

CORPORATE GOVERNANCE IN JAPAN: PAST PERFORMANCE AND FUTURE PROSPECTS

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Much has been written about the Japanese 'model' of corporate governance. Indeed, Japanese-style corporate governance has been described as an efficient alternative to corporate governance mechanisms available in the West, and as a model for developing economies. As opposed to American-style corporate governance, in which hostile takeovers and managerial incentive schemes play a major role, Japanese firms have traditionally relied on monitoring by large shareholders and banks. This article describes the evolution of corporate governance in Japan since the Second World War, and surveys the empirical evidence on its performance. Although there is substantial evidence on the effectiveness of the Japanese system, there is also evidence on its significant shortcomings. The article also evaluates the effects of the current macroeconomic and banking crises on corporate governance in Japan, and suggests possible directions for future changes, which are likely to make Japan more similar to the USA in this respect.

I. INTRODUCTION

The term 'corporate governance' refers to institutional practices designed to get optimal performance out of managers. Although mechanisms by which stakeholders influence management exist everywhere, a large volume of literature has been written about the allegedly unique mix of corporate governance mechanisms that exists in Japan. Indeed, Japanese-style corporate governance has often been described as an efficient and viable alternative to the corporate governance mechanisms available in the West, and in particular, in the

'Anglo-Saxon' financial systems of the USA and UK. Furthermore, some authors have argued that because the Japanese-style model of corporate governance is, at least in certain respects, superior, it should be emulated in emerging markets as well as in the reforming economies of Eastern Europe.

The objective of this article is to examine the empirical evidence on the evolution and performance of the Japanese system of corporate governance, and to discuss its future prospects in the light of the country's decade-long economic slow-down and severe banking crisis.

Of the many ways by which stakeholders can influence management (see Shleifer and Vishny, 1997, for a detailed survey), the present article focuses on five major corporate governance mechanisms.

- Managerial incentives (stocks and options, performance-based compensation): this category refers to a variety of means by which the income of the firm's management team is tied to firm performance.
- Hostile takeovers: if a firm is inefficiently operated, then there is scope for improved performance if an outsider (or some of the current shareholders) takes over the firm, replaces its management, and initiates a new business strategy.
- Managerial labour markets and 'career concerns': if managers are rewarded in the labour market for managing firms efficiently, then they will be unlikely to 'shirk' or consume 'on-the-job perks'.
- Monitoring and intervention by large shareholders: this refers to a variety of direct intervention methods on behalf of the major shareholders to guarantee that the firm is managed according to their preferences (e.g. Shleifer and Vishny, 1986).
- Monitoring and intervention by creditors, typically banks: this refers to a variety of methods by which creditors (rather than shareholders) intervene in firm operations (the theoretical foundation for this argument is Diamond, 1984).

Traditionally, in the USA and UK, the first three mechanisms seem to play the most important roles in corporate governance. In the 'Anglo-American' world, managerial incentive schemes are common, hostile takeovers are observed quite frequently, and the labour market for top managers is liquid and active. As we will see later, and in sharp contrast to the commonly used mechanisms of 'Western' corporate governance, Japanese-style corporate governance has traditionally been based on the last two mechanisms. Influential large and stable shareholders are often deeply involved in firm management. Possibly even more famous, is the role of large Japanese banks which intervene dramatically in client firm operations in periods of poor performance or financial distress. Why is Japan so different

from the USA in this respect? Which system is 'better'? Will the two 'styles' of corporate governance continue to co-exist? The rest of this paper tries to provide some answers to these questions.

The paper is structured as follows. The next section describes the evolution and formation of the 'Japanese model' of corporate governance in the early post-war years and characterizes its main features. Section III surveys the large and generally positive empirical evidence on the performance of the Japanese mechanisms of corporate governance. In section IV we turn to critiques of the Japanese system and in section V we examine the impact of the recession and banking crisis of the 1990s on its viability. Section VI concludes with some prospects for the future of corporate governance in Japan.

