Japanese Firms' New Corporate Governance After "Structural Reform"

By Naoyuki HARAOKA

Appearance of "Japan Remodeled"

FROM the 1990s to the early 2000s, Japanese businesses have tried various forms of reform. As a result, and especially thanks to businesses' restructuring efforts and progress in the disposal of nonperforming loans by the government, the Japanese economy is said to have realized a prolonged economic recovery until recently. Professor Steven Vogel of the University of California at Berkeley, who specializes in Japanese politics and economy, has given high marks to the Japanese economy's growth following structural reform in his recent book, *"Japan Remodeled" (2006).*

According to Vogel, Japanese firms, "in a distinctively Japanese fashion," have responded to increased pressure to cut costs by favoring "voice" (negotiations) over "exit" (severance of relationship) in adjusting their relationships with their long-term partners, such as employees, banks and suppliers, in order not to harm these collaborative relationships, and have worked to utilize the advantages of these relationships to surmount their problems. He writes that this process has brought a fundamental change in Japanese labor relations, corporate governance and inter-business relationships.

Change in Labor Relations

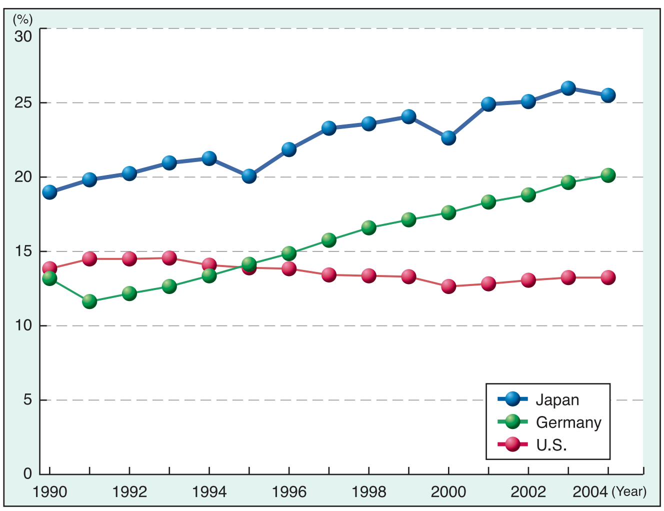
In their relations with employees, Japanese firms have made adjustment of working hours and used dispatched workers (agency temps) while at the same time restructuring their organizations by spinning off business divisions or creating holding companies. Through these practices, the long-term employment guarantee has shifted from employment within the firm to employment within the group and even among unaffiliated companies.

Namely, as the government has allowed firms to increase the flexibility that was already built into the Japanese employment system, Japanese companies, while maintaining their conventional practice of "life-time employment," have reduced the ratio of regular employees to their total workforce or, as mentioned above, guaranteed employment within the group, to carry out reform. They have been using many means of employment adjustment, such as temporary transfers to subsidiaries, job/workplace transfers and increased holidays. As a result, the ratio of part-time employment has increased, as indicated in *Chart 1.* Although the rate of job reduction by firms has increased, it is not as high as that in Germany or the United States, as shown in *Chart 2.*

Change in Inter-corporate Relationships

As the government's deregulation has allowed financial institutions to enter securities and other businesses through their holding companies, relationships between corporations and banks have shifted from the traditional "main bank" relationships to more diverse and broad ones, including transaction-based relationships for some multinationals and venture firms. By taking advantage of Commercial Code revisions, businesses

Chart 1 Part-time employment rate in Japan, Germany & the U.S.



Source : *Employment Outlook, OECD*

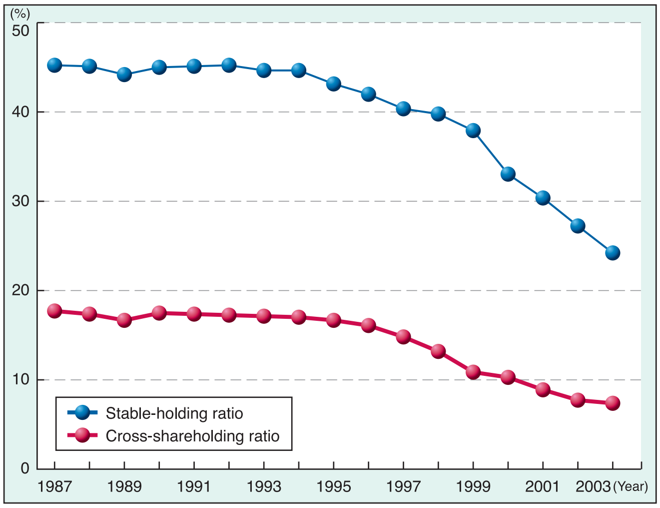
Chart 2 Rate of corporate downsizing in Japan, Germany & the U.S.

