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Working Paper No. 227

The Japanese Financial Crisis, Corporate Governance, and Sustainable Prosperity

by
[William Lazonick](#)

A Tale of Two Economies

During the 1970s and 1980s, Japan emerged as the world's second largest economy, surpassed only by the United States. The foundation of Japan's success was industrial innovation in a wide variety of mechanical and electronic applications that directly confronted the previously unchallenged position of the United States as the world's pre-eminent mass producer. During the 1980s American manufacturers looked to Japan for the latest in best-practice industrial management, while Japanese companies brought their learning, and money, directly to the United States.

Meanwhile, within Japan, the phenomenal success of its industrial corporations sparked a boom in stock prices that during the late 1980s reached unprecedented speculative heights. By 1989, the average price-earnings ratio of shares listed on the First Section of the Tokyo Stock Exchange (that is, stocks of the major industrial corporations) was over 70, when the comparable price-earnings ratio in the United States was less than 13.¹ While dividend yields on these Japanese stocks were minimal -- 0.39 percent in 1989 compared with 3.29 percent in the United States -- the rise in TSE (First Section) stock prices generated a compound annual rate of return of over 30 percent between 1985 and 1989.²

Then, in 1990, the Japanese stock market crashed. With the falling stock market came falling land prices and an accumulation of bad bank loans that in the late 1990s still will not go away. In addition to this banking crisis, the need to support retirees in a nation with a rapidly aging population has resulted in a burgeoning government deficit; Japan now ranks highest among the OECD nations in government debt as a proportion of GDP.³ Japan's financial morass and recessionary conditions in the 1990s stand in contrast to both its high-growth era that stretched from the mid-1950s to the early 1970s and its booming prosperity from the late 1970s through the 1980s. The growth rate of the Japanese economy has sputtered throughout the 1990s. In fiscal 1996 (through March 31, 1997), the rate of real GDP growth was less than one percent. During the first quarter of fiscal 1997 real GDP dropped by 2.9 percent.⁴ By world standards, Japan's current unemployment rate of less than three and a half percent is enviable, but by Japan's own post-World War II standards, the unemployment rates of 1996 and 1997 are the highest since the current mode of calculating the rates began in 1953.⁵ For many, if not most, economists, Japan is now facing the real world of international economics, and unless it quickly deregulates its capital and labor markets, it will not be able to get its economy back on track.

Meanwhile, in the United States, throughout the 1990s stock markets have been booming, and from the mid-1990s the economy has been growing rapidly. The current U.S. unemployment rate of 4.6 percent is the lowest for the nation since the late 1960s.⁶ The financial turmoil that the United States experienced in the 1980s, with the savings and loans crisis and major bank failures, now seems to be a thing of the past. Despite lingering concerns on the part of some American economists with growing income inequality and corporate downsizing, the current perception of the U.S. economy, both at home and abroad, is that in the late 1990s it is back on a path of sustained growth that will benefit more and more Americans as time goes by.

The purpose of this paper is to take issue with these perceptions of the weakness of the Japanese economy and the relative strength of the American economy for generating sustainable prosperity -- the spreading of the

benefits of economic growth to more and more people over a prolonged period of time.⁷ The main propositions on the sources of sustainable prosperity that underlie this argument are:

1. the economic development of advanced economies depends critically on the investment strategies of corporate enterprises to generate organizational learning;
2. both U.S. and Japanese corporate enterprises are making, and will continue to make, investments in organizational learning that can result in higher quality, lower cost products;
3. the prevalence of strategies of U.S. corporations that favor the downsizing of corporate labor forces and the distribution of corporate revenues to financial interests means, however, that the corporate contribution to organizational learning in the United States will fall short of that required for sustainable prosperity;
4. in contrast to this "downsize and distribute" strategy of U.S. corporations, Japanese corporate enterprises are pursuing, and will continue to pursue, a strategy of retaining corporate revenues and reallocating the labor force in ways that promote sustainable prosperity;
5. the choice between the downsize and distribute strategy that is more prevalent among U.S. corporations and the "retain and reallocate" strategy that is more prevalent among Japanese corporations reflects fundamental institutional differences between the two nations in the ways in which, at the macroeconomic level, money is saved and invested and, at the microeconomic level, corporate enterprises are governed;
6. in terms of sustainable national economic performance, the downsize and distribute strategy supports a system of saving and investment that favors living off the past, whereas the retain and reallocate strategy supports a system of saving and investment that favors investing for the future.⁸

In the advanced economies, major industrial corporations, by virtue of their prior success in developing and utilizing productive resources, control at any point in time vast amounts of productive resources and financial returns that remain to be allocated to alternative uses. Corporate strategy is about the forms that these allocation decisions take, and corporate governance is about the institutions that shape these allocation decisions.⁹ These institutions, which reflect the ways in which people are employed and the ways in which investments are financed, have deep historical roots in particular social -- generally national -- environments.¹⁰

But these institutions also evolve historically in response to the emergence of new pressures on corporations to allocate their resources and returns differently than they had in the past. Thus, for example, in comparison with the Japanese experience, throughout the twentieth century, the institutions of employment and finance that have prevailed in the United States have placed much more pressure on corporations to downsize and distribute. Yet, in historical perspective, the force of those pressures has changed, so that the ways in which U.S. corporations allocate resources and returns in the 1990s look much different even than in the 1970s.

In the case of the United States, the main sources of these pressures since the 1970s have been international competition and intergenerational dependence.¹¹ International competition has changed the ways in which U.S. corporations must allocate resources to organizational learning to generate returns. Intergenerational dependence has changed the demands on corporations to allocate returns to support people in retirement rather than employment. In the 1990s, these pressures of international competition and intergenerational dependence have been building in other advanced economies as well. Currently, for example, as Mary O'Sullivan argues, corporate governance in Germany is at a crossroads in responding to these pressures.¹²

Japan is not immune to the pressures of intergenerational dependence and international competition. Japan now has the most rapidly aging society in the world. At the same time, it remains a power in international industrial competition, and, despite high wages and a relatively strong currency, continues to create competitive pressures on the rest of the world. But Japan has also been a victim of its own competitive strength. The current banking crisis is the result of the ways in which, during the 1980s, the Japanese financial system reallocated the enormous financial returns of the nation's industrial success. Moreover, during the 1990s, the power of Japanese industry has led to a sharp increase in Japanese foreign direct investment, particularly in Asia, that has raised fears in Japan of an industrial "hollowing out". In response to these pressures, Japanese corporations are having to learn new ways of allocating resources and returns.

This paper represents an attempt to explain the institutions of corporate governance that prevail in Japan in the late 1990s, how they supported the retain and reallocate strategy in the past, and how in response to the productive and financial pressures of the 1990s, Japanese corporations are changing the ways in which they allocate resources and returns. I shall argue that Japanese corporations continue to pursue a strategy of retain and reallocate, largely because of the strong persistence of the institutions of lifetime employment and cross-shareholding that have shaped Japanese corporate governance in the past. Nevertheless, in response to the realities of the 1990s, important changes are taking place in the ways people are employed and remunerated in Japanese corporations. Working within the institutional framework of lifetime employment and cross-shareholding, the challenge now facing Japanese industrial corporations is how to retain people as productive employees for more years of their lives and how to reallocate these labor resources to make them more productive.

Institutions of Corporate Governance

Lifetime employment and cross-shareholding

The development of the Japanese economy before and during World War II was dominated by the *zaibatsu* -- large-scale enterprise groups generally under family ownership in which substantial strategic and operational responsibility had been delegated to salaried managers.¹³ During the 1920s and 1930s, the development strategy of the Japanese economy, and hence the investment strategies of the *zaibatsu*, had become increasingly driven by the investment requirements of militarization and imperial expansion. When, following World War II, the result was defeat and devastation, both the Allied Occupation and the Japanese people held the *zaibatsu* families and their top managers largely to blame. The decision by the Supreme Commander of the Allied Powers (SCAP) to dissolve the *zaibatsu* met with little resistance.

Beginning in August 1946, ownership of the stock of thirty *zaibatsu* holding companies, including those of Mitsui, Mitsubishi, Sumitomo, and Yasuda -- the largest of the *zaibatsu* -- was transferred to SCAP's Holding Company Liquidation Commission (HCLC) to be redistributed to the public. At the same time, another 53 companies went through reorganizations so that they ceased to be holding companies. In addition, hundreds of affiliated *zaibatsu* companies were classified as "restricted concerns", and, under the supervision of HCLC, ordered to dispose of their stocks. In an attempt to ensure that the *zaibatsu* business empires would not reconstitute themselves, holding companies were made illegal and limitations -- five percent for most types of enterprises, and ten percent for banks (later reduced to five percent) and life insurance companies -- were placed on the amount of stock that one company could hold in another.¹⁴

Overall 40 percent of all Japanese securities went through the liquidation process under SCAP, with the sale of stock being handled by the Securities Coordinating Liquidation Committee (SCLC). Employees were given the first right to buy stock issued by their companies. Many companies lent employees money to buy these stocks. Next in line for the opportunity to buy the stocks were residents of localities in which the stock-issuing company had production facilities. Stocks still left over were then placed on the securities market for sale. With the stock markets closed from the end of the war, at first such market transfers had to proceed through over-the-counter trading. In 1949 the stock exchanges were reopened, now, in contrast to the prewar era, as non-profit organizations that forbade blatantly speculative business such as futures trading.¹⁵

The *zaibatsu* dissolution process resulted in a wide diffusion of stockholding in Japan. But the reorganization of ownership and control of Japanese corporations in the decade after World War II went much deeper than a transfer of stock ownership. Also purged under SCAP were the top managers of the major Japanese corporations. Hidemasa Morikawa places the number of managers who were forced to resign between 1945 and 1948 at about 5000, with the average age of top managers of these companies falling from 60 to 50 over this short period.¹⁶ Taking over control of strategic decision-making in Japan's industrial enterprises were a young group of "third-rank executives", so-called because they were plucked from the ranks of middle management to take leadership positions. Commenting on these changes in stockholding and corporate control, Yutaka Kosai has argued that "nowhere was the separation of management and ownership more thoroughgoing than in postwar Japan."¹⁷

During the last half of the 1940s, however, the transformation of corporate control threatened to go much further as dire economic conditions and SCAP democratization initiatives gave rise to a militant labor movement of white-collar (technical and administrative) and blue-collar (operative) employees. Union membership jumped from 3.2 percent of the labor force in 1945 to 41.5 percent in 1946, and then rose to as high as 55.8 percent in 1949.¹⁸ The goal of the new industrial unions was to implement "production control": the takeover of idle factories so that workers could put them into operation and earn a living.¹⁹

As an alternative to the "production control" strategy of militant unions, leading companies created the institutional foundations of organizational control by establishing enterprise unions of white-collar and blue-collar employees. In 1950, under economic conditions deliberately rendered more severe by the Occupation's anti-inflationary "Dodge line", companies such as Toyota, Toshiba, and Hitachi fired militant workers and offered enterprise unionism to the remaining employees. The post-Korean War recession of 1953 created another opportunity for more companies to expel the militants and introduce enterprise unionism, which by the mid-1950s had become an entrenched institution at all of the major Japanese industrial enterprises.²⁰ Included as members of these enterprise unions were all male blue-collar (shop-floor) workers as long as they remained employed by the company and all male white-collar (administrative and technical) workers for at least ten years until they made the transition to management.

The acceptance, and indeed promotion, of enterprise unionism by employers created a presumption that the enterprise would be the entity responsible for providing employment security to union members from the time they were hired (usually straight from school) to the time they retired (at the age of 55 in the postwar decades but increasingly at the age of 60 since the 1980s). During the 1950s major industrial enterprises were willing to extend the promise of long-term employment to those members of their core labor forces on whom they depended for the development and utilization of productive resources and on whom they could rely to stay in the labor force and with the company over the long-term. The successful growth of these major industrial enterprises in general from the mid-1950s transformed the promise of long-term employment into a commitment to "lifetime employment" that by the 1970s had become a fundamental institutional characteristic of the Japanese economy.²²

Lifetime employment did not, and still does not, have clear contractual status in Japan. The legal status of "lifetime" employees is as "regular" (as distinct from "temporary") employees with no stated termination date in their employment contracts. In 1995, out of an active labor force of 47.8 million people, there were 37.6 million regular employees in Japan, of whom 26.1 million were male and 1.2 million female.²¹ Japanese labor law protects employees against wrongful dismissal, and in many disputed cases of permanent layoffs, the courts have tended to hold management responsible for ensuring that regular workers remain employed.

Membership in an enterprise union has traditionally provided the best institutional protection for regular employees to remain lifetime employees. From the mid-1950s to the mid-1970s only an estimated 35 percent of the participants in the Japanese labor force were members of enterprise unions, but that proportion included virtually all male employees of the major enterprises that were central to Japan's remarkable rise to industrial power. Nevertheless, changes in economic and industrial structure combined with the upward mobility of more and more white-collar workers into the ranks of (non-union) management has led the proportion of the labor force organized into enterprise unions to decline from 34 percent in 1975 to 31 percent in 1980, 29 percent in 1985, 25 percent in 1990, and just over 23 percent in 1996. In the major companies, therefore, lifetime employment also applies to many non-union regular employees -- most notably, managerial employees, who after a decade of employment with a company are no longer union members. With enterprise unions embedded in all the major enterprises that have been at the center of Japan's remarkable economic success, the prevailing ideology in Japan is that a company that has attained any substantial size must take responsibility for ensuring the employment of the regular workers it hires until the time that they retire.

Especially in the case of women, however, a regular employment contract does not necessarily entail lifetime employment. It is generally assumed that even those women who are regular employees will drop out of the full-time paid labor force at marriage and lose the status of regular employee. Indeed, despite the growing labor force participation rates for women, the tendency is still for women to leave paid labor when they have children.

When the children have grown, many return to the labor market, typically as "part-time" workers. A part-time worker, most of whom are women, is anyone who works less than 35 hours per week. Being "part-time" they do not have access to many of the employment benefits of "regular" workers. Even if a part-time worker stays with the company for a long period of time, she (or he) is not viewed as a lifetime employee.²⁴

What about employees of small and medium-sized companies that are subsidiary to core companies? In 1992, unions represented 58 percent of the labor force in companies with 1000 or more employees, 29 percent in companies with 300 to 999 employees, five percent in companies with 30 to 99 employees, and only 0.3 percent in enterprises with less than 30 employees.²⁵ But long-term relations between core companies and subcontracting companies are central to Japanese industrial organization.²⁶ A core company might hold out the promise of long-term relations with the subcontracting enterprise but does not take responsibility for ensuring the long-term employment of its workers. Nevertheless, the innovative strategies of core companies have depended critically on building long-term relations with specific subcontracting enterprises for the sake of developing and utilizing technology. When successful, these innovative strategies have created the financial returns to support lifetime employment not only in the core companies but also, de facto, in the subcontracting companies, even though these companies do not normally have enterprise unions.²⁷ Indeed, as we shall see, through the transfer of the regular employees of core companies to such subsidiary companies later in their careers, the relation between these two types of enterprise has become increasingly important for maintaining the promise of lifetime employment for core company employees as well.

In addition, as I shall also discuss, when a company is in financial trouble, it is the practice of the companies with which it has business relations -- including, for smaller companies, trade creditors -- to seek to support its recovery rather than condemn it to bankruptcy. The existence of lifetime employment in large companies is at the core of a national system of corporate governance that places the responsibility on the business community for keeping people employed and that encourages the business community to provide troubled companies with the requisite financial support.

In the 1990s lifetime employment remains a powerful force in shaping the allocation of corporate resources and returns in the Japanese economy. Just how deeply embedded the institution of lifetime employment is in the Japanese corporate economy is demonstrated in an article, provocatively entitled "The Lifetime Employment System Unravels," written in the fall of 1993 by Harumi Yamamoto, a reporter for the major daily newspaper, Asahi Shimbun. At the outset, the author recognized that, despite the already prolonged recession of the 1990s, "management's restructuring to date has had little impact on the bottom line . . . because of the persistence of lifetime employment and promotion by seniority." He continued:

These practices, traditionally followed by Japan's leading companies, make it impossible for management to lay off workers at will, no matter what the cost of keeping them on might be to a company's health. Companies overcame previous recessions by other measures, such as furloughing workers, eliminating overtime, and cutting executive salaries. Blue-collar workers were offered early retirement incentives, and these retirements were ostensibly voluntary, rather than constituting forced separations. Work force adjustments rarely if ever extended to white-collar workers. Managers might be shifted from managerial posts to sales positions or be transferred temporarily to subsidiaries, but the lifetime employment system guaranteed they would be kept at the company in some capacity.³⁰

What then, in the recession of the 1990s, constituted the "unraveling" of lifetime employment? It was, according to Yamamoto that, with white-collar workers making up more of the work force and with more of these employees being older and hence more highly paid, "businesses have begun targeting white-collar employees for separation bonus programs and other incentives to early retirement."³¹ Such unprecedented corporate restructuring programs, he went on, "violate the spirit of the lifetime employment system."³²

The most egregious violation to date, Yamamoto reported, was the decision of Pioneer Electronic Company, in January 1993, to demand that 35 managers in their fifties accept a company offer of early retirement or else be

fired. When this move was reported by the newspapers, "the plight of the managers caught national attention."

