Part II: Waves of Change in Japan

By Hisatake Masato

This is a story of change – change in Japan. "What," I hear you say, "Japan is changing? I thought it was just continuing to stagnate." Or "Japan changing? Yes, but for the worse."

Yet as I will detail, there are already numerous signs of very positive change, and Japanese corporate strategy and indeed the entire Japanese economic system are irrevocably changing.

That said, it might be admitted that this change has yet to yield striking benefits and Japan is still in the process of gaining a consensus as to whether or not these are all changes for the better. Yet there are numerous companies that are very tough survivors, and many Japanese are working to transform the economic systems to allow greater freedom of action. Adding to this, very serious study is being given to what kind of an economic system should and will result and what kind of economic society we are seeking.

To cite just two examples in the economic realm, one is Japanese corporate strategy in East Asia and the other is the systemic changes in the economy surrounding Japanese corporations.

1. Japanese Corporate Activity and Its Strategy in East Asia

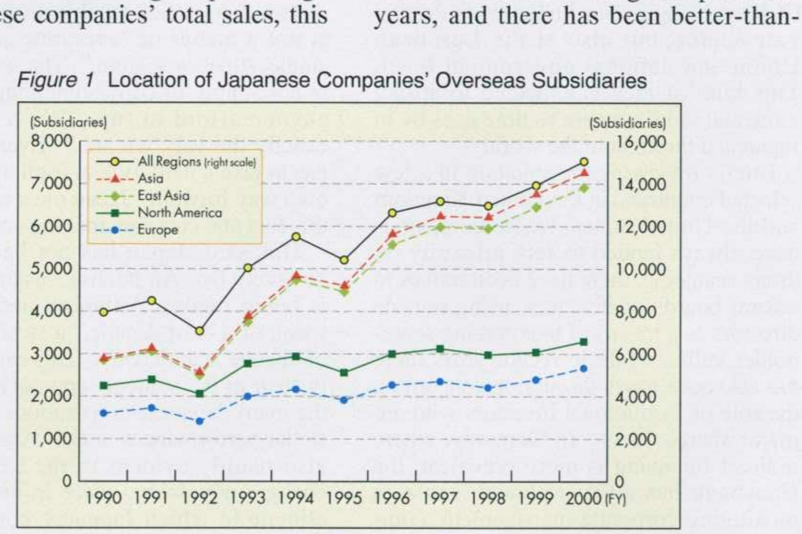
Many Japanese companies have achieved good earnings growth by such strategic efforts as developing new markets through differentiation strategies and optimizing the structure of production and division of labor throughout East Asia. Common to all of these corporate strategies is the realization that the expanding East Asian economies offer major opportunities and that companies need to proactively optimize their management structures in order to make the best use of new markets and the highly competitive labor costs of the region.

Japanese corporate activity overseas is on the increase, especially in East Asia. (Fig. 1) The continued strength in the four Newly Industrializing Economies (NIEs4: Hong Kong, South Korea, Singapore and Taiwan) and the four Association of South-East Asian Nations (ASEAN4: Indonesia, Malaysia, the Philippines and Thailand) has recently been joined by a sharp increase in share in China. (Fig. 2)

Not surprisingly, overseas sales now account for an ever-higher percentage of Japanese companies' total sales, this figure is up from 19.6% in fiscal 1991 to 30.1% in fiscal 2000. Within this, both North America and Asia now account for increasing percentages of sales, North America up from 8.9% to 13.1% and Asia up from 3.7% to 8.5% in the same period. (Fig. 3 on page 13)

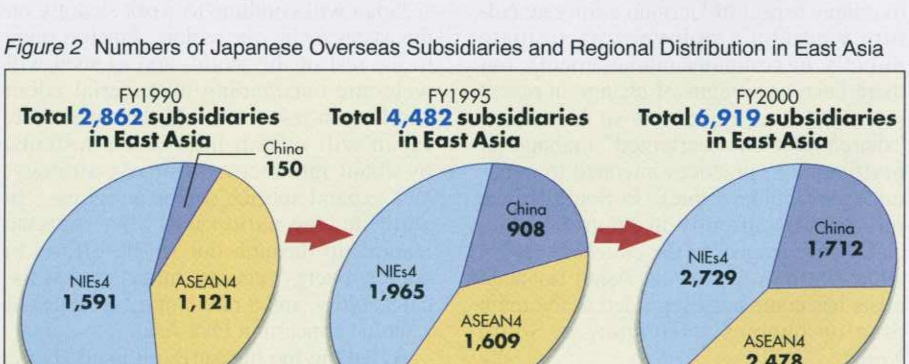
Yet are they making money? Looking at the figures for Japanese companies' ordinary profits and ordinary profit margins, both rose sharply in North America during the past few years, and there has been better-than-

Figure 1 Location of Japanese Companies' Overseas Subsidiaries



Source: Compiled from "Survey of Overseas Business Activities," METI

Figure 2 Numbers of Japanese Overseas Subsidiaries and Regional Distribution in East Asia



Source: Compiled from "Survey of Overseas Business Activities," METI

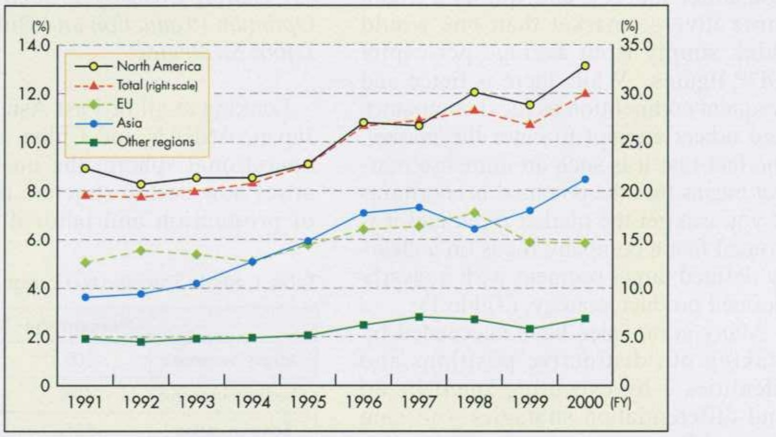
average growth in Asia for the last 10 years, although Asia did mark time briefly in fiscal 1997 and fiscal 1998 with the Asian financial crisis. It is clear that Asia has been an important overseas source of earnings for Japanese companies for the last decade or so. (Fig. 4) Looking for confirmation at after-tax profits as a way of assessing region-by-region earnings, after-tax profits in China jumped quickly to 17.8% of the East Asian total by fiscal 2000, and a Chinese presence has become increasingly crucial to Japanese corporate earnings. Yet in absolute terms, the NIEs4 and ASEAN4 remain very important earnings centers for Japanese companies. (Fig. 5 on page 14)

As the Chinese economy has boomed, China has become a much more attractive East Asian market. At the same time, the development of supporting industries in China has made China an increasingly attractive manufacturing center as well. The Chinese situation is evolving rapidly. Likewise, it is expected that ASEAN will also become an increasingly attractive market as intraregional trade and investment are liberalized. Assuming the ASEAN Free Trade Area (AFTA) can be put into effect to further enhance intraregional development, this should be a further spur to Japanese companies able to take fullest advantage of it by optimizing their production and other networks. In drawing up strategies involving East Asia, Japanese companies have to put the first priority on where and how in the overall value chain they are going to make their money.

