Stronger Corporate Governance: The True Shortcut to Higher Productivity

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Unexpected Dividends of "Abenomics"

The results of the economic policies of the Shinzo Abe administration have surpassed expectations. By pressing the Bank of Japan to embark on a bold policy of monetary easing, Abe has succeeded in achieving both a weaker yen and a rising stock market. In just six months since the autumn of 2012, when the possibility grew that Abe would become the next prime minister, the dollar has appreciated 25% against the yen, moving from 79 to 100 yen. The Nikkei stock index has risen from 8,600 to 14,000 yen and seems poised to move even higher. Replacing BOJ Governor Masaaki Shirakawa, who was reluctant to engage in monetary easing, with Haruhiko Kuroda, who had been arguing for quantitative expansion for some time, ensured a policy of monetary easing. This has been a relief to Japanese export industries that struggled through years of a strong yen and seems likely to improve corporate profits. Rising stock prices bring a surge in consumption centered on stockholders. Such a virtuous cycle is finally beginning to take hold.

Short-lived Effect of First & Second Arrows

Seen from an economics perspective, however, Abenomics also has numerous risk factors. Let us address a few in turn. First is the question of whether the Japanese economy will really be that much improved by a weaker yen and rising stock prices alone. Certainly a weaker yen means profits for export businesses. But what about imports? Prices for the gasoline and food that Japan imports are already beginning to rise. For fiscal 2012, Japanese exports totaled 64 trillion yen and imports 72 trillion yen. With imports exceeding exports by 8 trillion yen, a weaker yen is a negative for the Japanese economy. Because the balance on income — the sum of dividends and interest on financial assets such as stocks and bonds and overseas factories and offices owned by Japanese companies — is denominated in foreign currency, it increases in yen terms when converted to a weaker yen. Combining all these various factors, the weaker yen has almost no effect overall.

The End of Deflation?

The second is that a weaker yen and rising stock prices may not necessarily lead to beating deflation. Deflation is when the general price level — that is, the consumer price index (CPI) — trends downward. The CPI includes the prices of products such as food, everyday items, clothing, and general merchandise as well as the cost of fares, tuition, rent, and other services, but does not include currency exchange, the price of stocks, or the price of land. A weaker yen results in higher prices for imported goods that, to some degree, are probably shifted to consumers. To what degree depends on how far prices can rise without impacting sales. The income of ordinary workers, which makes up 60% of Japan's GDP, has fallen for the last 15 years, declining by 13% from 1998 levels. There is certainly nothing easy about the lives of ordinary citizens. Whether imported or made at home, if the price of products rises consumers simply cut back further on their spending; the inability to raise prices will make it impossible to do away with deflation.

The third risk factor is wages. In order to do away with deflation, it is essential that the income level of ordinary consumers — that is, their wages — rise. This is why Prime Minister Abe and the principal cabinet ministers have all called upon the leaders of the business community to raise wages. This appears to have led a number of large corporations to increase their bonuses but they remain reluctant to raise base wages. With conditions still difficult for small and medium-sized companies, the overall increase in wages this year is negligible and the outlook for next year and beyond is uncertain. If prices rise in the absence of an increase in wages, people will have a harder time getting by and the economy is likely to slow down once again. Before this happens, Abe needs to employ his third arrow: a strategy for growth.

Increased Productivity Key to Raising Wages

Even so, Japan has experienced continued deflation and falling wages for nearly two decades, a period unprecedented elsewhere in the world. Wages have not risen because companies have cut them in order to expand their profits, but this does not mean profit levels at Japanese companies are higher than those of companies in other countries. Indeed, they are lower. Why are profits and wages both low?

Ordinarily, corporations employ labor and capital equipment to produce and sell things. What remains after subtracting their direct costs such as raw material, fuel, and transportation expenses from sales is called "added value". Because GDP totals the added value generated by corporations, it must be increased in order to raise the economic growth rate. Without added value, corporations cannot pay wages and there is no compensation for capital. The problem with Japanese corporations is that they lack sufficient capability to

generate added value; in other words, their added value productivity is inferior. Here, "productivity" means more than simply generating greater output from a given amount of labor; improving productivity also means expanding profits by selling products at the higher prices that increased customer satisfaction makes possible.

Problems of Japanese Economy Springing from Sluggish Productivity

The cause of the "two lost decades" since 1990 was not only the collapse of the bubble or the financial problem of bad loans. At root was a decline in the ability of Japanese corporations to generate added value — that is, in their productivity. In order for Japan to break free of deflation and embark on a path of stable growth, it must take genuine steps to improve productivity. Leaders of the Japanese business world have called for the elimination of the "six disadvantages": the high yen, the cost of power, environmental regulations, the labor system, high corporate taxes, and the delay in negotiating free-trade agreements. Improvements in some of these areas are underway but seem unlikely to bring a dramatic increase in the competitiveness of Japanese corporations. Specifically, the following problems remain:

1. An inability to utilize talent effectively

An issue that always comes up when talking with corporate managers is the lack of talent. "We don't have global talent," they say. "There's no one we can entrust projects to." Yet it is these very same companies that are reluctant to hire foreigners or overseas students and lag behind in the utilization of their female labor force. What is particularly dispiriting is that talented graduates of top universities are spending their time doing tedious work at large corporations. The inability of these companies to modify their internal human resources (HR) rules and customs leaves them unable to fully utilize the talented people they have managed to hire, who soon leave for elsewhere.

