

## **The Dilemma of Japan's Corporate Governance**

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### **Abstract**

The internal balance of power sustained by main banks has been a pillar of Japanese corporate governance for decades. Accumulated earnings allow large Japanese firms to remain free from the control of main banks and cause a noticeable change in their corporate governance landscape. In light of the expanding international capital market, Japanese firms are urged to adopt Anglo-American corporate governance standards, which require outside directorship and transparency. However, it is feared that such a standard will undermine the corporate culture of the community firm, with which employees' career paths and social worlds are integrated. The unwillingness to accept this governance standard amidst the declining role of major banks contributes to a governance vacuum. The norms of organizational loyalty may help prevent the agency problem caused by the imbalance of power before a new equilibrium can be found. However, Japanese corporate governance is still vulnerable to earnings management, strategic traps, imprudent managerial decisions and other mismanagement. It has been proven once before that this can harm Japanese financial institutions.

**Keywords:** Japan, Economic Governance, Corporate Governance, Balance of Power

## 1. Introduction

The great success of the Japanese economy in the 1970s and 1980s prompted the question as to whether the Japanese corporate governance model deserved to be considered as an alternative to the Anglo-American model. Some scholars inclined to believe it did (Porter, 1996; Shleifer and Vishny, 1997; Whitley, 1999). The interest in the capability and governance system of Japanese firms can be dated back to the era of post World War II when the integration of firm skills across work functions<sup>1</sup> had been promoted and became their business strength (World Bank, 1993; Whitley, 1999). The role of the government in the Japanese firm's capability has also been noticed. The Japanese government provided financial amid other support to companies through the network of financial institutions, known as the "convoy" system, of which the main bank played the central role. Along with support, the bureaucracy also coerced the firms to comply with "administrative guidance" to ensure the national interest (Singh and Zammit, 2006: 223). The convoy system empowered the main bank to play a critical role in monitoring and partly disciplining Japanese firms in the past. The success of large Japanese firms and their internal capital accumulation since the 1960s has mitigated their financial dependence on local financial institutions, which then had to resort to other risky business transactions, including involvement with the securities and price-inflated real estate business. The role of the main bank<sup>2</sup>, which had been the strong pillar of Japanese corporate governance, has gradually disappeared (Aoki, 2001: 343). In this article, the definition of corporate governance is based upon the Trimiti Theory (Chaithanakij, 2006a), which was adapted from Zingales (1998), and defined as "the balance of authoritative capability and control power under cultural consensus that shapes the bargaining over resource allocation and quasi-rents generated by the firm."<sup>3</sup>

<sup>1</sup> E.g. design, production, maintenance, and logistic.

<sup>2</sup> Each large Japanese firm maintains a long-term relationship with one large bank, known as its main bank. The main bank is normally a large commercial bank, which has special roles to act as an outside monitoring institution beyond a financial service provider. It is found in Japan and Germany. The role of Japanese main banks as a monitoring agent lies in its capacity of bail-out or liquidation of trouble-laden firms. The role was indirectly supported by the central bank and other governmental agencies through the convoy system.

<sup>3</sup> Based on this concept, authoritative capability is involved with the development and deployment with firm specific assets in an effort to earn economic rent. However along this line, there is a chance of misuse or abuse of managerial authority. Firms need control power, another countervailing mechanism in place in which to maintain checks and balances. The right interaction between authoritative capability and control power largely determines the firm's success and depends a great deal on cultural consensus, which determines what behaviors are allowed and expected.

Meanwhile, national economic governance is defined as “the balance of institutional influence that shapes that pattern of resource allocation and economic development of the nation.”<sup>4</sup> There were failures among the successful firms which sought bail-outs by the government through the convoy system, particularly by the main bank. The convoy system might have provided a faulty safety net in that it possibly created a moral hazard and misled people away from their concerns over the soundness of an individual bank's management (Horiuchi, 2001: 92-3). The burst of the economic bubble in early 1999 that caused widespread bankruptcy in real estate firms and financial institutions has put the Japanese economy in the longest stagnation since World War II. Several corporate and governmental scandals were disclosed. There is evidence indicating that Japanese government interventions have largely been determined by parochial politics in which large declining sectors exert disproportionate influence (Noland, 2007: 17). The strong criticism from the media against alleged favoritism has brought the convoy system and governmental interference to a halt, along with the declining role of the main bank within the corporate governance landscape (Aoki, 2001: 343; Okumura, 2004: 3; Freedman, 2007: 39).