In fact, two conspicuous trends in East Asia today are (1) the quest for profits in China and elsewhere tapping the new markets sustained by widening stratification and (2) the quest for profits from enhancing scale and low-cost advantages through optimizing the production and division-of-labor strategies to effectively use the low-cost labor, supporting industries and other attractions that have developed in East Asia. In addition, many companies are also moving to, for example, further develop partnerships with local industry in the region.

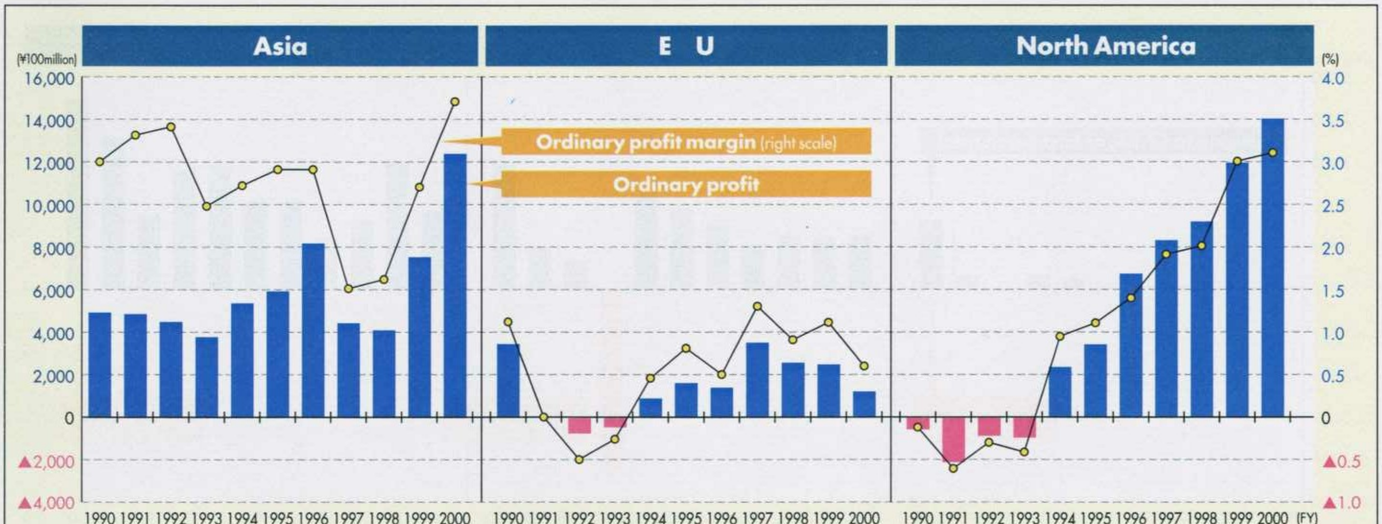
The following sections thus look at the strategic efforts deployed by companies active in East Asia to profit at the micro-

Figure 3 Overseas Contributions to Japanese Corporate Sales



Note: Figures derived by dividing overseas sales by total sales (domestic and overseas) and multiplying by 100.
Source: Compiled from "Survey of Overseas Business Activities," METI

Figure 4 Japanese Overseas Subsidiaries' Ordinary Profit and Ordinary Profit Margin by Region



Source: Compiled from "Survey of Overseas Business Activities," METI

economic level. As such, they also touch upon the implications of Japanese corporate strategy in East Asia.

(1) Strategies for Developing New Markets

It is imperative that Japanese companies wanting to capture new markets in East Asia come up with business strategies fitted to each East Asian market and take account of how each is different from Japan. For example, there is a wide gap between high-income and low-income customers in the Chinese consumer market, and this is a much more diverse market than one would think simply from average per-capita GDP figures. While there is fierce and frequent competition as local companies and others attempt to enter the market, the fact that it is such an immense market means that the potential is enormous if you can get the market right, and it is crucial that a company focus on a clearly defined target segment with a clearly defined product strategy. (Table 1)

Many companies have succeeded by staking out distinctive positions and identities – by executing smart brand and differentiation strategies – to gain favorable consumer recognition for their products at the time they entered the market. Many other, and many of the same, companies established competitive advantage and assured earnings by developing operations building upon their management strengths (e.g., core technology, capital and product superiority). (Table 2 on page 15)

Companies that are able to identify and respond to the characteristics of each of their East Asian markets can look forward to sharply better sales, even of products that might not be growing that strongly in the mature Japanese market.

(2) Cutting Costs by Structuring the Optimum Production and Division-of-Labor Strategies

Looking at all of East Asia, including Japan, ASEAN and China, as a single operational sphere, the question then arises how best to structure the network of production and labor divisions to reduce total supply chain costs and enhance earnings. To date, Japanese companies have invested heavily in ASEAN and have a large capital accumulation in that region. (In terms of stock, Japanese companies' outstanding foreign direct investment [FDI] in ASEAN was about 1.8 times the level for China as of 2001.) (Table 3 on page 15)

While some firms have concentrated their bases in ASEAN to take advantage of the ASEAN Industrial Cooperation (AICO) scheme and in anticipation of the AFTA's going fully onstream, these companies are still suffering from lower productivity than they had hoped for because Japanese investment has tended to be segmented country by country and many companies have been unable to integrate their regional operations.

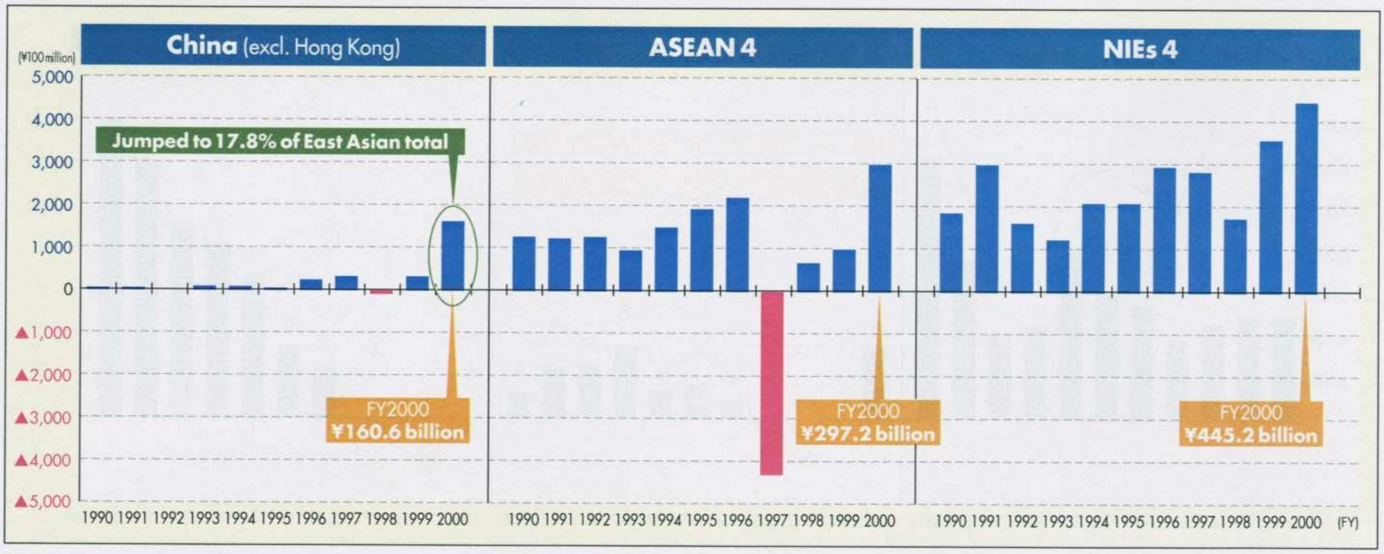
It is essential that these companies restructure their supply chains for greater efficiency and make ASEAN a

