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David A. C. Addicott

Pepperdine University, david.addicott@pepperdine.edu

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The Rise and Fall of the Zaibatsu: Japan's Industrial and Economic Modernization

Japan has a history of being a fiercely independent and strong-willed nation. From the repulsion of the Mongol horde in the Middle Ages to the projection of power throughout Eastern Asia in World War II, Japan has a long and storied tradition of deliberate prowess. This tenacity and strength is reflected in the development of Japan's modern government and economic structure at the turn of the century. The Japanese people seized the opportunity to develop many of their own institutions and had the unique experience of forming a modern nation-state through careful selection of the best characteristics of Western government, society, and economy. At the same time, these adopted institutions assumed a uniquely Japanese flavor, which is most visible in the evolution of the Japanese economy and the conception of the business conglomerates known as *zaibatsu* following the Meiji Restoration in 1868. As a result of the power and influence they wielded, the *zaibatsu* provide a case study of technocracy and corporate governance as catalysts for rapid economic development.

As the Meiji Restoration saw the overthrow of the Tokugawa Shogunate and heralded a complete revolution in Japanese government and society, so too did the *zaibatsu*, or literally "financial clique," experience a period of upheaval that was both profitable for some and ruinous for others.¹ The development of the *zaibatsu* was a natural result of both the expansion of the old money changing businesses and the end of the Samurai class. The Samurai class was phased

¹ Thayer Watkins, "The Zaibatsu of Japan" *San Jose State University*, accessed December 29, 2016, <http://www.sjsu.edu/faculty/watkins.htm>.

out by the Meiji, almost all of their ancient benefits were stripped, and their traditional rice stipend was replaced with a one-time issuance of government bonds. The Meiji government then sold the small industries which the Shogunate had spent years developing to the highest bidder, allowing many inspired tradesmen, known as the Meiji men, to engage in the privatization of industry.² Many of the disenfranchised Samurai deposited their government-issued bonds to generate capital to start businesses; some of these men successfully bid on the government's developed factors of production. As the first generation of Meiji men began to retire, their sons took over their nascent businesses and expanded them, creating a network of family-controlled, fiercely prideful businesses that frequently collaborated with the new government.³ The masterminds behind the creation of this government knew that the inclusion of the *zaibatsu* in industrial and financial planning was essential to forming a working capitalist economy, and so formed an increasingly close relationship with these "financial cliques." One such *zaibatsu*, the Mitsui company, was even given the responsibility of creating a new currency and forming a national bank after the Meiji Restoration.⁴ By providing enough productive capacity to supply the materiel and services necessitated by Japan's rapid territorial expansion, the *zaibatsu* gained an increasingly larger degree of state patronage. Labor and resources were amply available due to Japanese conquest of the weak nations of Eastern Asia. The *zaibatsu* thrived in this temporary environment of limitless demand and cheap sources of both labor and raw goods.⁵ These unique

² Joshua Schenkein, *Japan, The Great Power: Industrialization Through the Lens of Zaibatsu* (USA: Amazon, Inc., 2012), page #.

³ Albert J. Alletzhauser, *The House of Nomura* (New York: Harper Perennial, 1991).

⁴ Watkins, "The Zaibatsu of Japan."

⁵ Schenkein, *Japan, The Great Power*, PAGE.

conditions allowed the phenomenon of the *zaibatsu* to become an entrenched fixture of the rapidly growing Japanese economy.

