

THE FINANCIAL SYSTEM AND CORPORATE GOVERNANCE IN JAPAN*

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Abstract

Corporations may be said to be engines of any market economy and their proper behavior is a key to economic, hence human, security. This paper argues that one of the most important causes for the prolonged period of recessions of the Japanese economy in the 1990's is deeply rooted in the long-established financial structure of the economy and in the closely related issue of corporate governance. Although Japanese corporations have been traditionally understood that their activities are monitored and governed by "main banks," this framework has been changing over the last 10-15 years toward corporate governance driven by pressure from capital markets. This change has been necessitated by: (a) less need on the part of corporations to rely on banks in acquiring funds, (b) ongoing dissolution of cross shareholdings, (3) an increasing importance for the role of institutional investors, and (4) innovations in information and communication technologies. The change may be regarded as being one from "process innovation" toward a system conducive to "product innovation;" hence a desirable shift. There remain, however, a number of policy tasks, such as institutional improvement in securities investment trusts and the need to better define the role of institutional investors.

Keywords: corporae governance, Japan, financial system

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Introduction

For the Japanese economy, the 1990's was characterized by a prolonged period of recessions, and is commonly called "the lost decade." Upon entering the 2000's, and at present (in February 2004), it has not yet become clear whether the economy has been moving on the direction of renewed sustainable development. In a market-based economy, commercial corporations are the engines of macroeconomic activity. The pattern of long-running, or long-term, economic activities are substantially determined by how such corporations are organized and how their behavior is motivated and how disciplined it is. It is therefore no wonder that, over the last ten years or so, there has been increased interest in looking at corporations from the viewpoint of corporate governance. Since this also has much to do with public policy, research has been conducted not only by academic researchers but also by international organizations.

This paper focuses on corporate governance and aims: (a) to explain how the Japanese financial system is linked to corporate governance, (b) to show how the difficulties faced by the Japanese economy have roots in financial and corporate governance systems, (c) to evaluate recent changes in the financial system, and (d) to provide a brief prospect of

what is ahead, and to point out some important, and relevant, public policy issues.¹

After this introduction, section 1 first argues that the basic and determining factor for corporate governance are the methods of corporate financing, and then points out characteristic features of the Japanese financial system. Section 2 explains the corporate monitoring system operated by the main banks as being a traditional Japanese corporate governance system, and makes an assessment of its efficiency. Section 3 first presents two typical financial systems and the resulting corporate governance; then argues how changing circumstances necessitated a weakening of corporate discipline since the 1980's and has been experiencing further changes in recent years. The final section, section 4, presents a brief outlook on the Japanese system and points out public policies that are required.

1. Two views on corporate governance and the Japanese financial system

The term corporate governance has been used to mean a variety of things². However, broadly it can be

¹ This paper draws heavily on the author's earlier paper in Japanese, Okabe (2003), with the appendix added which draws on Okabe and Fujii (2004).

² Many overview papers have been written on recent research on corporate governance. Okabe (2002b) is an example of a concise

classified into two kinds. The first is to view corporate governance as a framework by which shareholders ("owners") of corporations discipline or monitor managers of corporations so that an efficient operation can be maintained. This understanding may be called a "finance approach," since it is based on the authority of the provider of funds to corporations; or an "agency view" since it regards managers of corporations as agents to operate corporations on behalf of the shareholders. The second understanding is to regard the issue not simply as a shareholder-manager relationship but to first regard the corporation as a coalition of stakeholders (shareholders, managers, employees, the firm's bank, and so forth) and then regard corporate governance as a complexity of relationships through which various interests are arbitrated; thus, eventually leading to, and disciplining, the behavior of corporations. That is, the latter view regards the firm as belonging not simply to shareholders but basically to all stakeholders. It analyzes the structure of authority and responsibility among stakeholders as well as the outcome of their overall interactions. This understanding may be called a "stakeholder view," in contrast to the first type, the "shareholder view" type. The first view is based primarily on US and British corporations, while the second view on Japanese and German ones. Accordingly, research done in the US and the UK are dominated by those from the shareholder viewpoint; a typically example is the well-known survey article by Shleifer and Vishny (1997). On the other hand, the second view is more commonly found in studies of Japanese corporations or in comparative studies, for example as in Aoki (2000). It is difficult to say which approach is superior; though our view is that the way corporations are financed provides a basis for understanding corporate governance, even if the second view is taken. In other words, the issue of corporate governance basically comes down to corporate financing. Hence, it is appropriate that here we review the basics of Japanese finance.

Characteristics of the Japanese finance

To understand the main features of Japanese finance, it is helpful to compare it with that in the US, which provides quite a contrast in many respects. Let us begin with the supply side of funding, namely the household sector that is the largest fund-supplying sector in the economy. The composition of financial assets held by this sector, namely the form of funds provision, is shown in Figure 1. We can see that in Japan the dominant portion of savings of the household sector is allocated (invested) in the form of bank deposits. Put differently, the transfer of funds from the household sector to other sectors is chan-

ned overwhelmingly by way of banks (deposit-taking financial institutions); implying that corporations acquire funds mainly in the form of debt, as opposed to equity. While, in the United States the share of bank deposits in the household portfolio is far smaller, and other type of assets relatively have higher shares; such as various equity-type financial assets including shares and other equities, investment trusts, or marketable bonds. This implies that US firms raise funds mostly by issuing marketable securities, rather than borrowing from banks.