Table 1 Strata Targeted by Foreign-Capital Companies and Local Companies (in Metropolitan Area)

	Percentage	Population	Companies
High-income	10%	40 million	Foreign-capital companies and some local companies
Median-income	40%	160 million	Local companies and some foreign-capital companies
Low-income	50%	200 million	Local companies

Source: Ke Long, 2003

Figure 5 After-Tax Profits for Japanese Overseas Subsidiaries in East Asia



Source: Compiled from "Survey of Overseas Business Activities," METI

Table 2 Strategies for Developing New Markets

A. Focusing on the Target

Case1: Focusing on the Target Consumer Stratum

This company set up its first store in 1993 in response to Shanghai's policy efforts to attract foreign-capital retailers. The target stratum was the 800,000 people in the top 5% of Shanghai's income pyramid (people with monthly incomes of CNY2,000 [annual incomes of CNY25,000] or more). The typical customer is a woman aged 25-30 working for a foreign-capital company. Some 90% of the customers are Chinese. To accommodate customers coming in from the suburbs, the company built a parking lot able to hold 300 cars. The interior of the store was designed to appeal to this customer stratum.

Case2: Individualized Product Strategy Making Adroit Use of the Brand Equity

This company is drawing upon its established brand strength in Japan to export its exclusive brand products for sale to high-income consumers in China. At the same time, it has also created a new brand and begun production in China of a distinctively different brand differently positioned but carrying the parent company's reassuring logo mark, and is selling it at less than half the price of the imports in an effort to create a mass customer base.

Case3: Targeting People Who Focus on Quality and Health Concerns

This company is generally uninterested in going into a new market unless the per-capita GDP tops $1,000, and it does a thorough feasibility study before entering any market. The economic disparity between urban and rural regions is about 3:1 in Southeast Asia. Once urban incomes top $3,000 or so, people tend to be more concerned about quality and health issues, and this is when the company begins selling its health and nutrition beverages to the target stratum.

B. Brand-Building and Differentiation

Case4: Increasing Gross Profits by Cutting Material Costs While Maintaining the Product's Luxury Image

This company took a successful Japanese product and moved quickly to position it as an upscale luxury item in the Shanghai market. Because it is a chic, fashionable beverage, they packaged it to project sophistication at the same time as they outsourced locally and took other steps to cut their costs and increase their gross profits. In addition, they fine-tuned the flavor based upon marketing studies to identify local preferences.

Case5: Product Strategy for Differentiation

Learning from earlier missteps, this company overhauled both its product strategy and its distribution. Working to distinguish its product from other beers on the market, it carried out market research and then developed a light beer with a distinctive taste. Once this product established a firm market presence, the company then built on that to strengthen its relations with retailers and to beef up sales of its other products as well.

Case6: Taking Advantage of the Opportunity to Invest in Establishing the Brand

After detailed market research, the company identified a promising market for hotels catering to the international set and moved in the 1980s to upgrade its properties. Hitching its fortunes to the government drive for reform and openness, the company sharply increased its investment and, at the same time, advertised heavily in and around Shanghai to establish its brand presence.

C. Establishing Competitive Advantage by Drawing upon the Strengths of Management Resources

Case7: Competitive Advantage in Core Technologies as a Result of Unrelenting Technological Development

Noting the new market in disposable intravenous (IV) equipment, the company moved to local production in an effort to cut distribution costs, developed a new production methodology and new materials, and otherwise pursued unrelenting technological innovation. As a result of this technological innovation and cost-cutting in its core product line of IV bags, it was able to establish a competitive advantage in its core business.

Case8: Building upon Corporate Strengths to Gain an Advantageous Position as a Wholesaler

With its deep pockets, this company was able to guarantee manufacturers against the risk that payment might not be collectable (an important business issue in China). At the same time, it was able to promise retailers that they would have access to market-leader products. This combination has given the company an advantageous position in its dealings with both sides.

more attractive production center. At the same time, companies are also investing anew in ASEAN to avoid the risk of putting all of their production eggs in the Chinese basket and to strike a better balance among their production bases. (Table 4 on page 16)

Different companies are doing different things, depending upon how amenable their product mixes are to benefiting from concentrating their investment and clustering their facilities, to optimize their supply chains by better structuring the production and division-of-labor strategies throughout East Asia.

(3) Adopting More Efficient Business Models

In addition, companies are also moving to adopt more efficient business models to take maximum advantage of the benefits of locating in East Asia. (Table 5 on page 16)

With these changes in East Asia, Japanese companies' efforts to make money in East Asia are proceeding at the microeconomic level. A focus common to all of these corporate strategies is that of perceiving the growing East Asia economy as a major opportunity and putting the necessary management structures in place to more aggressively develop new markets and be more cost-competitive. Special attention has been paid so far to management strategies enabling Japanese companies to take advantage of East Asia's low-cost labor.

Table 3 Japanese and U.S. Foreign Direct Investment by Region

Japan (¥100 million.)

	1996	2001
All regions	265,259	329,230
North America	95,016	164,108
E U	42,163	60,512
East Asia	89,757	63,072
China	9,390	13,109
NIEs 4	32,169	26,856
ASEAN 4	**48,198**	**23,107**
Others	38,323	41,538

USA (US$1 million)

	1996	2001
All regions	795,195	1,381,674
Japan	34,578	64,103
Europe	389,378	725,793
East Asia	66,661	111,628
China	3,848	10,526
NIEs 4	40,287	75,362
ASEAN 4	22,526	25,740
Others	304,578	480,150

Sources: Compiled from the Department of Commerce's "U.S. Direct Investment Abroad" for U.S. and the Bank of Japan's "Regional Balance of Payments" for Japan

Yet as the East Asian economies have grown and the region has become a major battlefield for companies from all over the world, Japanese companies are being forced to diversify their perspectives and business models and to rethink their management strategies for advantage-optimization in East Asia's vast markets.

2. Changes of the Japanese Economic Systems

Investigating the changes of various systems in national economies as they impact companies around the world, it is apparent that there are both diversifications of corporate systems and commonalities in the efforts being made to produce better business models. Japanese companies are no exception.

How are national economic systems changing with the globalization of the world economy? Given that there is greater cross-border capital mobility and that companies have greater latitude in deciding where to site their facilities, globalization has had a striking impact on management systems, particularly on corporate governance. Indeed, good corporate governance is an essential element if sound economic integration is to be achieved in East Asia and the region is to attract stable capital from outside the region.

There is at present great diversity from country to country in terms of their economic systems and the efforts being made to restructure them, this diversity reflecting, of course, such factors as (1) the different countries' different levels of development, (2) relations between government and industry (e.g., the government's role in making and enforcing the necessary rules to enable the economy to function), (3) financial structural factors such as how corporations procure capital and how widespread shareholding is among the populace, (4) management-labor relations, (5) the market for executive talent and (6) views on corporate social responsibility (CSR).