Prior to the Meiji Restoration in 1868, Japan had no proper business firms in the modern sense of the term. The merchant class, which happened to also be the lowliest and most frowned-upon social class in Tokugawa Japan, formed the backbone of the primitive economy that existed during the Edo period.⁶ Many of these small merchants operated their own money-changing shops. Trade between the two principal hubs of finance, Tokyo and Osaka, was heavily dependent upon these shops. Tokyo markets operated on the gold standard and Osaka the silver. These differences in money and standards of wealth measurement ensured that another resource, rice, became the standard by which wealth was measured and power maintained, and it was the key to the Japanese economy.⁷ Long before the Meiji Restoration, many Daimyo decided to sell rice tickets that served as placeholders for a certain amount of rice stored away in the lords' granaries or even rice that had not been yet grown. Revenue from these tickets served to fund required annual pilgrimages to Tokyo and the Daimyo's extravagant court lifestyle. Eventually, these tickets were accepted as valid currency throughout Japan. Farmers themselves also discovered they could purchase or hoard rice during good harvests, then sell their reserves at a markup during a bad crop. These rice exchanges were notorious for their shady tradesmen and underhanded sales tactics. The government attempted to control rice prices, even going so far as to hire 'water men' to throw buckets of water at the brokers to signal market close each day; but, price manipulation and insider trading still ran rampant in these largely

⁶ Alletzhauser, *The House of Nomura*.

⁷ Randall Morck and Masao Nakamura, *Business Groups and the Big Push: Meiji Japan's Mass Privatization and Subsequent Growth* (Cambridge, Massachusetts: National Bureau of Economic Research, 2007), 10.

unsupervised and unorganized environments.⁸ This largely unregulated and primitive trade floor constituted Japan's first futures market.

The dramatic economic growth following the Meiji Restoration was facilitated by the establishment of banks. As previously stated, the laws that abolished the title of Samurai also converted their rice stipends into bonds; the first banks were formed to accept bond deposits. The money deposited into these banks was then lent out to businesses who used their newfound capital to finance a rapid expansion of industrial capacity. Not ten years later, these same banks began to issue corporate stock. Formal business entities like the corporation did not even exist prior to the Restoration, but after less than a decade banks became the first businesses in Japan to become publicly traded companies. Unlike modern shares, these stocks served to divide ownership of the issuing companies rather than to raise capital, and so bank loans and bonds became the primary impetus for financing the growth of Japan's private sector.⁹ Meanwhile, the development of the limited liability corporation ensured prospective owners could insulate their personal fortunes from the inherent risks of starting a new business. And start them they did – national wealth climbed rapidly in the closing decades of the 19th century, not only thanks to the advent of heavy industry, but also from the production of simple goods like rickshaws, lamps, and fertilizers that improved the standard of living for ordinary Japanese. Trading and speculation in Japanese exchange markets did serve a place in Japanese money making, but carried a negative stigma associated with profiting off others' labor. The same pitched fever of the old rice markets permeated the new stock exchanges springing up across Japan and shares

⁸ Alletzhauser, *The House of Nomura*.

⁹ Randall Morck and Masao Nakamura, *A Frog in the Well Knows Nothing of the Ocean – A History of Corporate Ownership in Japan* (Chicago, Illinois: University of Chicago Press, 2005), 414.

fluctuated as the stories behind their pricing changed; tradesmen now saw shares not as ownership of a company but as a vehicle for wealth generation. Rumors, even if they were found to be false, could have profound effects on pricing and market patterns. Many traders only bought shares for short periods of time before selling them off to make a quick profit.¹⁰ This behavior made the new markets notoriously fickle, a trait which continued into the markets of the following century.

The formation of these new financial institutions served as the foundation for the means of generating capital that the *zaibatsu* would use to expand their business empires.¹¹ The *zaibatsu* themselves were the direct product of the Japanese interpretation and adaptation of the Western business firm. They were to Japan what moguls such as John D. Rockefeller, Cornelius Vanderbilt, and Andrew Carnegie were to America. The difference between the American titans of industry and the Japanese was one of specialization; the *zaibatsu* concerned themselves not just with the domination of one industry, but with a wide spectrum of enterprises.

Disenfranchised Samurai took the opportunity offered them by the formation of new banks to start businesses of their own; these men and their descendants continued to expand these conglomerates and broaden their reach across different industrial sectors.¹² At the top of each of these pyramidal networks of different firms and business interests rested the family bank or trading company, which would manage the distribution of wealth to its subsidiaries. The most successful of these businesses, which were the first proper *zaibatsu*, became known as the “Big Four”: these were Sumitomo, Mitsubishi, Mitsui, and Yasuda.¹³ Of course, there were dozens of

¹⁰ Alletzhauser, *The House of Nomura*.