Figure 1: Around here

Financing patterns are thus quite different in the two countries. However, some notes of caution are in order. First, the above statistics may overemphasize the difference between the two countries, since the price of company shares in the US has generally been on an upward trend while that in Japan has trended downward. Second, the financing pattern of corporations reflects not only institutional factors but also cyclical factors, particularly the attitude of the suppliers of funds. In particular, Japanese households have continuously shown risk-averse investment attitudes due to the prolonged economic stagnation in Japan, thus hindering the development of a somewhat riskier financing channel for the economy.

Generally speaking, the financial system of a country is a reflection of not only the demand and supply situation but also of social, cultural and historical factors. In the case of Japan, the heavy reliance on debt financing, rather than equity financing, is characterized by heavy bank-borrowing under the so-called "main bank" system, a form of close and continuous bank-firm relationship. In equity financing, also, a unique feature has prevailed: new shares are not often sold into the market to be held by those in the household sector (individuals), but rather they are allocated to financial institutions or non-financial firms, or they are mutually held in the form of "cross shareholdings" among allied companies.

These features have made Japanese corporate governance rather unique when compared with the Anglo-American style of governance. Next, let us provide an overview of the main bank system that has characterized the institutionalized Japanese corporate finance scene, and then critically evaluate how it functions for corporate governance.

2. Corporate governance in Japan (1): Monitoring by the main bank

Corporate governance in Japan has two basic distinctive features. One is that, as mentioned above, the main bank of a firm has had an important role in monitoring and disciplining the client firm. The other is that equity funding, in which shareholders are theoretically expected to discipline corporations, has had only a limited role in corporate governance, since shares have been extensively cross-held between banks and corporations or between non-bank corporations. These two features have substantial

one in Japanese; Shleifer and Vishny (1997) deals with theoretical aspects, while Bolton et al. (2002) offer a more comprehensive and recent overview. In the present paper, the term "corporations," "companies," and "firms" are used interchangeably.

limiting factors for corporate governance in Japan. Here let us review the first feature³, while we discuss the second feature later in section 3-2.

2-1. The meaning of a main bank

Financing patterns of an economy can be classified, as mentioned already, into two: indirect finance, or a bank-based financial system; and direct finance, or a market-based financial system⁴. In Japan, indirect financing has dominated the financial system for all the more than 50 years since World War II; and long-term close relationships between firms and banks have in fact been observed. For instance, even in 1993, when direct financing was gradually biting into the field dominated by indirect financing, more than 90% of large listed corporations still had a "main bank" or two (on average, 1.6 main banks).

A main bank relationship between a firm and a bank is usually characterized as having all or most of the following elements: (1) the firm continuously has had a large (or the largest) borrowing for a long period of time, (2) the bank is a main shareholder of the firm, (3) the bank carries out a variety of banking and other transactions with the firm, such as foreign exchange business and trustee function of corporate bonds, (4) the bank maintains a close human relationship by dispatching executives to the client firm, and (5) the bank often rescues the client firm when the latter is in financial distress, provided that the firm is judged as eventually being viable.

2-2. The function of the main bank and the assessment

The main bank has been understood to have had three functions. First, as an efficient provider of funds to the client firm. The reason for this is that the main bank relationship ameliorates the informational asymmetry in bank lending (since the bank is able to acquire pertinent information on the firm's financial position as well as on the risk of the investment project financing is needed for), and this makes it possible to place a loan at a lower lending rate than in the case without a main bank relationship. Second is monitoring, disciplining and, when necessary, controlling the client firm. This has been possible since a main bank, a creditor and shareholder of the client firm, is effectively in a position to monitor and control the firm on behalf of all the other shareholders. This practice has been widely recognized to have existed. Third, is the provision of 'insurance' against the client firm when the firm is in financial distress. It has been widely observed that the main bank of a firm often rescues the client firm, so long as the firm is deemed viable, by making emergency

loans or by arranging a rescue package involving all creditors. To sum up, the main bank system may be said to have: (a) enabled corporations to efficiently obtain financing, favorable in both quantity and cost aspects, (b) contributed to maintaining efficient business operations by disciplining corporations, and (c) to have assisted corporations to invest in more risky projects. Thus the system was a propelling force for the post-War high-growth of the Japanese economy. In fact, the main bank system attracted a great deal of attention internationally, especially in late 1980s and early 1990s when the Japanese economy was booming due to soaring of asset prices. For instance, the World Bank initiated a large-scale international research project on this in 1990, and it publicized not only the research results but also recommendations to developing and emerging economies to introduce a more or less similar system (for instance, Aoki and Patrick 1994)⁵.

However, it is important, and interesting as well to note that the assessment of main bank system by researchers has altered quite substantially over the last 10 years or so. Up until the mid-1990s, the corporate monitoring role of main bank was highly praised, as in the World Bank reports. But in recent years, number researchers have increasingly shown theoretically and empirically that the monitoring function of a main bank should, and in fact did, function not at any time but only when a set of conditions were satisfied. An econometric study reported in the Appendix shows that main banks were not performing a disciplining function as early as 1989, the peak period of the asset price bubble. The prolonged difficulty faced by the Japanese economy in a changing domestic and international environments actually provides evidence for this observation that implementation of the traditional functions is no longer expected⁶. Thus let us turn to recent developments in Japanese corporate governance.

3. Corporate governance in Japan (2): Recent developments

In this section, we discuss how Japanese corporate governance has changed, and what have been the causes that necessitated those changes. But before that, it is helpful to introduce a conceptual framework for the two kinds of financial systems. Since the mode of corporate financing determines the base of corporate governance, as mentioned earlier, the two financial systems define two types of corporate governance, as shown in Table 1⁷.

³ For detailed discussion, refer to Okabe (1999: chapters 1 and 2).