The long economic stagnation has come at a severe cost to Japanese employment. The traditional lifetime employment has taken a severe blow and it has recently been found to be shrinking (Robinson and Shimizu, 2006). The expansion of the international capital market has also been a prominent feature of this new landscape. Huge short and long term capital flows are available for all countries. It provides a new hope for the Japanese government to revive its economy. Foreign interest in the Japanese stock market has been widely witnessed. For example, it was found that foreigners' investments made a record high of trading value on the Tokyo Stock Exchange in the fiscal year 1998 (Ito and Patrick, 2005: 10). The Japanese stock market has shown signs of revival. The shareholding by individuals and foreigners in

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<sup>4</sup> Several work in the pasts - e.g. Vitols (1995), Dixit (2001), and Boyer (2005) - directly dealt with economic governance but do not provide the definition of economic governance. By overlooking the definition, one actually can save some effort debating the boundary of the unit under analysis - whether it should be society, country, nation or just system. Although these three words contain minor differences of meaning, in this article the words “society” “country” and “nation.” are used interchangeably because such simplification does not seem to pose any threat to the validity of my argument in this article. Moreover, I define economic governance differently from the general meaning of “governance” as provided in the United Nation Development Program (UNDP)'s and other public agencies' websites, e.g. the Canadian Centre for Philanthropy, which usually defines “governance” in a broader context. There are at least seven ways of defining “governance”- e.g. capability, interactive process, manner of power exercise (Siriprachai, 2007), but none of them provide any analytical perspectives.

an arms-length manner has continually increased and it recently accounted for close to 50% of total investments (Aoki, 2005). In an attempt to seize upon this opportunity, the Japanese government wanted to create more confidence in legal protections. It revised and passed a new law in 2002 in order to encourage the improvement of corporate governance in Japanese listed firms by the adoption of outside directors to the boards of directors, appointments which had been traditionally reserved as a reward for successful employees. The initiative has met with strong reaction from many firms (Buchanan, 2007).

The analysis in this paper will show that the reluctance of many Japanese firms to adopt outside directors amidst the waning influence of the main bank and the declining role of permanent employees is likely to create an unprecedented governance vacuum and subsequent exposure to the opportunism of high-level management. It also intends to show that some countries' corporate governance systems, particularly in Japan, may not be completely understood without incorporating perspectives of wider national economic governance<sup>5</sup>.

Section 2 makes the argument that corporate governance centers on the internal balance of power. The balance is delicate under the influence of the country's economic governance. Therefore, it is essential to understanding the national economic governance system. A framework by which to pursue this understanding is proposed in Section 3. Within the proposed framework, Japanese economic governance is analyzed in Section 4. The Japanese corporate governance system is then analyzed and its linkage to the country's economic governance is shown in Section 5. Major issues are briefed and their implications are drawn in Section 6. The conclusion of the research is provided in Section 7.

## **2. Internal Balance of Power as the Determinant of Corporate Governance**

There are several arguments claiming that legal and market institutions are the determinants of corporate governance (La Porta et al., 1998; Jensen and Ruback, 1983) because they help prevent conspiracy among actors inside the firm (Thiele,

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<sup>5</sup> The incorporation of the Trimiti national economic governance concept in this article is intended to help in building a complete picture of Japanese corporate governance dynamics. Its argument is kept to a minimum, just sufficient to convey the idea. It is not intended to serve as supporting evidence for any conclusion. For complete content, please see Chaithanakij (2007b). The Trimiti model is later found applicable for establishing a corruption theory (Chaithanakij, 2007c) and explaining the governance of industrial clusters (Chaithanakij, 2008).

2007). While there is evidence showing the effects of institutions on corporate governance, there is additional evidence to disprove that external institutions are sufficient determinants. Some firms in emerging economies appear to have some power to preclude the expropriation of minority shareholders even if legal protection is inadequate (Mitton, 2002; Klapper and Love, 2003; Chaithanakij, 2006b). Meanwhile, several firms in the U.S. and U.K which have always been considered as having strong legal institutions may have poor corporate governance (Krawiec, 2003; Anderson, and Reeb, 2004; Arcot and Bruno, 2005; Lasfer, 2006; Tirole, 2006: 16-20). There is mixed evidence for the claim that the effects of external markets act as the enhancer of firm efficiency (Agrawal and Jaffe, 2002; Gillan, 2006). Market competition helps remove the cozy cash cushion enjoyed by monopolists and has beneficial effects on managerial incentives, but it may also create perverse effects. Thus, competition will never substitute for proper governance structures (Tirole, 2006: 29).

Meanwhile, many arguments by legal scholars strongly support the claim that corporate governance is the result of the voluntary acts of internal actors (Cadbury, 1992; Veasey, 2001; Coffee, 2001; Rock and Wachter, 2001). Many provisions in country-level investor protection laws may not be binding because firms have flexibility in their corporate charters and bylaws to either choose to “opt-out” and decline specific provisions or adopt any provisions not listed in their legal code (Easterbrook and Fischel, 1991; Black and Gilson, 1998). Corporate Charters usually specify the procedures for selecting directors and officers, their power and the range of decisions that they may make without consulting the stockholders in very broad terms (Milgrom and Roberts, 1992). There are some empirical evidence that suggests that private enforcement tools are often more effective than public tools. However, some public enforcement is necessary, and private enforcement mechanisms often require public laws in order to function (Berglöf and Claessens, 2006). I have argued that the Trimiti theoretical framework, which relies on the internal balance of power as a determinant, has been proven for its validity in explaining the success and failure of U.S., German and Thai corporate governance (Chaithanakij, 2006a, 2006b, 2007a)<sup>6</sup>.

