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Changing the Rules of the Game:  
The Reform of (Corporate) Governance in Japan

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# Changing the Rules of the Game: The Reform of (Corporate) Governance in Japan

## Summary

Governance in Japan is moving from a system of stable “insider” relations to a more flexible model of market-based “outsider” or shareholder participation and control. This transformation remains costly and time consuming. But major changes in the commercial code, the bankruptcy code, accounting rules, shareholder structures, and labor market contracts have already irreversibly shifted the “rules of the game” towards a more open market economy. It is now necessary to enforce the implementation of these governance reforms by keeping a strong focus on transparency at every level, and by pushing the swift progress of the “accounting big bang” and the privatization of the postal savings system.

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# 1 Introduction

After more than one decade of crisis and stagnation, Japan overhauls its once successful model of governance. The former insider-oriented “stakeholder” model is turning into a more open, “market based” economy that is able to accommodate more diversified needs. The current government of Prime Minister Koizumi therefore gains continued support from local voters to major business lobbies for its promise of “true change” and “consequent implementation of painful structural reforms.”

The progress in the former “No. 1” economy remains slow, however, and the success of the prescribed medicine is far from clear. The first part of the article therefore focuses on the question of why the transformation of Japan’s governance structure has been so difficult, while the second part reviews the state of affairs of current reforms. The paper concludes that the most important governance reforms are already in place and have started to shift the “rules of the game” towards a much more liberal and transparent market economy.

Section 2, “A Japanese Stakeholder System,” starts with a compact overview of the core elements of the Japanese (corporate) governance system, followed by the recommended solution (section 3, “An Old Solution: Open Markets”). Section 4 (“Why is the Transformation So Slow?”) details what kept the economy back for so long, and section 5 (“Governance Reform”) concludes that many of the necessary reform steps were already introduced during the last decade, which was too often described as a “lost decade.” Section 6 (“Blocked Finance”) outlines the current state of affairs in the former center of Japan’s governance model as an example for the progress and the remaining deficiencies of the reform process. Finally, section 7 sums up the results and deficiencies of current reform steps, and, additionally, the appendix in section 8 (“Appendix: The “Bubble” as a Result of Partial Deregulation”) provides an example of the risks of partial and misguided reform steps.

## 2 A Japanese Stakeholder System

The “classic” Japanese corporate governance framework after WWII was clearly oriented to market results and produced some of the highest growth rates in any country. But it was not geared towards profit maximization on every level of production and planning as recent “economic value added” concepts would require, nor did capital market oriented payouts play an important role.<sup>1</sup> 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.<sup>2</sup> 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,

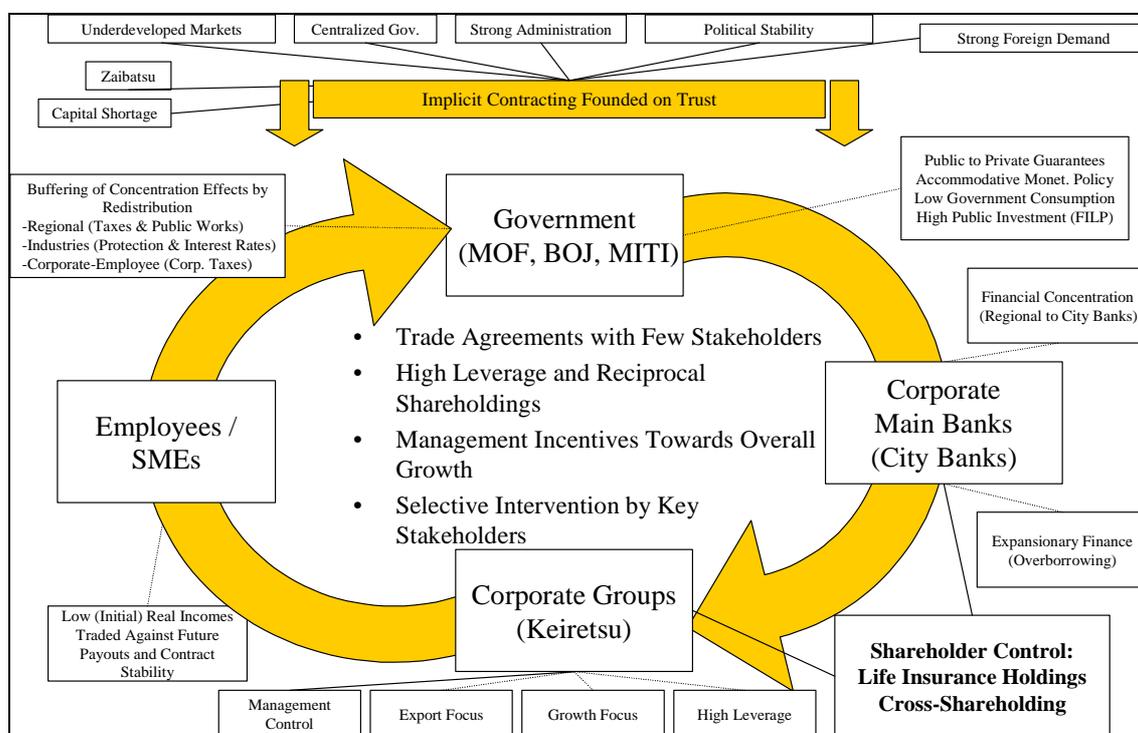
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<sup>1</sup> Instead of a review in this article, see, for example, the articles in Aoki (1994, 1994a), Chew (1997), or Kester (1991, 2000). On the more specialized, but important issues of the “triggering” of the financial crisis and the following structural break, see Hoshi et.al. (1990), and Schulz (1997, 1998).

<sup>2</sup> In the Japanese literature this credit extension was coined “overloan,” and “overbanking” respectively (see Suzuki 1980 and Schulz 1998).

which could be recycled as savings to create a dynamically growing economy (Schulz 1998).<sup>3</sup> Figure 1 drafts the model in a stylized form.

**Figure 1: Stakeholder Governance: A Japanese Catch-up Model**



Source: © FRI (2003).

In such a system,<sup>4</sup> 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

<sup>3</sup> 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.

<sup>4</sup> For an alternative, much more sophisticated model, see Aoki (2001).

determined allocation and set the standard of success. The role of Japan's government and its ruling party, the LDP, was therefore clearly important for the strong industrial and regional concentration process but much less so for interventions into allocation and industrial policy. Rather, the important role of the government in Japan developed as an agent for the redistribution of the high returns from economies of scale and scope in the exporting manufacturing industries. The government used high taxes on corporations, inheritance, and a steep income tax progression to curb concentration effects and for transfers into the only slowly developing regions outside of the industrial power houses in Tokyo, Osaka, and Nagoya (Schulz 2002a).

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 an efficient and flexible solution by focusing on price signals and competition 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

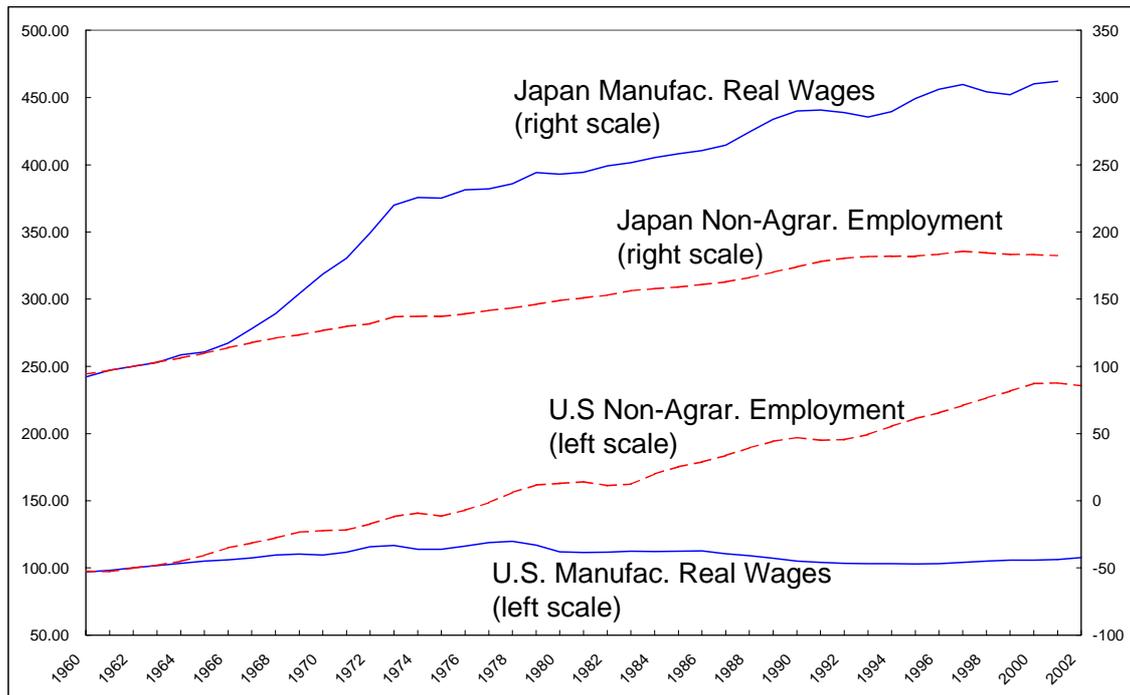
the beginning, when strong business swings and cycles still affect the narrow developing environment, because its stakes cannot easily be traded or renegotiated. The market system, in contrast, built on a concept of personal freedom and flexible independent decisions within a set of stable rules, is 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.

## 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 wages of manufacturing wages in the more capital market oriented U.S. economy (Figure 2). 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.<sup>5</sup>

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<sup>5</sup> For the newer literature on the efficiency of Japanese system, see – from different perspectives – Kaplan (1997), Sheard (1994) or Prahalad (1997). For some early and consistent criticism, in contrast, see Kester (1991) and Jensen (1991), or later Jensen (1997).

**Figure 2: Real Wages and Employment in Japan and the U.S.**

Remark: Left and right scales are indices of the same dimensions (1962=100), 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 CPI's. Employment in Japan is based on numbers of persons engaged in the sector. Unlike the U.S. data, they therefore include self-employed etc.

Source: © FRI 2003. Data from IMF, International Financial Statistics (2003). Ministry of Public Management, Home Affairs, Posts and Telecommunication (2002): Monthly Report on the Labor Force Survey. Ministry of Health, Labour and Welfare (2003): Monthly Labour Survey.

In contrast to the huge success in terms of income creation in Japan, Figure 2 also demonstrates, however, 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).<sup>6</sup> 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

<sup>6</sup> 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 setup.