Country	10% cut 2001 (%)	10% cut 1991 (%)	Cumulative likelihood for each firm, 1991-2001
Japan	5.9	2.0	0.213
Germany	9.3	9.9	0.402
U.S.	20.6	9.2	0.445

Notes : *Sample covers listed corporations with more than 2,000 employees. A firm making worker reduction denotes a reduction of employment of 10% or more over a one-year period. Cumulative likelihood is the probability of reducing employment at least once between 1991 and 2001.*

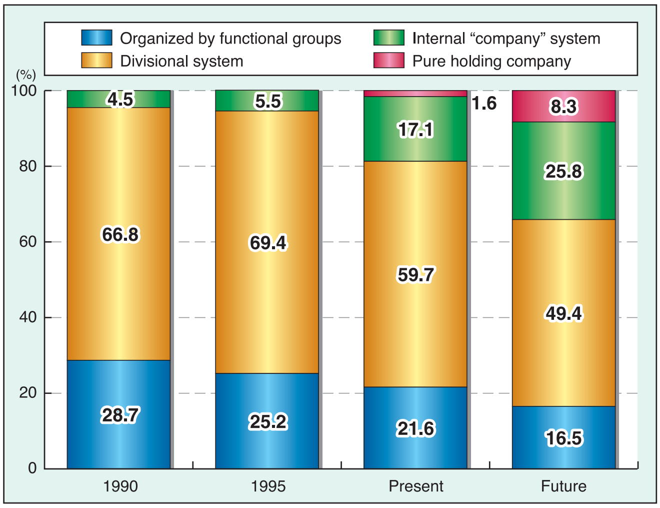
Source : *Adapted from "Stakeholders under Pressure: Corporate Governance and Labor Management in Germany and Japan" (Gregory Jackson)*

Chart 3 Ratios of stable & cross-shareholdings in Japan



Source : *NLI Research Institute*

Chart 4 Corporate reorganization in Japan since 1990



Source : *"Corporate governance in transition," Ministry of Finance, Policy Research Institute*

have redesigned their corporate governance systems to appeal more to international investors, without fundamentally altering the way they do business. Also on the strength of the new government policy to encourage spin-offs, firms separated or re-integrated affiliates.

As shown in *Chart 3,* the change in the traditional main bank relationships has reduced the ratios of cross-shareholdings and stable holdings. Moreover, as a result of the increase in separation of business divisions, progress has been made in the introduction of more autonomous internal "companies" and holding company structures *(Chart 4).* According to Vogel, "holding companies could make it easier to develop a functional substitute for venture capital by funneling investments into virtually autonomous subsidiaries with compensation structures designed to foster innovation." These changes in long-term relationships have rendered Japanese businesses more open to outsiders. In fact, M&A deals in Japan have increased recently, particularly acquisitions of Japanese firms by foreign companies.

Fruits of Gradual Reform & Future Prospects

Thus, Vogel says, Japanese businesses have tried to revitalize themselves through incremental reform without undermining their business management based on lifetime employment and seniority-based promotion and pay (which are inherent characteristics of the Japanese economy), and without changing their basic principle of attaching great importance to long-term inter-corporate relationships. According to him, this approach has been successful to some extent as it brought about a prolonged business recovery until a while ago. Also from the perspectives of innovation and openness to other countries, the situation has improved or is likely to improve.

The above is the gist of Vogel's discussion on the incremental structural reform by Japanese firms, which was introduced in his book mentioned before. The "lifetime employment and seniority-based pay systems" that feature in the Japanese model of business management have been maintained in principle although they have been changing little by little recently. This can be seen in the low ratio of worker reduction at Japanese firms as compared with those in the United States and Germany as shown in *Chart 2.* However, the high rate of worker reduction by foreign subsidiaries in Japan has also been pointed out. It suggests the possibility of the Japanese management model undergoing a radical change as the ratio of foreign firms increases in the Japanese economy. The question is whether these incremental reforms will be able to eliminate "moral hazard," which is thought to be the greatest impediment to "innovativeness" (which includes innovative and unique ideas in addition to technological innovation) at Japanese firms.

As society becomes more conservative and social classes and strata become more rigidly fixed, the problem of "moral hazard" is bound to rise. That is to say, it becomes easier to enjoy vested interests instead of working hard. A relatively commonly observed vested interest in present-day Japan is the fact that "if one is with the same employer long enough, his or her promotions and pay increases come without regard to his or her abilities." As Vogel points out, the introduction of good points of the "market principle," albeit incremental, has rendered the long-term inter-corporate relationships more open and has resulted in more open competition. Henceforth, this is expected to have a favorable impact on innovation. However, given the growing importance of the role of innovation in Japan in the future, which will be marked by an aging and declining population, it appears that Japanese businesses need to consciously implement reform in a way that will further reduce moral hazard. JS

(All charts are reproduced from *"Japan Remodeled."*)

Naoyuki Haraoka is Editor-in-Chief, Japan SPOTLIGHT.