# The Japanese Economy after the Flux Decade

## Where Will Changes in Company Structure Lead?

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## Summary

How should one interpret the changes in Japan's company structure that have been affecting the Japanese economy since the early 1980s? This text proposes a conceptual framework from the firm's point of view, after examining empirical evidence. Has Japan's corporate governance made a substantive institutional transformation, and, if so in which direction? Four stylized analytical models of corporate governance are presented, and the conditions in which each would be viable are identified. Using this theoretical background, the text examines the driving forces, as well as the historical constraints, of the changes taking place in Japan. The nature of the on-going institutional changes in Japan's corporate governance can be interpreted as a possible transition from the traditional bank-oriented model to a hybrid model, built on the combination of managerial choice of business model, employees' human assets, and stock-market evaluations. No single mechanism has emerged as dominant, but a variety of patterns seems to be evolving.

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# Introduction

In retrospect, the early 1990s can be regarded as a watershed in the post-war history of Japan's political economy. In the political domain, the half-century-long, one-party rule of the Liberal Democratic Party (LDP) came to an end in 1993. By that time, it had also become clear that the bubble in financial and real-estate markets had burst. These two events ushered in a period of unprecedented uncertainties, and in response, various trials and errors in the polity and the economy. Economy-wise, this period is conventionally characterized as a prolonged deflationary phase,[2] and many have blamed faulty macroeconomic policy for the malaise. It became the fashion among the media, and even in academia, to dub the period as a "lost decade", referring to the losses of wealth, growth potential, secure permanent-employment jobs and even social morale. Over the last few years, I have challenged this popular view by upholding the idea that this period may be more accurately characterized as a "flux decade", meaning an unfinished period of institutional change.[3]

Underlying the apparent depression, competition between firms became keener during this period, and managers' responses to challenges such as deflationary pressures, the rise of industrial China and the impacts of information technology (IT) steadily differentiated the better performers from losers in the industry. Through this process, economic practices have been undergoing various changes of substantial magnitude. In the political domain, the LDP regained its position as the ruling party, but in coalition with other parties, making clear the need for electoral support in order to stay in power. This competitive aspect of the polity has been gradually changing political power structures as well as the relationships between politicians and various interest groups and bureaucrats.[4] These changes in the economic and political domains have been mutually

2 This popular characterization is somewhat inaccurate in that the Japanese economy actually registered a positive growth rate in the mid-1990s.

3 A series of my essays on this view are collected in Aoki (2002).

4 See Toya (2005) for an early account of this process.



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reinforcing each other. Thus, I posit that although there may not have been any single event signalling a dramatic institutional change in either the political or economic domain, the cumulative effects of incremental changes have been substantial and irreversible. This evolutionary process is continuing, and it is likely to carry on for some time, even for another decade or more, for the reasons I will soon present.

Corporate governance institutions – roughly understood as the accepted rules of the game among the corporate stakeholders governing the corporation – are no exception in Japan. In this domain as well, changes have been taking place in formal laws, practices, relationships with the polity, and so on, so that the old rules of the game can no longer be taken for granted. At the same time, new rules are still being sought and are in the process of evolving. This may be a good time, nonetheless, to stop and take stock of the cumulative changes that have been achieved so far and to examine their implications and prospects. The text that follows attempts to do just that by presenting facts and empirical analysis taken from the recently published volume, *Corporate Governance in Japan: Institutional Change and Organizational Diversity*, edited by Aoki, Jackson and Miyajima,[5] and by applying the analytical tools developed in comparative institutional analysis.

## A Changing Corporate Landscape: Anecdotal Evidence

To appreciate the changes that have taken place in Japan's corporate landscape over the past decade or so, it is worth noting the stylized features of the preceding system, which I will refer to as the *traditional J-system* for referential convenience.[6]

5 (2007), Oxford University Press.
6 See Aoki (1990) and Aoki, Patrick and Sheard (1994) for a more detailed characterization of the J-system.


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## Features of the J-System

- One-party rule by the LDP was taken for granted. Under such political stability, triadic coalitions between LDP politicians, interest groups and ministerial bureaucrats were formed along various industrial, occupational and professional lines to protect the mutual vested interests of the incumbents. LDP leaders, in cooperation with top bureaucrats of the Ministry of Finance, mediated among these coalitions (the so-called "bureau-pluralism" or "compartmentalized pluralism").

- Top management (the representative directors) of the corporate firm was ranked as the pinnacle of the career ladder for its permanent employees. The board of directors, almost exclusively composed of insiders, functioned as a substructure of top management.

- One of the main objectives of management of the so-called "J-firm" was to provide steadily growing benefits to its permanent employees in the form of seniority wages, promotion opportunities, bonus and severance payments, fringe benefits, and so on, subject to a reasonable level of profits.

- The main bank was the major supplier of funds to the corporate firm. Other financial institutions and investors expected the main bank to be a principal monitor of the firm (the so-called "delegated monitoring"). The main bank did not overtly intervene with the management of firms in an excellent/normal corporate-value state. The control rights were expected to shift to the main bank, however, in a critical corporate-value state. The bank would then decide whether to bail out and restructure the firm at its own cost, or to liquidate it (the so-called "contingent governance").

- The government regulated the banking industry to assure rents to individual banks according to their market shares. It also intervened, if necessary, to bail


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out financially distressed banks or to arrange for their acquisition by healthier banks (the so-called "Convoy system"). More broadly, this system was embedded in the unique political-economy institution: the LDP.