II. THE ORIGINS OF THE JAPANESE SYSTEM OF CORPORATE GOVERNANCE

(i) The American Reforms and the Dissolution of the *Zaibatsu*¹

Even though some parts of the contemporary system of corporate governance in Japan date back to the wartime period (Okazaki, 1994), our starting point in the present analysis is the American occupation reforms of the early post-war years. The economy of pre-war and war-time Japan was dominated by large, diversified conglomerates (*zaibatsu*) which controlled over a quarter of all capital assets in the economy, and much larger shares in modern, heavy industries (Hadley, 1970). The *zaibatsu* were family-owned conglomerates, controlled through holding companies, which, in turn, held a large number of shares in a first tier of subsidiaries. First-tier subsidiaries controlled a second tier of companies, and so forth, and formed a 'pyramid' of firms. Horizontal ownership and personnel ties between group firms were also common. During the Second World War, the *zaibatsu* groups increased their market power, and played an important role in providing military equipment and supplies to the Japanese Imperial Army. Following Japan's defeat in 1945, the American occupation authorities regarded the *zaibatsu* as an important part of the

¹ This section draws heavily on Yafeh (1995).

Japanese social and economic structure that was responsible for the war. In particular, the market power of the *zaibatsu* and the tremendous wealth of the founding families made the dissolution of the conglomerates one of the first and most important targets of the American occupation.

The *zaibatsu* dissolution reforms started soon after the end of the war and ended around 1950. During this period, all holding companies were dismantled and prohibited by law, the founding families were stripped of their shares, and the pre-war managers were purged and prohibited from taking office. The resulting change of ownership was of enormous scale, and over 40 per cent of all corporate assets in Japan changed hands (Bisson, 1954). The shares transferred were resold by the Holding Companies Liquidation Commission, using several methods which were designed to guarantee a dispersed ownership structure (Hadley, 1970). Indeed, following the conclusion of the reforms, shareholding by individuals in Japan reached an all-time high of approximately 70 per cent around 1949 (Aoki, 1988).

Yet, despite the hopes of the American occupation authorities, the newly created dispersed ownership structure proved unstable. With the reopening of the Tokyo Stock Exchange in 1949, individuals who received shares during the reforms (especially company employees and residents of cities where the companies operated) began to sell the stocks they held. Consequently individual shareholding declined, and in the early 1950s a new ownership structure emerged: instead of individuals, most Japanese companies were now owned by other companies and by financial institutions, most notably large commercial banks ('city banks'). This pattern of ownership, in which the largest shareholders are non-financial and financial companies rather than individuals or investment funds, still exists in Japan today.

There are several possible reasons why the period of dispersed ownership in Japan was so short. Individuals may have been too poor and too risk-averse to wish to hold equity, and preferred to increase their consumption or save in the form of bank accounts rather than hold risky shares. Another reason, commonly asserted by many authors

(e.g. Miyajima, 1994), is that the reformed firms in Japan were exposed to hostile takeovers, given the dispersed ownership and the low equity prices in the Tokyo Stock Exchange soon after the war. To prevent this, managers sought to establish a friendly and stable ownership structure by convincing managers of firms with whom they had been associated in the pre-war period to acquire some of each other's equity on behalf of the companies they managed, thus insulating themselves from external threats. This created the foundation of the cross-shareholding arrangements, which, as will become clear later, have characterized the ownership structure of Japanese firms until today, and have made hostile takeovers extremely rare. Note, however, that even if the new ownership structure insulated Japanese managers from the threats of hostile takeovers, it is not clear if this was 'good' or 'bad'. Although it is often alleged that Japanese managers can focus on long-term objectives and are not under pressure to produce results that will be observable to shareholders within a month or a quarter, it is also possible that this form of ownership prevented effective corporate governance. We return to this point later.

