Toward a System of Balanced Capitalism – Can Japan Avoid the Dangers of "Financialization"?

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A global debate is simmering: What is the future of capitalism? What is the social responsibility of a company? And how should corporate governance systems balance stakeholder and shareholder rights? The tradeoffs that countries face differ widely. The United States has long had a strong emphasis on *maximizing shareholder value* (MSV), and the current debate is about how to reduce the power of financial interests. In Japan, where the emphasis has long been on stakeholders – including employees, suppliers, trading partners, and banks – the concern is how to amplify the interests of shareholders so that the economy can benefit from the disciplinary pressures of the market.

Lately, the US system has come under attack. The belief in the stock price and its use as the anchor for corporate incentives and decision-making have led to a so-called "financialization" and a threat to the viability of the US economy. At this moment, Japan offers an alternative, even though it remains to be seen whether a more balanced system of capitalism can be defended against short-termism. A closer look at what has gone wrong in the US may help shape these debates, and offer some ideas for how Japan can pursue MSV without the dangers of financialization.

Why Is Capitalism Under Attack in the US?

There are three main reasons. The first is that the US – and several European countries – still have not recovered from the 2008 Global Financial Crisis. This has given rise to a "lost generation" in the US, namely millennials who witnessed how the 2008 collapse took away their parents' homes and savings, including for college education. Many US millennials deeply distrust Wall Street *(Chart 1)*.

The second reason is growing income inequality. Nowhere is this trend more pronounced than in the US. *Chart 1* shows the estimated share of total income earned by the 1% richest people, for the US and Japan. The two trendlines have very different slopes. One reason is that collapse of the bubble economy in 1991 brought a huge correction in Japan, whereas the 2008 Global Financial Crisis did not for the US. Yet, since the early 2000s income inequality has also risen in Japan, triggering concerns about an "uneven society" *(kakusa shakai)*.

The third attack on capitalism comes from those concerned with the decline in corporate performance, wages, and societal cohesion in the US. The hollowing out of manufacturing has begun to wipe out the middle class. The US has the highest poverty rate among people older than 65 among OECD countries. In addition to flaws in the pension system as well as the 2008 losses, this is due to the long-term destruction of jobs and falling wages, to levels so low they no longer support families, let alone retirement savings. These developments have brought societal and political turmoil, a turn to aggressive populism, and calls for reform.

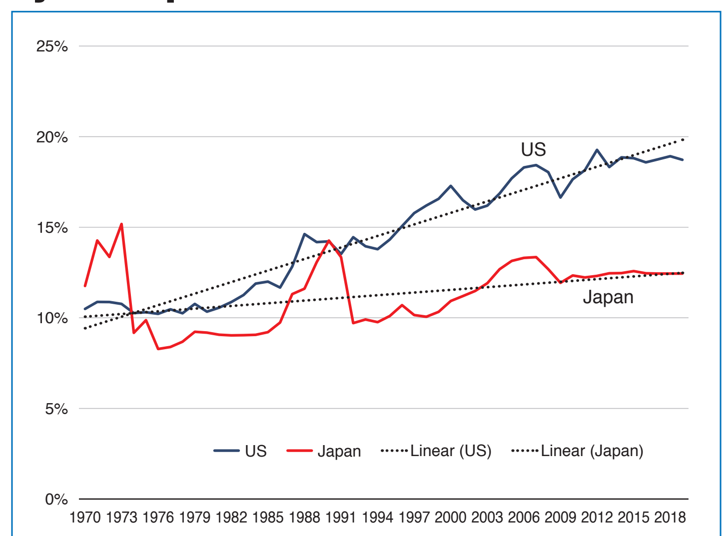
In 2018, Sen. Elizabeth Warren proposed the "Accountable Capitalism Act", to push for regulation to stop what she called the "looting" of US companies by Wall Street. In 2019, Rep. Alexandra Ocasio-Cortez called for the replacement of capitalism with a new system of "democratic socialism". While neither of these initiatives may succeed as drafted, they represent and shape the new discourse in the US.

What Went Wrong in the US: the Phenomenon of Financialization

The above problems are all seen as associated with the ongoing trend toward large firm *value extraction*, as opposed to value

CHART 1

Income inequality: share of total income by the top 1% earners



Source: Constructed with data from World Inequality Database

creation. These terms were coined by William Lazonick, author of *Sustainable Prosperity in the New Economy* (2009), and *Predatory Value Extraction* (2020, with Jang-Sup Shin). They claim that value extraction is caused by an excessive adherence to the MSV view above all other societal interests.