The traditional J-system started to ebb even as early as the 1980s.[7] It was only after the bubble burst, however, that changes became evident. In contrast to the above features of the traditional J-system, we now observe the following events and features.

- The Corporate Code reforms of 2002 made corporate firms choose between two types of board structure: the US-type system with independent subcommittees (on auditing, managerial compensation and nomination), or a modified traditional system with a semi-independent statutory auditor's board (Gilson and Milahaupt, 2004; see Shishido, Chapter 11 in Aoki *et al*, 2007). By 2005, more than 60 major companies (including Sony, Oryx, Toshiba, Hitachi, Nomura Holdings) had adopted the US-type system.[8,9] Even among companies that opted for the second structure, there seems to be some tendency toward including a greater number of outside directors, although the definition of the independence of outside directors is not as rigorous as in the 2002 US Sarbanes–Oxley Act.

- The boards and top management of listed companies are now increasingly exposed to the open evaluation of the stock market as a result of the unwinding of cross-stockholdings (see Miyajima and Kuroki, Chapter 4 in Aoki *et al*, 2007). At the height of the bubble, the holdings of tradable stocks by

7 An early account of this tendency may be found in Aoki (1988), Chapter 7, particularly, pp. 293–7.
8 The Japan Association of Corporate Directors, a voluntary organization of directors, academics, lawyers, accountants, and so on, is campaigning to increase the number of corporations adopting the US-type system to 300 within a few years.
9 A dramatic example of the consequences of these changes was the decision of Sony's Board to replace the top management in 2005 in response to poor corporate performance; this action was reported to have been pushed by the active involvement of independent directors.


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financial institutions rose to almost 50 percent of total stockholdings. They are now down to around 20 percent. On the other hand, individuals and foreigners now hold close to 50 percent in a more or less arm's-length manner. Particularly, the propensity of foreign portfolio investors to trade shares more frequently strongly influences share prices, making exiting a particular threat to firms (see Ahmadjian, Chapter 3 in Aoki *et al*, 2007). A noticeable number of bank and securities company employees, as well as bureaucrats, left jobs that guaranteed lifetime employment to join or form investment funds or other financial service companies in order to use their expertise to their greater advantage.[10]

- Facing increasingly active and unpredictable stock-market trading, the managers of listed companies are now much more alert to potential takeover threats. One incident, which attracted wide attention, was the takeover attempt of Nippon Broadcasting System, Inc. (NBS: No. 1 in sales in the broadcasting industry) by Livedoor Co., Ltd. (LD) in the winter of 2005.[11] By taking advantage of a loophole that existed in the stock-exchange regulations at the time, LD quietly acquired more than 30 percent of NBS's shares off the exchange floor, in lieu of launching an open takeover bid. The management of NBS attempted to counteract the threat by issuing new equity subscription rights – amounting to 150 percent of issued capital – and assigning them to Fuji TV Network, Inc., a friendly company that owned 12 percent of NBS. LD appealed to the court for an injunction. After widely publicized court debates, the Tokyo District Court judged that NBS's plan was "unjust". It stipulated that

10 A well-publicized example is Mr. Murakami, a former bureaucrat of MITI, who founded MAC asset management funds, worth several billion US dollars, using aggressive, US-style stockholder activism. He was later indicted for insider trading, but this incident does not seem to indicate a reversal in the trend.

11 This company, founded in the late 1990s by a then-college-student named Horie with an initial capital of Y6 million, had increased its market value to Y800 billion by the end of 2005. But in 2006 the top management was indicted by the Public Prosecutors Office for corporate accounting fraud and for spreading false financial information.


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"the Board of Directors, which is nothing but the executive organ of the corporation, shall not decide the composition of corporate control", implicitly endorsing the doctrine of stockholder sovereignty. Although it was ironically LD – later indicted for illegal stock trading, spreading of false financial information and accounting fraud – that elicited this stockholder-friendly court judgement, this case is noteworthy in that the court's judgements became a major actor in resolving disputes over corporate control.[12] Now public debate is under way regarding whether the so-called poison pill should be legally permitted and, if so, under what conditions so as not to provide unconditional entrenchment for incumbent managers.

- In 1995, bureaucrats at the Ministry of Finance were busy figuring out ways to liquidate *Jusen* companies (Home Financing Corporations), which were suffering from non-performing loans lent to land speculators worth 7 trillion yen. Agricultural cooperative financial institutions were major lenders to these companies, while banks were major owner-cum-lenders. The agricultural lenders were able to recover most of their loans to *Jusen* thanks to the infusion of public funds made possible by the powerful lobbying activities of allied politicians. Their logic, based on the general expectations held under the traditional J-system, was that the main banks should assume the major part of responsibility, not the other lenders. This case made the prospect of injecting public funds into the ailing financial sector enormously unpopular, and the government grew timid about overtly engaging in such activity. Delays in injecting public funds certainly deepened and prolonged the magnitude of the financial crisis, but it had the unintended consequence of placing the financial

12 Another legal case worth noting, which may be considered even more important than that of LD vs. NBS in terms of the established firms involved, is the one in which Sumitomo Trust Bank (STB) appealed an injunction of the merger between two mega financial institutions – Mitsubishi–Tokyo Financial Group (MTFG) and UFJ – in 2004 on the grounds that STB had a prior agreement to be merged with the trust division of UFJ. This appeal was denied by the court, but it is said that since the incident, even traditional firms have become very careful about how they draw up contracts with one another in order to avoid possible lawsuits.


