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The Reform of (Corporate) Governance in Japan

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Summary

There is wide agreement that governance in Japan during the period of "high growth" was based on a system of contributions from different stakeholder groupings, closely interlinked as "insiders" of the corporate finance and production process. In the meantime, however, the system has outlived its usefulness by becoming too complex for a mature economy. As a result, governance is moving to a system of "outsider" or shareholder participation and control. This transformation remains costly and time consuming because the closely linked system of stakeholder interests requires a stepwise introduction of profit-oriented governance in accord with acceptance of different stakeholder groups (the government, bureaucracy, management, suppliers, workers, etc.)

This article concentrates on the question of why it has been (and is) so difficult to implement this turnaround, and if the current reform plans are up to the task.

1. Introduction

After one decade of crisis and stagnation, most arguments about the causes and cures of Japan's weakness have been fully aired, and it is time to act. This seems to be the message that jump-started a new government[1] under Prime Minister Koizumi in 2001[2], a government that did not detail any new plans or specific ideas but gained broad support from local voters to major business lobbies by promising "true change" and "consequent implementation of painful reforms".

The same "all said" argument might apply to research on governance and reform because the debate has converged into a set of rather convincing arguments on why the Japanese "model" was appropriate to provide high growth from a low level with rather closed (capital) markets, but needs a major overhaul to become fit for more diversified needs and open markets.[3] Much less obvious, however, is the answer to the question of when and how a turnaround to renewed strength by implementation of the prescribed medicine can be expected. This article will therefore concentrate on the question of why it has been (and is) so difficult to turn the Japanese "stakeholder model" closer to a "market based" or "shareholder economy", and if the current reform plans are up to the task.

The article starts with a compact overview of the core elements of the Japanese (corporate) governance system (section 2), including the recommended solution (section 3). Section 4 will detail what kept the economy back for so long somewhat more extensively. Building on this, section 5 will conclude that many of the necessary reform

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[1] In Japan, due to the overwhelming importance of the Liberal Democratic Party (LDP), democratic competition is a matter of competition between the party's factions, rather than a matter of competition between parties. For this reason, the new "Koizumi" (the current prime minister) government is a new government, although only the cabinet changed, and the ruling coalition remained the same.

[2] In Japan, because the LDP easily dominates any coalition government, the election of the LDP's party head becomes an election of the prime minister. During the party's 2001 party-presidency election Junichiro Koizumi won not only the traditionally reformist party members' votes from the cities, he also won overwhelming support from local (regional) party members. This marks a precedent in Japan for a candidate with a reformist program.

[3] Instead of a review in this article, see, for example, the articles in Chew (1997) or Kester (1991), (2000). On the more specialized, but important issues of the "triggering" of the financial crisis and the following structural break, see Hoshi et al. (1990), and Schulz (1997), (1998).

issues were already introduced during the last decade, which was too often described as a "lost decade" for Japan. Finally, section 6 will draft the possible future strategies and goals of Japanese corporations, and section 7 will summarize by looking at what is still missing.

2. A Japanese Stakeholder System

The "classic" Japanese corporate governance framework after WWII was oriented to market results, but it was not based on financial profitability considerations on every level of production and planning. According to Kester (1991) it consisted of:

- implicit contracting founded on trust;
- extensive reciprocal shareholdings and trade agreements with few stakeholders;
- managerial incentives toward overall corporate growth;
- selective intervention and coordination by key stakeholders (main banks and bureaucracies).

The rationale behind the system at the time of development was the mobilization of as many resources as possible to develop an economy with underdeveloped and — to a large extent — destroyed markets. The structure of the system was based on existing market ties from pre-war, family owned international trading houses (Zaibatsu; see Shibagaki, 1984), which developed through governmental backing and central bank guarantees into industrial groups (Keiretsu) with main banks (city banks) at their center. The flow of funds in this system thus evolved from central bank guaranteed credit lines of the city banks to their industrial groups.[4] The Keiretsu corporations, in turn, used these funds and guarantees to extend their networks in two directions. First, they built up a network of suppliers with low prices in exchange for procurement guarantees and development support. Second, they hired workers on a low-income basis in exchange for (implicit) "lifetime employment" guarantees. To close the finance-cycle, the huge investments (made possible by the system of guarantees and trust) created income, which could be recycled as savings to create a dynamically growing economy (Schulz, 1998).[5]

In such a system, corporate governance and control became rather top-down structures, blended into a whole network of (implicit) vertical and horizontal guarantees and stakeholder interests. This does not imply, however, that the system developed as an autocratic system in which decisions were developed at the top and passed through an authoritarian structure — as in so many developing countries where bureaucratic elites have tried to develop (or exploit) their countries by means of governmental plans. The Japanese government, for example, did not select corporations, sectors, or investment plans for easy control of funding and finance guarantees. Instead, it provided support to rather independent private banks at the center of corporate groups, and encouraged private investments in export sectors where independent world market prices determined allocation and set the standard of success. Basically, finance and the monitoring of investments therefore remained private and rather independent from the government. The banks were free to choose the best investment plans within the diversifying industrial groups, while the groups allocated the resources to the most successful branches and projects, and the groups' firms selected and trained employees from a relatively egalitarian but competitive education system.

Given the enormous amount of criticism of the Japanese system during the past decade of stagnation, it is most important to note this "market side" of the Japanese stakeholder system. The stakeholders' various plans were always anchored close to competitive market solutions by accepting price signals from world markets as an outside constraint for key industries, which set the standards of competition for the different domestic groups and their suppliers. On the other hand, however, the stakeholder system remained quite different from a "pure" market economy where independent (individual) interests and decisions find a flexible (efficiency) solution close to optimum by competing against each other for the highest incomes.

Judging from today, it seems fair to say that the two systems have their specific strengths at different levels of development. The stakeholder model may be much faster in terms of developing companies and markets at lower costs because it builds on a set of personal relationships and guarantees that do not require an established set of public rules, trusted enforcement mechanisms, and readily available sophisticated information (technologies) to raise and allocate huge amounts of investment capital. Based on dependent individual interests, enclosed and bound within networks of interlinked stakeholder arrangements, this system also proves much more stable and secure from the beginning, when strong business swings and cycles still affect the narrow developing environment, because its stakes cannot easily be traded or renegotiated. The market system, in contrast, built on a concept of personal freedom and flexible independent decisions within a set of stable rules, is able to develop efficiency beyond a stakeholder setup when competing interests and trends need to be integrated into a diversifying economy. The following sections will therefore argue that the Japanese perception of a "structural crisis" is the crisis of a stakeholder system at the verge of developing into a more market based "shareholder" system.

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4 In the Japanese literature this credit extension was coined "overloan" and "overbanking", respectively (see Suzuki, 1980; Schulz, 1998).

5 To remain stable, such a system needs a whole set of restrictions and preconditions. For a discussion, see Schulz (1998). Already this condensed draft should make clear, however, that the system becomes vulnerable if growth slows or becomes unstable.

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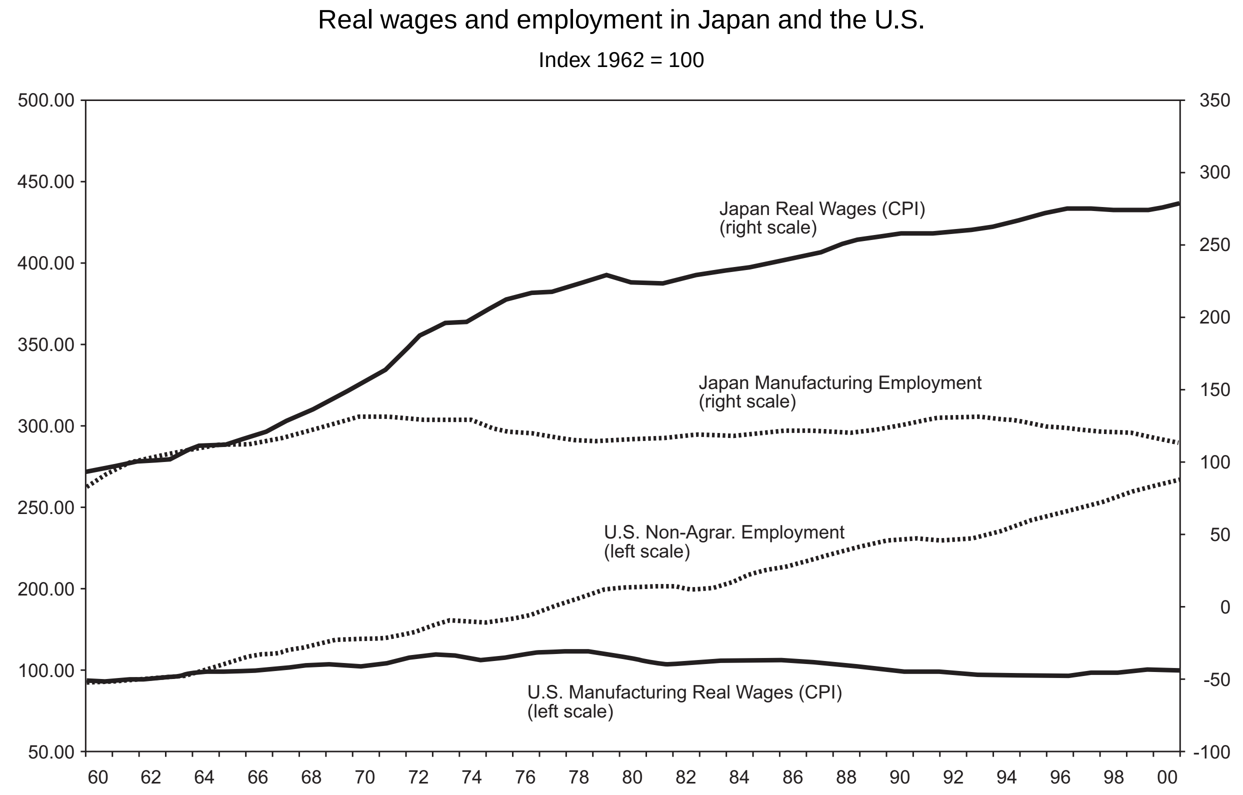
Figure 1



