CORPORATE GOVERNANCE IN JAPAN: A REVIEW OF LEARMOUNT

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I need to start this review with a frank admission. As an economist, I admit to not being particularly uncomfortable with the views associated with "the hegemony of economics-informed approaches" to corporate governance which Simon Learmount takes square aim at in his recent book *Corporate Governance: What Can Be Learned from Japan?* That said, Learmount's warning to corporate governance researchers, as well as interested spectators of the Japanese economy, that over-reliance on any particular model of corporate governance may run the risk of focussing on the wrong questions and issues is salutary.

While the purported narrow focus of economics-informed approaches may well be a valid argument, it does lead one to pose the question of what the "right" model may be. In addition, as to the usefulness of models, the question of the *correct* level of complexity for models of corporate governance naturally arises. In part, this explains Learmount's focus on Japan. He is interested in the convergence of national systems of corporate governance, as well as the roles of organisational trust and cooperation in governance systems, so this in no small measure explains Learmount's interest in the rather unique Japanese corporate governance system.

Learmount uses a case study methodology to explore the governance practices of Japanese companies. The use of case studies is pursued in order to offer an insight into how Japanese companies are "actually" operated and controlled. His analysis is structured around four principal themes, namely the role of shareholders, the role of the main bank, the role of employees and the role of senior management in the governance of these companies.

First, while an increasing accountability to foreign institutional shareholders is noted, stable shareholdings with a select group of shareholders is still the norm. These stable shareholdings are reciprocal exchanges between business partners, which cement business relationships. Learmount argues that the complexity and depth of these relationships are largely independent of the level of shareholdings. He concludes that shareholding, per se, may be an irrelevant indicator of what is a symbiotic relationship. In fact, he argues that firms tend to select their majority shareholders. Of course, it goes without saying that selection of favourably

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inclined and sympathetic shareholders may also be symptomatic of management entrenchment.

The chapter on the role of the main bank in Japan is the one that will strike most Japan researchers as the most difficult to reconcile. It has long been argued that the main bank has played a major role in monitoring companies (e.g., Sheard, 1989; Aoki, 1994). On the other hand, my sense is that the recent studies that suggest that the monitoring by banks was largely ineffective (e.g., Hanazaki and Horiuchi, 2000) are more representative of today's consensus view.[1] There are two reasons normally forwarded for this rather less sanguine view of the role of banks. One hypothesis is that the banks themselves were not effectively monitored and disciplined (that is, "who monitors the monitor?"). A second hypothesis is that the banks performed well not because they monitored and disciplined their client firms, but because the firms were themselves disciplined by international competition. When client firms reduced their reliance on bank credit in the 1980s, the banks were forced to extend their funds to non-traded-goods industries, such as real estate and finance. The consequence was a serious non-performing loans problem in the 1990s. Rather than arguing along these lines, Learmount contends that since monitoring can be perceived as an action that would destroy a main bank-firm relationship, that monitoring only occurs in the most extreme of circumstances (i.e., severe financial distress) if at all.

Consistent with the underlying theme of his book, Learmount argues that the relationship that firms have with their main bank is not based on protection of the extent of the bank's investments. Also, running somewhat counter to the prevailing view (as espoused by Yafeh, 2000, Hoshi and Kashyap, 2001, e.g.), Learmount argues that the relationship between firms and their main bank is as strong as it ever was, *if not stronger*. Because they are at such variance with modern research, statements such as these require far more substantiation than they receive in the book.

The book's treatment of employees is somewhat more standard and less controversial. (Possibly because the literature on Japanese labour and human resource management practices is so immense.) However, the question that most interests Learmount is whether the interests of employees are promoted at the expense of shareholders. He answers this question in the affirmative. Using an argument akin to the economists' notion of revealed preference, Learmount argues that Japanese firms have a continued commitment to 'traditional' practices.

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1 A somewhat more generous view is that main banks role as monitor has simply "run its course" (Yafeh, 2000). As opposed to American-style corporate governance, in which hostile takeovers and managerial incentive schemes play a major role, Japanese firms have traditionally relied on monitoring by large shareholders and banks. However, Yafeh argues that deregulation, financial innovations and the globalisation of capital markets has made the traditional system of main bank monitoring increasingly ineffective and outmoded.