The news proved profoundly disturbing to the Japanese public. As other media outlets picked up and began following the story a sense of popular indignation and betrayal began to build. Newspapers and television stations were flooded with letters and phone calls condemning Pioneer and questioning whether the action violated labor laws. Pioneer had long been regarded as one of Japan's elite companies and a most attractive place to work, and its surprising action brought home to many just how serious the recession had actually become.³³

When interviewed by *Asahi Shimbun* in February 1993, the president of Pioneer, recognized that

the way in which the separation notices were given, telling the employees they would be summarily discharged, gave the company a very cruel image, and that was unfortunate. However, it is true that the employees were encouraged to resign. Virtual unemployment is not only a burden on the company, it is also painful for employees who report to work day after day with nothing meaningful to do. It is better for both Pioneer and these employees for them to find another workplace where they are needed and where they can work with zest and enthusiasm.³⁴

As for the 35 Pioneer managers who were asked to resign, according to Yamamoto, "[they] viewed the company's action as an inexcusable breach of trust. After all, they had sacrificed their private lives to do whatever the company asked of them, only to be essentially fired with barely any warning." By mid-May 1993, of 17 of the 35 employees interviewed by *Asahi Shimbun*, 13 had resigned but the other four were still employed by Pioneer. Three of those interviewed were considering lawsuits, but recognized the costs and delays that would be involved. Representatives of Pioneer's enterprise union, to which, being in their fifties, the 35 managers no longer belonged, said that the company's action "sullied its reputation and damaged work morale."³⁵

A survey in December 1992, just around the time Pioneer announced its job cuts, revealed that in the manufacturing sector alone, over one million white-collar workers were "virtually unemployed", remaining on company payrolls, but with little productive work to do. In the 1990s there has been a severe problem of an overabundance of lifetime employees in their fifties who, under seniority pay systems, draw high salaries but whose labor services are being underutilized.

Americans, in the 1990s, take corporate downsizing as a matter of course. One point of the Pioneer story for Westerners, however, is that, even after three years of recession, the attempted firing of 35 corporate employees can still provoke such a popular reaction in Japan. The other point of this story for Westerners is that Japanese statements about the "unraveling" of lifetime employment need to be both treated cautiously and considered in context. In responding to changing economic conditions, what has been at issue in Japan in the 1990s is not the institution of lifetime employment; despite the prolonged recession of the 1990s, lifetime employment remains intact.³⁶

Nevertheless, as I shall elaborate later in this paper, during the 1990s, within the framework of lifetime employment, Japanese corporations have adjusted how they reallocate both the labor services of workers in their fifties (and, in a small but growing number of cases, workers in their sixties) and the rewards that these workers receive. In doing so, the solution of early retirement plans, so popular as a more humane way of downsizing the labor force in many American and European companies, has by no means become the norm in Japan. On the contrary, as we shall also see, the persistence of the institution of lifetime employment means that unions and governments have exerted effective pressure on companies to take responsibility for ensuring that their lifetime employees keep working for more years than has traditionally been the case. Since the late 1970s the government has encouraged companies to raise the mandatory retirement age of their workers from 55 years old to 60 years old. A Ministry of Labor survey found that, in 1994, 78 percent companies of all sizes, 98 percent with 5000 or more employees, and 95 percent with between 1000 and 5000 employees had a mandatory retirement age of 60. Eight percent of companies of all sizes, one percent with 5000 or more

employees, and three percent with between 1000 and 5000 employees had a mandatory retirement age of over 60. The current policy of the government and the unions is to get companies to raise the mandatory retirement age to 65 years old, although as of 1994 less than one percent of companies with over 1000 employees (but seven percent of companies with 30 to 99 employees) had done so.³⁷

For a company to sustain a commitment to lifetime employment, especially as working "lifetimes" are becoming a decade longer than was previously the case, requires that the corporate organization exercise significant control over the allocation of its financial returns.³⁸ In the postwar decades, cross-shareholding has been the institution that has ensured that organizational control. It is an institution that was designed to ensure -- and that continues to ensure -- that outsiders to the corporate organization, including first and foremost public stockholders, will be unable to lay claim to the corporate surplus at the expense of insiders: the lifetime employees.

Such organizational control was by no means assured after the dissolution of the *zaibatsu*. In the aftermath of the *zaibatsu* dissolution and with the reopening of the Tokyo Stock Exchange in 1949, individuals owned 69 percent of outstanding stock, securities companies 13 percent, other financial institutions ten percent, nonfinancial companies less than six percent, and the government less than three percent.³⁹ To finance the growth of their companies, enterprise managers needed to maintain as much control as possible over surplus revenues, both for internal financing and to provide a financial base for taking on bank loans. In the United States, organizational control over the allocation of surplus revenues had been accomplished earlier in the century through the widespread distribution among the wealthholding public of the outstanding shares of dominant enterprises.⁴⁰ But in post-World War II Japan, subsequent to the dissolution of the *zaibatsu*, the undeveloped state of both enterprises and the stock markets left Japanese enterprises vulnerable to, if not takeovers, demands on their earnings from outside interests.⁴¹

To ensure that outsiders could not use stock ownership to gain access to company revenues that were needed for internal finance and to service bank loans, the banks and the industrial companies, within and across enterprise groups, took equities off the market by holding each other's shares. Increasingly, business relations among companies, be they industrial or financial, became cemented by cross-shareholding arrangements, with a company that had closer relations with another company being more likely to hold larger amounts of that company's shares, up to the legal maximum of five percent of shares outstanding (ten percent in the case of insurance companies).

Over time, as business relations among financial and industrial enterprises changed, the web of cross-shareholding became more intricate. Although cross-shareholding is not based on a legally enforceable contract, the practice became widely established during the 1950s and 1960s as an institutional arrangement for doing business in Japan. By 1955 cross-shareholding represented 25 percent of outstanding stocks listed on the Tokyo Stock Exchange, and by 1960 it was about 40 percent. It declined slightly in the early 1960s. But after the opening up of Japanese capital markets in 1964, when Japan joined the Organization for Economic Cooperation and Development, the business community, fearing foreign takeovers, took steps to increase cross-shareholding. By 1975, cross-shareholding absorbed 60 percent of outstanding stock, and since then has risen to its current level of about 65 percent.⁴²

Besides the absorption of stock already on the market, Japanese corporations increased the overall level of cross-shareholding during the 1950s and 1960s by offering existing stockholders rights issues at par and stock dividends, as well as by distributing shares at par or free to other businesses. During this period, only those shares not absorbed as rights issues were then sold to the public at market prices. It was not until the early 1970s that Japanese companies began to offer new shares to existing stockholders as rights issues. This practice of public equity offerings expanded considerably in the 1980s.⁴³

From 1949 to the 1990s, the proportion of stock outstanding held by individuals declined more or less continuously while the proportions held by industrial corporations and financial institutions increased. In 1993, of total stock outstanding, financial institutions held 45 percent (of which banks held 16 percent, trust companies ten percent, and life insurance companies 13 percent), business corporations 24 percent, individual

investors 24 percent, and foreign investors seven percent.⁴⁴

As in the case of lifetime employment, the financial turmoil of the 1990s has led some observers to predict that financial institutions would sell off their cross-shareholdings, and that the system would subsequently fall apart. In particular, these observers have been looking for troubled banks to sell off their cross-shareholdings, especially given the propensity of their major corporate clients to go directly to securities markets rather than banks for money.⁴⁵ For example, writing in the mid-1990s Minoru Nakamura and Koji Yamada, researchers at Nomura Research Institute, wrote:

As long as stock prices continued to rise as they had done in the second half of the 1980s, [city and long-term credit] banks could justify their investments by increases in the unrealised capital gains from their stock holdings. However, when stock prices collapsed early in the 1990s, they could no longer justify such stock investment. Worse yet, they had to realise the hidden profits of their stock holdings to offset their charge-off on bad loans, with the result that the financial capacity of these banks to hold shares for the purpose of cross-shareholding has badly weakened. In other words, the relationship between issuers and their loyal shareholders which had long been a characteristic of the Japanese stock market since the war is now disintegrating with the weakening of the banking system.

In the late 1990s, as I shall discuss in detail, the banking system remains weak, if not weaker, than a few years ago when Nakamura and Yamada wrote. But has cross-shareholding been disintegrating, as they claim? Strictly on the numbers and using the conventional measure of the extent of cross-shareholding, there was a decrease in the proportion of stocks that are cross-held of almost four percent in the first half of the 1990s. From 1989 to 1995, the proportion of outstanding stock of companies listed on the Tokyo Stock Exchange held by financial institutions (excluding investment trusts) declined from 42.3 percent to 40.0 percent, while the proportion held by non-financial business corporations fell from 24.8 percent to 23.5 percent. Most of the proportionate increase in holdings was by foreigners, with a small increase also for individuals.

Yet, given the financial turmoil of the 1990s, in which one would expect some significant financial restructuring of Japanese banks, the grounds seem slim for asserting that the institution of cross-shareholding is "disintegrating." Indeed, during the first half of the 1990s, banks' stockholdings as a proportion of their total assets increased significantly. Between 1989 and 1995, securities as a proportion of total assets of all Japanese banks rose from 14.0 percent to 15.5 percent, and stocks as a proportion of total securities held by these banks rose from 23.5 percent to 35.1 percent, so that the proportion of stocks to total assets rose from 3.3 percent to 5.4 percent. For the city banks, whose business has historically been closely tied to the financing of industrial corporations, over this period securities as a proportion of total assets rose from 10.7 percent to 12.4 percent, and stocks as a proportion of total securities held by these banks rose from 30.9 percent to 48.5 percent, so that the proportion of stocks to total assets rose from 3.3 percent to 6.0 percent.⁴⁷

The example of one much-publicized sell-off of cross-shareholdings by a major bank -- the troubled Long-Term Credit Bank (LTCB) -- provides some insights into the how limited sell-offs of cross-shareholdings by banks have been. The sell-off occurred in 1996, after LTCB's profits had plunged into the red during the previous year with losses of 110 billion yen.⁴⁸ Contrary to the notion that banks were engaged in selling off their cross-shareholdings during the first half of the 1990s, the LTCB sell-off was the first to be undertaken by one of the major Japanese banks. Denying press reports that it would sell off up to one-sixth of the market value of its stockholdings (about 500 billion yen), LTCB claimed that it would in fact only be selling off a small (but unspecified) proportion. Bank officials claimed that they made the decision "after we looked carefully at the very poor performance of these assets relative to others." Significantly, the stocks that LTCB put up for sale were not those of industrial corporations but rather securities companies -- financial enterprises with which, as we shall see, LTCB will be increasingly in competition as Prime Minister Ryutaro Hashimoto's recently initiated "Financial Big Bang" unfolds.⁴⁹

A key indicator of the persistence of cross-shareholding as a prime institution of Japanese corporate governance is the low dividend yield on corporate stock through the 1990s. In the 1950s the dividend yield (dividends, including stock dividends and splits, as a percentage of the market price of the stock) on TSE First

Section stocks was between six and seven percent. It then declined steadily to around four percent during the 1960s, two percent during the 1970s, and under one percent in the 1980s.⁵⁰ With the prices of stocks soaring in the late 1980s, the dividend yield dropped to an all-time low of 0.39 percent in 1989. As the Nikkei stock price average fell from over 38,000 in 1989 to under 20,000 in 1995, the dividend yield recovered to about 0.70 percent, with actual dividend payments being cut in the recession of the early 1990s. Over the period 1990-1994, dividend yields on corporate stock averaged 0.75 percent in Japan, 3.02 percent in the United States, and 4.58 percent in Germany.⁵¹

With the implementation of further financial liberalization in Japan, financial interests will undoubtedly exert more pressure on industrial corporations to pay out higher dividends. Whether and under what conditions this pressure will be effective in breaking down the wall of cross-shareholding so that portfolio investors can gain access to corporate revenues is a matter that I shall discuss in the concluding section of this paper. Suffice it to say that thus far through the 1990s dividend levels on corporate stock show no sign of rising. Like lifetime employment, the institution of cross-shareholding remains intact.

The system of corporate governance

Together, lifetime employment and cross-shareholding form the institutional foundations for the operation of the Japanese system of corporate governance, with cross-shareholding making the persistence of lifetime employment possible (although not necessarily viable). Lifetime employment means that the company takes responsibility for a certain class of employees from the time they are hired to the time they retire. By ensuring that the returns of the enterprise can be devoted to reinvestment in the productive capabilities of these employees and the capital equipment that they can use, cross-shareholding provides a foundation of financial commitment for the pursuit of the enterprise's employment objectives.

From the perspective of the Anglo-American agency theory of the firm that contends that corporations should be governed in the interests of stockholders without regard to the interests of employees, the institutions of cross-shareholding and lifetime employment make the Japanese system appear to be what one scholar has termed "anti-governance".⁵² Such a perspective ignores the corporate governance implications of the institutionalization of the commitment to deliver lifetime employment as the fundamental objective of the Japanese enterprise. The commitment to lifetime employment accentuates the need for active corporate governance in the allocation of resources and returns. The corporation must develop and utilize its productive resources, including its human resources, in ways that enable it to generate the returns on a sustainable basis that can keep its labor force employed at acceptable standards of living. The prime tasks for Japanese corporate governance are the allocation of human resources and the returns to human resources so as to achieve such sustainable productivity. Within the rigidity imposed by the commitment to lifetime employment, such corporate governance requires considerable flexibility in the allocation of resources and returns.⁵³

The Japanese system of corporate governance is an intensely hierarchical structure, with ultimate strategic decision-making being the prerogative of an executive board of top managers, of whom the president is the most powerful figure. Many of these top managers also sit on the company's board of directors. Among the largest Japanese companies, about one-tenth of the directors are employed by other corporations that are major shareholders of the company and with which the company has extensive business relations. Another one-fifth of the directors are full-time managers with the company who have pursued most of their careers with other companies or government agencies but have been permanently transferred.⁵⁴ Typically, banks, business enterprises, and government agencies have each supplied about one-third of these part-time and full-time "dispatched directors", with banks generally having no more than one such director with any one industrial or commercial enterprise at a time. The rest of the directors, including the company auditors, are lifetime company employees or former employees.

The meetings of the boards of directors, therefore, are in effect executive management meetings, and any independent supervisory function that the board of directors as such might supposedly serve is merely ceremonial. Even more of a ritual are stockholders' meetings, held once a year. Legally, top managers and the board of directors are responsible to stockholders, who, according to the Japanese Commercial Code have the right to elect directors, approve the annual balance sheet, and decide dividends, as well as approve other issues

decided by top management such as gifts of stocks to companies for business purposes.

But who are the stockholders, what are their objectives, and how can they exert their influence? The essence of cross-shareholding, which accounts for about two out of every three shares, is the willingness of participant companies to be stable shareholders. Except under conditions of financial duress, a Japanese company does not sell the stock of another company that it holds as a stable investor. Even when it does sell the stock, the buyer is another stable shareholder and the seller is expected to repurchase the stock when it regains its financial strength. Stable shareholders do not typically come to stockholders' meetings, but routinely give their proxy votes to the top managers of the companies in which the shares are held. Besides eschewing capital gains and control rights, as we have seen, stable shareholders, as participants in the web of cross-shareholding, have also, over time, been increasingly willing to accept low levels of dividend yields, given the market value of the stock that they hold. Given these demonstrated objectives and actions of stable shareholders, Japanese cross-shareholding in effect represents a system whereby the Japanese business community protects the power of corporate managers to control the allocation of the resources and returns of the companies for which they have executive responsibility. In contrast to stable shareholders, individuals or institutional investors who hold their stocks only for the sake of the financial returns that these stocks can yield tend to be "unstable" stockholders. Those stockholders who would like the opportunity to exercise their voice find that they are given little chance to do so. It has long been the practice for Japanese companies to hold their stockholders' meetings at the same time on the same day each year. For example, on June 27, 1996, 94 percent of 1,864 listed companies held their stockholders on the same day, and most at the same time. It is thus difficult, if not impossible, for the activist stockholder to influence more than one company per year. Save for uncontrollable interruptions, meetings rarely last more than half an hour; the average for the 1,766 companies that held their meetings on June 27, 1996 was 26 minutes.⁵⁵ Even the June 27th shareholders' meeting of Sumitomo Corporation, which had revealed two weeks before that one of its London copper traders had hidden losses of \$1.8 billion over the previous decade, lasted only 38 minutes, with (according to the Nikkei Weekly report) "only one question [being] allowed and it was not directly answered."⁵⁶

One way in which many Japanese companies have eliminated embarrassing questions at stockholders' meetings is to pay blackmail to professional *sokaiya*, often linked to the underworld *yakusa*, who approach management beforehand with the threat that they will ask such questions. Having been paid, the *sokaiya* will often then come to the stockholders' meetings to return the favor to management by ensuring, through intimidation, that other stockholders do not step out of line. A 1982 government reform that sought to limit the influence of *sokaiya* resulted in a number of major companies experiencing marathon stockholders' meetings, of which the longest was Sony's (subsequent to the displacement of its proprietary Betamax system by the VHS format) at thirteen and a half hours.⁵⁷ In the 1980s the government made it illegal for managers to make blackmail payments to *sokaiya*, but as evidenced by the *sokaiya* scandals of 1997, many major Japanese enterprises still engage in the practice.⁵⁸

Since the prevalence of cross-shareholdings and control over shareholders' meetings block unstable stockholders from reaping financial returns in the form of dividend yields, the only way in which they can generate financial returns is through stock-price appreciation. The Nikkei stock price average (which reflects the prices of 225 stocks listed on the First Section of the Tokyo Stock Exchange) appreciated gradually during the 1950s, stagnated during the 1960s, and then, save for declines in 1974 and 1975 in the aftermath of the Oil Crisis, rose at a relatively rapid pace until 1982. After a small decline in 1983 to about 7000, the Nikkei exploded over the next six years to a peak of 38,915 at the end of 1989. Subsequently, of course, it crashed, falling as low as 14,309 in September 1992, and as of mid-January 1998 remained hovered around 16,000.

During the 1970s and 1980s, therefore, even as the dividend yields on stock fell from around three percent to well under one percent, unstable stockholders were kept happy by the runup in the market prices of corporate equities. As for stable shareholders, throughout the 1970s and 1980s, but particularly in the "bubble" period of the late 1980s, they declined to cash in on the rise of *other* companies' stocks. At the same, time, however, Japanese industrial enterprises engaged in the practice of selling large quantities of their *own* stocks to the public at inflated market prices either directly in the form of equities or indirectly in the form of convertible bonds.

As can be seen in Table 1, beginning in the early 1970s, but especially in the late 1980s, Japanese companies raised large amounts of funds through public issues of stocks. Meanwhile the volume of conversions of bonds to stocks (some but not all of which ended up in the hands on unstable shareholders) was high throughout the period. In addition, during the 1980s Japanese companies issued large volumes of warrant bonds -- bonds with rights (or warrants) to buy stock attached -- that were mainly floated abroad. In the late 1980s large amounts of warrants were exercised, accounting for 16 percent of the number of new shares issued by listed Japanese corporations between 1987 and 1989 (see Table 2).