¹¹ Watkins, “The Zaibatsu of Japan.”

¹² Morck and Nakamura, *A Frog in the Well*, 374.

¹³ Takeo Hoshi and Anil Kashyap, *Corporate Financing and Governance in Japan* (Cambridge, Massachusetts: The MIT Press, 2001), 9.

other conglomerates that emerged after the Russo-Japanese War (1904-1905) which qualified as *zaibatsu* but were known as “Second Tier *Zaibatsu*”. These companies include familiar names such as Nomura, Kawasaki, and Nissan. Of the principal *zaibatsu*, Sumitomo and Mitsubishi both had roots stemming from the Tokugawa period, while Mitsui and Yasuda were founded just after the Meiji Restoration.¹⁴

These organizations played a pivotal role in Japan’s aspirations for territorial and economic expansion. In the Imperial ideal of the era, a nation’s status as a world power depended on its access to raw materials, profitable and numerous colonial endeavors, and ability to project military power. Japan’s imperial ambitions required a complete overhaul of its navy and army, and the government bought up everything from munitions and clothing to rations and coal in order to expedite the process of restructuring its armed forces.¹⁵ Just 30 years after the Meiji Restoration in 1868, the Empire of Japan had expanded its borders to include Korea, Manchuria, and Taiwan. It is important to note the autonomy of this new, modern military from the civilian government; the Imperial Japanese Army General Staff office and its counterpart in the navy were responsible for all planning and execution of military operations. These offices reported directly to the Emperor and thus had inherent power over any established civilian government.¹⁶ The military was also deeply influenced by expansionist thought promoted by the state, and officers who conquered in the Emperor’s name drove Japanese soldiers onwards across Eastern Asia. Influenced by the war-hawking of officers and widespread militarist ideology, this rapid projection of Japanese imperial power finally gave the *zaibatsu* and other companies the

¹⁴ Watkins, “The *Zaibatsu* of Japan.”

¹⁵ Schenkein, *Japan, The Great Power*, PAGE.

¹⁶ Alletzhauser, *The House of Nomura*.

land, labor, and access to raw goods needed to expand production to new heights. The Japanese government was also committed to settling over five million Japanese citizens in the puppet state of Manchukuo set up to administer what was once Manchuria, and had already determined to establish modern farms and factories there to further fuel their massive war machine for a push into China. The demand for war materiel was so great that the Japanese government awarded dozens of lucrative contracts to the Big Four as well as the new, “second-tier” *zaibatsu*.¹⁷ This rapid expansion, ironically, would eventually help to unseat the families in control of the *zaibatsu* from direct oversight and ownership of the companies which bore their names.

The private owners of these companies realized that they could raise twice as much capital and still maintain direct control over their business ventures by allowing 49 percent of shares of their principal holding company to be sold publicly, which would prop up the price of their shares as well as supply revenue from which they could fund still more business enterprises. For each of these new enterprises, up to 49 percent of shares could be sold, dramatically increasing the capital under the command of the *zaibatsu* while still allowing for direct control of each of their subsidiaries. At the same time, the families themselves and their vast fortunes were insulated from any legal action or financial loss in any of their subsidiaries; each one was independently incorporated and had its own distinct group of shareholders.¹⁸ This pyramidal structure was the conglomerates’ answer to meeting the rapidly increasing demand from the Japanese government. From 1912 to 1930, as the *zaibatsu* became ever more complex and sophisticated, the lower tiers of these pyramids were constantly reshuffled and restructured according to their profitability. Early on, in 1909, the Mitsui Council restructured their

¹⁷ Morck and Nakamura, *Business Groups*, 23.

¹⁸ Morck and Nakamura, *Business Groups*, 25.

businesses for the second time, completely rearranging firms and organizing them so the more profitable, solvent firms were placed closer to the holding company and the weaker firms were placed closer to the base of the pyramid.¹⁹ This business practice insulated the parent company from the majority of losses suffered by these more unprofitable businesses, since the lower down on the pyramid a business was placed, the greater the portion of shares owned by public shareholders who had nothing to do with the *zaibatsu* leadership.