Yet even as there is considerable diversity, so are there commonalities in the efforts being made to improve the various economic systems. The allocation of resources to improve governance with checks and balances and to enhance the necessary foundational mechanisms (e.g., corporate disclosure and information access), may focus on "markets" or "organizations" (typically companies). Within this, the main points in the organization mechanisms by which resource-allocation decisions are made are (1) where the decision-making power is located and (2) how information is generated, gathered and shared within the company – and there are international commonalities in both.

That said, there are differing views of what corporate governance is for, some contending that the priority should be on shareholder rights and others that it should be on the rights of such non-shareholder stakeholders as employees and creditors. Like Jean Tirole, I see corporate governance as the design of systemic institutions put in place to constrain management in the interests of enhancing the economic welfare of all stakeholders. In fact, there has been increasing discussion of CSR recently, with many people saying that companies should not just pursue short-term profit but should incorporate environmental concerns, employment issues and other social values in their management. This is especially true in Europe, where CSR is being promoted vigorously not just in the private sector but also by various national governments and at the European Union (EU) level. Typical is the green paper on CSR, entitled "Promoting a European framework for corporate social responsibility," that the European Commission issued in July 2001. This paper argues that a company's making a proactive effort to protect the environment, stabilize employment and otherwise be socially

Table 4 Structuring the Optimum Production and Division-of-Labor Systems

Case1: Integrating Operations

This company, which manufactures home appliances and other general-use products made to different specifications depending upon lifestyles and other conditions in each of its local markets, used to have manufacturing facilities in each of the countries where it did business. Because this dispersion was highly inefficient, the company did the profitability and other numbers for each product and withdrew some products from some markets. At the same time, it established central supply facilities in Asia, consolidated its factories, and otherwise reorganized its operations for greater efficiency.

Case2: Developing an ASEAN-Wide Procurement Structure

While still trying to keep manufacturing close to its markets, this company has worked to develop local industries throughout ASEAN so that it can move to ASEAN-wide procurement (obtaining, for example, engines from Indonesia, transmission parts from the Philippines, chassis frames from Thailand and plastics from Malaysia). Development and manufacture of the core parts, however, has been kept in Japan. The company has split its ASEAN and Chinese operations for risk diversification.

Case3: Going into the Downstream Market with an Eye to Serving Set Manufacturers

This company maintains the bulk of its manufacturing for technology-intensive electronic components in Japan (in part to obtain the convergence benefits). Yet it has moved its downstream processes to North America and Europe, where its customers are, so it can respond faster and more flexibly to the procurement needs of these set manufacturers.

Case4: Establishing a Factory in ASEAN to Avoid the Risk of Over-Concentration in China

With a factory manufacturing laser printers in China, this company set up a factory making bubble-jet printers in Vietnam (Hanoi area) to spread its exposure.

Table 5 Efficient Business Models

Case1: Expanding Local Procurement by Co-Developing with Local Companies

As a result of several years of material co-development with local companies, this company was able to develop a better material meeting all of its quality requirements. Consequently, it then became possible to procure this material inexpensively from local sources.

Case2: Cutting Costs by Supplying Standardized Products

This company was a forerunner to overseas markets. Assuming there would be cost savings, it offered to supply standardized, mass-produced products to clients that had formerly bought products made to order. By making such standardized products account for about 70% of its sales, the company was able to cut its costs and lower its prices. Following that, it was able to cut costs still further by outsourcing parts to China.

responsible also makes the company more competitive and contributes to sustainable growth for the economy as a whole. Similarly, the European Commission issued a follow-up report on CSR in 2002 stating that EU policy will continue to emphasize CSR. It is expected that there will be increasing attention to and discussion of CSR in Japan and elsewhere worldwide.

While there is very vigorous discussion of corporate governance modalities, this inexplicably includes the quixotic argument that issues of corporate governance are irrelevant to the company's or even the national economy's performance because there is such a diversity of corporate governance modalities among companies that do well on corporate performance indicators. This position is flawed for a number of reasons, among them: (1) unless we accept the proposition that the corporation is a totally irrational entity, it fails to explain why so many companies are working so hard to find better corporate governance modalities and (2) the very fact of diversity does not in itself prove that corporate governance does not impact performance, and to argue that it does is akin to arguing that, in the major leagues, the diversity of bat weights, bat lengths, training regimens and more among batters who have hit .300 or better means that bat selection are irrelevant to good batting. They are not, but they necessarily differ depending on the batter's build, batting style and other factors.

Consistent with the move to enhance corporate systems while maintaining national diversity, Japan is also moving to reform its economic system with special attention to corporate systems. (Table 6)

On the legal front, Japan has adopted new corporate accounting standards that conform to international standards, has worked to ensure greater disclosure of more information, and has sought to enhance management flexibility by allowing holding companies. As part of this, the amendments to the Commercial Code (that were passed in 2002 and went into force on April 1, 2003) provided the corporate governance option of responsibility-specific committees within the board of directors.

In actual practice as well, the close relations between companies and their main banks are changing and the banks are becoming less important, at least at the big companies, as companies seek to clean up their balance sheets. (Figs. 6 and 7 on page 18) In shareholdings too, there has been a conspicuous decline in the cross-holding of equity between banks and operating companies to provide stable shareholder blocs for both. (Fig. 8 on page 19) Instead, institutional investors have arisen to buy up many of the shares that the cross-holders have shed, and it is expected that such institutional investors will play an increasingly important role in checking management performance.

Investing for the long term, pension funds are especially alert to corporate governance issues and are active at general meetings of shareholders. An indication of how such pension funds act

Table 6 Major Systemic Changes in Corporation Law

Year	Category	Specifics
1993	Amendment of the Commercial Code	Introduction of outside corporate auditors and boads of corporate auditors
		Extending the term of office of auditors (from 2 years to 3 years)
		Setting the fee for filing a shareholder class action (at ¥8,200/suit)
1997	Amendment of the Commercial Code	Easing regulations on a company's owning its own stock to facilitate stock options
	Amendment of the Antitrust Law	Allowing pure holding companies
1999	Amendment of the Commercial Code	Establishing a system for exchanging and transferring shares
2000	Amendment of the Commercial Code	Establishing a system allowing stock splits
	New accounting standards go into force	Starting consolidated accounting in earnest
		Mandating disclosure of consolidated cash-flow sheets
		Adopting tax effect accounting
2001	Amendment of the Commercial Code	Lifting the ban on treasury stock
		Establishing a system for reserving new-issue shares (to facilitate stock options)
		Diversifying the kinds of shares (limited-voting shares adopted and shares linked to performance approved)
		Tightening the criteria for external auditors and raising the number required
		Strengthening auditor status and authority
		Extending auditor term of office (from 3 years to 4 years)
		Capping directors and auditors' liability in shareholder class-action suits
	New accounting standards go into force	Changing accounting for retirement benefits
		Adopting current-value accounting for financial products
2002	Amendment of the Commercial Code	Giving companies the option of establishing committees to monitor execution
		Establishing major asset committee
		Diversifying the kinds of shares (linked to election or termination of directors and auditors)
	New accounting standards go into force	Adopting current-value accounting for cross-held shares

Source: Compiled by METI from assorted data can be gleaned from the Pension Fund Association's (PFA) record. (Table 7 on page 19) Of the 970 corporate resolutions that were put to shareholder meetings, the PFA voted against 234, or 24.1%, of them.