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<sup>6</sup> Based on these studies, there is a balance of power between management and labor in German firms whereas U.S. management and Board of Directors face possible class action lawsuits brought about by stockholders supported by strict legal liability systems. Meanwhile, concentrated ownership of Thai listed firms does not allow any forms of countervailing power. Besides, the legal protection of property rights in Thailand is also weak.

Since there is no evidence indicating otherwise, we can argue that Japanese corporate governance still rests on the internal balance of power. The typical characteristic of the balance of power functioning in other advanced economies is evidenced by executive replacement, either through the board's decision or shareholder's resolutions when a firm performs poorly<sup>7</sup> (Tirole, 2006: 26). However, the external driving forces of governance can be different, particularly from the U.S. counterpart. While American corporate governance is very much driven by the high efficiency of the U.S. stock markets, Japanese corporate governance is driven by two related sources of power: the main bank and the employee. The former is much involved with the country's economic governance system, elaborated in the following section.

### **3. The Concept of the National Economic Governance System<sup>8</sup>**

There have been several attempts to establish the concept of national economic governance to explain economic structure and performance (Whitley, 1999; Hall and Soskice, 2001; Boyer, 2005) but none seems able to provide a strong theoretical core in which to explain the different advancement of economies across countries (Foss, 1999; Kristensen, 1999). Figure 1 shows the analytical framework of a national economic governance system, called Macro Trimiti<sup>9</sup> (Chaithanakij, 2007b), which is strongly supported by the inductive result in response to Dixon's (2003) four cultural solidarities, namely hierarchist, enclavist, fatalist and individualist. From this framework, each country's economic structure is under the influence of four major types and five sub-types of institutions generally accepted for societal analysis (Acemoglu and Johnson, 2003; Roland, 2004): social logic system (Bourdieu, 1990: 125) or ground rules (Pistor, 2005); social institutions, which may appear in cognitive forms such as customs (Aoki, 2001; Greif, 2005) or vertical and horizontal organizations such as civil societies (Evans, 1995; Bloom, Steven, and Weston, 2004); legal institutions (La Porta et al., 1998, 1999; Dixit, 2001; Pistor, 2005); market institutions (Hayek, 1945: 524-5; 1976: 65; Coase, 1991: 55), which provide signals of price, quality, volume (Spence, 1973; Stiglitz, 1994: 168; White,

<sup>7</sup> Though executive replacement by SEC or a public prosecutor is legally possible, it is rare and unheard of. Thus, I claim that legal institutions have only a minimal direct influence in the matter.

<sup>8</sup> The full content is presented in Chaithanakij (2007b), which articulates that pro-society values is a major, if not the most influential, underlying force of societal institutions.

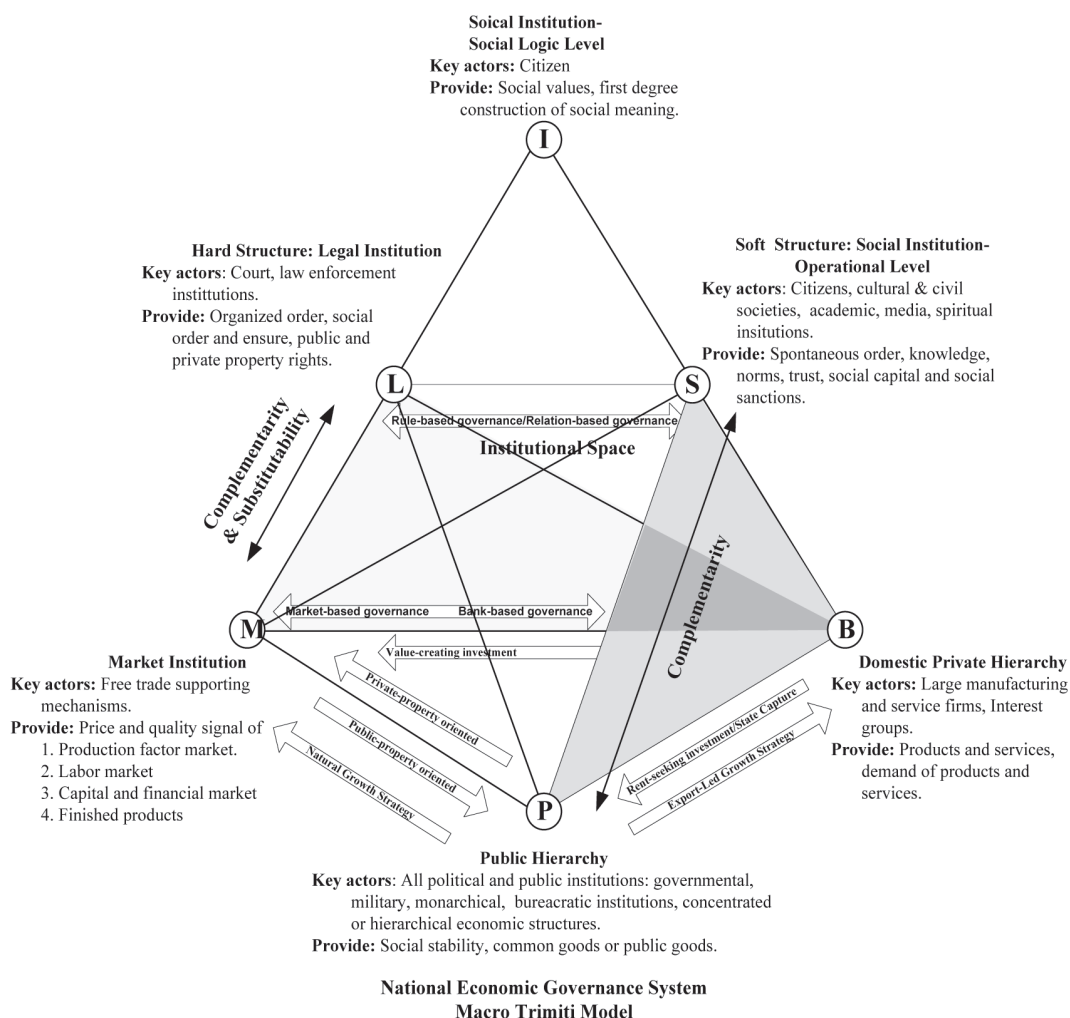
<sup>9</sup> Named after the Trimiti corporate governance theory (Chaithanakij, 2006a), which shares the balance-of-power concept and similarly three-major sources of power.