2. Slow decision-making

Something I often hear from foreign companies is that business negotiations that seem to be going well suddenly stop cold when it comes time to make the final decision, with internal reasons (the need for approval from the board, or to discuss things with the bank) often cited as the cause. Even company presidents are unable to make decisions for themselves. Irritated, such potential partners lose patience and go elsewhere. By the time approval is finally granted, it is too late; the business opportunity has been lost. Middle management prioritizes gaining the consent of their superiors more than taking decisive action on their own.

In the last few years, there has been a conspicuous decline in flat-panel televisions and other digital appliances. After all, it has been clear for quite a while that there is no way to win competing against South Korea, China, and Taiwan when it comes to the simple assembly of consumer durables. European and American electrical manufacturers such as GE, Siemens, and Philips pulled out of such businesses and shifted their focus to areas like health care, energy, social infrastructure, and industrial machinery. Had Japanese corporations taken appropriate measures two or three years ago, they could surely have avoided the dreadful situation they face today.

3. Aversion to risk

Business always entails risks. When thinking of profit as compensation for taking risks, one can say there is no profit without risk. The story of the tremendous success of the Walkman, a business Sony President Akio Morita pushed ahead with over opposition from within his own company, is well known. But in the wake of the collapse of the economic bubble, corporations were so busy restructuring that such stories were no longer heard from Japanese companies. There are few examples of successful Japanese companies in fields such as IT or biotechnology where the pace of innovation is rapid. Instead, Japanese companies tend to excel where they can maintain competitiveness through constant efforts to make improvements that result in ever more refined craftsmanship.

The other day a leader of industry in India had this to say during a meeting with the management of a Japanese corporation: "I often hear Japanese corporate management grumble about the lack of infrastructure in India, how hard it is to secure suitable sites, or the difficulty of maintaining relations with labor unions. But in India we treat all overseas companies equally. Corporations from other countries find ways to manage and profit handily. Japanese companies seem unprepared to take on risk." This seems an apt observation.

4. Resigned to low profits

Generally speaking, profitability at Japanese corporations is low. Return on equity (ROE) is about 20% in the United States but only 8% for Japanese corporations. In the United States, shareholders are

said to demand accountability if a company fails to achieve 15%. The same is true when there is a drop in the stock price. On the other hand, few Japanese corporations establish ROE targets, and falling stock prices rarely cause shareholders to demand management resignations unless the company is also in the red. As a result, low profitability continues forever.

Two years ago, the Great East Japan Earthquake forced the manufacturing plant of the exclusive provider of semiconductors for automobiles to cease operations, shutting down automobile production lines around the world. Despite playing such a critical role, this company had been in the red for years. For such a situation to have continued is due to nothing less than the negligence of its management.

Strengthening Corporate Governance Key to Improving Productivity

The problems raised above are not ones that the government can do anything directly to solve. Corporations must find their own solutions by themselves. Still, if existing systems and practices are an impediment to corporate self-reformation, the government needs to move actively to make corrections. It is in this regard that the deliberations underway concerning a growth strategy are particularly significant. Going forward, conventional support for R&D and subsidies such as tax breaks will be unnecessary; the strategy for growth should be centered on creating an environment that encourages individual corporations to change.

On 2 April, the Headquarters for Japan's Economic Revitalization instructed relevant ministries and agencies to consider their "policy response for the time being" with respect to a number of topics. Among them, I wish to draw attention to the strengthening of corporate governance (CG). CG is a matter of who watches over corporate management and how, and is a role that typically falls to investors, that is, those who put up the money. In Anglo-Saxon countries such as the United Kingdom and the US, it is generally stockholders who monitor management decisions and behavior. Things are somewhat different in continental European countries such as Germany and France where, in addition to stockholders, a broad range of stakeholders including employees, the local community, and trading partners are also expected to maintain a watchful eye, but in either case there is a recognition that joint-stock corporations require an appropriate system of checks and balances on management in order to function. In Japan, a company's "main bank" traditionally watched over corporate performance. These days, however, given the precipitous decline in borrowing from banks, CG has been weakened in the absence of any other mechanism for monitoring a business corporation's performance.