Remark: Right and left scales have the same dimensions, they were shifted to provide a better overview. For the U.S., hourly wages, and for Japan, monthly wages were used to calculate real wages. Nominal wages were discounted with their respective CPIs. Unfortunately, no similar series for the two countries were available.

Source: © FRI. Data from IMF, International Financial Statistics (2000).

2.1 Stakeholder governance has been efficient

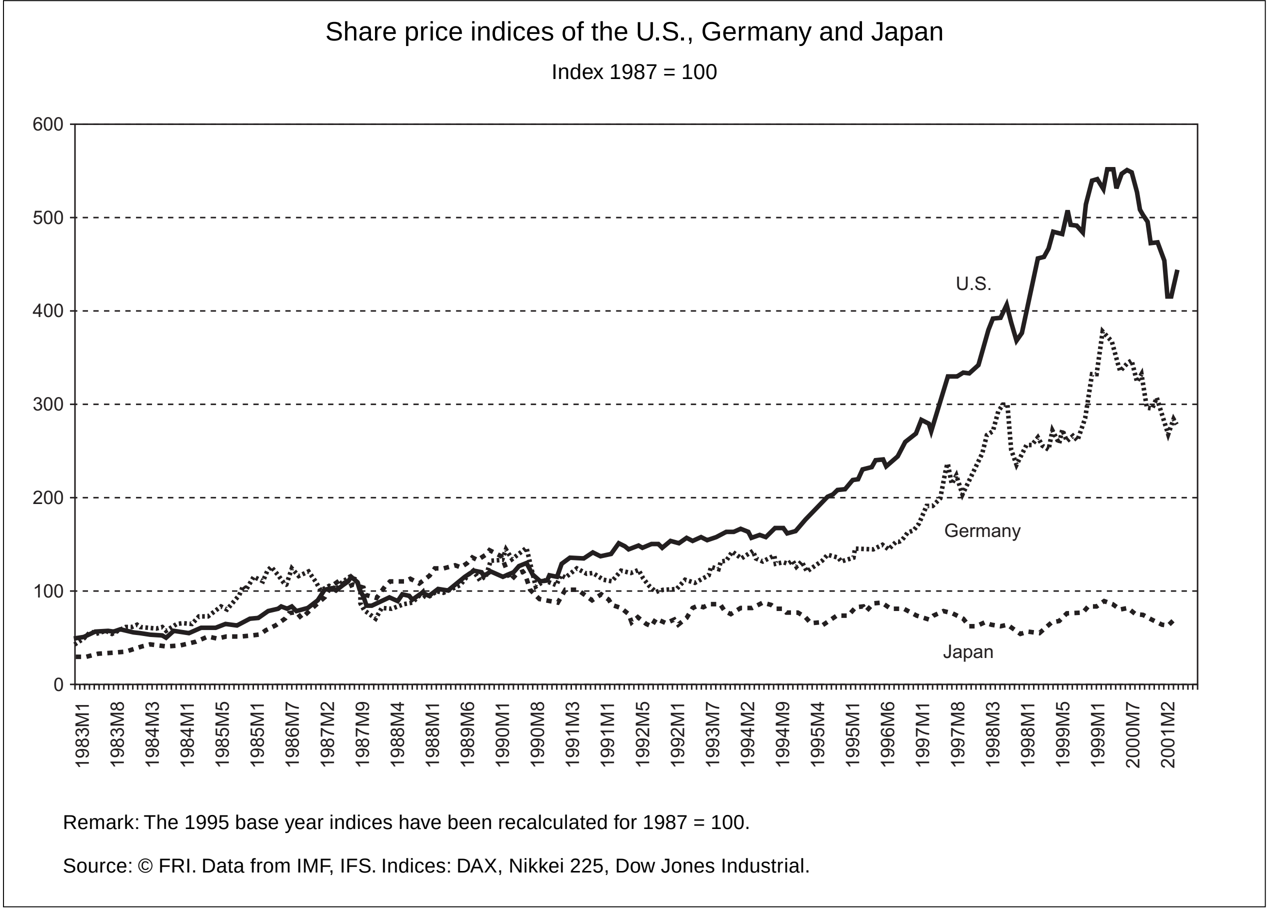
After WWII the Japanese economy proved the possible strengths of a stakeholder economy impressively. Between 1960 and 1990 it produced one of the highest growth rates in the world, and almost tripled real incomes during that period. This result is far beyond the stagnation of real incomes in the more capital market oriented U.S. economy (Figure 1). Consequently, until the early 90s, there was at least as much hype about the Japanese ”miracle” and “model”, as there is doom and gloom in the literature now.[6]

In contrast to the huge success in terms of income creation in Japan, Figure 1 demonstrates that the U.S. was able to integrate an increasing workforce during the same period, while employment in Japan stagnated. The time series’ in the figure are almost mirror images of each other. It is important to stress this feature of a stakeholder economy, because it tends to double as an insider-outsider society (i. e., keeping outsider out and insider in).[7] In Europe, for example, unemployment, especially long-term structural unemployment, has already become a major obstacle and hindrance to development. Japan, fortunately, with its different demographics, is not yet struck by per-

[6] For the newer literature on the efficiency of Japanese system, see — from different perspectives — Kaplan (1997), Sheard (1997) or Prahalad (1997). For some early and consistent criticism, in contrast, see Kester (1991) and Jensen (1991), or later Jensen (1997).

[7] The organization in groupings requires barriers for entrance and exit because high fluctuations would undermine the negotiated contracts. For the unemployed in a stakeholder economy it is therefore rather difficult to reenter employment in one of the groups. Offering lower wage demands, for example, is often not sufficient because existing employees cannot easily be dismissed or their contracts renegotiated. Furthermore, for the unemployed the acceptance of a lower-paid job becomes risky if the required qualifications are regarded as mediocre because the entrance into the old qualification bracket might become blocked. Unemployed as a stakeholder group (though rarely organized), on the other hand, might be able to negotiate higher payouts and benefits compared to a more flexible market set-up.

Figure 2



sistent high unemployment rates, but has had to secure its high level of employment by relying on massive public investment and consumption, creating public debt equivalent to 130% of GDP.

The downturn of the Japanese stakeholder system is not a temporary crisis that can be overcome by fiscal policy, however. The next sections will outline some of the most significant weaknesses that require a general overhaul to keep the system competitive.

2.2 Stakes became inefficient and corrupted

In strong contrast to its former successes, and in even stronger contrast to the U.S. during the last decade, the Japanese economy has turned close to stagnation. This development is highly visible when stock price indices are compared (Figure 2).

U.S. stocks and markets have developed much better than their stakeholders' counterparts during the last decade. Of course, the high valuation of U.S. stocks has partly been due to an investment bubble.[8] But the main attraction for foreign capital in the U.S. was – and is – the high transparency and good use of entrusted capital at listed U.S. corporations (Miller, 1997). During the 90s, they managed to boost their return-on equity (ROE) from levels only a little higher than Japan's 7% to 30% today, while Japan fell back to a lackluster 1.4% during the same period (see Figure 3).[9]

But shareholders have not been the only ones bleeding in Japan's stakeholder society since the early 90s. Most of the economy's fundamentals have severely deteriorated, and many stakeholder agreements and contracts have become corrupted during the downturn:

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[8] During the crash of 2000–2001, stock valuations came down internationally. By May 2001, U.S. stocks lost 16% of their February 2000 peak, Japanese stocks, however, were falling even more severely, and lost 20% of their peak, although they had not been rising as much before (Germany: 26%). As a consequence, the bubble does not, in general, affect the comparison results negatively. On the contrary, during the crisis capital tended to stick to the U.S. markets rather than fleeing into even more opaque markets.