2002) as well as support by the system for repeated transactions (Furubotn and Richter, 2005: 314) and disciplined pluralism (Kay, 2005: 18); private hierarchies, which allow the accumulation of productive capabilities (Landau, 2003), such as Japanese keiretsu groups (Boltho, 2001: 122; Buchanan, 2007: 32-3); and public hierarchies, which refers to bureaucratic and governmental organizations. Bureaucratic and governmental organizations provide the basic protections of property rights and, in some cases, subsidize national technological development for chosen private sectors (Von Tunzelmann, 2003) which is widely evident in North Eastern Asian economies (Martin, 2001: 98; Ahrens, 2002; Breznitz, 2005a), though transparency often becomes the issue that is called to attention (Belloc and Pagano, 2005)<sup>10</sup>.

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<sup>10</sup> All forms of government support require a judgment, which is more than often not difficult to prove in its fairness for all parties concerned. This ambiguity naturally invites an abuse of power and the possibility of corruption.

**Figure 1** Trimiti Economic Governance Model<sup>11</sup>



<sup>11</sup> The Trimiti Economic Governance Model was created by Surasak Chaithanakij (2007b) in order to present a national economic governance model. The four institutions – legal, market, social and hierarchy - are deduced results in response to Dixon's (2003) four social solidarities. Bourdieu's concept (1990) of the social logic system (I) provides the foundation for social logic institutions, which are claimed to underpin the developmental path of all other institutions. The role of the private hierarchy is separate from that of the public hierarchy (P) in order to reflect the increasing role of firms as a source of national capability. A certain point on the MBL plane denotes U.S. economic governance whereas a certain point on the PBS plane denotes the Japanese economic governance.



I take the view of society as a composite of six interactive institutions in contrast to the four institutions proposed by Boyer (2005). My framework shows more segregation of institutions than the framework of Hollingsworth and Boyer (1997) and Boyer (2005) by two sub-categories – social logic and legal institutions, which are important for an extensive explanation – e.g. institutional persistency and the main characteristic of Anglo-American capitalism respectively. In this framework I strongly assume the balance of institutional influence as the necessary condition for equilibrium (March and Olsen, 1995) in order to fulfill the objectives of economic development, e.g. growth, income distribution, welfare<sup>12</sup>. Though the distribution of power among institutions and their modes of coordination proposed by Hollingsworth and Boyer (1997), this may help to explain the different characteristics among forms of capitalism, although they do not explain how each form of economy functions.

In one aspect, an economy functions similarly to a production system, in that all of its units must operate in concert. However, it may consist of many institutions, some of which seek to expand their influence. The economy should be considered as having governance only if the balance of influence among institutions can be such that it can keep the economy on the course chosen by its majority constituents. Though the coordination quality among institutions is important for the smooth functioning of society as proposed by Hollingsworth and Boyer, the balance of influence among institutions is more important. This balance is necessary for preventing any attempt by any institution to dominate others, which may cause disruptions in its course to prosperity. Within this perspective, each of the societal institutions provides certain governance elements to society in order to continuously function, for the benefit of its constituents and for continuing harmony.