In any case, it is far from certain that the motivation behind the change in ownership that was observed in Japan in the early 1950s was indeed the threat of hostile takeovers. In fact, it is not clear who the potential raiders could have been. Instead, an alternative explanation for the short life of individual ownership in Japan is simply that it was inefficient. Yafeh (1995) shows that, other things equal, the greater the percentage of a firm's outstanding shares expropriated and resold by the American authorities, the worse was the firm's performance in the early 1950s. This is consistent with the view that large shareholders play an important role in corporate governance (Shleifer and Vishny, 1986; Yafeh and Yosha, 1999). Stated differently, in the absence of takeovers and managerial incentive schemes, dispersed ownership structures may not last because they leave management unchecked, and are therefore inefficient.² But dispersed ownership could also have been replaced by concentrated family ownership. Apparently this did not happen in Japan because the 'old wealth' of the pre-

² Attempts to create a 'democratic' ownership structure by decree seem to have failed elsewhere, too. See, for example, Karpoff and Rice (1989) who use a sample of Alaskan fisheries.

war period had been destroyed by the American occupation reforms which stripped the wealthy *zaibatsu* families of most of their assets.

Whatever the reasons, as a result of the American occupation reforms a new ownership structure emerged in Japan. Companies were now owned by other companies, often as part of reciprocal cross-shareholding ties (which were further reinforced in the late 1960s), banks became influential shareholders, hostile takeovers were virtually absent, and so were institutional investors. Corporate governance in this environment was based on concentrated and stable ownership, combined with bank finance.³

(ii) Large and Stable Shareholding

Many authors have documented the ownership of Japanese firms. Prowse (1990), for example, compares corporate ownership in Japan and the USA, finding that in the USA households hold nearly 60 per cent of the outstanding corporate equity, whereas in Japan the comparable figure is only slightly more than a quarter. On the other hand, banks hold over 20 per cent of all outstanding corporate equity in Japan, versus zero per cent in the USA. It is important to note that the different corporate owners in Japan are typically also stable owners, rather than liquid portfolio investors. For example, Weinstein and Yafeh (1998) and Yafeh and Yosha (1999) provide evidence for the high stability of ownership patterns in Japan, showing very little change in corporate ownership over periods of eight or more years. Yafeh and Yosha also report figures on ownership concentration for listed Japanese firms in the chemical industry, where the top ten shareholders often hold about 50 per cent of the outstanding equity. In addition to concentration and stability, Flath (1993) emphasizes cross-shareholding arrangements of Japanese companies within the bank-centred corporate groups (*keiretsu*).

In conjunction with stable and large shareholders, high levels of bank debt have also been a traditional characteristic of Japanese corporations. Hoshi and Kashyap (1999), for example, report that in the

1970s the ratio of bank debt to assets among large publicly traded Japanese firms was about 0.36, a figure which was six times the comparable figure for large American firms at the time. Not only were Japanese firms bank-financed, but debt relations, much like ownership ties, tended to be extremely stable over time (Aoki *et al.*, 1994; Sheard, 1994). There is no wonder, therefore, that large shareholders and banks have played a central role in corporate governance in Japan, especially in view of the fact that other, 'Western', corporate governance mechanisms were virtually absent. We have already mentioned that hostile takeovers are extremely unlikely in an environment of concentrated and stable shareholding. Managerial incentive schemes have also been rare, largely because of legal restrictions that limited their applicability. The *Wall Street Journal* (9 April 1998) reports that Japanese companies began to offer stock options to executives only in 1997. Even as late as spring 1998, only 56 companies offered such schemes to their executives and even among these few firms 'the average value of stock options issued . . . is a far cry from the millions of dollars in stock options the US executives are often granted'. Similarly striking figures are presented in the *New York Times* (19 January 1999), where the structure of chief executive officer (CEO) pay in ten different countries is compared. Long-term incentives, such as stock options, account for a much bigger share of a US executive's salary than they do for CEOs in Japan. Finally, 'career concerns' are unlikely to constitute an effective mechanism to discipline Japanese managers, because top executives typically rise through the corporate ranks and the market for CEOs is virtually non-existent.