[9] If not stated otherwise, data in this article are from the *Nikkei Shimbun* Database.

Figure 3

Return on Equity (ROE) in manufacturing Japan — U.S.

Source: Nikkei (8 October 2000). Japan: 1,345 Corp.; U.S.: S&P400.

- Lifetime employment, which for Japanese employees was the companion piece for accepting only moderate wage increases and some of the world's highest consumer prices during the period of high-growth, has become increasingly dysfunctional. Today, lifetime employment covers less than 20% of the workforce, unemployment is increasing, and existing (implicit) lifetime contracts are broken by layoffs, early retirement, and peer pressure. Even contracted employees' benefits and savings are at the fringes of being bankrupted, as the underfunding of corporate pension plans by the equivalent of 14% of GDP indicates.
- Corporations are increasingly cheating on their customer relations. Recent serious examples include loss cover-up's of banks and insurers, undisclosed and illegal procedures at atomic power plants (the Sumitomo Group Tokaimura Power Plant even created a disaster close to Tokyo), and the cases of corporate cover-up's of customer complaints (see the Mitsubishi Motors Case below). But, however much these business practices are unacceptable today, it is important to note that in a phase of structural change not all of these cases can be categorized as "pure" moral hazard. Many undisclosed procedures, like the cover-up of customer complaints and the secret repair of product defects have been accepted business practice in the former (and still predominate) stakeholder system.
- Bureaucracy scandals are flourishing. Typical instruments of stakeholder governance, like after-retirement employment of bureaucrats at corporations ("Amakudari"), or extensive stakeholder meetings involving bureaucrats during dinners, entertainments, golf and other leisure time activities turned into an obstacle for different reasons after market conditions changed. First, relative to stronger competition and profit-squeezes this type of stakeholder governance became too expensive. Second, during the course of the development of the economy bureaucrats became too dependent on this source of income, and increasingly lost their judgment and higher social stakeholder function. Third, in an increasingly deregulated market the closed meetings became offensive to non-group partners. In the meantime, the public's trust in its institutions is so severely damaged that most ministries and agencies are being forced to undergo strict reorganizations. On a more positive note, however, the increasing numbers of scandals are at least as much due to a structural change in the perception of what is acceptable today as sound, legal, or normal, as they are signs of

deeply rooted (and much harder to cure) corruption and cronyism.

- Governments and lawmakers are regarded as incompetent. In the former stakeholder setup, a relatively powerless, unskilled, and poorly informed government was not regarded as a problem because it only served a limited role in the general concept of matchmaking. Today, however, the strong need for an efficient market framework to bind the disintegrating stakes has become one of the foremost requirements for Japanese society, and current lawmakers (often third-generation inheritors of their seats) are unable to deliver. As a consequence, during elections in 2001, a relative outsider within the ruling LDP was elected as prime minister with the highest popularity rating ever, even though he only promised change and reform by "all means" including "pain" for most stakeholder groups without clearly specifying what this would mean in reality.
- Fiscal and monetary policies are deadlocked. One of the strengths of the Japanese stakeholder system was the coordinated approach to monetary and fiscal policy. During high growth, in general, monetary policy had been expansionary when possible, and fiscal policy remained rather restrictive to keep as many resources available for corporate use as possible. This concept gradually started to change when the economy shifted into lower gear during the 70s. First, the MOF increased its thrust and debts to fulfill higher demands for social security and public services in what had become an affluent society. Second, the Bank of Japan (BOJ) reinforced its disinflationary stance to secure lower consumer prices and a strong exchange rate during the 80s. Third, the system ran out of control when the MOF started to use its fiscal might to bolster flagging investment demand after the Japanese asset bubble burst in the early 90s. Lastly, by the late 90s, both trends ended at loggerheads. During the 90s, the BOJ became convinced that the Japanese economy was in the midst of a severe structural crisis which needed monetary constraints to press ineffective, reluctant, and protected stakeholder corporations into high gear restructuring. The MOF, on the other hand, is still desperately trying to soften the edges of the crisis with an enormous fiscal expansion.
- As a consequence, fiscal programs have encouraged entire sectors to retain inefficient business practices and allocations on a huge scale, while other (potentially efficient) companies have been suffering under a restrictive policy that has made credit increasingly unavailable and raised real lending rates beyond levels in the US. The most notorious of these inflated sectors include construction, distribution, property, and finance and services. Together these industries account for 60% of Japanese companies although they generate just 32% of the nation's revenues. In the meantime, they also represent up to 85% of all big bank non-performing loans (FT 2001.06.14). Within this group, the worst cases are probably construction and retail. The construction industry now has 15% more companies than a decade ago, and has surpassed the U.S. construction industry in size, while the retail sector has increased total floor space despite severe overcapacity and falling sales. As a result, labor's share of national income has been increasing since the bursting of the economic bubble in 1989, and profits remain depressed.

3. An Old Solution: Open Markets

The problems Japan is experiencing today are rather typical for a maturing stakeholder economy. In a mature, open society stakeholder concepts lose their appeal and efficiency. Group interests are increasingly difficult to define and organize because the members of the society are becoming personally more and more independent from

Table 1

Mitsubishi Motor Case

One typical — and by no means the worst — example of defunct corporate governance in a "classic" Japanese stakeholder-company is the current Mitsubishi Motors case.

— The automaker has been engaged in a systematic effort to avoid recalls for nearly 30 years by hiding customer complaints about quality or engaging in secret recalls and repairs. These practices seemed to be part of its corporate culture.

— Some 200,000 additional vehicles, including large buses, have been found to have defects or other problems. These unreported defects caused disputed accidents, including one that caused injuries. Now, the company will have to recall over 500,000 vehicles worldwide.

— Mitsubishi Motors appears to have failed to learn any lessons from the series of scandals that have rocked the company in the past decade. The company's management also mishandled a sexual harassment case at its plant in the U.S., which led to a major damages suit. Three years ago, the president and several other senior executives were forced to resign amid a scandal involving payoffs to corporate racketeers.

With its top management unable to improve corporate governance, and public trust severely undermined, Mitsubishi Motors has sought salvation in an alliance with DaimlerChrysler AG. With this decision, one of the most traditional Japanese keiretsu's has followed the path of many other stakeholder corporations: unable to shift its insider network into an equilibrium with higher profitability on its own, it introduced outside-control to execute the necessary steps and to buy the credibility for the necessary costly transformation.

each other, while becoming socially increasingly dependent on the working of the society as a whole.[10]

Theoretically, already Adam Smith solved this control problem[11] by proposing a reduction in the complexity of the system as a whole. In his model, the necessary negotiations and renegotiations of millions of personal relationships and implicit contracts of the stakeholder model were replaced by simple and clear-cut rules, which offered a high degree of freedom to the individual. By doing so, this liberal market model freed necessary resources for a further development of the economy. Since the writings of Adam Smith, the efficiency of this liberal solution was rarely disputed for models with perfect markets and free and evenly powerful participants.[12] Empirically and historically, however, the general model developed into different types of governance and economic control, depending on the level of development and the (historical) structure of market conditions and preferences.[13]

In Japan, as already discussed above (section 2), market participants have been extremely successful with a market model that gave preference to the development of stakeholder negotiations over market solutions. However, stakeholder groups never seriously questioned a competitive market result as the final goal of production, and competition between and within the different groups has been maintained by keeping key areas of the economy (the export sector) open to world market competition. But today, in a globalizing world with strong outside competition, liquid markets for international capital, and growing consumer demands, open markets in key sectors are not enough to secure the success of the system as a whole. The system requires a makeover in favor of flexibility and payouts on all levels.

Unfortunately, at this point the stability of the stakeholder model, as analyzed by Adam Smith, becomes an obstacle. As long as the system is still producing high returns, this aspect is not easily visible because the returns can be used to extend the scope of the existing stakeholder groupings, or to buy acceptance from outsiders (see Jensen, 1997). But such a strategy of maintaining the status quo only undermines the efficiency of the system even further. The obvious result becomes only visible when the growth rates are finally coming down, and the system has to compete with more efficient outsiders. Now, the former strength turns into a weakness, because the lower returns will induce the insiders of stakeholder groups to stick to their stakes, and to block any further developments. The growing group of outsiders, on the other hand, will push at their borders, and refuse to cooperate with the unwilling insiders; both forces are undermining the integrative and productive features of the system as a whole.