Under this framework, each of the institutions plays a different role in promoting governance. The social logic institutions provide informal general guidance. The legal institution stipulates formal rules whereas the social institution renders informal rules. The market institution facilitates the exchange mechanism and

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<sup>12</sup> For example, the liberal market governance of Anglo-American economies require a balance between the role of the market and fair competition rules supported by strong legal protections whereas coordinated market governance like those of Germany and Japan require a balance between a strong cultural institution and an active role of public hierarchies in order to guide government officials in determining how resources are allocated. This means that the government officials of liberal market governance tend to let the market determine resource allocation and restrain them from interfering in the functioning of economies. The complete concept of economic governance can be found in Chaithanakij (2007b).

efficiency discipline. The public hierarchy delivers most of the public goods whereas the private hierarchy produces most of the private goods for internal exchange or export to other societies. The market competition, internally and externally, puts pressure on the public as well as private hierarchies to accumulate productive capability and effectively and efficiently deploy it for production. Each society maintains different institutional combinations; some may find the right balance leading to economic governance while others may not. It is impossible to completely characterize this balance with the present evidence. However, two patterns of economic governance systems have emerged for comparative analysis: the market-oriented system and the hierarchy-oriented system.

The U.S. economy may represent the society that leans toward the end of a market-oriented economic governance system (represented by MBL plain in Figure 1) whereas Japan, leans toward the end of the hierarchy-oriented economic governance system (represented by PBS plain in Figure 1). This kind of comparison has appeared on several occasions since Hall and Soskice's work (2001) though most of these comparisons have been shown to be without strong theoretical support. U.S. economic governance relies on a fair balance among market institutions, a private hierarchy and a strong legal institution as represented by the MBL. Meanwhile, the Japanese economy tends to rely on a different balance of institutional influence. The following section will provide the characteristics and dynamics of Japanese economic governance in detail.

## **4. Japanese Economic Governance: A System in Transition**

### **4.1 General Characteristics**

The Japanese economic system is characterized as coordinated capitalism by Hall and Soskice (2001). Business firms tend to rely more on bank financing or financial markets than on the stock market. The Japanese firm, the most important actor in the Japanese economy has long been described as a social institution whose mission extends well beyond mere profit or stock value maximization (Berglof and Perroti, 1994). The Japanese firm can be categorized into *keiretsu* or *non-keiretsu*. Firms that are tied as a group of companies known as *keiretsu* usually have a cross-shareholding, director interlocking, and trade and lending network. Firms in the same *keiretsu* usually share the same main bank. When one member of the *keiretsu* is in trouble, the main bank or other stronger members are supposed to bail-out the one that fails. However intervention by bail-out of other firm members waxes and wanes with temporal fluctuations in *keiretsu* cohesion

(Lincoln and Gerlach, 2005: 287). After a lengthening period of economic stagnation, the influence of *keiretsu* is declining. There have been a number of cases in which there was no bail-out (Higgins, 2004: 99) and firm liquidation ensued (Aoki, 2001)<sup>13</sup>. Though such strong network relationships provide a faulty safety net for *keiretsu* members and helped them sail through troubled waters in the past, it makes some firms immune and poorly adaptive to mounting pressures from World markets.

#### 4.2 Former Strong Intervention by Government

In contrast to U.S. economic governance, in which governments have been relatively reluctant to intervene unless the economy is in crisis or in imminent danger or crisis, Japanese corporate environments from the end of the World War II until the long stagnation have been tightly shaped by government regulators who institute industrial policies for the private sector (Katz, 1998). Government interference is characterized by Ahrens (2002: 463) as the Flexible Market-enhancing Governance Structure (MEGS), which require the legitimacy transparency of government to promote demand-motivated research and development. From the 1950s to 1980s, Japanese bureaucracy showed an apparent continuity of supporting industries, which were characterized as high future income elasticity of demand<sup>14</sup>, a high potential for productivity growth and, increasingly, a high use of advanced technologies (Itoh et al., 1988).

The Japanese government also strictly regulated the banking industry in order to assure rents to individual banks according to their ranking. It also intervened, if necessary, to bail out financially distressed banks or arrange for their acquisition by healthier banks (Ito and Patrick, 2005: 2-3). Though the government agencies – the Ministry of Justice and the Bank of Japan – provided supports including soft loans to ailing banks and bailed out financially distressed banks and other financial firms (known as the convoy system), they also punished failed management

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<sup>13</sup> A bail-out is a mild form of influential exertion. According to Aoki (2001), the threat from the main bank is to liquidate the firm's assets and lay-off all employees and plays a key part in disciplining failing firms. In this respect, the bail-out by *keiretsu* members may be far less influential than the dual roles of bail-out and threat of asset liquidation played by the main bank. Thus, the role of *keiretsu* members in Japanese corporate governance is completely ignored in this article. Meanwhile there is the competing argument that international trade and competition might be a major driver of the waning role of Japanese main banks. Such an argument is unlikely to prevail because the higher efficiency of Japanese production systems can absorb most of the adverse impacts caused by competition in international product markets.

<sup>14</sup> In other words, the goods for the high-income people.

by replacing it with their own officers or other trusted bankers. This provided a credible discipline on the management of financial and non-financial firms (Aoki, 2001: 340).