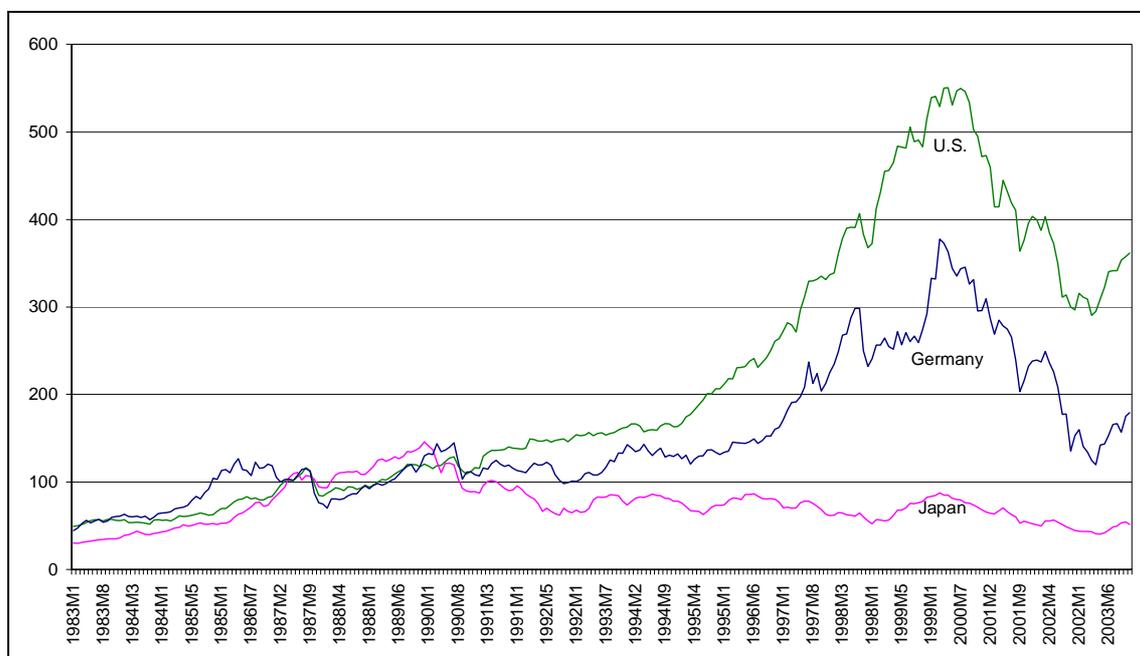
yet struck by persistent high unemployment rates, but has had to secure its high level of employment by relying on massive public investment and consumption, creating public debt equivalent to 155% of GDP.

The downturn of the Japanese stakeholder system is not a temporary crisis or a business cycle development that could be overcome by fiscal policy, however. On the contrary, the increasing reliance on fiscal programs shifted the role of the government from focusing on redistribution and limited stakeholder interventions into the role of a major investor and therefore further from an efficient stakeholder setup. 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 3).

**Figure 3: Share Price Indices of the U.S., Germany, and Japan**



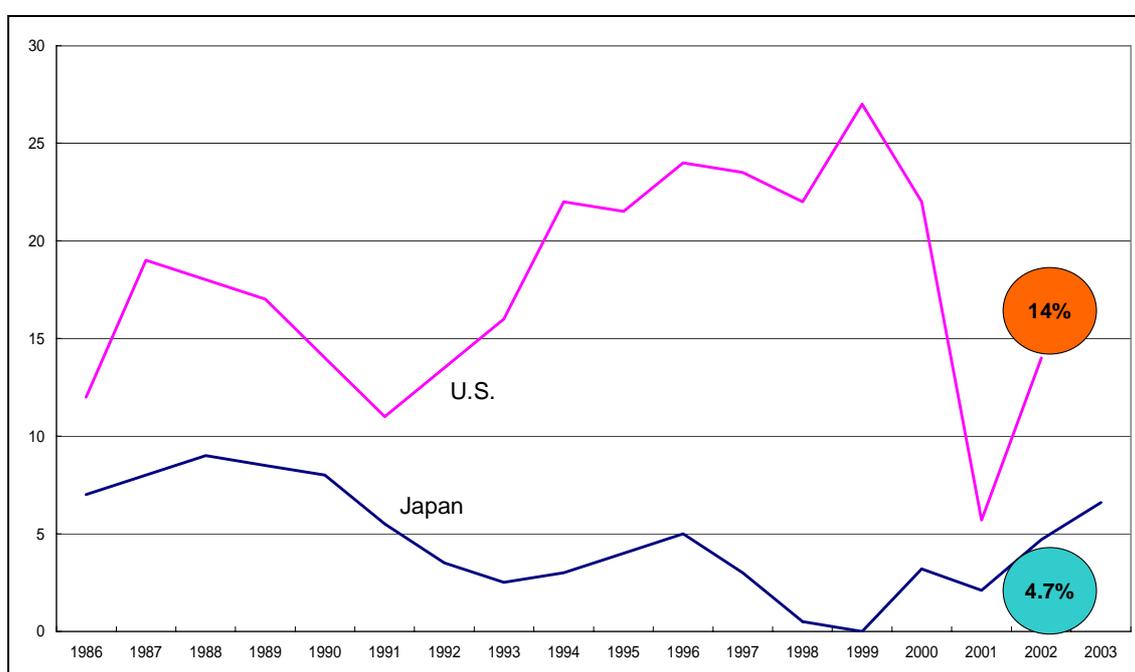
Remark: The 1995 base year indices have been recalculated for 1987 = 100.

Source: © FRI. Data from IMF, IFS. Indices: DAX, Nikkei 225, Dow Jones Industrial.

U.S. stocks and markets have developed much better than their stakeholders' counterparts during the last decade, even though this has been partly due to an

investment bubble that might not be completely solved by now.<sup>7</sup> But the main attraction for foreign capital in the U.S. was – and is – the relatively high transparency and good use of the entrusted capital at listed U.S. corporations (Miller 1997). They managed to keep their return-on equity (ROE) ratios well beyond Japan's levels of usually below 10%. During the boom years of the 90s, U.S. companies boosted their income to almost 30% of stock investors' capital, while the return remained below 9% for Japan's shareholders during the bubble of the 90s and even fell to 0% in 1999 (see Figure 4).

**Figure 4: Return on Equity (ROE) at Major Companies in Japan – U.S.**



Remark: Japan: Nikkei300; U.S.: S&P500.  
Source: Nikkei Financial, various issues

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:

- Lifetime employment, which for Japanese employees was the companion piece for

<sup>7</sup> During the crash of 2000-2002, stock valuations came down internationally. By March 2003, U.S. stocks lost 46% of their March 2000 peak, Japanese stocks, however, were falling even more severely, and lost 52% of their peak, although they had not been rising as much before (Germany even lost 68% from the peak). 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. rather than fleeing into even more opaque markets.

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. As Kimura/Schulz (2004) demonstrated, the non-regular workforce (part-timers and workers with contracts limited to two, earlier one years) has approached 30% of the entire workforce, the highest ratio in the entire OECD. Even contracted employees' benefits and savings are at the fringes of being bankrupted, as the under-funding 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, as in the case of Mitsubishi Motors (in 2000) that lead to the takeover of majority shareholding by a foreign company, Daimler-Chrysler. But, however much these business practices are unacceptable today, the problem with these cases is that they cannot easily be solved from the inside because they cannot be categorized as simple unlawfulness or moral hazard. Many undisclosed procedures, like the cover-up of customer complaints and the secret repair of product defects at Mitsubishi Motors have been accepted business practice in the former (and still predominate) stakeholder system. Increasingly, even Japan's most traditional keiretsu's are therefore following the path of many other stakeholder corporations: unable to shift its insider network into an equilibrium with higher profitability and transparency on their own, they introduce outside-control to execute the necessary steps and to buy the credibility for the necessary costly transformation.

- Bureaucracy scandals have been 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, and poorly informed cabinet and parliament was not regarded as a problem because they 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 LDP presidential elections in 2001, a relative outsider within the ruling LDP was elected and became 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 terms of a detailed reform agenda.<sup>8</sup>

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<sup>8</sup> 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 presidential 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. It therefore also makes sense to

- Fiscal and monetary policies have been deadlocked for almost one decade. 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, was still desperately trying to soften the edges of the crisis with an enormous fiscal expansion. Only recently, during the year 2002, and with the new Koizumi government in charge, seems this deadlock to have been solved by pushing for a more restrained fiscal and more expansionary monetary policy.
- 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 financials and services. Together these industries account for 60% of Japanese companies although they generate just 32% of the nation's revenues. In 2003, after years of writing down problem loans, the real estate, wholesale/retail, and construction sectors alone still represented up to 80% of all

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consider the new "Koizumi" government as a "new" government, although only the cabinet changed, and the ruling coalition remained the same. Democratic competition is still a matter of competition between the LDP's factions, rather than a matter of competition between different parties.

bank non-performing loans even though they account for only 29% of total bank loans. 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. Only very recently, from the second half of 2002, did massive cost cutting and restructuring spread from the manufacturing sector to retail and wholesale. Corporate profits have therefore strongly improved during 2003 (see Figure 4). Unfortunately, however, does this restructuring not yet represent clear and sustainable strategies for future growth, it only marks the cleaning up of inefficient structures that have been sustained for too long (see also Kimura/Schulz 2004).

### 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 each other, while becoming socially increasingly dependent on the working of the society as a whole.<sup>9</sup>

Theoretically, Adam Smith already solved this control problem<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup>

In Japan, as already discussed above (section 2), market participants have been

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<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> 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.

<sup>12</sup> 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.

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, broad IT-based information dissemination, open markets in key sectors, and growing consumer demands 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 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 the “classic” Japanese system are facing huge risks when giving in to outside forces by trading their proven but outdated “stakeholder values” against untested future market results or “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 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 interlocked stakeholder interests therefore requires a whole series of (often simultaneous) reform steps that are not easy to plan or equilibrate for any government or corporation. Market results after structural reforms, that include basic changes in the legal framework or major changes of a broad set of regulations, are usually quite different from the planned intentions, even if tried concepts from abroad are imported and implemented. The financial “big bang” of the 1980s, for example, was a boon for London’s financial market, which developed into the world’s financial center, while Japan’s financial liberalizations provided to the “bubble” in Tokyo.

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. Even though 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, the results were quite different in Japan. The transformation became extremely unbalanced because liberalized banks could expand their credit supply outside former stakeholder networks, while the targeted (SME) corporations found little efficient uses for the credit glut inside the still remaining boundaries of the old stakeholder system. As a result, an asset “bubble” in the real estate market 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 the Appendix: The “Bubble” as a Result of Partial Deregulation).

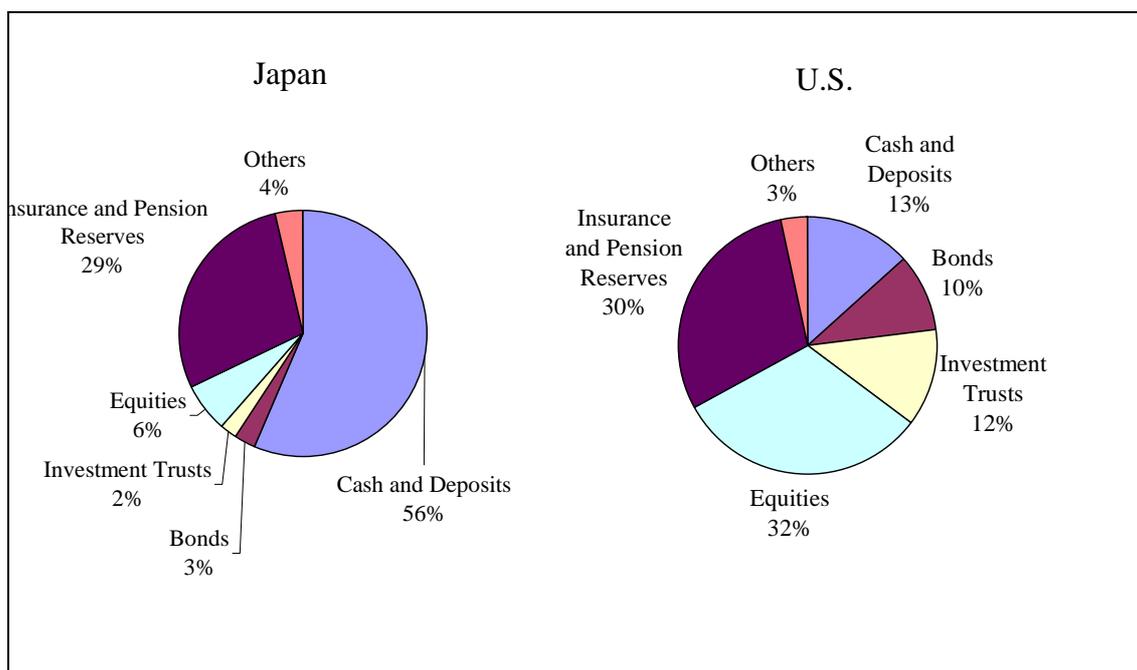
With this development, the problems of the Japanese economy during its transition to a liberalized (financial) market increased dramatically. As a consequence of unchecked misallocation (see Kimura/Schulz 2004) productivity broke down, and the country did an unprecedented dive from a top spot in every international competitiveness ranking to a mediocre middle position behind countries that were never able to produce much growth (down to rank 30 in IMD’s World Competitiveness Yearbook, for example).<sup>13</sup>

Even more important for Japan’s future than this drop in potential productivity is, however, that private households simultaneously lost their confidence in the allocation function of the old banking structure, governmental guidance, and the new capital markets. As a result, they hardly supply the economy with any new capital and refuse to bail out the banking system with tax funds 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 5).