Although, once again, it is not altogether clear what the relevant metric for gauging adherence is. While there seems to be some movement towards increased performance-based pay, Learmount concludes that predictions of the imminent demise of long-term employment, seniority system of promotion and wages will prove to be misguided.

Finally, Learmount notes the lack of independent directors and presence of insiders on the Boards of the firms in his study. Further, Japanese managers do not *feel* accountable to shareholders and there are no obvious sanctions on managers who perform poorly. Further, there are no radical transformations taking place. It all seems very much business as usual, according to Learmount.

The common view is that Japanese corporations pay insufficient attention to shareholders as the owners of the corporation. Obviously, despite this seeming lack of shareholder oversight, until the 1990s Japanese firms performed well. Interestingly, Shishido (1990) addresses what appears to be a conundrum by utilising what he terms the "Company Community" model of Japanese corporate governance. This model sheds insights into the dual problems of balancing the monitoring and autonomy of management and balancing the interests of financial capital and human capital. Shishido argues that the company community concept solves these problems through an intricate system of monitoring consisting of three levels. The first level is the in-house monitoring by core employees who are the quasi-residual claimants. The second level is the monitoring by cross-shareholders in the firm, the main bank in particular. Cross-shareholding also has the effect of stabilising the management position against outside control. The third level is the monitoring by exit of the outside shareholders. In fact, he regards this third level as having become increasingly important in Japan. More strikingly, Shishido views the functional convergence between the Japanese and Anglo-Saxon corporate governance systems as *already having taken place*.

Overall, Learmount's book suggests that a system of reciprocal responsibilities, obligations and trust within and between companies acts as an important means by which most Japanese companies are governed. This is very much in the spirit of Ronald Dore's (1987) view of the Japanese firm as a Community. In Japanese corporations, there is a complex system of responsibilities, reciprocities and trust in socio-economic relationships. What Learmount terms the "socially endogenous system of corporate governance" can guarantee the accountability of company directors and employees. In his view, "moral sentiments" have the potential to solve opportunism problems. In particular, in Japan there are "(s)ocialising forms of accountability inherent in trusting relationships."

The hegemony that Learmount rails so vigorously against has its origins in Berle and Means' (1932) view of the modern corporation. Learmount argues that as soon as one takes seriously the notion of the separation ownership from control that it predisposes the researcher/ academic/ policy-maker to assuming that there

is "problem" to be solved. Further, the agency approach so favoured by economists, along with the view of firms as a nexus of contracts where stakeholders are guided by self-interested behaviour, may not be appropriate for the study of Japanese corporate governance. Japanese corporate governance has a different focus from its Anglo-American counterpart, which focusses on the protection of investor capital and financial investments. Of course, from a policy perspective, Learmount is highly critical of those increasingly vocal commentators who argue that Japanese corporate governance should be more Anglo-American in style (and substance).

Learmount conducted his case study interviews with various members of fourteen companies during the 1998-1999 period. The 1990s were trying times for Japan, of course. Within Japan, they are now widely referred to as the "Lost Decade". Of course, by the end of the millennium the tide of opinion about what was so virtuous about "Japan Inc." had most definitely turned. Focus on corporate disclosure, accounting practices, Board structures and the role and influence of shareholders lead to calls for sweeping reforms. Symptomatic of these changes is the trend towards Anglo-American style capital market financing (see Yafeh, 2000). A central element of the debate in turning Japanese economic fortunes around has been the governance of its companies. More generally, how Japan's main bank system, cross-shareholdings and long-term employment relationships will transform and evolve in a globalising environment is of great concern. The response to globalising capital markets and the implications of the non-performing loans crisis in its banking sector is the most prominent and specific of the concerns at the time of writing this article. Some authors have even questioned whether the Japanese system is sustainable. For example, the highly influential and impressive work of Hoshi and Kashyap (2001) suggests that the twenty-first century system will almost certainly *not* be bank-centred.[2]