Japan already ran against the limits of its former stakeholder setup in the 80s: the economy had outgrown its former efficient setup of well-organized, diversified conglomerates (executively controlled only by management and bureaucracies), while the Japanese society had outgrown a phase where limited consumer and voter participation could easily be traded against future growth prospects. During the 90s, it also ran against the limits of a stakeholder society with low — or negative — returns: management, bureaucrats, and politicians have been wasting resources trying to save the former stakeholder setup, while employees, consumers, and investors have started to refuse to cooperate with other stakeholder groups and the system as a whole. Today, they openly demand structural change and new perspectives.

4. Why is the Transformation So Slow?

If the direction for the Japanese stakeholder society is as clear as described above, and if the case for major changes has already become accepted by most stakeholder groups in the meantime, why is the transformation so slow?

The general property of a well-constructed stakeholder model, to provide structural stability between and within the stakeholder groups, has already been mentioned above. This feature is, on the other hand, directly opposed to a flexible response to an undesired stagnant equilibrium. On top of this, the single stakeholders of a "classic" Japanese system are facing huge risks when giving in to outside forces by trading their proven but outdated "stakeholder values" against untested "shareholder values".

As long as the system is not on the verge of bankruptcy, and stakeholders' economic power remains based on their personal relationships, exclusive information, and

[10] The classic examples are farmers (of the [very] old economy), who can survive during a crisis by relying on subsistence of their own products but remain dependent on the narrow network of their extended family or village for production. The software engineer (of the new economy), on the other hand, is personally extremely independent — he might even work from home. But for his income and food, he completely relies on the products of the rest of the economy.

[11] Work on the problem started much earlier with the writings of Mercantile economists who tried to find a new solution for a feudal system of production, which, as a system of (implicit) personal contracts, could not keep up with technological developments and became too complex to control.

[12] Beyond its ability to increase productivity, the properties of the liberal economic model were intensely disputed, of course. Especially its lack of a concept of income distribution (beyond the efficient allocation of resources) gave — and gives — rise to a whole array of more regulated models.

[13] In terms of macroeconomics, the already mentioned unsolved issue of income distribution, plus the inherent tendency for business cycles to occur (the flip-side of the coin of strong dynamic properties), invites many regionally and historically differing solutions to the general model — depending on local preferences and social structure.

other types of oligopolies, every single member feels much safer within the limited “insider” groupings, than being stripped of these assets in an “outsider” world of transparent contracts, specialization, and disclosed information. After having seriously invested into stakeholder relationships for decades, the stakeholders’ natural direction is to rather double their former investments than writing them off and heading into the opposite direction even though this might be the better option in the long-run.

A successful transformation of existing stakeholder interests into shareholder interests therefore requires a careful equilibration of corporate governance, financial structure, and market framework changes at once (Schulz, 2001). First, shareholder interests need to be established and widespread, while corporate governance needs to come into line with shareholders’ interests in order to create an efficient control instrument. Second, prospective (future) productivity gains need to be high and carefully distributed to compensate (former) stakeholders for their loss of stake values. Third, because this compensation can be realized in the future only, the transformation needs to be transparent to become accountable for the stakeholders, plus it needs to be reinforced by social buffers to keep temporary losses from becoming final losses for groups or individuals.

Table 2 lists some of the most important requirements and steps of such a transformation together with the possible gains for each stakeholder group.

Unfortunately, in its first attempts of transformation by means of deregulation during the early 80s, the Japanese government did not proceed carefully enough and targeted only limited (even partial) sectors. Particularly, in the early 80s, the Japanese government introduced a major wave of liberalizations in its financial markets to overcome the already visible limitations of its highly regulated financial industry.[14] The transformation became extremely unbalanced, however, because major parts of the old stakeholder system were left in place. As a result, an asset “bubble” developed and left Japanese stakeholders not only with depressed assets values, but also with a deeply rooted distrust of its economic system, its institutions, and the concept of partial liberalizations (see Table 3).

With this development, the problems of the Japanese economy during its transition to a liberalized (financial) market increased dramatically. Following the misallocation, productivity broke down, as the Japan Center for Economic Research (JCER) documented in its international productivity ranking (see Table 4). Japan dropped from 3rd place in 1990 to 16th place in 2000 in terms of potential competitiveness compared to its rivals in the OECD and Asia.

Even more importantly, however, private households simultaneously lost their confidence in the allocation function of the old banking structure, governmental bureaucrats, and the new capital markets. As a result, they hardly supply (capital) markets with any new capital and refuse to bail out the banking system at the same time. Today, they avoid the capital markets, keep cash, and count on deflation and appreciation of the Yen for their returns (Figure 4).

[14] These liberalizations were in line with — even initiated by — a major wave of financial liberalizations in almost all industrialized countries to adapt to growing capital flows and advancements in information technologies.

Table 2

From stakeholders to shareholders: requirements and chances

	Requirements and costs	Chances and gains
Government/ Cabinet	The government needs better democratic control, public participation, and more party competition.	Gains competence and power.
Bureaucracy	Inflated monolithic bureaucracies need to be broken up to compete and oversee each other as (independent) agencies.	Younger and/or motivated bureaucrats gain the chance of mobility and measurable success within specialized, service oriented agencies.
Legal system	The legal system of courts, lawyers, and auditors needs to be expanded and has to become more service oriented.	Gains a general upgrade in volume, reach, and imortance.
Managers	Managers need to be controlled by (outside) boards and shareholders.	Gain stock-options to transform their insider-interests into profit-oriented outsider-interests.
Employees	Skilled workers have to be trained, sometimes transferred. Salaried workers face short-term job-insecurity.	Gain performance-based promotions and long-term stability.
Households	Households need to diversify their savings and assets, and need to become better informed to carry out independent dispositions and public control.	Gain long-term improvements of productivity, stability of the pension systems, and more consumer sovereignty.

Table 3

The bubble of the 80s as a result of partial deregulation

A series of studies claims that the Japanese economy was undergoing a structural change in finance and (especially) banking starting from the financial reforms in 1982 (Hoshi, Kashyap and Scharfstein, 1990; Horiuchi, 1995; Schulz, 1997). The hypothesis claims that the development of liberalized financial markets in Japan allowed major corporations to raise their funds on their own, and left Japanese city banks — mainly catering to big business — with a declining customer and asset base. To make up for the shortfalls they ventured into an extension of credit lines to smaller corporations with no (implicit) governmental guarantees, and asked — in a classic banking way — for real estate as collateral to make up for the largely unknown risks. The following spiral of increasing asset prices, collateral value, and credit extensions then developed into the bubble of the late 80s because banks did not develop suitable risk-valuation schemes to avoid the macroeconomic trap of their limited microeconomic calculations.

The hypothesis that the bubble developed because of liberalizations and structural change is backed by comparable developments in most industrialized countries. However, in no other country than Japan have the consequences been so severe and lasting because most countries could fall back on more flexible markets and institutions. As a consequence, they swiftly cleaned up their financial sectors by bailing out the better institutions, demanding improvements in risk management, and letting the poorer ones (together with their corporate bad debts) die (see, for example, the S&L crisis in the US). Japanese regulators, in contrast, shied away from further advancements in financial transformation, because they feared a "domino effect" in the closely-knit network of corporate-bank relationships. As a result, they did not get to the root of the problem by, for example, introducing a fast cleanup through a meaningful Financial Resolution and Collection Institution, and overhauling business procedures and models of the affected city banks. Instead, many of the monetary "zombies" were kept alive, first by BOJ credit lines, then by fiscal public money. After 1996, when the BOJ started to rule out further interest rate decreases, the Ministry of Finance even tried to make up for the lack of business demand by shelling out for huge construction projects, and started to supply credit directly from postal deposits to small and medium-size enterprises through the public fiscal investment and loans program. With this development, the quality of the financial system in Japan fell even behind the situation of the former stakeholder set-up because increasing parts of private financial intermediation were replaced by governmental credit and control.