⁴ This dichotomy, while quite simple and easy to understand, has an inaccuracy in one important respect: the actual US system should be described not as direct finance but as a market-based indirect financial system, and the desirable future Japanese system should also be characterized by the same terminology, as will be discussed in section 4.

⁵ After this, the World Bank conducted research on what kind financial system is to be recommended to developing countries. The most recent comprehensive research outcome is compiled in Demircuc-Kunt and Levine (2001).

⁶ For theoretical and empirical analyses of these functions, refer to Okabe (2002a: chapter 5).

⁷ For details of the following discussion, refer to Okabe (1999: chapter 1), and Okabe (2002a: chapter 6). The most comprehensive description on this theme is probably Allen and Gale (2000).

3-1. Two types of financial system

Table 1: Around here

First type is the “Anglo-American model,” or the “market-based financial system.” In this, the financial transaction, in principle, takes place in an open market between the market participants keeping each other at arm’s length; each transaction is theoretically independent of previous and future transactions. Here, financing takes place in the form of securities; by selling them when procuring funds and by buying them when providing funds. It is from this characteristic that this type is sometimes known alternatively as security-based finance, a market-based system, or an open-market model. In this system, firms procure long-term funds in the capital markets; depending on banks for only short-term funds, so that bank dependency is relatively low. As the relationship between a firm and a bank remains relatively weak, it becomes necessary for firms to hold abundant internal funds for conducting daily transactions and some capital expenditure.

Further, it is the pressure of a hostile takeover coming from the stock market, not the bank, that monitors and controls the firm and indirectly secures the efficiency of the firm’s operation. Accordingly, the Anglo-American model is often called the ‘outsider’ model, from the viewpoint of corporate governance. Contrarily, in the second type, namely the Japanese-German model, financial transactions take place basically between banks (or other financial intermediaries) and a client firm in a bilateral manner that has a continuous element coming from the maintenance of a close long-term relationship. In this case, the main financing method is bank lending (loan), so that this system is often known alternatively as loan-type finance, bank-based finance, an institution-based system, a bank-based system, or a bilateral model. Here, banks provide not only short-term but also long-term funds, either by making a loan or by acquiring corporate bonds or equities issued by corporations; so that the firm’s dependency on the bank is high. Banks may often acquire stocks issued by the client firm and hold that stock in a ‘stable’ manner. Accordingly, a bank is both lender and shareholder for the client firm, so that the bank comes to participate in the management of the client firm in both these capacities. Thus corporations are said to be monitored and disciplined by banks (especially main banks), rather than controlled by the pressure of the stock market. Therefore, the Japanese-German model is sometimes called the ‘insider’ or network-type model, again from the viewpoint of corporate governance.

For a firm, the maintenance of a close and continuous relationship with a bank means that the firm can count on timely and flexible borrowing from the bank; thus it is not necessary for the firm to maintain to hand abundant internal funds or liquidity. Further, if this kind of bank-firm relationship is maintained, it generates to the bank a large flow of information

about the client firm (thus reducing the information asymmetry), and this may somewhat reduce the cost of funding for the firm since the risk premium in the borrowing rate is smaller.

Functional properties of the two financial systems

These two systems naturally display distinctive performance characteristics. In terms of information processing, the Anglo-American model is a system in which all the information is brought into the market, which tends to have well-developed systems for the acquisition and distribution of information. So the cost of information is low, and the risk involved in initiating a project is basically dispersed onto market participants. Accordingly, this system is more responsive to changes in circumstances, and is suited for riskier economic activities, such as developing new industries or new technologies. In particular, the system is suitable for establishing new firms, because such firms usually cannot borrow from banks due to a lack of physical collateral, usually a prerequisite for bank borrowing. In fact, this kind of performance nature of the system has been seen in the invention and development of railways, the computer and biotechnology. We can state here that the system is well suited to ‘product innovation.’

In contrast, the Japanese-German model, which is characterized by the delegation of the funding process to intermediaries, does not work well when there is a diversity of opinion and high risk. But it is a superior system for finance in cases where agreement of opinions among stakeholders is important; because, in this system a long-term relationship is maintained and items of private information are shared among the various stakeholders. Accordingly, this system is suited for financing where a business enterprise may be redeemed as a going concern, and the firm’s goal is to accelerate capital investment or to accumulating firm-specific labor skills, both of which are crucially important for mass-scale production of existing products. Thus this system is suited for financing existing products or industries where innovation and risk are relatively small, and improving technological and production efficiency is more important. This interpretation can be validated when we see that both Japan and Germany have had competitive edges in industries such as automobiles and electronics. We can state here that system is good for ‘process innovation.’

In addition to the above two types, financing through venture capital needs to be noted. Venture capital is a financing institution whose main activity is to supply money to risky newly established firms by acquiring shares and to proffer advice on the business operation to those firms. Venture capital has offered a way to combine funding of high-risk projects and managerial support in a flexible way for new and innovative firms, which typically lack collateral, track record and managerial experience (CGFS 2002). Accordingly it has a character resembling the

Anglo-American or capital-market based system. Since the Japanese economy now requires product innovation, as will be discussed later, it is important for this mode of financing to grow in Japan in future.

3-2. Changing environment and weakening of corporate governance

What is the historical evolution of main bank system based Japanese corporate governance? Up until the late 1980s, the Japanese economy seemed to be performing marvelously well, especially in the late 1980s when the economy boomed from the rise of asset prices, giving the appearance that there was no problem in the financial system. Rather, many observers, both Japanese and overseas, pointed out that the Japanese financial system was one of the factors contributing to the booming economy. However, it was in this period that the previously much praised financial system and its resulting corporate governance system began to show its limitations, and to fail to carry out the functions required of it. This fact, unfortunately, was not properly recognized by either the policy makers or academic researchers. Malfunctioning of the financial system started due to changes in the economic environment, as follows.