This period of stability and profitability was not fated to last. The popularity of militarism and military adventurism had quickly grown and spread through the ranks of the Japanese armed forces and civilian population, reaching its zenith in the 1930's. The Japanese victories of the past few decades fed the flames of patriotism and military jingoism. The Taisho period ushered in a time of democracy in Japan, and this civilian government made attempts to encourage peaceful relationships with other nations.²⁰ For a time, a policy of peace was preeminent in Japanese foreign policy. However, the implosion of world commerce following the stock market crash of 1929 paired with the government's consent to international requests to limit its naval power in 1930 both angered and emboldened the military. Ultrationalist secret societies sprang up within the military and sought to gather sufficient support and power to unseat the democratic government. In 1932, this period of civil democracy was brought to a decisive end by the assassination of the Prime Minister on the orders of one of these officer societies. The assassins were put on trial and sentenced to 15 years' imprisonment, but the public largely saw the officers as acting out of a patriotic duty to the Emperor. The military

¹⁹ Alletzhauser, *The House of Nomura*.

²⁰ Tetsuji Okazaki, *The Japanese Firm: Sources of Competitive Strength*, (Oxford, England: Oxford University Press, 1994).

never fully succeeded in establishing a dictatorship, but by World War II many army and navy officers concurrently held important positions within the nominally civilian government.²¹

Condemning the “short-term focus” of the various *zaibatsu* families, the military was able to engineer a significant public outcry against these “anti-patriotic” families. They took full control of the financial and strategic decision making capabilities of the *zaibatsu*, whose controlling families were largely stripped of their assets and any leadership roles within the companies.²² This was possible thanks to the weak economy in Japan and of the entire world during the 1930’s. This weakness and apparent impotence of world markets to recover convinced many Japanese, common workers and wealthy business owners alike, that capitalism had failed as a socioeconomic system. With widespread public support, the process of nationalization of the financial sector and many *zaibatsu* began in earnest. In 1926, there were 1,402 different banks operating in Japan. By 1945 only 61 remained.²³ The banking system was protected by the government but also enclosed and cut off from real decision-making; the government could simply remove and replace any of the handful of people who controlled the banking system if they so desired. After the start of the Second Sino-Japanese War in 1937 (World War II), the military passed new laws that forced the *zaibatsu* to reorganize their holding companies into joint stock ventures or face exorbitant tax rates. The government then also severely restricted the income of the leading families by placing the issuance of dividends under control of the state; because the *zaibatsu* were overseeing joint stock companies and not limited

²¹ Okazaki, *The Japanese Firm*.

²² Morck and Nakamura, *A Frog in the Well*, 414.

²³ Okazaki, *The Japanese Firm*.

partnerships, their only source of income were the dividends paid to them by the company²⁴.

The families lost practically all significant sources of income at this point. One might look at the rapid expansion of the Sumitomo group from 1937 to 1945 on retained earnings alone and wonder what sources the Sumitomo family could have relied on for income. The Sumitomo group grew by 32% during this period, it appears that the Sumitomo family (along with others) relied on loans from group banks for income.²⁵ The existence of these loans placed financial institutions in a strengthened position during the reconstruction that was about to begin.

With the *zaibatsu* largely out of the picture, the State Planning Ministry was founded and in 1940 announced an “Outline of the Establishment of a New Economic System.” This system would force firms to operate without issuing shares, and instead be required to meet a system of quotas²⁶. These planners also controlled the prices of goods produced throughout the nation and across the Empire. Unrealistic quotas and poor planning ensured that by 1942 Japan was in financial crisis, as many firms had not been able to meet production quotas.²⁷ Firms actually began to refuse to meet these standards in order to turn a profit on the goods they managed to manufacture. Central planners attempted to correct for these issues by implementing new incentives and corporate governance standards, which were met only with limited success. By 1944, the composition of private consumption in gross national expenditure had fallen to less than 60 percent of its 1936 level.²⁸ In fact, by the time the United States occupation force

²⁴ Alletzhauer, *The House of Nomura*.

