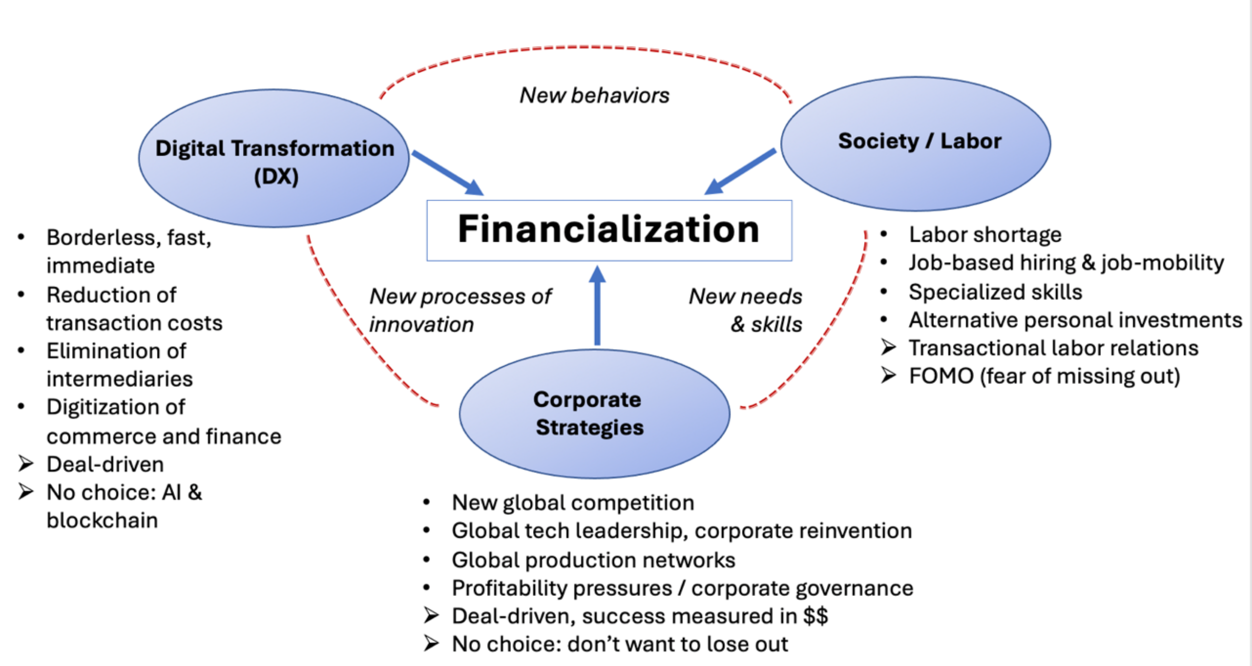
2.1. A New Push for Financialization, the Digital Transformation and Employment System Change

Three big currents are combining in the 2020s that will bring an increase in financialization in all countries, including Japan. Exhibit 1 models their confluence to show how they feed into the advance of financialization.

The first current is the digital transformation (DX). The DX signifies the arrival of decision making based on AI/ML (artificial intelligence/machine learning) that will disrupt business and daily life, from manufacturing processes (industry 4.0), commerce (blockchain), and finance (fintech, proptech, matech, insurtech, etc.) to government regulation (personal ID numbers, cybersecurity, privacy, etc.). [6] The DX is borderless, ubiquitous and immediate, and its global reach is inescapable (Schaede/Shimizu 2022).

[6] "Fintech" stands for financial disruptions, "proptech" refers to real estate/properties, "matech" to marketing and sales, and "insurtech" to insurance. The DX is understood here to refer to fast advances in computing powers and

Exhibit 1: The Interplay between Financialization, the Digital Transformation, Societal Change, and Corporate Reinvention



For the purposes of this paper, the most important aspect of the DX is that it will digitize commerce and finance, as well as work and daily life. At its core, the DX greatly reduces friction and transaction costs, because it replaces intermediaries with algorithms. This makes relationship-based decision-making superfluous, and thus reduces the human element in work and daily life. Machines can process yes/no decisions faster and more consistently. They replace much of the friction and noise that currently still characterize our daily lives – from receiving a government form to managing the supply chain, or calculating the risk of a loan. At the business level – such as on the manufacturing shopfloor – hyper-rational and hyper-efficient robots will bring many advances, just as open distributed ledgers will greatly advance global logistics. In this new world, the best (and perhaps only) way to assess the quality of deals is in terms of monetary metrics.

Second, just as the digital transformation arrives, most industrialized societies are undergoing significant demographic change, and Japan is the first country to experience the

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storage capacity and capability, combined with similarly great advances in technologies and techniques that allow the collection of data, including scrambled and unsorted information such as pictures and video. New data processing and analysis tools, aided by artificial intelligence and machine learning (AI/ML) allow the processing of such data in completely novel ways. Underlying these is a new infrastructure of 5G-based networks that provide constant, real-time connectivity, and offer new means of communication among autonomous systems, aided by edge computing and "the cloud". In combination, these are disrupting how companies compete, industries are organized, and economies structured.

ageing and shrinking of society. It is estimated that by 2050, Japan's labor force will have shrunk from the current 65 million to a mere 50 million people (Schaede/Shimizu 2022). This is already greatly affecting the country's employment system. Japan's current process of phasing out lifetime employment bears many parallels with the United States in the 1980s, when the onset of the "externalization" of labor (Pfeffer/Baron 1988) meant outsourcing a growing portion of jobs, and delegating the matching of non-regular workers to external employment agencies. Both created a market for short-term labor and made workers much more fungible. In Japan, as the labor shortage raises the negotiation power of labor, especially the top talent can demand individualized career paths and pay according to accomplishment, not seniority. Japan has begun to discuss a shift from the "membership system" of lifetime employment to "job-based hiring" (*jobu-gata*) employment, based on an individual's skills. This is making Japan's employment, which used to be relationship- and commitment-based, much more transactional and pay-oriented. As this happens, job-changing is becoming more frequent and labor mobility is rising significantly in Japan, even if it is still low compared to the hypermobility that characterizes many industries in the United States today.

The third pressure for financialization is the new global competition and the necessity for large firms to build new processes of innovation for the DX. The coming "4th Industrial Revolution" creates new customers and markets in fields where Japanese companies could compete strongly in the future if they build the necessary capabilities today. However, this requires a business reinvention, by refocusing on new core competencies and crafting new global strategies. To accomplish these pivots, large companies need to carve-out or exit business units or subsidiaries they no longer need, and this necessitates a market where they can trade corporate assets (Schaede 2020).

In sum, as shown in Exhibit 1, financialization has three root movements: a *change in the innovation requirements* caused by the DX; a *change in norms and behaviors* in the workforce with demands for mobility and transaction-based decision-making; and a *change in corporate resources,* in terms of labor and finance. In combination, these push the entire system toward the commoditization and mobility of physical, human, and capital assets in the pursuit of higher returns on investments, namely, financialization. Japan is no exception from these trends.

2.2 . Trends towards Financialization in the United States

Financialization emerged as a theme in the United States in the 1980s (e.g., Lazonick 2009 a/ b, Lazonick/Shin 2020; for overview articles in Japanese, see Shimano 2014, Kamino 2015, Kaneki 2018). Until the 1960s, U.S. corporations were characterized by strong "retain and reinvest" norms, whereby the majority of retained earnings were used to build more production sites and train more people. There was limited job-changing, and the "organization man" – similar to Japan's "salaryman" – was assumed to work for only one company for their entire career. Over time, the successes of this approach contributed to its downfall. By the 1970s, many U.S. companies had grown into huge, unwieldy conglomerates that were increasingly unable to make rational investment decisions (Lazonick/Sullivan 2000). Their decline in performance happened just at a time when new competitors – especially from Japan – challenged U.S. industry. The OPEC oil price cartels of the 1970s threw the U.S. into a deep-seated recession, with high inflation lasting throughout the 1980s.

During this downturn of the U.S. economy, a new belief emerged among U.S. economists not only that the market is superior in the efficient allocation of resources, compared to governments or corporate managers. Rather, under the banners of "efficient market hypothesis" and "agency theory", a body of theories emerged to argue that the economy overall benefits when companies are governed by a "market for corporate control" that provides strong discipline on managers to optimize operational efficiencies. The postulate that markets are always efficient meant that a company's stock price was seen as containing all available information and reflecting rational expectations about the company's future value (Jensen/Meckling 1976, Fama/Jensen 1983). Corporate and managerial performance came to be measured, in the first instance, by profitability, and managers were expected to pursue the singular goal of maximizing shareholder value (MSV), i.e., to manage for an increase in the stock price. In corporate governance, this meant that companies should be managed solely in the interest of shareholders, who take precedence over all other stakeholders, including employees, vendors and suppliers, or communities (e.g., Lazonick/O'Sullivan 2000).

The corporate strategy literature at the time identified two main ways in which companies could improve. The first was to increase efficiencies and optimize operations and the "value chain", either within a conglomerate or consisting of a local network of suppliers (Porter 1985). The second was to clearly identify the firm's core competencies, and invest resources in building these, while disbanding all non-core businesses (e.g., Rumelt 1974, Prahalad/Hamel 1990). The posterchild for this new approach to management was General Electric, where famous CEO Jack Welch stipulated a new two-step rule of "be first or second in market share, or exit". During the 1980s, a huge wave of a "refocusing" swept across the United States, as more than half of all listed firms engaged in restructuring and reorganization to dismantle the erstwhile conglomerates (e.g., Markides 1995a,b). Refocusing swiftly improved performance, as downsizing – laying off workers and exiting low-performing businesses – raised profitability. In the process, employees and business units came to be seen as modular assets, like LEGO blocks, that could be traded easily. Important long-term strategy considerations, such as the role of synergy across operations, tacit knowledge accumulation, or exploration of future businesses were devalued. Companies continued to slim down in response to securities analysts' demands for easy-to-compare businesses, as well as positive stock market responses to restructuring. The financial industry and the stock markets took over in determining corporate strategy and reorganization (Davis 2009).

Corporate refocusing required a new, liquid market for trading corporate assets and new types of money to finance these deals. The emergence of new financial players was helped by financial deregulation that had begun in the 1970s. The U.S. government allowed a slow erosion of the Glass-Steagall separation of different types of banking and proactively pushed stepwise deregulation of interest rates and stock trading fees. Under the header of “financial innovation”, new, unregulated instruments such as money-market funds, junk bonds and, later, the collateralized debt obligations at the heart of the 2008 global financial crisis were developed. These new instruments attracted new investors and led to the rise of leveraged buyout (LBO) funds, which today are known as private equity. Over time, Dore (2008) observed “increasingly leveraged and incomprehensible forms of financial intermediation”.