Unfortunately, some of these current themes seem tangential, rather than central, to Learmount's book. In what may be reflective of selection bias in his methodology, Learmount asserts "Most of the companies I studied are governed well, albeit differently from their Anglo-American counterparts." It is never clear however, how this conclusion is reached in his monograph. It really is a matter of faith. In fact, there is precious little in his case studies apart from interviews with

2 Driven by a process of reforms that culminated in what is known as the "Japanese Big Bang", Hoshi and Kashyap show that the largely successful era of bank dominance in post-War Japan is over. Deregulation has exposed the banks to competition from capital markets and to foreign competitors. The banks are destined to shrink as households change their savings patterns and their customers continue to migrate to new funding sources. In addition, securities markets are set to re-emerge as central to corporate finance and governance. Deregulation also allowed large bank customers to quickly shift from bank financing to capital market funding. Hoshi and Kashyap show that large Japanese firms, particularly manufacturers, are now almost as independent of bank financing as comparable U.S. firms.

some key personnel. There are no data or statistics for the companies that he studies. Therefore, it is impossible to determine how the companies he studies have evolved over time, have responded to the economic malaise, or ideally, how they compare with either other Japanese companies in the same sector or with their counterparts in the West.

An implication of Learmount's book is that fundamental change in Japan will, of necessity, be multi-faceted. Organisational, psychological and sociological dimensions all interact with the more familiar economic and political economic forces that economists normally train their sights on. An holistic approach is required to effectively analyse the key determinants of change in the structure of corporate governance, human resources management and the nature of contracts between the firm's stakeholders – explicit and implicit. Another theme, and a factually relevant point worth repeating, is that there is considerable inertia in the Japanese economy.[3] Change is occurring, but from a Western perspective, it is occurring at a snail's pace. From a Japanese perspective, change is likely to come with some, not insignificant, cost. Consequently, the slow pace of change is entirely explicable.

In addition to the globalisation of capital markets, recent changes in corporate governance have also been spurred by the slowdown in economic growth and the Asian economic crisis. For the post-war period up to the late 1980s, Kester (1991, p.50) describes how organisational inertia and resistance to structural change in Japan was in large part driven by the reluctance on the part of managers and owners to breach implicit contracts with labour. In turn, institutional features such as reciprocal shareholding arrangements significantly reduce the temptation to tender shares owned in a target company (see Hoshi, 1998). Kester (1991) discusses how an active market for corporate control only began to emerge in Japan from the late 1980s.

For what it's worth, my opinion is that change in Japan is slowly occurring and is being in large measure driven by globalisation, rather than the banking crisis alone.[4] I agree with Learmount in one sense, albeit for entirely different reasons.

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3 Genda and Rebick (2000) argue that Japan has been undergoing structural shifts in its labour markets, both external and internal, and that these changes have been amplified by demographic factors. However, they also note that the shifts are not particularly notable, when compared with European, and particularly, U.K. developments. In a similar fashion, Kato (2000) describes how Japanese firms have been 'fine-tuning' rather than dismantling their existing employment practices. However, he argues that some of the recent changes have the potential to result in reduced commitment by union officials to rank-and-file workers. This may eventually lead to the 'breakdown of the system'.

4 Fan *et al.* (2003) argue that the increased modularity of manufacturing products has had a considerable impact on the financial system, in that it encourages transactions without relationship and changes the concept of the firm from an organic entity based on internal markets to a simple sum of independent projects. Second, the diminishing

That lies in questioning the role for public policy in the pursuit of the ideal corporate form, although not necessarily the much-touted U.S. style 'A-firm'.

In fact, I question the accuracy, as well as the usefulness, of the popular Western image of a Japanese firm. Just how pervasive *in* Japan is the prototypal J-firm? Are most Japanese firms simply clones of flagship mega-corporations such as Sony, Toyota and NEC? In fact, while corporations such as these are influential and obviously high profile, they are not ubiquitous. Within the Japanese economy, small- and medium-sized companies employ the bulk of the Japanese workforce. In fact, nearly 90 per cent of all private sector workers are employed in businesses with fewer than 300 workers (Sugimoto, 1997, p.80). As with the small firm sector in the West, there is considerable labour turnover in this part of the economy. Consequently, there is no lifetime employment for the overwhelming majority of Japanese workers (Hiwatari, 1999).[5] Naturally, some of the small businesses are part of *keiretsu* networks. However, these same businesses, particularly small sub-contractors, are likely to face greater exposure to market forces and are unlikely to enjoy the full range of insurance and financial benefits provided to fully-fledged subsidiaries.