III. THE PERFORMANCE OF THE JAPANESE MODEL OF CORPORATE GOVERNANCE

The Japanese model of corporate governance which evolved under these circumstances has sometimes been described as 'state-contingent corporate governance' (e.g. Aoki *et al.*, 1994, and Berglof and

³ One could argue that another important component of corporate governance in Japan is intensive product market competition. Conceivably, companies operating in highly competitive environments, such as the Japanese electronics or automotive industries, cannot be managed very inefficiently. However, because there is no clear empirical evidence on this governance mechanism for Japan, it is not discussed further in the present paper.

Perotti, 1994). Whenever firm performance is satisfactory, management acts independently or, some argue, is monitored by the company's large and stable shareholders. When firm performance is poor, then creditors, and in particular, the firm's *main bank* (to be defined later) intervene, initiate a restructuring plan, and discipline the poorly performing management.

A vast literature provided empirical evidence supporting the performance of this model. The disciplinary role of large and stable shareholders has been supported in a series of studies by Kang and Shivdasani (1995, 1996, 1997) who report a positive correlation between ownership concentration and board turnover or restructuring of poorly performing firms. Yafeh and Yosha (1999) provide evidence on monitoring by large shareholders in firms whose performance is 'normal.' Examining several aspects of firm behaviour, they find that concentrated ownership is associated with reduced company spending on activities with scope for managerial private benefits (e.g. entertainment expenses).

A much larger literature provides evidence on the role of Japanese banks in corporate governance. For example, Sheard (1989) describes forms of intervention by Japanese (main) banks, and Kaplan and Minton (1994) as well as Morck and Nakamura (1999a) find that poorly performing firms are more likely to have a bank executive named to their board of directors than well-performing companies. Kang and Shivdasani (1995, 1997) find that executive turnover and the initiation of a restructuring plan are more likely for poorly performing Japanese companies that have a main bank.⁴

Since banks in Japan often hold equity stakes in borrowing firms, a sharp identification of the motivation for bank intervention (debt or equity stakes) is not easily obtained. Kang and Shivdasani (1995, 1996, 1997) attempt to separate out the effects of debt and equity ties on restructuring and board turnover of poorly performing firms, and argue that both main-bank ties and ownership concentration

are important in this respect. However, and in line with the notion of state-contingent corporate governance, Yafeh and Yosha (1999) show that Japanese banks do not play an important role in restricting the managerial private benefits of firms whose performance is satisfactory. The reason is probably that banks are primarily interested in protecting their outstanding loans (and therefore intervene only when debt repayment is at risk), because their equity stakes are small in comparison with the size of their debt.

In addition to the evidence on bank intervention in poorly performing client firms, Prowse (1990) argues that Japanese banks buy the equity of debtors with high R&D expenses and liquid assets so as to prevent 'asset substitution' policies. Flath (1993) predicts that Japanese banks should hold more equity in firms that are harder to monitor, for example, fast growing companies with high variance in performance and high R&D and advertising outlays. He does not, however, find a statistically significant positive relation between R&D or advertising expenses and banks' equity stakes.

This vast literature on effective corporate governance in Japan appeared against the backdrop of Japan's economic performance until the early 1990s. It was combined with a series of influential papers by Hoshi, Kashyap and Scharfstein (1990, 1991) documenting the efficient flow of information between Japanese firms and their lending banks (the very same banks that are so important for corporate governance). All this created the feeling that the Japanese model of corporate governance may in fact be superior to that of the USA and the UK. Apparently, the Japanese economy was performing very well, with no need for hostile takeovers that often involved costly litigation. There was also no need to tie the compensation of management to share prices and create managerial myopia or short-term objectives. The Japanese method of corporate governance, it has often been argued, encouraged long-term investment which seemed to pay off in the form of company growth and market share all over

⁴ The concept of 'main bank' has many definitions that essentially describe long-term and stable relationships between firms and the banks that finance them. These ties typically include equity and personnel as well as debt relations. Main-bank client firms that maintain close equity and personnel ties with other clients of the same bank are often called 'group-affiliated' or '*keiretsu* members'. The groups are described as 'bank-centred' or 'horizontal'. Firms with looser bank ties and cross-shareholding arrangements are described as 'unaffiliated' or 'independent'. See Weinstein and Yafeh (1995) for a discussion of these definitions and their applications in the empirical literature.