²⁵ Morck and Nakamura, *A Frog in the Well*, 421.

²⁶ Morck and Nakamura, *A Frog in the Well*, 422.

²⁷ Hoshi and Kashyap, *Corporate Financing*, 60.

²⁸ Okazaki, *The Japanese Firm*.

entered Japan, the question had become not whether the economy could recover, but how to go about completely rebuilding it.

At the end of World War II, not only had the military nationalized a large portion of *zaibatsu* holdings, but remaining assets were severely damaged by the conflict. The military economic advisors who came to Japan with the Supreme Commander for the Allied Powers (SCAP) were Americans whose memories were still fresh with thoughts of the Great Depression. These Keynesian economists recommended and implemented liberal fiscal and monetary policies similar to those of the American New Deal under President Roosevelt. Fourteen *zaibatsu* were targeted for destruction, but only ten of the fourteen were ever actually dismantled by SCAP.²⁹ In 1945, General MacArthur suggested that the *zaibatsu* themselves walk the Americans through how best to dissolve them. Needless to say, a commission of the most powerful *zaibatsu* went to work with a great deal of enthusiasm, fervently jumping at the chance to hide their assets. As more experienced economists arrived from America, this plan was quickly abandoned.³⁰ Finally, in 1948, SCAP came up with a list of 325 companies, mostly *zaibatsu* subsidiaries, to be broken up and sold back to the public. MacArthur envisioned the sale of these assets would provide the first step to establishing a middle class in Japan. Again, though, only 18 were ever actually dissolved.³¹ Some *zaibatsu* families managed to conceal a small portion of their former wealth and attempted to ensure the firms that they once managed were not broken up and sold. In some cases, like that of Nomura Group, the company's employees were allowed the first chance to purchase shares in Nomura subsidiaries. Unknown to SCAP, these loyal employees had been

²⁹ Gary D. Allinson, *Japan's Postwar History* (Ithaca, New York: Cornell University Press, 1997), 75.

³⁰ Masahiko Aoki and Hyung-Ki Kim, *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (Washington, D.C.: World Bank Office of the Publisher, 1995) 373.

³¹ Allinson, *Japan's Postwar History*, 76.

lent money by each Nomura firm to purchase stocks and hold them until they could be sold back to the Nomura Group at a later date. Some others, like Sumitomo, were able to retain their vast holdings of real estate, as the Americans could not see the value of lands that had been ravaged by war and largely ignored these acquisitions.³² This oversight provided a financial shelter for many companies. However, SCAP managed to irrevocably change the *zaibatsu* system: in 1946 one in four stocks were held by *zaibatsu*; by 1950, this number was reduced to only one in twenty. Eventually, ownership of these shares passed primarily to individual investors and financial institutions.

After the Treaty of San Francisco was signed in 1952 and the SCAP post was made permanently vacant, the Japanese government relaxed some of the laws banning several key features of *zaibatsu*. During this period, new businesses referred to as *keiretsu* were formed from the bits and pieces of the *zaibatsu* left behind after the departure of the Allied occupation forces³³. Many of these organizations are still in existence today, some even with their old financial institutions at the helm. Instead of being owned and managed by a single family, however, ownership of these companies has passed to individual shareholders. The *keiretsu* are much looser organizations of firms, and do not hold the same pyramidal structure as the *zaibatsu* once did. However, throughout the second half of the 20th century they still wielded great influence on Japanese economic and military policies.³⁴

During this time, the Japanese government made it a priority to nurse its weak postwar economy back to health, often at the expense of other social goals. Over time, Japan's economic

³² Alletzhauser, *The House of Nomura*.

³³ Taggart R. Murphy, "The Keiretsu and the Japanese Economy." *The Asia-Pacific Journal* 1 June 2008, accessed December 26, 2016, <http://apjjf.org/-R-Taggart-Murphy/2790/article.html>.