Financialization was propelled further by deregulating the activities of institutional investors. A 1979 revision of the ERISA (Employee Retirement Security Act) allowed pension funds and life insurance companies to shift their vast portfolios into increasingly risky asset classes, beginning with the stock market (Krippner 2005, Walter/Wansleben 2019). As these investors entered the stock market, they called for more emphasis on shareholder value maximization. In terms of their own business model, too, asset managers were incentivized to heed the short term, as they were assessed based on their own quarterly earnings. This made them keenly interested in companies with strong quarterly earnings, and they pushed corporate managers toward more short-term performance indicators (e.g., Lowenstein 1988, 1991).

The 1980s also saw rapid advances in information technologies that enabled much faster and cheaper stock trading, as well as new research on arbitrage trading and other methods to exploit pricing mismatches across markets or asset classes. The institutional investors developed new trading techniques and shifted their portfolios to focus on companies that promised a rapid increase in stock prices. In addition to leveraged buyout firms, new players such as hedge funds and activist investors joined the fray, and they created a new language of investing. Each with their own focus and methodologies, they all aimed to identify companies that either traded below their net worth, showed “capital inefficiencies” that could be cleaned up to cause the stock price to “re-rate”, could be taken apart and sold off in pieces at a bargain, or could be easily improved and grown.

In the 1980s, especially this latter category of “turnaround” and “growth”, LBO funds were seen as playing an important positive role for the U.S. economy. They identified companies not performing optimally, took a medium-term position, worked with management and consultants to improve operations, and finally sold off their position with a high return. As we will see below, many finance professionals, including the late David Swenson who for many years led Yale University’s investments, considered this type of constructivist investments as a “superior form of capital” (Swenson/Rubin 2017). Private equity funds that specialized in carve-outs – helping large conglomerates to trade business units – also proved beneficial: by funding a liquid market for corporate assets, they greatly helped the conglomerates to refocus and shed non-core businesses. The result of America's experience with this financialization was an extended stock market rally, which validated the theories of MSV, agency theory, and efficient markets.

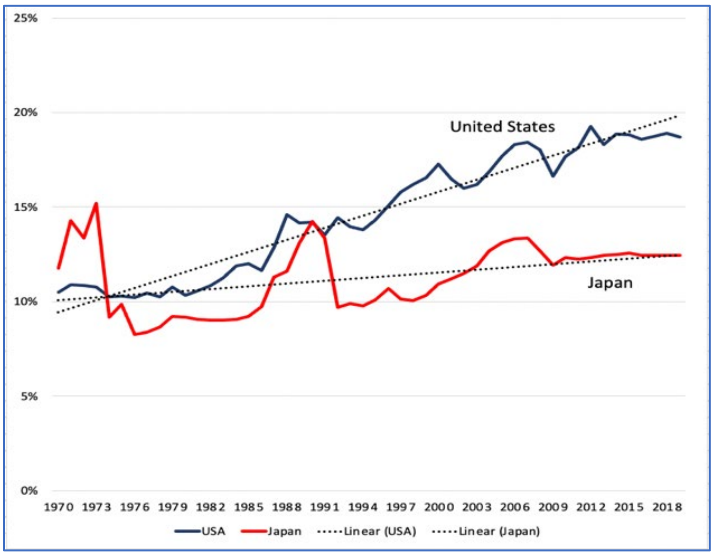
2.3. Negative Signs of Financialization in the U.S.

Over time, from these positive beginnings emerged business models and investment schemes that created moral hazard and led to the rise of dealmaking that served primarily the investors, at the expense of companies and employees. The fast growth of more aggressive fund investors also pulled household savings into riskier asset classes. When the U.S. government began to privatize (or marketize) household savings in the 1970s, several welfare functions that had previously been the responsibility of the state or employers to households. One example is the shift from the "defined benefit" pensions (where companies built up reserves to pay certain amounts to long-term workers upon retirement) to "defined contribution" pensions (where employees get tax deductions for pension savings in financial instruments of their choice, held in transferable pension accounts). Average Americans began to take on more personal financial risks as they shifted these funds from savings and leveraging and financing their own assets (Dore 2000). The financial motive began to imbue all walks of life: success came to be measured in financial returns, status to be determined by wealth, and social relations and activities viewed in terms of utility (Davis 2009). Of course, these new markets also brought benefits for the economy overall, as they offered ample opportunities for risk-taking and innovation, and increased returns on entrepreneurial activity. But over time, FOMO (the fear of missing out) also pulled more people into risky investments that were too complicated to understand, and this ultimately caused huge household losses with the 2008 Global Financial Crisis (GFC).

In spite of the positive effects for innovation, strong economic resilience, and the opportunities presented by a high "business metabolism", the huge financial losses especially by America's middle class from the 2008 GFC have led to a growing sentiment in the United States that financialization has caused damage to the American economy and society (Davis 2009; Lemann 2019). The discourse about a better form of capitalism, or at least how to protect workers and their pension accounts from aggressive, high-risk deal-making, has heated up for three main, interrelated reasons. First, the United States (and some European countries) still have not recovered from the GFC. This has given rise to a "lost generation" in the U.S., namely millennials who distrust Wall Street and real estate, having witnessed how the 2008 collapse wiped out their parents' homes, personal savings, and college funds. Political cleavages, the rise of populism, and direct challenges to America's demography are sometimes also attributed to this sense of "loss".

Exhibit 2: Income Inequality: Share of Total Income by the Top 1% Earners

Source: Constructed by author with data from World Inequality



The second reason is growing income inequality. While this is a global phenomenon, it is particularly pronounced in the United States. Exhibit 2 shows the estimated share of total income earned by the 1% richest people in the U.S. and Japan. The two trendlines have very different slopes, partially because the collapse of the bubble economy in 1991 (see below) brought a huge correction in Japan, while the 2008 Global Financial Crisis did not do the same for the U.S. Not only were financial institutions not held accountable for the 2008 losses, but the hypermobility of talent and money in the United States appears to benefit only a small portion of the economy, at the expense of the many (Kaplan/Rauh, 2009, 2013). What is more, Pistor (2019) shows how in the U.S., the law has been used to selectively code certain assets to turn them into protected, complex financial products to give financial advantage and protection only to their holders. Thus, wealth is structured so that it creates more wealth, by being defined as assets that exist in law only.

Underlying both trends is the third concern about financialization, which is the long-term erosion of corporate performance and wages in the United States. As Lazonick and his various co-authors (2000, 2009a, b, 2014, 2020) have argued, the "maximizing shareholder value" (MSV) doctrine has shifted managerial incentives away from the previous long-term growth through "retain and reinvest", and to the pursuit of much more short-term oriented "downsize and distribute". Over time, long-term corporate strategies for innovation, skill formation and value creation were replaced by short-term metrics of profitability.

When American business launched its turn to the market by refocusing the former conglomerates in the early 1980s, new rules for more transparency and disclosure helped to shine light on inefficient management. Regular (typically, quarterly) earnings reports reduced the information monopoly of insiders and provided the public with access to corporate information. But when household savings were directed into new investment vehicles such as mutual funds, and institutional investors became majority shareholders in many companies, the previous "owners" – investors with a sincere interest in the long-term growth of a company – were replaced by institutions that were "absentee shareholders" (Lowenstein 1988). The fierce competition among those professional asset managers became based on short-term measures such as quarterly earnings and ROE. Even investments funds with a long-term goal are now assessed regularly for their mark-to-market performance at any given time. Today, even long-term value investors are incentivized to favor dividend payouts and management actions that drive up the stock price in the short run.

The continuous pressure on companies to increase ROE has made "downsizing" corporate America's new normal, both in terms of corporate divestitures to focus the company smaller and in cutting labor and replacing (expensive) long-term employees with (cheaper) non-regular workers. Many companies have been pushed to pay out larger portions of retained earnings in the form of dividends or stock buy backs (Lazonick 2014). CEOs in the U.S. (and increasingly, Europe) who receive a substantial portion of their pay in stock options are usually happy to follow these incentives from the financial markets, as they stand to benefit from the resulting increases in stock market valuation.

There is now a growing concern in the U.S. that while financialization has enabled and propelled the new economy, including companies such as Alphabet (Google), Amazon, or Facebook, it has eroded the manufacturing base of the U.S., as well as the middle class that used to work in that sector. Crotty (2005) calculated that "payments to financial markets" (meaning, net interest, dividends and stock buybacks) as a percent of cash flow increased from roughly 20% in the 1960s to the 70% range in the 1990s. Lazonick (2014) showed that some leading U.S. companies have returned more than their annual earnings to shareholders. Over time, these payouts have curtailed U.S. corporate spending on R&D and human resources training. Innovation, too, has shifted from long-term building of core competencies to a much more fast-paced, high-risk investment play. Thus, financialization is making it more and more difficult to innovate for the future. Moreover, Lazonick/Shin (2020:2) show that while labor productivity in the U.S. has increased, hourly wages have been large flat since the 1980s. They attribute to cost-cutting pressures on companies who have found ways to reduce unionization rates and offer less pay and fewer benefits to employees.[7]

The rise of aggressive investors – and in particular hedge funds, leveraged buyout funds, and activist investors – has further contributed to financialization in the U.S. Insofar as

[7] The rise of Silicon Valley and the birth of venture capital funds have further contributed to financialization and income inequality in the U.S. Because VC funds usually have, at most, a five-to-ten-year investment horizon, they aim for quick, lucrative exits through a sale or an IPO. Their financial successes have put the entire U.S. investment industry on a short clock (Lazonick 2009). Moreover, Silicon Valley has attracted young talent away from secure positions at established firms, by offering potentially enormous pay through stock options. This has fueled hypermobility for short-term financial gain, often at the expense of long-term value creation.