Table 4

International potential productivity ranking

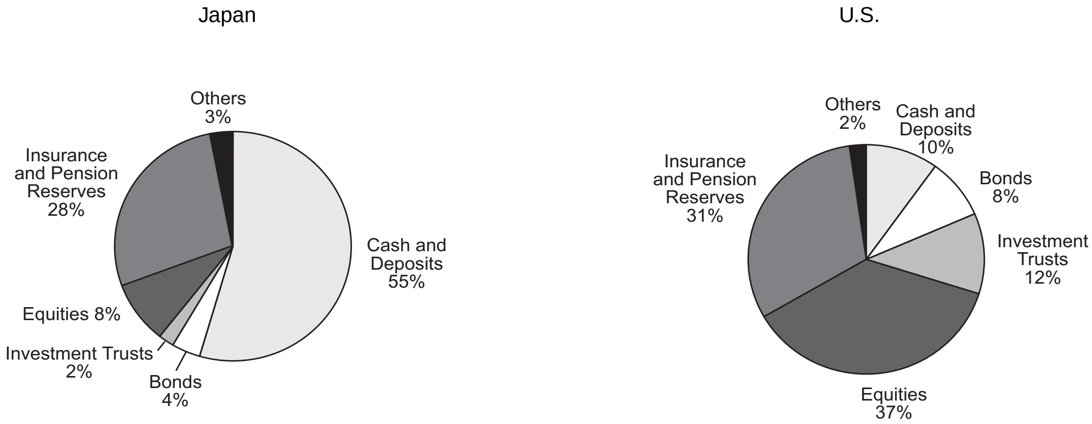
	1980	1990	2000
1	Singapore	Singapore	USA
2	USA	USA	Singapore
3	Hongkong	**Japan**	Netherlands
4	**Japan**	Netherlands	Finland
5	**Germany**	Hongkong	Hongkong
6	Switzerland	**Germany**	Norway
7	Netherlands	United Kingdom	**Sweden**
8	Canada	**Sweden**	Australia
9	Finland	Finland	United Kingdom
10	**France**	Norway	Switzerland
11	**Belgium**	Canada	Canada
12	Iceland	Switzerland	**Germany**
13	United Kingdom	Belgium	New Zealand
14	Norway	New Zealand	**Belgium**
15	**Denmark**	**Denmark**	**Denmark**
16	**Sweden**	**Austria**	**Japan**
17	Australia	**France**	Iceland
18	New Zealand	**Iceland**	**Ireland**
19	**Austria**	Australia	Taiwan
20	**Ireland**	Iceland	**Austria**
21	**Italy**	Taiwan	**France**
22	Taiwan	**Italy**	**Italy**
23	**Spain**	**Spain**	Korea
24	Malaysia	Korea	**Spain**
25	Korea	Malaysia	Portugal
26	China	Portugal	Malaysia
27	Portugal	Thailand	China
28	Thailand	China	Thailand
29	Philippines	Philippines	Indonesia
30	India	Indonesia	India
31	Indonesia	India	Philippines

Note: Ranking based on weighted estimates for the contribution to an increase of GDP per capita. The total potential economic competitiveness based on the "principal components analysis (PCA)" for factors of eight fields: (1) international finance and trade, (2) corporate activities, (3) education, (4) domestic finance, (5) government, (6) science and technology, (7) social infrastructure, (8) IT.

Source: JCER (2001).

Figure 4

Japan, U.S. financial assets held by households



Source: Japan Times (4 September 2000).

From this period of misguided and unfortunate transformation in the 80s and 90s, many obstacles to the future success of the Japanese economy still exist. To provide an overview, it is worthwhile outlining some of the most important obstacles in the following sections. The most obvious, of course, is the sorry state of the Japanese financial system.

4.1 Blocked finance

The financial system in Japan is still in bad shape and unable to allocate funds efficiently.

- In the ten years since the bursting of the "bubble" in 1991 Japanese banks have only been able to dispose of 60% of the bad debts on their balance sheets. Recently, due to increasing numbers of bankruptcies, and despite serious write-off efforts, bad debts are even increasing again.
- Cross shareholding at Japanese corporations is decreasing, but still important. The ratio of cross shareholding of total outstanding stocks is down from 52.1% in 1989 to 39% in 1999 (GS/MITI).
- Banks have lost their role as main banks to many major corporations. They are, however, still closely linked to the corporate sector because a lack of consumer credit and investment banking skills keeps them dependent on corporate credit for their income. With this development they did not only fail as an efficient monitor during the bubble of the 80s, they also failed during the financial crisis of the 90s, when most small- and medium-size enterprises (SME's) still heavily depended on banking credit. Thirteen percent of these companies (responding to the Ministry of Finance's Policy Research Institute survey) even intended to strengthen their relationship with their main bank, while 64% said they would maintain the relationship at its present level. Monitoring inabilities, huge debts, and general risk aversion in the banking sector during the crisis in combination with the lack of other financing possibilities proved to be a fatal relationship cocktail during the credit crunch of the 90s (Corbett, 1998).
- To relax tight credit conditions for SME's the Fiscal Investment and Loans Program (FILP; about 40% of the national budget) started to extend credit from national postal savings to the private sector. As a result, direct financial stakeholder relationships are building up between the public and the private sectors that have not been important before. Today, many SME's depend on public credit, while the private banks have to compete with subsidized public credit when they try to build their business outside of the former keiretsu borders.

4.2 Insufficient transparency and efficiency

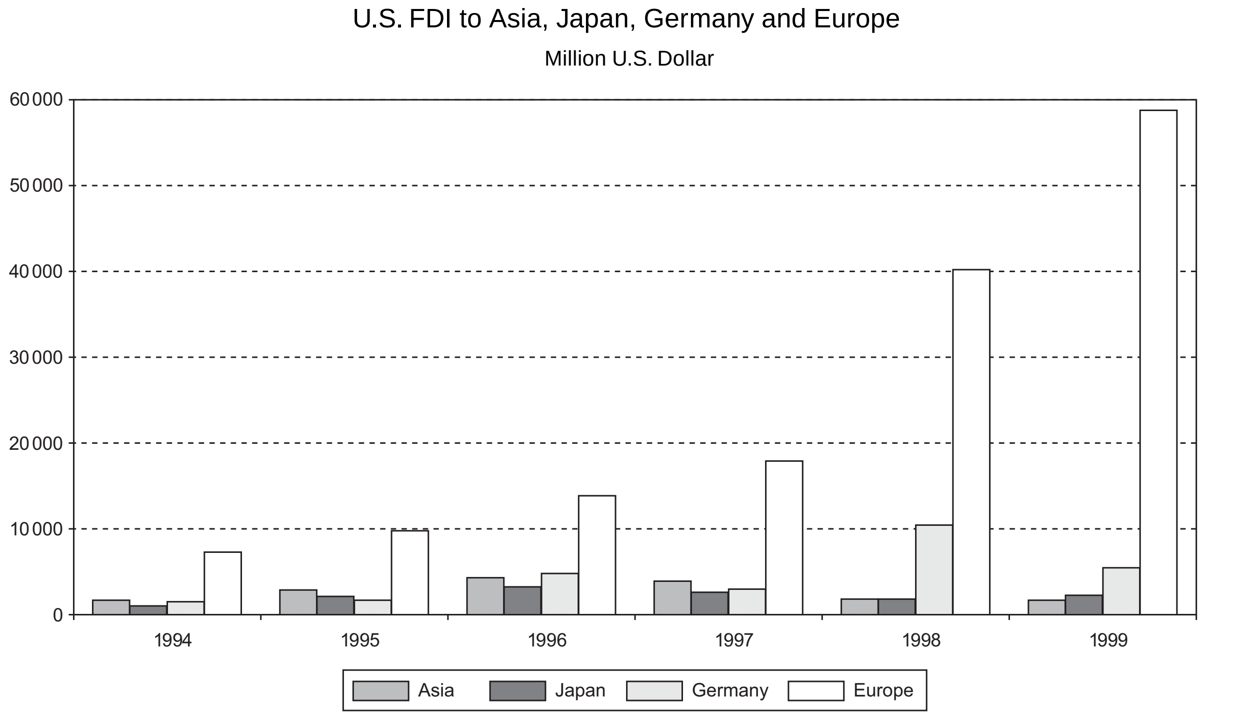
Corporate control and disclosure in Japan are still not sufficiently transparent.

- Balance Sheets are (by and large) still based on historical costs, and subject to a wide array of discretion. The valuation of traditional Japanese companies therefore remains extremely difficult. The PER's of major corporations, for example, are rarely meaningful indicators to assess the profitability of Japanese companies. Examples are Fujitsu's PER of 400 in October 2000 (which was not the peak of an IT bubble in Japan) and 75 as of August 2001 after a dramatic decline of its profits, share price, and trustworthiness. Such valuations are, of course, rather meaningless as a guide to a conglomerate of over 500 group companies and affiliates that still produces a whole array of standard electric devices (like refrigerators) along with its focus on information technologies. Another example, at the other end of the spectrum, is Daiei Inc., Japan's largest supermarket operator. Daiei boasted a PER of 2.4 in October 2000 because of its mounting interest burden. By August 2001, its PER went up to 11 only because endless plans for restructuring were followed by some real and visible cost cutting (while the situation for supermarket chains even deteriorated in general).
- Firms still have too many directors involved in management, even auditing officers, almost always chosen from the companies' ranks, and both are generally kept protected from outside criticism. Also, the decisions about levels of remuneration or resignations of directors are usually reserved for the extremely powerful presidents.
- Consequently, Japanese private investors refrain from investing in Japanese capital markets, and 65% of institutional investors think that investor relations at shareholder meetings are still problematic, although they have seen some improvements recently. Another 15%, however, believe there has been virtually no change (Quick Corp. Survey 2000).
- To foreign investors as well, such a market setup provides no major attractions. Foreign direct investment (FDI) in Japan during fiscal 1998 accounted for just 0.27% of GDP. This is the lowest ratio of any OECD nation.