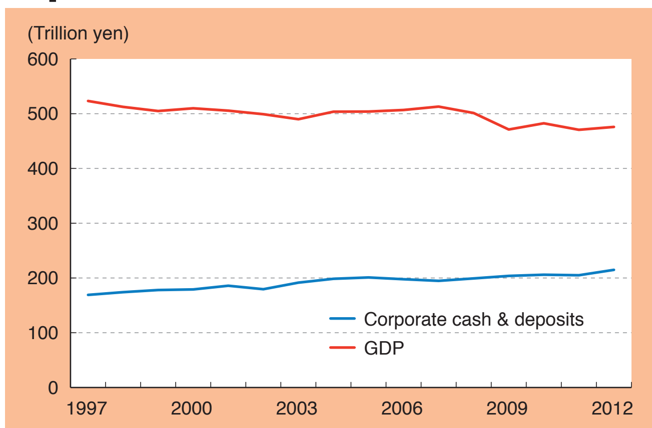
The reason weaker governance is a problem is that Japanese corporations have endured a long period of unprofitable business operations caused by a lack of the kind of pressure that would force management reforms, like having incompetent managers quit. For a joint-stock corporation, when business results lag or the stock price languishes, one expects stockholders to demand that management be replaced or the non-performing division cut off, leading naturally to management reforms. Why doesn't this happen in Japan? The biggest reason is long-term trading relationships such as joint stockholding and *keiretsu* arrangements. If Company A and Company B each hold the other's stock, Company B will not press firmly for change even if there is a problem with the way Company A is being managed. The reason is that Company B fears the criticism of Company A when it has problems of its own. The same is true in the case of long-term trading relationships; there is a long history in industries like automobiles and electronics of parent companies that are assemblers sending retirees to take up influential positions at subsidiaries whose stock they hold, and then purchasing subsidiary components at higher-than-market prices in return. In such cases, the ties of joint stock-holding and HR exchange between parent company and subsidiary have often stood in the way of achieving rational corporate management.

Ways to Effectively Utilize Excessive Corporate Savings

What is remarkable about Japanese corporations in recent years is their excessive cash and deposit holdings. In the 15 years between 1997 and today, Japanese corporations increased their cash and deposits by 46 trillion yen. During the same period, nominal GDP declined by 47 trillion yen. As a result, Japanese corporations have currently accumulated 215 trillion yen in cash, held either in hand or in banks *(Chart)*. Cash and deposits held by US corporations have also been increasing, but still total about 180 trillion yen. Considering that the US economy is roughly three times that of Japan, the level of cash Japanese corporations have socked away seems even more extraordinary. Most of it, too, is in bank accounts earning no interest. This is one of the major reasons their return on assets (ROA) is so low. From a stockholder perspective this is

CHART

GDP & Japanese corporate cash & deposits



Source: National income statistics, financial statements, statistics of corporations by industry

unforgivable behavior. And because there are no borrowers for the excessive capital accumulated in the banks, it is directed to holding massive amounts of government bonds. Economic decline is to be expected when such an enormous pool of capital, equivalent to half of GDP, is used in this way. The April 10 *Financial Times* wrote, "Japan's private savings — almost entirely generated by the corporate sector — are far too high in relation to plausible investment opportunities" and argued that the key to revitalizing the Japanese economy is getting rid of excessive corporate savings.

In order for the Japanese economy to become more productive, corporations should invest aggressively in growth areas and should either return their excess capital to stockholders in the form of dividends or raise wages, which increases employee motivation and encourages consumption, thereby fostering economic growth from the demand side. Encouraging corporations to move in this direction is the original role of CG. If there is functional monitoring of a corporation by their stockholders, they will demand to know the company's investment plans; if capital expenditure plans are unclear, they will press the company to return capital to stockholders. As a result, excess cash is used for investment or is distributed to stockholders and employees as dividends and wages. This can be expected to increase consumption and investment and to accelerate growth. This is why I believe strengthening CG to be an essential part of the strategy for growth.

Business World Seeking Stronger Corporate Governance

Better-functioning CG offers the promise of more than just preventing the accumulation of excess capital. It also pushes management to improve low profitability, long seen as a problem with Japanese corporations. In a written opinion put forward by Sakane Masahiro, a member of the Industrial Competitiveness Council and former CEO of Komatsu Ltd., he raised "social, management, and investor tolerance of low capital-efficiency management" as a problem with Japan's industrial structure. He argued that correcting this will require "pushing forward systematic change to strengthen corporate governance". Specifically, he mentioned quicker decision-making and monitoring for low-ROA management through a system of independent directors and auditors. This is eminently sensible thinking and it is encouraging to hear such opinions from a top member of Japan's business community. However, it remains a minority view within Japanese industry. I hope such thinking moves closer to reality by being expressed as an official opinion of the Industrial Competitiveness Council.

At the same time, it is easy to talk about strengthening CG but hard to accomplish it. Joint stockholding among companies has declined considerably compared to 20 years ago but it is still rare for management proposals to be voted down or amended at stockholder meetings. There is a limit to what the individual stockholder can do. Attention must be directed, then, to institutional investors like life insurance companies and pension funds that manage massive amounts of investment capital. These organizations employ numerous professional financial analysts capable of analyzing corporate financial materials in detail, offering opinions, and pressing for changes in management direction when needed. It is essential for improving the profitability of Japanese corporations that the role of such institutional investors be legally established and their rights strengthened so that they can carry out their responsibility as institutions to which funds have been entrusted. JS

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