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authorities more or less at arm's length of the financial industries. The Banking Bureau and Securities Bureau of the Ministry of Finance, which had formed exclusive collusions with respective industries to protect incumbents' vested interests, were severed organizationally from the Ministry in the 1997 Administrative Reform and were reorganized as the Financial Services Agency (FSA). The Agency became pressured to engage in the monitoring of the financial soundness of banks in an arm's-length manner, and sometimes even in an adversarial manner. The restructuring of the banking and securities industries is now largely left to the private sector. In this way, an essential feature of the so-called "convoy-system" seems to have been laid to rest.

- Some of the overt attempts by the government to bail out distressed firms did not yield good results, as was the case of Daiei, Inc., a supermarket giant. Direct and discretionary intervention in industrial restructuring by the government is now increasingly looked upon with suspicion. In response, the Industrial Revitalization Corporation of Japan is publicly funded in order that public involvement in financially distressed firms be more transparent; its management is recruited from the private sector.[13] The Civil Rehabilitation Law (2000) introduced a Chapter 11-like provision and gives incentives to distressed firms to file earlier for bankruptcy. Foreign-owned equity funds, bank-related corporate revival funds and other financial services are in place and have replaced commercial banks as major players in the reorganization/rehabilitation of financially-depressed firms (see Xu, Chapter 6, and Yanagawa, Chapter 7 in Aoki *et al*, 2007). Markets for corporate assets are growing in a size and scope that was never seen before the burst of bubble (see Kikutani, Itoh, and Hayashida, Chapter 8 in Aoki *et al* 2007). The number of mergers and acquisitions more than quadrupled between 1985 and 1995.

- Some major companies have gone through large-scale restructuring by

13 The Industrial Revitalization Corporation of Japan now plans to dissolve itself one year ahead of schedule, because its missions seem to have been successfully fulfilled.


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reducing the number of their permanent employees without necessarily breaking their long-term employment commitment. They have achieved this by transferring employees to subsidiary and related firms, implementing hiring freezes and cuts, as well as early retirement.[14] Macro-wise, between 1995 and 2005, the number of regular employees decreased by 4.1 million, while temporary employees in various categories increased by 6.5 million. It seems fair to say that many Japanese firms are still committed to the permanent-employment system, but the core has shrunk (see Jackson, Chapter 10, in Aoki *et al*, 2007).[15]

- In the 2005 election of the Lower House, Premier Koizumi led the LDP to a landslide victory by campaigning for the privatization of Japan Post. This one-issue platform was meant to be targeted at the so-called "reform-resisting power", that is, the coalitions between politicians (both inside and outside the LDP), specific interest groups, and the bureaucracy. He succeeded in expelling from the LDP those politicians who opposed the privatization. Thus the institution of bureau-pluralism seems to be entering a critical phase.[16]

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14 For example, an integrated steel company reduced the size of its pool of permanent employees by more than half, although it was said to have cost them about Y30 million per employee in severance payments and early retirement incentives. Partly through the employment reduction and partly through the recovery of markets, its market value increased fourfold in 2005.

15 Kato (2001) contrasted the job retention rates of Japanese and US workers before and after the burst of the bubble. It turned out that the job retention rates of Japanese employees did not fall significantly from the period prior to the burst of the bubble economy in the late 1980s to the post-bubble period.

16 After the end of the one-party dominance of the LDP in 1993, a change in the parliamentary election system from a multiple-seat district system to a single-seat district system was introduced, and several elections have taken place since then in both the Upper and Lower Houses. In the old system, politicians from the same party representing different interest groups were electable in tandem in each district. Thus, interest mediation within the ruling party and through the administrative process (for example, budgetary expenditures, entry-restricting regulations) became a political focal point, leading to the institutionalization of bureau-pluralism. Since the electoral system change, however, it has become increasingly difficult for politicians representing a particular interest group to be elected. Thus,


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The facts cited above are meant to be only illustrative at this point. But in taking them together, it may be hard not to have the impression that considerable changes are taking place in Japan's corporate landscape. But is this impression substantiated? In other words, is Japan's corporate world, in general, and corporate governance, in particular, undergoing an irreversible change? If so, in which direction? Is the stock-market discipline going to dominate corporate management?[17] Can the management afford not to heed the voice of the employees any more? Or, is the reduction in the size of the pool of permanent employees just an inevitable, temporary reaction to the prolonged deflation, and does the old model still persist? Alternatively, is Japan's corporate sector in the process of an earnest search for a model of its own, adaptable to the evolving environment? If so, is it moving in a good direction?[18] In what way are changes in the corporate domain related to changes in the political domain? To consider these and related issues, it is necessary to examine company structure more closely, for it is the changes that have been taking place at the firm level that have had the greatest impact on the Japanese economy over the last two decades. If these institutions are indeed undergoing changes that are putting them on a new and irreversible path, where will they lead Japan's economy? To delve into such questions, the following section presents a conceptual and analytical framework of institutional analysis by which several prototypes of corporate governance structure, as well as associated fitting conditions, are identified.

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the power of the Prime Minister in policy-making and endorsing party candidates has been gradually strengthened. The 2005 election may be regarded as a spectacular manifestation of this on-going tendency.

17 Actually, even in the United States, some evidence seems to point to the rather weak stock-market discipline (for example, statistically significant yet economically insignificant pay-performance sensitivities and the "trouble with stock options").

18 Such a normative question is raised explicitly by Dore (Aoki *et al,* 2007, Chapter 13). Below I will not deal with the normative issue as such, but implicitly suggest ways by which evolving patterns could be improved for better corporate performance.