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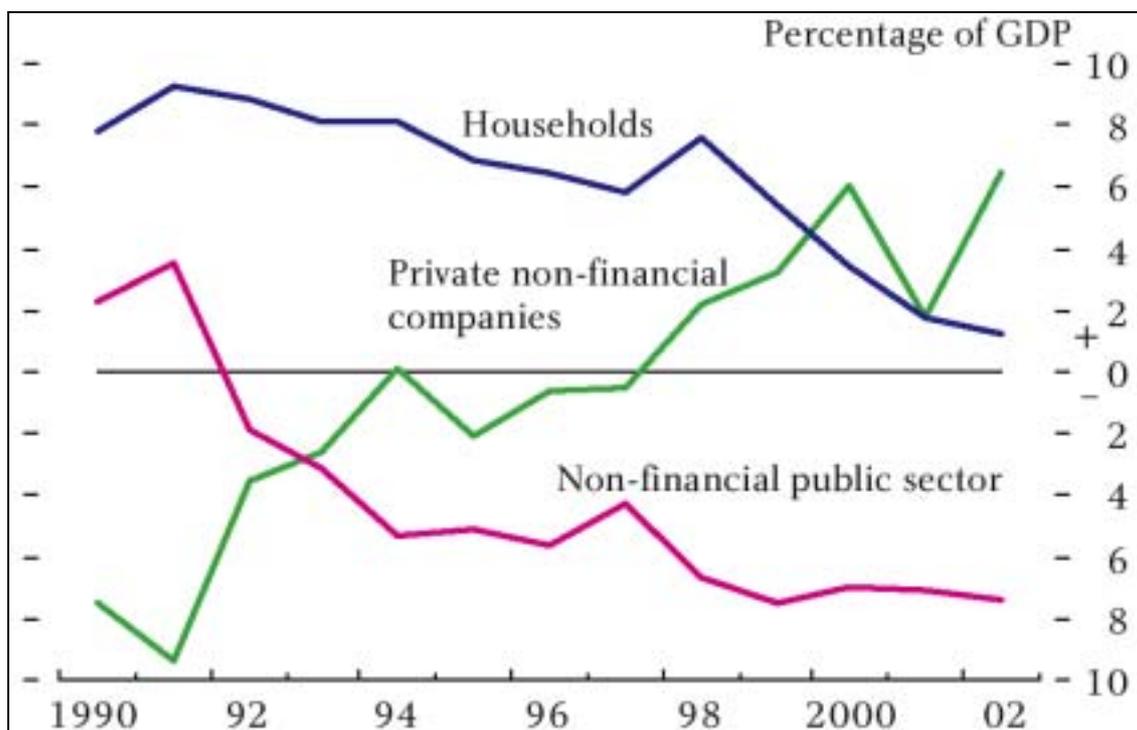
<sup>13</sup> IMD’s ranking is often criticized for relying too much on “soft” executive surveys than on “hard” economic data analysis. And indeed, a change in the 2003 ranking structure pushed Japan up to place 11 (behind Thailand and Spain) because a differentiation of countries with more and less than 20 million inhabitants has been introduced. But even the Japan Center for Economic Research (JCER 2001), which estimated a ranking based on weighted contributions of “hard” productivity factors to GDP per capita, had to document in its international potential productivity ranking that Japan dropped from 3<sup>rd</sup> place in 1990 to 16<sup>th</sup> place in 2000 compared to its rivals in the OECD and Asia. The center base its “total potential economic competitiveness” on a model of “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.

**Figure 5: Japan, U.S. Financial Assets Held by Households (2003)**



Source: BOJ Homepage, Data of June 2003.

This unfavorable balance sheet situation, which does not allow for efficient long-term investment, becomes especially problematic if the banking sector, which could transform the available short-term assets from the household sector into long-term investments in the corporate sector, is not performing well. In Japan, the situation has become even more complicated because the household sector does not only prefer to conserve its funds in rather risk-free assets, it also lost its propensity to save, as the sectoral balance sheet developments in Figure 6 demonstrate.

**Figure 6: Sectoral Financial Balances**

Source: BOE (2003) - Financial Stability Review December 2003.

Figure 6 shows that after the burst of the bubble in 1991, Japan's sectors have almost reversed their normal financial balance positions that would require corporations to run a deficit for investment, households to have a surplus from savings, and a more or less neutral public sector. In 1991, Japan's corporations started to sharply reduce their investment and debt position, and effectively became a surplus sector in 1997 by saving more for debt repayments (and cash reserves) than it would invest. At the same time, the public sector reacted by investing heavily and building up debts at almost the same rate as the corporate sector reduced its debts. During the course of the decade-long crisis, the household sector therefore gradually reduced its financial surplus from savings to avoid low yield investments and major cuts into its consumption.

These sectoral reactions have arguably been rational for each sector after being confronted with a crisis situation in 1991. Clearly, the corporate sector needed to clean up its balance sheet (which was full of bad investments), the public sector intended to avoid overall negative demand, and the household sector wanted to maintain its standard of living. Since at least 1997, however, when the post-crisis trends did not return to more normal levels and started to accelerate again, it has become clear that this development is by no means sustainable.

The first major reform steps therefore started during the Hashimoto cabinet of 1996-1998, which pledged six basic reforms: administrative reform, structural fiscal reform, structural social security reform, structural economic reform, financial system reform, and educational reform. Unfortunately, most of these reforms did not succeed after 1997. The privatization of the three postal services (mail, postal savings, and *kampo* life insurance) never left the planning stage because of strong resistance from within the LDP and the ministries, who did not accept the loss of this important source of income and market control. The plan to reduce the Ministry of Finance's power by removing its control over financial policy also did not succeed at first. A functional Financial Services Agency only gradually developed from 1998 and took over financial supervision and planning from the MOF in July 2000. The consumption tax was increased from 3% to 5% to improve the fiscal balance. But the introduction could not build on earlier improvements of market conditions and coincided with the (Southeast) Asian crisis. It therefore led to even bigger debt-financed fiscal programs under the same government. Similarly, the 1997-implemented restriction of a maximum of 50% for the potential national contribution ratio (the ratio of taxes, social welfare premiums and budget deficits to national income) was already scrapped in 1998 again.<sup>14</sup>

Two important reforms succeeded, however, although only slowly and gradually. First, the financial market reforms, this time coined the "financial big bang" after London's successful financial market reform, finally liberalized the banking sector from most restrictions, and opened Japan's financial markets to foreign groups. Due to their severe financial situations, the domestic banks hardly used this leverage, however, while the foreign banks, brokers, and insurance companies, which stormed the market with the first upturn of the business cycle, could not win over Japanese households to their services fast enough to make a profit. Second, the administrative reform, which set out a target of reducing the 22 ministries and agencies into one strong cabinet office and 12 ministries/agencies to streamline the bureaucracy and strengthen the cabinet functions was implemented as planned by 2001. This reform also succeeded with its goal to give the prime minister greater initiative in policy planning and crisis management, as the

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<sup>14</sup> The ratio for Japan currently stands at 47%, but is projected to climb to about 60% in 2025 due to ballooning social welfare and debt-servicing costs. The figure stands at 37% in the U.S. and just above 50% in Britain and Germany.

Koizumi government of 2001 proved. The prime minister and the government can now play a much more important role in cutting through old follower-networks.

The often criticized general result of this period of delayed, incomplete, and unfortunate structural reforms was, however, that Japan's government and corporations now face a situation of further deteriorated maneuverability, funds, and public trust. At the same time, they face much higher demands for broad and well-planned structural reforms from major stakeholder groups. Both therefore need to draw up convincing plans to shift (corporate) governance, the financial structure, and the market framework towards a new market equilibrium, while succeeding with the implementation of concrete (if limited) reform steps that produce immediate tangible results. The next section gives an overview about the necessary reform steps, the remaining obstacles, and what has already been implemented so far.

## 5 Governance Reform

The key to success for Japan's structural transformation is to focus on a limited set of key reforms that have the potential to shift the "rules of the game" in Japan's stakeholder economy towards a more flexible market-oriented governance framework. To achieve this, the targeted reforms need to address three basic preconditions. First, the reforms need to show that prospective individual gains could compensate (former) stakeholders for their loss of stake values (Schulz 2001). Fortunately, this has become much easier during the last decade because the fast deterioration of stake values in almost every sector has increased the interest in (individual) risk-taking. Secondly, the reforms need to have a strong focus on transparency not only as their final objective (to replace closed insider-governance by transparent market rules), but at every stage of reform because the current stakeholder groups require accessible progress reports for their continued support and risk taking. Finally, the transformation of insider-oriented governance should be accelerated by the promotion of outsiders into key positions. Outsiders provide knowledge and incentives for innovation, and demonstrate the "outside" chances to current insiders if they try to advance from their established networks.

Table 1 lists some of the most important requirements and steps of such a transformation together with the possible gains for each stakeholder group.

**Table 1: Key Reforms - Requirements and Chances**

	<b>Requirements</b>	<b>Chances</b>
<b>Government/ Cabinet</b>	The government needs a strong cabinet with an effective opposition and higher levels of public participation.	Gain competence and power vs. ministry bureaucracies and lobby groups.
<b>Bureaucracy</b>	Inflated monolithic bureaucracies need to be broken up to compete and oversee each other as (independent) agencies. The civil servant status of many employees should change to public employee.	Younger and/or motivated bureaucrats gain the chance of mobility within (and outside of) specialized, service oriented agencies.
<b>Legal System</b>	The legal system of courts, lawyers, and auditors needs to be expanded to settle market-based disputes.	Gains a general upgrade in size, reach, and importance.
<b>Markets</b>	Regulations need to focus on transparency and investor protection.	Volume and efficiency would increase.
<b>Managers</b>	Need to become more independent from internal corporate networks. Need to be controlled by (outside) boards and shareholders.	Gain stock options to transform their insider-interests into profit-oriented outsider-interests.
<b>Employees</b>	Need to focus on market-oriented skill development. Especially Japan's "salary-man" need to be prepared to face higher job-insecurity.	Gain performance-based promotions, and more independence from the fate of single companies.
<b>Households</b>	Households need to diversify their savings and assets, and to increase their public participation.	Gain long-term improvements in productivity and consumer sovereignty.
<b>Foreigners</b>	Foreign capital and employees are needed. Domestic corporations need to be prepared for more competition.	Chances for Japan's productivity, global integration, pension systems, and diversified lifestyles would increase.

