The Jerome Levy Economics Institute of Bard College
Public Policy Brief
HIGHLIGHTS

No. 48A, December 1998

Japanese Corporate Governance and Strategy

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The prolonged recession in Japan today stands in contrast to its high growth from the mid 1950s through the early 1970s and its booming prosperity from the late 1970s through the 1980s. The growth rate of the economy has sputtered in the 1990s and was even negative in 1997 (Yokoyama 1997). During the first quarter of 1998 Japan's gross domestic product declined at an annual rate of 5.3 percent (Abrahams and Tett 1998). By world standards, its unemployment rate of just over 4 percent in April 1998 is enviable, but the unemployment rates since 1996 are higher than they have been in Japan since the current mode o f calculating the rates began in 1953 (Nikkei Weekly 1998). As many economists see it, Japan has now entered the real world of international economics, and unless it quickly deregulates its capital and labor markets, it will not be able to get its economy back on track.

The crisis of the Japanese financial sector has certainly contributed to the prolonged recession of the economy in the 1990s, and industry is facing competitive challenges, particularly from South Korea, Taiwan, and China. However, Japanese enterprise remains a power in international competition. While financial institutions wallow in bad loans, most major industrial enterprises are cash rich, Japan remains a creditor nation with a high savings rate, companies are investing in new technologies, and the economy is generating persistent trade surpluses. Despite the financial turmoil, Japan's formidable productive system is not in danger of collapse. Nevertheless, the system of corporate governance faces short-term pressures from the banking crisis of the 1990s and long-term pressures from the growth of intergenerational dependence. These financial challenges will inevitably have an effect on how people are employed and remunerated.

The Japanese System of Corporate Governance

In deciding how to allocate productive resources and financial returns, Japanese enterprises pursue a "retain and reallocate" strategy, retaining corporate revenues and reallocating the labor force (in contrast to the U.S. "downsize and distribute" corporate strategy). Cross-shareholding and lifetime employment are the institutional foundations that shape the allocation decisions. Cross-shareholding, which accounts for two out of every three shares, is the holding of corporations' stocks by a network of other corporations. Lifetime employment means that the company takes responsibility for a certain class of employees from the time they are hired to the time they retire. By ensuring that the returns of the enterprise can be devoted to reinvestment in the productive capabilities of these employees and the capital equipment that they can use, cross-shareholding makes possible the enterprise's pursuit of its employment objectives.

The essential feature of cross-shareholding, relative to corporate governance, is the willingness of participant companies to be "stable shareholders." A Japanese company that is a stable shareholder is willing to forgo capital gains and does not sell the stock of another company except under conditions of financial stress; if it

must sell, it sells to another stable shareholder and is expected to repurchase the stock when it regains its financial strength. Stable shareholders forgo control rights and routinely give their proxy votes to the top managers of the companies. Stable shareholders also have been willing to accept dividend yields that are low given the market value of the stock they hold. These actions make cross-shareholding a system whereby the Japanese business community protects the power of corporate managers to control the allocation of the resources and returns of their companies.

The Japanese system of corporate governance is intensely hierarchical, with ultimate strategic decision making the prerogative of an executive board of top managers. The board of directors is usually made up of top managers, lifetime company employees, employees of other corporations who are stockholders of the company or with which the company has extensive relations, and bank or government agency employees who have been permanently transferred to the company. Within the management structure key allocation decisions are generally made by a process of consensus decision making. Top managers ultimately make the decisions but they are integrated into a process that makes them aware of the capabilities and expectations of those responsible for implementation (Nonaka and Takeuchi 1995).

The intense demands of organizational learning, particularly in the presence of rapid technological change, place limits on the motivation and ability of older workers, with given education and experience, to attain higher levels of productivity.

This integration extends down the hierarchy to enterprise unions and the joint consultation committees (JCCs), which involve labor and management (Nakamura 1997). Union officials, who are company employees, confer with management at different levels of the enterprise on matters of remuneration, work conditions, work organization, interdepartmental and intercompany transfers, and production, but the unions have no explicit rights to engage in the executive or supervisory institutions of corporate governance. In large companies JCCs gather information for both management and labor as a preliminary to collective bargaining; in smaller companies, in which enterprise unions are absent, collective bargaining takes place in the JCCs (Kuwahara 1982, 51). JCCs can make management aware of what labor wants, but they do not give labor the power to influence the allocation of resources and returns against the wishes of top management (Nakamura 1997).