The large Japanese firms undoubtedly attract the lion's share of the attention of commentators due to the contribution that they have made to the Japanese economy's export performance. These firms wield political and economic influence at home *and* abroad. In addition, the governance structure, lifetime employment system and seniority-based wage structure of the large corporations are indeed distinctive. They differ from their Western, particularly U.S., counterparts, and this fact may well have contributed to the popularisation of the 'types of capitalism' approach to analysis. Such an approach, however, tends to bias the efforts of researchers towards the study of what is uniquely Japanese, what is uniquely American or perhaps even, what is uniquely Australian(!). It tends to predispose one to look first for "cultural differences" in the way in which corporations are organised. This approach to social science tends to sit uncomfortably with most economists. Of course, such a research concentration has both costs and benefits. Aoki's (1990) caricatures of Japanese and American firms are based on observable and static characteristics of large Japanese and

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role of national boundaries in transactions implies an increasing role for market competition in disciplining the behaviour of wayward firms. The authors argue that this implies an inevitable change in the regulatory framework which will need to respond to these changes by relying more on market-based regulation methods.

5 Interestingly, employer tenure data published by the OECD (1997, table 5.6, p.139) indicate that Japanese employees spend an average of 11.3 years with one employer. The OECD average is 9.6 years. The fact that average tenure for U.S. employees is among the lowest for OECD countries at 7.4 years may explain the attention given to the purported long tenure of Japanese workers. (That is, it's not that the tenure of Japanese workers is particularly long, rather that the tenure of U.S. workers is relatively short.)

American corporations. It should always be kept in mind that the J-firm and A-firm are models – no more than that. They distinguish types of firms on the basis of how information is acquired and processed, control is exercised, operations are financed, how incentives are provided to employees, the incentives to cooperate or compete, to monitor and shirk, and more generally, the involvement and specific investment by stakeholders in the corporation, and so on. As an economist and, of course, I'm extremely fond of models. Models are useful for understanding and focussing our thinking, and hopefully, for also helping us to frame testable hypotheses.[6] In the present case, however, the 'varieties of capitalism' approach provides little guidance on how actual corporations are likely to evolve and change if they are subjected to a succession of either positive or negative economic shocks. After all, some of the mooted changes that are being bandied about are not marginal changes, e.g., they involve calls for the abandonment of the lifetime employment system. As Hamada (2001) points out, it is not clear whether the J-firm should strive to look more like an A-firm, an hybrid of the two or, I might add, something else altogether different.

The world is dynamic and, of course, corporations must be sufficiently flexible to meet the challenges that arise in a changing environment. What are the costs of overhauling a human resources management system that has apparently served Japan so well?[7] Has its time really come? The firm is often described as a nexus of contracts. Taking the broadest possible definition of contract, i.e., which encompasses social, economic and legal elements, provides a particularly useful way in which to frame one's thinking about the relationship between the firm's various stakeholders.

During the 1980s there was considerable debate in the United States about suspected breaches of implicit contracts during the height of the 'merger wave'. One aspect of the hostile takeovers that attracted considerable attention was the fact that some of the takeovers were financed by 'stripping' excess assets from employee pension funds and renegotiating the wages of long-term (mainly, union) employees. Corporate restructuring through takeovers is in large measure value-enhancing. Considerable controversy still exists, however, about the primary effects of shareholder activism. On one hand, it may force companies to abandon

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6 An example of the usefulness and testability of the J-firm/A-firm distinction is Ichniowski *et al.* (1997). These authors found that it was unprofitable for American firms to adopt Japanese-style human resource management practices in a piecemeal fashion. The profitability of such changes in "culture" rested on the adoption of the entire menu of employment and human resource management practices, due to the complementarity of the component parts.