Bureaucratic control once worked through the system of “administrative guidance” instead of formal legislation. This required a certain discretion and autonomy on the part of the senior levels of civil service, which could act as the guardian of national interest (Singh and Zammit, 2006: 223) and its Ministry of Finance applied pressure through affiliated companies, suppliers, acquaintances, retired officials serving as directors in the firm, and bank boards. Until recently, a variety of organizations in Japan operated in the so-called convoy system, where businesses were protected by the government not unlike a warship protecting a convoy of ships (Higgins, 2004: 98-101).

### **4.3 The Balance of Institutional Influences**

Besides having a mission of extending beyond profit maximization (Berglöf and Perroti, 1994), Japanese firms tend to have a close system of human resources. The concept of community firms and corporate hegemony are predominant in the Japanese corporate managerial system. These concepts are supported by internalism, which is comprised of lifetime employment for regular employees; pay biased towards seniority and a reliance on internal promotion or internal-market recruitment (Okuno-Fujiwara, 1999: 272; Buchanan, 2007). The employment security has been the cornerstone of the Japanese economy and the rationale for governmental support provided to its private sectors. Meanwhile the consensus-based culture has been dominated by the decision-making process in Japanese companies (Higgins, 2004: 109). Before decisions were made, widespread consultations (*nemiwashi*) became the norm. This allowed responsibility to be shared broadly, as well as rewards. Rapid responses might be difficult but implementation was highly effective once a decision was made (Freedman, 2007: 26). “Good faith and fairness” are also the norms governing relationships in Japan, partly held as a substitution for formal contracts (Kobayashi, 2006: 117-8). Social institutions in Japan do not exert their influence through the formal organizations of civil societies like in the West. Instead, they are embedded in the people’s way of life and shown in the subtle influence in their decision-making processes.

Within this evidence, it is safe to argue that Japanese economic governance relies on complementarity of the three pillars – private hierarchy, public hierarchy and social institutions – which are denoted by a certain point on the PBS plain in Figure 1. The form of coordinated markets have been adopted in Japan in order to restrain the

uncertainty tied to liberal market institutions (White, 2002: 7) and allows the private hierarchy to gain strength and accumulate capability. The system was in balance and it worked well. Government protection combined with cheap funds encouraged fast and steady industrial development (Freedman, 2007: 24). Japanese corporate governance has been integrated into its larger economic governance system.

Analysis under the Macro Trimiti framework indicates that when the Japanese government allows the capital market to take a larger role in its economy, it apparently fails to convince the private sectors to move in the same direction which causes an institutional imbalance. The social institutions of Japanese society are apparently too obstinate to accept the Western standard of corporate governance. However, Japanese social institutions may not be the only cause which impedes change. It appears that the private hierarchy may have won its fight over adapting to a new balance.

## **5. The Dilemma of Japanese Corporate Governance System**

Japanese corporate governance has been very much exposed to the influence of its national economic governance system. The impact can be distinguished particularly from a firm's objective and its business strategy.

### **5.1 Objective of Japanese Firms**

There has been an increasing amount of evidence indicating that Japanese firms have been targeting for long-term profits (Porter, 1996). Whereas Japanese firms lack focus on current performance, one of their main objectives was to provide steadily growing benefits to its permanent employees (Aoki, 2005). The traditional policy of "retain and reinvest" had been widely distinguished (Lazonick, 2002: 227). From the 1990s until 2002, whereas the U.S. and U.K. firms demanded shorter-term returns, Japanese and German family companies remained satisfied with far longer-term returns and had scarcely converged to the U.S. model of strategic planning and hardly adopted the financial instrument of discounted cash-flow methods for financial decisions (Carr, 2005). The objective of firm's long-term profits is compatible with an economic governance system that includes firm such as social institutions (Berglöf and Perroti, 1994), whose philosophy may not suit short-termism and arms-length relationships as predominant traditions of the stock market. This Japanese business model worked quite well in the past for industries of relatively low and moderate technology with stable market demand, but it does not seem to go hand in hand with rapid change in high technology sectors and those with uncertain business conditions.

## 5.2 Japanese Employee, Business Strategy and Corporate Governance

The Japanese business strategy of cost leadership is found to be compatible with high productivity. Top Japanese firms in autos, steel, machines tools and consumer electronics demonstrate much higher productivity than their U.S. and European counterparts, beating world-class productivity benchmarks by 20%. (Robinson and Shimizu, 2006: 70). Japanese firms have extremely high productivity compared to other major OECD countries (Ito and Patrick, 2005: 4). Undoubtedly cost leadership is found to be the dominant strategy mostly adopted by Japanese firms (Song et al., 2002; Allen et al., 2006) among three strategies under Porter's (1985) business strategic typology<sup>15</sup>.