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## Four Prototype Institutions of Corporate Governance

In the literature, various types of corporate governance structures are discussed, and their advantages and disadvantages are compared. In this section, I briefly describe four stylized models of corporate governance. All of them, except for the last one, are derived from rigorously formulated game-theoretic models.[19] Thus, all of them are bound to have unrealistic features in certain respects as a description of an actual corporate governance institution. They can, however, be useful for pinpointing technology conditions, corporate governance institutional environments, and so on, that would make them viable and efficient in the use of human and physical resources.

### 1. Stockholder Sovereignty (SS Model)

This is the most widely discussed model, as well as the most widely supported, in the orthodox literature. An authoritative economic-theoretical foundation for this model can be found in the writings of property-rights theorists, as represented by Hart. As a starting point, he argues for the inseparability of ownership and management.[20] One of his crucial assumptions is the existence of complementarities between managerial ability (malleable according to the manager's effort) and the right to control the use of physical assets in non-contractible events. That is, the value of the manager’s incremental effort is assumed to be enhanced, if he or she has discretionary rights for deciding how physical assets are to be used. If this is the case, then it follows that it is more efficient for the manager to own physical assets, provided that he or she is not financially constrained. The employees may be contracted according to the level of firm-specific skills in which they will invest. The value that the firm produces net of the contractual payments to the employees accrues to the owner-cum-manager as

19 See Aoki (2001), Chapters 5, 11 and 12.

20 The following is an interpretation of the main points analysed in Hart (1995) applied to the present context. See Aoki (2001), p. 119–23.


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profit. This is the case of a neo-classical, proprietor-run firm.

If the manager is financially constrained and needs to rely on equity financing, then he or she has to yield fundamental control rights to the stockholders and be subjected to an incentive-based contractual arrangement as an agent of the stockholders. The present value sum of expected streams of profit accruing to the stockholders is called the fundamental stock value (note the distinction between the (gross) value-added by the firm inclusive of contractual payments to the employees and the stock value of the firm as a residual after those payments have been made). The manager is motivated to make the best effort both by the fear of being discharged in the event of a financially depressed state and the prospect of receiving incentive payments in the event of an excellent corporate-value state. Under this scheme, an investor who conceives of a new business plan to enhance the stock value may take over the firm through open bids in the stock market and replace the management. This event can occur even if the implementation of the plan induces a reduction in the gross value-added of the firm and, accordingly, the breach/termination of (implicit) contracts with the employees. In this model, the government could play the role of the liberal state: not interfering with private employment contracting, and only enforcing private contracts as a third party.

## 2. Corporatism–Co-determination (D model)

In the previous model, the employees are provided with incentive contracts for investment in firm-specific skills. Let us consider an alternative situation in which firms are situated in an institutional environment of social-compact corporatism, where the wage rates are regulated according to standard job qualifications set through collective bargaining between the industrial association and the industrial labour organization. The government allows bargaining outcomes to be legally binding for all firms in relevant industries. Thus, an individual employer’s ability is constrained in inducing the employees to acquire and use firm-specific skills with the promise of firm-specific payments. In such a situation, even if the interests of the manager and the employees are basically


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opposed concerning the distribution of control over work (and the use of physical assets as a corollary), the sharing of control rights (for example, in the form of the work council) is of mutual interest.

A sharing arrangement – called co-determination – can be extended to the stockholding company, in which seats on the board are shared between the representatives of both the investors and employees.[21] This model is reminiscent of some of the basic aspects of corporate governance institutions in Germany (the *Deutsch* model). Contrasting this model with the previous one suggests that there are institutional complementarities between corporatism and co-determination on the one hand, and between private employment contracting and the liberal state on the other.

### 3. Relational Contingent Governance (RCG model)

This model allows for the control rights of the firm to "shift" between stakeholders – the *insiders* (managers and workers) and a designated monitoring agent representing the *outsiders* (investors) – contingent on the firm's performance. Taking the complementary relationship developed in the SS model between managerial effort and control rights over physical assets a step further, no distinction is made here between the contributions to the gross value of the firm by the manager and the workers. Their efforts are judged collectively, and they are jointly responsible for the total output value of the firm. When total output is above or at the expected level, that is, when the firm is in an excellent or normal corporate-value state, the *insiders* not only hold the control rights, but also receive residuals after contractual payments to the outsiders. As contributions of individual insiders to the total value are not clearly distinguishable, payments

21 In this setting, more external financing will be made in the form of long-term debt contracts than in the SS model. This is so because, in the context of co-determination, the investors and the employees have common preferences for debt contracts in order to control the risky behaviour of the manager, while the manager prefers to limit the residual control rights of the stockholders. See Aoki (2001), pp. 287–91 for a rigorous analysis. A proof of the institutional complementarities between co-determination and the corporatist state is also given there.


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to them must be regulated by organization-specific rules (such as payment by seniority, simple sharing, and so on) rather than as individual performance-based payments. When the total value output is below level, however, or in a distressed corporate-value state, the relational monitoring agent takes over the control rights and must decide whether to bail out or terminate the firm (in the worst case scenario) depending on the nature and magnitude of the crisis.[22] This would also mean destroying the firm's specific collective human assets. Since in the short run bailing out a firm is often more costly than liquidating it, some rents need to be assured in order for the monitoring agent to be induced to assume the costs when necessary. The monitoring agent can guarantee such rents through the stable fees it receives from long-term relationships with different firms and/or through government subsidies that cover the monitoring costs. Such safety nets can, however, lead the monitoring agent to practice soft-budgeting tendencies: under the government's financial umbrella, it may be less costly for the monitoring agent to bail out firms that deserve to be terminated. Although this model is a purely theoretical construct, the traditional Japanese governance structure emulated some basic aspects of it, with the so-called main bank playing the role of the relational monitoring agent.[23]

From the above three models, we can deduce that three factors may be crucial in determining a viable form of corporate governance: the nature of manager/employees' human assets, their relationships with physical assets, and their relationships with the government. Namely, in the SS and D models, employees' individual skills – either firm-specific or general – can be identifiable and are made individually contractible, while in the RCG model they are not, and their rewards can contain elements of firm-wide sharing of values and losses.