Table 1
The Decline of Bank Debt in Japanese Corporate Finance: The Ratio of Bank Debt to Assets for Large Listed Japanese and US Manufacturing Firms,^a Selected Years

	Japanese firms	US firms
1972	0.39	n/a
1977	0.37	n/a
1980	0.31	0.07
1982	0.30	0.07
1987	0.23	0.08
1992	0.14	0.09
1997	0.13	0.09

Note: The term ‘large’ refers to Japanese firms whose assets exceed ¥120 billion, and to US firms whose assets exceed \$10 million.

Source: Hoshi and Kashyap (1999).

the globe. Perhaps the symbol of this favourable school of thought is the Aoki–Patrick (1994) book, which was sponsored by the World Bank, and essentially stipulated that emerging markets as well as the reforming economies of Eastern Europe should start off with Japanese-style bank finance, at least until their economies were mature. However, in spite of the worldwide acclaim, the Japanese bank-dominated system of corporate governance involved some very serious problems to which we turn next.

IV. SOME DOUBTS BEGIN TO EMERGE

In the mid-1990s, in spite of the apparent success of the Japanese model of corporate governance, and even before the magnitude of the Japanese banking crisis became evident, some doubts about its superiority began to emerge. First, it is important to note that not all firms in Japan maintain long-term relations with their share and debt holders. If bank–firm relations, combined with stable shareholding, is an effective means of corporate governance, how come only a third to half of all listed firms in Japan

can be classified as affiliated with a bank-centred group and maintaining extremely stable debt and equity relations?⁵ Why is it that since the early 1980s many other firms in Japan have preferred to finance themselves through arm’s length transactions (in the stock market or with different banks), and to have fewer stable shareholders? This ‘revealed preference’ of Japanese firms and the diminishing importance of bank–firm ties is clearly evident in the two-decade-long trend decline in bank finance (see Table 1).

All this suggests that many Japanese firms did not find the system of bank finance combined with stable shareholding very satisfactory. One explanation for this phenomenon is provided by Weinstein and Yafeh (1998) who argue that the Japanese bank-centred system of finance and governance has two significant negative consequences. The first is that banks exert influence on the behaviour of client firms, and this influence, which is *not* restricted to periods of financial distress, is designed to serve the bank’s interests as a major lender, leading to non-profit maximizing behaviour of the firm. Banks induce clients to borrow more than profit maximization would warrant, and, in addition, banks

⁵ Companies affiliated with bank-centred corporate groups are the ones that are most typically associated with main bank finance and stable and concentrated ownership. However, because group affiliation is informal, any classification of companies into group-affiliated and unaffiliated would be tricky and inaccurate. Several sources attempt to do this according to the extent and stability of loans, equity, and personnel ties a firm maintains with its main bank as well as with stable shareholders within its bank-centred group. Estimates vary by rather wide margins, but are usually between a third and a half. Of course, many of the unaffiliated firms also rely on bank finance and stable ownership to a certain extent; see Weinstein and Yafeh (1995).

seem to influence client firms to adopt low-risk and low-return investment strategies, resulting in poor performance (low profitability and growth rates) of main-bank-dependent firms in comparison with 'independent' firms. Weinstein and Yafeh also show that the influence of banks within the Japanese system allows them to extract rents from firms that depend on them, although the liberalization of financial markets during the 1980s seems to have eroded some of the banks' monopoly power. A similar argument is made by Morck and Nakamura (1999a), who claim that assigning the task of corporate governance to banks, as has traditionally been done in Japan, does not always lead to maximization of firm value because banks as creditors have different objectives from banks as shareholders. For example, banks intervene in the operations of client firms if their cash flow or liquidity is low, but not necessarily when share-price performance is poor.⁶