Today, the list of recommendations for reform Table 1 has become impressively long, even though only the most urgent and (by and large) most widely accepted issues have been added to the table. Fortunately, however, the last decade of crisis in Japan has not been a "lost decade." Throughout the last decade, as already discussed, the sense of urgency for real reform has dramatically increased, and from the middle of the 90s, many reforms have been drafted or introduced along the lines of "international

standards.”<sup>15</sup>

As will be shown in the following, many of these reforms and new regulations have the potential to improve conditions in many sectors during the next years, although the remaining obstacles to transformation might keep the general view on Japan’s chances depressed.

## 5.1 Central Government Reform

Due to the slow response of the Japanese government to the lasting crisis, its apparent inability to react to structural changes by adjusting the market framework caught everyone’s attention. In Japan, traditionally, the parliamentary 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 – seeing skyrocketing debt and unsatisfactory public works – has become increasingly suspicious of the rationality of this setup. An important result of this changing mood against a ministry-dominated government is administrative central government reform, which was initiated by the major reform push of the Hashimoto Cabinet in 1997 – and succeeded although almost all other reform initiatives of that year were later shelved.

By January 2001, the central government became integrated into one cabinet office with powerful cabinet ministers and 12 administrative units (ministries and agencies). To support the cabinet ministers, 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. parliamentary system, and is clearly designed to show that ruling party politicians are responsible for carrying out policies. To enforce the process, the

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<sup>15</sup> In Japan, most reform discussions are heavily influenced by a concept that reform proponents call “international standards.” In most cases no international standards, drafted, for example, by international organizations like the WTO or the International Accounting Standards Board exist, however. The perception of “international standards” is therefore usually based on reform proposals of ministries (especially the MOF and the METI) or other pressure groups, which backup their proposals with some international comparative research. Most often these proposals are 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 irresistible trend seems to be identified and requires a reaction from the stakeholder groups.

most powerful ministry of all, the MOF, lost its responsibility for financial regulation to a separate Financial Agency.

After the reform became effective, it almost immediately shifted the power balance from top ministry-bureaucrats to cabinet ministers and especially the prime minister. The new Koizumi government, which was brought into office by a presidential election within the LDP, made the most of the opportunity and selected rather strong and independently selected cabinet ministers for some key positions. Developing this powerbase, effectively pushing for reforms, establishing a new and efficient power balance, will take some time, however - as the often agonizing power struggles between the cabinet ministers, the LDP, and the ministries are demonstrating.

Another remaining obstacle to this administrative reform is that it was implemented under the influence of severely deteriorating budget conditions. By reorganizing the ministries, strong emphasis was placed on short-term efficiency gains and cost cutting by targeting economies of scale effects through ministry-mergers. The resulting super-ministries, though being better controlled from the top, have certainly not become more flexible, nor are they now easier targets 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 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 postal savings and life insurance 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 are clearly intended to pave the way for a new and efficient equilibrium of the legislative-executive power balance in the long run. In the short and medium run, however, this transition has high transformation costs because the restructuring procedures cause inefficiencies and power struggles. Short- and medium-run success therefore depends on the impact of an underlying layer of

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 a long way to convincing important stakeholder groups like governmental agencies, management of conglomerates, and foreign investors to join into a synchronized effort for future growth.

## 5.2 Market Framework

### **Commercial Code**

In April 2003, a major reform of the commercial code of 1899, which had not been seriously revised for the previous 50 years, became effective. Key changes were the introduction of stock splits, lower par values, outside stock options, and outside director requirements. By doing so, the code changes the emphasis from protecting companies from powerful shareholders to shareholder protection and market liquidity.<sup>16</sup> Furthermore, the code will see another revision that will probably include most current special exceptions and regulations (see below) by 2005. The new code will consolidate the portion of the existing law that governs such issues as business organization with laws prescribing the functions of limited liability companies and auditing entities.

### **Outside Directors and Auditing**

The Commercial Code revision allows companies to switch to a U.S.-style corporate governance structure. A change requires companies to set up an in-house committee structure with independent directors in three committees for executive nomination and compensation as well as for auditing. Companies seeking to adopt this governance model must abandon the traditional statutory auditor system. But even companies that have decided to retain the internal auditing system are required to improve their auditing system and redesign the procedure of monitoring complaints from whistle-blowers. The role of internal auditors as supervisor of top management has therefore been strengthened, although their influence is still not as far-reaching as those

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<sup>16</sup> In Japan, as in other Asian countries with powerful controlling family owners, after WWII this protection was seen as necessary against the resurrection of controlling owners in the corporate groups (“Zaibatsu”). Later it became a handy insurance against foreign takeovers. Though these problems are solved in Japan, the concentration of ownership in other Asian countries remains extreme. According to the World Bank, two-thirds of listed Asian companies are controlled by a single shareholder, compared with just 3% in the U.S.

of their U.S. counterparts. Most Japanese corporations still do not see their internal auditing system as an independent institution, and the interaction with outside auditors remains limited (see section 5.3).

On April 1, 2004, another revision of the Law on Certified Public Accountants will increase the independence of accountants at auditing firms. It will introduce a rotation system to disallow the continued audit of the same auditor. Auditors will also no longer be allowed to provide consulting and auditing services at the same company. Finally, they cannot be appointed to managerial positions at the companies they are auditing for at least one auditing period.

### **Limited Liability of Directors**

The commercial code revision simplifies the procedure for limiting the liability of directors. In general, directors are jointly liable towards the company and third parties, i.e., they can be held individually responsible for the full amount of liability and are only able to internally recourse on other directors. Japanese directors therefore tended to refrain from risky decisions without full consent of the board, and were, on the other hand, shielded from external claims by the company as long as they complied with an internal consensus. After the amendment, the liability of directors can be limited in the articles of incorporation or at shareholder meetings<sup>17</sup> in order to encourage them to execute bold strategies, and to foster the hiring of talented personnel.

Along with the introduction of outside directors and improvements to their internal auditing systems, a growing number of listed companies (currently 284 firms) are therefore limiting the liability of executive directors.

### **Stock Options**

It has become much easier to grant stock options to regular employees. Option programs are now allowed to simply target “employees and board members,” and companies are not required to specify the names of awarded employees anymore. Moreover, companies are allowed to award options to people who are not its own

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<sup>17</sup> Under these regulations, representative directors can be held liable for a maximum equivalent of six years’ pay, executive directors can be held liable for four years’ pay, and the liability of independent directors can be held to just two years. The shareholder meeting can limit the liability of individual directors even retroactively if he acted in good faith and without gross negligence.

employees. The remuneration of directors, on the other hand, now has to be disclosed to the shareholder meeting.

### **Share Buy-Backs and Treasury Stocks**

Listed corporations were already allowed to buy back their own shares from 1995, but only to retire them. From October 2001, companies were allowed to buy back their own shares regardless of their reason for doing so. Share buybacks have since become a mainstay of corporate financial strategy partly because of low stock prices and the unwinding of cross-shareholdings. At the end of March 2003, 30 listed companies (including Kao and Toto) have become the largest shareholders of themselves, while more than 400 companies bought enough of their shares to become the top 10 shareholders of their own companies.

Furthermore, until September 2003, companies needed to have their stock buyback programs approved at shareholders meetings for a period of year. After the revision, companies can change their charters to allow boards to decide the amount and the period of share purchases. These companies are only required to explain their actions to the shareholders meetings later.

With this revision, Japan turned from one of the most restrictive countries concerning stock buy-back programs to one of the most liberal. This liberalization might have gone too far, however, because it eliminates an important mechanism to guard shareholders from unsound buybacks, and therefore might reduce market transparency.

### **One Yen Corporations**

According to the current Commercial Code, the minimum capital for a joint-stock company is 10 million yen and a limited-liability company needs 3 million yen. From February 2003 until 2008, however, a “Small and Medium Sized Companies Challenge Supporting Law” allows investors who are not currently entrepreneurs to set up a company with much less capital. At the end of 2003, the total number of users of this special system stood at 6,246, or almost 10% of the number of regular companies founded during the first nine-month period. Two hundred and thirty eight firms even opened with a capital of only 1 yen. With the next revision of the commercial code in 2005 these special regulations might become permanent.

### **Corporate Reorganization and Bankruptcy Laws**

Japan's bankruptcy code, consisting (now) of a Corporate Reorganization Law, a Civil Rehabilitation Law, and a Bankruptcy Law, has never been seriously revised after it was enacted immediately after the end of World War II. As a consequence, the Corporate Reorganization Law, which should have been Japan's major procedure for corporate reconstruction and bankruptcy of large stock corporations (1,000 or more creditors), was rarely used. The difficulty of renouncing liens and adjusting the intertwined security interests of many creditors under the law severely limited its usefulness. So the dominant approach to dealing with non-performing corporate borrowers has been the implementation of main-bank or ministry arranged restructuring plans based on debt forgiveness by banks, and bank-bailouts by ministries.

Only in April 2003 did a major revision of the Corporate Reorganization Law become finally effective, and this now allows for a faster and more streamlined reorganization process. The process of reorganization can now start before the value of debtors' assets has seriously deteriorated because no prior court judgment about the survival chances of the corporation from the applicant's district court is necessary anymore. Also, the bill helps debtors to restructure their operations and assets by creating a new system to nullify liens, so that key assets could be transferred before a restructuring plan is approved.

More important for a conclusive revision of Japan's bankruptcy code has been, however, the introduction of a Civil Rehabilitation Law in April 2000. This law is open to all corporations but was intended to serve smaller companies. Even large corporations often prefer its procedures (over the corporate reorganization law) because the procedures are allowed to start before the corporation declares bankruptcy, because the procedures are much faster, and because it allows the existing management to remain in power. The average time for approval of a reconstruction plan by the court under the Civil Rehabilitation Law is six months, for example, while it usually takes at least two years under the Corporate Reconstruction Law.

This difference in timing is basically due to the different levels of court intervention. Under the Corporate Reorganization Law, the court rigorously screens reconstruction plans, while a Civil Rehabilitation Law case is basically negotiated

between creditors and the debtor. In fiscal 2002, 16 of 29 insolvent listed firms therefore opted for the Civil Rehabilitation Law, while only 8 firms sought court protection from creditors under the Corporate Reorganization Law. Overall, of 19,500 bankrupt corporations in 2002 (almost all of them non-listed firms), 6,606 applied for court-supervised corporate liquidations under the Civil Rehabilitation Law. Only about 5% of these corporations were actively seeking rehabilitation, however (Tokyo Shoko Research and Teikoku Databank).

These numbers show that the setup and handling of Japan's Bankruptcy Code still rarely leads to "rehabilitation" or "reconstruction." The problem with the Corporate Reorganization Law is that, although reconstruction has a relatively good chance of success, it needs further streamlining and incentives to become an important market instrument. The market-based procedures Civil Rehabilitation Law, on the other hand, lead to too many liquidations and too little "rehabilitation." This is because companies that apply for its procedures are already seen as being "as good as dead," with their customers and other firms often ceasing to do business with them.