PFA opposition was strongest in the area of amending the articles of association, where the PFA voted against 48.9% of the resolutions offered. Most of these amendments were to lower the bar for special resolutions at shareholder meetings and PFA did not think that the need for the amendments had been adequately explained. The next highest area of opposition was in bonuses and other gratuities to retiring directors, where the PFA voted against 42.9% of the motions. Many of these "against" votes were cast out of concern that such payments might compromise the independence of outside directors and outside auditors charged with holding management's feet to the fire, and there was also a strong "nay" vote against rewarding management in the face of disappointing corporate performance. Similarly, the PFA opposed 20.3% of the slates for election to the board of directors and 33.3% of the motions on executive compensation. This activist stance by this large institutional investor is a clear manifestation of the growing attention being paid to corporate governance.

In this same vein, the PFA released its "Guidelines for Voting at Shareholder Meetings" in February 2003 and has vowed to follow these new guidelines starting in April. Under the guidelines, the PFA sets forth explicitly the "corporate governance principles" it expects companies to observe and the "specific standards for exercising its voting rights," and it sees the appropriate exercise of its voting rights as an important trustee responsibility and a means of enhancing shareholder value.

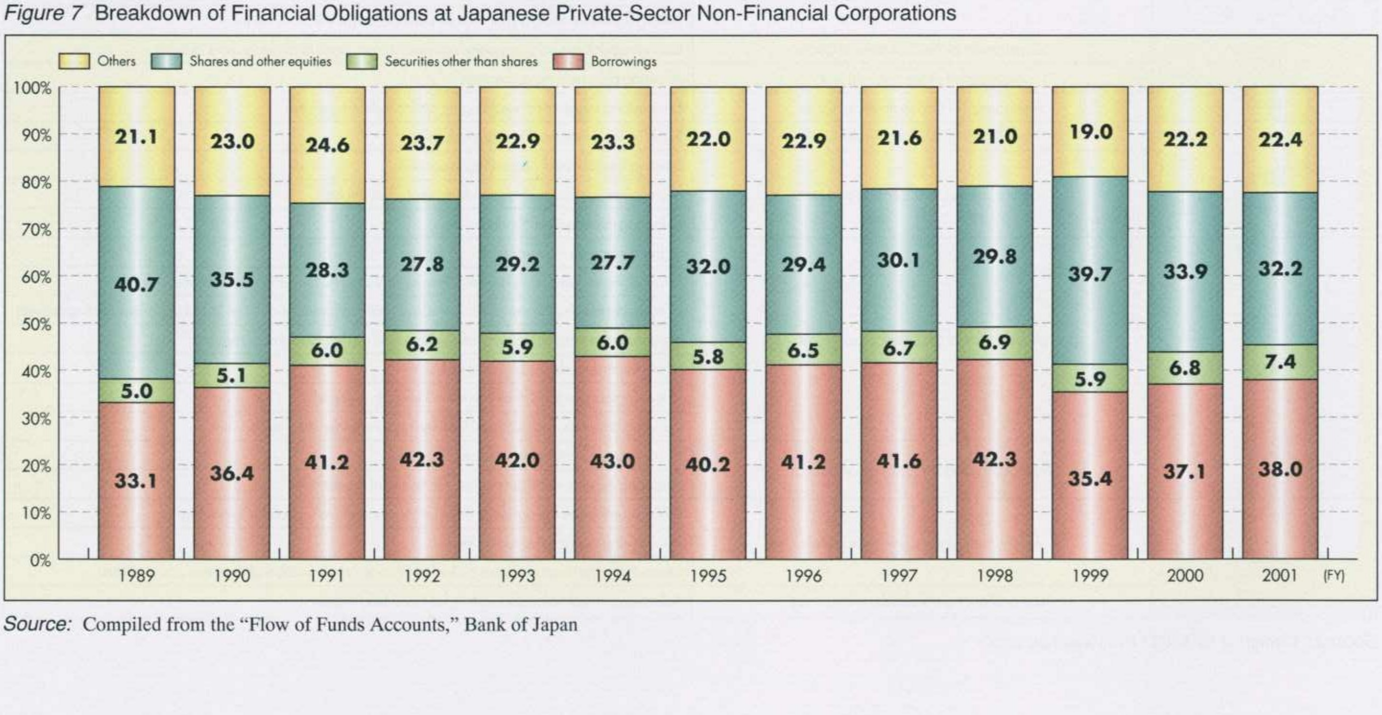
Market activity may also be gauged by mergers and acquisitions (M&A) and initial public offering (IPO) activi-

Figure 6 Dependency on Borrowing from Financial Institutions

Notes: 1. Dependency on borrowing from financial institutions is derived by dividing total short and long-term borrowings from financial institutions by total capital.
2. Small and medium-sized enterprises (SMEs) are defined as firms capitalized at less than ¥100 million. Big companies are the rest.

Source: Compiled from "Financial Statements Statistics of Corporations by Industry (annual)," Ministry of Finance

Figure 7 Breakdown of Financial Obligations at Japanese Private-Sector Non-Financial Corporations

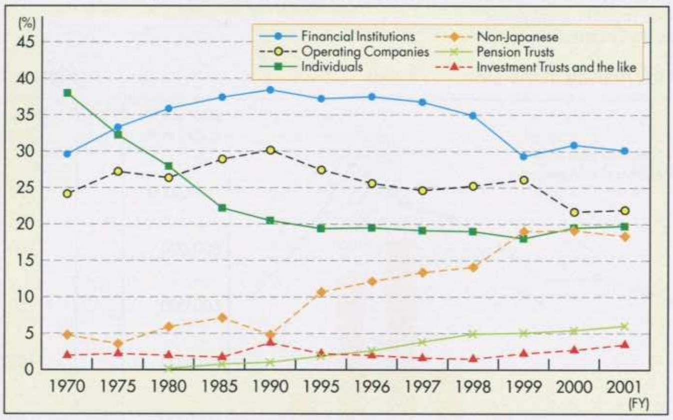


Source: Compiled from the "Flow of Funds Accounts," Bank of Japan ty, and here too the market is becoming increasingly active in Japan.

Looking first at M&A activity, changes are underway in the traditional pattern of depending upon main banks for capital and more active use is being made of take-over bids (TOBs) and other M&A activity to restructure, regroup and otherwise revitalize companies. It is thus worth looking at M&A activity in Japan, the United Kingdom and the United States, over the last decade. (Figs 9, 10 and 11 on page 20) By value, Japanese M&A activity peaked in 1999 and there has since been a sharp drop-off to only about one-quarter of value with the decline in the high-priced activity that took place during the IT boom. By numbers of deals, 2000 was the peak year and the number is now down about 10%, which is not as sharp a drop as the decline in value. In the United Kingdom, too, deal value in 2000 is down to about 25% of its peak in 1999, approximately the same drop as in Japan, but the number of deals is down to less than 60% of 2000's peak. In the United States, the 2002 value is about one-quarter of the 1999 peak value, down about the same as in Japan and the United Kingdom, but the number of deals has plunged to about half of the 1998 peak figure. The reason there has been a relatively smaller decline in the number of deals in Japan is probably that companies, including foreign-capital companies, have started making precision use of M&A to promote corporate restructuring, realignment and the like, such that the per-deal value of such activity has declined while there has been a lesser decline in the number of deals. The sweeping revisions to the Industrial Revitalization Law, the establishment of the Industrial Revitalization Corp. of Japan, the adoption of policy guidelines encouraging prompt reorganization and other factors are all expected to further promote corporate restructuring and realignment, and it is hoped M&A will not be a passing fad but will prove an effective tool in corporate regeneration.