22 See Aoki (2001), Chapter 11.3 for rigorous conceptualization and proofs of various properties claimed here.

23 Some aspects of the relational contingent governance model may also be found in the relationship between the venture capitalist and the entrepreneurial firm, although it is not embedded in government protection. See Aoki (2000) and (2001) p. 302 and Chapter 12; and Kaplan and Stromberg (2003).


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Second, the SS model presupposes complementarities between the manager's human assets and his(her) exclusive control over physical assets (that is, a manager's human assets become more valuable when he or she is endowed with exclusive control rights over physical assets) through the stockholders' agency relationship. In the other models, however, the control of physical assets may be complementary to both the employees' and the manager's human assets (as in the D model), or to the employees' and the manager's human assets combined (as in the RCC model). Third, in the former two models, the role of the government may be characterized as "neutral", in the sense of a third-party contract enforcer (the so-called liberal state as in the SS model), or as "enabling", when it gives employees' and employers' organizations the means to jointly attain the status of quasi-state organs (the so-called "enabling state" (Streeck, 1977) as in the D model). In the RCG model, the role of the government may become relational vis-a-vis the monitoring agents (banks) in assuring rents for them in order to make the model viable as an institution. From these observations, the following fourth model may be suggested as another possibility.

## 4. External Monitoring of Internal Linkage (EMIL Model)

The EMIL model is based on complementarities between the *managerial business model* and employees' human assets, rather than between physical assets and managerial human assets. The managerial business model is composed of organizational architectural design, marketing strategies, organization-specific reward systems, relations with the labour union, design of work environments, and organizational values to be shared by the employees. Complementarities in this case imply that the employees prefer to be associated with the relevant business model, since it can generate greater gross value for those willing to develop human assets specific to it, and who identify themselves with its values.[24] The function of the management of the firm then becomes to create and sustain this productive internal linkage.

24 The importance of similar complementarities between the firm and human assets are emphasized by Rajan and Zingales (2000).


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Different from the SS model, the role of physical assets is secondary, in that employed physical assets are composed of general-purpose machines, or are relatively small in value in comparison to human assets. If, however, the management lets it be known that as part of its business model a proportion of the value created by the complementary linkage will accrue to the stockholders according to a certain rule, and if the stock market is informative, the fundamental stock value may be constructed as a summary statistic correlated to future values of the linkage. The role played by the board of directors is indeed determining in the EMIL model, where financial analysts exert a strong influence on the Board. If the board of directors is entrusted to effectively replace or appoint top management contingent on the (expected) stock value, the management can be disciplined to create and sustain a valuable internal linkage. On the other hand, the stockholders themselves may be motivated to do a better job of monitoring if they can benefit from making good evaluative judgements. Therefore, there are complementarities between the creation and sustenance of internal linkage on the one hand, and the stock-market evaluation on the other. Complementarities can thus be dual – external as well as internal. In this model, the board of directors ought to act not as the agent of the stockholders, interested primarily in maximizing their returns, but as the "trustees" for all the stakeholders, including the employees and the managers (Blair and Stout, 1999). Management would thus not be forced to increase the stock value to the detriment of the employees, because that would be likely to destroy the valuable internal linkage. This model would work better if the government helped infrastructural services for stock markets to process corporate information more accurately and to facilitate fair and equitable stock transactions.


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## Factors Triggering Changes in Japan's Corporate Governance

The theoretical presentation above brings to light the fact that some stylized features of the traditional J-system are reminiscent of the RCG model, with the main bank serving as the relational monitor. This makes sense in that the sharing of information between the management and the *genba* (work spots), as well as among the *genba*, was an established custom within the J-firm, facilitated by its practice of ambiguous job demarcation, job rotation, life-time internal career development, and so on.[25] The RCG model-like, information-sharing practice co-evolved with the permanent-employment system (the absence of active labour mobility), the main bank system, and bureau-pluralism, as complementary institutions.[26] On the other hand, the comparison of the D model and the RCG model helps us understand that, contrary to frequently-made casual references to the "Rhein model" (Albert, 1991), the German–Japanese model (of bank-oriented governance), and the like, the Japanese main-bank system and the German co-determination system cannot be lumped together in the same class of corporate governance. They operate on different mechanisms in terms of industrial relations, contractual arrangements, selection and replacement of management, and so on, not to mention their differences in statutory legal arrangements. Therefore, it is also likely that, as a result of path dependency, there have been differences in their responses to changes in the market and technological environments, which have accelerated since the 1980s. Let us briefly review some basic impacts of these changes on the Japanese system.