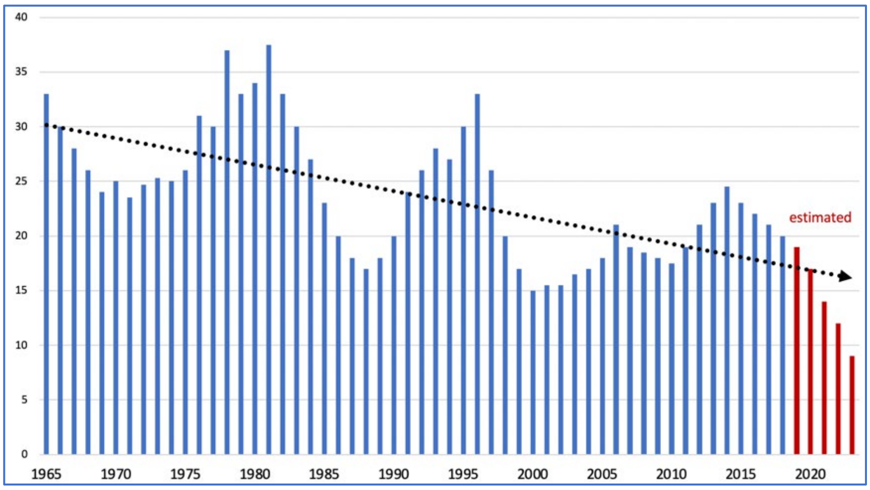
these investors pursue short-term "predatory value extraction" (Lazonick/Shin 2020), they can bring significant damage to certain companies. What is more, they may turn the entire economy toward short-termism. This is because, in general, a company's best defense against a takeover bid by an aggressive, short-term investor is to be very well-managed such that there are no gains to be made from financial schemes. This is the welcomed, quiet discipline of the market. However, because the market assesses "good management" in terms of short-term stock price increases, takeover threats over time shift all companies to short-termism; in other words, the predominance of short-term financial metrics can be harmful not only to companies that are targeted, but for all companies, and thus the economy overall.

One indicator of the impact on the U.S. economy of this constant pressure toward short-term results is the rapidly falling life-expectancy of U.S. firms. Exhibit 3 shows the average "life span" of leading U.S. companies in the S&P500, i.e., counting the years a company was included in the index. From over 35 years in the 1950s, this is expected to fall below 10 years by 2023. In other words, today's leading U.S. firms are strong for barely one decade.

Citing Schumpeter's "creative destruction", many macro economists view this reduction as a sign of "healthy" creative destruction and attribute the higher turnover to exogenous technology shocks (e.g., Caballero et al. 2008). A high churn in companies is seen as a sign of innovation and contributing to the resilience of the U.S. economy. In some instances, this may well be true.

Exhibit 3: Average Company Lifespan on the S&P500 Index

Source: In years, rolling 7-year average. Constructed from Innosight 2018 Corporate Longevity Forecast



However, at the corporate strategy level, new research is now emerging in the United States that recommends more emphasis on in-house innovation and long-term corporate growth. Under the labels of "ambidexterity" and "dynamic capabilities", these scholars begin with the assumption that large companies should never die, as they have the resources to out-innovate startup companies, if they can just manage their internal processes properly (e.g., Christensen 1997, Teece et al. 1997 O'Reilly/Tushman 2021, Binns et al. 2022). Thus, large companies need a new organizational design that allows "corporate explorers" to drive innovation in large firms. Managers can pivot their company in anticipation of technology shifts and exploit those shifts through innovation. They can replace old assets, retrain the workforce, and ride new technology waves, thereby ensuring a healthy evolution and thus longevity of their company. To be sure, such pivoting takes money, investments, and leadership. If a company fails, it means that managers failed to invest in the firm's dynamic capabilities. There are two main reasons for such failure. One is that managers are unable to identify new technologies or are too risk averse to invest in them. The other is that they are forced to distribute company earnings to shareholders rather than reinvest in the company, which is increasingly the situation in the U.S.

2.4. Financialization in Japan: The Bubble Economy and the Lost Decades

Japan's corporate governance system, financial system and overall economic focus have traditionally been on stakeholders, including employees, suppliers, trading partners, and banks. During the country's period of rapid growth in the second half of the 20th century, strict financial regulation channeled most of corporate finance through the banking system. For large firms this was anchored by long-term relations with a "main bank". For these banks, the stock price was much less relevant than steady cash flow that enabled reliable and punctual interest payments on loans. For employees, the system of lifetime employment also provided stability. Salaries were determined by size of company and years worked there. This provided a system stabilizer during a period of fast economic growth (Schaede 2008, 2020).

Japan's first experience with financialization occurred during the "bubble economy" from 1987-1991. This was a period of financial gambling, ironically exactly at the time when the efficient market hypothesis became mainstream in the U.S. A house of cards was built where bank loans financed real estate purchases which drove up stock prices based on which more bank loans were provided for other highly risky money schemes. When the bubble collapsed, it not only caused a banking crisis and huge write-offs, by one estimate of 3x GDP at the time in real estate and stock market losses alone (Koo 2011). It also altered the growth trajectory of the entire economy by putting it on a much more measured path (Shirakawa 2021).

From this bubble experience to this day there continues a strong suspicion in parts of Japanese business and government of the stock price as an accurate indicator of a company's true worth (Schaede 2020). But as Japan's economy fell into two decades of stagnation, similar to the U.S. in the 1980s, some economists in Japan identified the lack of market discipline as the culprit. These reformers proposed policy measures to introduce more risk money and increase the metabolism of the economy (e.g., Caballero et al. 2008, METI 2017, Team Shift the Curve 2014, Toyama 2020). Between 1998-2006, under Prime Minister Junichirō Koizumi, Japan revised most of its commerce-related laws, with the goal to give CEOs more freedom to engage in corporate repositioning and refocusing. At the turn of the century, "choose and focus" (*sentaku to shūchū*) had become the lead catchphrase (Schaede 2008). However, the efforts at corporate reform were interrupted by the downturn of the global economy after the 2008 GFC.

The government under Prime Minister Shinzō Abe pushed for reforms to revive the stock market, also with an eye to enabling Japan's GPIF (the largest general pension fund in the world) to reach its obligations. This included new rules on corporate governance, stock market reporting, accounting and disclosure, all of which have brought transparency and a new market orientation to Japan's governance system. Research by economists and political scientists show that these reforms pursued a neoclassical agenda of pushing Japan's political economy into a system governed by the discipline of the markets, and thus financialization (e.g., Hoshi and Lipscy 2021, Lechevalier 2014, Tiberghien 2014).

One expression of the reformers' push to the market was the concept of "zombie" firms (Caballero et al. 2008). Zombies – companies without a compelling business model and low or negative profitability - were seen as an outgrowth of relationship banking, as they were kept alive through forbearance lending by their main banks. The authors estimated that approximately 30% of listed firms and 15% of assets were associated with such zombie lending in the 1990s. In many cases, banks engaged in this loan evergreening to uphold their minimum capital requirements, as required by the international "Basel capital standard" rules: write-offs of delinquent loans might have pushed them below those requirements. Nor did the banks want to be seen as worsening the recession by pushing companies into bankruptcy.

Caballero et al. (2008) viewed these policies as a credit distortion that pulled down the entire economy, by depressing market prices, hogging assets (including talent), and reducing overall productivity. They concluded that this was a "very inefficient program to sustain employment" (Caballero et al. 2008:1944). With the counterfactual unknown, we cannot be sure whether the opposite policy – letting 30% of Japan's listed firms and 15% of assets fall into bankruptcy or liquidation – would have been less "efficient" for Japanese society overall. In any event, the Japanese government decided to support banks in keeping companies alive for societal reasons. Many of these companies are now once again viable, and even if their ROE may have been depressed for many years, they have offered steady employment to many workers.

Either way, these measures to support companies through the recession at the turn of the century were costly. Japan's extended stagnation made the resilience of the U.S. economy look very attractive. New laws were written and policies adopted with the explicit goal to make Japanese business more transparent and deal oriented. By the early 2010s, Lechevalier (2014) observed a "great transformation of Japanese capitalism". Banks and companies in distress had been merged, sold or liquidated in increasing numbers, and many of the previous keiretsu, main bank and subcontractor relations were redefined or undercut (Schaede 2008). As the country searched for new, better ways of running the economy, the postulates of neo-classical thinking about the superiority of the market in governing corporate strategies seemed to offer the solution.

However, there was also significant pushback. Government agencies were said to be divided over how much "market" was the right amount. Some politicians intervened in deregulation programs by demanding special protection of certain industries, from agriculture to regional banking. One example of this division in discourse and direction was the 2014 "Ito Report" and its revision in 2017 (Ito 2014, 2017). While the 2014 Report pushed a core message of increased "capital efficiency", with a goal of a minimum ROE of 8% for listed companies through reducing cash holdings, cost-cutting and organizational redesign, it 2017 revision softened this stance significantly.[8]

Still, the 2014 "Ito Report" formed the basis of Japan's corporate governance reforms of the mid 2010s, including Japan's 2015 Corporate Governance Code, modelled after the OECD Code of 1999, and a turn to maximizing shareholder value as a core concept (Milhaupt 2018). Together with the 2014 Stewardship Code, these reforms moved Japan closer to other OECD countries, and thus were successful in attracting foreign and institutional investors to the Japanese stock market. By 2020 these combined to holding 50% of ownership stakes in the average Japanese listed company (and more so in globally successful ones) (Schaede 2020).

The reforms also made Japanese corporate assets attractive to domestic and global activist investors, hedge funds, and private equity funds. As we will see in Section 4, their arrival brought the desired change in facilitating Japan's business reinvention through a market for corporate assets, supporting the renewal of Japan's small- and medium-sized enterprise sector, and highlighting the need for new leadership, vision and forward-looking strategy making in large firms. But they also pushed financialization further, with market forces, becoming a huge factor that all companies must reckon with.

Just at this moment in time, Japan also experienced the onset of the DX and deep-seated changes in its employment system, partially due to demographic change (Schaede/Shimizu 2022). The 2019 "Workstyle Reform" legislation introduced new choices in employment relations, for both employers and employees. Job-changing became easier, and a market for mid-career career changes emerged. For employees, the highest returns to labor were no longer earned through dedication and tenure, but skills, versatility, and mobility. This brought "everyday life" financialization for Japanese society overall. While Japanese households are still mostly savers, stock market and mutual funds' investments have been on the rise since the

[8] The reason for this shift was that the 8% ROE benchmark incentivized corporate strategies that were potentially counterproductive. Research showed that to meet the 8% target, some companies began to buy back their own stocks and reduce R&D spending and employment (Chattopadhyay/Shaffer/Wang 2017). The 2017 Ito Report suggested a more situational assessment of ROE by company and industry.

1998 financial "Big Bang" reforms. And while pensions are still mostly based defined-benefits, systemic change is coming there, too.