There is more indirect evidence on the tendency of banks to enforce relatively conservative behaviour on their clients. Montalvo and Yafeh (1994) find that Japanese main-bank client firms invest more in imported technology than other firms, a feature which is consistent with the view that banks prefer low R&D expenditures (which are risky), and encourage firms to invest in imported technology instead.⁷ Hoshi *et al.* (1993) document the tendency of many (leading?) Japanese firms to depart from the traditional environment of bank finance and stable shareholding, and operate, instead, in a more 'Anglo-Saxon' (market-based) environment. Other authors (e.g. Allen, 1993; Carlin and Mayer, 1999) have argued (not necessarily in the Japanese context) that bank finance and governance is suitable for the financing of 'traditional' manufacturing industries, but is not appropriate for financing innovation. When the technology is novel and unknown, a large and liquid stock market with a 'diversity of opinions' is required to evaluate future prospects. This idea is supported by two recent studies documenting the tendency of innovative firms from

countries where banks dominate the financial system to favour (US) stock-market finance (and dispersed ownership); see Blass and Yafeh (1999) and Pagano *et al.* (1999).

The trends of the 1990s, as well as the notion that bank finance may not be suitable for the age of high technology, suggest that even if the Japanese system of corporate governance was adequate in the past, it may no longer be sufficient for the advanced Japanese economy. The macroeconomic recession and the banking crisis of the 1990s, to which we turn next, have reinforced this feeling.

V. THE BANKING CRISIS, THE RECESSION OF THE 1990S, AND THE CHANGING PATTERNS OF CORPORATE GOVERNANCE

Once the magnitude of the banking crisis in Japan became apparent, many authors expressed doubts about the effectiveness of Japanese banks in enforcing corporate governance. If banks are so good at monitoring the activities of their client firms, how come they cannot recover so many of their outstanding loans? Why did the banks finance investment in land- and real-estate-related projects, thus accelerating the rise in asset prices in Japan, which ended with the collapse of the 'bubble' in 1990?

Horiuchi (1998) is one of the most influential proponents of this view. He argues that the Japanese government protected the banks from competition, and guaranteed their survival through the 'convoy system' (according to which ailing banks were assisted by their stronger peers and were not allowed to go bankrupt). Moreover, *Amakudari* (the practice of government officials taking positions on retirement in private financial institutions) did not improve bank performance, nor were the salaries of bank executives tied to performance. All this, Horiuchi argues, has led to bad banking practices

⁶ The very nature of long-term ties between banks and their clients that may help solve problems of asymmetric information between the firm and its outside stakeholders (Hoshi *et al.*, 1991), endows banks with some monopoly power because the information they collect on client firms is private. See Rajan (1992) for a theoretical discussion of these issues.

⁷ This is not the explanation provided by Montalvo and Yafeh, who interpret the additional investment of bank clients in licensed foreign technology as evidence of fewer liquidity constraints. The term 'conservative' in this context is meant to convey the feeling that Japanese firms with close ties to banks tend not to be the most innovative leaders in their industries. For example, Toyota and Honda in the automobile industry or Sony in the electronics industry are all firms that do not maintain close ties with a main bank.

because banks simply did not care about taking excessive risks and financing poor investment projects. This view casts doubt on the ability of banks to act as major monitors of client firms in a poorly regulated and not very competitive environment.

Hoshi and Kashyap (1999) argue that the crisis in the Japanese banking system does not reflect moral hazard on behalf of the banks, but rather poor timing of the financial liberalization measures. For example, while companies became free to finance themselves in domestic and foreign equity and bond markets, banks were restricted in the scope of their activities, while private savings were still channelled to the banking system. Banks are not 'guilty' of wilful moral-hazardous behaviour but, Hoshi and Kashyap argue, will no longer be able to play such an important role in corporate governance once the reforms are complete. The authors provide evidence on the changing patterns of corporate finance, indicating that many of the large Japanese companies are now no more dependent on bank debt than their American counterparts (see Table 1 again). There is, therefore, in their view, little scope for the continuation of Japan's bank-centred system of corporate governance.

Sheard (2000) argues that the Japanese government encouraged banks to play an important role in corporate governance by actively supervising their activities. Now that regulation of the banking sector is changing, there is a possibility that banks will no longer be expected to play such an active role.