First, the gradual opening of financial markets, which began in the early 1980s, allowed better-run firms to rely on various financial instruments, including bonds and equity issues abroad. Japanese banks steadily lost their better corporate clients and failed to adapt to this new market environment. As is well known, their soft-budgeting tendency became one of the major driving forces of

25 For information sharing within the J-firm, see Aoki (1988), Chapter 2, and Aoki (1990).

26 For these institutional complementarities and their historical origins, see Aoki (2001), Chapter 13.


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the bubble in the late 1980s, culminating in their own crisis after it burst. Nevertheless, the eclipse of the main-bank system and the globalization of financial markets eased constraints for the management of the J-firm to experiment with various business models (see Jackson and Miyajima, Chapter 1 in Aoki *et al*, 2007). This is because institutional complementarities between a financial institution and other institutions (in employment, innovation, supply relations, polity, and so on) imply that a change in one of them can trigger changes in the other and create momentum for cumulative, mutually reinforcing changes – the phenomena conceptualized as dynamic institutional complementarities. The presence of institutional complementarities is one reason for the robustness of institutional arrangements, but, if the complementary linkage is broken somewhere, it can also become a source for generating over-all institutional adaptations.[27] More on this to follow.

Second, as product markets matured and globalized, with technological innovation progressing at an unprecedented rate, the structure of industrial competition became more complex, making the simple-minded expansion of shares in an existing market obsolete as a corporate objective or as a corporate evaluative criterion. Competition over managerial business models has become fierce across markets and is continuing to create new markets. Thus, a new mechanism for evaluating corporate firms has become a necessity. It became clear that banks, entrenched in relational financing, could not adequately perform the monitoring role in this respect. Instead, as noted in Section 1, the management of the corporate firm is becoming more interested than ever in stock-market performance as an external evaluative mechanism.

Third, the progress of communication and information technology introduced dramatic impacts on the value of (tacit) information sharing among agents within an organization, as well as within a particular collusive group. One primary reason for exclusive information sharing was the limit of available

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27 See Aoki (2000), Chapter 10 for an analytical examination of dynamic institutional complementarities, and Chapter 10 for their application to Japanese economic history since the 1930s. Also, see Aoki (2006) for a summary exposition.


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information channels. This has been steadily overcome by the increasing capacity of digitalized communications and the associated social demands for information disclosure and transparency. Even some of the tacit know-how at work spots has become digitalizable through computer-aided design, computer-controlled machines, and the like. People no longer need to spend most of their time communicating face-to-face with a fixed number of partners to gain useful information. Mobile phones, the internet, e-mail, and so on, have dramatically changed the patterns, scope and range of communications among people. The impact of information and communication technology can be considered one of the main reasons for the apparent erosion of the competitiveness of Japanese firms, which knew how to use tacit information sharing to their greatest advantage in the pre-IT revolution era of the 1980s.[28]

In spite of all this, there still seems to be valuable information that cannot be digitalized, at least within a short period of time, but which can be shared among a small number of people with particular common interests and complementary areas of competence, and which is potentially valuable in generating new ideas (such as business strategies, technological innovation, work improvement on spots (*kaizen*, and so on).[29] The paradox is that such information sharing in a niche could become potentially more valuable precisely because it is novel and scarce in the context of the increasing amount of information widely shared in the public domain.

Indeed, we have observed divergent responses among Japanese corporate firms in this regard. The better performers often belong to the type of firm that continues to foster and utilize valuable information sharing among its employees in combination with the complementary use of emergent information technology.

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28 See Aoki (1988; 1990) for the view that the competitiveness of the Japanese manufacturing industry up to the late 1980s was very much reliant on the use of tacit knowledge shared among the workers on the shop floor, as well as between the workers and the management, the R&D organization and the shop floor, and the prime manufacturer and the suppliers.

29 See Cowan *et al* (2000) and Aoki (2001), Chapter 12.1 for a taxonomy of knowledge by which some types of tacit knowledge may be regarded as economically valuable.



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This type may look superficially similar to the traditional J-firm, but a non-negligible difference has taken shape over the past decade or so: the management's leadership plays a much more active role in terms of the design of the organizational architecture that fits the new information technology (for example, a flatter, modular structure;[30] spinning-off of affiliated firms rather than a large integrated firm[31]), a reward system to elicit employees' cooperation and individual initiatives in a balanced way, and so on. Even the on-site *kaizen* (work improvement) movement has been reformed with more emphasis on the active role of the local leadership.[32] In these firms, sustaining the permanent employment system is still regarded as important,[33] although it has been modified in terms of promotion schemes and reward systems, with a certain degree of competitive elements (see Jackson, Chapter 10 in Aoki *et al*, 2007). On the other hand, there seem to be two types of mediocre to problematic performers. Firms of the first type are composed of those that were hasty in emulating the so-called Western-style reward system based on individual performance evaluation, destroying the spirit of valuable information sharing.[34] Firms of the other type are led by old-fashioned managers who confine themselves to passively mediating various interest groups within an organization rather than taking the initiative to formulate a competitive business model in response to the new informational and market environments. They often try to rely on outdated collusive networks within

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30 For the innovativeness of the modular organization in a complex system, see Baldwin and Clark (2000). See also Aoki (2001), Chapter 4, where the value of information encapsulation (modularization) is discussed.

31 Kikutani, Itoh and Hayashida (Aoki *et al*, 2007, Chapter 8) analyse this tendency of Japanese firms.

32 For example, field work by Kato (unpublished) shows that there is a more advanced and sophisticated case in which a full-time *kaizen* support group was introduced. Its main job was to assist various *kaizen* teams by doing experiments for them.

33 Consider the case of Toyota Motor Corporation that was downgraded by international bond rating companies immediately after the Asian financial crisis because of its permanent employment practices. Nevertheless, it is still enjoying one of the highest stock values in the manufacturing industry.