The MSV doctrine was developed by economists concerned exclusively with efficiency. It was first articulated in 1970, with Milton Friedman's famous quote that "the social responsibility of the company is to maximize profits". Companies must focus on driving costs down, including labor, so as to be as profitable as possible.

This was tied to corporate governance with the 1976 agency theory paper by Michael Jensen and William Meckling. Their starting point is the assumption that there is an irreconcilable conflict of interest between "owners" (people who hold shares) and "managers" (hired to run the company). Managers are assumed to be dishonest and driven by self-interest; they only want to enrich themselves. Therefore, shareholders must be protected from these managers. This is done through a system of corporate governance that gives power to shareholders, by way of full access to information, board memberships, and the right to affect financial allocations and strategic decisions. Shareholders take priority over all other interests, based on the assumption that as providers of capital they pursue the interests of the market. It is further assumed that the market clears all information, which is reflected in the company's stock price.

What has made this theory so harmful is its connection with "financialization". Together, they have made US corporate governance exceedingly short-sighted and undermined the ability of large US firms to innovate for the future. Traditionally, the term financialization referred to the shift in economic activity from the manufacturing to the service sector, and its impact on employment and GDP composition. The new meaning of financialization refers to a societal change toward using money as an incentive for all actions and the only metric to define success. For example, employment is about pay rather than learning or achievement, and house ownership is about capital gains rather than community-building. In the US, this has been termed as the rise of the "transaction man", in contrast to the former "organization man", America's version of Japan's "salaryman".

In terms of corporate governance, the rise of Silicon Valley and the birth of venture capital (VC) funds contributed greatly to financialization. VC funds invested in young companies in the hope of making a quick, lucrative "exit" through a stock listing. The new companies offered stock options to attract young talent away from secure positions at established firms. In the process, innovative enterprise became associated with the stock market, and a company's stock price became critical for attracting finance and talent. Eventually, this created a new hypermobility of people and money.

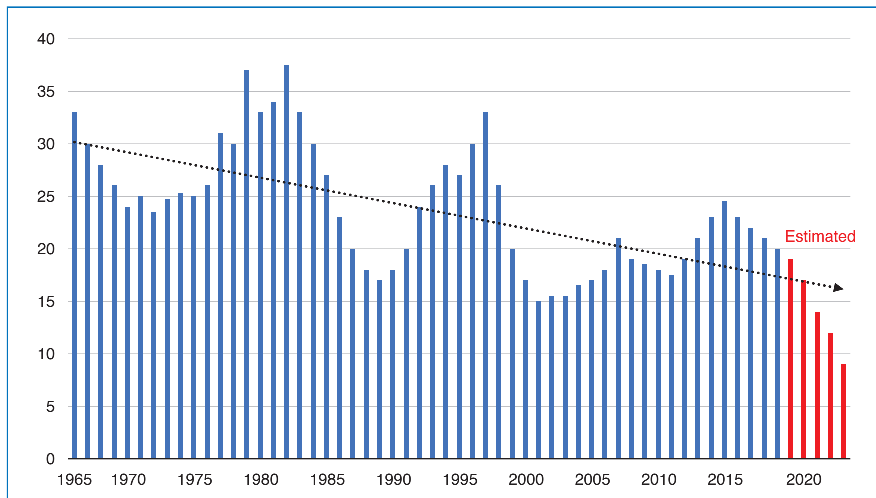
And this hypermobility has undermined collective and cumulative learning and innovation processes in large US firms. "Speed to market" became the mantra. Companies from Intel, Microsoft and Apple to GE, GM, and IBM suffered from this process. Lured by social trends and large stock option-based compensation packages, their executives became obsessed with boosting stock prices rather than investing in more innovation and higher wages.

The nature of "stock ownership" has also changed. This is a global phenomenon and applies to Japan as well. Today, people who buy stocks no longer become owners who care about the company. In fact, most people do not even become shareholders anymore. Rather, they put money into funds run by asset managers. Often these are simply indexed in a basket of stocks; if asset managers hand-pick stocks, they rarely consider long-term strategic plans of their portfolio companies.

Finally, empowering shareholders has invited "hedge fund activists". These fall on a spectrum from helpful to harmful. Harmful hedge funds – the vultures *(hagetaka)* – scout the world's stock markets for targets with a low stock price, high cash holdings or sellable assets. Vultures usually assume short-term positions and demand financial allocations that serve the singular goal of creating a short-term spike in stock price. They pressure management to use retained earnings to buy back stock and pay out extraordinary, very high dividends. Like a bank robber, when they leave they have taken a chunk of cash, for no service or value creation whatsoever *(Chart 2)*.