3. Private Equity Investments and Financialization

"Private equity" (PE) is an asset class where funds pool investments from institutions such as pension funds, university endowments, life insurance companies, and wealthy individuals, to make targeted investments in turnaround, growth, distressed or carve-out projects. Developed in the United States in the 1980s as "leveraged buyout" (LBO) funds due to their use of high levels of debt, these funds acquire and then turn around privately held (not listed) companies, subsidiaries or business units, typically over a period of four to seven years.[9] Due to their recent fast growth, PE funds have been labelled "the new kings of Wall Street" (The Economist 2022).

With about \$4.8 trillion of assets under management (AUM), plus \$2.3 trillion in "dry powder" (assets ready for investment) as of 2021, the global private equity industry has tripled in size over a decade and continues to grow fast (Cohen et al. 2022, The Economist 2022). In 2017, it was estimated that there were about 4,800 PE firms globally, with 21 of the 25 largest funds headquartered in North America. By far the largest is Blackstone (over \$95 billion raised between 2015-2020), followed by Carlyle (\$62 billion), KKR (\$55 billion), as well as TPG, Warburg Pincus, Neuberger Berman and CVC Capital Partners with about \$36 billion each (Batt/Morgan 2020). Because this industry deals in privately held assets and disclosure rules are minimal, these data are estimates and may underrepresent the industry's true size. Most PE firms are unknown, and they often operate in stealth fashion. There is little transparency, and most consumers, and sometimes even employees, are unaware that their nursing home, emergency room, department store, restaurant chain, or even rental apartment are owned and operated by a PE fund.

Between 2004 and 2019, the global PE market was assessed as having grown from \$1 trillion to almost \$5 trillion in assets. Of this total, North American firms raised about 66%, European firms 20%, and Asian firms 14% (Batt/Morgan 2020). The COVID-19 pandemic did not slow fundraising down, and the year 2021 reported a new record with approximately \$940 billion raised (Cohen et al. 2022). In terms of deal-making, in 2021 global private equity transactions accounted for roughly \$1.2 trillion, a 111% increase over 2002 and representing about 20% of overall global M&A volume in that year. The main drivers of this activity were record numbers of buyouts (i.e., distress deals) after the 2008 GFC as well as the availability

[9] Venture capital (VC) developed later, as a sub-category with a specialization on startup companies. Today, VC makes up about one quarter of U.S. private equity.

of capital and easy debt financing at low interest rates. PE firms also accelerated their exits: in 2021, a total of 3,895 exits, valued at $665 billion, surpassed the 2,594 exits worth $521 billion in 2020 (Cohen et al. 2022, The Economist 2022).

Despite this fast growth and increasing impact, little is known about PE. Available data are likely to suffer from selection bias (e.g., success cases only). The industry's effect on the economy and financial markets cannot be assessed with accuracy. Although the PE industry is not considered large or consolidated enough to cause systemic financial risk for an economy overall, it can still have a huge impact on local economies (e.g., through consolidating smaller companies) and labor relations (e.g., by pushing layoffs). As the industry grows, regulators are becoming concerned about the large amounts of debt generated (see below). Thus, while some view the industry as instrumental in supplementing the market for corporate control (e.g., Davis et al. 2014), others express concern about the detrimental impact of some of the more predatory deal-making schemes (e.g., Kaplan et al. 2011; Appelbaum/Batt 2014; Phalippou et al. 2018, The Economist 2022).

3.1. Functions of Private Equity Investors

PE investors are called "limited partners" (LP), and they include institutions with important public duties such as pension funds and university endowments. One PE firm typically runs several funds simultaneously, and each fund is its own legal entity. The common maturity of a fund is seven to ten years. The LP provide some 98% of the fund's capital, and delegate decision-making to the fund managers ("general partners", GP). The GP invest about 2% of the capital. They commonly use a "2-and-20" fee structure, earning an annual 2% management fee on the entire fund, and keeping 20% of the final capital gain, the so-called "carry". Many GPs also charge their portfolio firms an additional "transaction" or "monitoring fee" of about 3% per year. [10] One common means to increase investor returns from an ongoing investment is to pay out dividends over the course of the project, as explained below (e.g., Kelly 2019, Appelbaum/Batt 2014, Batt/Morgan 2020, Phalippou et al. 2018).

Within the PE industry, globally the largest categories are corporate buy-out and carve-out funds. These acquire business units and subsidiaries from large, diversified firms, or small- and mid-sized privately held companies. Like VCs, the GP set milestones for business improvement, and may bring in a new management team to execute a turnaround or growth strategy. They aim to improve operations, build more efficient processes, and increase performance and profitability. Many PE funds have their own consulting firm or in-house consultants, in addition to access to a network of professional CEOs.

[10] These may remain undisclosed even to the LP and have been harshly criticized as "flagrant self-dealing" (Batt/Morgan 2020). In early 2022, the Securities and Exchange Commission estimated that total PE fund fees ran at about $250 billion each year, or almost 50% of the exit sales in 2021.

A PE firm's fund is evaluated based on the internal rate of return (IRR) they earn. PE firms compete by building a reputation and track record across their funds. They tend to specialize in a particular area where they build deep knowledge and a network. They strive to earn high returns by investing most of their assets under management as fast as possible, so that they can show returns at around the half-time of the fund. One key to earning higher returns on investment is leverage: The higher the debt leverage, the riskier the project but the higher the returns. The debt that the fund takes out is assumed by the portfolio company, meaning it is not a liability of the fund. If the project succeeds, the fund scores big; if it fails, the portfolio company is left with the debt, while the fund loses the equity capital invested.

Over the past few decades, PE funds have claimed to outperform alternative modes of investment, such as the stock market (Davis et al. 2014, Kaplan et al. 2011). However, critics have pointed out that the lack of rules and transparency affords PE firms great liberty at presenting their results. For examples, they could increase their track record by averaging different funds over a longer (or shorter) time span.

Exhibit 4: The 2x2 of PE Funds

Character / Time Horizon	Short (less than 12 months)	4-7 years
Engaged/ low profile	*Rare opportunities* • Support healthy SME in succession planning / transition • Non-critical turnarounds • Support strategic pivots and trade valuable assets	*"Superior Form of Capitalism" Economic Value Creation* • *Improved management and operations* • *Reinvestment in assets and skill formation / worker engagement* • *Enhanced use of technologies*
Aggressive/ high profile	*"Naïve playbook" Financial engineering* • Aggressive debt finance • Dividend payouts • Stock buybacks • Asset stripping	*Rare: Push Change-Resistant Managers* • *Push for significant change; bring market discipline* • *Hired by insiders* • *Strategic pivot*

PE funds fall on a spectrum of length of investment horizon (short to long) and profile (high to low). One may think of this as a 2x2 matrix (Exhibit 4), with the two dominant boxes the long-term, engaged, low profile variety, as opposed to the short-term, aggressive, high-profile ones. Another way of expressing this differentiation is to think about high-quality, long-term owners on the one end, and short-term, aggressive financial engineers (aka "vultures") on the other. In a 2017 interview, the Chief Investment Officer at Yale University descried the former as "intelligent capital investment" and labeled their "buy –make better – sell" activities a "superior form of capitalism". In contrast, he found the aggressive, short-term approach to be "a naïve playbook that is destroying the quality of companies and the market overall." [11]

A high-quality, engaged PE firm will introduce seasoned managers who know how to rebuild an organization. Their approach is akin to flipping a house, based on high-level business management and operational skills. This corporate remodeling usually takes four to seven years. For the PE firm, the risk is that if the turnaround effort falls short, it will wipe out the entire investment; the reward comes by selling the remodeled firm at a much higher price.

Many in the U.S. celebrate PE funds for contributing to economic efficiency and resiliency in this way. They do this by identifying "hidden value", i.e., companies with viable assets that lack the managerial skills to profit from them. As they turn underperforming businesses into successful companies, they build new jobs, enable innovation, and return money to the PE investors. Even when the turnaround attempt fails, the PE firm takes the company into liquidation in an organized process that, ideally, frees up human, physical and financial capital for better use. In this positive view, PE firms increase overall economic activity not only by buying and selling corporate assets, but also by signaling the possibility of an intervention and a buyout in case of sub-optimal performance. Their mere existence extends the discipline of the market across the entire economy and all companies.

3.2. PE as Value Extraction

In contrast to this high-quality approach, there are also PE firms that abuse financial engineering techniques to earn returns as fast as possible, through a set of tactics that only enrich the fund, at the expense of the portfolio company (Appelbaum/Blatt 2014). Like a chop shop, these PE investors employ aggressive debt financing and tax avoidance schemes, pay themselves dividends and fees, and often renege on contracts with suppliers, vendors, and employees and their pensions.

The core mechanism for this value extraction is the leverage, which has earned their activities the label "capitalism on steroids" (Batt/Morgan 2020). The typical U.S. buyout deal uses about 65-70% debt (loans from banks and others) and 30% equity from the PE fund. The portfolio company is saddled with this debt, and must manage the turnaround with a focus on generating cash to pay the interest on the debt (or pay down the debt itself). For small firms, which may not need a lot of debt, this inflow of financial assistance is often advantageous. But for large-firm acquisitions or carve-outs of large business units, the debt is often huge even as operations may already be quite efficient. To service the debt, these companies will then have to downsize, not to company leaner or to upgrade, but simply to service the new debt (Batt/Morgan 2020).

[11] Swenson/Rubin (2017). On short-termism and value destruction, see Lazonick (2009a, b, 2014), Lazonick/O'Sullivan (2000), Appelbaum/Batt (2014). I thank Yoshito Sakakibara for suggesting the 2x2 matrix.

Underlying this risk-taking behavior is the moral hazard inherent in the PE business model. Because the GPs put up only 2% of their own money into any fund, and debt pays for about two thirds of any investment, they risk only about 0.6% of the total enterprise cost (Applebaum/Batt 2014). At the same time, all risks are carried by the portfolio firm. From this moral hazard have developed five negative practices in the U.S.:

(1) *Increasingly excessive debt taking,* whereby the portfolio company assumes the responsibility for the debt; because the interest payments are tax deductible, it is free for the PE;

(2) *Asset stripping,* whereby the PE fund invests in a business with valuable, tradeable assets such as real estate; they then sell those assets to pay the fund, and eventually force the company into bankruptcy;

(3) *Dividend payout and dividend recapitalizations*, whereby the PE pays out dividends to the GP and LP (investors) prior to the exit. This strips away money that should be used for the turnaround effort, thus reduces chances for success. In a dividend recapitalization, the PE issues additional debt for the purpose of paying out dividend, further undermining the viability of the portfolio firm;[12]

(4) *Premature bankruptcy (so-called 363 sales)*, whereby the PE firms first strips the assets and then applies for Chapter 11, with streamlined sales of assets which allow PE to default on unsecured creditors, including employee benefits.