34 This type is conspicuously found among laggards in the electric machinery industry, once considered the most competitive industry.


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the framework of ebbing bureau-pluralism in an attempt to avoid losing ground.[35]

## A Gradual Transition to the EMIL Model?

In facing the challenges described above, Japanese firms have been strenuously trying to adapt their business models, human assets, and associated corporate governance mechanisms in one way or another. As a result, the traditional RCG-type institution appears to be in eclipse as the behavioural beliefs and practices characterizing it can no longer be taken for granted. On the other hand, concerning the universally accepted rules of the game regulating the interactions of the corporate stakeholders, no clear alternative pattern has yet emerged. If, however, we interpret the anecdotal evidence described in Section 1 in the light of the theoretical models in the previous section, we may interpret the emergent pattern as a gradual move to the EMIL model from the RCG model. In general, the presence of institutional complementarities is thought to preclude the possibility of a hybrid institution.[36] But, as discussed in the last section, the opening of financial markets has eased the constraints on institutional choice in other domains. For example, some action choices that were not supported by the traditional main-bank system may become viable in Japan.

Indeed, diverse patterns are being observed, and will be observed for some time, in the areas of organizational architecture, employment practices, market strategies, supplier relations, industrial relations, and so on.[37]

Those diverse business models need to be compared and assessed in terms of the values generated in possible cooperation with the employees' human assets.

35 Miyajima and Kuroki (Aoki *et al,* 2007, Chapter 4) detected that low-performing firms tend to sustain their main bank relationships with mutual stockholdings.

36 It is because the presence of complementarities normally involves the non-convexity of sustainable choice combinations. See Aoki (2001), Chapter 8.3.

37 These diversities (particularly in organizational architecture) are described and their implications for institutional change are discussed by Jackson and Miyajima (Aoki *et al,* 2007, Chapter 1), and Sako (Chapter 14).


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Product-market evaluations (thus current profit) are a fundamental mechanism for evaluating the value of the internal linkage between a business model and human assets. The product market can evaluate only the present outcome of the internal linkage, however, not possible outcomes in the future. Furthermore, a valuable internal linkage takes time to build. In the previous section, I suggested that the bank may not be up to the evaluative task. Although there may still be cases in which they can monitor relatively well the corporate-value state of firms of a particular type, their time horizon may not be long enough, and their expertise may not be sufficiently nuanced in the evolving complex environments. Instead, stock markets may be potentially in a better position to predict future outcomes by aggregating dispersed information, expectations and values prevailing in the economy, if they can filter out noises to a reasonable degree.[38] Of course, the last condition, which I will come back to shortly, is still a long way from being taken for granted.

Even if we assume for a moment that the stock market is hypothetically informative, a corporate governance structure may not be complete with just that. One more critical question still remains to be resolved: how can a stock-market evaluation of an individual firm be used effectively in the selection and replacement of management at the firm level? Remember the crux of corporate governance lies in the way in which management is selected and replaced when necessary. In the RCG-like institution of the traditional J-system, the control in this respect was arranged in a contingent manner. That is, in excellent and normal states of the gross corporate value of the firm, the mechanism was firmly gripped by the insiders (the top management was selected by internal promotion without any outside intervention), while in a critical state, control rights shifted to the main bank. In the currently evolving situation, the insiders seem to retain effective control as long as the corporate-value state seems to be without problem. But in the new environment, who will exercise the disciplinary function in a critical state

38 In fact, market prices cannot be completely perfect. If all information available in the economy could be immediately and completely reflected in market prices, then nobody would be motivated to collect information (Grossman and Stiglitz, 1980).


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of corporate-value? No single solution seems to have been established yet.

For small and medium-sized firms, as well as large firms with large bank loans, there still may be cases in which banks can perform major monitoring and disciplinary functions. But for large firms with rather limited bank loans, not to say of those with no bank loans, the ability of the banks to correct poor management before a real crisis becomes evident is definitely limited, even if they play certain roles *ex post* in arranging the bail-out or liquidation of failed firms.[39] Further, even in this case, the banks are no longer embedded in the protective framework of bureau-pluralism, as already noted, and it is thus likely that their involvement will be more passive.[40] One possible alternative to the bank's disciplinary role would be to transform the board of directors from the traditional status of a management substructure into a quasi-independent body that could discipline top executive management when the firm is in a critical state of corporate-value. As noted already, some firms may be heading somewhat in that direction by adopting a board structure with independent subcommittees, or by increasing the number of independent directors.[41] How it will work has yet to be seen, but an experiment is certainly worthwhile.[42] For start-up firms that are not mature enough for stock-market evaluation, venture capital firms, which act as a sort of market surrogate in a relational manner, are gradually gaining visibility.[43] For the time being, firms

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39 Xu (Aoki *et al*, 2007, Chapter 6) provides evidence of banks' tendency not to bail out distressed firms until bankruptcy is filed.

40 Arikawa and Miyajima (Aoki *et al*, 2007, Chapter 2), however, detected some evidence of a tendency for soft-budgeting towards laggard firms in the early 1990s.

41 One of the proposals that seems to be widely supported in the current discussion on corporate governance reform is that the provision of the poison pill might be allowed if the board of directors, with a majority of outside directors, approves it. Such a stipulation might provide incentives for the company to make the board more open and independent.

42 Gilson and Milhaupt (2004) suggest that, at least as currently structured, we should not expect too much from these committees.