The on-going banking crisis has affected the Japanese bank-centred corporate governance system in other ways as well. One notable phenomenon is the wave of bank mergers in view of the prolonged recession. Sakura Bank, the main bank of the Mitsui group, is negotiating a merger with Sumitomo Bank. DKB, Fuyo, and IBJ are in the process of merging. Sanwa Bank has announced plans to merge with Tokai Bank and Asahi Bank. Securities and insurance companies are undergoing a wave of consolidation as well. What is particularly interesting is that these mergers blur the borders between the various

bank-centred groups. This is bound to have an effect on corporate governance as traditional shareholding and financing arrangements (main-bank ties) are undergoing dramatic changes. It will be interesting to see whether bank-firm ties will continue to exist once a merged bank serves as a main bank for two competing firms, something that so far has never happened in Japan.

Morck and Nakamura (1999b) go even further and argue that the Japanese system of bank-centred corporate governance is one of the *causes* of the current macroeconomic crisis in Japan. They argue that 'creditor-controlled firms are risk averse and therefore might excessively direct their capital investment towards the expansion of existing facilities, minor variations in product design, and other low risk, low return ventures' (p. 13). This, in their view, can lead to an 'old-fashioned Keynesian recession' with excessive capital expenditures and under-utilized productive capacity. Such views may well accelerate the pace of financial market reforms in Japan and help reduce the influence of banks on corporate governance.

VI. FUTURE PROSPECTS: CONVERGENCE?

The previous section suggested that the prolonged banking crisis could bring about changes to the Japanese practices of corporate governance, at least to some extent. And there are yet other forces pushing for change. Holding companies, which were banned by the American occupation forces after the Second World War, became legal again in Japan in 1998. Thus, holding companies could emerge as new players on the corporate governance scene, although they are unlikely to become very powerful.⁸

Some deregulation of the corporate pension market is also under way, so that in the future institutional investors may become important players in Japanese corporate finance and corporate governance. Sheard (2000), for example, believes that once these institutional investors no longer invest in bank

⁸ News articles on this issue seem to focus mostly on the possibility of financial holding companies that will control subsidiaries providing a variety of financial services. Holding companies controlling unrelated industrial companies are probably less likely to emerge, because the nature of benefits that could be derived from such a structure in a developed economy is unclear; see Khanna (2000).

deposits and life insurance companies, they may well become influential shareholders. In addition, American-style corporate governance mechanisms have begun to penetrate Japan. One notable example is the changing patterns of managerial compensation. Incentive schemes and managerial stock options have been gradually introduced ever since the legislation restricting their use was repealed in 1997. A few hostile takeover bids have recently taken place; one takeover target was the poorly performing *Shoei* group where bidders were local; in other cases, foreign firms were the ones making hostile takeover attempts. There are also some signs suggesting an imminent demise of 'life-time employment' practices, although so far changes seem to have been slower than might have been expected (see Genda and Rebeck in this issue). If labour markets are to become more active and movements of employees between firms more frequent, a more liquid market for senior managers may also develop, making managerial 'career concerns' a more salient feature of Japanese corporate governance. Moreover, if labour practices do change and long tenures of employees with firm-specific human capital become less common, then stable long-term equity ties, as well as long-term relations with a bank accompanied by bank assistance during financial distress, may all become less desirable.⁹ Finally, another force pushing for change is the ongoing economic slow-down which has made long-term cross-shareholding arrangements difficult to maintain, as firms in various degrees of financial difficulties are tempted to liquidate their holdings in other companies. So far, the sale of equity stakes held by corporations for long periods of time has not been a widespread phenomenon (Suzuki, 1998). Nevertheless, if the prolonged recession is to accelerate the trend of divesting of corporate shareholding, a more liquid trade in corporate equity may emerge, combined with less concentrated ownership. These changes, if they take place on a large enough scale,

may further enhance the transformation of corporate governance practices in Japan.