Table 1. Paid-In Funds Raised by Offerings of Listed Stocks on All Japanese Stock Exchanges, 1965-1994

percent of paid-in funds, type of new issue

Year	Number of companies issuing new shares	New share issues, 100 million yen paid in	Rights issues	Public issues	Private issues
1965	100	1429	98.1	0.1	1.8
1966	223	1938	94.0	1.2	4.9
1967	234	2528	95.9	3.0	1.0
1968	230	3241	95.0	3.6	1.4
1969	388	5296	87.8	11.2	0.9
1970	374	6613	80.0	19.1	1.0
1971	249	5410	71.8	18.3	9.9
1972	429	12982	26.6	66.3	7.0
1973	315	7314	41.3	53.6	5.1
1974	322	6125	58.3	40.8	1.0
1975	219	9024	71.9	27.0	1.1
1976	284	8115	34.5	64.2	1.3
1977	332	7095	30.2	65.7	4.1
1978	250	10329	29.8	64.1	6.1
1979	253	6605	19.4	70.3	10.3
1980	256	11601	15.2	78.1	6.7
1981	285	17932	26.8	71.4	1.8
1982	172	10154	18.3	79.4	2.4
1983	126	8495	16.7	65.6	17.8
1984	153	8148	8.5	87.2	4.2
1985	131	6513	28.7	67.2	4.2
1986	110	6315	19.0	75.1	6.0
1987	149	20839	22.9	71.7	5.3
1988	236	45638	21.8	76.0	2.2
1989	325	75600	13.7	82.8	3.5
1990	98	6646	42.0	29.7	28.2
1991	60	3427	61.5	9.7	28.9
1992	34	1517	37.7	5.4	57.0
1993	16	1883	0.1	28.6	71.3
1994	42	4722	10.2	30.3	59.5

Notes: Rights issues are stock issues to existing shareholders, which were generally at par value before the 1980s, but increasingly at price between par and the market price during the 1980s.

Public issues are stock issues to the general public at the prevailing market price.

Private issues are placements of stock, typically below market price, to "selected persons having some special relationship with the company, such as its directors, employees, banking institutions with which the company deals, its suppliers, or distributors." (Japan Securities Research Institute, *Securities Market in Japan*, 1996, JSRI, 1996, 41.)

Sources: Japan Securities Research Institute, *Securities Market in Japan*, 1984, JSRI, 1984, 28; Japan Securities Research Institute, *Securities Market in Japan*, 1996, JSRI, 1996, 43.

Table 2. Types of New Share Issues of Listed Japanese Corporations, 1975-1996 percent of total number of shares issued annually

Year	Rights Issues	Public Issues	Private Issues	Conversions	Warrants	Gratis Issues	Stock Splits	Other Issues
1975	66.7	3.5	0.4	3.7	0.0	21.6	0.4	3.8
1976	36.0	11.2	0.6	10.0	0.0	36.7	3.4	2.0
1977	46.7	11.3	1.7	5.0	0.0	32.6	2.1	0.6
1978	32.1	14.4	6.0	13.5	0.0	34.2	1.9	-2.1
1979	20.5	16.0	3.3	25.5	0.0	31.8	0.5	2.4
1980	19.1	17.6	3.4	24.0	0.0	35.5	0.1	0.4
1981	39.5	16.6	0.7	17.8	0.0	24.5	0.4	0.5
1982	20.3	18.5	1.2	11.6	0.1	44.6	0.3	3.3
1983	11.9	6.1	7.0	23.7	1.4	44.2	5.5	0.3
1984	12.3	8.2	3.4	29.8	2.2	38.1	4.3	1.8
1985	9.0	5.9	1.2	34.9	4.4	37.6	6.0	0.9
1986	4.1	3.8	0.9	31.2	9.7	36.8	6.7	6.9
1987	4.4	5.8	2.5	38.3	18.3	26.4	0.2	4.1
1988	6.5	9.8	1.3	35.2	16.1	30.0	0.4	0.7
1989	4.4	19.3	0.5	30.0	13.5	30.1	1.9	0.2
1990	5.2	8.8	1.7	12.7	4.0	30.3	26.3	11.1
1991	6.3	0.6	2.8	9.1	5.4	*	52.0	23.8
1992	8.9	0.1	6.9	5.0	6.9	*	57.3	15.0
1993	2.4	0.1	13.1	9.5	18.8	*	24.7	31.4
1994	0.5	0.7	10.8	8.8	9.6	*	46.1	23.6
1995	8.9	0.4	17.5	12.2	12.1	*	36.2	12.8
1996	8.6	3.8	11.1	9.6	15.2	*	16.1	36.6

Notes: For definitions of rights, public, and private issues, see notes to Table 1. Conversions are common stock issues in exchange for convertible bonds or preferred shares. Warrants are stock issues in exchange for the warrants attached to warrant bonds.

Gratis issues are stock dividends or the issue of par value shares by incorporating legal reserves or premiums over par of previous stock issues into the company's capital.

Stock splits are the conversion of outstanding stocks into non-par shares.

Under the amended Commercial Code, effective, April 1, 1992, "gratis" issues are deemed to be stock splits. Hence, for 1991 through 1996 (as signified by * in the table), gratis issues are included in stock splits.

Other issues include share increases or decreases as a result of mergers or reductions in capital stock.

Sources: Tokyo Stock Exchange, *Annual Securities Statistics*, 1990, TSE,

1990, 136-137;

Tokyo Stock Exchange, Annual Securities Statistics, 1996, TSE, 1996, 142-143.

Given these sales of equities, much of which ended up in the hands of unstable shareholders, how then did Japanese corporations maintain the levels of cross-shareholding at about 65 percent during the 1980s? As indicated in Table 2, they distributed massive amounts of stock to stable shareholders as rights issues, private placements, as "offerings to selected persons" for business purposes, and as stock dividends. According to Zielinski and Holloway, writing in 1989, "around 40 percent of the money raised in the equity market is eventually plowed back into the stock market in answer to reciprocal calls for cash from cross-shareholders." Thus, while during the late 1980s the public was buying up shares of Japanese companies at price-earnings ratios that averaged about 58 in 1987 and 1988 and 71 in 1989, Japanese companies were ensuring that stable shareholders who sought neither capital gains nor high dividend yields would continue to hold a marked majority of their outstanding stock.

Protected by cross-shareholding, corporate governance in Japanese companies is firmly under the control of inside managers, supported by the inside managers of other Japanese financial and nonfinancial companies, subject to the basic condition that as individual companies and as a group they maintain their commitment to keeping the core of their labor forces employed over the course of their working careers. The absence of stockholder power in Japanese companies does not mean that top managers can do just as they please in the allocation of corporate resources and returns. Despite the financial commitment provided by cross-shareholding, during the post-World War II decades, Japanese industrial companies were highly dependent on bank finance. During the era of high-speed growth in the 1950s and 1960s, retained earnings were hardly sufficient to fund the investments in technology and organization that this industrial development required. To supplement retained earnings, companies were able to turn to a highly regulated banking system that, since the Meiji era, had been structured to provide financial commitment for industrial development.

The prime mode of bank finance of industrial development in the post-World War II decades took the form of the "main bank system." A company's "main bank" is the financial institution that takes the lead in providing it with loan finance, even though much if not most of the loans are made to the company by other financial institutions. By taking responsibility for monitoring the performance of the company and for leading the rescue of the company should it fall into financial distress, the main bank permits other banks to make loans to the company without having to take on these functions themselves. The result is that, based on the reputation of the main bank and its close relationship with a particular company, a de facto loan syndicate finances the company.

The origins of this system can be traced to the early 1930s, when the Ministry of Finance (MOF) and the Bank of Japan (BOJ) linked up with the government-controlled Industrial Bank of Japan (IBJ) and the most powerful zaibatsu bank, Mitsui, to rescue 20 large companies that were in deep financial trouble. In the build up to and during World War II loan syndication was widely used to finance "national policy firms", with IBJ as the main bank in 82 of 121 loan syndicates. This method of financing continued after the war, first with BOJ acting as an active organizer of loan syndicates, but then from 1950 with the city banks (formerly connected with the major zaibatsu) and IBJ (now reorganized as a joint-stock company but initially supported by MOF) taking the lead. In addition, during the 1950s, to complement IBJ, the government supported the emergence of two other non-depository long-term credit banks -- the Long Term Credit Bank of Japan and the Nippon Credit Bank -- with MOF using postal savings deposits to absorb their debenture issues and BOJ supplying them with preferential credits. Indeed, throughout the postwar decades MOF and BOJ continued to support the banking system in these ways, but in the early 1950s they played critical roles in enabling the city banks and long-term credit banks to provide the financial commitment that launched the high-growth era.

The result of this form of financial commitment under the main bank system was that Japanese industrial corporations could engage in developmental investment strategies with debt-equity ratios far in excess of those that existed in the advanced economies of the West, and with debt financing that was almost entirely in the form of unsecuritized bank loans as opposed to securitized bonds. In 1960, bank loans accounted for 65 percent of the financing of large Japanese enterprises, whereas bonds accounted for less than seven percent, paid-in capital 14 percent, and reserves 14 percent. For the period 1962-1979, bank loans as a percent of all

sources of funds to the non-financial corporate sector were 45 percent in Japan, 19 percent in the United States, 24 percent in Germany, and 21 percent in Britain. During the second half of the 1970s, Japanese bank finance declined to 42 percent of all sources of funds to non-financial corporations, down from 50 percent during the first half of the decade, a trend away from bank finance that continued during the 1980s. Yet even during the 1980s, bank loans as a percent of all non-financial corporate funds were 34 percent in Japan, 15 percent in the United States, 19 percent in Germany, and 21 percent in Britain.

Besides the Industrial Bank of Japan, the most important main banks are the city banks that are part of the Big Six enterprise groups (*kigyo shudan*). These enterprise groups are also called horizontal keiretsu because they link together a number of powerful companies across an array of distinct industries. The city banks of these groups are the recently merged Bank of Tokyo-Mitsubishi Bank, Sakura Bank (another merger of the 1990s that includes the former Mitsui Bank), Sumitomo Bank, Fuji Bank, Dai-Ichi Kangyo Bank, and Sanwa Bank. Three of these banks had been part of the oldest and most powerful zaibatsu, Mitsui, Mitsubishi, and Sumitomo, that, in the early 1950s, after the zaibatsu dissolution, built on the legacy of interfirm relations to reorganize themselves into enterprise groups. SCAP had banned the formal re-emergence of the zaibatsu groupings, but after the official end of the Allied occupation in April 1952, the groups of companies that had previously constituted Mitsui, Mitsubishi, and Sumitomo resumed the use of the traditional zaibatsu names. By the 1970s the other three powerful horizontal keiretsu -- Fuyo, Dai-Ichi Kangin, and Sanwa -- emerged around Fuji Bank (formerly part of Yasuda zaibatsu), Dai-Ichi Kangyo, and Sanwa, respectively.

In 1987, the non-financial enterprises that were part of the Big Six horizontal keiretsu included 163 parent, or core, companies, 4,960 subsidiaries (in which the group held more than 50 percent of the stock), and 6,875 affiliates (in which the group held between 10 percent and 50 percent of the stock). The core companies alone accounted for 13 percent of assets and 15 percent of sales in the Japanese economy, and with all of the subsidiaries and affiliates, 27 percent of assets and 25 percent of sales. Each of these enterprise groups has a President's Council, at which the presidents of the parent companies in the group (ranging from 20 companies in the Sumitomo council to 47 companies in Dai-Ichi Kangin council) get together to discuss matters of common concern, but without having legal means to enforce member enterprises to act as part of a collectivity.

In addition, during the postwar decades a number of companies such as Toyota and Matsushita emerged as the core companies of vertical keiretsu. As such, each of these core companies have provided development finance to large numbers of subsidiaries that supply it with goods and services, either directly or through a chain of suppliers and distributors. These core companies often provide substantial finance, both in the form of equity stakes in and loans to these subsidiaries. To make matters more complicated, many of the core companies of the vertical keiretsu have relations with the horizontal keiretsu. And whether the relations among companies be vertical or horizontal, both cross-shareholding and bank lending transcend keiretsu relations, and have become inextricable from the dense web of business relations that tie the fates of Japanese companies together.

Much has been made by students of the "main bank system" of the role of the main banks in monitoring corporate management in an industrial economy in which companies are clearly not run for stockholders. During the 1950s and 1960s, when the Japanese economy, and the industrial companies that constituted its developmental core, faced uncertain futures, main banks did have to know to whom they were making financial commitments. As the financial institution obliged to lead the effort to revitalize an ailing company, personnel at the main bank had to understand the long-run potential of a company if and when circumstances placed it under financial duress.

But by the 1970s and 1980s, once the Japanese economy and its core companies had overcome the inherent uncertainties of the developmental process, the monitoring role of the main banks became virtually routine. Indeed, so as not to be overly dependent on any one main bank, strong industrial companies sought bank loans from an even greater range of sources than had previously been the case, or, they used retained earnings or funds raised on securities markets to pay off large amounts of their bank debt. Awash with cash and having lost their best customers, the banks then turned to making loans to real-estate developers and stock speculators, among others. After the "bubble economy" burst in 1990, the collapse of land and stock markets left the banking system with a massive bad loan problem.

As Shigeru Watanabe sums up the implications of the 1980s and early 1990s for the role of bank influence on

the major industrial corporations:

In the process, the banks lost their clout as a key element of corporate governance of Japanese companies. Even if they had not lost their prestige with the bursting of the speculative bubble, the banks would have been eased out of their dominant position in the corporate governance of Japanese firms, given the changes in the flow of funds caused by the end of the fund shortages and freer access to the financial and capital markets, because the leverage they have enjoyed in corporate governance came from the lender's power; when the borrower's position has strengthened, that power has gone forever.

Watanabe, a researcher at the Nomura Research Institute, then states in typical "principal-agent" fashion:

But nothing has replaced the banks. Now that equity-linked financing has come to take on the largest weight among the corporate financing vehicles, shareholders should impose discipline on corporations. However, they, including institutional investors, are not up to the task.

Such a view is based on a perspective that a company should be run for the sake of financial interests, be they debtholders or stockholders. Yet, even when, in earlier decades, the Japanese banks did have more power over how the industrial corporations to which they lent allocated their resources and returns, they were actors in a highly regulated financial system in which, given the uncertainties involved, they were willing to take relatively low returns on their lending activities to support the success of the industrial economy. One reason that, as financial enterprises, banks were willing to participate in such a system is that they knew, as the experience of the 1990s has proved to be the case, that the government stood behind them should the loans go bad.

As central participants in the cross-shareholding movement, moreover, the banks themselves were not run for the sake of their stockholders, but for the sake of developing the economy. At the enterprise level, developing the economy meant delivering on the promise of lifetime employment, not only to their own employees but to the employees of the industrial enterprises that the banks helped to finance. It was the successful development of these industrial enterprises that transformed lifetime employment from a promise to a reality in the postwar Japanese economy. As part of a dynamic process of development, the institution of lifetime employment gave top managers the incentive to develop and utilize the capabilities of the company's employees, while making the delivery of lifetime employment a prime corporate objective.

The fact is that Japanese corporations have been, and continue to be, governed by their top managers as part of a hierarchical structure of organizational control. Within the management structure itself key allocations decisions are generally made by a process of consensus decision making that includes the formal *ringi seido* that involves the circulation of a memorandum to be signed by all concerned and the informal *nemawashi* that seeks out differences of opinion and generates discussion before an important decision is made. Top management ultimately makes the allocation decisions but, prior to the taking of an important decision, a process exists to tap the knowledge and experience of those responsible for implementation. This discussion extends down the hierarchy to the enterprise unions through joint consultation committees (JCCs) that involve labor and management. Having themselves come up through the company and having been members of the union during the early parts of their careers, most top managers have experienced JCCs from the labor side. For example, a 1978 survey by Nikkeiren (Japan Federation of Employers' Associations) found that two out of three of the major companies had executives -- accounting for almost one in six executives -- who had at one time served the company as union officials. Union officials, who are company employees, hold regularly scheduled conferences with management at different levels of the enterprise to resolve issues concerning remuneration, work conditions, work organization, interdepartmental and intercompany transfers, and production. In contrast to the institutions of works councils and co-determination in Germany, Japanese enterprise unions have no explicit rights to engage in the executive or supervisory institutions of corporate governance. Rather, in large companies, JCCs perform an information-gathering function for both management and labor that is a preliminary to collective bargaining. In smaller companies in which enterprise unions are absent, JCCs actually constitute collective bargaining.

A 1994 survey of the activities of JCCs in large companies found that 69 percent of companies with 5000 or more employees, and 77 percent of companies with 1000 to 4999 employees used JCCs to report and explain basic business policy to workers. But on most issues only nine to 12 percent of the companies reported that

they listened to workers' opinions, and only three to seven percent of companies said that they needed the consent of workers to implement a change. On the introduction of new equipment, however, not only did managers in 56 percent of the smaller companies (1000-4999 employees) report and explain the introduction of new equipment to workers, but over 21 percent of the companies listened to workers' opinions. But a meager 1.3 percent of these companies said that they needed the consent of workers to introduce new equipment.

JCCs, therefore, can make management aware of what labor wants, but they certainly do not give labor the power to influence the allocations of resources and returns against the wishes of top management. Since the 1970s overt and prolonged strife has become virtually nonexistent in the major companies largely because of the adherence of management to the principle of lifetime employment and a willingness of management, behind the wall of cross-shareholding, to share the gains of enterprise with workers when they are available. Enterprise unions, whose officials are members of management, enforce workers' claims on enterprise earnings, taking into account the financial condition of the enterprise in relation to the requirements for reinvestment. Within the framework of lifetime employment and cross-shareholding, workers have been willing to restrain their demands for pay increases on the understanding that what they do not take now the enterprise will invest in ways that will benefit them later. Guiding this wage bargaining at the enterprise level is the benchmark for wage increases created by shunto, or the Spring Offensive, the annual national debate over the condition of the economy and the consequent possibilities for augmenting the earnings of Japanese employees without jeopardizing the sustained prosperity of their companies or the economy.