(5) *Excessive layoffs* intended to reduce the cost structure (including wages, benefits, and pensions); while product quality and customer service may suffer because of understaffing, this damage will take several years to materialize and does not harm the PE.

Asset stripping and value extraction became more common in the 2010s, in the so-called "real estate stripping". In this scheme, a PE invests in a company that owns real estate, such as a grocery or department store chain, and divides it into two parts: a property company and an operating company. The property company then sells the real estate, and the returns are used to repay the fund's GP and LP for the acquisition. The operating company then must lease back the property it once owned (possibly at inflated rates). This eventually pushes the operating company into bankruptcy (Batt/Morgan 2020).[13]

[12] In the U.S., the tax rate on dividends is lower than that on capital gains, which incentivizes the PE to pull the funds out of the company early. This represents value because the company already carries a lot of debt, so that the new loans are "junk bonds" which carry a higher interest rate.

[13] While the recent increase in bankruptcies in the U.S. retail industry is often attributed to the rise of e-commerce, between 2012 and 2019, ten of the 14 largest U.S. retail chain bankruptcies were PE-owned and recorded an estimated 1.3 million layoffs. Also, between 2015-2018, seven regional grocery store chains failed, all PE-owned. No publicly traded grocery chain went bankrupt at that time. Almost all failures were caused by excessive debt, and occurred in companies that had extensive real estate holdings (Appelbaum/Batt 2014; Batt/Morgan 2020).

It is now feared in the U.S. that such deals destroy companies, stall innovation, cause unemployment, and over time erodes the core of the economy, while benefitting only a few financial actors. These deals have also contributed to the rise of a shadow banking system and new, unregulated instruments such as CLOs (collateralized loan obligations) that create fee income for banks at little risk. The standard PE fund compensation system sets incentives for GP that are mostly about short-term gains, and this is often in contradiction of the declared PE goals to create value.

It is not always easy to tell a value-creating PE from an aggressive, short-term one. The mission of both will be presented as improving economic outcomes by financializing turnarounds, succession deals, or – in the case of venture capital – innovative ideas. Even within one large PE, fund managers may have different approaches. The world's largest private equity funds – KKR (oldest), Blackstone (largest overall), Carlyle (largest PE), and Bain Capital Private Equity (largest restructuring) – have assets under management exceeding $100 billion each, and operate in multiple market segments with different objectives. They have been associated with both value-creating turnarounds and destructive financial schemes.

Davis et al. (2014) show that companies that were taken over by a PE paid higher wages and had higher employment pre-LBO than their publicly traded competitions. Post-LBO, however, their wages had fallen, and employment growth was lower (thus increasing productivity measures, but not value creation). They made up for this employment loss by acquiring other firms with many employees that they then downsized. In contrast, Ayash/Rastad (2021) find that an investment by a PE increased the probability of bankruptcy by 18% and show that the main cause was the sharp deterioration in capital structure. They also found that firms with PE investments are ten times more likely to file for bankruptcy than competitors that remained public.

3.3. PE and Financialization

Regardless how one assesses the individual cases, overall, by the very nature of its business model the growth of the PE industry has contributed to financialization in the U.S. One reason is that PE takes dead-or-alive decisions for large companies into the sphere of private deal-making, based on stark financial calculations. Furthermore, financialization necessarily occurs through the core goals of this industry: (1) commoditizing assets, (2) employing high leverage, and (3) chasing short-term returns.

First, almost by definition, PE is associated with financialization because its economic contribution is to commodify and trade assets. This necessitates treating workers, pensions, IP knowledge etc. as fungible. Moreover, the PE business model is predicated on exit within a fairly short period of time. Regardless of whether the investment in the portfolio company is one year or seven years with the portfolio company, the GP need to manage the portfolio company so that it produces results that translate into clear payoffs within a maximum of seven years, which often precludes managing for stability or longevity.

Second, PE may increase systemic risk due to the various forms of secured, unsecured, and collateralized debt created. The sheer size of this debt may destabilize the banking system. As Appelbaum/Batt (2014) show for the U.S., lax financial regulation of new instruments that obscured the quality of debt greatly contributed to the 2008 GFC. As syndicates of banks provided highly leveraged loans and sold them as tranches of collateralized loan obligations (CLOs), they collected fees and carried little risk, while the true risk nature of the CLO tranches remained obscured.

A similar process is assumed to underlie PE investments. In the four years prior to the GFC, debt accounted for up to 75% the purchase price of portfolio companies in the U.S., and leveraged debt issued by PE-owned companies skyrocketed. Between 2005-2007, PE reported investments of $634 billion in 956 leveraged buyouts, and just ten U.S. banks underwrote $489, or 77% of the total. Overall, banks provided about $1.1 trillion in loans to the PE industry in those three years (Appelbaum/Batt 2014). The true risk profile of the CLO tranches was only revealed when the market collapsed. In the decade of the 2010s, the U.S. market for high-risk loans doubled, and almost 40% of these leveraged loans were to companies controlled by private equity (Bloomberg 2019). All these transactions have become part of the U.S. experience with financialization.[14]

Finally, non-transparency and IRR-chasing introduce negative aspects of financialization by benefitting a few insiders over broader groups of investors and stakeholders. In the U.S., prior to the 2008 GFC, PE funds were excluded from the Investment Company Act of 1940. Only with the 2010 Dodd-Frank Act, Section 404, came new disclosure rules, as PE and hedge funds with more than $150 million in assets have to register and provide basic information to the SEC. The larger the fund, the more requirements apply. However, this information is not made publicly available, to allow the private turnarounds that constitute the industry's contribution to the economy.

This non-transparency tends to benefit primarily the insiders. Even PE investors may be unaware of the PE's true performance and activities. The GP can affect IRR reporting by choosing a particular time frame, making distributions, or selling off companies prematurely. Such activities to produce higher IRR contribute to financialization, as institutional investors – themselves subjected to FOMO – will tend pick the PE with the highest IRR in the shortest time frame. These various pressures toward short-termism of the U.S. economy have recently

[14] These transactions have also invited "direct lenders", organized as other funds, private management accounts, or fund-of-funds. The 2010s also saw a boom in unregulated private lenders willing to take higher risks than banks. In a low-interest rate environment, investors desperate for higher yields have increased their risk tolerance and are willing to place bets on these unregulated vehicles.

brought calls for new regulation to change some aspects of the PE business model such that incentives deter "naïve" financial schemes and nudge PE funds toward responsible, value-creating strategies.

4. Japan's Emerging Private Equity Industry

With the multiple technological disruptions of the DX (digital transformation) approaching, many Japanese companies face the challenge how to pivot from 20th century businesses into the new digital economy. The digital transformation is changing how companies compete. For Japan — where manufacturing still accounts for about 21% of GDP — this is the second shock to the manufacturing industries in two decades. In the late 1990s, Japan's erstwhile competitive leadership in mass-producing high-quality consumer end products, such as in electronics, was undermined by the rise of South Korea and Taiwan and, soon thereafter, China. Many companies were slow to react, but eventually the leaders repositioned upstream in the value chains to specialize on critical components and advanced materials, to anchor many important global supply chain in input parts (Schaede 2020).

The DX is about to bring another shock, with the arrival of "industry 4.0", new logistics and business process technologies, and the shift to AI/ML-governed business processes. It challenges not only what kind of products and services companies offer, but how to produce them. This necessitates the generation of new business models and income streams, and thus new strategic visions. As leading large companies pivot and reinvent, they must sell off large valuable assets, such as subsidiaries and units that are profitable but no longer fit. These sales also bring employment changes and feed into the growing labor mobility. And, as more companies are trading valuable assets, deals are getting larger and bolder. Banks in Japan, foreign and domestic, prepare to supply the needed debt at a time of zero interests and excess liquidity.

These shifts also bring more financialization, and a welcome and necessary shift to market-oriented, global competition. The question then becomes: Can more mobility, agility and efficacy to corporate finance and corporate reorganization be introduced while avoiding the potentially negative consequences of the hypermobility and hyper-commoditization that many in the U.S. is now concerned about?

4.1. The Arrival of PE in Japan

Japan's first experience with PE funds occurred in the mid-1990s when the post-bubble economic crisis attracted Wall Street firms to Tokyo. The struggling domestic banks tried to salvage any value from non-performing loans by selling off the collateral. This made the PE entry to Japan easy and lucrative. Moreover, as several large banks failed or consolidated into larger financial groups, some of their best and brightest younger employees joined foreign PE funds. This initial bonanza of dealing in defaulting businesses ended in the early 2000s, and some of the Japanese employees then moved to establish their own funds.

Even though this first PE wave helped alleviate the non-performing loan burden, most of corporate Japan still viewed PE negatively, as they benefitted from Japan's economic woes. This sentiment was reflected in a 2007 NHK-TV drama series titled *Hagetaka* ("Vultures"). Foreign buyout funds were portrayed as cold, calculating, and canny invaders from Wall Street that threatened Japan's long-standing business norms and killed small and family-owned businesses. But, not without awe and admiration, the show also highlighted the advantages of rational calculations and financial engineering in improving Japan's mismanaged companies. The TV series triggered heated discussions in all walks of Japanese social and political life regarding the costs and benefits of market discipline versus Japan's traditional style of long-term obligations, efforts to preserve generations-old businesses and the dignity of small store owners, as well as society's responsibility in protecting hard-working people.[15]

Between 2003-2007, Prime Minister Koizumi triggered an economic uptick with his "leave it to the market" deregulation, which invited a second round of PE growth. The number of annual deals nearly quadrupled from 23 in 2002, to 90 in 2007, for a total value exceeding US-$ 10 billion in 2007. Still, most of these early deals were non-core divestitures and turnarounds, and foreign investment funds continued to be viewed with suspicion. In 2006, U.S. Steel Partners, an activist fund with a medium-term horizon, launched an intervention in Bull-Dog Sauce Co., Ltd., one of Japan's preeminent condiment makers. The company employed a poison pill by issuing warrants to dilute the fund's stake, and the courts sided with the company, labeling U.S. Steel Partners an "abusive acquirer". In the end, the shareholders lost significantly, and the company adopted many of the activist's recommendations – leading many in Japan to doubt the court's interpretation (Givens 2010).