³⁴ Allinson, *Japan's Postwar History*, 103.

goals evolved from simply restoring some semblance of normalcy to equaling or perhaps surpassing the United States as the world's premier economic powerhouse. For a time, it appeared Japan was well on its way to doing just that; economic development benefited from an exceptionally educated population that was willing to go to extraordinary lengths to provide for their families. The *keiretsu* were the second pillar of Japan's rapid economic growth during this period. Companies that agreed to form *keiretsu* benefited from reciprocal stock ownership, which allowed them to gain excessive financial strength and a network of support that allowed them to outperform both foreign and domestic companies. Management was focused not on producing capital but on gaining market share in the long-term, which dramatically increased product exposure to market forces. They frequently pursued pet projects in high growth sectors, which, coupled with their long-term mindset, had the potential to be wildly profitable. This market was one of extreme competition, and companies would frequently accept failure after failure to avoid embarrassment in front of rivals rather than admit defeat or surrender market share to competitors. Fierce competition ensured that companies were quick to adopt new innovations in production or technology; however, many of these ideas were repurposed from those of foreign companies. The Japanese government acted as a business partner for many of these firms and offered administrative oversight and extraordinarily cheap credit. They also offered a business environment protected by tariffs, which allowed *zaibatsu* to grow quickly at the expense of the Japanese consumer.³⁵ Eventually, the bubble of cheap credit and bad corporate debt would pop, sending the Japanese economy into a severe recession.

³⁵ Robert J. Crawford, "Reinterpreting the Japanese Economic Miracle." *Harvard Business Review* January-February 1998, accessed December 30, 2016, <https://hbr.org/1998/01/reinterpreting-the-japanese-economic-miracle>.

Since their conception, the holding corporations of the *keiretsu* had been slowly selling off more of their partners' shares, further weakening formal and financial ties between different businesses. The *keiretsu* system was once more endangered in the 1990's when Japan entered their deepest recession since the end of World War II. Many banks were forced to merge or close their doors, causing the lines between traditional *keiretsu* to blur together. Still more banks sold shares off to finance their own business and lost control over subsidiary companies. The *keiretsu* system as it exists today is one of informal relationships between different companies that once served as part of the same holding group. A few of these relationships continue to be backed by a system of mutual shareholding, but this practice is slowly dying out. Companies are no longer easily bailed out by large parent banks, and so the *keiretsu* system has deteriorated further into a loose mass of alliances between individual firms, albeit one that still manages to serve as a cornerstone of Japanese economy and society.³⁶

It is difficult to overstate the effect the *zaibatsu* had on the development of the modern Japanese nation. Through these organizations, Meiji Japan managed to industrialize and expand faster than any state in history. Militaristic ambition and demand for raw goods to fuel a growing Japanese economy provided the *zaibatsu* with desperate markets hungry for their goods and services. Financial institutions with shadowy roots in the Tokugawa period developed into fully fledged securities, stocks, and futures exchanges. These institutions, along with the establishment of formal banking systems, provided the capital the *zaibatsu* needed to begin their rise to power. The *zaibatsu* structure began as a uniquely Japanese interpretation of the Western cartel or monopoly, in the style of the American industrial tycoons. As Japan became increasingly militaristic and confident in its martial ability, the officer cadre slowly gained more

³⁶ Murphy, "The Keiretsu and the Japanese Economy."

control over the civilian government and was able to initiate conflicts subversively with neighboring nations such as China and the United States that eventually ended in defeat. Meanwhile, the *zaibatsu* were heavily nationalized and transformed into state-run firms and after the war they were disbanded and outlawed by the American occupation forces. As one studies the rise and fall of the *zaibatsu* alongside that of their government, one can all too easily draw parallels to the handful of modern American financial institutions considered “too big to fail.” As we look forward to a bright future of an increasingly expanding and globalized economy, it is exceedingly important to recognize and learn from not only the lessons in power, nepotism, and corruption but also those in innovation, organization, and efficiency a case study of the Japanese *zaibatsu* so gracefully provides.

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