This situation becomes even more problematic because a survey by METI's Japan Small and Medium Enterprise Agency (April 2003; covering 1,500 owners of failed firms) revealed that 43.4% of owners of failed firms also plunged into personal bankruptcy. Only 13.7% were able to restart their businesses, far below the nearly 50% in the U.S.<sup>18</sup>

### **Consolidated Group and Capital Taxation**

From fiscal 2002, corporate groups have been allowed to file a single tax return by offsetting profits and losses of firms within the group. But the system remained limited to loss carryovers from parent companies to fully owned subsidiaries (and not vice versa), and carries a tax surcharge of 2% until March 2004. Despite these limitations, 134 firms filed consolidated tax returns in fiscal 2002. Of these corporations, only 18 had to report a taxable aggregate profit of 32.5 billion yen. If they had filed separately, their combined taxable income would have reached 928.7 billion yen. The resulting tax reduction was therefore almost 900 billion yen for these corporations

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<sup>18</sup> A mediation law to avoid bankruptcy of consumers and small businesses, which became effective in February 2000, seems to have brought no solution to this problem as well.

(Nikkei 2004.01.15).

On December 17, 2003, Japan's ruling coalition finalized a blueprint for a fiscal 2004 tax reform that targets major changes in the taxation of stock investment trusts. The capital gains tax rate will be lowered to 10%, the same rate as on listed stocks. Stock investment trusts will also have a loss carry-forward period of three years. After the changes, investment trusts can be included in brokerage accounts that allow any combination of offsetting gains and losses of stock and fund holdings.

As a result, Japanese corporate groups will be able to reduce their restructuring costs and individual investors will become subject to a very favorable tax regime for stock investments. Especially if these changes are seen against the background of (planned) tax increases on pensions, the elimination of deductions for senior citizens in 2004, cuts of mortgage tax deductions in fiscal 2005 and 2006, and a likely consumption tax hike in fiscal 2007.

### 5.3 Transparency

A lack of transparency has been one of the major – often deliberately preserved – obstacles to market development during the last two decades. Today, the growing reluctance of Japanese investors to invest in opaque businesses and markets and an increasing degree of outside pressure is finally resulting in real improvements in transparency.

#### **Accounting Big Bang**

Japan's "Accounting Big Bang" now requires mark-to-market accounting for major parts of equities and real estate holdings. Since 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 (especially real estate) as losses becomes binding for large corporations in fiscal 2005. But companies with capital of 100 million yen or less (SMEs) remain exempt from the rule. The exemption therefore covers about 2.42 million, or 97%, of all Japanese companies.

In terms of implementation of fair value accounting standards, Japan therefore remains behind the European Union, where listed companies will be required to adopt

International Accounting Standards (IAS) from 2005,<sup>19</sup> or the U.S. where accounting standards are also shifting closer to the IAS. In Japan, no plan to adopt these standards, which have a good chance of becoming adopted globally, exist and politicians often continue to support lobbying for the lax implementation of existing standards. Chances for the fast development of a market for securitization, which would greatly increase the transparency of Japan's asset markets and encourage firms to get rid of idle assets in their operations, therefore also remains limited. As a result, balance sheets remain (by and large) based on historical costs and subject to a great deal of discretion. Earning results and accounting figures are usually not available on a quarterly basis.

Hopefully, increasing pressure from investors, who are now becoming increasingly watchful of data released by corporations, will change this situation soon. Of the Nikkei300 firms that disclosed only sales and order data for April-June in 2003, for example, the share turnover on the day following the data release (compared to the preceding five trading days) rose by about 50%. In contrast, the turnover figure for companies that released more data, including those on profits/losses for the same quarter, jumped an average of 80% (Nikkei 2003.10.23).

### **CPA Gap**

Currently, Japan has about 20,000 lawyers, judges and public prosecutors. Only one-fourth the number of France, the next following developed country with the fewest legal professionals per capita. There are also only about 15,000 CPAs. From April 2003, the revision of the CPA law and the resulting reform of the CPA exam are expected to eventually increase the number of CPAs to 50,000 (the U.S. economy employs more than 300,000 CPAs). But even if this is finally achieved, it will take time to build up an effective accounting structure. The Japan Institute of Certified Public Accountants found, for example, that of the 1,262 CPA's who passed the exam in October 2003, about 20% were still looking for work at the end of December.

One reason for this lack of demand is that banks do not require CPA reviews of financial statements from prospective borrowers before deciding whether to make loans. If this

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<sup>19</sup> The IAS, recommended by the International Organization of Securities Commissions, a group of securities regulators in major countries, is designed to ensure the thorough implementation of mark-to-market accounting in the corporate sector.

situation changed, it would certainly help to not only increase the transparency of Japanese smaller corporations' balance sheets, but also help to develop the credit supply for riskier loans with higher interest rates to Japanese SMEs (see section 6). Japan's corporations seem not yet to be willing to support this "accounting big bang," however.

An extreme result of this lack of accounting transparency is that the collapse of corporations and even banking institutions as a "sudden death" is still a common phenomenon in Japan. In the latest major case, the Ashikaga Bank, a major regional bank close to Tokyo, did not disclose any doubts about its financial standing in its fiscal 2002 financial statements. Only after inspections were conducted by the Financial Services Agency did the bank's auditing firm reluctantly admit that the bank's ability to remain in business was questionable (The Nihon Keizai Shimbun 2003.12.07).

### **Investor Relations**

Due to the liquidation of cross-share holding and the decreasing number of "stable shareholders," Japanese companies now need to build a broad basis of shareholders, including pension funds, foreign investors and individuals. In a survey of all listed companies conducted by the Japan Investor Relations Association in April 2003, 72% of the 1,057 respondents therefore supported promoting IR activities for individual investors.

A Nihon Keizai Shimbun survey (Nikkei 2003.10.23) of the same year showed, however, that only 21% of polled firms had implemented such programs. This result is in line with the experiences of institutional shareholders. In 2000, 65% of institutional investors thought that investor relations were problematic (Quick Corp. Survey 2000). In a 2003 survey by The Nihon Keizai Shimbun, even 76% of them were discontent with the IR activities of companies. Ninety-four percent of the polled institutional investors in 2003 claimed, however, that the disclosure of corporate information had increased over the previous three years. Investor relations are still extremely underdeveloped in Japan, although some progress can be seen recently.

### **EVA**

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 as an instrument for restructuring and increasing the profitability of their companies. EVA measures the extent to which net profits exceed capital costs at every level of operation. In its simplest form, EVA is calculated by deducting the cost of capital and interest paid from the net operating profit after taxes. If a company is in the black in terms of EVA, it has generated a profit based on capital contributions by shareholders.

The Nikkei Quick Information Technology Company calculated a comparable, aggregate shareholder value concept for Japan's 3,219 listed companies for fiscal 2002 by subtracting the cost of capital, including interest and dividends, from the return generated by the invested capital (Table 2). According to this measure, in terms of "corporate surplus profit," Japanese corporations had been negative for nine consecutive years up to fiscal 2001. In fiscal 2002, however, with more companies attaching importance to shareholders, a slight positive surplus profit was recorded for the first time (Nikkei 2003.11.25).

**Table 2: Corporate Surplus Profit Ranking in FY 2002**

	Best Performers		Worst Performers	
Rank	Company	Surplus Profit	Company	Surplus Profit
1	Toyota Motor	305,428	NTT	-347,368
2	Honda Motor	277,647	Sony	-311,381
3	Nissan Motor	275,706	Hitachi	-183,727
4	Takeda Chemical	217,463	Matsushita Electric	-167,255
5	Tokyo Electric Power	88,095	Central JR	-138,170
6	Chubu Electric Power	77,134	Softbank	-131,459
7	Kansai Electric Power	69,936	NTT DoCoMo	-77,339
8	Canon	65,187	Furukawa Electric	-71,363
9	Seven-Eleven	53,103	Fujitsu	-57,910
10	Kao	48,619	NEC	-55,838

Note: Figures in millions of yen

Source: Nikkei (2003.11.25).

This development does not only show, however, that shareholder values have increased in Japan. It also demonstrates the huge problems for corporations in turning around their operations. Many of the worst performing companies, like Sony, for example, which has failed to produce positive value for the last ten years, adopted EVA-like performance measures years ago.

## **Cross Shareholding**

The structure of shareholdings in Japanese listed companies has changed considerably. In 2003, corporate shareholders (companies and financial institutions excluding trust banks) reduced their shareholding from over 60% to less than 40%, or about the same as the portion held by individuals and foreign investors, while trust banks accounted for another 20% (basically public and private pension holdings and investments; see Figure 7).

Until March 2003, direct cross-shareholdings declined to 7.4% of overall stockholdings by publicly traded companies and banks, down 1.5 percentage points from a year earlier, according to a survey by NLI Research Institute. The decline marked the 12th straight year of year-on-year decreases. This decline is overwhelmingly due to strong selling from the banking sector, which was ordered by the government to limit stockholdings to the level of equity capital by September 2006. Mitsubishi Tokyo Financial Group, Sumitomo Mitsui Financial Group, UFJ Holdings and Sumitomo Trust & Banking had already reached this target level by March 2003, and continued to sell off several hundred billion yen in shares during the fiscal first half. Overall, these major banks unloaded almost half their cross-shareholdings and reduced the ratio by 1 percentage point to 3.7%. Non-financial firms, in contrast, held on to a major share of bank stocks despite heavy paper losses, although they also reduced their ratio of cross-shareholding of stocks of the four biggest banking groups from the 50-60% levels at the end of the 1990s. Corporate stakes in the four biggest banking groups remain at around 30-38% as of March 31, 2003.

As a result, although Japan's banking groups have reduced their cross-shareholding in the meantime, cross-shareholding of corporations remains a major obstacle to efficient investment. According to a survey of 1,452 companies in the first section of the Tokyo Stock Exchange of Mizuho Trust & Banking, only 51 corporations had positive rates of return on investment (consisting of stock price gains and dividend distributions) from 1990 through March 2003. The 51 firms with positive returns were typically corporations that reduced their high levels of cross-shareholdings found in former "keiretsu" group firms. In contrast, the 1,284 companies with negative rates of return had ratios of cross-held shares exceeding 50%, and 776 even had cross-holding ratios of more than 80%. The survey also found a correlation between higher losses and

stronger relationships with its bank through higher cross-shareholding ratios (Nikkei 2003.07.14).

## 5.4 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. Today, even the more traditional Japanese corporations are giving in to shareholder pressure and the obvious necessity to speed up the restructuring process by inviting outside directors.

### **U.S.-Style Governance and Outside Directors**

After the new Commercial Code allowed a shift to U.S.-style corporate governance (with three independent committees to conduct audits, to nominate board members, and to set executive pay) from 2003, a total of 36 listed companies adopted the system. At five of these companies, including Hoya, Seiyu and Resona Holdings, outside directors outnumber insiders in the meantime, at another five, inside and outside directors are the same number. At 26 companies, insiders outnumber outsiders.

With this move, especially the internationally operating corporations (i.e., Sony, Toshiba, Mitsubishi Electric, Konica) hope to not only enhance transparency of their management, but also to better appeal to overseas investors, which have become an important force during the last years. Especially in cases where foreign companies have a controlling stake, the new structure better supports executives from abroad who serve as outside directors. Another important reason is the current move towards restructuring and integration of group operations. While trying to better coordinate listed or unlisted group firms, current or former executives from the parent company are starting to serve as outside directors at group firms (Nikkei 2003.06.15)

Still, most Japanese companies have decided to retain the Japanese-style governance model, and 80% of listed companies remain directly opposed to the introduction of U.S.-style CEO systems. This reluctance notwithstanding, major companies are moving closer to CEO-based systems because they see the necessity of more transparent governance structures, and a stronger focus on fast and flexible decision making at the top level. A quarter of listed companies have, for example, installed independent directors on their boards.