The 2008 Global Financial Crisis forced many U.S. funds to retreat from Japan. As mentioned above, since then, Japan has greatly reformed its corporate governance code, and introduced a new stewardship code that prescribes the role of institutional investors in the new system. In 2018, a Japanese fund manager reflected on the case to comment that "there has been a complete change since the Bull-Dog case in 2006. This would take a completely different path today."[16]

Reflecting the new sentiment, Prime Minister Abe's "Abenomics" reform program invited a third PE boom, when Japan emerged as an attractive, stable PE market in the mid-2010s. Unlike previous episodes, a large portion of this new activity was domestic: funds were

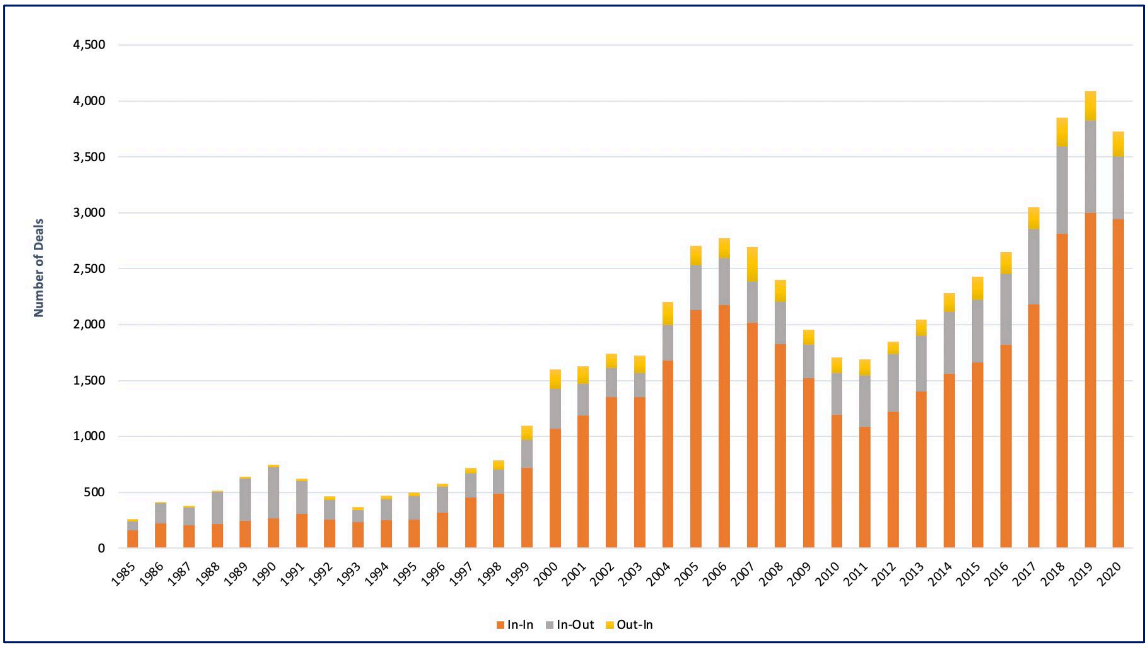
[15] E.g., https://www2.nhk.or.jp/archives/search/special/detail/?d=drama040
[16] Interviews, Tokyo, February 2020.

raised and invested within Japan, by a growing number of global and domestic players. Between 2013-2017, the PE industry in Japan raised roughly $3 billion annually, and in 2017, assets under management were estimated at around $30 billion, with over $10 billion in dry powder. In 2017 alone, Japan-focused PE funds raised $5.7 billion, and regional funds that included Japan raised $22 billion, twice the amount of 2016.[17] While still only about a 10^{th} the size of the U.S. market, this made PE a power to reckon with in Japan.

In industry statistics, PE activities are considered mergers and acquisitions (M&A). Exhibits 5 (number of deals) and Exhibit 6 (amounts, in billion Yen) show that the years 2018 and 2019 were record-setting for Japan's M&A market, with about 4,000 deals worth ¥30 trillion (roughly $300 billion) and ¥17 trillion ($170 billion) respectively. The trendlines are clearly upwards-sloping, and even though 2020 looked more subdued due to the COVID-19 pandemic, industry reports suggested that both supply and demand continued to grow (BCG 2017, PwC 2021).

Exhibit 5: Mergers and Acquisitions, 1985-2020, in Number of Deals

Source: MARR/Recof Data, https://www.marr.jp/genre/graphdemiru



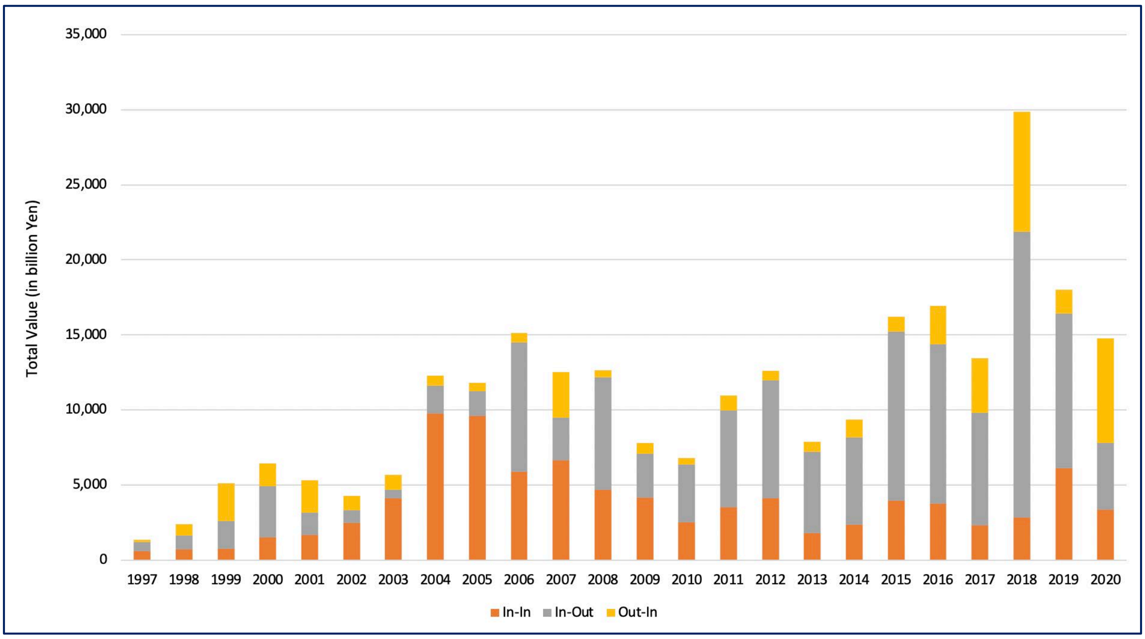
In terms of number of deals, most of this M&A activity was domestic, whereas by value, most were so-called "in-out" deals, i.e., Japanese companies acquiring companies abroad. According to industry estimates, about 50% of domestic M&A were business succession deals (involving small firms), followed by 20% of both divestitures and

[17] Sekine (2018)

management buyouts (carve-outs and spinouts) by large firms. A smaller number, though an important portion in terms of value, were mergers between large Japanese firms.

Exhibit 6: Mergers and Acquisitions, 1985-2020, in Volume (billion Yen)

Source: same as Exhibit 5



Within these M&A data, which include mergers, corporate acquisitions, and venture capital, little is known about the exact size of the PE industry. Most global databases gravely underestimate the size of this market. For example, Washimi (2020) reports data from Pitchbook of $20 billion, with 70 deals per year, but there are some concerns that these numbers may be underestimated. This data confusion underscores the necessity to address the lack of transparency in the PE industry, both for research and regulation, as discussed in Section 5 below.

4.2. Japanese PE: Carve-Out and Succession Deals

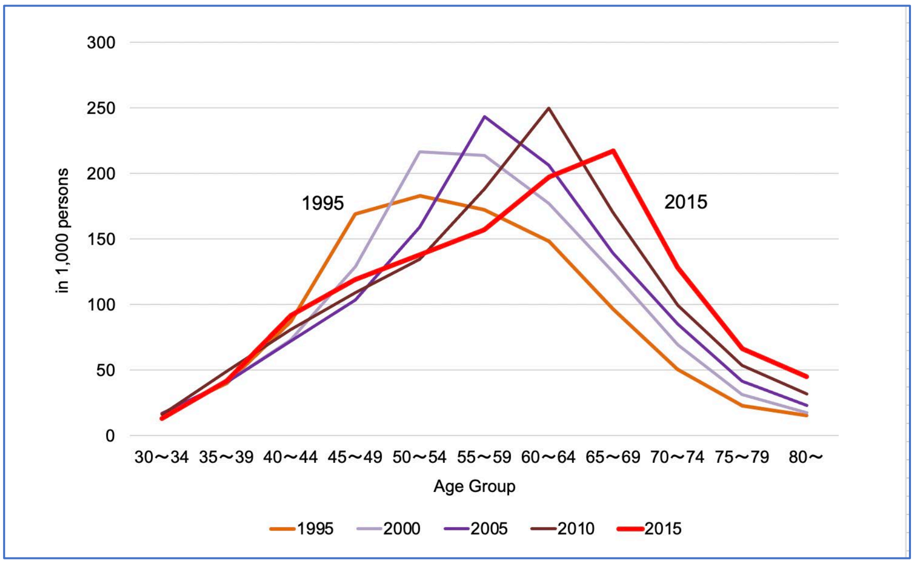
Japan's rapid growth in private equity activity in the 2010s was driven by two main market segments: small firm succession deals, and large firm carve-outs. About 50% of Japan's domestic M&A activity in the late 2010s was said to be associated with the "succession challenge", caused by a massive retirement wave of post-WWII founders of small firms that lack a successor.

Exhibit 7 shows that between 2000 and 2018, the median age of managers of small firms increased from 47 to 66, and it was estimated that, by 2023, over 300,000 small firm owners will reach the age of 70, with 62% having no succession plan. It has been estimated that simply letting these small firms die would be costly to society: they employ an estimated

6.5 million people and contribute about ¥22 trillion (roughly $220 billion) to GDP (MARR 2019). Their banks and surrounding regional economies may also depend on them. In a separate study from 2020, Carlyle, Japan's largest PE fund, estimated that there were 2.6 million family-owned companies, and that 71% of these had a need for either succession planning or restructuring.[18] To facilitate restructuring in this middle market, in 2018 the tax reform for corporate succession offered incentives for PE funds to invest. This has opened a new market opportunity for domestic PE funds domestically to bring in capital, advice and management experience to small firms.