CHART 2

Average company lifespan on the S&P500 Index



Source: In years, rolling 7-year average. Constructed from Innosight 2018 Corporate Longevity Forecast

One indicator of the long-term damages to the US economy is the rapidly falling life-expectancy of US firms. *Chart 2* shows the average "life span" of leading US companies in the S&P500, i.e. counting the years a company was included in the index. From over 35 years in the 1950s, this is expected to fall below 10 years by 2023. In other words, today's leading US firms are strong for barely one decade.

Macro economists may view this reduction as a sign of "healthy" creative destruction, and attribute it to exogenous technology shocks. However, at the company level, this is wrong. Business scholars believe that companies should never die. They can pivot in anticipation of technology shifts and exploit them through innovation. They can replace old assets, retrain the workforce, and ride new technology waves. But, such pivoting takes money, investments, and leadership. If a company fails, it means that managers failed to invest in the firm's dynamic capabilities. There are two main reasons for such failure. One is that managers are unable to identify new technologies or are too risk averse to invest in them. This may be the case in Japan. The other is that they are forced to distribute company earnings to shareholders rather than reinvest in the company, which is the situation in the US.

Japan's New Shareholder-Priority Trends

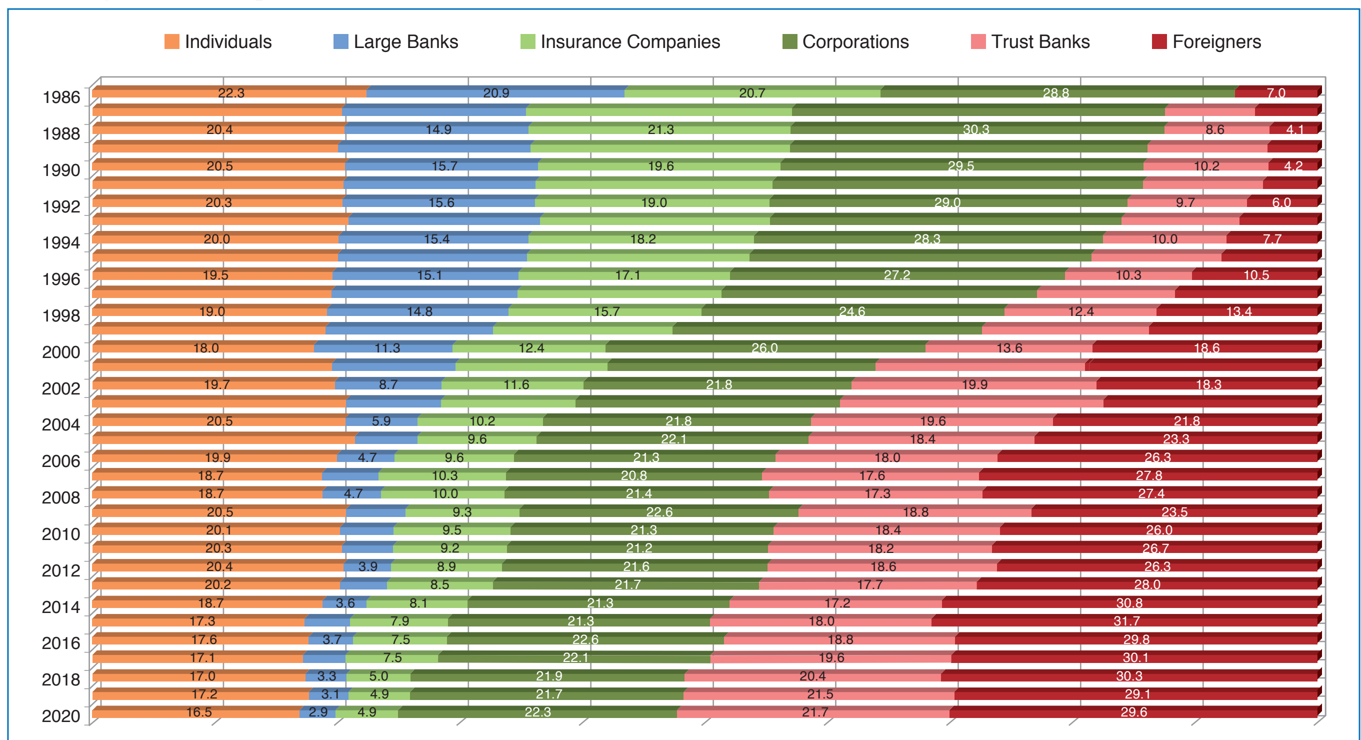
Until the turn of the century Japan held the exact opposite view from agency theory. Rather than protecting companies from managers, the Japanese view was that markets were unpredictable, and managers and their companies needed to be protected from those markets. This was done through long-term, mutual ownership trade and investment relationships with business partners. The most important partners were employees, suppliers, and trading partners. Shareholders were mostly domestic and were often also stakeholders. Their interests were aligned by mutual, reciprocal obligations of support.