First, accumulation of business profits had strengthened financial positions and self financing capacities of firms; along with a decline of corporate dependency on banks. Second, blue chip firms had been able to raise funds in overseas markets (by issuing securities) more easily, in greater volumes and at less cost than in the tightly regulated domestic markets. This also led corporations to rely far less on bank borrowing than before, so that banks had increasingly lost their basis for monitoring corporations. Consequently, in the late 1980s, Japanese corporations had lost the basis of their efficient operations and increasingly went on to speculatively acquire real estate. Banks, on the other hand, also revealed their own problems in the lack of a disciplinary mechanism, which led to seeking business scale rather than efficiency and to insufficient screening when making loans. This situation brought about unsound bank loan practices and, after the mid-1990s, those loans turned out to be non-performing, and this continues to distress Japanese banks even today.

Put simply, changes in the economic conditions after the 1980s rendered the traditional corporate governance mode no longer workable or effective. In fact, recent research, such as Hirota (1996), Weinstein and Yafeh (1998), Horiuchi (2002), Osano and Hori (2002), in increasing numbers strongly confirm this observation. Accordingly, it has been more customary in recent years to say that one of the important causes of the bubble economy in late 1980s was the fragile nature of both the monitoring power of main banks and corporate governance of banks themselves. That is to say, it has become a general understanding that the "vacuum of corporate governance" of Japanese firms, or its weakening, emerged

during the bubble period and has become an important structural problem for the Japanese economy. For a detailed discussion, please refer to Okabe (1999: chapter 2) and Okabe (2002a).

The above argument leads to the following general conclusions. First, there is no single answer to the question of what the "best" financial system is; that answer depends on various economic and other conditions. One size does not fit all nor does it even fit all the time. Second, conditions to determine an optimal financial system include such factors as the stage of economic development, effectiveness of regulation, degree of openness of the economy or of financial globalization, and information and communication technology. These factors can jointly determine an optimal financial system for a country. If given these factors, then, can we say that the Japanese financial system has been, and is, changing for the better? Let us first sort out the recent developments that have altered the Japanese financial system, and then in section 4 we hope to answer that question.

3-3. Changing environment and changes in the financial system

The weakening of corporate governance, as mentioned above, is an outcome of a mix of a variety of factors. Of these, the four factors that follow are ones that have already had an effect and are particularly important in formulating any forecast regarding the future financial system. They are: (1) changing patterns of corporate finance, (2) dissolution of cross shareholding, (3) increased role of institutional investors, and (4) effects of innovations in information and communication technology (ICT). Let us briefly review them in turn.

(1) changing patterns of corporate financing: notable, growing out of debt

How has the financing pattern of Japanese corporations, on which corporate governance is based, evolved in recent years? Statistics for 1991-2001 are shown in Table 2. From this, we can note the following: (1) the total amount of funds acquired maintained a clear downward trend throughout this period, (2) internal funds have always had an overwhelming importance, (3) acquisition of external funds declined drastically (for the period of 1998-2001 such acquisitions actually were negative; that is, there was a net repayment of debt), and (4) of all external finance sources, bank borrowing rapidly decreased while equity funding remained rather stable.

Table 2: Around here

Does negative external funding (net repayment) mean that corporate financing has lost meaning for corporate governance? Not so, for the following reasons: even though the yearly acquisition of funds, as shown in the table, is negative for these years, the aggregate amount of this flow of funds, namely the net amount outstanding (financial assets minus fi-

financial liabilities) still show a position of net fund acquisition. In fact, the corporate sector is still the largest fund raising sector in the economy; on the basis of stock. To use the statistics as of the end of March 2002; business corporations (non-financial private corporations) had financial assets of 688 trillion yen, and with financial liabilities of 1,101 trillion yen. This is a net balance of financial liabilities of 413 trillion yen. Of the financial liabilities, 419 trillion yen was in bank borrowing, 354 trillion yen was in shares and other equities, and 81 trillion yen was in debentures and issuance of commercial papers⁸. To conclude, corporate financial structure as stock still shows net financial liabilities (and traditional indirect financing still dominates); so basically, the disciplining mechanism coming from the financial structure has not lost its validity, even though corporations rapidly decreased borrowing on a net flow basis. Of the four characteristics above, (1) is obviously a reflection of stagnant capital investment due to the prolonged economic depression. But what about items (2), (3) and (4); what do they mean to corporate governance? A fundamental theory of corporate finance, the Modigliani-Miller theorem, asserts that under a set of assumptions (perfect market, absence of tax, etc.) the value of a firm is not affected by its method of finance, whether debt financing or equity financing. But in reality this is not so. In Japan and the US, an explanation called the "pecking order hypothesis," or the hierarchy theory of financing, has been recognized as describing the actual situation⁹. According to this hypothesis, a firm behaves in the following way: in the first place it will have an order of preference for choosing a method of finance, and then it will successively utilize the method of finance with the least cost, thus minimizing the total cost of funding. The feature (2) can be explained by this hypothesis.