Examples of Japanese-style governance models, which try to improve flexibility and efficiency in their boards by putting a rather strong emphasis on the separation of management supervision from the execution of business, are the “internal monitoring” models of Toyota and Matsushita. Toyota reduced its board of directors from 58 to 27 in 2003. The 31 directors who were excluded from the new board are now focusing solely on daily operations as “managing officers”. The specialty of the system is, however, that 14 of the remaining board members became “senior managing directors” and are intended to bridge the gap between the board room and daily operations by retaining their double roles as board members and managing division chiefs. At the same time, Toyota appointed three foreign managing officers for the first time in its history. Matsushita also chose not to completely separate management functions, but rather to overlap the functions in an even more traditional Japanese governance framework. After reducing the number of directors from 27 to about 19, the chairman, president and vice presidents became solely responsible for the handling of strategic decision-making and supervision. The remaining directors share a supervisory role, but also remain responsible for the execution of business operations (Nikkei 2003.04.25; 2003.08.14; 2003.11.10).

At most other companies, however, still too many directors are involved in operational management, and even auditing officers are usually chosen from the companies’ ranks. Also, the decisions about levels of remuneration or resignations of directors remain usually under the discretion of the powerful presidents.

Although this traditional Japanese corporate governance model keeps management costs low, and is well adapted to existing internal promotion structures, it has become an obstacle to effective restructuring. As the low profit rates have demonstrated for decades by now, Japanese directors seem to rarely think beyond existing operational structures and are often opposed to downsizing their operations until they have to comply to outside pressure.

### **Institutional Investor and Shareholder Control**

Institutional investors are showing a growing interest in corporate governance. According to a survey of the Japan Securities Investment Advisers Association (June 2003), investment advisory companies voted against or abstained from some 20% of

management proposals at shareholders meetings in May and June 2003. This figure is up from only 8% a year earlier. The survey also showed that 56 of the 93 investment advisory companies either voted against or abstained from some corporate proposals. This means that the proposals made by each company ran into negative votes and abstentions about 6% of the time, up from 3% a year earlier. The proposals that often drew opposition included those approving retirement pensions for former executives as well as appointing directors.

With such activity the investment advisory companies followed increasing demands for higher investment returns from pension funds and direct calls to exercise their voting rights as shareholders more aggressively. The Pension Fund Association, Japan's leading pension fund association, which manages 1,800bn yen of Japanese equities, for example, pledged reprimands against companies that produced three consecutive years of losses without paying dividends. During shareholder meetings in May/June 2003 it therefore opposed about 60% of the motions put by 1,264 companies. Particularly, it opposed the re-election of directors in 635 votes out of 1,101, rejected retirement payments in 689 cases out of 1,071, and voted against dividend policies at 466 companies. Still, although these actions have certainly increased the awareness of corporate managers, the PFA has not succeeded in blocking any proposals (Financial Times 2003.06.27). M&A Consulting, probably Japan's best-known shareholder activist, on the other hand, is already more successful by targeting smaller companies with excessive cash reserves. M&A Consulting says that the group's main fund has outpaced the Japanese market by about 70% since its 1999 inception, largely by pushing some 20 companies to institute share buybacks.

Shareholders are also not shying away from lawsuits anymore. In September 2000, the Osaka District Court sent a strong signal when it ordered 11 (former) executives and directors of Daiwa Bank to pay a total of 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. By setting a precedent in terms of judicative involvement and fine level, the ruling had a strong impact on Japanese managers' consciousness of transparency necessities.

Another shareholder lawsuit against 11 former senior executives at Mitsubishi Motors over their part in the automaker's cover-up of users' complaints (in 2000), a case

which played a decisive role in bringing the corporation under foreign control (by DaimlerChrysler), finally reached an out-of-court settlement in December 2003. The suit was filed by a member of Shareholders Ombudsman, an Osaka-based nonprofit organization. Under the deal administered by the Tokyo District Court, the former president and 10 other directors agreed to pay a total of 180 million yen in settlement money to establish a fund aimed at revamping the company's legal framework. This settlement marks another important precedent because it is the first time executives of a company have been obliged to use the settlement money for a specific purpose. Direct payments to the plaintiffs, which would greatly increase their incentives to seek court action, are still not on the agenda, however.

### **M&A's and the Demise of Keiretsu Structures**

Already during 2000 an unprecedented 1,635 M&A's (including business transfers, equity participation, and increased capital commitments) were announced. This was more than 50% up from the same period the year before. Of these M&A plans 64.5% were domestic, and most of them demonstrated a focus shift from diversification to strengthening core-business competence. Those aiming at strengthening existing businesses accounted for 53%, for example, while those aiming at enhancing peripheral businesses stood at 22%. Only the remaining 25% aimed at entering new businesses (Recof Corp. Survey 2001). In 2003, M&As by Japanese companies came to 2,006 (including announced plans) during the year, a decline of 10% from the record year of 2002. The drop, the first in eight years, was blamed on a sharp decline of 16% in M&As aimed at expanding business scale. Through an increase of companies that raised their stakes in group firms by 20%, the trend towards business integration remained intact (Nomura Securities Co.'s Financial Research Center).

Another consequence of increasing merger activity is that Japan's traditional keiretsu's, or company groups are disintegrating. Mergers like the Mizuho Financial Group (now the world's biggest bank), that brought together Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan, for example, are cutting through the group-oriented main-bank nets. Foreign takeovers are setting important examples, and are often actively used as a tool to cut through old relationship business. Nissan, for example, cut costs by 20% during the three years after its takeover by selling suppliers and opening its affiliate-centered procurement. Following this example, Mitsubishi

Electric's also started to cut its annual materials procurement costs by trimming the number of its suppliers by about 2,000 in 1999. At the same time, it started to increase its purchases from overseas firms from then one-fourth to one-third of overall procurement.

These are important changes in Japan's (former) keiretsu groups that are further accelerated by the fast development of Internet-based e-marketplaces. Until the 1990s internally developed IT-networks were an important glue of Japanese keiretsu groups. With the shift of business relations and procurement to open Internet-based IT solutions a major economic reason for the former group relationship became outmoded, and current M&A activity is readjusting the structures.

### **Foreign Ownership**

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 capital, it has 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. Another result of the opening of stakeholder relationships and corporate networks is that it 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. Finally, the devaluation of stakeholder values has brought asset prices down to competitive levels – so that companies like Goldman Sachs and the Lone Star Group are about to become the largest golf operators in Japan, for example.

These developments are highly visible in the market of mergers and acquisitions, where Japanese financial institutions are clearly not up to the competition with their foreign counterparts. Goldman Sachs, Merrill Lynch, and Morgan Stanley, for example, were already 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 and Vodafone Plc's acquisition of a stake in Japan Telecom, were dominated by foreign players. In 2003 Citigroup was the top financial advisor for M&As of Japan companies, handling 20.79 billion dollars worth of deals. In second

place was Merrill Lynch and fourth place the Deutsche Bank group, who provided advisory services to the injection of public capital for the Resona Group (in third place was Nomura, which handled the most cases).

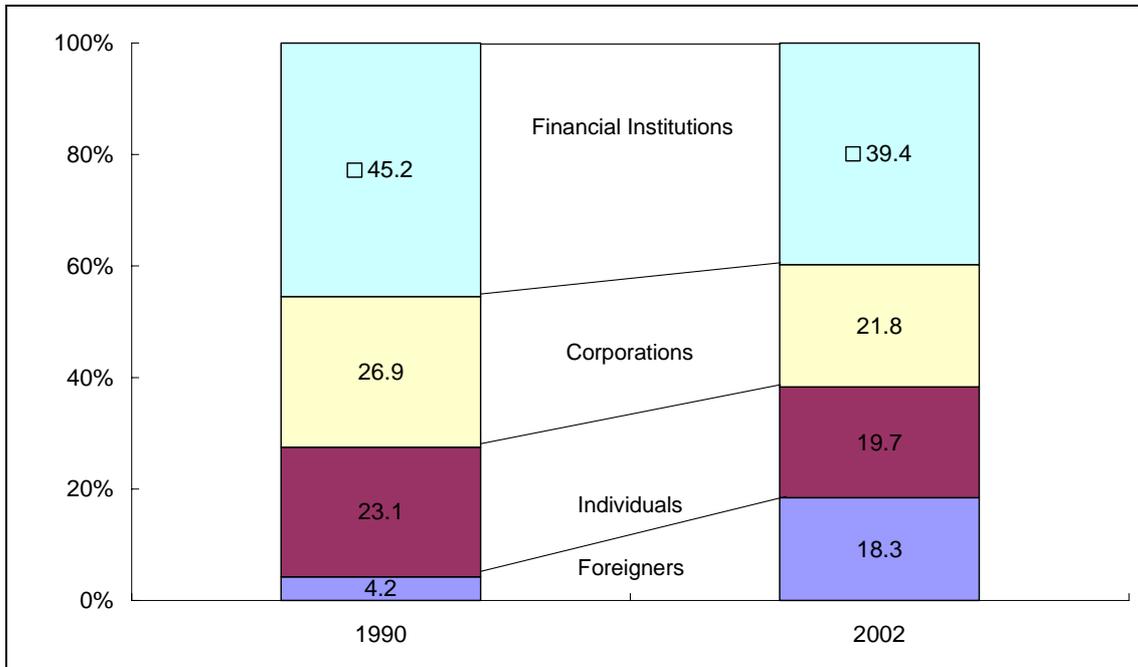
The same is true for advanced financial services, such as securitization of assets, structured finance and derivatives. Already in 2000, the Industrial Bank of Japan, for example, failed to win an order from Nissan Motors to raise 1.1 billion dollars for the construction of a new auto plant in Mississippi despite long being the 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. But even in standard asset management, where domestic players usually have advantages over foreigners, Fidelity Investments Japan and Goldman Sachs Asset Management Japan moved up one rank in the 2003 Nikkei Popularity Ranking of Asset Management Firms to fourth and fifth places, respectively. In terms of growth of assets under management Franklin Templeton Investments Japan and MFS Investment Management KK ranked No. 1 and 3 respectively, with both showing gains of over 500% in 2003.

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, the lowered levels stock prices, and the huge dollar interventions of the BOJ, which provide enormous liquidity to U.S. investors, 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 (Recof Corp.). Some funds have even specialized in buying Japanese bankrupt firms. Ripplewood Holdings, for example, has already bought a whole portfolio of former icons of “Japan Inc.” Most prominently, they bought the failed Long-Term Credit Bank of Japan and restructured it into the new Shinsei Bank in 2000. Already in 2001 gross profits jumped nearly fivefold to 100 billion yen. In early 2004 they are planning to sell some 30% with an estimated profit of 500%. Ripplewood also bought the huge Phoenix Resort Ltd. with the Seagaia resort park in Kyushu for 16.2 billion yen, which had originally been built at a cost of some 200 billion yen.

In the meantime, these investments do not remain isolated entrances into the Japanese economy anymore; foreign ownership has already become a major force in

Japanese corporations. In Figure 7, data from 2002 show that foreigners already owned 18.3% of Japanese stocks; in 2003 they even increased that share to 19.5%. Most likely, they will become the second largest shareholder group after Japanese banks.