The other key issue for the enterprise unions is whether to cooperate with management in its plans for the reallocation of labor, especially when as, in the recession of the 1990s, to keep people employed over a lifetime means putting them in jobs where they can generate the productivity that can justify their pay. For workers in their twenties, thirties, and forties, the key to labor allocation is integration of workers into a process of organizational learning that enables them to become more productive as under the seniority pay system (nenko) they receive higher earnings. When they reach their fifties, however, the key to the process of labor allocation is the transfer of workers to jobs where they can live off their experience but often at lower pay. Central to this process in major companies has been the transfer of workers to subsidiary enterprises, a process that, as we shall see in the last section of this paper, has in the 1990s become much more central to the maintenance of lifetime employment as an institution that has a profound influence on Japanese corporate governance.

Financial Pressures in the 1990s

The banking crisis

During the post-World War II decades, the Japanese erected a highly regulated financial system that was extremely effective in supporting the development of the Japanese economy. Into the 1990s the system was characterized by a range of highly specialized private-sector institutions whose financing activities were supported by MOF through its Trust Fund Bureau and BOJ over which MOF exercises considerable control. With all financial vehicles moving in the same direction and at the same pace under MOF, the "convoy fleet system" (gososendan) became the popular name for the Japanese financial infrastructure.

Making finance available to Japanese business enterprises into the 1990s were: three long-term credit banks that have made long-term loans to major industrial enterprises; seven trust banks and 27 life insurance companies that have also made long-term loans to large companies, but which increasingly since the 1980s have absorbed corporate government securities, both domestic and foreign; 11 city banks (centered in Tokyo, Osaka, and Nagoya) that have made ostensibly short-term loans, many of which have been continually rolled over to finance long-term investments, to major companies; 64 regional banks spread out over Japan's 47 prefectures that have extended loans to larger regional businesses; 66 second-tier regional banks that have catered to the financial needs of small and medium-sized enterprises (SMEs); and large numbers of credit unions and credit associations that have extended loans to small enterprises and farmers.

BOJ has supported this system of business finance by both maintaining a structure of low and stable interest rates and by extending "overloans" to banks, especially the city banks, so that, by "overborrowing", they could increase their volume of business loans beyond that permitted by their deposit base. MOF's Trust Fund Bureau, which controls the investment of Japan's postal savings deposits and public pension funds, has

supported the system through the Fiscal Investment and Loan Program, also known as zaito, by financing infrastructural investments, SMEs, and public works (including housing) and by absorbing the debentures of long-term credit banks (which have no depository base, other than their corporate customers) and other financial institutions. In addition, zaito draws on funds that the Ministry of Posts and Telecommunications controls in the postal insurance system.

Zaito must generate sufficient returns to cover the savings, pension, and insurance obligations to households for the funds that it uses. But these rates are kept low by Japan's regulated interest rate structure, and MOF and BOJ coordinate their policies and operations. Zaito functions as a second or shadow government spending budget, but one that does not rely on either tax revenues or public debt issues. During the first half of the 1980s, investments and loans made with zaito funds were about 50 percent of the government's general account appropriations. This proportion increased sharply in the 1990s, as depositors shifted their accounts from banks to postal savings, and as the government used zaito to try to fight the recession. In 1994 zaito funds injected into the economy were equal to 65 percent of government spending from the general account.

As indicated in Table 3, in terms of the distribution of financial assets across these institutions in 1993, Trust Fund Bureau and city banks, followed by the regional banks, dominated in loans, while Trust Fund Bureau, trust banks, and life insurance companies dominated in securities.

Table 3. Financial Assets of Japanese Financial Institutions, March 31, 1993

-----trillion yen----- -----percent of-----

Institution	Loans	Securities	Assets	loans	securities
Long term credit banks	47.6	14.2	61.8	5.0	3.3
Trust banks	59.8	76.5	136.3	6.3	17.7
Life insurance companies	61.1	67.4	128.5	6.5	15.6
Non-life insurance companies	7.2	12.3	19.5	0.8	2.8
City banks	223.2	46.5	269.7	23.6	10.8
Regional banks	126.5	32.5	159.0	13.4	7.5
Second-tier regional banks	50.9	9.5	60.4	5.4	2.2
Credit assoc. & unions	93.5	22.6	116.1	9.9	5.2
Agricultural institutions	41.0	29.0	70.0	4.3	6.7

Postal insurance	25.9	29.8	55.7	2.7	6.9	4.0
Trust Fund Bureau	210.4	92.2	302.6	22.2	21.3	21.9
Total	947.1	432.5	1379.6	100.0	100.0	100.0

Source: Minoru Nakamura and Koji Yamada, "Financial Institutions of Japan," in Shigenobu Hayakawa, ed., Japanese Financial Markets, Gresham Books, 1996, 125.

Having supported the development of the Japanese economy in the post-World War II decades, during the 1990s this highly coordinated and regulated financial system has fallen into crisis. In all of these financial institutions, the first half of the 1990s witnessed a mounting accumulation of bad loans. In March 1992, MOF revealed the extent of the bad-loan problem, and the BOJ cut the discount rate to an all-time low of 1.75 percent in order to help debtors make their payments. Nevertheless, the volume of bad loans continued to increase, and financial institutions began to write off large amounts.

In September 1995, bad loans were 5.4 percent of all loans of all banks and cooperative institutions, of which 3.5 percent were loans of bankrupt companies or loans that were past due by more than six months, while the other 1.9 percent were loans that had been restructured at a reduced rate of interest (see Table 4). Hardest hit in terms of bad loans as a proportion of all loans were the long-term credit banks (7.3 percent) and the trust banks (10.2 percent). But, given the size of their loan portfolios, the bad loans were concentrated in the city banks, which accounted for 35.7 percent of all bad loans in the private-sector financial system. Even though the trust banks had a relatively low proportion of their total assets in loans, they also had the lowest level of loan loss reserve and hidden reserve coverage among the major bank lenders.

Table 4. Bad Loans of Banks and Cooperatives, September 1995

-----trillion yen----- -----percent-----

A	L	B	L/A	B/A	B/L	(R+H)/B	B/Total	B
City banks	433.2	275.7	13.6	63.6	3.1	4.9	90.4	35.7
LTCBs	87.3	54.5	4.0	62.4	4.6	7.3	87.5	10.5
Trust banks	250.8	61.5	6.3	24.5	2.5	10.2	50.8	16.5
Subtotal	771.3	391.8	23.8	50.8	3.1	6.1	79.8	62.5
Regional banks	200.2	133.9	5.0	66.9	2.5	3.7	128.0	13.1
2nd regional banks	68.8	51.0	2.8	74.1	4.1	5.5	50.0	7.3
Regional banks total	269.0	184.9	7.8	68.7	2.9	4.2	100.0	20.5
Total banks	1040.4	576.7	31.6	55.4	3.0	5.5	84.8	82.9
Cooperatives	263.9	129.1	6.5	48.9	2.5	5.0	47.7	17.1
TOTAL	1304.3	705.8	38.1	54.1	2.9	5.4	78.5	100.0

A = assets, L = loans, B = bad loans, R = loan loss reserve, H = hidden reserve (difference between market value and book value of stockholdings)

Source: Akitoshi Takatsuki, "Money and Banking in Japan," International Management, International

University of Japan, photocopy, October 1996.

In March 1997 total bad loans for Japanese banks were estimated at 28 trillion yen, up from 22 trillion yen in March 1996 and 13 trillion yen in March 1995. A significant proportion of these bad loans had been made to jusen housing loan companies that were incorporated by banks, insurance companies, and securities companies in the 1970s for the purpose of making housing loans to individuals. The jusen themselves used funds borrowed from the financial institutions. But in the 1980s many of the banks turned to making housing loans themselves, thus leading the jusen to turn instead to financing real estate development projects. When, in 1990, at the onset of the financial crisis, MOF introduced regulations that limited bank loans to real estate companies and nonbank lenders, the jusen turned to the cash-rich agricultural cooperatives.

As land prices continued to plummet in the early 1990s, the jusen loans went bad. In September 1995, seven jusen companies had 12.9 trillion yen in loans outstanding, of which about two-thirds were problem loans. About 48 percent of these borrowings came from banks (of which over one-third was from trust banks) and another 42 percent from agricultural cooperatives. At the end of 1995 MOF ordered the banks that had founded the jusen companies to write off all of their loans (3.5 trillion yen) to affiliated jusen and 45 percent of their loans (1.7 trillion yen) to non-affiliated jusen. MOF contributed 685 billion yen of public funds to wind down the jusen companies, thus enabling the agricultural cooperatives to write off only 530 billion yen. In July 1996, the government set up the Housing Loan Administration Corporation to take over about 6.8 trillion yen of the loan outstanding of the seven failed jusen.

A number of failures of smaller (second regional) banks and cooperatives occurred through 1996. The first big bank failure occurred in November 1997, with the bankruptcy of the Hokkaido Takushoku Bank, the weakest of the ten city banks. It is expected that it will require one trillion yen from the Deposit Insurance Corporation to cover the bank's bad loans. The failure of Hokkaido Takushoku occurred in spite of the MOF pledge in the early 1990s that none of Japan's major banks would collapse. In the aftermath of the Hokkaido Takushoku failure, there were proposals to use postal savings money -- managed by zaito -- to buy subordinated bonds issued by banks to supplement funds available to the Deposit Insurance Corporation. Shortly, thereafter, the fourth largest Japanese securities company, Yamaichi, also collapsed, raising fears of a recall of foreign loans (including loans to the U.S. Treasury) that, in the midst of financial failures in a number of other Asian economies, could have triggered an international liquidity crisis. In December 1997 The Liberal Democratic Party put together a plan to use at least 10 trillion yen of public money to support the nation's financial system.

This crisis of the Japanese financial sector has certainly contributed to the prolonged recession of the Japanese economy in the 1990s. At the same time, however, Japan's industrial economy is very strong. While the financial institutions wallow in bad loans, industrial enterprises are cash rich. In 1991 the ratio of their net financial assets to GDP was minus ten percent; in 1996 plus six percent. Japan remains a creditor nation with a very high savings rate. Japanese companies are investing in new technologies, and the Japanese economy is generating persistent trade surpluses. At 3.2 percent, unemployment in Japan is high by the nation's postwar standards but low by world standards. Despite the financial turmoil, Japan's formidable productive system is not in danger of collapse.

Indeed the Japanese financial crisis of the 1990s is the result not of an underlying weakness in the productive capacity of the Japanese economy, but of the transformation of the role of the nation's financial sector with the maturation in the 1970s and 1980s of perhaps the most highly successful national economic development effort in world history. The origin of the crisis lies in the participation of financial institutions in the unregulated financial speculation to which the phenomenal success of the Japanese industrial economy in international competition in the 1980s gave rise. During the 1980s, the returns on the wealth that Japan's industrial development had created since the 1950s far surpassed the ongoing investment requirements of the Japanese economy, so that even within a highly regulated financial system this surplus wealth was permitted to find outlets in real estate and corporate stock speculation. Thus, in the wake of the very real and ongoing success of Japan's industrial economy in international competition, the "bubble economy" emerged.

In the process, Japan's banks became less involved in financing the development of the industrial economy, and instead turned to helping to expand the bubble until it burst. The very success of Japanese industrial corporations made them by the 1980s much less reliant on the major banks to mobilize capital for their further

development. In search of new business, Japanese banks engaged in lending activities that helped fuel the speculative fervor. When, in 1990, the stock and land markets crashed, much of the value of the assets against which Japanese banks had lent money vanished into thin air.

During the 1950s and 1960s, the role of the financial sector was to commit finance to industrial development through the provision of low-cost and secure loans to industrial enterprises whose innovative potential was yet to be revealed and whose prospects for financial returns were, hence, highly uncertain. The ability of banks to gain access to BOJ preferential "overloan" credits and Trust Fund Bureau investments in bank debentures was conditional on their willingness to play this developmental role. By the 1970s, the successful development of the industrial companies that had been central to the emergence of Japan as a major economic power meant that they had much less need for the banking system to play this developmental role. Beginning in the 1970s and increasingly in the 1980s, as these industrial enterprises succeeded in developing and utilizing their productive capabilities to generate sustained competitive advantage, they generated the returns that could be committed to finance of their new productive investments, and they possessed the organizational capabilities that greatly reduced the uncertainty inherent in these new investments. These companies now had larger and more secure streams of retained earnings that they could use to finance their further growth, and for their additional funding requirements they could go directly to securities markets.

Moreover, with accumulated productive capacity in place, by the late 1970s companies did not have to invest as much capital as in the high-growth era to get a given amount of sales revenues. They could also use retained earnings and securities issues to reduce their bank debt, as indeed in the late 1970s and 1980s they did (see Table 5). In 1980 for Japanese nonfinancial corporations, internal sources of finance (depreciation charges and retained earnings) accounted for 58 percent of the total sources of funds, in 1985 54 percent, and in 1989 51 percent. Of the external sources of finance, in 1980 equity and debt offerings accounted for only 12 percent and bank loans for 87 percent -- proportions that were in line with the sources of external finance during the 1960s and 1970s. In 1985, however, equity and debt offerings had risen to 17 percent of external finance and bank loans had fallen to 81 percent, with "other sources" of funds accounting for the other two percent In 1989 the proportion of securities offerings was 27 percent, and bank loans only 64 percent, with commercial paper (unused before the late 1980s) accounting for 5 percent and "other sources" the remaining 4 percent.

Table 5. Net Sources of Funds for Japanese Non-Financial Corporations

Five-year averages, percent

Source	1970-74	1975-79	1980-84	1985-89
Internal funds (depreciation and retained earnings)	43.2	51.9	55.8	53.4
Equity issues	3.3	3.3	3.5	4.5
Bonds	1.7	2.5	1.4	5.9
Commercial paper	0.0	0.0	0.0	2.3
Loans (including foreign)	51.7	42.3	39.3	33.8

Source: James E. Hodder and Adrian E. Tschoegl, "Corporate Finance in Japan," in Shinji Takagi, ed., Japanese Capital Markets: New Developments in Regulations and Institutions, Blackwell, 1993, 137.

From 1965 through 1977 the growth rate of bank borrowing by large manufacturing companies was persistently positive, averaging about four percent per year, whereas from 1983 to 1989 this growth rate was persistently negative at between minus one and minus two percent per year. In 1975 retaining earnings accounted for ten percent of the capitalization of these companies, paid-in capital 20 percent, corporate bonds five percent, and borrowings 65 percent. In 1990 retained earnings had risen to 28 percent, paid-in capital 24 percent, corporate bonds 26 percent, and borrowings 22 percent. Depending on the terms under which they could raise funds on capital markets, even when these companies did not need to float securities to fund new productive investment, it could be worth their while to do so to pay off bank debt or even simply to build up cash reserves. Hence, the same developmental process that in the 1970s and 1980s eliminated the uncertainty inherent in bank loans to industrial enterprises also enabled these industrial enterprises to reduce their reliance on bank loans.

Especially during the bubble economy of the late 1980s, as price-earnings ratios of corporate stock increased dramatically, listed companies found that they could raise large sums by floating equities. In addition, the

liberalization of the access of Japanese companies to international capital markets in the mid-1980s led to many Japanese companies to engage in zaiteku -- or "financial engineering" -- which included significant issues of convertible (including warrant) bonds as well as commercial paper on foreign markets. Companies listed on the Tokyo Stock Exchange raised about two trillion yen annually through the sale of convertible bonds in the 1970s, and about four billion yen annually in the first half of the 1980s. From 1986 sales of convertible bonds shot up, reaching 11 trillion yen in 1987 and peaking at 24 trillion yen in 1989. Warrant bonds were particularly attractive to foreign lenders because they could sell the detachable warrants which could be converted to stock. About 80 to 90 percent of these warrants were sold back to Japanese investors. The value of the detachable warrant in the booming stock market meant that instead of a bond coupon of about five percent that would be needed to float regular convertible bonds, Japanese industrial enterprises were able to float warrant bonds with a coupon of one percent. In 1990, when the bubble had burst, one Tokyo-based analyst of a Western money-market firm recognized that in securing these cheap funds on international securities markets, Japanese industrial enterprises "borrowed for the future".

It was an important part of the country's rise to industrial-empire status. The borrowing window was too good to overlook, and corporate treasuries exploited Japan's rise to the hilt. What is most impressive is that all this borrowing took place even though they did not need the money.

The result of the increased access of Japanese companies to internal sources of finance and capital markets in the 1980s was, therefore, a dramatic decline in their reliance on bank borrowing. During the late 1970s and even more so in the 1980s, the city banks, long-term credit banks, and the trust companies that made loans to the larger Japanese industrial enterprises found themselves both losing their best customers and amassing huge volumes of loanable funds -- in part because of large increases in deposits by these very same corporate customers. As Shigeru Watanabe has put it:

As large sums of funds flowed back to the banks from their blue chip borrowers, the banks were pressed by the necessity of finding new borrowers and had to change their stance from one of waiting for customers to come to them with hat in hand to one of reaching out to their prospective customers with specific project proposals to cultivate and stimulate their loan demand. Table 6 shows how, from March 1985 to March 1990, Japanese banks altered their loan portfolios. Loans to manufacturers declined, while loans to "real estate and construction" shot up. So too did loans to "non-bank corporations", "other corporations", and "individuals", with much of these funds either taking the forms of residential mortgages, loans backed by real estate as collateral, or loans to non-bank corporations such as the jusen companies that used the funds to make real-estate loans.