What of IPO activity and bankruptcies among listed companies? Mothers was established in November 1999 at the Tokyo Stock Exchange and Nasdaq Japan in May 2000 at the Osaka Securities Exchange to expand IPO opportunities and facilitate capital procurement by high-tech venture start-ups and other promising new companies. (The operating agreement between Nasdaq Japan and the Osaka Securities Exchange was terminated on Dec. 16, 2002, and the company has changed its name from Nasdaq Japan to Hercules.) Figures 12, 13 and 14 on page 20 show data on IPO activity in Japan, the United Kingdom and the United States. In Japan, the peak for the decade came in 2000 with the IT boom and the openings of the new stock markets, after which the number of IPOs fell along with the sluggish stock market, the 2002 figure being only a little more than 60% of the peak level. In the United Kingdom, 2002 was less than

Figure 8 Composition of Japanese Shareholding



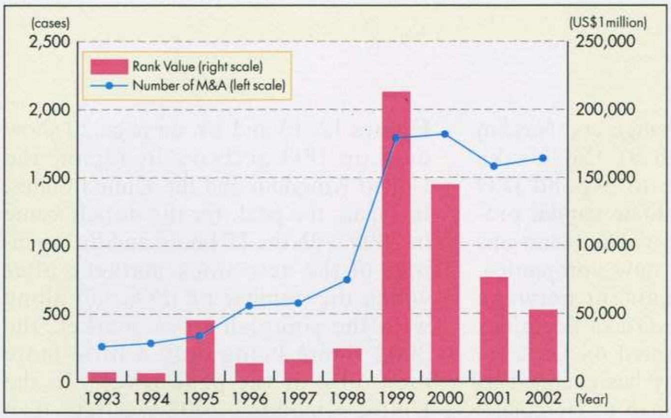
Notes: 1. Financial institutions do not include investment trusts and pension trusts (except for 1970 and 1975, which include pension trusts).
2. Non-Japanese includes both individuals and institutions.
3. Percentages are calculated in value terms.
Source: Compiled from "2001 Share ownership Survey," All domestic stock exchanges (Tokyo, Osaka, Nagoya, Fukuoka and Sapporo) in Japan

Table 7 Pension Fund Association Voting Record on Motions at Major Companies Where It Is a Shareholder

	Number of motions	Voted for	Voted against	Percentage opposed
Election of Directors	138	110	28	20.3%
Director Remuneration	6	4	2	33.3%
Election of Auditors	124	108	16	12.9%
Auditor Remuneration	8	8	0	0%
Distributions of Profits	161	135	26	16.1%
Stock Options	34	29	5	14.7%
Provision for Repurchasing Own Shares	95	90	5	5.3%
Bonuses to Retiring Directors	133	76	57	42.9%
Amendment of Articles of Association	184	93	90	48.9%
Mergers, Spin-Offs and Shift to Holding-Company Format	59	55	3	5.1%
Sale of Operations	6	4	1	16.7%
Reducing Capital Reserves	22	20	1	4.5%
Total	970	732	234	24.1%

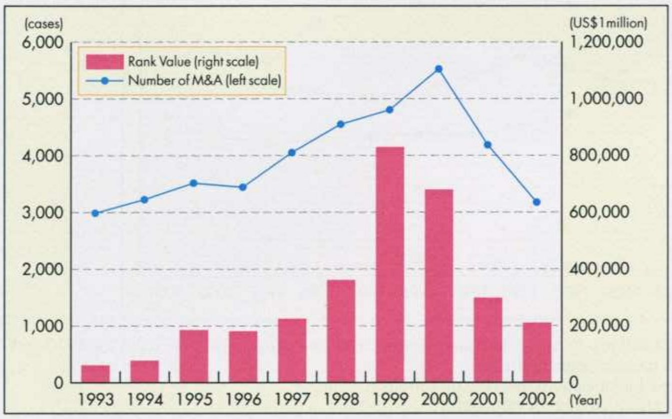
Notes: 1. Figures are for 212 companies which held shareholder meetings between July 2002 and March 2003.
2. Numbers do not necessarily compute because abstentions are not shown.
Source: Pension Fund Association

Figure 9 M&A Activity in Japan



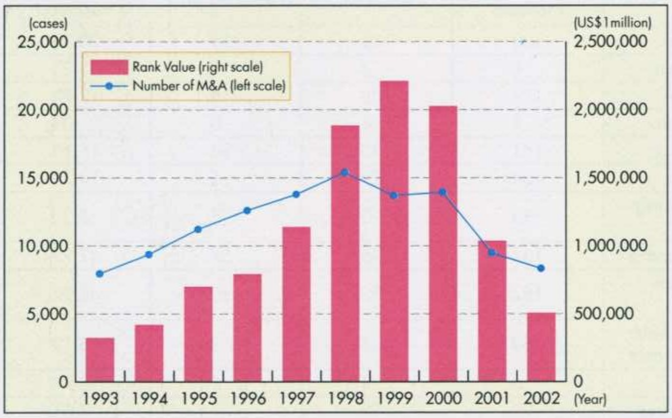
Note: Rank value is defined as the value of the transaction minus the value of obligations incurred plus short-term debt plus long-term debt plus preferred stock minus the sum of cash and securities. As such, it is the value of the transaction including net debts.
Source: Thomson Corporation

Figure 10 M&A Activity in the UK



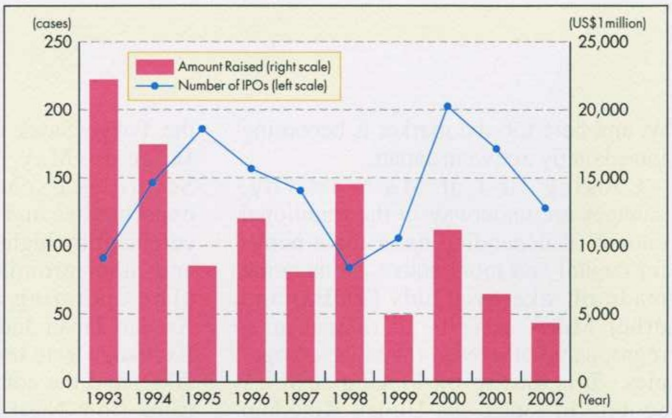
Note: Rank value is defined as the value of the transaction minus the value of obligations incurred plus short-term debt plus long-term debt plus preferred stock minus the sum of cash and securities. As such, it is the value of the transaction including net debts.
Source: Thomson Corporation