But it is difficult to interpret features (3) and (4) by applying this hypothesis. The reason for this comes from the hypothesis' presumption. The pecking order hypothesis does not properly take bankruptcy risk into consideration, thus limiting its applicability. This is quite an important limitation, since bankruptcy risk has been generally rising during the long period of stagnation of the Japanese economy through the 1990s and early 2000s. In other words, when a firm tries to raise funds, its concern is more with bankruptcy risk than the cost of funds. This is because the cost of funds in Japan is extremely low due to the historically unprecedented easy monetary policy overseen by the Bank of Japan, on the one hand, and bankruptcy risk is generally high, on the other. Accordingly it becomes rational behavior for firms to reduce debt that would increase corporate risk and to increase owned capital, a financial buffer. It can be understood that the this kind of corporate

behavior resulted in features (3) and (4). As seen above, corporations have rapidly decreased borrowing from financial institutions, banks in particular, and even when borrowing has not decreased, the bargaining position of banks has been substantially eroded in the extremely loose monetary environment. It is therefore natural that the monitoring authority and power of main banks has rapidly declined. A good example to demonstrate this situation is the "forbearance lending;" the behavior of banks to refinance firms even in cases where there is little prospect of firms repaying the loans extended. Various statistics show that in the first half of the 1990s banks extended further loans to, real estate and service industries whose profitability was hovering at low levels rather than force them to repay. Consequently banks assisted in slackening the business operations of these firms, still less monitored them to assist in efficient operations (Sekine, Kobayashi, and Saita 2003). This kind of bank behavior indicates that the ability of banks to discipline corporate behavior has declined drastically. It is certainly true that the disciplining function of debt has not been lost; in as far as firms have debt outstanding. But we can see that the traditional corporate governance framework---banks monitoring client firms---has now collapsed and the disciplining function of the stock market has been gaining importance.

(2) Dissolution of cross shareholding

Another important feature of Japanese corporate finance, or of the Japanese economic system more generally, is "cross shareholding," or mutual holding of shares between banks and their client business corporations, or between non-financial business corporations¹⁰. When shares are held mutually, there are two potentially serious problems arise. First, it is likely that the disciplining pressure coming from the capital market is relatively weak. This happens because, when shares are held mutually, managers of both corporations are likely to implicitly agree not to intervene in the management of the counterpart corporation; and because the possibility of bloc share trading or a hostile takeover is decreased. The second problem is that, when equities are mutually held between banks and insurance companies, mutual equity holding increases the systemic risk of the entire financial system (BIS 2002, p135). This is all the more likely, since in recent years the financial positions of Japanese insurance companies have been rather fragile. Further, this kind of mutual equity holding reduces the monitoring and disciplining function of insurance companies vis-a-vis banks, and tends to induce forbearance lending by banks, thus generating a serious issue regarding the efficiency of the entire economy.

⁸ Author's calculation based on Bank of Japan Financial and Economic Statistics Monthly, September 2002, page 255.

⁹ For details, see Okabe (1999: chapter 1, section 4).

¹⁰ Detailed analysis of cross shareholding, including the reasons for, its effects, and the future outlook is presented in Okabe (2002a).

Figure 2: Around here

Cross shareholding, which involves the above problems, has been unraveling especially after the mid-1990s, as seen in Figure 2. This has important implications for corporate governance. When cross-held shares are released from both parties and are sold in the market, a substantial part of such shares have been acquired by Japanese institutional and foreign investors. Important here is that foreign investors have traditionally been keen on a return on equity (ROE) in their investment (see Appendix for empirical evidence), and that Japanese investors (pension trusts, investment trusts) have in recent years likewise become increasingly keen on ROE. This means that the higher the ROE of the share, the more it is preferred and consequently acquired by investors in the stock market. This kind of selective investment attitude of investors implies that Japanese corporations are likely to feel more pressure from the capital market and from shareholders; and that governance is likely to have an Anglo-American element of efficiency rather than an expansion of business volume. Accordingly, we can state that the dissolution of cross shareholding, as observed in recent years, has somewhat rectified the "vacuum of corporate governance" and has contributed to raising the efficiency of Japanese corporations.

(3) Increased role of institutional investors

When we discuss the prospect of Japanese corporate governance, we cannot dismiss the possibility of the increased role of domestic institutional investors. Institutional investors are specialized financial institutions that manage savings collectively on behalf of small investors, governed by a specific objective in terms of acceptable risk, return maximization, and maturity of claims (Davis and Steil 2001). Typical institutions include pension funds, investment trusts, and life insurance companies.

Institutional investors have shown remarkable growth in the major countries of Europe and in North America over the last ten years (Davis and Steil 2001). However, in Japan their growth has remained moderate, even though some improvements have been made in the legal framework (regarding securities investment trusts) under which they operate, and deregulation has taken place (such as allowing banks to sell investment trusts at their counters). But a great increase in growth can be expected in Japan because the kind of financial assets (instruments) that institutional investors provide have good potential for growth. Until recently, and even now, alternative financial assets available to households have been quite limited, as shown earlier in Figure 1, and households are now much more willing to diversify their portfolio than previously, as various surveys have indicated. Given these circumstances and the traditional risk-averse attitudes of Japanese households, they are more likely to choose medium-risk medium-

return financial assets (such as investment trusts) rather than to suddenly invest in high-risk high-return assets. Another reason is that pension funds, already an important institutional investor, are expected to increase in size and number due to the aging of Japan's population; thus the assets held by those funds are also expected to grow.