Exhibit 7: The Age Distribution of SME CEOs in Japan, 1995-2015

Source: Constructed from https://www.chusho.meti.go.jp/pamflet/hakusyo/H30/h30/excel/b2_6_02.xlsx



The second large category was Japan's fast-growing corporate carve-out activity. As of 2019, Japan still had more than 250 conglomerates, defined as firms with more than 50 consolidated subsidiaries.[19] In addition to the strategic pivot necessary to compete in the DX, the conglomerate discount on the stock price put significant pressure on these companies to refocus, lest the discount invite activist investors. In 2015 alone, Japan saw 842 spinout cases worth over $50 billion, followed by 850 cases in 2016 worth over $30 billion.[20]

[18] Interview, Carlyle Tokyo, March 23, 2020.

[19] Advantage Partners website, https://www.advantagepartners.com/en/descripion/description2
, accessed April 24, 2019.

[20] METI (2017). Another growing PE opportunity are mid-sized companies in distress, or in need of business improvements. In the 2010s some of these were forced into bankruptcy despite having strong key projects and a loyal customer base, because they lack the management wherewithal to escape the crisis. In contrast, so-called management or leveraged buyouts (MBO/LBOs) are still rare, probably because delisting a company from the stock market, perhaps to escape a vulture attack, is widely seen as a failure in Japan.

By the mid-2010s, the world's largest PE funds had committed billions of dollars to the Japanese market, and a domestic industry was flourishing. In 2016, KKR declared that Japan had become "first priority" outside the U.S. and invested $10 billion in Japan in three mega deals: Hitachi Kokusai Electric, and Hitachi Koki Co., as well as Calsonic Kansei, a core supplier to Nissan Motors (which declared bankruptcy in 2022).[21]

Regarding PE investors, unlike the U.S. where pension funds (43%) and insurance companies (13%) dominate, in Japan 53% of PE investments are sourced from corporations and banks (Watanabe et al. 2018; Washimi 2020). Thus, Japanese banks are exposed to PE as investors as well as leveraged debt lenders. Large companies use PE as an investment opportunity not only for their pension funds, but to deploy a portion of their large cash holdings. Japan's PE industry has also attracted so-called "policy investors", such as public pension and benefit programs associated with the agricultural *Nōrin Chūkin* bank, the *Yūcho* postal saving system, and regional banks with surplus funds. Thus, safeguarding the PE industry from short-term, self-interested financial schemes has become a public policy concern.

4.3. PE Funds in Japan

There are three large categories of PE firms active in Japan: (1) global portfolio PE firms that pursue a variety of goals, including exchange rate diversification; (2) foreign (mainly U.S.) PE firms with large offices in Japan, as part of a wider Asia strategy or with a country focus, and (3) Japanese-owned domestic PE firms. For the purposes of this analysis, the latter two are of most relevance.

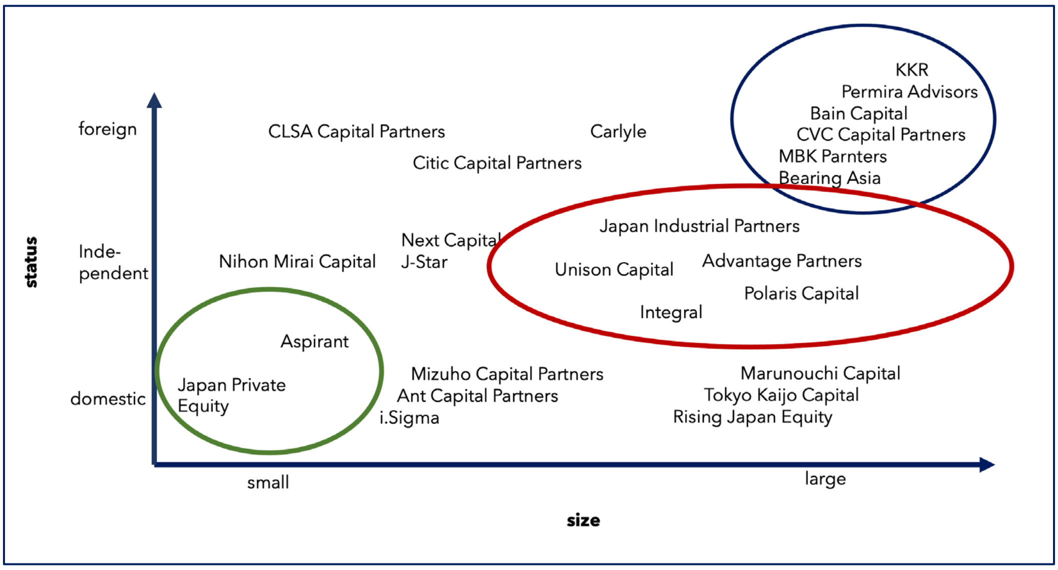
Exhibit 8 maps the main PE funds in Japan, as of 2020, by status (foreign, independent, domestic) and size. The leading foreign PE firms in Japan are the Big 4: Bain Capital PE, KKR, Blackstone and Carlyle. Carlyle has been in Japan since 2001, and in addition to global assets, had raised more than $5 billion domestically by 2021.

The largest Japanese PE firms, with more than $500 million of assets under management as of 2018, include Advantage Partners (the oldest and largest), Integral, Japan Industrial Partners, Polaris, Advantage, Tokio Marine Capital, Marunouchi, Unison Capital, and NSSK (*Nippon Sangyō Suishin Kikō*, an offshoot of TPG). The next tier consists of about 20 funds with assets over $100 million, including CLSA Sunrise Capital, New Horizon, Rising Japan, Whiz Partners, AZ-Star, Globis Capital, i.Sigma, and ACA. In 2018, the entire domestic industry was estimated to have 235 PE funds, up from 175 in 2017; in other words, an average of one new PE fund was created per week in 2017. Many of the Japanese funds had less than $300 million of assets under management and focused on the small and middle market.

[21] "Profits and Pitfalls – taking over a Japanese company", *Nikkei Asian Weekly*, June 11, 2018; "Global Firms seek a piece of Japan carve-out action", *PEI Media* November 5, 2018, "KKR Founders set sights on Japan conglomerates", April 14, 2019.

Exhibit 8: Stylized Mapping of Japanese PE Companies

Source: based on author interviews with over 10 Japanese PE firms



Almost all these PE firms, including the foreign ones, employ Japanese fund managers and office heads. Industry observers sense that they are more likely succeed in gaining access to Japanese CEOs by creating a sense of relationship and trust. These fund managers have a variety of backgrounds, but the stereotypical career path of the leading firms is that of a former career in Japanese banking, trained to navigate Japan's business norms. Groomed as traditional bankers, they understand – and often genuinely share – the seller's preferences for creating long-term value and honoring employment promises. They also know how to be responsive to conservative Japanese asset owners such as pension funds. Their cautious approach brought a major increase in reputation during Japan's third PE boom in the 2010s. In sharp contrast to the U.S. at the time, PE funds were increasingly seen as helpful to the Japanese economy.[22]

4.4. How to Avoid Financialization: Enforcing Norms

This positive view of PE is reflected in the Japanese research on PE in Japan. Washimi (2020) sees PE funds as "saviors" of the Japanese economy, bringing new sources of "ideas and commitment", and the "ability to carry out business reforms". In a small sample study of SME, he finds PE funds to have been instrumental in helping address the succession challenge, and that sales of PE funds increased above average while employment numbers stayed constant. While the study may have suffered from a selection bias and a small sample size, it nonetheless bespeaks of the enthusiasm that Japanese reformers have expressed for PE.

Similarly, IIoka (2020) shows how PE has a positive impact by offering alternative investments for institutional investors constrained by long periods of zero-level interest rates,

[22] Interviews, with more than 10 private equity fund managers, Tokyo, spring 2020.

while also addressing the succession challenge and the growing need for large firms to restructure and increase their capital efficiently. Still, the lack of data on this fast-growing alternative asset class makes it difficult to assess the industry's overall contributions.

In the process of engaging with PE, Japanese companies have developed their own strategies to avoid the aggressive short-term investors. Through sanctioning mechanisms such as shaming and exclusion, corporate leaders have built a system that provides incentives for participants to assume more long-term and value-creating strategies. For the large manufacturing companies, carving out a business unit means parting with a business that carries the company name and employ long-time colleagues. A keen sense of loyalty and obligation to employees often makes a trade difficult for a CEO. For small-firm CEOs, too, selling the companies they have built is about much more than money. There is a sense of legacy, mixed with a responsibility to employees, communities, and the company image. And while these corporate leaders are often fully aware that this is not market-rational, they nevertheless proceed slowly and demand assurances that the units sold off will not simply be stripped of their assets and discarded. As they try to find a new home for their assets, they are looking not for the highest bidder but the right owner. [23]

While trust is not often associated with global private equity, in the late 2010s many corporate leaders attempted to make it a precondition. Through this insistence, they developed a set of rules against schemes that were obviously rent-seeking and short-term. Many industry insiders observed that even hard-core Wall Street players kept promises not to "flip" (selling off short-term). Two main defense mechanisms emerged. First, the reputation costs of betraying promises made to a CEO proved to be high. Any PE fund that violated a deal condition greatly diminished chances of succeeding with another bid. Tokyo's financial industry is well networked and news travels fast, and Japanese corporate are also prone to have long memories. To be successful a PE fund must build a reputation for reliability, and one fund manager reports that making a PE deal in Japan takes "years of courtship".[24] This is even more the case for the smaller succession deals that are often arranged quietly and exclusively with one PE fund. To get this exclusivity requires a convincing value creation plan, and a promise to deliver. And because the sellers (often, the founding CEOs) are looking not for the best price but the right owner, they will simply not deal with perceived "vultures". Foreign investors, too, have realized that the rushed deal-making of Wall Street is not a winning strategy in Japan, and have toned down their playbook.[25]

[23] Interviews with more than 10 private equity fund managers, Tokyo, spring 2020.
[24] Interview, global PE fund in Japan, Tokyo, spring 2020.
[25] E.g., "A Successful Strategy for Activist Investors in Japan: Ask, Don't Tell", *The Wall Street Journal*, April 17, 2019.