A mix of the collapse of the bubble economy, the 1998 banking crisis and financial reforms necessitated a shift to heeding the concern of global shareholders. Corporate governance reform was seen as necessary to attract and respond to the demands of global finance. Beginning under Prime Minister Junichiro Koizumi in the early 2000s, and then extended under the headline of "Abenomics", Japan's system has moved rapidly toward the market *(Chart 3)*.

Chart 3 shows that since 2000, Japan's shareholder structure has changed dramatically. The data are averages for the roughly 3,000 listed companies. Whereas in 1986, on average about 70% of shares

CHART 3

Changes in Japan's shareholder structure, 1986-2020



Source: As of March each year; constructed from JPX 2020 Survey Data

were held by "patient capital" (banks, financials, corporates), today over 50% of shares are in the hands of domestic and foreign institutional investors. The reality for the largest 400 firms is even more skewed towards institutional and foreign blockholders. Banks and trading partners are often no longer large shareholders.

For CEOs, this requires a completely new reality of shareholder relations. Because investments are through trust banks, and therefore anonymous, CEOs no longer even know who all their largest shareholders are. The only certainty is that institutional investors demand high returns on investment. Unlike the quiet and patient shareholders of the old, the new shareholders will either demand change, or sell if they are unsatisfied. Both push Japan's system toward MSV.

Japan & the MSV: What Are the Tradeoffs?

It is understandable why Japan's reformers were viewing MSV as a solution after the collapse of the bubble and the two "lost decades". As the *Table* lays out, there are significant benefits to MSV, compared to a stakeholder priority, including speed, technology bets, career opportunities, and efficiency increases due to market discipline. These looked like powerful levers to overcome the costs of Japan's stakeholder system, such as slack, rigidity and widespread inefficiencies. Japan's goal with corporate governance reforms was to create a system that helps managers make the difficult decisions of strategic repositioning, including restructuring, exiting unprofitable legacy businesses, and placing more aggressive innovation bets (see my *The Business Reinvention of Japan, 2020* on this topic).

Moreover, the "Abenomics" programs also considered the economic needs of Japan's demographic trends, and included reforms to attract global finance to Japan. The government saw a great need to raise market liquidity and stock prices, as that would help raise the returns on investments by the government pension investment fund (GPIF) and private corporate pension funds. Higher returns are badly needed to sustain a fast-aging society. Attracting global investors meant playing by their rules of the game, which include increased shareholder rights and access.

And third, MSV has become a global ideology. Economists, including within Japan, proclaim it as the truth. The virtues of profits, efficiencies and speedy bets are often celebrated, without due consideration of the downsides of empowering shareholders. Anyone who stands up in defense of stakeholder interests risks being ridiculed as old-fashioned, or worse, ignored for not being enlightened.

Evidence of this ideology in Japan can be found in the 2014 "Ito Review", which formed the basis of Japan's corporate governance reform. It stipulated that companies should improve "capital efficiency" and strive for ROEs exceeding 8%. This is a clear push toward MSV. Similarly, METI's "Study Group for Risk Capital Supply for the Fourth Industrial Revolution" of 2018 produced a 180-page report on the desirability of "risk money", without mentioning once the dangers of financialization.

TABLE

Tradeoffs between shareholder vs stakeholder priorities

	Costs / Dangers	Benefits / Gains
Stakeholder priority	slack, no urgency	long-term view
	no risk-taking	longevity
	limited competition	predictability
	rigidity of worker careers	social cohesion
	in-house focus, no cross-fertilization	re-investments in assets (people, R&D, facilities, etc.)
	incrementalism	innovation
	inefficiencies and low profits	stability
Shareholder priority	no long-term value creation	immediacy / speed
	no personal responsibility by shareholders	risk-taking
	short-term gambling	huge technology bets
	no social contribution; layoffs and restructuring	labor mobility and career opportunities
	market focus: no re-investment	efficiency and high profit margins

Source: compiled by the author

Defending Against Harmful Attacks

As the calls for US reforms increase, various countries are becoming more nuanced in how they shape their own governance systems. For example, after an initial attraction to MSV, Germany remains steadfast in upholding its system of "co-determination". This ensures the representation of workers and union work councils on the board of directors.