Figure 11 M&A Activity in the USA



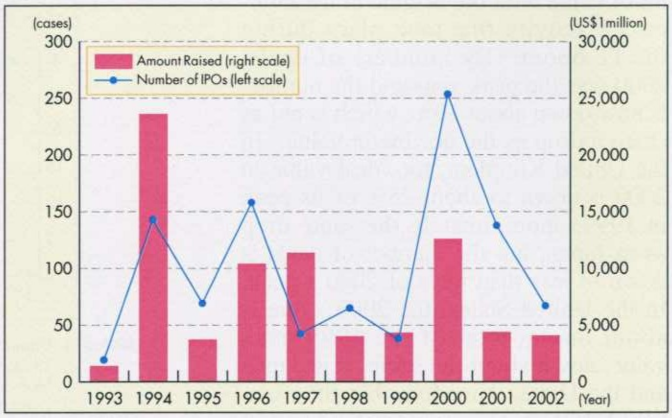
Note: Rank value is defined as the value of the transaction minus the value of obligations incurred plus short-term debt plus long-term debt plus preferred stock minus the sum of cash and securities. As such, it is the value of the transaction including net debts.
Source: Thomson Corporation

Figure 12 IPO Activity in Japan



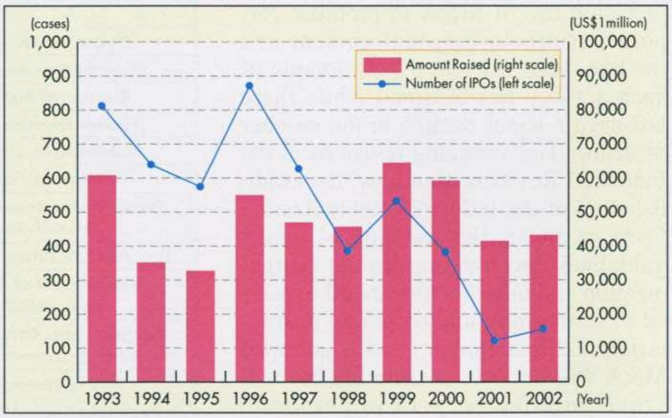
Source: Thomson Corporation

Figure 13 IPO Activity in the UK



Source: Thomson Corporation

Figure 14 IPO Activity in the USA



Source: Thomson Corporation

30% of the 2000 peak: while in the United States the peak came in 1996 and 2002 was down to less than 20% of that level. As such, Japan experienced a relatively smaller decline in the number of IPOs. At the same time, there are large numbers of IPOs-in-waiting – companies that have put off listing because of the sluggishness in the stock market – and there is still great interest in Japanese corporate IPOs.

Along with the shift to IPOs, the banks have come under increasing pressure to clean up their non-performing loans, meaning that things have gotten tougher for companies that are not doing well or have debt overhang in the current lingering economic doldrums. As a result, it is no longer rare that a number of listed companies have also filed for bankruptcy. (Fig. 15) Although there were only 16 listed-company bankruptcies in the 1980s, this started to balloon in the mid-1990s, rising to 14 in 1997 alone before tapering off somewhat in 1998 and 1999. In 2000, however, bankruptcies again proliferated, rising to 29 – a postwar record – in 2002.

There are also major changes underway in labor markets and employment. We would like to look at this area, which is, along with the main-bank system, an issue of prime importance in Japanese-type corporate governance, with special attention to relations between the corporation and the employees, who are also central players. There has been increasing mobility in labor markets of late, and a number of companies are moving to restructure the relationship between company and employee by adopting performance-based pay, annual packages and other new wage systems. Here it is worth starting by looking at the changes in the employment picture as seen in the spring labor offensive (*shunto*), which has for decades been the venue where the crucial negotiations between management and labor on both wages and working conditions took place.

The atmosphere for the 2002 spring labor offensive was especially grim, with the unemployment rate standing at 5.5% as of December 2001 and other economic and employment indicators equally bleak.

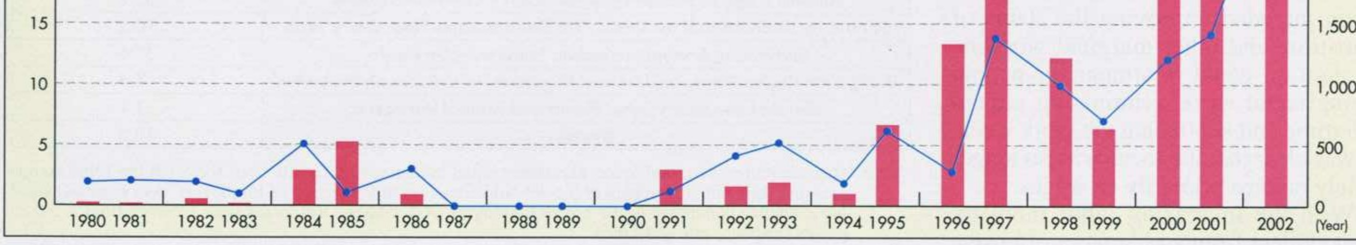
As such, management's position was that it would not only not be able to raise base salaries but would have to rethink or freeze annual raises and adopt a number of emergency measures such as work-sharing – that everything would have to be on the table. Management was clearly not in the mood for generous wage settlements. Labor, in the figure of Rengo (Japanese Trade Union Confederation), abandoned the effort to extract industry-wide settlements (which had been a staple since Rengo's founding in 1989), couched its demands in terms of "staying ahead of the curve," and was more interested in job security than in wage hikes.

Labor and management were agreed on the importance of securing and maintaining jobs, and a number of unions abandoned even the pretense of seeking wage hikes. Even when the unions did press for wage hikes, as in automobile and shipbuilding industries, management's response was basically no. And after the deadline for all of the companies to respond had passed, a number of big electronics firms and other companies came back with calls for wage give-backs or postponements of the annual wage creep, reduced add-ons for overtime and other "emergency policies" to effectively reduce wages. The spring labor offensive had clearly reached a major turning point.

The upshot was that the average wage increase was 1.6% (according to a Ministry of Health, Labour and Welfare survey of leading companies), which was even less than 2001's 2.01%. As such, this means there were a number of companies that not only refused to raise the wage floor but also froze the annual increases. (Fig. 16 on page 22)

The 2003 spring labor offensive took place in the face of an every harder

Figure 15 Bankruptcies among Listed Companies in Japan



Source: Compiled from "Bankruptcy Survey on Stock-Listed Companies, 2002" Teikoku Databank management line on annual wage hikes. (Table 8) The Committee on Management and Labor Policy at Nippon Keidanren (Japan Business Federation) released its position paper for 2003 on Dec. 17, 2002. Titled "Diversity Generating Dynamism and Creativity," the report included the observation that, "The social phenomenon of the shunto spring labor offensive ... is over. Today, rather than wage levels and the amount of wage increases, the two sides are more concerned with discussing the creation of personnel and wage systems to stimulate high value-added labor and the most appropriate combinations of employment types to make this possible." Specifically on wage hikes, the report stated, "Management and labor are attempting to determine wages in a practical manner in the face of a deflationary spiral. Maintaining and strengthening competitiveness precludes any further rise in nominal wage levels, and increasing base wage levels is out of the question. Freezing or reviewing the annual wage increment in line with reforming wage systems is another issue that could come up for discussion." As such, this was a clear indication that management wanted not only to hold the wage floor steady but also to work on reforming the automatic annual increases.