4.3 Inconsistent governmental control and regulation

The Japanese governmental and bureaucratic system is still a closed stakeholder setup with only one party, the LDP, in charge of lawmaking and governance control for decades. As in many corporate groups, competition of ideas and strategies develops within the party between the powerful factions, which form a kind of party system within the dominant group-party LDP. Governance,

Figure 5



Source: CEIC Database (2000).

bureaucratic knowledge, and control of the market framework, however, are concentrated in one dominant ministry, the MOF. Below, some key elements and consequences of this bureaucracy-centered system are listed. A closer discussion will follow in section 5.

- Administrative guidance remains strong, case-by-case, and dominated by the MOF.
- Cabinets and lawmakers lack power and advice, and are regarded as incompetent.
- The public sector is growing fast (public debt has risen to 130% of GDP), and favors unproductive investments, especially in construction.
- The education system is outmoded. It does not promote internationalization or creativity.
- Employee dismissal is still regulated by precedents in court. Japan ranks as the third most difficult OECD country in terms of employee dismissal (after Italy and Norway).
- The pay-as-you-go social security system is piling up debts. If unchanged, VAT will have to increase from 5% to 25% by 2025 to finance the gap (Health & Welfare Ministry).

5. Reform Plans and Achievements

The last ten years of crisis in Japan have not been a "lost decade", although the remaining obstacles to transformation listed above still depress any optimism for a fast turnaround anytime soon. During the decade, as already discussed, the sense of urgency for real reform has dramatically increased. Also, starting even earlier during the 80s, many reforms have been drafted or introduced along the lines of "international standards".[15] It is therefore most likely that the reforms that are "under construction" will be swiftly implemented, and that the already introduced reforms, which could not show their potential because they remained isolated, will unfold now.

5.1 Regulations, control, and the market framework

The most important step to enhance the efficiency of the system as a whole is the overhaul of the market framework. In the past, progress in this field has been rather slow or unbalanced, in the meantime, however, most reforms (see below) are looking promising. Especially if the new Koizumi government succeeds in cutting some costs, refocusing public spending into productivity enhancing areas, and beefing up the social safety net, the reform package should be able to reestablish the public's trust.

Below, some of the more significant reforms have been outlined. Firstly, however, because a successful reform process requires as much the right mixture of consistent laws and directives as it requires the control and enforcement of these rules, the general setup of democratic and bureaucratic control requires the highest attention. In Japan, traditionally, the parliamentarian system has been weak, and bureaucrats of the powerful ministries — especially the MOF — effectively ran the country. But during the course of the current crisis the Japanese public — along with skyrocketing debt and unsatisfactory public works — has become increasingly suspicious of the rationality of this setup. As a first result, after considerable discussions and power struggles, a central government reform became effective by January 2001, which shifted the power balance from bureaucrats to lawmakers.

To gain parliamentary power from bureaucrats, central government became integrated into one cabinet office and 12 administrative units (ministries and agencies) with powerful cabinet ministers. To support them, the new system also introduced senior vice ministers and parliamentary secretaries (66 legislators), who are in charge of controlling the ministries and agencies but remain ruling party legislators. This system is based on the proven U.K. parliamentarian system, and is clearly designed to show that ruling party politicians are responsible for carrying out policies. To enforce the process, the most powerful ministry of all, the MOF, lost financial regulation responsibilities to a separate Financial Agency. Unfortunately, however, it will take quite some time before lawmakers will be able to effectively control Japan's bureaucracy by building up independent knowledge and qualifications, as the current endless power struggles demonstrate.[16]

To make things even more difficult, the current bureaucratic reshuffle was heavily influenced by the financial crisis and the extremely tight budget conditions. By reorganizing the ministries, strong emphasis has therefore been placed on efficiency and cost savings, which is often not necessarily the option for democratic control. The Ministry of Land, Infrastructure and Transport, for example, is the product of a four-way merger and employs now about 70,000 bureaucrats in bureaus inherited virtually intact from the three ministries and the agency that have been

[15] In Japan, most reform discussions are heavily influenced by a concept that reform proponents call "international standards". If no international standards have been drafted by, for example, the WTO, the "international standard" becomes the result of internationally comparative research at the MOF, METI, or any pressure group seeking reform. Most often it is oriented towards the legislation and procedures of Japan's main trading partner, the U.S. Within the Japanese stakeholder system, this type of reform mediation has a standing term, "gaiatsu" or "pressure from abroad". It is used, however, much less for giving in to foreign demands for, say, tax reductions on rice imports, than for stakeholder discussions about target and procedure changes when a new trend is (seemingly) identified and requires a reaction from the system.

[16] Gaining the greatest amount of publicity by far has been the struggle between the foreign minister Tanaka and the foreign ministry.

put under the same administrative roof. As such, it now controls 80% of public works spending.

The Ministry of Public Management, Home Affairs, Posts and Telecommunications succeeds, among others, the Home Affairs Ministry, which supervised all local finances, and the Posts and Telecommunications Ministry, which (alone) had 280,000 employees and 360 trillion yen in postal savings and insurance funds. In combination, this ministry now not only controls the former Posts Ministry's enormous funds, it has also won a major say in how these funds should be allocated, which means that it has become in charge of the world's biggest financial institution single-handedly.

To sum up, these reforms seem to be paving the way for a new and efficient equilibrium of the legislative-executive power balance in the long run. In the short and mid run, however, this transition will rather create transformation costs by producing even more scandals, inefficiencies and power struggles. The short- and midrun success therefore depends on the underlying layer of minor, but significant, reforms of the commercial code, bankruptcy laws, taxation, and public accounting. If the changes in these fields consist of convincing building-bricks for market reform, it will go along way to convincing important stakeholder groups like the BOJ and white-collar employees to join into a synchronized effort for future growth. If, for example, the BOJ, which is sticking to its restrictive monetary policy because of complaints about the lack of "structural reforms" (see Schulz, 2001a), becomes convinced that the reforms it has been demanding for years are on the way, a synchronized monetary expansion to overcome deflation and depression becomes possible, hopefully laying the foundation for a restoration of consumer confidence in general.

As a consequence, the evaluation of the "plans and achievements" in Japan is put down to the earlier discussion of the goal of "market reform" (see section 4) and the "structural difficulty" of achieving it. Therefore the synchronized introduction of improvements in the field of consumer and investor sovereignty, transparency, outside control, and mobility is necessary. Fortunately, the following sections will draw a rather convincing picture of the planned reforms.

- The commercial code of 1899, which has not been seriously revised for the last 50 years, will not only be revised to introduce stock splits, lower par values, outside stock options, and outside director requirements, it will (judging from the plans) change its emphasis from protecting companies from powerful shareholders to shareholder protection and market liquidity. The code deliberations have to be completed by 2002.
- In February 2000, a mediation law to avoid bankruptcy of consumers and small businesses took effect. In April 2000, a civil rehabilitation law was introduced and is speeding corporate rehabilitations. Bankruptcy procedures have been streamlined during 2000, allowing companies to apply for court protection before their liabilities surpass their assets with the approval of half a company's creditors, down from the previous three-fourths. As a consequence, the number of court-supervised corporate liquidations has already jumped 46.4% year on year to 2,414 in the first half of 2001 (Tokyo Shoko Research Ltd.). Together, the revised laws and procedures provide more efficient possibilities for dealing with risk taking and bad loan disposal.
- Consolidated capital gains taxation will allow for portfolio improvements and higher corporate dividend payouts. It is supposed to start in 2002. Recently, however, various measures to prop up the stock market are being discussed. The laws might therefore be introduced earlier and become quite attractive for stock buyers.
- (Outside) legal advice and accounting will be upgraded by certifying more lawyers and certified public accountants (CPA).
  — Currently, Japan has about 20,000 lawyers, judges and public prosecutors, one-fourth the number for France, the next following developed country with the fewest legal professionals per capita. There are also only about 15,000 CPAs.
  — Because only about 800 auditors are certified under Japanese standards annually, major auditing firms have started to hire more CPAs with U.S. qualifications to make up for the low supply. Even more encouraging, this trend may also be in anticipation of the creation of uniform international certification standards, a measure being considered by the World Trade Organization (*Nikkei,* 23 July 2001).