If institutional investors grow in number and in the financial activities they participate in, corporate governance will be profoundly affected. It is because that, above all, institutional investors are subject to a fiduciary duty, the responsibility imposed upon agents (such as insurance companies and pension funds) to manage entrusted funds for the ultimate benefit of the principal (individuals). Therefore, when institutional investors choose financial assets, company shares in particular, for their portfolios, it is natural that they tend to focus on the rate of return, and to prefer shares with higher rates of return. As a result, the pressure coming from the stock market encourages corporations to operate more efficiently. In fact, in the United States, since mid-1980s a series of laws have been passed regarding financial investment by pension funds, and trustees of pension funds have been required to be actively involve in the management decisions of the corporations in which they invest (such as by exercising voting rights). As a result of this, US corporate governance has been said to have been strengthened. In Japan, on the other hand, the fiduciary duties of institutional investors are rather ambiguous, hence clarification of this situation remains an important public policy issue; nevertheless the influence of institutional investors on corporate governance is sure to steadily increase in the coming years.

(4) Effects of information and communication technology (ICT) innovation

Information and communication technology (ICT) innovation is also likely to affect the various modes of corporate governance. Since the real extent of the influence of ICT on the economy is not yet clarified, suffice it to mention here two aspects regarding financial markets. One is that ICT innovation enables the valuation of a firm, by financial markets, to be more accurate since ICT generally tends to provide financial markets with more information of all aspects of a corporation, and to provide it more efficiently and in a more timely manner. Therefore, continually evolving situation of ICT and its effects on financial markets is conducive to promoting the operational efficiency of corporations. In fact, in the US, changes in the character of financial markets that have been driven by ICT innovation are reported to have strengthened the disciplining of corporations through the market-based corporate governance mechanism (mergers, acquisitions, and takeovers) or by restructuring business operations (Holstrom and Kaplan 2001).

The other effect is that ICT innovation has brought about a revolution in financial transactions

and financial products, since it enables instantaneous acquisition and processing of massive amounts of financial and other data. For instance, derivatives (financial contracts of trading risk or other property as derived from an underlying asset), and asset-backed securities (ABS, a marketable security that is issued by bundling, and backed up by relatively smaller assets) are good examples. If the transaction of these financial products increases in Japan, corporations will be able to rely more on market-based finance or to diversify their methods of financing; consequently risk can be more widely dispersed, from financial institutions to various economic agents (CGFS 2002). This will promote efficiency within the entire economy, and probably strengthen corporate governance by market forces.

4. Prospect and policy issues

Four factors mentioned above, namely the changing patterns of corporate finance, the dissolution of cross shareholding, the increased role of institutional investors, and ICT innovation, all have been instrumental in driving the changes that are moving Japanese corporate governance from a bank-based to a market-based corporate governance system. Thus the system is anticipated to change, from one in which disciplining pressure comes from a single institution (the main bank), to one in which various markets (such as stock, debenture, ABS, and derivatives markets) take over that role. This change in how disciplining power on corporations is exercised is likely to show three characteristics.

First, as mentioned several times, change will take place from an overall bank-centered governance to more or less a shareholder- or stock market-centered corporate governance. However, this change is not as simple as “from indirect finance to direct finance,” but it is rather a change “from a bilateral or relationship centered indirect finance to a market-based indirect finance.” The point is that indirect finance will probably still dominate but that market elements will increase. In reality, the US financial system should be characterized basically as “market-based indirect finance,” rather than “direct finance” (Okabe 1999: chapter 1, section 2); which is precisely the system that is expected to evolve in Japan, and is the one deemed desirable (Royama 2002).

Second, corporate governance is not expected to converge to one kind of system but rather to diversify. The reason being that corporate governance systems involve a variety of aspects, not only economic but also historical, social and cultural ones; and there is probable no one universally accepted optimal model. For instance, the number of “good” Japanese companies whose top priority is that of the shareholders’ interest is comparatively few (Niihara 2003). Also, the recent amendment of the Business Law (enacted in April 2003) aiming to strengthen corporate governance offers two options to choose

from for a corporate governance structure¹¹. This is one of the factors that will cause the Japanese corporate governance system to diversify. Further, a recent survey (Policy Research Institute 2003) covering 400 large corporations has revealed that in the manufacturing industry, diversity in terms of business areas, organizational structure, and corporate governance structure has increased since 1990.

Third, although there is a definite and strong trend for Japanese corporate governance moving toward an Anglo-American or market-based governance system, there is little possibility that it will converge on that mode. One reason is that there are two kinds of factors determining corporate governance: one is the factors that converge easily internationally, such as financial markets reflecting financial globalization, financial data, and accounting rules; the other is those that are less likely to converge, such as the social system of a nation, commercial and corporation laws that reflect history and commercial practices. Another reason is that to efficiently achieve sustainable economic growth, both institutions and markets have their own roles and either one alone would not make for an efficient system (Levine 2002, Bech and Levine 2000). This conclusion is also confirmed from an analysis (Shirai 2003) of the late 1990s economic crisis of East Asian countries and the lessons derived from the policy responses of the nations effected.

In summary, we can state that there are indications that disciplining mechanisms are being reestablished for Japanese corporations (see Appendix for an econometric evidence), after a vacuum of corporate governance was experienced for close to fifteen years. This means that Japanese firms have been increasingly obliged to emphasize efficiency of capital, ROE, or efficiency of assets, ROA, rather than to merely expand sales volume. Financial system also may be said to have been changing to a more desirable one in two respects, commensurate with changes in economic environment.