**Figure 7: Japanese Shareholder Ownership by Type**



Source: © FRI. 2004. Data from Tokyo Stock Exchange Factbook 2003.

This shift in stakeholder relations is even more pronounced for Japan’s best and most internationalized companies. In the September 2003 Nikkei Ranking of Foreign Shareholdings, Rohm claimed the first place with 48.1% of its shares hold by foreigners. But also Canon, Hoya, Yamada Denki, and Orix accounted for foreign shareholdings beyond 45%. Between March 2003 and September 2003 alone, Rohm and Hoya saw foreign ownership jump by about 8%.

### 5.5 Labor Relations

Labor relations in Japan have a long tradition of stability, but also of low labor productivity. As Kimura/Schulz (2004) have shown, this seems to be much less the result of operational inefficiencies, than of misallocations of labor inputs between industries and limited incentives for the production of shareholder values. Governance reforms therefore do not only need to focus on incentives for performance and profit orientation, they also need to improve the flexibility and mobility of employees beyond existing group barriers.

## **Stock Options**

Stock options offer a simple way for the transformation of employee stakes into company shares. They are therefore quickly gaining acceptance in corporate Japan. According to a 2003 study by Nikko Cordial Securities Inc., about 30% of all publicly traded firms have adopted stock option programs. Nissan Motor first awarded simulated stock options to a group of 30 board members in 1999. Already by July 2003 these options represented a total gain of 6.5 billion yen, or close to 220 million yen per person. Meanwhile, Nissan awarded stock options to more than 650 employees this year. Although these employees are not able to exercise their options yet, their total paper gain is estimated to be about 3.5 billion yen, or more than 5 million yen each (Nikkei 2003.07.15).

A problem with this fast adoption of stock options is that these programs easily result in a reduction of stock market transparency, as the U.S. example has demonstrated. In Japan, this issue is especially problematic because the corporations might be able to exploit their still rather low levels of outside control and opaque accounting for overly generous option programs.

## **Flexibility and Mobility**

The flexible transfer of broadly trained employees within group firms has always been one of the strengths of Japanese corporations. Also, due to a fairly large bonus-element in wages, a flexible negotiation of wages on the basis of the income situation of corporations has not been a problem in principle. The low growth rates of the last decade now have also broken with the tradition of Japan's "shunto" (spring labor offensive) wage negotiations that lead to quasi-automatic wage gains. In spring 2003, for example, base wages stagnated while bonuses at manufacturers increased 1.58% and 1.41% at non-manufacturers. Even major corporations with top business results did not need to offer any base wage increases to their employees. Furthermore, as a result of these quasi-automatic wage hikes (or stagnation), the unions at major corporations have not taken any major strike action for more than two decades, and saw their membership numbers falling from 34.4% in 1975 to 19.6% in 2003.

Outsourcing is growing strongly. Retired workers (retirement age is around 60) are being rehired on flexible contracts, while part-time workers accounted for a record

25.5% of corporate employees in 2003. Another 4% worked on the basis of temporary contracts. Already in fiscal 2001, the number of temporary workers had exploded by 140% to 1.75 million from five years earlier. From 2004, this figure will increase further because it will become possible to extend more contracts from the current limit of one year to three years, and manufacturers will be allowed to hire temporary workers for factory work.

A consequence of base-wage stagnation and the increasing number of temporary workers at corporations is that bonus payments have become more flexible as well. After changing from basically seniority-based wage structures for managers to more flexible schemes with strong merit-based elements in the early 90s, corporations were also able to introduce more performance based bonus systems for regular workers. In a wage survey of listed firms with 284 valid replies by the Nihon Keizai Shimbun in March 2003, 30% of the corporations claimed they already instituted performance-based wage structures or that they were currently overhauling their seniority-based wage increases. As one of the current major cases, Matsushita Electric Industrial will scrap the 30% portion of its wages that is based on seniority entirely for more than 64,000 domestic workers in non-managerial positions in April 2004. It currently negotiates with its labor union about how this system can be transformed into performance-based bonuses.

With these changes it should become possible for Japanese corporations to extend their already high degree of labor flexibility within their corporations and groups to external labor markets. In this development the explosive growth of temp staff agencies is certainly only an intermediate step leading to cost-cutting and more flexibility of work structures, but not necessarily to increasing operational efficiency. Many corporations therefore found that the changes in their personnel systems did not increase productivity and profits – at first, at least. Many major corporations are therefore now trying to improve their staff structures on an as-needed basis by changing their hiring policies towards mid-career and year-round hiring practices. An employment survey for fiscal 2004 of 1000 corporations compiled by the Nihon Keizai Shimbun (November 2003; 912 valid responses) found that 31% of the corporations are now hiring mid-career employees, and that the hiring of mid-career employees increased by 9.3% in fiscal 2003. In the electrical machinery sector, mid-career and

year-round hiring was even up by 24% (Nikkei 2003.11.03).

These changes in corporate governance carry high costs for employees. Older workers in their fifties are often pressed into early retirement, and mid-career workers now face higher job insecurity and competition from performance based personnel systems and new mid-career entrants into their corporations. The young Japanese currently carry the main burden after graduating from school or university, however. They are confronted with the worst labor market situation for young people in decades. The jobless rate last year for the 15-24 age bracket was 9.9% and for the 25-34 age group was 6.4%. Nearly 40% of new high school graduates could not find a full-time position, and 25% of university students were forced to take a part-time job after graduating.

Current mid-career employees, on the other hand, can already see some improvement in their working conditions. At Fujitsu, for example, 70% of the company's workers said they were satisfied with their work assessment by supervisors in 2003. At Takefuji, Japan's leading consumer finance company, employees were able to break the long-standing practice of corporations asking for "voluntary" overtime beyond legal limits without paying. Two employees sued the company for failing to pay them for "voluntary" overtime beyond the legal limits and reached a settlement of about 6 million yen each. After this, it was revealed that the practice was company-wide and the corporation had to settle 3.5 billion yen on around 5,200 workers.

Clearly, by moving to a strong reliance on part-time workers and offering little chances for graduates, these "structural changes" in Japan's personnel governance and labor markets have produced a costly and in the long run not sustainable situation. Further structural reforms in the labor market institutions, the social security network, and the education system are therefore urgently necessary. Many of these steps, like the privatization and greater independence of universities to improve specialized education and the labor market chances of students, are now on their way. But judging from the difficulties, which labor market and education reforms face anywhere, it is rather clear that these costly reforms will probably need another decade until their results surface.

## 6 Blocked Finance

The most obvious obstacle to a solution of Japan's current economic deadlock is the paralyzed state of the banking sector. The current state of affairs in the former center of Japan's economic model is also a good example for the progress and remaining deficiencies in Japan's governance model. Clearly, without a well-functioning financial sector, Japanese corporations will not be able to focus on efficient investments, and Japanese households will not become interested in more risky, and hopefully more profitable investments.

### **Bad Debts**

Only in 2003 were Japanese banks finally able to start a significant disposal of the bad debts that remained or had built up on their balance sheets for more than ten years. By the end of September 2003, the aggregate amount of nonperforming loans of 132 city, regional, trust and long-term credit banks stood at 28.33 trillion yen (Interim Report of the Japanese Bankers Association). This figure was nearly 30% lower than its peak in March 2002. The figure also fell below 30 trillion yen for the first time in more than three years, and the percentage of nonperforming loans to overall lending declined 1.14 percentage points to 6.64% from March 2003.

But the quality of the banks' capital continues to deteriorate. The capital ratio of the six city banks other than Mitsubishi Tokyo Financial Group remained at about 10% - despite earlier (refundable) public capital injections, and large-scale capital increases of more than 2 trillion yen of new capital in fiscal 2002 alone. This capital ratio, although being perfectly adequate in healthier economies, still marks a critical level in Japan as long as significant nonperforming loans and cross-shareholdings remain in their books. Even more problematic is that the ratio of deferred tax assets as a percentage of core shareholders' equity rose to nearly 100% at Mitsui Trust Holdings and 40-60% at the other groups in 2003.<sup>20</sup> The banking groups therefore remain highly vulnerable to any change in market conditions as the case of the Resona Group, one of Japan's biggest

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<sup>20</sup> Deferred tax assets are claims on tax refunds for taxes that are paid on current loan loss reserves if the loans will become irrecoverable in the future. In Japan, banks are allowed to include up to five years of projected tax refunds in their capital base calculations. This is a highly problematic way of accounting because deferred tax assets are premised on earnings projections and expectations that loans will go bad.

banking groups, demonstrated.

The Resona Group had included more than 700 billion yen of tax-deferred assets in its shareholders' equity, but was forced to reduce that amount by about 40%, or nearly 300 billion yen, when one of its auditing firms refused to accept the plausibility of future tax returns on such a level. As a result, the capital ratio fell to 2% at Resona's banking unit and to below the 4% level for the entire group. As a result, the group needed to be rescued by effective nationalization (with a capital injection of 1.96 trillion yen in public funds). This development did not only mark another major crisis in Japan's financial sector, however. It also set a positive signal, which started the strong 2003 bull-run in Tokyo's stock exchange. Especially the fact that the crisis was started by an independent vote of an auditing firm – against strong resistance from the bank and (it is rumored) even the newly founded Financial Service Agency, Japan's new financial watchdog – was interpreted as sign that transparency in Japan is increasing. Furthermore, because the following capital injection proceeded with public funds without devaluation or cancellation of the shareholders' stock, risks in Japanese financial markets decreased to a level where foreign investors started to pour funds into the market.

### **Main Banks and the Lack of Financial Strategies**

Banks have lost their role as main banks with strong capital relationship to major corporations by unwinding cross-shareholding positions. In fiscal 2002, the percentage of listed firms' shares held by banks stood at 7.7% - worth about 20 trillion yen - compared with a peak of 20.9% in fiscal 1985. In 2003 the percentage even fell to below 4% of their assets. Listed companies, on the other hand, are increasingly reducing their dependency on banks, by reducing their combined parent-only bank borrowings another 4% from the year before to 77.73 trillion yen at the end of fiscal 2002. The percentage of bank loans to total assets held by listed firms fell to 21%, compared with a 20-year high of 33% in fiscal 1982 (Nikkei 2003.10.20).

In contrast to this development, the importance of lender-borrower relations has even grown relatively, however. According to a survey of 246 Nikkei 500 firms conducted by The Nikkei Financial Daily (August 2003), 72% of the corporations said they had a main bank, while 24% said they position several banks as their main banks.

Only 14 respondents, especially major firms like Toyota or Sony, had no main banks. But another Nikkei survey of 343 Nikkei500 firms in the same month also showed that the corporations did not depend on one or a few main banks for their funding needs. They borrowed from an average of 20 financial institutions. Furthermore, the corporations that increased the number of their banks (20%) mainly attributed the increase to the “adoption of syndicated loans.” At the same time (during the last three years), many corporations (42%) reduced the number of their banking ties quoting “a reduction in the scale of fund-raising.”