43 See Hata, Ando and Ishii (Aoki *et al*, 2007, Chapter 5). See also Aoki (2000), Kaplan and Stromberg (2003), and Rajan and Zingales (2000) for the nature of the corporate governance role of the venture capital firm.


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may try a variety of corporate governance mechanisms – subject to evolutionary selection – for using stock-market signals or implicit corporate values.[44]

Even if stock-market evaluation progresses in Japan, it is unlikely that Japan's corporate governance institution will move towards an SS-type model reminiscent of the US system. For one thing, a transition from the RCG to the EMIL model would imply a shift from the practice of *sharing* information, responsibilities, and outcomes between the management and the employees, to the development of firm-specific *complementary* relationships between the two. To repeat, these relationships presume that the management will have greater autonomy in designing business models than in the old RCG-like model, yet the models will still require specific associated employee human assets in order to work. From an evolutionary perspective, this shift appears fitter than a shift to a clear demarcation of the management and the employees through individual contractual relationships as in the SS model.[45] Therefore, it is possible that the voice of employees, implicitly or overtly, will continue to play a part in the managerial formulation of business models, if not directly in the legally specified mechanism of corporate governance as in the D-model.[46]

Finally, I will add a few words regarding the relationships between corporate governance and the polity. Needless to say, in order for an informative stock market to evolve, there must be an effective mechanism in place to filter out the noise in processing corporate information and in forming a fundamental stock value from it. For that to occur, there must be shared beliefs among the market

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44 Another alternative is the model in which the founding family, albeit of relatively small holdings, exercises effective control over the executive management. Practices akin to this model can be found in companies like Toyota Motor Corporation and Suntory, Ltd.

45 Abe and Hoshi (Aoki *et al,* 2007, Chapter 9), as well as Jackson (Chapter 10), provide some empirical support for this prediction. They find that an increase in foreign ownership does not necessarily lead to a distinctive modification of human resource management, even though there may be some modifications of certain aspects.

46 See an interesting contribution by Sako (2006), which documents and analyses the emergent diversity in corporate organizational structure as a result of strategic interplays between the management and the enterprise union at the firm level.


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participants that regulatory rules are formulated and enforced in such a way that corporate information will be disclosed transparently, but not in a way that stifles active trading among a broad range of informed participants. Furthermore, these beliefs must be supported by an infrastructure of various competent professional services (for example, accounting, the law, systems engineering, financial analysis, academic theorizing and analysis), as well as trade-facilitating, and information-processing technologies. In these respects, Japanese practices have a lot of room for improvement. Although some reforms have been achieved over the past decade, irregular events have also emerged, such as the LD case, which was generated by deficiencies in regulatory rules, and which revealed the inadequacy of stock-exchange infrastructure technologies.[47] It would not be possible to control fully the misconduct of some players seeking profits at the risk of violating the law or by taking advantage of loopholes in regulatory rules in a shrewd manner. Corporate monitoring by the stock market is an important function, and such incidents, should not prevent its nurturing. There does not seem to be any better mechanism for evaluating and predicting uncertain corporate performances by summarizing economically valuable information dispersed throughout the economy. Thus, we cannot help but try to make markets work better.

In this regard, the changes in the polity occasionally referred to above may be relevant. In the traditional J-system, the primary role of regulatory agencies was to assure the stability of the bank-oriented financial system. They did so by providing rents to banks in rather opaque forms of entry and rate regulations, as well as through back-door agreements between parties concerned with bailing out financially distressed firms. In these arrangements, the interests of bankers and their employees, and those of the regulatory bureaucrats and politicians, were intricately interwoven. But, as noted, the framework of bureau-pluralism in which such schemes were embedded is now in eclipse. In fact, the waning of bureau-pluralism in the polity and the various changes that have taken place in the

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47 Immediately after the arrest of the top executives at LD in January 2006, there was a tremendous number of sales bids, particularly by individuals of small holdings, that exceeded the systems capacity of the Tokyo Stock Exchange, forcing it to shorten trading hours for a few consecutive days.


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economic and social domains mutually reinforce each other, making the reversal of either one alone less likely.

Better-performing corporate firms and new entrepreneurial firms do not need the paternalistic, specific protection of politicians and the bureaucracy. The associations of lifetime occupation holders (such as doctors, nurses, postmasters, contractors, and so on) are losing their organizational integrity, and thus political influence, because the members of younger generations are more diverse in their values, expectations, and behaviour.[48] Thus, demands for deregulating rules aimed at protecting particular interest groups are rising, as well as demands for implementing rules that assure a broader spectrum of public interests (for example, pension reforms adapted to the rapidly ageing population, remedies for public finance deficits) and public safety (for example, health, construction standards, child protection). The gradual transformation of the Finance Service Agency from an institutional agent of bureau-pluralism to a regulator sustaining an arm's-length relationship with the constituent industry, is nothing but a symptom of a bureaucratic response to these trends. Such a tendency may be more conducive to the development of an institutional environment for the stock market to become more informative. The reason is that rules for stock-market transactions, the disclosure of corporate information, and the like, must be formulated and enforced in a neutral, arm's-length manner vis-à-vis concerned parties, but not by government in collusion with the incumbents in the financial market.

48 There is a danger, however, that the protective framework of bureau-pluralism will be replaced by protective legislation enacted at the urging of the business community, in tacit alliance with those segments of the public that are disillusioned and have been made indignant by some misconduct in the stock market and corporate world. I owe this comment partially to Milhaupt. Also see Rajan and Zingales (2002) for related discussion.


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