Table 6. Net change in Japanese banks loans, March 1985 to March 1990

Change in trillion yen Percent change in share

City and Long-term City and Long-term

regional banks credit, and trust banks

All banks regional banks credit, and trust banks All banks

All corporations 65.4 31.2 96.6 69.5 93.4 75.8

Manufacturers -1.5 -3.3 -4.7 -1.6 -9.9 -3.7

Real estate/ construction 22.3 7.7 30.0 23.7 23.1 23.5

Non-banks 15.4 21.0 36.4 16.4 62.9 28.6

Others 29.1 5.8 34.9 30.9 17.4 27.4

Individuals 27.3 1.3 28.5 29.0 3.9 22.4

Others 1.4 0.9 2.3 1.5 2.7 1.8

Total 94.1 33.4 127.4 100.0 100.0 100.0

Source: Minoru Nakamura and Koji Yamada, "Financial Institutions in Japan," in Shigenobu Hayakawa, ed., Japanese Financial Markets, Gresham Books, 1996, 139.

Land, of course, has always been a scarce, and hence valuable, asset in Japan, especially in the Tokyo-Nagoya-Osaka triangle where Japan's industrial development has been concentrated. Not only is usable land scarce in Japan, particularly in the most developed areas, but what land there is does not easily change hands. In Tokyo the annual turnover of land is about two percent, so when demand increases it presses against a highly inelastic supply. During the first half of the 1980s the value of land for commercial, industrial and residential uses in the six largest cities rose by about 40 percent. Then in the last half of the 1980s these land prices rose by over 200 percent.

Real estate loans in Japan went from an average of just over one trillion yen per year in the first half of the 1980s to about 7 trillion yen per year in the last half of the decade, peaking at almost 11 trillion yen in 1987. The long-term credit banks, city banks, and trust companies -- for which loans to large companies had been an important part of their business -- became heavily involved in loans related to real estate. The city banks increased residential mortgages from about eight percent of their loan portfolios in 1984 (and seven percent in 1985) to 16 percent in 1990. Long-term credit banks increased loans to the real estate industry from less than four percent of their portfolios in 1984 to over 13 percent in 1990, and trust companies from about 12 percent to 16 percent. In addition, loans to non-bank financial institutions, which in turn lent heavily on real estate, amounted to only two percent of the loan portfolios of long-term credit banks and eight percent of the portfolios of trust companies in 1983 but 22 percent and 25 percent respectively in 1990.

Adding to the upward pressure on land prices were increases in government loans for housing purposes. As we have seen, a key support for the Japanese system of finance is the Trust Fund Bureau of MOF which controls investment of funds in postal savings accounts and public pension plans. At different periods in Japan's postwar development, Trust Fund Bureau, through zaito, its Fiscal Investment and Loan Program, has been able to make strategic investments, in the form of long-term loans, to sectors of the economy that were deemed to be lacking sufficient capital. As can be seen in Table 7, loans for housing have always been an important part of zaito's budget. During the high-growth era of the 1950s and 1960s, however, large proportions of zaito loans were also devoted to support investments in transportation and communications infrastructure and in industry, with large-scale industry and technology projects more predominant in the 1950s and loans to SMEs in the 1960s. What was different about the 1970s and (even more so) the 1980s was the extent to which zaito loans went to housing. In addition during the 1970s and 1980s, zaito increased the proportion of its loans to SMEs, loans that typically had land as collateral, borrowing up to 80 percent of its market value. In seeking to provide much-needed support to expanding and upgrading Japan's housing stock and to facilitating the growth of new firms, these Trust Fund Bureau loans added to the inflationary pressure on land prices.

Table 7. Fiscal Loan and Investment Program (Zaito), Budget Allocation, 1955-1990

percent

1955 1965 1975 1985 1990

Housing 13.8 13.9 21.4 25.4 30.3

Environment 7.7 12.4 16.7 15.7 15.3

Social welfare 2.1 3.6 3.4 2.8 3.1

Education 4.5 3.1 2.9 3.6 2.0

Small and medium enterprises 8.1 12.6 15.6 18.0 15.7

Agriculture, forests, fishing 8.9 7.2 4.1 4.3 3.1

Natural disasters 7.7 3.1 1.2 2.3 1.2

Roads and highways 3.7 7.9 8.0 8.8 9.8

Transportation, communication 12.2 13.9 12.7 8.4 8.3

Regional development 8.5 7.0 3.3 2.4 2.5

Industries and technology 15.8 7.8 3.0 2.9 2.9

International trade 7.0 7.5 7.7 5.4 5.8

TOTAL 100.0 100.0 100.0 100.0 100.0

Source: Takatoshi Ito, The Japanese Economy, MIT Press, 1992, 164.

Accompanying the rise in land prices was a rise in stock prices, apparently with stock prices leading land prices. As price-earning ratios of listed stocks soared, it was tempting to look to the increase in the value of land as a justification. Fortunes that were made on the stock market could be turned to the purchase of land. On the supply side, the willingness of banks to lend during the 1980s was very much based on the notion that land and stock prices would remain high. Indeed, during the height of the bubble of the late 1980s, there was a tendency for banks to increase the proportion of loans backed by land that was valued at increasingly inflated prices. Furthermore, banks sold and bought back some of their cross-shareholdings to increase their capitalization, and thereby augmented the volume of loans that they could make under the equity capital requirements for banks engaged in domestic and international lending. The dramatic decline in stock prices and land prices since 1990 have wiped out a considerable proportion of the collateral on the loans that the banks and other financial institutions made in the 1980s.

The intergenerational dependence crisis

The banking crisis of the 1990s is an example of what happens when financial markets rather than business organizations drive the allocation of resources in the economy. For the financial system to aid the process of economic development, it needs to commit financial resources to enterprises that, through investments in organization and technology, can develop and utilize productive resources. In the post-World War II decades, this function was performed more by banks that mobilized Japanese household savings; from the late 1970s this function has been performed more by successful industrial enterprises that, protected by cross-shareholding, can mobilize their own internal revenues.

Besides the role of the financial system in the process of "value creation", it also has a role to play in the process of "value extraction". The process of economic development entails the allocation of not only financial resources to the development and utilization of productive capabilities but also financial returns to participants in the process. Key participants are employees, who receive their returns in the form of a stream of earnings. As part of a dynamic process of economic development, value extraction and value creation can reinforce each other. On the supply side, the expectation of a stream of earnings from participation in a successful enterprise can give employees the incentive to engage in those activities that create the earnings that they can extract. On the demand side, the success of large numbers of enterprises in a national economy in creating value provides the earnings to large numbers of employees that can absorb the products that these enterprises produce and hence generate the financial returns that the enterprise can reallocate. These returns can be further enhanced by generating products that, even with high earnings for national employees, can gain market shares in international competition.

But, even under a system of "lifetime employment", employees do not remain productive forever, particularly when, as in the case of Japan, the very success of their process of economic development has been a significant factor in permitting people to live longer. To support people in retirement, there is a need to balance on a sustainable basis the allocation of financial resources to support productive employment with the allocation of returns to support retirement. Such a balance is easier to achieve in the presence of investments in productive capabilities that make employees more productive over longer spans of their lives.

With the most rapidly aging population that the world has ever known, Japan faces a severe challenge in balancing the allocation of resources to productive employment with the allocation of returns to support retirement. The proportion of the Japanese population aged 65 or older increased from five percent in 1950 to 15 percent in 1995, a period during which the proportion U.S. population aged 65 and over rose from eight percent to just over 12 percent. In 1995 Japan's elderly population was still a smaller proportion of the total than in most Western European nations. But, with the elderly rate expected to rise to 20 percent by 2010 and 25 percent by 2020, Japan is expected to have the most aged society in the world within the next generation.

Driving this rapid aging of Japanese society is a combination of longer life expectancies and declining birth rates. In 1955, on the eve of the Japanese high-growth era, the average life expectancy at birth was 64 years for a Japanese man and 69 years for a Japanese woman. By 1987, these figures were 76 years for men and 81 years for women -- the highest average life expectancies in the world -- a distinction that Japan still maintains. Meanwhile, the birthrate has declined persistently, reaching a record low of 1.43 in 1995 (the 1995 birth rate for the United States was 2.05 and for Germany 1.28). The rate was so low that in 1995 fewer babies were born in Japan than in any year since records began to be kept in 1899.

These demographic trends have generated a crisis of intergenerational dependence. In 1990 17 percent of the Japanese population were in the 20-29 age group, while only 12 percent were in the 60-69 age group. The proportion of the younger group rose to 19 percent in the mid-1990s but will decline steadily into the early decades of the next century. Around 2005 the proportions will be about equal at between 15 and 16 percent, but then the proportion of the older group will become increasingly greater than the proportion of the younger group. In 30 years, it is expected that the proportion of those receiving government pension payments will increase to over 40 percent from the current 20 percent.

Despite Japanese savings rate that remain at 14 percent of GDP, these demographic shifts have already resulted in ballooning government deficits to support the social welfare needs of the elderly population. All Japanese are covered by national health insurance, with premiums based on income, and government subsidies for retired, elderly, and low-income people. The public pension scheme is a two-tiered system. Available to all Japanese residents, with 70 million participants in 1995, is a national pension plan, which provides the same benefits to and requires the same premiums from each insured person. The government also operates an employee pension plan, in which 33 million people participated in 1995, with premiums and payments depending on the income of the insured. In addition in 1995 12 million people were covered by corporate pension funds (42 trillion yen in assets), which can substitute for the state-run employee pension scheme, and which are generally managed by life insurers and trust banks. Another 11 million people contributed to tax-qualified pension funds (18 trillion yen in assets in 1995) that are managed in-house by companies, and which cannot substitute for the government's employee pension plan. One can begin to receive pension benefits at age 60, but in an effort to keep people working for more years and to reduce the cost to the government, the age at which one can receive full benefits is being extended to age 65.

According to the latest government estimates, by 2010 public pension benefits will be 15.5 percent of national income, up from 7.5 percent in 1986, and over the same period public medical insurance benefits will rise to between 9 and 15 percent of national income, up from 7.5 percent. Largely as a result of increased social welfare expenditures, for 1997 combined central and local government debt as a proportion of GDP was projected to be 96 percent in Japan, compared with 62 percent in the United States, 60 percent in both France and Germany, and 59 percent in the United Kingdom. Beginning on April 1, 1997, the Japanese government increased the consumption sales tax from three percent (which began to be levied in 1989) to five percent to try to stem the growth of its indebtedness. Meanwhile, moreover, the banking crisis will not go away; in early December the Japanese government was proposing a ten trillion yen bond issue to support the financial system. It is possible that the government debt would be even greater but for zaito spending on goods and

services that would otherwise have to come out of the government's general account budget.

The persistence of economic recession in the 1990s has not helped matters. Nor has the fact that as a long run trend, higher levels of female labor force participation means that women are no longer as able or willing to care for the sick and elderly as they were in the past. Between 1980 and 1990, as the number of people aged 65 and over increased by 3.8 million, the proportion of the elderly living with children or relatives declined from 72 percent to 63 percent. Proposals are now being floated for government funding of long-term nursing care for the elderly.

The highly regulated structure of interest rates and the low yields on Japanese corporate equities are making it difficult to generate the returns required to support the nation's aging population. At the same time, however, the high volume of savings per Japanese household helps to offset these low returns. Low interest rates also reduce the burden of the government deficits that are incurred to help support the aging population. Nevertheless, with interest rates and dividend yields low, expectations of returns on savings are not being met. Besides government deficits incurred to meet the obligations of the public pension system, corporate pension plans are under heavy pressure as well. A study done for seventy-one major companies, including Nippon Steel, Hitachi, and Toyota, calculated a 35 percent underfunding of pension assets in 20 years with a return on investment of 3.5 percent (the current average) and with 4200 enrollees paying pensions to 1000 retirees at current rates. The growing pension crisis is creating pressure to deregulate interest rates and unravel cross-shareholding for the sake of higher returns.

Proposals are also being floated to cut pension benefits and/or raise premiums. An alternative is to keep people working for more years of their lives and to make working people more productive. The Japanese pension problem would be further exacerbated if, as is the case in the United States and Germany, corporations and their employees opted for early retirement plans. Given a surplus of workers in their fifties in many Japanese companies, the recessionary conditions of the 1990s have made it particularly tempting for top management to offer early retirement packages to lifetime employees in their early fifties rather than keep them employed until the mandatory retirement age (currently 60 in most companies). Some companies have implemented such programs. For example, by offering a number of popular early-retirement packages, between 1993 and 1996, IBM Japan reduced its workforce from 25,500 employees in 1993 to 20,500 to 1996. But, with the departure of many middle managers and a resurgence of its business activity, by early 1997 IBM Japan faced a shortage of experienced personnel who could actually manage a business and could not be replaced by young college graduates. In February 1997, therefore, the company terminated the buyout plan for employees under age 55. Companies that are too aggressive about encouraging early retirement risk losing hard-to-replace human resources. Much more common among major Japanese companies, as we shall see, is a strategy of reallocating lifetime employees to subsidiaries so that they can remain employed and productive for more years of their lives.

Responses to the Financial Crisis

The retain and reallocate strategy

If the Japanese were to follow the American model for dealing with the problem of intergenerational dependence, they would disband the system of cross-shareholding and deregulate domestic interest rates to generate a cash flow out of corporations that would support higher returns to savings. Much to the benefit of the long-run development of the Japanese economy, however, the American model is not one that is being pursued in Japan. Nor does it appear that is it one that will be pursued in the near future.

Unlike the American institutional environment that favors market control over the allocation of corporate resources and returns, the Japanese institutional environment favors organizational control. The American model entails a corporate governance strategy of downsizing corporate labor forces and distributing corporate revenues, whereas Japanese are pursuing a corporate governance strategy of retaining corporate revenues and reallocating corporate labor forces. The institutional foundations for this retain and reallocate strategy are cross-shareholding and lifetime employment -- institutions that, as we have seen, are still very much intact in Japan.

Yet the financial pressures brought on by the banking crisis and the retirement crisis persist in Japan. How, given their institutional environment, are the Japanese responding to these pressures? What are the implications of these responses for understanding the politics of corporate governance in Japan?

The long-term financial problem facing the Japanese is the increase in intergenerational dependence. The question is whether in the late 1990s their solutions to this problem are consistent with solutions to the shorter run problem of restructuring the banking system. The government strategy for resolving the problem of intergenerational dependence entails keeping people employed for longer periods of their lives, while maintaining savings high and returns on domestic savings instruments low. The purpose of the government strategy is to keep people productive for more years of their lives so that, as much as possible, they can sustain their standards of living through productive employment. This national strategy is consistent with, and relies fundamentally on, the corporate strategy of retain and reallocate, which in turn depends on the influence of the institutions of lifetime employment and cross-shareholding on corporate governance.

The retain and reallocate strategy requires the mobilization in existing enterprises and new enterprises of committed finance for the development and utilization of productive resources. Retained earnings (protected by cross-shareholding) along with low-cost debt (through regulated lending) remain, as in the past, the prime means of mobilizing this committed finance, with the added advantage that, when warranted, major Japanese companies now have easy access to securities markets to raise additional long-term funds.

The retain and reallocate strategy starts from the fact that the Japanese already remain in the labor force much longer than in any other advanced nation. In the early 1990s, the labor force participation rate of men aged 60-64 was 75 percent in Japan, compared with 55 percent in the United States and 35 percent in Germany. This despite the fact that employed workers in Japan are eligible for pensions at the age of 60.

Although high by international standards, the current labor force participation rate of Japanese men aged 60-64 is actually a sharp decrease from the rate of 84 percent that prevailed in the 1960s. It appears that, as in other countries, Japanese workers have responded to increases in pension benefits by retiring earlier. The rate declined to 71 percent in the late 1980s, primarily because of an increase in real pension benefits -- in 1973 the government began indexing public pension benefits to inflation -- but also because of a decline of the self-employed proportion of the population, who have a higher labor force participation rate of older workers. In part because of the recession of the 1990s and in part because of a government policy to reduce pension benefits, from 1988 to 1993 the labor force participation rate of 60-64 year old men reversed direction, increasing from 71 percent to 75 percent in 1993.

Working to increase this labor force participation rate over the next decade will be a government policy, already in place, to raise the mandatory retirement age from 60 to 65. As early as 1984, in view of the rapid aging of the population, the Ministry of Welfare had proposed reducing future pension benefits and raising the minimum age of eligibility from 60 to 65. Benefits were reduced but, in the absence of policies that would ensure that those between the ages of 60 and 65 would be able to find employment, political opposition prevented raising the age of eligibility. The Ministry of Labor, therefore, proposed to the tripartite Employment Policy Council that employers should be required to keep employees on their payrolls until the age of 65 -- a policy that employers vigorously opposed.

In 1994, the Japanese government revised the public pension system by moderating benefit levels and by gradually extending the age at which people would be eligible to draw the full pension annuity from 60 to 65, effective in 2013. The reform also introduced a new partial pension for those between the ages of 60 and 64 that provides about half of the full pension for those who would like to retire before 65. For those eligible for pensions who still remain employed, the reform increased the amount of permitted earnings to ensure that total income (earnings plus pension benefit) would not decrease as earnings rise. Public pension policy is therefore working to keep people employed longer.

Meanwhile, through the government's administrative guidance supplemented by pressure from the unions, companies have been encouraged to keep people employed longer. As we have seen, by the early 1990s virtually all large companies and even the vast majority of small companies had increased the retirement age to 60, which in effect meant that, under the system of lifetime employment, companies undertook to keep their

workers employed to this age. Starting in fiscal 1998, under the Law Concerning the Stabilization of Employment of Older Persons, employers are being requested to extend the retirement age to 65 by the year 2013.

In the late 1990s, the age-structure of corporate employment combined with the continuing recession puts a strain on most companies that would seek to keep people employed even longer than is presently the case. The post-war baby boomers are now creating a big bulge of middle-aged employees in Japanese companies. But the demographics are changing, with the size of the population in their twenties peaking at 19.2 million in 1996, with a predicted drop to 12.5 million in 2015. Meanwhile, the number of people in their sixties will increase by about four million. Between 2000 and 2010, the proportion of the labor force aged 15-29 is expected to decline from 23 percent to 18 percent, while the proportion over the age of 55 years is expected to increase from 23 percent to 27 percent. Other things equal, employers will find it necessary to employ an aging labor force over the next two decades.