Second, unlike in the U.S., throughout the 2010s, corporate assets were rarely auctioned; if they were, at least until 2020 the bids were usually by invitation only.[26] Any deal required long cycles of interaction. Sometimes sellers demanded that there be two buyers, one ideally Japanese, in the hope that this would introduce more power balance, and an additional layer of insurance against short-termism. As one fund manager remarked: "Of course, the occasional fake long-term proposal happens, and then they go in and break the company apart or flip it right away, that is a social reality. But those guys can do it only once – they will never get another deal in this town." [27] All this resulted in the emergence of a private equity market that differs greatly from the U.S., not just in tone but also in durations of deal making and expectations of value creation.

However, given that financialization is baked into the very nature of the PE business model, as seen above, even the best soft mechanisms such as shaming cannot stop trends towards financialization. As the market grows larger and draws in more players, and FOMO pushes CEOs to speed up decisions, financial metrics are likely to prevail over any traditional sense of obligation. As more cases of aggressive gain-hunting occur, concerns are getting louder. For example, Watanabe et al. (2018) paint a cautious picture, warning that the highly leveraged deals could, eventually, also cause systemic financial risk, as the debt overhang on these deals might cause banks to default. This is particularly worrisome given that banks are huge investors in, as well as lenders to, the emerging private equity industry.

The U.S. experience suggests that, as Japan enters the fourth phase of PE characterized by increased financialization, it may be advisable to create a new system of disclosure and regulation that deters self-interested, short-term deal-making from gaining the upper hand. The emerging U.S. system may offer some hints on how this can be approached.

5. Discussion of Regulating Private Equity in the U.S.

In the U.S. there are now several initiatives aimed at curtailing the detrimental aspects of PE while preserving the industry's positive aspects. In 2019, then presidential candidate Elizabeth Warren released a proposal for new legislation under the title "Stop Wall Street Looting Act of 2019", presenting measures to address the moral hazard and create disincentives for the worst practices of private equity firms. [28] The proposal met with vehement criticism from market-oriented politicians and the PE industry itself, and while its future is unclear and its recommendations may be specific to the U.S. system, it nonetheless contains insights that are helpful for other countries, including Japan. Furthermore, since private equity is a global

[26] Interviews, with more than 10 private equity fund managers, Tokyo, spring 2020.
[27] Interview, PE fund manager in Tokyo, March 2020.
[28] https://www.congress.gov/bill/116th-congress/house-bill/3848/cosponsors; see also Stuart (2019).

industry, eventually a global regulatory framework may be required to effectively curb the excesses of this industry while allowing its positive contributions to the economy. The U.S. proposal may be a first step for such a framework.

The suggested programmed had seven generally applicable propositions for regulations that would disincentivize rent-seeking behavior without inhibiting the value-creating activities of PE funds (Appelbaum/Batt 2014):

1) *Change the 2/20 compensation system to reduce moral hazard*

The global industry norm (including in Japan[29]) of charging an annual 2% from the fund plus collecting 20% of the carried interest is unrelated to the risk that the GP assume. GPs gain from more risk-taking, but lose little with failure. To change these incentives, GPs should be required to invest more of their own funds, and assume more legal liability for unsecured.

2) *Disallow excessive debt taking and junk bonds*

Aggressive debt-taking has fueled a shadow banking system, including a new "private (direct) lending" industry that evades banking regulations and increases systemic risk. This can be reduced by (1) requiring a certain equity "down payment" (i.e., limiting the amount of debt that can be used to acquire a portfolio company); (2) make debt more expensive by changes to the tax code[30]; and (3) requiring full disclosure of leverage for each investment.[31]

3) *Reduce incentives for asset stripping*

To prevent "looting" of a portfolio company (such as selling off real estate holdings), standard contractual arrangement should make the GP and the fund personally and collectively accountable for damage caused by premature asset stripping.

4) *Prohibit dividend payments to PE Investors in the first 2 years*

Paying dividends to fund investors before an exit is a form of asset stripping. These benefit only the investors, as they guarantee a return regardless of the outcome of

[29] Interviews with various Japanese venture capitalists, Tokyo and Silicon Valley, 2019-2021

[30] The U.S. tax code allows that debt (in contrast to equity or dividends) can be deducted from corporate income. The intention is to promote behavior that benefits the US economy, such as home ownership. For some PE this interest write-off is a key strategic move, but it only increases their returns and does not create value for the economy overall.

[31] This has already been adopted in the EU, through the 2013 "Alternative Investment Fund Manager Directive" (AIFMD). It requires fund managers to set maximum leverage limits, and regularly disclose these to investors and regulators..

the turnaround effort. This can be prohibited. The EU, through its AIFMD, disallows PE from adding extra debt for 24 months after the acquisition.

5) Prohibit or require full disclosure of fees

Charging management, advising, or monitoring fees can be a form of asset stripping. In 2022, it was estimated that U.S. PE typically charge $250 billion in fees annually.[32] Full disclosure would clean up such fees. Value-creators can still levy charges that are appropriate, but vultures can no longer drain the company's resources.[33]

6) Protect employees and pensions

In the U.S. at least, the most common victims of a PE investment are employees. While layoffs may be necessary in some cases, regulation can govern the PE obligations in this process to reduce costs and burdens of workers. Possible solutions include: (1) require fair warning for layoffs [34]; (2) require fair severance pay; and (3) stipulate that PE are the legal employers and therefore accountable for employee pension liabilities.[35]

7) Increase disclosure and transparency

The fast growth of the PE industry makes the lack of public information becoming problematic for investors, target companies, the economy, regulators, and academic research. Many of the detrimental schemes are possible only because there is no stringent disclosure. In some cases, it may be beneficial if it is not publicly known that a certain company has been taken over by a PE fund, as it may facilitate the turnaround effort. However, all leveraged buyouts should be known to the regulators, so they can publicly disclose and intervene in detrimental schemes.

In the U.S., PE regulation is proceeding. With the 2010 Dodd-Frank Act following the GFC, the SEC was put in charge of overseeing the PE industry in the U.S. In 2002, the

[32] "SEC Considering New Rules on Private-Fund Fees, Conflicts, Gensler Says", *Wall Street Journal*, November 10, 2021. Note that even if the PE firm brings in internal consultants to help the firm, paying them a fee still means reducing the cash available for the turnaround.

[33] Fees are also charged in Japan, where some funds – including venture capitalists - levy "consulting fees" from their projects. There is little transparency about this.

[34] In the U.S., if a company, store or plant is closed, the employer is liable for 60 days of pay and benefits after the announcement. PE are said to sometimes shut down companies abruptly to avoid this liability. In some cases, PE firms have also argued that they are not the employer, and therefore not liable. A regulation has been proposed to disallow these sudden layoffs.

[35] In the U.S., in case of bankruptcy, pension obligations are considered unsecured debt. Sometimes, PE let companies fail for the sole purpose of writing off these obligations. While bankruptcy laws differ across countries, the insight is that bankruptcy law should remove such gains for PE.

Securities and Exchange Commission (SEC) announced a push for concrete measures to regulate this industry more strongly.[36] In February 2022, the SEC proposed new rules on disclosure on investment costs, performance, valuations, and conflicts of interests, as well as the prohibition of accelerated-monitoring fees. Given that the industry's lobby is strong, drawn-out legal fights are expected.

In Japan, how to revitalize the PE market is now being discussed (e.g., Taniyama 2021). While there are already certain rules on PE fund creation, structure and reporting, similar to other countries there are discussions on how to increase disclosure and transparency of this industry.[37]

Because the PE industry is global, it will migrate to where regulations are most lenient. Where PE is seen to fulfil mostly desirable functions, regulators may be unwilling to be strict. Countries may also be lenient for FOMO reasons, as they want to attract PE finance. The race to be "the least regulated playing field" is how financialization has proceeded in other areas, from corporate governance to financial innovation and deregulation. PE is yet another engine in this movement to place superiority of financial interests over all others. Global collaboration may be required to agree on minimal disclosure standards and other rules that are enforced equally in all markets.

6. Conclusions

Unlike the digital transformation (DX) and demographic change, which cannot be stopped, financialization can be reined in by regulation. This paper has argued that financialization is spurred by the confluence of the DX, labor changes, and the need for corporate reinvention, and all may promote short-term deal-making with potentially negative consequences for an economy. These factors have been crystallizing globally, as is shown with the case of its emerging private equity (PE) industry, which by its very nature and business model contributes to financialization.

The positive functions of PE include providing risk-financing for the restructuring of distressed companies; providing capital and managerial know-how for suboptimal performers; assisting small firms that have limited access to credit; helping mid-cap firms, including founder companies, to innovate and grow; and facilitating large-firm strategy pivots into the new digital economy and dynamic changes in global competition. Regulatory policies need to ensure that all these activities continue to be encouraged.

However, in the United States at least, PE activities also include "looting" activities such as excessive debt-taking, asset-stripping, and fee charging. These activities are short-term

[36] "SEC Signals Shift in Attempt to Ban Certain Private-Equity Practices", *Wall Street Journal,* February 10, 2022.
[37] FSA Website "Fando kanren bijinesu wo okonau kata e (tōryoku/todokede gyōmu ni tsuite), https://www.fsa.go.jp/common/shinsei/fund.html, accessed June 2022.

oriented for the sole gain of PE fund managers and investors. The paper has presented a list of possible regulations that would minimize these activities while leaving the value-creating measures intact. To prevent a global race to the bottom (of least regulation), global collaboration may be required to make such policies meaningful.

A long-term shift from “retain and reinvest” to “downsize and distribute” threatens to erode some of Japan’s current strengths by inhibiting innovation, skills enhancement, and wage increases. Some of these “downsize and distribute” activities, camouflaged as “creative destruction”, have already occurred in Japan. Moreover, recent reforms in the employment system and demands from younger employees, while offering more options, are also shifting labor relations to more pay-oriented bargaining, and employment from “organization-oriented” to “transaction-based”. A certain adjustment in that direction may be highly beneficial to lubricate markets and increase the economy’s metabolism overall. However, as these trends accelerate, and are fueled by a bandwagon or FOMO effect that pulls more people in the direction of higher mobility and transaction-based thinking and investing, Japan may lose some of the important features that have so far prevented rampant income inequality.

In his initial announcement of “New Capitalism”, Prime Minister Kishida proposed that the key to success was to “embed structures into capitalism that correct its various harmful effects, thereby maximizing the benefits that capitalism brings”. Addressing financialization may be one such way toward such a more balanced capitalism.

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