5.2 Transparency

A lack of transparency has been one of the major — often deliberately introduced or preserved — obstacles to market reforms during the last decades. The already discussed formal market reforms, together with outside pressure (see the following sections 5.3 and 6) and the growing reluctance of Japanese investors to invest in opaque businesses and markets (section 4.2), have led to real improvements and adopted reform plans.

- An "Accounting Big Bang" requires mark-to-market accounting for major parts of equities and real estate holdings (for a history and early reform plans, see *Nikkei,* 1993).
  — From fiscal 2000, not only most assets but also pension liabilities have to be accounted at market value.
  — A rule for an impairment accounting method that requires companies to register latent losses on fixed assets as losses on their books is still under discussion, but seems to be on its way.

- Cross shareholding is declining.
  — For the ninth straight year, the ratio of shares reciprocally held by listed Japanese companies declined. According to the NLI Research Institute, the number of equities reflecting the practice of cross-shareholding slipped 2.69 percentage points to 10.53% in fiscal 1999 — the biggest drop since the institute started to conduct the survey in fiscal 1987.
- The most efficient and internationally competitive companies have adopted EVA (Economic Value Added, a shareholder value concept; see Stern Stewart, 1998), or similar concepts, and demonstrate its potential for the long-term health of the companies.
  — Kao, Advantest, Hoya, and Sony undertook serious reform, adopted EVA, and deliver top performance (not counting the current general downturn in IT).
  — However, only 1.9% of the corporations in a *Nikkei* survey of TSE corporations named EVA as the most important benchmark, 38.2% still named pretax profit and 18.7% cited sales.

5.3 Outside control

Outside control is the most sensible and difficult issue in all stakeholder economies. However, after a decade of crisis and falling prices, outside control has entered Japanese corporations in its most radical form: foreign takeovers. Section 6 will provide a closer look on the significance and impact of internationalization of Japanese corporations. But even within the "purely" Japanese network of corporate control, outsider control and participation has become one of the most important developments in Japanese corporate governance.

- Supervisory boards and outside directors are spreading (see Sakamoto, 1998, for their significance in Japanese corporations).
  — Hoya appointed half of its board of directors from outside the company in June 2001. If the board demands the resignation of the president, outside directors will cast the deciding votes. Nomura Securities will hire two outside directors and establish a holding company to oversee group firms to revamp corporate governance before listing on the New York Stock Exchange. According to a 2001 survey by the *Nihon Keizai Shimbun* a total of 38.8% of TSE's first section corporations are already hiring outside board members and 24.2% are considering a similar measure.
  — Sony contracted outside directors, and moved from all-powerful presidencies with dependent directors to a meaningful CEO system, which keeps top management away from day-to-day decision-making. A 2001 survey by the *Nihon Keizai Shimbun* finds that 35.7% of TSE's first section corporations have introduced CEO systems, indicating that a growing number of firms have reduced the number of directors to streamline decision making and limit the power of presidents.
- Institutional investors and shareholders are gaining control.
  — Institutional investors are showing a growing interest in corporate governance, with 28% voting against or abstaining on at least some issues at shareholder meetings held in June. According to a survey conducted by Quick Corp. (2000), 19% of the institutional investors felt that the emphasis at the meetings had shifted toward shareholders.
  — Sony's shareholder meeting for fiscal 2000 saw 70% more shareholders attending the meeting (1700).
- Successful shareholder suits
  — The Osaka District Court ordered 11 current and former executives and directors of Daiwa Bank to pay a total of 775 million dollars (about 83 billion yen) as compensation for bond trading losses incurred by a rogue employee (undiscovered for 11 years, and undisclosed for two months) at its New York branch. The impact on managers' psychology and consciousness was enormous because such judicative involvement and huge fines were unthinkable in Japan before.

5.4 Efficiency and restructuring

Operational efficiency has never been "all bad" at Japanese corporations. On the contrary, to increase capital efficiency and payouts now, Japanese corporations can build on their proven operational skills by introducing competition into outmoded (implicit) contracts and arrangements, and by setting new incentive structures. A growing number of corporations are actively promoting such measures in the meantime.

- Stock options are spreading fast.
  — Mitsubishi Corp. and Fujitsu Ltd. added stock-option provisions to their corporate charters. Overall, a total of 463 companies either secured shareholder approval or are planning to submit resolutions for stock option plans during the year before a June 2001 survey by Nikko Securities and Towers Perrin, up by 40 companies, or 9%, from the previous survey.
- Growth strategies are aiming for corporate strength and core-business competence instead of diversification.
  — Of all M&As, those aiming at strengthening existing businesses accounted for 53%, and those aiming at enhancing peripheral businesses stood at 22%. Only the remaining 25% aimed at entering new businesses (Rec. of Corp. Survey).

- M&As are increasing fast.
  — With cross shareholdings being reduced, M&As will increase for companies with high cash flows, hidden reserves and inefficient managements. Late 2000, Maruichi Steel Tube Ltd., Nippon Mitsubishi Oil Corp., Komatsu Ltd. and Fuji Photo Film Co., for example, had low or negative M&A ratios (measuring years to recoup takeover costs).[17] As a result, a takeover would bring in the company's cash flow as a sort of dowry (Moriyama Office).
  — During 2000 an unprecedented 1,635 M&As (including business transfers, equity participation, increased capital commitments) were announced (see Figure 6). This is more than 50% up from the same period the year before. Of these M&A plans 64.5% were domestic. Mergers between keiretsu corporations and corporations beyond these frameworks are also accelerating (Recof Corp. Survey).

5.5 Corporate flexibility and labor mobility

The high degree of flexibility within Japanese stakeholder groups and corporations has to be extended beyond the existing group barriers.

- Outside offers and competitors are starting to compete with keiretsu (company grouping) contracts.
  — Mergers like the Mizuho Financial Group (now the world's biggest bank), bringing together Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan, are cutting through the group-oriented main bank nets.
  — To cut costs by 20% over three years, Nissan sold suppliers and opened its affiliate-centered procurement. From 1999, Mitsubishi Electric's annual materials procurement costs were cut by 200 billion to 1.5 trillion yen. It trimmed the number of suppliers by about 2,000 and now uses about 5,000 suppliers. Starting in October 2001, it intends to reduce those costs by an additional 20% over the next two years, and plans to cut the number of suppliers to around 4,000 while increasing purchases from overseas firms from the current one-fourth to one-third of overall procurement.
  — Matsushita is moving its procurement to Internet-based e-marketplaces.
  — The new Toyota Corolla and the Vitz were directly designed within their focal market, Europe.
- The workforce is becoming more flexible.
  — Payments into corporate pension plans — until recently remaining within the issuing corporation's fund — are becoming portable between corporations (also, 401(k) type funds are growing in popularity). With this, one of the most important obstacles to white-collar mobility will be removed.
  — Wage hikes are modest in general. Even such highly profitable companies as NTT DoCoMo have not raised basic monthly pay during 2000, and Toyota Motor granted the lowest wage increase since 1982. Performance based bonuses and wages are being introduced.
  — Outsourcing is growing strongly. Retired workers (retirement age is around 60) are being rehired on flexible contracts. In 2000, the Temporary Work Services Association found 70% more temporary workers then five years ago at its member-companies in the Tokyo area. During 2000 alone, staff at agencies increased by 25%.
  — Union membership has fallen from 34.4% in 1975 to 22% in 2000. After not taking any major strike action for two decades, unions at major electronics makers even drastically reduced or abolished their strike funds.

6. Outlook: Second Wave of Internationalization

As a consequence of the restructuring of Japanese corporations and the ongoing market reforms, a huge window of opportunity has opened for foreign corporations in Japan. All three consequences of the current structural change (which have been stressed in this article) are working for the chances of foreign corporations.

- First, the dissolution of stakeholder relationships has opened a market for (especially) foreign investment banks to offer their services as outside mediators with deep market knowledge. Building on this, foreign ownership and capital investment has not only become a source of scarce capital, it also doubled as a label of quality for newly gained "market knowledge" of troubled companies and as a welcome excuse for further dissolution of outdated relationships.
- Second, the opening of stakeholder relationships and corporate networks allows foreign corporations to enter these networks as suppliers. Open procurement, based on market prices and quality, puts foreign corporations on a more equal footing with Japanese group firms.
- Third, the devaluation of stakeholder values has brought asset prices down to competitive levels.

These developments are highly visible in the market of mergers and acquisition, where Japanese financial institutions are clearly not up to the competition with their foreign counterparts. Goldman Sachs, Merrill Lynch, and Mor-

[17] When cash flow grows larger in relation to stock price, the ratio gets smaller.

Figure 6

M&A by numbers and advisor ranking by value of deals (2000)

* Excluding spin-offs, open market repurchases and withdrawn deals.