Even though there seems to be a feeling that a new style of corporate governance in Japan is about to emerge (as reflected, for example, in a large number of recent *Financial Times* articles on this subject), the changes that have taken place so far have been far from revolutionary. Hostile takeovers and managerial incentive schemes are still rare, while cross-shareholding arrangements are still common. Bank finance has remained dominant among smaller Japanese firms.¹⁰ In addition, there are forces that may make the transition to 'American-style' corporate governance slow and difficult. For example, if Japanese saving ratios continue to be high and a large portion of these savings is to be held in the form of bank deposits even after the 'Big Bang' deregulation reforms are complete, then a stock-market-based system of corporate governance is unlikely to develop.¹¹ If banks manage to recover from their current malaise, perhaps through diversification into financial activities such as underwriting, then they may well remain powerful players on the Japanese corporate governance scene.¹²

Assuming some changes in the direction of a more market-based system of corporate governance will eventually take place in spite of these difficulties, is all this good or bad news? Hoshi (1997) summarizes some of the main benefits (and costs) of the existing Japanese system of corporate governance. He emphasizes benefits such as the ability of the system to function even in the absence of developed securities markets. He also points out that the Japanese style of corporate governance prevents unnecessary bankruptcies by facilitating renegotiation with a small number of creditors and investors. In addition, this style of corporate governance induces stability and therefore encourages the accumulation of firm-specific knowledge and capital by employees, suppliers,

⁹ Aoki (1988) points out that the various characteristics of the Japanese firm, most notably its human resource management practices and its financing arrangements, are all part of an interrelated system of attributes. For example, when employees have a significant amount of firm-specific human capital, then cross-shareholding arrangements and main bank ties may be a mechanism that helps hedge against risks to the firm and to the value of the firm-specific skills of its employees.

¹⁰ The decline in bank finance documented in Table 1 has characterized larger Japanese companies; there is no comparable decline in the case of small firms; see Hoshi and Kashyap (1999).

¹¹ Bank deposits may be especially appealing to risk-averse consumers in recession periods.

¹² Hamao and Hoshi (2000) document the recent entry of Japanese banks into the underwriting market, following the removal of restrictions that prohibited such activities until the mid-1990s.

and financial institutions. Finally, Japanese style corporate governance facilitates the implementation of government policy, assuming it is beneficial.

All these benefits may have served Japan well in the past. But the prolonged recession suggests that this may no longer be the case. Bank-induced investment in physical capital is no longer as profitable as it used to be. Bank-induced 'conservatism' seems to have run its course as well. Instead, new financial institutions capable of providing finance and support for innovative sectors (e.g. venture capital firms) may be needed. Similarly, stability and firm-specific capital may no longer be appropriate in the third millennium. All this is evident in the 'revealed preference' of leading Japanese companies, which are changing their financing patterns towards more market-based finance, leaving their long relationships with banks (and even with employees) behind. No wonder that corporate governance mechanisms are changing as well, albeit very gradually. Eventually, all this will probably amount to a transformation of the institu-

tions of the Japanese economy into a form that is economically efficient for a country on the technological frontier.

By way of conclusion, it is perhaps useful to recall that the present bank-centred system of corporate governance emerged during the 1950s as the outcome of the economic environment of the early post-war era. It seems that new institutions, which are more suitable to the present economic environment, are about to emerge, even if the transition process is going to be slow. Admittedly, this new set of institutions is likely to require some changes in the legal infrastructure: laws providing a suitable framework for a market-based system of corporate governance (e.g. takeover laws, laws providing adequate protection for minority shareholders, etc.) will probably have to be created or modified.¹³ Yet in the long run, the new methods of corporate governance are likely to help the Japanese economy recover from the current slow-down and maintain the global competitiveness of Japanese companies.

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¹³ La Porta *et al.* (1998) classify the Japanese legal system as belonging to the German tradition, and argue that legal systems based on the British common law tradition are the most suitable ones for market finance and governance. Nevertheless, Japanese law seems to provide fairly high protection to shareholders (including minority shareholders—see their Table 2) in comparison with the entire group of countries whose legal systems are of German origin. This suggests that while some changes in the Japanese legal environment are probably going to be required in order to accommodate a more market-oriented form of corporate governance, these changes appear to be less radical than what would be needed in most other countries.

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