The system may be said to have been changing from what was suitable for “process innovation” to what is suitable for “product innovation.” The traditional, well-established, Japanese financial system that has historically played an important role, has now lost the validity for its functioning under a new set of domestic and international circumstances. That is, many Japanese products, such as fiber, iron and steel, chemical products and machinery, in which Japan once enjoyed comparative advantages, are now facing keen competition of China and other East Asian countries, and cannot compete on price, and

¹¹ In addition to the existing system, where an auditors’ committee audits the board of directors, a US-type governance institution was introduced as a new option. In this, executives are stipulated to literally execute company operations, while the board of directors specializes in monitoring the company operations conducted by executives, and within which duty the board is required to establish auditing and another two committees of which half the members must be chosen from outside the corporation.

gradually on quality as well. Accordingly, Japanese industries need to shift the products toward a more technology-intensive mix to survive internationally; therefore, the financial system must change to foster such industrial change. Continuing changes in recent years can be usefully evaluated in accordance with this evolutionary trend.

Another aspect is that the changes in the system toward a market-based one may be said to be in a direction that will ensure a more stable system or to a system more resilient to various shocks. In a bank-based system, risks inevitably concentrate in banks, while in market-based system, risks are broadly dispersed to various agents within the economy. Indeed, these characteristics have been confirmed in the period of the late 1990s to the early 2000s when the stability of financial institutions (especially banks) in Europe and the US remained remarkably stable, even though a number of defaults of debentures occurred owing to some general depression. This was in sharp contrast with the bitter experiences of the late 1980s to early 1990s (CGFS 2002).

However, issues of public policy remain to be addressed, if the recent trends are to yield the expected results. One area is to nurture an environment for company shares to be held more extensively throughout the economy, and for companies to be more appropriately monitored by shareholders¹². This would include improvements in the legal and institutional frameworks of securities investment trusts, and the establishing of a system of effective corporate governance by institutional investors. Also, there are many lessons to be learned from the drastic improvement in the US situation, regarding accounting disclosure and auditing systems; these should improve the framework of Japanese capital markets. The recent amendment of Japanese Commercial Law, enacted in April 2003, now provides an improved legal framework, but in reality there remains work to substantiate this new framework: such as adjusting monitoring capacity of boards of directors, and substantiating the contribution to come from outside directors for better corporate management and governance.

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¹² Since employees of corporations are important stakeholders, particularly in Japan, there is validity for their representatives to participate in company management. In this regard, the German system is highly suggestive (Okabe 1999: Box 2-1).

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Appendix: Corporate governance structure and company performance: an empirical study

How, and to what extent does corporate governance, in particular the ownership structure, affect the performance of companies? Here an empirical study conducted jointly by the author and his student, and reported elsewhere¹³, is briefly summarized. The study aims to investigate how various "governance variables," namely debt and the ownership structure, affect company performance or the value of the company. Specifically, the following multiple regression model was estimated:

$$TOBIN = \alpha_1 + \alpha_2 DEBT + \alpha_3 MB + \alpha_4 DIR + \alpha_5 FOREIGNER + \alpha_6 INDIVIDUAL + \alpha_7 FINANCIAL + \alpha_8 CORP + \varepsilon$$

where

TOBIN: Tobin's *q*

Tobin's *q* = (Total market value of issued shares + Interest-bearing debt) / (Owned equity + interest-bearing debt).

DEBT: Debt to asset ratio

Debt to asset ratio = Total debt / Total asset.

MB: Dependency on main bank

MB = Amount of lending by the top lending bank / Total debt.

DIR: Directors' shareholding ratio

FOREIGNER: Foreigners' shareholding ratio

INDIVIDUAL: Individuals' shareholding ratio

FINANCIAL: Financial institutions' shareholding ratio¹⁴

CORP: Other corporations' shareholding ratio

ε : Error term

Estimations were run using cross-section accounting data of large (listed) companies for two years: 1989 (for 501 companies) and 1999 (for 499 companies). 1989 was the peak period of the "bubble economy," and 1999 was the most recent year for which consistent statistical data is available. For the details of the data and the basic statistics of the sample¹⁵, refer to Okabe and Fujii (2004).

Table A: around here

Estimated results, shown in Table A, are generally satisfactory with all the variables highly significant. From this, we can make following observations: (1) Debt had a steady disciplining role, as expected, for both 1989 and 1999.

(2) Having a main bank had a negative effect on company performance for both years. This implies that the monitoring and disciplining function of a main bank, if it existed, had already disappeared as early as in 1998. This result is broadly consistent with other recent research, quoted in the main text of this paper. We may interpret this result to imply that one of the causes for the asset price bubble in late 1980s was that of the vacuum of bank corporate governance.

¹³ Okabe and Fujii (2004).

¹⁴ Excluding investment trusts and pension funds.

¹⁵ Some interesting figures are: the average of Tobin's *q* is 2.31 for 1989, indicating asset price bubble, while 0.60 for 1999; the debt to asset ratios are high for both years with 68.69 and 64.36, respectively, reflecting the reliance on bank finance; and individuals' shareholding ratio rose from 25.77 to 30.57.

(3) Shareholding by foreigners had consistently positive effects on company performance (disciplining function). This is because their motives are usually to obtain high investment returns and sometimes discipline the company with their "voice."

For the others of the four explanatory variables, the nature of the influences changed (signs of the parameter reversed) between these two years, statistically significantly. For each of these cases, the following interpretation can be made, with reasons presumably effecting the change.

(4) Directors' shareholding had a negative effect on company performance in 1989, but became positive in 1999, although the size of the parameter in the latter is quite small. The negative effect in 1989 is due probably to moral hazard on the part of directors, while the change to a positive value in 1999 is due presumably to the increase in incentives, or the tightening of the role of directors as seen in the increased amount of litigation against directors for poor or illegal company performances.