It is quite convincing that the marked superiority of Japanese productivity is ascribed to the human resource system, in which life-time employment and internalism are predominant. A recent survey shows continued commitment to the long-term employment policy (Miyajima, 2005). To encourage the highest participation of employees in order to improve productivity, Japanese firms have allowed employees to have an expansive role in low and middle- management levels. The joint labor-management consultation session is such a typical role (Jackson, 2005: 62). Under this system, managerial authority is balanced to a certain extent by the employee. The slow employment adjustment in Japanese firms (Abe, 2002) and moderate executive compensation is naturally a result (Freedman, 2007: 32). The convoy system supported by the government through main banks was intended to provide employment security, which in turn encouraged total devotion by employees. Vitols (1995) suggests that the regulation of labor markets is the key factor influencing company's choices between price and quality-competitive strategies.

## 5.3 Recent Developments

During the early years of the burst of the bubble economy which was followed by long economic stagnation, the Japanese government rushed to bail out the failing financial institutes during the late 1980s and early 1990s. The bank bail-out was criticized as favoritism. More scandals, both in the Ministry of Finance and the banks were found. The convoy system was kept at bay. The Bank of Japan and the Ministry of Finance have had to keep a distance from banks and securities companies (Aoki, 2001: 343). Four financial institutions were left bankrupt and a credit crunch ensued. The role of main banks as a countervailing power to management

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<sup>15</sup> Cost leadership, differentiation and focus are the three generic strategies categorized by Porter (1985).

in the Japanese corporate governance landscape has been found to be in steady decline (Okumura, 2004: 3). The corporate scandals in the 1990s led to a general consensus with the principle ministries involved that corporate governance reform was necessary. The Japanese government introduced the Committees System in 2002, as a formal governance option in order to promote corporate governance for large companies. The system rests on the fundamental concepts that a degree of supervision by external directors is necessary for good governance and that supervision should be separated from execution to enhance objectivity. The government initiative drew a strong reaction from *Keidanren*, the Japanese Business Federation as well as several incumbent managers. The social underpinnings of the community firm and the corporate hegemony in Japanese firms proved too strong. Thus, changes to the Committees System are expected to be marginal (Buchanan, 2007).

To allow outside directors on to boards will definitely send a strong signal to all employees that the firm is departing from the once shared-belief of internalism and lifetime employment. This action will mark the acceptance of the influence of stock markets on the internal affairs of firms. This clearly implies an on-going erosion of internalism and lifetime employment. Obviously, it is not helpful to improving the morale of employees. In fact, in exchange for gaining a good reputation by complying with the code of corporate governance, firms may suffer losses in morale and productivity.

## **6. Discussion: Balance of Power as the Risk Management System**

Balance of power is a necessary condition of corporate governance, which facilitates an effective risk management system in firms. When conditions are undermined, firms are left vulnerable to excessive risks, either with or without management's awareness.

The declining role of the central bank, which once used to be an effective control mechanism for firms (Aoki, 2001: 331-2), has caused an unprecedented risk in the Japanese corporate governance landscape by knocking the high-level corporate power structure out of balance. Mark Roe (2002, 2003) shows that the explanatory power of the law can only be limited. He decomposes managerial agency costs into two categories: (1) the first is associated with "private benefits" that managers can try to appropriate in accordance with opportunism; (2) the second is linked to managerial errors and frauds, based on the ability of managers to exploit investment opportunities "in the best interest of shareholders". If the law is able to efficiently reduce the first category of costs, then it is revealed as incapable of eliminating other costs. The behaviors associated with the first category of risk can be easily noticed by a loyal



employee, so they are unlikely to pose a threat to the Japanese firm. The second category is more sophisticated in nature because it is involved with numerous assumptions that require judgments. In the past, the main bank, with its financial expertise and knowledge of the firm, had the capability to function as the countervailing power to minimize this sophisticated kind of risk whereas the employee may not have had this capability. However, it becomes clear that Japanese corporate governance is losing as the role of the main bank.

A recent study on Japanese firms exposed to capital market pressure tends to support Roe's argument on the second category of risks. The recent empirics indicates that strong employee participation via labor-management councils had no positive or negative impact on information disclosure and shareholder rights, and had a positive effect on board reforms (Miyajima, 2005). This implies that Japanese employees may be incapable or unwilling to take an active role in deterring unethical activities, such as earnings management and dubious investment, as long as the activities do not show clear evidence or an immediate threat to the employee's interest, although they may do this to outside shareholders' interests or firms in the long term.

Moreover, the countervailing power of the Japanese employee may be in question due to the change in the managerial culture and shrinking permanent employment. There is research which indicates that decision making in Japanese firm becomes more top-down than middle--down as well as less hierarchical with fewer levels of management. From 1995-2005, the number of regular employees decreased by 4.1 million, while temporary employees in various categories increased by 6.5 million. Many Japanese firms still commit to the permanent employment system but the core has actually shrunk (Robinson and Shimizu, 2006).