In Japan, too, many people are aware of the dangers of MSV. Concerns about the deleterious vultures have entered the reform agenda. True, the latest round of corporate governance reform, of 2014-2017, brought significantly more outside and independent board members, new communication patters and investor relation practices, and much greater transparency and access to information. Any global investor interested in a large investment in a Japanese company can now easily proceed.

To balance this opening, in 2014 Japan introduced a Stewardship Code, to make it a "sandwich reform" package. The purpose is to nudge asset managers toward representing asset owners' interests, with the expectation that these interests will be focused on long-term value creation, rather than short-term value extraction. The guideline asks for an open policy on how asset managers will vote on

personnel decisions, poison pills, dividend pay-outs and other financial matters at the shareholders' meetings. By April 2020, 284 institutional investors had signed up to adopt the code (see the FSA website at www.fsa.go.jp).

Japan's institutional investors are quite concentrated, and the four major trust banks are all former members of business groups. But as shareholders diversified, trust banks began to serve a larger circle of clients. They may become pivotal in situations of hostile investor attacks. While CEOs might be tempted to hope that the asset managers will be on their side, it would be foolish to trust notions of legacy trade relations. Depending on the case, these asset managers may well side with an activist investor and demand change. Already, data show that asset managers account for a growing number of no-votes, in particular in matters of CEO succession, CEO pay and board of director positions. Thus, the stewardship code is an enabling mechanism, but it entails no insurance that vultures will be expelled.

Can Japan Have MSV Without Financialization?

Thus, in my view, Japan's goals with the "sandwich reforms" of corporate reforms (opening up boards and information) and stewardship (holding institutional investors accountable) is to benefit from the advantages of market discipline while establishing a mechanism that can help defend against deleterious financial engineering. It is a very good concept. But can it work in the long run?

Since the corporate governance reforms of 2015, the increase in activist investor purchases of Japanese stocks has been remarkable. According to data reported in the *Nikkei Shimbun* on Jan. 26, 2020, not only has the amount invested risen to an estimated ¥3.4 trillion (roughly $34 billion) in 2019 alone. What is more, a survey showed that firms that were targeted increased their stock buybacks by 3.7 times since 2015, compared to 2.6 times for firms without such investors.

Other signs of financialization are also surfacing. Vulture attacks have arrived, as witnessed in recent high-profile cases of FANUC, Sony and Softbank. They came, demanded stock buy-backs, enriched themselves, and left. Domestic signs of financialization are also popping up. Executive compensation is skyrocketing, and not only for foreign executives. In 2018, Sony's Kaz Hirai became the highest paid Japanese executive of a listed firm on record. Outside hires into the C-Suites are rising, often at global pay levels. The increase of labor mobility and toward market wages by job category will severely undermine Japan's long-standing system of wage parity through seniority pay. Japan's trendline in *Chart 1* is bound to slope further upwards very soon.

Of course, Japan is still a very different and much more balanced system than the US. Many in government and business agree that stakeholders matter. The vast majority of senior executives are internal managers who have worked their way up the corporate ladder and were selected for their dedication to the company. Most see their roles as, first and foremost, protecting the careers of those beneath them. Companies are managed for the long run, and many of the JPX400 firms are over 100 years old. The US can learn a lot from this system.

Yet, financialization is a slippery slope. Perhaps Japan can learn from the US on what could be done to deter it. In particular, four distinct measures are currently proposed in the US to ensure long-term value creation:

(1) *No financial engineering*: disallow open-market stock buybacks and rampant dividend payouts;

(2) *Long-term pay incentives*: tie executive compensation to long-term success (such as pensions, as is the case in Japan);

(3) *Co-determination*: include stakeholders in the boards of directors, such as workers, taxpayers, community members, suppliers);

(4) *Support "retain and reinvest"*: tax incentives etc. for R&D and employment investments by large-firms.

It may also be helpful for Japan to remember its lessons from the 1987-1991 bubble economy, which after all was Japan's own experience with unbridled financialization. What we learned during the bubble is that the stock price does not reflect the true capabilities and long-term prospects of a company. And the market can get it wrong.

Value creation is a long-term, cumulative process. Profitability is a very good measure to assess a company, but only over the long run. The challenge for Japan today is how to push companies to take calculated risks and make deep-technology bets. This is a new assignment for many CEOs, and the market and MSV may indeed bring helpful levers. Yet while transparency and sharp cost-benefit calculations are needed, investment decisions are best decoupled from short-term shareholder concerns. JS

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