Since the 1970s overt and prolonged labor-management strife has been virtually nonexistent in major Japanese companies, largely because of the commitment of management to lifetime employment and management's willingness, protected by the wall of cross- shareholding, to share the gains of the enterprise with employees. In turn, workers' claims on enterprise earnings take into account financial requirements for reinvestment and the performance of the economy as a whole. Workers have been willing to restrain their demands for pay increases on the understanding that the enterprise will retain and invest what they do not take now in ways that will benefit them later.

The Banking Crisis

The immediate problem facing the Japanese economy is the banking crisis. The financial crisis of the 1990s is the result not of an underlying weakness in the productive capacity of the Japanese economy, but of the transformation of the role of the nation's financial sector with the maturation of perhaps the most successful national economic development effort in world history. In the 1950s and 1960s Japanese banks were actors in a highly regulated financial system in which, given the uncertainties involved, they were willing to take relatively low returns on their lending activities to support the success of the industrial economy. One reason that banks were willing to participate in such a system is that they expected the government would stand behind them should the loans go bad. As central participants in the cross-shareholding movement, the banks themselves were run not for the sake of their stockholders but for the sake of developing the economy.

By the 1970s and 1980s the Japanese economy and its core companies had overcome the uncertainties inherent in the developmental process; the returns on the wealth that Japan's industrial development had created since the 1950s far surpassed the ongoing investment requirements of the Japanese economy; and the very success of the industrial economy made corporations much less reliant on the major banks to mobilize capital for their further development. Awash with cash, having lost their best customers, and in search of new business, the banks turned to making loans to real estate developers and stock speculators, and the "bubble economy"

emerged. When, in 1990, the stock and land markets crashed, much of the value of the assets against which Japanese banks had lent money vanished into thin air.

Intergenerational Dependence

The long-term problem facing the Japanese is the increase in intergenerational dependence and the associated problem of funding the pension system. Japan has the most rapidly aging population in the world. The proportion of the population aged 65 and older increased from 5 percent in 1950 to 15 percent in 1995, a period during which the proportion of the U.S. population aged 65 and over rose from 8 percent to just over 12 percent. The question is whether the strategies for dealing with this condition are consistent with solutions to the more immediate problem of restructuring the banking system. The current strategy for handling intergenerational dependence is to keep people working longer so that, as much as possible, they sustain their standard of living through productive employment.

Recent reforms of the public pension system involve moderating benefit levels and changing retirement ages. The reforms changed the age of retirement with full benefits from 60 to 65 (effective in 2013) and introduced a partial pension for retirement between ages 60 and 64. For those eligible for pensions who still remain employed, the amount of permitted earnings was increased to ensure that total income (earnings plus pension benefit) would not decrease as earnings rise (Seike 1997).

To remain competitive, Japanese companies that employ an aging labor force have to concern themselves with the productive contributions of older workers, relative to both their pay and the productive contributions that could be made by younger workers. High levels of education and training and the good health of the labor force combine with the prevalence of in-house organizational learning to enhance the productivity of employees over the course of their careers (Lazonick 1997). Nevertheless, the intense demands of organizational learning, particularly in the presence of rapid technological change, place limits on the motivation and ability of older workers, with given education and experience, to attain higher levels of productivity. To enable companies to fulfill the commitment of keeping workers employed, the employment system must be flexible enough to permit the reallocation of labor resources and returns to labor in response to changes in the productive and competitive environments.

One source of flexibility is the ability to reduce the number of new hires. In the past companies hired large numbers of new high school and college graduates and then, after a decade or so, decided which of the cohort were best suited for employment tracks that provided more responsibility, authority, and pay. Now employers have to be more selective about new hires, and competition among companies for graduates with specific capabilities has intensified. In addition, companies traditionally filled openings for lifetime employment positions with young people and then trained them. Now many hire people who already have specialized skills, either through work experience or university training.