Source: Nikkei Weekly (5 March 2001). Data from Rec. of Corp., Thomson Financial.

gan Stanley, for example, were the top three arrangers of M&A deals involving Japanese companies in 2000. In particular, international deals, such as DaimlerChrysler AG's purchase of shares in Mitsubishi Motors Corp. (7211) and Vodafone Plc's acquisition of a stake in Japan Telecom, were dominated by foreign players (see Figure 6).

The same is true for advanced financial services, such as securitization of assets, structured finance and derivatives. The Industrial Bank of Japan, for example, failed to win an order from Nissan Motors to raise 1.1 billion dollars for the construction of a new auto plant in Mississippi despite long being a main bank for the automaker. Instead, Nissan invited fund-raising plans from a number of financial institutions and eventually placed the order with J.P. Morgan.

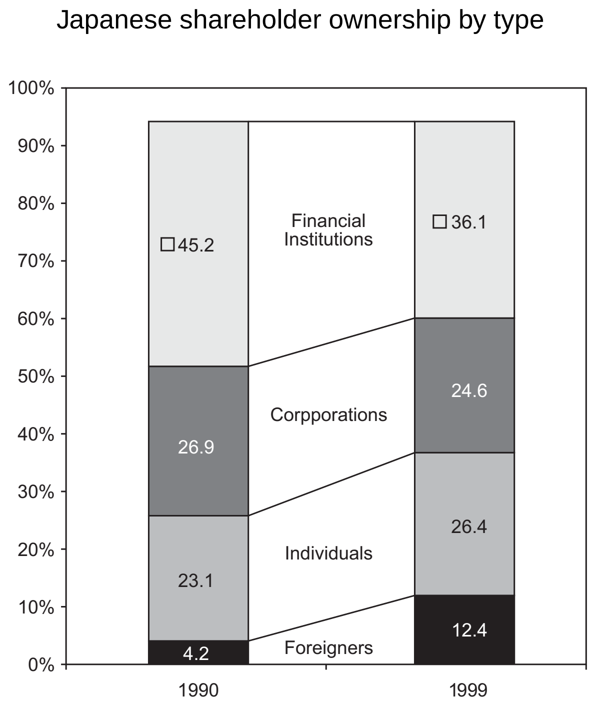
After mediation, funds led by overseas investors are also stepping up purchases of Japanese companies where they are often seen as prime “fixer-uppers”. Here, the trend of Japanese companies to unload less-profitable businesses to focus more on core operations, and the slumping stock prices are working together as supporting factors. From January to May 2001, for example, overseas funds acquired 28 Japanese companies, compared with one in all of 1998, 13 in 1999 and 25 in 2000 (Rec. of Corp.). Some funds have also specialized in buying Japanese bankrupt firms. Ripplewood Holdings, for example, a company that raises the value of ailing firms and sells them at a profit, has already bought a whole portfolio of former icons of “Japan Inc.”. They bought the failed Long-Term Credit Bank of Japan, restructured it into the new Shinsei Bank, which saw its gross profit jump nearly five-fold on the year to 100 billion yen in 2001. They bought Nippon Columbia with the Denon brand name. Recently, they even bought the huge Phoenix Resort Ltd. with the Seagaia resort park in Kyushu for 16.2 billion yen, and claim this to be a sound investment because some 200 billion yen had been invested in the resort.

In the meantime, these investments do not remain isolated entrances into the Japanese economy anymore; they have already become visible on a macroeconomic level. In Figure 7, data from 1999 show that foreigners already owned 12.4% of Japanese stocks. This development, of course, will further accelerate the reform of the insider-oriented Japanese stakeholder system.

In contrast with earlier limited export-led internationalization, where Japanese corporations produced for the world market at home and only sold their products abroad, the entrance of foreign corporations into Japan marks one of the most important aspects of globalization. The second element is the diversification and development of foreign direct investments from Japan, which was already tried during the 80s by picking up assets abroad — most often in real estate and with terrible results (see Muramatsu, 1995). As a consequence of the general overhaul of the Japanese stakeholder system, Japanese corporations are now turning to internationalization and FDI's again — but with a different concept this time. This time, unlike the 80's, strategies build on Japanese governance strengths of relationships, technology transfers, and minority stakes.

- In a company survey of the Japan Bank for International Cooperation (October 2000) 54.5% of the companies said that they plan to bolster and expand foreign operations over the next three years. According to the survey, the automobile industry has the most aggressive stance, followed by the electric machinery and electronics, and the precision machinery industry. China will likely be the most popular location.
- In one of the industries with the internationally highest M&A activity levels, telecommunications, NTT DoCoMo

Figure 7



Source: © FRI. Data from Tokyo Stock Exchange 1999. Based on Unit Shares.

(unlike its peers) has settled with minority stakes and alliances in Europe and the U.S., although (also unlike its peers) it has a successful cutting-edge wireless Internet handset technology that it could export (I-Mode; already 20m handsets).

It remains to be seen if these strategies of a "second wave of internationalization" will become successful soon. But given the newly gained experiences with foreign competition and cooperation in Japan's domestic market, the accumulated knowledge of production abroad (forced by the high Yen exchange rate and trade protectionism in export markets from the mid 80s), and the new focus on core competences for investments at home and abroad, these strategies have a very good chance for success in the longer run.

7. Conclusion

During "high growth", governance in Japan was based on a system of contributions from different stakeholder groupings, closely interlinked as "insiders" of the corporate finance and production process. Workers traded low real incomes for lifetime employment, consumers accepted high current prices for future growth and income, financial institutions discounted group-based and implicit governmental guaranties for low risk premiums, and corporations took the risks for high-growth, low (current) yield investment and diversification.

But Japan is not a developing economy anymore. The system, which worked well before, has outlived itself by becoming too complex for a mature economy. The same is true for the demands and interests of its economic agents. Today, former workers have to cash in their lifetime investment, consumers demand lower prices to realize Japan's riches, and financial institutions and corporations are hard-pressed to provide the required current yield in competition with foreign competition.

As a result, governance in Japan is moving to a system of "outsider" or shareholder participation and control, which will be based on higher specialization of single entities, but wider diversification of the system as a whole. This transformation remains costly and time consuming. Japanese management is well aware that the closely linked system of stakeholder interests requires a stepwise introduction of profit-oriented governance in accord with other stakeholder groups (government, bureaucracy, suppliers, workers).

During the last two decades, wrong or unclear incentives for change have blocked efficient allocation by alienating "insiders" of existent groups. In contrast to the widely held perception of a "lost decade" in the 90s, the time was spent moving the Japanese stakeholder society closer to a market based economy in most key areas. In the meantime, due to outside forces, stagnation, and recognition of inefficiencies, the transformation is widely accepted, and most required steps are on their way. Japanese corporations can build on their well-proven operational efficiency. Corporate control is diversifying through boards, shareholding fund managers, and foreigners. Stakeholder relations are becoming more flexible. Governmental regulations are modernizing, and the bureaucracy is restructuring.

Unfortunately, these significant changes will still need some time until they can work in concert and produce the much-needed results. Especially because general (macroeconomic) policy and politics have only joined the process of market reforms so very late is the Japanese economy quite sure to see more "short-term pain", as promised by the Koizumi cabinet. The current hopes for a return to an efficient governance model therefore rely on mid-run policy improvements. If governmental policy is finally able to deliver a convincing outlook for the direction of fiscal plans, bad debts, and market-oriented public works, other important players — like the BOJ — will most likely join and the reformed governance model will look quite promising for the future. Without these policy changes, however, no reform of (corporate) governance will be sufficient to convince households to provide the missing link to sustainable growth by switching from economizing for a most uncertain future to a more optimistic level of consumer demand.

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Zusammenfassung

„(Corporate) Governance“-Reform in Japan

Es gibt einen breiten Konsensus darüber, dass japanische „Governance“ während der Phase des Hochwachstums auf einem eng verflochtenen System von „Stakeholder“-Beziehungen beruhte, das heute wegen der stark zugenommenen Komplexität der entwickelten japanischen Gesellschaft als überholt gelten muss. Als Ergebnis wandelt sich der japanische Marktrahmen zu einem System, in dem die Beteiligung und Kontrolle von „außerhalb“ der alten Beziehungen eine immer größere Rolle spielt. Diese Transformation ist kostenintensiv und zeitraubend, da eine stärkere Profitorientierung und Ausschüttung der Gewinne nur im Einklang mit den verschiedenen Stakeholder-Gruppen (der Regierung, Bürokratie, Management, Zulieferer und Beschäftigte) erfolgen kann.

Dieser Artikel versucht die Frage zu beantworten, warum es so schwierig war (und ist), die Transformation zu implementieren, und ob die gegenwärtigen Reformpläne dafür ausreichend sein werden.

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