7 Gilson and Roe (1999) describe the lifetime employment system of J-firms as having a 'bright side' and a 'dark side'. The latter involves the lack of exposure to the external labour market and worker immobility. The 'dark side' encourages productivity and commitment (because employees fear the potentially large costs associated with job loss), but the J-firms' lack of 'macro'-flexibility leaves them unable to respond to rapid technological change.

outmoded management and compensation practices (Jensen, 1993). On the other, such activism may result in opportunistic actions that undermine the trust necessary for the development of firm-specific human capital and organisational effectiveness (Shleifer and Summers, 1988; Garvey and Gaston, 1997). Of course, the main problem with reneging on implicit contracts is that such opportunism undermines the value of the firm and may create inefficiencies. "*The breach of trust accompanying such deals might spread enough fear of further breach through the economy as to either vastly complicate or even prevent profitable trade*" (Shleifer and Summers, 1988, p.53). Seen in this light it is not surprising that J-firms have been reluctant to embrace drastic changes to lifetime employment and related human resources management practices. I also find it interesting that the developments and resulting debate in the United States during the 1980s, find themselves mirrored in a similar debate being conducted in Japan more than ten years later.

A somewhat more cynical political economic explanation for the resistance to changing the status quo management and human resources system is that employees are the most important and influential stakeholders in J-firms. Directors and managers of J-firms are normally drawn from the ranks of long-term employees. Simply put, resistance by self-interested groups of 'insiders' explains the slow pace of change in the structure of corporate governance (see Miwa, 1998).

While it is hard not to agree that organisational, psychological and sociological aspects as the mechanisms for change (or inertia); what is very clear is that political economic considerations are extremely important in maintaining the status quo or realising change. The promise of improved economic efficiency is not a sufficient condition for change. Some authors contend that celebrated institutions, such as lifetime employment, the seniority wage system and enterprise unionism arose for primarily political reasons. As mentioned previously, Gilson and Roe (1999) argue that lifetime employment evolved in post-War Japan for reasons that had more to do with closing external labour markets and ensuring industrial relations peace than for the provision of specific human capital investment incentives. Similarly, Hiwatari (1999) argues that enterprise unionism, in large part, arose by historical accident and only in small measure by conscious design. Enterprise unionism generated better employment conditions for its members through such guarantees of lifetime employment. The *quid pro quo* was wage restraint when 'crises' hit their firms. Enterprise unionism became more significant as the export-oriented industries, in which such unions were prominent, became more influential.

Hoshi (1998) describes the heavy involvement of government in Japanese corporate governance through *amakudari* – the placement of retired bureaucrats on the boards of large corporations. In part, this is entirely consistent with the 'industry policy as driving force' view of Japan's economic development. However,

Hoshi's (1988) analysis suggests that, rather than being the agent of change, due to its heavy involvement as a stakeholder, the government is often instrumental in resisting change. Outwardly, the role of the government tends to be contradictory at times. Genda and Rebick (2000) note that much government policy has acted to maintain existing employment practices. Weinstein (1997) concludes that the government's tax and financial policies continue to inhibit foreign takeovers through the promotion of stable shareholding.

Corporations in every country face the need to change due to the very nature of changing dynamic comparative advantages. The need for change becomes more apparent in the face of dramatic changes in the economic environment. There is always resistance to change, of course. Mooted changes in organisational direction involve winners and losers. For example, if Japanese firms abandon lifetime employment practices and renegotiate implicit contracts, then this will undoubtedly adversely affect incumbent employees. On the other hand, the effect of demographics and greater external labour market opportunities for experienced workers may work to offset some of these losses. Some of the changes in organisational design may be inevitable as the Japanese labour market and corporate environment globalise. Blomström *et al.*, (2000) and Ito and Fukao (2001) note that deregulation has opened up much of the industrial and service sectors to foreign multinationals. Inward foreign direct investment into the Japanese economy is small, but is likely to increase as deregulation opens up industrial and service sectors. This has the potential to serve to accelerate change to the existing corporate culture.

In conclusion to what may seem to be a critical review, like Learmount (p.6) I suspect that "the commonly advocated 'solution', that Japanese companies must adapt to the demands of international markets and move towards the more 'open' Anglo-American system of corporate governance, is not the only possibility for change."

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