But, in an employment system that is influenced by corporate strategy, technological change, and international competition, other things are never equal. To remain competitive, Japanese companies that employ an aging labor force have to concern themselves with the productive contributions of older workers, relative to both their pay and the productive contributions that could be made by younger workers. In the Japanese case, the high level of education and the good health of the labor force in general combines with the prevalence of in-house organizational learning to enhance the productivity of older, more experienced workers. The system of lifetime employment creates incentives for companies to invest, and reinvest, in the capabilities of these workers and make full use of their experience.

Nevertheless, the intense effort and commitment that organizational learning demands of workers, particularly in the presence of rapid technological change, place limits on the incentive and ability of older workers with given education and experience to attain higher levels of productivity. To enable companies to fulfill the commitment of keeping workers employed even longer than is currently the case, the employment system must be flexible enough to permit the reallocation of labor resources and returns to labor in response to changes in the productive and competitive environments.

Within the framework of lifetime employment, Japanese companies already had such a flexible employment system in place coming into the 1990s. During the 1990s that flexibility has been increasing in a number of dimensions. The first source of flexibility of the employment system is the ability to maintain employment of existing workers by reducing the number of new hires. The Japanese employment system is noted for the practice, especially among the major companies, of recruiting new employees directly from the educational system (high school in the case of blue-collar workers, university in the case of white collar workers). In the past, when a company was growing rapidly and had not yet accumulated a large supply of experienced workers whom it had to support, it could hire large numbers of new university graduates and then, after a decade or so, decide which of the cohort were best suited for employment tracks that provided more responsibility, authority, and pay.

What is new in the 1990s is that employers have to be more selective about new hires. Hence there is a heightened competition for university graduates with specific capabilities. All Japanese companies used to adhere to the principle of hiring new employees at the same time every year to begin work on April 1. This hiring institution (which to be sure some companies violated in practice) was meant to reduce competition among companies for employees and ensure that the new employees would enter the company and continue their careers in it as a cohort. Now it is becoming acceptable for companies to hire out of season. According to a 1996 survey by Keidanren of 501 Japanese companies, 13 percent said that they already hire at various times during the year and another 32 percent that they had such hiring practices under consideration.

In addition, Japanese companies have traditionally filled all openings for lifetime employment positions with men who were newly graduated from high school or university. These employees would then be trained internally to develop specialized skills. Now, however, many Japanese companies are hiring people who have already developed specialized skills, either through work experience or university training. The Keidanren survey of 501 companies found that 27 percent were already recruiting people for specific jobs, another 12 percent for specific research jobs only, and 22 percent had such recruiting practices under consideration. For

example, in the summer of 1996, Fuji Xerox started recruiting new graduates who already had significant training in accounting, corporate planning, legal affairs and intellectual-property management to fill specialized jobs in these areas. According to the manager of the company's employment-development center, "many students [with such training] didn't consider coming to our company because they had to be salesmen for the first few years." The more specialized recruits can now avoid such unwanted work. At the same time, an increasing proportion of young workers who go to work for corporations are engaging in job-hopping, although the ultimate objective of such labor mobility is still to find the particular company that can offer an attractive lifetime career.

The second source of flexibility is in rewards. Traditionally, lifetime employees have been recruited to companies from high schools or colleges, and then over the course of their careers saw their earnings increase primarily on the basis of seniority pay (with supplements for larger numbers of dependents). The main forms of competition among employees were over the pace and type of promotion, although even then seniority bulked large as a criterion for eligibility for promotion over the first two decades of company service. During the 1990s individual performance has begun to count much more in determining promotion and pay. A 1995 survey of 210 companies based in Tokyo found that 24 percent had introduced merit pay systems and another 28 percent planned to do so in the next three years. In 1993 and 1994, Fujitsu, one of the leading computer companies, became a pioneer in instituting merit-pay systems for its managers and team leaders. In 1996 Toyota Motor Corporation stopped promoting its managers based on seniority and increased to over 65 percent the proportion of management pay linked to performance. No longer will employees need a university degree and 20 years at Toyota to be eligible for promotion from the lowest managerial rank of section chief to the next rank of deputy manager. In other cases, companies have transformed managerial employees from "line" to "staff" personnel. For example, NEC, another leading computer company, stripped 1300 of its 6000 managers of their supervisory functions and now employs them as in-house specialists working without subordinates.

The third, and perhaps most important, source of flexibility is the reallocation of labor resources to positions in subsidiary companies that offer lower pay and/or responsibility. As employees reach their late forties and early fifties, major companies, in consultation with their enterprise unions, maintain the right to reallocate employees to subsidiary enterprises where pay is generally substantially lower. Provided they can absorb these employees, the benefit for the subsidiary is that it gets experienced personnel without having to invest in their skill development. In some companies, the core company assigns employees to the subsidiaries, whereas in other companies the subsidiaries recruit employees from the core company. At the same time, a small proportion of managerial employees who are considered to be especially valuable to the company, are given the opportunity to continue to work for the company in positions of executive responsibility and at relatively high pay even after the official retirement age.

One type of labor reallocation is *shukko* -- the "temporary" placement of a core company employee with a subsidiary, with the core company often supplementing the pay of the transferred worker. In theory, under *shukko*, the worker could be transferred back to the core company but in practice the transfer often becomes permanent with the subsidiary taking over responsibility for the employee. A second type of labor reallocation is *tenseki* -- the permanent transfer of an employee to another company. Most *shukko* and *tenseki* transfers are from larger to smaller companies. Of all companies with 1000 or more employees, about 87 percent engage in *shukko* and *tenseki*, and these transfers apply particularly to employees in their fifties. Many if not most employees who are loaned to another company find that their new employment eventually becomes permanent; that is, while employed at the new company, they find their status transformed from *shukko* to *tenseki*.

Traditionally, both *shukko* and *tenseki* transfers were from a core company to a related company within the enterprise group, but increasingly in the 1990s, as subsidiaries have found it difficult to absorb the number of experienced personnel that the core companies want to reallocate, the core companies have been finding unrelated enterprises to which they can make *tenseki* transfers. In other words, the commitment to lifetime employment on the part of the core company is maintained, but the web of companies at which an employee might end his career has become wider. Along with the wider web for maintaining lifetime employment, the late-career pay of the transferred workers is more likely to be lower and his working conditions less attractive.

It is from this perspective of the reallocation of labor resources that the Japanese phenomenon of enterprise

"spin-off" has become of increased importance in the 1990s. Hiroyuki Odagiri characterizes what he calls "hive-off" as "an organizational device intended to foster flexibility and reduce costs in labour management, and to offer posts to middle-aged workers, mostly of a white collar nature." As he describes the process of separating the new-born company from its parent:

There are several steps in hive-off. In the first step, the change may be merely legal and superficial, that is, from a section within a big company to a legally separate company with the entire share held by the parent company and nearly all the staff maintained as before. As the subsidiary expands, it starts hiring its own employees and often seeks to enlarge its financial basis by inviting other parties (often companies or the public) to invest in its shares. In some cases, this process continues up to the point at which the staff transferred from the parent company are in a minority or non-existent, the parent's share of ownership becomes less than half, and the management is chosen by internal promotion from among its own people. There are even cases where the subsidiary becomes totally independent of the parent firm due to the latter's restructuring policy, and other cases of the subsidiary expanding rapidly to dominate the former parent. Major companies take people and money and spin off new businesses rather than keeping this labor and finance under the control of a legally distinct business enterprise. Spin-offs can be suppliers or distributors in a vertical keiretsu or manufacturers of a new line of products as part of a horizontal keiretsu or kigyo shudan. Spin-off cuts down on layers of management and decentralizes authority and responsibility far more effectively than the much vaunted multidivisional enterprise, in which responsibility may be decentralized while authority remains centralized. In horizontal keiretsu, by creating new units of strategic decision making that are focused on particular products, spin-off facilitates the integration of enterprise strategy and organizational learning. Spin-off increases the number of managerial positions that entail authority and responsibility, without increasing the layers of management, and hence is of great importance to the functioning of shukko.

Spin-off, therefore, reflects a system of corporate governance that permits a company to allocate both money and people to the creation of a new business enterprise, which then itself has considerable autonomy in the allocation of resources and returns. During the 1970s and 1980s, spin-off was used increasingly as an organizational strategy. During the 1990s, it has become a particularly effective means for a company to reallocate labor resources in ways that create new opportunities for its employees and potential sources of new employment in the economy more generally.

Although not all spin-offs entail the development of new technology, spin-off often functions as the Japanese form of venture capital. In May 1997, Takahide Sakurai, co-chairman of the Committee on Economic Policy of Keidanren (Japan Federation of Economic Organizations), explicitly proposed such new ventures as one way of meeting the challenges to the Japanese employment system in the 1990s:

[Japanese executives] will probably also learn that organizing specialists in groups can produce good results, in which case they will be revamping their organizational structure by spinning off more ventures. . . . It is now especially important that companies look beyond their existing fields of business to the possibilities for in-house ventures in new fields. We at Keidanren are asking each of our corporate members to launch at least one such venture. And the number of firms responding to this call is on the increase.

In making this proposal, Keidanren, the most powerful organization of business interests in Japan, is promoting, on a national basis, a business strategy that has long been practiced by the major industrial enterprises. The leader in this campaign is Toyota Motor Corporation, whose president, Shoichiro Toyoda, is chairman of Keidanren. In the summer of 1996, Toyota Motor Corporation set up a 50 billion yen venture capital fund to provide financial assistance to ventures within its group. In June 1997 it expanded the program to include ventures outside the Toyota group, generally taking equity stakes of 50 percent or more in each company. In so doing Toyota Motor Corporation became the biggest single source of venture capital in Japan; the next largest fund has 20 billion yen. As of June 1997 the Toyota fund had financed eight ventures, and, with applications from about 300 companies, Toyota planned to invest in about ten companies per year in industries such as semiconductors, information and communications, biotechnology, environmental technologies, and services for senior citizens.

Such efforts by Japanese corporations to allocate resources to new sources of domestic employment have become all the more important as during the 1990s Japanese companies have increasingly shifted many of their

operations to lower cost locations in Asia. In 1989 about 43 percent of foreign direct investment by Japanese enterprises was to Asia; by 1994 about 83 percent, with more than 60 percent going to China. Most of this foreign direct investment is in manufacturing, and much of it has been undertaken not only by large companies seeking to rationalize their global operations, but also by SMEs (often in joint ventures with local companies) struggling to cope with high costs in Japan that have been exacerbated by the strength of the yen. There has been considerable outsourcing of materials and components that have then been reimported into Japan, and hence have directly replaced jobs in Japan in a period that has seen a major decline of manufacturing employment. In general SMEs have been moving the production of mass-produced components abroad while maintaining precision and non-standard manufacturing in Japan. In 1995 imports of color televisions surpassed domestic production for the first time, while foreign production accounted for 60 percent of all microwave ovens and almost half of all VCRs manufactured by Japanese companies. More generally, between 1988 and 1994, the import penetration ratio for capital goods rose from 3.6 percent to 7.8 percent, for consumer durables from 4.7 percent to 10.2 percent, and for non-consumer durables from 4.9 percent to 10.6 percent.

The acceleration in the pace of foreign direct investment and the rise in import penetration in the 1990s has raised fears of a "hollowing out" of employment in Japan. Although in 1995, Japanese companies produced only seven percent of their goods abroad, compared with 26 percent for U.S. companies and 15 percent for German companies, the threat is that the Japanese mastery of the management of mass production may be making it easier for Japanese companies to respond to high costs at home by relocating overseas. Besides directly replacing the jobs of Japanese workers, the importance of SMEs in outsourcing to Asia has compounded the problems facing large Japanese companies in their efforts to reallocate senior employees to subsidiaries in Japan.

Yet within Japan the consensus seems to be that the fears of "hollowing out" are overdrawn. Much depends on the incentive and ability of Japanese companies to make new innovative investments in higher value-added products and processes that require complex organizational learning. A 1994 survey by the Export-Import Bank of Japan found that well over 90 percent of Japanese companies that had transferred production facilities overseas either had retained their key technologies or were developing more advanced technologies in Japan. Many opportunities exist for developing these technologies in small technologically oriented companies that are networked horizontally and vertically with other innovative enterprises in their industries.

In contrast to the decline in demand for bank loans by those Japanese industrial enterprises that, through the success of their innovative enterprises, grew large in the postwar decades, SMEs still rely heavily on bank finance. Thus the growth of SMEs provides opportunities for bank finance on the model that proved so successful in the past. In addition, the growth of SMEs is also being supported by the large number of powerful industrial enterprises that now exist in the Japanese economy. Indeed, as we have seen, the support of SMEs has become all the more important for these large companies, not only to develop the capabilities of their suppliers and distributors, but more generally to enable them to reallocate older workers to subsidiaries while investing in the capabilities of younger workers in the core company, and thereby maintain their commitment to lifetime employment.

There is abundant evidence that, in the late 1990s, Japan is well-positioned in terms of its accumulation of technological capabilities and investments in new technologies to regenerate its industrial base. In manufacturing the Japanese retain distinct competitive advantages in the integration of precision engineering, advanced materials, and electronics. Prime sectors for industrial innovation are in the provision of telecommunications services, transportation services, and energy -- inputs to Japanese industry and key components of the Japanese cost of living that remain high cost in comparison with other advanced economies. Another key sector, as we shall discuss, is financial asset management, where the challenge is to transform specialized banks into diversified financial service providers without undermining the Japanese system that provides financial commitment to economic development.

The success of Japanese manufacturers in factory automation combined with the movement abroad of manufacturing processes that employed Japanese blue-collar workers means that, to take advantage of the new technological opportunities, a larger proportion of the Japanese labor force will need higher levels of education and specialized training. After remaining stable since the late 1970s, the ratio of males in the college-age cohort

attaining a college education began to increase in the mid-1990s. The changing hiring patterns of Japanese companies along with the increasing use of incentive pay reflects the needs of these companies to attract and retain more highly specialized personnel than was the case in the past. Under these changing technological and employment conditions, the institutions of lifetime employment and cross-shareholding are becoming all the more important as social foundations for the integration of the capabilities of highly educated and specialized producers into cumulative and collective learning processes.

The politics of corporate governance

What groups in the Japanese economy have an interest in the corporate strategy of retain and reallocate? The Japanese labor movement, for one, has a strong interest in this strategy. Such an interest on the part of labor cannot, however, be taken for granted. In the United States, the downsize and distribute strategy during the 1980s and 1990s has proceeded largely with the acquiescence of organized labor. In excluding labor from any influence over the allocation of corporate resources, the institutions of corporate governance in the United States have left organized labor with virtually no power to oppose corporate downsizing. As for the allocation of corporate returns, the wages of unionized workers in large industrial companies in the United States are high relative to others in the economy with the same level of education. But even for these workers, as well as for retired or downsized blue-collar workers who had long employment tenures with these companies, much of the corporate returns that are accruing to them are coming from their corporate pensions, which have increasingly in the 1990s been invested in corporate stocks. Hence, senior unionized workers who have been victims of the "downsizing" strategy have nonetheless benefited from the "distribution" strategy, thus helping to account for the quiescence of the U.S. labor movement -- which first and foremost represents these senior workers -- to the corporate strategy as a whole.

In Japan, in contrast, the organized labor movement has an influence over the allocation of corporate resources as well as the allocation of corporate returns, and is using that influence to reinforce government initiatives to keep the labor force productively employed. Within the framework of lifetime employment, enterprise unions are striving to unite interests of older and younger workers by supporting corporate strategies that keep older workers employed and productive for more of their lifetimes and that reinvest in organizational learning that create new opportunities for younger workers.

The task is made easier, however, for the Japanese unions as well as Japanese employers by the general exclusion of women from the commitment to lifetime employment and by the demographics of the Japanese labor force, that reflect not only changes in birth rates and death rates but also the general exclusion of immigrants from access to good jobs in Japan. Rather than have labor migrate to capital, corporate capital is migrating to labor. Through foreign direct investment, residents of foreign nations are now gaining relatively good jobs in Japanese companies. It is important to recognize that the intergenerational unity of interests of labor within Japan is one that exists alongside the exclusion of groups who have been, over the last few decades, vying for inclusion in the United States. At the same time, it is also important to recognize that in the United States, under the regime of downsize and distribute, it has largely been women and minorities who have been excluded from stable and remunerative jobs. Social exclusion exists under both systems, but it works in different ways.

In Japan, the retain and reallocate strategy means that the returns to employees come more from productive employment than from high yields on financial assets. During the 1990s, the savings rate in Japan has remained high at about 13 percent (compared with four or five percent in the United States), and the average amount of savings per household in Japan in 1996 were 13 million yen. As a proportion of national income, insurance policies in force in Japan were in 1994 almost two and a half times those in the United States. In generating incomes for households, the high volumes of savings per households are offset by the low yields on savings instruments available within Japan's regulated financial structure.

Bank and postal savings deposits absorb fifty-five percent of these savings, with life insurers holding 20 percent, private pensions five percent, and money trusts four percent. Another 12 percent of savings are in securities. Japanese life insurers, which manage a large portion of private pension funds, have a legal obligation to pay benefits out of interest income, and have invested primarily in Japanese government bonds. During the 1980s, in search of higher yields, the life insurers invested heavily in U.S. treasury bills, but sustained huge

losses in the last half of the 1980s with the appreciation of the yen relative to the dollar of about 60 percent. In the last half of the 1980s the insurance companies also shifted their assets from domestic loans and bonds to equities, and then sustained huge losses in the early 1990s when the stock market crashed.

In the 1990s, with the cost of their obligations around five percent but with dividend yields on stock well under one percent, the insurers have stayed away from new stock purchases. They have shifted much of their assets into subordinated bank debt and loans to consumer credit companies, but have not been able to come close to the five percent rate of return they require. In early 1996, the life insurers reduced their guaranteed returns to pension funds from 4.5 percent to 2.5 percent, leading some major pension funds to turn from life insurance companies to trust banks and investment advisory companies to manage their portfolios. In the spring of 1997, Nissan Mutual Life Insurance Company, the sixteenth largest life insurer, went bankrupt, resulting in more withdrawals of funds from the insurance companies.