Rengo, on the other side of the table, published its "Immediate Policy for the 2003 Spring Struggle (Part 2)" on Jan. 10, 2003. Postulating job security and preservation as the most important issue, this paper called for maintaining the upward momentum in wages. For the second year in a row, Rengo decided against coming out with a one-size-fits-all demand on the wage floor and decided instead to work on getting the annual increases. Other issues touched upon included improving the status of part-time and other marginal workers, promoting equal treatment for people doing equal work, eliminating unpaid overtime and shortening the work week. It was clear that the focus was no longer solely or even primarily on wages.

With the increasing labor mobility also evident from spring labor offensive trends, the pattern of labor-management relations has begun to change from the old pattern typified by lifetime employment and steadily higher wages.

When corporate sales and profits were on a steadily improving course, companies offered the raise of base salaries and annual wage increases in an effort to attract and hold the employees they needed. Employment was premised on the assumption of lifetime employment and workers were offered lavish incentives. In the 1990s, however, even as the Japanese economy entered an extended slump, international competition heated up as the economy globalized. Thus companies are working to build greater flexibility into their personnel policies by, for example, rethinking the wage structure typified by annually higher wage floors plus annual increases and shifting to new wage packages that are more performance-centric.

Figure 17 on page 23 shows the trend toward annual salary schemes at listed companies. As seen, more and more companies are moving to annualize salaries, and this is having a major impact on the traditional pattern of industry-wide wages negotiated in the spring labor offensive.

At the same time, the big companies are leading the way in shifting to year-round hiring, including new university graduates, and greater flexibility is also being built into the old pattern of everybody hiring all at once. (Table 9 on page 23)

In the past, employees identified closely with their companies and companies with their employees, and companies were attentive to employees as important stakeholders. More recently, however, the pattern has been to associ-

Figure 16 Spring Wage Increases

Source: Compiled from Ministry of Health, Labour and Welfare data

Table 8 Wage Decision-Making should be:

	Percentage of companies
Annual Wage Increases Only. Bonuses if Conditions Allow.	33.2
Should Focus on Annual Increases. No Need to Raise Floor Every Year.	10.2
Rethinking Annual Increases. Some may Go Down.	37.6
Using Both Higher Floors and Annual Increases, with Focus on the Latter.	4.4
Should have Both Higher Floors and Annual Increases.	1.1
Others	13.5

Note: Questionnaires were sent to top executives (chief human resources officer or above) at the 1,966 companies that were either members of the old Nikkeiren (Japan Federation of Employers' Associations) standing executive committee or the Tokyo Employers' Association. Responses were received from 275 companies (response rate of 14.0%).

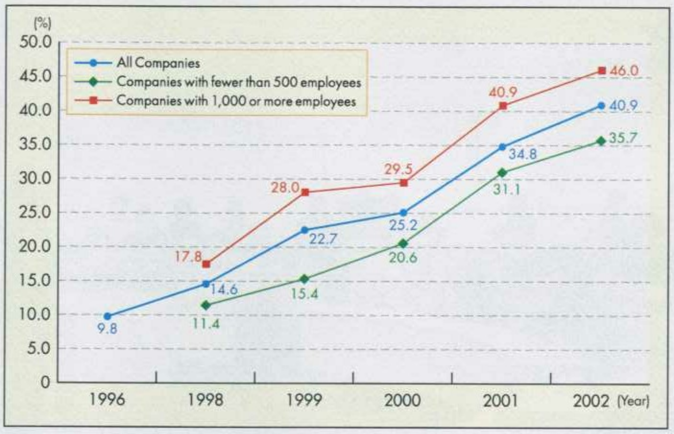
Source: "The Results of a Survey of Top Management of Major Companies on the 2002 Spring Wage Negotiations," Japan Business Federation, August 2002 ate more at arm's length based on an equal relationship. The fact is that it is increasingly possible for people to pick and choose where they want to work, and it is expected that labor will be an increasingly important corporate governance issue. Companies are increasingly going to the labor markets, and this is in turn engendering changes in the relationship between labor and management.

As epitomized by the "lost decade" phrase, many people have come to feel the Japanese economy has stagnated and Japan will not or cannot change. Yet despite the harsh economic climate, many companies have innovated unrelentingly and have turned in very respectable performances. Of course, things are still grim for corporate balance sheets as they have to take major paper losses from the stock market slump and more, but the silver lining is beginning to break though for some companies as some of their divisions have reported higher ordinary profit margins.

The electrical machinery sector, which was especially hard-hit in 2001 with the end of the IT boom and the global economic slowdown, achieved higher ordinary profit margins in 2002 as inventories were worked off, fixed costs were reduced with restructuring and other initiatives, and other reforms were effected. Likewise, the transport machinery sector centering on the auto industry, which experienced lower ordinary profit margins in 2001 despite outperforming the all-industries average, also did better in 2002 than in 2001 on the strength of strong sales in North America. Because the all-industries average ordinary profit margin was no better in 2002 than it was in 2001, this improved performance by some sectors means there were worse performances by some sectors, and differentials are beginning to show up among industries. (Fig. 18)

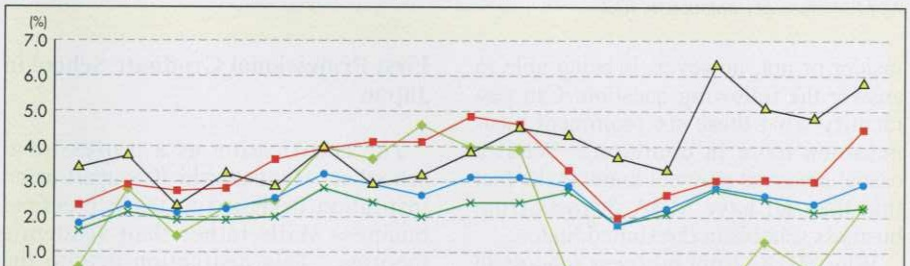
Elsewhere in East Asia too, changes are underway in economic systems as they impact companies, and it is clear that Japanese and other companies are having to work unrelentingly on reform, both to be more competitive in the face of globalization's advance and to fulfill their community and social responsibilities. JJTI

Figure 17 Number of Companies Adopting Annual Salary Schedules



Note: The 2,547 listed companies were sent questionnaires. Responses were received from 303.
Source: "Sixth Survey on the Changing Face of Japanese Personnel Practices," Japan Productivity Center for Socio-Economic Development

Figure 18 Japanese Companies' Ordinary Profit Margins



Source: Compiled from "Financial Statements Statistics of Corporations by Industry," Ministry of Finance

Table 9 Companies Switching from Hiring New University Graduates in April to Hiring Year-Round

	Already hire year-round	Plan to switch	Considering switching	No plans to switch	No response
All industries	6.6%	3.0%	25.6%	62.3%	2.5%
With 5,000 or more employees	16.8%	2.6%	37.9%	41.8%	0.9%
With 1,000-4,999 employees	8.5%	2.5%	36.5%	51.6%	0.8%
With 300-999 employees	9.6%	3.5%	24.2%	61.6%	1.2%
With 100-299 employees	9.1%	3.0%	29.5%	56.7%	1.7%
With 30-99 employees	5.5%	3.0%	24.2%	64.4%	2.8%

Source: "2001 Survey on Employment Management," Ministry of Health, Labour and Welfare

Hisatake Masato, Ph.D., is the director of the Research and Analysis Division of the Trade Policy Bureau in the Ministry of Economy, Trade and Industry. He was formerly an associate professor at the Institute of Economic Research at Kyoto University.