The unhealthiest part of these new “main-bank” ties is the dependence of small and midsize corporations on bank lending from almost insolvent banks. Financial institutions will lend funds without collateral or a guarantor only if they have intimate knowledge of the financial conditions of borrowing firm. This is problematic in Japan, because banks have not yet developed appropriate internal risk-assessment systems and outside relationships with CPA-firms for independent reviews of borrowers’ financial conditions. The “long-standing relationship” therefore remains the only effective instrument for credit evaluation. This leaves little room for startup corporations and higher income for banks from riskier lending, of course. If a company with a good business plan but no collateral and stable banking-ties is in need of credit and is willing to pay a risk-premium on top of the current (maximum-risk) lending rates of 5.5% at major banks, it still has virtually no place to go. As a result, these companies end up at finance companies, which are specialized on high-risk loans, insist on a guarantor, and only offer lending rates from well above 10%. Schaede (2004) calls this situation, where virtually no credit is available at interest rates between (risk-free) major banking rates of up to 5.5% and high-risk finance company rates beyond 10%, the “middle risk gap.”

During 2003 some banks have initiated lending programs for loans of up to 20-30 million yen without collateral or a guarantor to small and midsize companies at interest rates ranging from 5-10%. But this market is still very small, and banks are still not used to asking prospective borrowers to have their financial statements reviewed by CPAs before deciding whether to make loans. This also explains why rigorous audits of financial statements by CPAs have never become common in Japan. Unfortunately, current solutions to the problem beyond the banking sector focus much less on the development of efficient markets for securitization and private investors than on public

programs for credit guarantees (see below, “Public Financial Institutions”).

This development is problematic for the fragile financial sector in Japan, because it shows that the banks are still dependent on corporate credit for their income, and have not yet developed the necessary credit and investment banking skills that could form the basis for more diversified financial markets.<sup>21</sup> The “fatal relationship-cocktail” (Corbett 1998), which thrives on monitoring inabilities, huge debts, and general risk aversion in the banking sector, together with the lack of other financing possibilities, is therefore still dragging the economy. As a consequence, lending by Japanese banks fell another 5.1% in December 2003 - after six consecutive years of lending decreases.

### **Public Financial Institutions**

To relax tight credit conditions for SME's the government uses funds from the public postal savings and special government bonds to extend credit to the private sector.<sup>22</sup> In 2003, the Bank of Japan also started to buy securities from smaller firms that are backed by their accounts receivable. As a result, direct financial stakeholder relationships are building up between the public and the private sectors that have not been important before. In the meantime, the regional governments, which still see their regional economies faltering, have started to build up their own institutions to provide credit to SMEs. The Tokyo Metropolitan Government, for example, plans to start a new bank in April 2005. The bank will provide up to 200 billion yen in funds to guarantee loans extended by local financial institutions (including shinkin credit banks) to SME borrowers. The new bank is intended to use an easier set of criteria for credit approval than those adopted by the other credit guarantee associations.

Today, many SMEs therefore depend on public credit, while the private banks

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<sup>21</sup> Even loans to households, for example, still account for only 20% of banking loans or 10% of the banks' assets. Ninety percent of these loans are low-margin housing loans.

<sup>22</sup> The most important of the existing programs is the state-backed “credit guarantee system.” Small and midsize companies can use the credit guarantee corporation located in their prefecture as a loan guarantor when they receive loans from financial institutions. Lenders are fully (100%) reimbursed if the borrower defaults on a loan covered by the program. Although these corporations also use the general credit insurance system, they do have a system for variable insurance premiums and charge a uniform insurance premium of 1%, regardless of the soundness of the borrower and past default rates sustained by the lender, instead.

(which overwhelmingly depend on public credit for their capital base as well) have to compete with subsidized public credit when they try to build their business outside of the former keiretsu borders.

This situation is not likely to change anytime soon because the financing of Japan's huge government debt and its increasingly indebted public corporations (the balance of central government and regional bonds tripled since fiscal 1990) depends on the assets of the public postal savings and insurance systems, which total more than 350 trillion yen in 2003. Japan's postal savings, worth 233 trillion yen, are comparable to the deposits at the four top banking groups, and postal insurance assets, which are worth some 125 trillion yen, exceed the combined total at the largest five life insurance companies. Combined, the two systems hold 120 trillion yen in government bonds, which represents slightly more than 20% of the total outstanding. Furthermore, the Government Pension Investment Fund (162 trillion yen) invests 80% of its funds in the Fiscal Investment and Loan Program (FILP)<sup>23</sup> and other policy-related purposes. Overall, the government's Council on Economic and Fiscal Policy (CEFP) believes that personal assets totaling about 1,400 trillion yen (almost three times GDP) are being inefficiently invested in the public sector.

As a result of these developments it is still hard to be optimistic for Japan's financial sector. The current reductions of nonperforming loans and of cross-shareholdings are important steps. But a key element for a sustainable equilibrium of Japan's financial markets is still missing: the government needs to retreat from its participation in the financial market by privatizing the postal savings and life insurance systems. Japan's banks, at the same time, need to develop clear-cut business strategies that could guide another round of consolidation to solve the still looming problems of over-banking and lack of international competitiveness.

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<sup>23</sup> Japan's Fiscal Investment and Loan Program, which basically funds most public corporations, has a volume of about 20 trillion yen, or about 25% of the national budget or 55% of tax revenues. With the reform of the FILP in April 2001, the automatic flow of funds from postal operations to public corporations was halted. But the postal savings system continues to invest most of its funds in government bonds and "zaito" bonds issued to finance the FILP program, which are then channeled to public corporations. Therefore, the flow of funds to public institutions saw little change.

## 7 Conclusion

Japan's mature economy had already outgrown its former structure of stakeholder governance with closely organized conglomerates and principal control by management and bureaucracies at its center 20 years ago. From the early 90s, the economy further ran against the limits of a stakeholder society when returns started to deteriorate. As a result, governance in Japan is moving from a system of stable "insider" relations to a more flexible model of market-based "outsider" or shareholder participation and control.

This transformation remains costly and time consuming because it requires major changes in the closely linked system of stakeholder interests, including changes of the market framework, management incentives and employment structures. But the past decade has not been a lost time for the reform of Japan's governance model (as Japan's reform-critics often complain) – although many of the changes that work forcefully today are less the result of active planning than of a rather frustrating deterioration of former stakeholder values. Today, asset, consumer and capital prices have come down by deflation, the importance of stakeholder groups like ministries and banks has deteriorated, and foreign investors have become the owners of almost 20% of Japan's listed stocks and are now the dominant shareholder group in some of its best companies.

Much more important is, however, that a series of market reforms has started to shift the "rules of the game" of Japan's stakeholder economy towards a more flexible market-oriented governance framework. Successive electoral reforms and a central government reform in 2001 gave more power to the cabinet and its ministers, who almost from the start have been trying to fill these "bigger shoes" by pushing for more structural reforms under Prime Minister Koizumi. Changes to the commercial code have shifted the market framework towards a new emphasis on transparency, outside control, and sound auditing. The introduction of a civil rehabilitation law, the reform of the corporate reorganization law, and the extension of consolidated taxation have increased the flexibility of restructuring and reduced its costs. And the start of labor market deregulation has extended the range of temporary contracts, transferable pensions, and stock-options and therefore greatly extended the toolkit of corporations to cut costs,

restructure, and shift from lifetime to temp-staff employment.

These institutional changes are now clearly transforming Japan's rather insider-oriented governance model, although their current success largely depends on the extension of the corporate toolkit for cost cutting and restructuring. The necessary following steps of structural reforms to reinvigorate Japan's propensity for innovation and value added production, in contrast, cannot easily be planned as a "grand design" of structural reforms by a government or other stakeholder groups anymore. It is therefore more important to keep a strong focus on transparency at every level of governance reform, so that current "insiders" of stakeholder groups can get the necessary information for their planning of new steps, evaluation of risk taking, and continued support for market reforms. Furthermore, and potentially as important in a rather closed stakeholder economy, the transformation of insider-oriented governance should be accelerated by promoting outsiders into key positions. Outsiders provide knowledge and incentives for innovation, and demonstrate the "outside" chances for current insiders if they try to transform their established structures.

The current reductions of cross-shareholdings and nonperforming loans, the growing numbers and independence of CPAs (Certified Public Accountants), as well as the appearance of more and more outside directors and mid-career hires, are important steps in this direction. But key elements for a sustainable governance structure are still missing. First, the "accounting big bang" needs to be enforced to further disentangle Japan's unhealthy relationships between banks and corporations. Second, the government needs to retreat from its participation in the financial market by privatizing (effectively) nationalized banks, and, most importantly, the postal savings and life insurance systems. Unfortunately, Japan's government currently seems to be moving in the opposite direction on the latter point. To soften the high restructuring costs for Japan's SMEs (Small and Medium-size Enterprises), the government keeps nationalizing private banks, while regional governments start to found more public banks and extensively use postal savings for credit guarantees.

Nevertheless the chances for renewed life in Japan's economy today are much better than during the past decade. This is because important stakeholder groups are increasingly convinced that many elements of the reform process are falling into place in the meantime, and are starting to invest in Japan's future again. The BOJ, for example,

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which was sticking to a rather restrictive monetary policy during the 90s (see Schulz 2001a), became convinced that the reforms it has been demanding for years are now on the way. It therefore started a synchronized monetary expansion and foreign exchange intervention policy with the MOF from the end of 2002. During 2003, foreign investors regained their interest in major Japanese corporations and started to “recycle” the flood of liquidity from Japan’s dollar interventions by buying more shares than Japanese banks and investors needed to (or wanted to) sell. Profiting from the improved business conditions after years of restructuring and cost cutting, Japanese corporations gradually stepped into the market by upgrading their investment plans. Now, even Japanese households seem to become convinced of the sustainability of the process, see their bonuses and overtime grow, and start to buy new and innovative products and services. Hopefully, this will start a private-demand driven cycle of growth that would allow Japan’s corporations to regain strength in the development of innovative products and services.

## 8 Appendix: The “Bubble” as a Result of Partial Deregulation

Financial reforms, which started in the late 70s, increasingly allowed major corporations to raise their funds independently from limited and expensive stakeholder networks with their main banks. This left Japanese city banks – mainly catering to big business – with a declining customer and asset base. To make up for the shortfalls, they used further liberalizations (especially for banking) after 1982 to venture into an extension of credit lines to smaller corporations with no (implicit) governmental guarantees, and asked – following classic governance preferences in banking – 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 when monetary policy joined the concert after the (unrelated) Plaza Accord (Hoshi/Kashyap/Scharfstein 1990, Horiuchi 1995, Schulz 1997).

Clearly, the fundamental pitfall in this development was less the speed (or slowness) of the liberalizations, than the lack of equilibrating incentives for banks to develop suitable risk-valuation schemes that would have warned them about the macroeconomic risks of their limited microeconomic credit valuation schemes. In other countries, with already more flexible markets and institutions, where real estate bubbles also developed at the same time, credit risks remained contained in a limited group of institutions and did spread throughout the entire financial sector. Also, financial regulators in these countries (in the U.S. and Sweden, for example), swiftly cleaned up their financial sectors by bailing out the better institutions, demanding improvements in risk management, and letting the vulnerable banks (together with their unrecoverable debts) go bankrupt.

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 introducing a fast cleanup through a meaningful Financial Resolution and Collection Institution (which was founded only much later), and overhauling business 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, with the private financial sector still in disarray, the Ministry of Finance even extended its stake by stepping in to the paralyzed banking sector from the demand AND the supply side. It did not only continue to substitute for a lack of business demand by setting up further huge construction projects, it also started to supply credit directly to small- and medium-size enterprises through the public Fiscal Investment and Loan Program.

With this development, the quality of the financial system in Japan fell even behind the situation of the former stakeholder setup because increasing parts of private financial intermediation were replaced by governmental credit and control. This “financial socialism” plays an important part in Japan’s current slow response to changes in business conditions.

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