Given low and regulated interest rates and the low yields on corporate stock, any higher rates to Japanese pensions will have to come from investments on international capital markets. Such investments, even in safe foreign securities, are fraught with exchange rate risks, as the Japanese life insurers found out in the late 1980s. A prime motivation of the "Financial Big Bang", announced by Prime Minister Hashimoto after his re-election in November 1996 is to better position the Japanese financial sector to manage such risks as they pursue higher yields on the savings under their control.

Japan now suffers not so much from a crisis of the Japanese financial system as a crisis in the ways in which the financial enterprises that have been central to that system -- particularly the long-term credit banks, trust banks, securities companies, life insurance companies, and some of the weaker city and regional banks -- allocate the financial resources under their control and generate financial returns. In the 1990s these financial enterprises have found themselves on the short end of speculative investments, made within a highly segmented financial system, that cannot generate returns. The "Financial Big Bang" entails a deregulation of the segmentation of financial services in Japan to create new business opportunities, both at home and abroad, for those banks, securities companies, and insurers that are best able and willing to rise to the challenge. Such a strategy requires financial enterprises that have a sound financial base at home and that can develop the capabilities to operate simultaneously and quickly on international securities markets and money markets. These augmented capabilities could open up new sources of profits for these financial enterprises, thus enabling them to employ more people in Japan and to bring in higher returns on household savings.

But, despite the image of radical change that the reform's slogan is meant to impart, Japan's "Financial Big Bang" does not entail a deregulation of domestic interest rates nor a dismantling of cross-shareholding (see Table 8). From the government's perspective, the success of this strategy of financial reorganization will depend on the ability of Japanese financial enterprises to learn how to make profits in the international world of financial liquidity, while being denied the opportunity to extract higher financial returns from productive enterprises at home. Such a transformation, if successful could enable now fragile financial enterprises to survive while tapping into high returns on financial assets abroad that would augment the returns on savings at home. Thus the returns on domestic savings could be increased without undermining financial commitment to productive enterprises in Japan. In transforming their capabilities to provide financial services, Japanese financial enterprises already face formidable competition within Japan from foreign companies. the largest of whom have been operating in Japan since at least the mid-1980s.

Table 8. Deregulation Timetable for Japan's "Financial Big Bang"

FISCAL 1997

Securities houses will be allowed to handle consumer payments for their clients.

FISCAL 1998

Companies and individuals can handle foreign exchange transactions without government authorization. Banks will be allowed to sell their own investment trust over the counter. Ban on financial holding companies will be lifted. Firms can become securities brokerages without government licenses. Securities houses will be allowed

to expand asset management services.

FISCAL 1999

Securities houses will be free to set their commissions on securities trading of any size. Market-value method will be applied to marketable securities. Barriers that restricted banks, trust banks and securities houses from entering each other's markets will be removed. Banks will be allowed to issue straight bonds.

BY THE END OF 2001

Banks and securities houses will be allowed to enter insurance sector.

SCHEDULE NOT SET

Enactment of a new financial services law that would govern banking, securities, and insurance sectors.

Source: Masato Ishizawa, "'Big Bang' program taking clearer shape," Nikkei Weekly, June 16, 1997.

Neither the deregulation of domestic interest rates nor the unraveling of cross-shareholding is part of the "Financial Big Bang" agenda. Indeed, despite its failure to control the bubble economy of the late 1980s and to contain the accumulation of bad loans in the 1990s, the power of MOF and BOJ to coordinate and regulate the Japanese financial system in favor of productive investment has increased during the 1990s. The need to ensure financial conditions that can help transform non-performing loans into performing loans has provided a rationale for maintaining the structure of low and regulated interest rates. As for financial leverage, MOF's Trust Fund Bureau directly controls at least half of financial transactions in Japan. With the return on postal savings accounts still somewhat more favorable than the return on commercial bank accounts, and with the banking system in fragile condition, an increasing proportion of Japanese household savings have been deposited with the post office.

Some, however, see the current financial reforms in the organization of the banking sector as a prelude to a dismantling of cross-shareholding that will eventually give financial interests their higher returns. In May 1997, for example, Akiro Kanno, Vice Chairman and Senior Executive Director, Zenginko (Federation of Bankers Associations of Japan) remarked to an audience of American, European and Japanese business executives and government officials:

Japan is trying to carry out financial deregulation in a very Japanese way: protecting vested interests and preserving the old divisions of work. A new system is necessary, one that can account for and tax new financial products. Investor protection needs to be implemented and monitoring and supervision must be brought to a level of global acceptability if Japan is to take its place alongside London and New York as a world financial market. A slowdown of the reform efforts would be the worst possible thing. Because of the current savings peak -- attributed to the ageing population -- the Tokyo market must be reformed now; this is quite possibly the last chance. Reform efforts are underway in the banking industry, one that for so long has been like a fortress to foreigners because of the cross-shareholding of shares (accounting for up to 70% of total shares at its peak). Banks are now beginning to sell off their cross-held shares to make better use of their funds. Relationships are changing in the industry. Observers should expect more M&A activity involving foreign companies. The financial change will be the key reform.

Others contend that, with the deregulation of the financial services sector, Japanese households will gain access to alternatives forms of savings that will lead to withdrawals from the postal savings system. For example, Jesper Koll, head of research at JP Morgan Securities Asia, has argued: "By the year 2010, the postal savings system will be privatized, either by law or simply circumstance." How far the "Financial Big Bank" can proceed without creating powerful financial interests that have not only the incentive but also the ability to extract higher yields from the Japanese economy itself remains to be seen. What can be said is that the current agenda for financial reform is being driven by a retain and reallocate perspective on the relation between corporate performance and financial returns. Such a strategy is inconsistent with the ideology of financial deregulation and shareholder "value-creation" that has driven the downsize and distribute strategy in the United

States. It is dangerous, therefore, to analyze the possible outcomes of the transformation of the Japanese financial sector from an American perspective on the allocation of resources and returns.

In terms of its policies on retirement and interest-rate regulation, the Japanese government has thus far manifested its commitment to the retain and reallocate strategy. But some cracks in the unity of the government position have already appeared, not just from the rise of new political parties that espouse more far-reaching financial reform, but also within the ruling LDP itself. Over the past year, Junichiro Koizumi, the Minister of Health and Welfare -- that is, the ministry responsible for dealing with the financial requirements of an aging society -- has been in the forefront of a movement to privatize the postal savings system, and has, reportedly, threatened to resign if Prime Minister Hashimoto does not support him on this issue. In February 1997, Koizumi advocated privatization of the postal businesses at a Diet Budget Committee meeting. Then at a Diet plenary session he stated: "If the New Frontier Party (Shinshintō) [the largest opposition party] submits bills for privatization of postal businesses, I will vote for them."

The postal savings system, of course, provides the bulk of financial resources of *zaito*, which is in turn the source of MOF financial, and political, leverage over the economy. As a "shadow budget, *zaito* has often, quite rightly, been accused of permitting government spending plans to proceed outside the government's general account. As Koizumi argued: "Japan is being drawn into global competition. I doubt whether one can truly carry out meaningful reform if we leave intact a national bank that operates outside the market economy." Koizumi added in an interview: "I don't think I am odd. The politics here are what is odd."

Finally, will corporate executives, in their decisions concerning the allocation of corporate resources and returns, continue to pursue the retain and reallocate strategy. Japanese corporate executives have not heretofore had the same opportunities as their American counterparts to use the stock market to cash in on their positions of corporate power. In May 1997, however, the Diet voted to change the Commercial Code so that corporations can issue stock options to their employees. The legislation is seen as an effort to help revitalize the flagging stock market. When stock options were banned under the Commercial Code, some companies had issued warrant bonds and then bought back the warrants to give to top executives. With stock options now legal, a survey of 200 major listed companies found that 70 percent were eager to begin a stock-option system, and by the beginning of June Toyota, Orix, Nichimen, and Tokyo Electron had announced plans. In Toyota's case, it is planning to give stock options to all of its 56 board members. According to the Nikkei Weekly report, however, a Toyota director "sought to allay worries that company leaders would take drastic action, like announcing layoffs, to raise stock prices. The introduction of stock options, he said, will not hurt the good parts of Japanese-style management."

The Ministry of International Trade and Industry has also seen stock options as a way of encouraging new ventures. As we have seen, in line with the retain and reallocate strategy, an important Keidanren initiative is to encourage the top executives of major corporations to allocate both money and people to the spin-off of business enterprises and the support of new ventures. Adherence to the retain and reallocate strategy is also evident in a recent statement by Takahide Sakurai, president of Dai-ichi Mutual Life Insurance Co., Japan's second largest life insurer, and co-chairman of Keidanren's Committee on Economic Policy:

The task of a progressing collapse in Japan's system of long-term employment appears to be premature. . . . While it is certainly no easy matter to find a set of employment arrangements that can enhance the satisfaction of workers even as it pleases employers by lifting productivity, Japan's companies need to do just that. Should they abandon their efforts to construct such a system, surplus workers will find themselves being swept into the labor market, and the unemployment rate will move higher yet. This is because Japan's labor market for people in midcareer remains underdeveloped, since companies prefer recruits fresh out of school. Over the longer term, the graying of the Japanese population will swell the ranks of middle-aged and older workers. Companies must therefore continue to seek better employment systems without allowing short-term business trends to distract them.

Other Keidanren representatives appear less committed to a strategy of retain and reallocate that has a more flexible version of lifetime employment as its foundation. In May 1997, Masaya Miyoshi, president and director general of Keidanren was reported to have remarked at a high profile conference in Tokyo:

Nikkeiren [Japan Federation of Employers Associations], Keidanren's sister organisation, produced a report a few years ago that is still valid. It sees a Japanese employment market where executives and executive candidates will keep lifetime employment, but a second group of specialists will become increasingly mobile, constantly moving around in order to find the best opportunities. A third group, which is already forming, will be temporary staff. Government action such as portable pensions and pay scale will promote labour mobility. There is also less and less bias towards moving to a foreign company.

Miyoshi's reference is to a 1995 Nikkeiren report, Japanese Management in a New Era -- Direction and Concrete Policies, in which, among other things, a survey of its 2000 member companies, revealed that 20 percent had already introduced a performance-oriented wage system. The Nikkeiren report proposed that in the future corporate employees be classified into 1) career-track workers (managers, managerial candidates, and core production workers) to whom the institution of lifetime employment would continue to apply, 2) well-trained and well-educated specialists employed on a short-term contracts and paid according to results, with no retirement pay, and 3) general workers, employed as hourly part-time workers doing simple tasks with no retirement pay. Nikkeiren would like to see the size of the first group diminish and the second group expand. But to date the employment of well-educated and well-trained people without lifetime employment is negligible, largely because corporate investments in the development of the requisite capabilities of these people still relies on a system of lifetime employment.

Besides Keidanren and Nikkeiren, the other important organization that brings together Japanese corporate executives on issues of national social and economic policy is Keizai Doyukai (Japan Association of Corporate Executives). Its 1600 members include the top executives of 900 large Japanese corporations who, according to the organization's brochure,

[share] the common belief that corporate managers should be key players in a broad range of political, economic, and social issues. Within Keizai Doyukai, each member sheds their corporate identity and participates as an individual, free to express opinions and ideas distinct from any specific company or industry.

At Keizai Doyukai's fiftieth anniversary general assembly in April 1996, its chairman, Jiro Ushio (also CEO of Ushio Inc.), suggested that the organization review cross-shareholding and intragroup keiretsu arrangements with a view toward moving toward global standards and creating an entrepreneurial spirit. He has emphasized the "reform of the financial system and the dismantling of the convoy fleet system" and "active corporate management of firms with an emphasis on ROE." At the Economist's Fourth Roundtable with the Government of Japan, Yuzaburo Mogi, Vice Chairman of Keizai Doyukai (and president of Kikkoman Corporation), took up the free-market theme more explicitly. As he put it:

The attitudes of Keizai Doyukai include much overlap with those of Keidanren. A Keizai Doyukai document entitled "Declaration in support of market principles" encompasses the ideals of free and liberal markets and a globalism that results in an enhanced Japan as a venue for business activities. The current situation of a debt that is 90% of GDP and a rapidly ageing society is a crisis for Japan. Japan is second in the world in terms of GDP but only captures 0.4% of the world's inward FDI. There is a huge imbalance in outward versus inward direct investment. In most places, this ratio is 2:1; in Japan it is 15:1. Reasons for this include high prices, the high cost of personnel, excessive government and private regulations that make it difficult to do business, and customs and practices that are difficult for foreigners to understand and adopt. However, Japan has a high growth potential despite the bubble. There is a good unemployment level, high quality labour and a huge savings base. How can the situation be fixed? First the Japanese market must work more like a market. The system that worked during the post-war expansion and the bubble economy is no longer proper for the period of stable growth in a new information-oriented environment. Today the government market represents 10% of GDP and another 40% is comprised of heavily regulated markets -- accounting for half of the economy. In order to meet future challenges, the financial institutions must change; corporate management must change; more responsibility should go to shareholders instead of employees and clients; international accounting standards must be adopted with more disclosure and better investor relations; and new business ventures must be created. Japan has a start-up rate of 4.6% versus 15.8% in the USA. A favourable environment must be created for this to change.

In this version of the changing objectives of the corporation, the notion of creating shareholder value, so

popular in the 1980s and 1990s with American corporate executives, is creating shareholder "esteem". In responding to a question on the difference between a Japanese kaisha and a Western-style company, Mogi reportedly said that

there are parts of the Japanese system -- lifetime employment, seniority systems and company relationships -- that are good and must be protected. One example is the superb training that it allows. But, the government recognises that this system no longer works in a Japan that has "caught-up" already. The market must now be the mechanism to allocate resources and shareholder esteem becomes essential, [thus] enabling the development of a new Japanese system that takes the best from the Japanese employment system making it work towards a desirable ROE."

The commitment to lifetime employment and cross-shareholding among Japan's top corporate executives is, therefore, by no means complete or wholehearted. Within the Japanese system, it is these top managers upon whom the blame is heaped when their companies cannot sustain the employment of their regular labor forces. What has been going on in Japan in the 1990s, however, is not an unraveling of lifetime employment but a movement toward greater flexibility in the allocation of the labor resources of lifetime employees and the returns that they receive. More flexible hiring, remuneration, and reallocation of personnel across companies are all important elements of the current attempts to keep the Japanese labor forces employed productively for longer periods of their lives.

Be it in Japan or elsewhere, it is organizations, not markets, that, by developing and utilizing productive resources, generate the sustained competitive advantage of enterprises and the sustainable prosperity of nations. The challenge facing Japanese companies is to ensure that the move to a more flexible allocation of labor resources and returns results in the higher quality, lower cost products that can sustain the prosperity of the Japanese economy. Corporate responsibility for the development and utilization of human resources will remain essential to meeting the challenge. Rhetoric about the benefits of "free markets" for the allocation of resources and returns is no substitute for the careful analysis of how institutions, organizations, and markets interact to generate economic development.

ENDNOTES 1.Japan Securities Research Institute, Securities Market in Japan, 1996, JSRI, 1996, 62. 2.Ibid.; Tokyo Stock Exchange, Fact Book 1996, TSE, 1996, 71-72. 3.Nikkei Weekly, Japan Economic Almanac, 1997, Nihon Keizei Shimbun, 1997, 16-17 4.Kiho Yokoyama, "Sharp GDP shrinkage deepens worry," Nikkei Weekly, September 15, 1997. 5.Nikkei Weekly, Japan Economic Almanac, 1997, 56-57. 6.Bureau of the Census, United States Department of Commerce, Historical Statistics of the United States from the Colonial Time to the Present, U.S. Government Printing Office, 1976, 135; Bureau of the Census, U.S. Department of Commerce, Statistical Abstract of the United States, 1997, (117th edition), U.S. Government Printing Office, 1997, 397. 7.For the United States, see William Lazonick and Mary O'Sullivan, "Corporate Governance and Corporate Employment: Is Prosperity Sustainable in the United States?" Jerome Levy Economics Institute Working Paper No. 183, January 1997, an abridged version of which appears as a Jerome Levy Economics Institute Policy Brief No. 37, January 1998. See also William Lazonick, "Organizational Learning and International Competition: The Skill Base Hypothesis," Jerome Levy Economics Institute Working Paper No. 201, August 1997. 8.These different corporate strategies are influenced by corporate governance institutions that reflect different degrees of "market control" and "organizational control". Market control encourages a corporate strategy of "downsize and distribute"; organizational control a corporate strategy of "retain and reallocate." For the distinction between these types of control and their application to industrial finance in comparative-historical perspective, see William Lazonick and Mary O'Sullivan, "Finance and Industrial Development. Part I: the United States and the United Kingdom," Financial History Review, 4, 1, 1997; and "Finance and Industrial Development. Part II: Japan and Germany," Financial History Review, 4, 2, 1997. 9.See Mary O'Sullivan, Innovation, Industrial Development, and Corporate Governance, Ph.D. dissertation, Harvard University, 1996; Mary O'Sullivan, "The Innovative Enterprise and Corporate Governance," INSEAD, photocopy, 1997. 10.See, for example, Lazonick and O'Sullivan, "Finance and Industrial Development. Part I"; and Lazonick and O'Sullivan, "Finance and Industrial Development. Part II." 11.Lazonick and O'Sullivan, "Corporate Governance and Corporate Employment"; Mary O'Sullivan, Contests for Corporate Control: Corporate Governance in the United States and Germany, Oxford University Press, forthcoming. 12.For the case of Germany, see Mary O'Sullivan, "Organizational Control in the Federal Republic of Germany," Report to the Jerome Levy Economics Institute, December 1997. See also William