Japanese employees may have strong loyalties toward firms. However, a culture of loyalty might not help in preventing or disclosing potential fraud at all within the Japanese context. Scandals at the largest brokerage house, Nomura Securities, and at one of the major banks at that time, Dai-ichi Kangyo, in late 1995 and early 1996 would be unthinkable for the firms that prioritized corporate loyalty. It was found that a basic "protection racket" was transferring funds to the *yakuza* (organized crime) in the form of loans never intended to be repaid and stock purchases with no downside risk (losses were made good by the brokers) (Freedman, 2007: 39). Chikudate (2002: 304) posits that the socialization for organizational loyalty is a two-edged sword. Socialization, cultural leadership and other techniques of human resource development used to be the key managerial techniques by which to induce the loyalty and productivity of the Japanese employee. However, this can turn out to be a double-edged sword of disciplinary power in that managers could become mundane thinkers.



In this respect, corporate culture may facilitate the slide into collective myopia and increase the potential for unethical activities.

The recent Japanese corporate code reform in 2002 also made firms choose between two options of board structures: the American-type committee system and a modified traditional system with a semi-independent statutory auditor's board. The amendment was combined with a shift in securities regulation, shareholder activism, and the notion of lifetime employment. The changes marked the adoption of an optional Anglo-American standard of transparency as well as formalization of the Japanese norm. However, the new concepts of corporate governance appear incompatible with Japanese cultural values of hierarchy and collectivism. The initiative has drawn a strong reaction from Keidanren, the Japanese Business Federation (Buchanan, 2007).

Even if the Japanese firm chooses to comply with the new code, the outside directors, unfamiliar with the firm's environment may not completely substitute for the departing role of the main banks, which have accumulated knowledge on these firms for decades. Meanwhile, since corporate governance is of the internal balance of power, the recent improvement in legal protection and enforcement in 2002 (Buchanan, 2007) may induce the appearance of more cooperation from Japanese managers, but, it can hardly catch the reality of the internal power imbalance soon enough. A recent study indicates that the out of court restructurings ending in 2005 tended to fail to gain the trust of the market because of procrastination in implementing fundamental solutions. Without their party's intervention, no fundamental changes can be expected from the restructuring (Inoue et al., 2007) indicating that the Japanese firm can not be expected to change easily. It is likely that the more "outside" the directors are, the less likely they are to have adequate access to information and thus, their effectiveness may be compromised (Sarra and Nakahigashi, 2002: 330).

The decreasing role of main banks in Japanese firms has started to seclude the firm's power structure from its economic governance system. Meanwhile internalism and its incompatibility with cost-leadership strategies are expected to make it more difficult for Japanese firms to fully embrace the outside-director system. Under the Macro Trimiti framework in Figure 1, feeling the opportunity from the expanding international capital market, the Japanese government has put forward an effort to move its economic governance system from the existing plane (PBS) toward the (MBL) plane. However, the internal governance system of its firms does not seem ready for any such adaptation. The strong culture of internalism that has supported the growth miracle of the Japanese economy has appeared to impede changes, and unintentionally created a governance vacuum. The limited scope of authority and

weakening power of lower-level employees are likely to cause an inability to cope with some risks taken on by management. Therefore, some Japanese firms are vulnerable to earnings managements, strategic traps, imprudent managerial decisions and other mismanagement, which have already proven to harm Japanese financial institutions, at least until a new form of balance- of- power is found.

## 7. Conclusion

This paper has presented a new economic governance model that can help explain the dilemma of Japanese corporate governance, whose balance had been maintained in two separate levels – the upper level by the influence of governmental agencies through the main bank and convoy system, and the lower level by employees through management-labor consultation. Business success has provided the larger firms with an internal source of funding. The self reliance of larger firms, coupled with the declining influence of main banks and governmental agencies has shifted the balance- of- power away from the precedent setting economic governance system in which human resources and strong government are dominant. Recent governmental and corporate scandals have forced government agencies to keep a certain distance from the private sector. The influence of Japanese government through the convoy system and main banks has come to a halt. With the disappearing role of the main banks as a countervailing power, coupled with the reluctant establishment of the substitute countervailing mechanism under the new code, Japanese corporate governance is vulnerable to the risks associated with the decisions of high-level management, including earnings managements, strategic traps, imprudent managerial decisions and other mismanagement.

It has also been shown that Japanese corporate governance may be analyzed in isolation to understand its efficacy. However, if we want to understand more about its evolutionary aspects, we may not succeed if we lose sight of the country's wider national economic governance, and vice versa.

This article has no intention to prove or disprove the superiority of any particular corporate governance model. Presently, there is insufficient evidence to determine whether the market efficiency gained can adequately compensate for the loss in organizational loyalty and productivity as Japanese firms adopt American business model. Past studies indicate that country and industrial factors have more influence over firm performance than corporate governance factors (Palepu et al., 2002). Besides, no model has been proven as infallible. Experience has shown that the Japanese model cause firms to remain slow in adapting to new environments and prolonged stagnation of the Japanese economy is a result. Meanwhile, recent sub-

prime loan problems in the U.S. have indicated to us that market-based governance, largely driven by unrestrained greed, can also bring economic volatility and possible disaster.

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