(5) Both financial institutions' shareholding and other corporations' shareholding ratios had negative effects on company performance in 1989, but both became positive in 1999. This result is rather difficult to interpret, since various theoretical analyses conclude that there is no unique direction (the sign of the parameter) for the effect of bloc shareholders. But the results indicate that bloc shareholders have positively influenced company performances in more recent years.

(6) The shareholding ratio of individuals' changed, quite contrary to the above three cases, from positive in 1989 to negative in 1999. The positive effect in 1989 is due probably to more concentrated shareholding among individuals thus having a disciplinary effect. While the negative effect in 1999 may be explained by a dispersion of shares to more individuals, implying that (smaller) individual shareholders are reluctant to monitor the company by putting in time and other resources to this end, but that they prefer a "free ride" on the disciplining activities by other types of shareholders. All in all, the results suggest that the disciplinary effect on corporations coming from shareholders, except for shareholding by individuals holding smaller blocs, seems to have increased in recent years.

Table 1. Two types of financial systems and their properties: Anglo-American and Japanese-German models

	Anglo-American model	Japanese-German model
Main financial transaction	Open market	Bilateral transaction
Main funding instrument	Securities	Loan
Dependence on banks	Low	High
Nature of bank loan	Short term	Short term and long term
Importance of internal funds	High	Low
Shareholding by banks	Not important	Important
Major shareholders	Households Institutional investors	Banks Intercompany shareholding
Block share trading	Frequent	Not frequent
Corporate control	Stock market	Banks (main banks)
Information processing	Market acquires and distributes diversity of opinion and risk; Information cost is low	Banks and client companies jointly own information by keeping long-term relationship; economies of scale in information acquisition
Allocation of risk to various economic agents	Risk is dispersed broadly concentrated in banks	Risk is essentially
Performance characteristics	More responsive to change	Superior at implementing corporate policies that require agreements among various groups
Suitable economic activity	Developing new industries, new technologies and starting up new businesses (Product innovation)	Improving the production process and efficiency of existing products (Process innovation)
Industry examples	Railways, computer and biotechnology	Automobiles and electronics

(Source) Okabe (2002a) Table 6.1, with some revision and expansion.

Table 2. Sources of funds of private non-financial corporations, yearly average in trillion yen

	1990-93	1994-97	1998-2001
Acquired funds total	86.2	53.0	37.7
Internal funds	52.5	48.1	43.6
External funds	33.7	4.9	-5.9
New stock issue	2.7	2.4	2.1
Debenture	2.7	-0.8	-0.7
Bank borrowing	28.3	3.3	-7.3

(Source) Calculated by the author using Financial Statements Statistics of Corporations, Ministry of Finance. <<http://www.mof.go.jp/1c002.htm>>

Table A. Regression results of the relative value of corporations

	1989	1999
Debt	0.05620 *** (77.57)	0.00991 *** (83.81)
Main bank	-4.35247 *** (-31.15)	-0.64923 *** (-33.07)
Directors' shareholding ratio	-0.02989 *** (-14.82)	0.00420 *** (83.81)
Foreigners' shareholding ratio	0.07965 *** (24.32)	0.02829 *** (45.60)
Individuals' shareholding ratio	0.01697 *** (17.27)	-0.00704 *** (-104.77)
Financial institutions' shareholding ratio	-0.01918 *** (-32.79)	0.00155 *** (12.04)
Other corporations' shareholding ratio	-0.01578 *** (-23.63)	0.00307 *** (20.43)
Adjusted-R ²	0.9939	0.9983
N	501	499

(Note) t-values in parentheses; asterisks ***, **, * indicate the significance at 1%, 5%, 10% levels, respectively.

(Source) Okabe and Fujii (2004), Table 4-3.

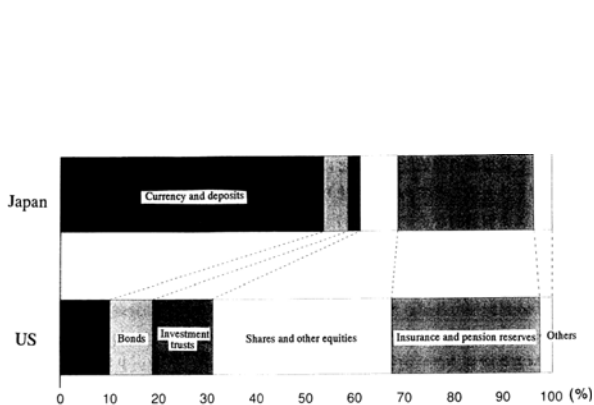


Figure 1. Financial assets held by households: Japan and the US end of March 2000

Source: Bank of Japan (2000, chart 8)

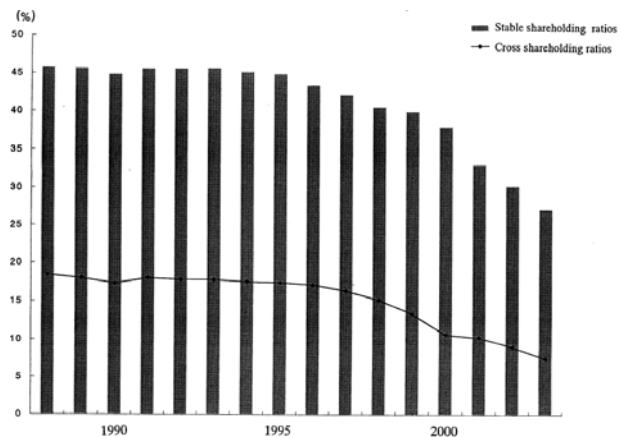


Figure 2. Stable shareholding ratios and cross shareholding ratios (in per cent, at the end of March)

Source: NLI Research Institute (2003)