Lazonick and Mary O'Sullivan, "Corporate Strategy, Organizational Learning, and International Competition," Paper presented to the Corporations and Human Capital conference, organized by the Brookings Institution and the MIT Sloan School of Management, January 12, 1998. 13. Hidemasa Morikawa, *Zaibatsu: The Rise and Fall of Family Enterprise Groups in Japan*, University of Tokyo Press, 1992; Hidemasa Morikawa, "The Increasing Power of Salaried Managers in Japan's Large Corporations," in William Wray, ed., *Managing Industrial Enterprise*, Cambridge University Press, 1989. See also Lazonick and O'Sullivan, "Finance and Industrial Development, Part II." 14. T. F. M. Adams and Iwao Hoshii, *A Financial History of the New Japan*, Kodansha International, 1972, 23-25. See also T. Bisson, *Zaibatsu Dissolution in Japan*, University of California Press, 1954; Eleanor Hadley, *Antitrust in Japan*, Princeton University Press, 1970. 15. Adams and Hoshii, *Financial History*, 26. 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Hiroyuki Fujimura, "New Unionism: Beyond Enterprise Unionism?", in Mari Sako and Hiroki Sato, eds., *Japanese Labour and Management in Transition: Diversity, Flexibility, and Participation*, Routledge, 1997, 299. 19. Joe Moore, *Japanese Workers and the Struggle for Power, 1945-1947*, University of Wisconsin Press, 1983; Andrew Gordon, *The Evolution of Labor Relations in Japan: Heavy Industry, 1853-1955*, Harvard University Press, 1985, 343, pt. 3; N. Hiwatari, "Japanese Corporate Governance Reexamined: The Origins and Institutional Foundations of Enterprise Unionism," paper prepared for the Conference on Employees and Corporate Governance, Columbia University Law School, November 22, 1996. 20. Gordon, *The Evolution of Labor Relations*, ch. 10; Michael Cusumano, *The Japanese Automobile Industry: Technology and Management at Nissan and Toyota*, Harvard University Press, 1985; David Halberstam, *The Reckoning*, Morrow, 1986, pt. 3; Hiwatari, "Japanese Corporate Governance". See also William Lazonick, "Cooperative Employment Relations in Manufacturing and Japanese Economic Growth," in J. Schor and J-I. You, eds., *Capital, the State, and Labour: A Global Perspective*, Elgar, 1995. 21. Japan Institute of Labour, *Japanese Working Life Profile, 1995-1996*, JIL, 1996, 25. 22. See, for example, Kazuo Sugeno, "Management Flexibility in an Era of Changes: The Courts' Balancing of Employer and Employee Interests," in Japan Institute of Labour, *Management Flexibility in an Era of Changes: The Methods of Accommodating Working Conditions and Work Organizations*, JIL Report Series no. 3, 1994. 23. Japan Institute of Labour, *Japanese Working Life Profile, 1995-1996*, 48; *Nikkei Weekly*, Feb. 24, 1997. 24. See Akira Wakisaka, "Women at Work," in Sako and Sato, *Japanese Labour and Management in Transition*; Kazuo Sugeno, "Flexibility in Working Time in Japan (I)," *Japan Labor Bulletin*, 29, 6, June 1990: 5-8; and Kazuo Sugeno, "Flexibility in Working Time in Japan (II)," *Japan Labor Bulletin*, 29, 7, July 1990: 5-8. 25. Hiroki Sato, "Labour Management Relations in Small and Medium-Sized Enterprises." 26. See, for example, Toshihiro Nishiguchi, *Strategic Industrial Sourcing: The Japanese Advantage*, Oxford University Press, 1994. 27. See Hiroki Sato, "Labour-Management Relations in Small and Medium-Sized Enterprises: Collective Voice Mechanisms for Workers in Non-Unionised Companies," in Sako and Sato, *Japanese Labour and Management*. 28. Robert J. Ballon, "Bankruptcies in Japan," *Journal of Japanese Trade and Industry*, 1, 1996: 44-48. For the "main bank" system as it applies to the resurrection of large companies in financial trouble, see Paul Sheard, "The Main Bank System and the Governance of Financial Distress," in Masahiko Aoki and Hugh Patrick, eds., *The Main Bank System: Its Relevance for Developing and Transforming Economies*, Oxford University Press, 1994: 188-230. 29. Harumi Yamamoto, "The Lifetime Employment System Unravels," *Japan Quarterly*, 40, October-December 1993: 381-386. 30. *Ibid.*, 381. 31. *Ibid.* 32. *Ibid.* 33. *Ibid.*, 382. 34. Quoted in *ibid.*, 383. 35. *Ibid.*, 384. 36. In October 1996, I met with the top executive of a Japanese subsidiary of an American electronics company who had previously spent his "lifetime" working for a major Japanese bank. When I questioned him about the state of the lifetime employment system, his quick response was that "the system is in shambles." Subsequent questioning, however, revealed that his statement was a wish, not a reality, a conclusion with which the man ultimately agreed. As for Westerners, in November 1996 in Tokyo, I attended a talk given by the former Tokyo bureau chief of *Business Week* at which a number of Tokyo correspondents of American magazines and newspapers were present. The presentation and subsequent discussion was all about how, during the 1990s, their editors only wanted to hear, and print stories, that the vaunted Japanese industrial machine was falling apart. 37. Japan Institute of Labour, *Japanese Working Life Profile*, 77. 38. See Lazonick

and OOSullivan, "Finance and Industrial Development. Part I"; and "Finance and Industrial Development. Part II." 39. Robert Zielinski and Nigel Holloway, *Unequal Equities: Power and Risk in Japan's Stock Market*, Kodansha International, 1991, 26-27. 40. See Lazonick and OOSullivan, "Finance and Industrial Development, Part I"; OOSullivan, *Innovation, Industrial Development, and Corporate Governance*, ch. 5. 41. Japan Securities Research Institute, *Securities Market in Japan*, 1986, JSRI, 1986, p. 51. 42. James E. Hodder and Adrian E. Tschoegl, "Corporate Finance in Japan," in Shinji Takagi, ed., *Japanese Capital Markets: New Developments in Regulations and Institutions*, Blackwell, 1993, 150. 43. Hodder and Tschoegl, "Corporate Finance in Japan," 154; Japan Securities Research Institute, *Securities Market in Japan*, 1986, JSRI 1986, ch. 2; and Japan Securities Research Institute, *Securities Market in Japan*, 1996, 43. 44. Japan Securities Research Institute, *Securities Market in Japan*, 1996, 11. 45. See Gwen Robinson, "Japanese go straight to markets to raise cash," *Financial Times*, October 15, 1996, 22. 46. Minoru Nakamura and Koji Yamada, "Financial Institutions in Japan," in Shigenobu Hayakawa, ed., *Japanese Financial Markets*, Gresham Book, 1996, 140. For similar arguments by another Nomura Research Institute analyst, see Seiji Ogishima, "Recent Trends in Japanese Stock Cross-Shareholding," *NRI Quarterly*, Autumn 1994. 47. Akitoshi Takatsuki, "Money and Banking in Japan", International Management, International University of Japan, photocopy, Fall 1996, 35-38. I am grateful to Akitoshi Takatsuki for making these materials available to me. 48. Gerard Baker, "Japan's tearaway starts break-up of the family," *Financial Times*, July 13-14, 1996. 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Scher, "Japanese Cross-Shareholdings: Corporate Governance or Anti-Governance?", Paper presented at the Annual Meeting of the Association for Japanese Business Studies, Ann Arbor, June 2-4, 1995. See also Michael L. Gerlach, *Alliance Capitalism: The Social Organization of Japanese Business*, University of California Press, 1992, 254: "The reasons for these high rates of corporate capital retention and investment remain obscure, however." Ulrike Schaede, "Understanding Corporate Governance in Japan: Do Classical Concepts Apply?", *Industrial and Corporate Change*, 3, 2, 1994, 319: Concluding that "cross-shareholdings are based on an implicit contract with a *non-intrusion* clause, so that the common US [principal-agent] model of ownership and governance does not apply well in many cases", the author however makes no mention of lifetime employment as an objective of corporate governance or even of employees as "stakeholders." See also W. Carl Kester, *Japanese Takeovers: the Global Contest for Corporate Control*, Harvard Business School Press, 1991, who, like most Western observers of the Japanese corporation, assumes that the "market for corporate control" favored by agency theory is the form of corporate governance that has historically been the norm among American corporations and assumes, implicitly at least, that it generates superior economic performance in the U.S. context. For a critique of this Western perspective as applied to the United States, see William Lazonick, "Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism," *Industrial and Corporate Change*, 1, 3, 1992; OOSullivan, *Contests for Corporate Control*. For a Western perspective on Japanese corporate governance that is broadly consistent with the arguments in this paper, see James C. Abegglen and George C. Stalk, Jr., *Kaisha, The Japanese Corporation*, Basic Books, 1985 53. Hence the Japanese system of corporate governance reflects what Ronald Dore has aptly called "flexible rigidities" in the operation of the Japanese economy. See Ronald Dore, *Flexible Rigidities: Industrial Policy and Structural Adjustment in the Japanese Economy, 1970-1980*, Stanford University Press, 1986. 54. Gerlach, *Alliance Capitalism*, 132-137, 299, notes 21 and 23. The term for government officials who are completing their careers with business enterprises is *amakudari*, or "descent from heaven." See also Schaede, "Understanding Corporate Governance," 309-313; Hiroyuki Odagiri, *Growth Through Competition, Competition Through Growth*, Strategic Management and the Economy in Japan, Oxford University Press, 1994, 38-42. 55. Kaoru Morishita, "Scandals put corporate culture on trial," *Nikkei Weekly*, June 23, 1997; for the 1997 meetings, see *Nikkei Weekly*, June 30, 1997. 56. *Nikkei Weekly*, June 17, 1996; "Dissenting shareholders run into Sumitomo stonewall," *Nikkei Weekly*, July 1, 1996. 57. Gerlach, *Alliance Capitalism*, 236; Odagiri, *Growth Through Competition*, 39. 58. Morishita, "Scandals put corporate culture on trial"; Michiyo Nakamoto, "Japan sokaiya scandal embroils more companies," *Financial Times*, October 27, 1997, 4. All *Nihon Keizai Shimbun* articles on the sokaiya scandals since March 7, 1997 are available in English on the *Nikkei Weekly* website. 59. See the table on "Types of New Share Issues," in Japan Securities Research

Institute, Securities Market in Japan 1986, ch. 2; which explicitly notes the practice of dispersing free shares for business purposes, subject to the approval of the shareholders' meeting. Compare with the same table in Japan Securities Research Institute, Securities Market in Japan 1996, 40, which states in a footnote that "in order to offer subscription rights to the general public and selected persons other than shareholders at a preferentially profitable price, a special resolution made by a general meeting of shareholders is required."

60.Zielinski and Holloway, *Unequal Equities*, 163. 61.Lazonick and O'Sullivan, "Finance and Industrial Development. Part II". 62.See Masahiko Aoki and Hugh Patrick, eds., *The Japanese Main Bank System*, Oxford University Press, 1994. 63.Juro Teranishi, "Loan Syndication in War-Time Japan and the Origins of the Main Bank System," in Aoki and Patrick, *Japanese Main Bank System*; see also Tamaki, *Japanese Banking*, 98-99, 101, 122-123, 145-146. 64.Teranishi, "Loan Syndication"; Frank Packer, "The Role of Long-Term Credit Banks Within the Main Bank System," in Aoki and Patrick, *Japanese Main Bank System*. 65.See the data on purchasers of coupon debentures of long-term credit banks in Packer, "The Role of Long-Term Credit Banks", 154. 66.Teranishi, "Loan Syndication", 56. 67.Masahiko Aoki, Hugh Patrick, and Paul Sheard, "The Japanese Main Bank System: Introductory Overview," in Aoki and Patrick, *Japanese Main Bank System*, 37. 68.Mitsubishi Economic Research Institute, *Mitsui-Mitsubishi-Sumitomo: Present Status of the Former Zaibatsu Enterprises*, Mitsubishi Economic Research Institute, 1955, 17; Hadley, *Antitrust* ch.11. 69.Morikawa, "Japan: Increasing Organizational Capabilities"; Maruyama Yoshinari, "The Big Six Horizontal Keiretsu," *Japan Quarterly*, 39, 2, April-June 1992 70.Maruyama, "Big Six Horizontal Keiretsu," 190. 71.Ibid., 188-189; Gerlach, *Alliance Capitalism*, 237-238. 72.See Aoki, Patrick, and Sheard, "Japanese Main Bank System". 73.See Paul Sheard, "Main Banks and the Governance of Financial Distress," in Aoki and Patrick, *Japanese Main Bank System*. 74.Shigeru Watanabe, "Corporate Finance", in Hayakawa, *Japanese Financial Markets*, 101. 75.Ibid. 76.Abegglen and Stalk, *Kaisha*, 208; Robert J. Ballon, "Decision Making and Implementation," *Journal of Japanese Trade and Industry*, 2, 1996: 54-55. 77.See Ikujiro Nonaka and Hirotaka Takeuchi, *The Knowledge-Creating Company: How Japanese Companies Create the Dynamics of Innovation*, Oxford University Press, 1995. 78.Keisuke Nakamura, "Worker Participation: Collective Bargaining and Joint Consultation," in Sako and Hiroki, *Japanese Labour and Management*; Koichi Shimokawa, *The Japanese Automobile Industry*, Athlone, 1994, ch. 3. 79.Maruyama Yoshinari, "Big Six Horizontal Keiretsu", 196. 80.See O'Sullivan, "Organizational Control in the Federal Republic of Germany." 81.See Masahiro Ken Kuwahara, "Worker Participation Within Undertakings in Japan," *Comparative Labor Law Journal*, 5, 1, Winter 1982, 51. 82.Keisuke Nakamura, "Worker Participation: Collective Bargaining and Joint Consultation." 83.Mari Sako, "Shunto: The Role of Employer and Union Coordination at the Industry and Inter-sectoral Levels," in Sako and Sato, *Japanese Labour and Management*. See also Ronald Dore. *Taking Japan Seriously: A Confucian Perspective on Leading Economic Issues*, Stanford University Press, 1987, 70-72. 84.See Yoshio Suzuki, ed., *The Japanese Financial System*, Oxford University Press, 1987; Aoki and Patrick, *Japanese Main Bank System*; Tamaki, *Japanese Banking*; Hayakawa, *Japanese Financial Markets*. 85.See Sakamoto Sakae, "BOJ Autonomy and MOF Dissolution," *Journal of Japanese Trade and Industry*, 6, 1996, 28. 86.See for example Kaoru Morishita, "Japan's financial convoy system approaches the end of the road," *Nikkei Weekly*, July 8, 1996. 87.See Suzuki, *Japanese Financial System*. 88.Minoru Nakamura and Koji Yamada, "Financial Institutions of Japan," in Hayakawa, *Japanese Financial Markets*; see also Yukihiro Endo, "Historical Development of the Japanese Financial System," in Hayakawa, *Japanese Financial Markets*. 89.See for example Yumio Suzuki, "Fair or foul: public investment mushrooms," *Nikkei Weekly*, March 17, 1997. 90.Nakamura and Yamada, "Financial Institutions of Japan", 131-136. 91.Bad loans are defined as loans to bankrupt borrowers, loans for which any part of interest has not been paid in six months (except when loans have been restructured), and, from fiscal year 1995, loans for which the interest rate has been reduced below the official discount rate that prevailed at the time of the reduction. 92.Nakamura and Yamada, "Financial Institutions of Japan", 137-143. 93.Takatsuki, "Money and Banking in Japan," 5. 94.Kaoru Morishita, "Sharp Asset Devaluation Leads to Demise of Housing Loan Companies," in *The Nikkei Weekly*, Japan Economic Almanac, 1997, *Nihon Keizei Shimbun*, 1997, 20-21. 95.Kazunari Yokota, "Bank Failure Boosts Calls to Use Public Funds," *Nikkei Weekly*, Nov. 24, 1997. Note that in 1995, the number of city banks had been reduced from eleven to ten, when Bank of Tokyo and Mitsubishi Bank merged. 96.Stephanie Strom, "Key Japanese panel devises \$77 billion bank rescue plan," *New York Times*, December 16, 1997. 97.Presentation by Jesper Koll, in *The Economist Conferences*, "Summary Paper" of, Fourth Roundtable with the Government of Japan, (held May 12-14, 1997 at Hotel Okura, Tokyo), *The Economist Conferences*, 1997, 28. 98.For a purely financial perspective on the "bubble economy" by a staff person for *The Economist*, see Christopher Wood, *The Bubble Economy*, Atlantic Monthly Press, 1992. 99.Japan Securities Research Institute, *Securities Market in Japan 1996*, 2-3. 100.Watanabe, "Corporate Finance," 100. 101.See, for example, David Lake "Borrowing

for the Future," *Business Tokyo*, October 1990. 102. Watanabe, "Corporate Finance," 96. 103. Lake, "Borrowing for the Future"; Roy C. Smith, "Why Japanese Companies Finance Abroad," in Ingo Walter, ed., *Restructuring Japan's Financial Markets*, New York University Press, 1993. 118-119. 104. Mark Farrington, senior analyst at MMS International, quoted in Lake, "Borrowing for the Future." 105. see Takatsuki, "Money and Banking in Japan," 59. 106. Watanabe, "Corporate Finance," 101. 107. William T. Ziemba, "The Chicken or the Egg: Land and Stock Prices in Japan," in William T. Ziemba, Warren Bailey, and Yasushi Hamao, *Japanese Financial Market Research*, North-Holland, 1991, 51. 108. Yoshinori Shimizu, "Problems in the Japanese Financial System in the Early 1990s," *Hitotsubashi Journal of Commerce and Management*, 27, 1992, 32; see also Ziemba, "Chicken or the Egg," 47-49. 109. Ziemba, "Chicken or the Egg," 55: 110. Shimizu, "Problems in the Japanese Financial System," 35-36. Another expanding market in the 1980s for Japanese city banks, long-term credit banks, and trust companies was overseas lending; the proportion of overseas loans in the portfolios of all Japanese banks rose from just over three percent in 1975 to six percent in 1980, eight percent in 1985, and 11 percent in 1990. 111. Takatoshi Ito, *The Japanese Economy*, MIT Press, 1992, 164; Ziemba, "Chicken or the Egg," 50. 112. Ziemba, "Chicken or the Egg." 113. Nakamura and Yamada, "Financial Institutions in Japan," 136-137. 114. For a more general argument concerning the roles of organizations and markets in the allocation of resources in the process of successful economic development, see William Lazonick, *Business Organization and the Myth of the Market Economy*, Cambridge University Press, 1991. 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