A second source of flexibility is in rewards. Traditionally, lifetime employees were recruited to companies from high school or college and then saw their earnings increase primarily on the basis of seniority (with supplements for larger numbers of dependents). In the 1990s individual performance has begun to count much more in determining promotion and pay.

Third, and perhaps most important, as a source of flexibility is the major companies' right, in consultation with their enterprise unions, to transfer employees in their late forties or early fifties to subsidiary enterprises, where pay and responsibilities are generally substantially lower (Japan Institute of Labor 1997, 30-31). Provided the subsidiaries can absorb these employees, the benefit for them is that they get experienced personnel without having to invest in training. The practice of transferring also allows those managerial employees who are considered to be especially valuable to the company to continue to work for the company, even after the official retirement age, in positions of executive responsibility and at relatively high pay.

From the government's perspective, the success of this strategy of financial reorganization will depend on the ability of financial enterprises to learn how to make profits in the international world of financial liquidity, while being denied the opportunity to extract higher financial returns from productive enterprises at home.

This reallocation of labor resources is part of the Japanese phenomenon of enterprise "spin-off." Spin-off is a product of a system of corporate governance that permits a successful company to allocate both money and people to the creation of new business enterprises, which then have considerable autonomy in the allocation of their own resources and returns.

The Future of the Japanese Corporation

There is abundant evidence that Japan is in a good position in terms of its accumulation of technological capabilities and investments in new technologies to regenerate its industrial production. In manufacturing it retains distinct competitive advantages in the integration of precision engineering, advanced materials, and electronics. Prime sectors for industrial innovation are in the provision of telecommunications services, transportation services, and energy-inputs to industry and key components of living standards that remain high in cost in comparison with other advanced economies (Okina and Kohsaka 1996). In order to take advantage of the new technological opportunities, a larger proportion of the Japanese labor force will need higher levels of education and specialized training.

Japan must also address reorganization of its financial sector. The retain-and-reallocate strategy emphasizes income from productive employment rather than income from financial assets to support the employees over the course of their lives. Given low and regulated interest rates and the low yields on corporate stock that prevail in Japan, any additional inflows to Japanese pensions will have to come from returns to investments on international capital markets. Such investments, even in safe foreign securities, are fraught with exchange rate risks. A prime motivation of the "big bang" financial reorganization policy announced by Prime Minister Hashimoto in 1996 was to put the Japanese financial sector in a better position to manage such risks as it pursues higher yields on the savings under its control.

The financial "big bang" entails a deregulation of the historic segmentation of financial services in Japan to create new business opportunities, both at home and abroad, for those banks, securities companies, and insurers that are best able and willing to rise to the challenge-those that have a sound financial base at home and can develop the capabilities to operate simultaneously and quickly on international securities markets and money markets. These augmented capabilities could open up new sources of profits for these financial enterprises, thus enabling them to employ more people in Japan and to bring in higher returns on household savings.

Despite the image of radical change that the reform's name is meant to impart, the "big bang" does not entail a deregulation of domestic interest rates nor a dismantling of cross-shareholding. From the government's perspective, the success of this strategy of financial reorganization will depend on the ability of financial enterprises to learn how to make profits in the international world of financial liquidity, while being denied the opportunity to extract higher financial returns from productive enterprises at home. Such a transformation, if successful, could enable now fragile financial enterprises to survive by tapping into high returns on financial assets abroad, augmenting the returns on savings at home but not undermining financial commitment to productive enterprises.

How far the "big bang" can proceed without creating powerful financial interests that have not only the

incentive but also the ability to extract higher yields from the Japanese domestic economy remains to be seen. What can be said is that the current agenda for financial reform seeks to work within the corporate governance framework that emphasizes the retain-and-reallocate strategy. Such a strategy is inconsistent with the ideology of financial deregulation and shareholder "value creation" that has driven the downsize-and-distribute strategy of U.S. corporations. It is dangerous, therefore, to analyze the possible outcomes of the transformation of the Japanese financial sector from an American perspective on the allocation of resources and returns.

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The full text of this paper is published as Levy Institute Public Policy Brief No. 48.

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ISSN 1094-5237
ISBN 0-941276-64-3