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Book Review

# Corporate Governance in Japan: Institutional Change and Organizational Diversity. Edited by *Masahiko Aoki, Gregory Jackson and Hideaki Miyajima.* Oxford: Oxford University Press, 2007.

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The editors of *Corporate Governance in Japan: Institutional Change and Organizational Diversity* have assembled fifteen chapters on the changing patterns of corporate governance among Japanese enterprises since the 1990s. The collective goal of the volume is to examine empirically and theoretically four interrelated issues: the changes in the key features of Japanese corporate governance; whether and how those changes are fundamental in Japan's post-World War II corporate governance institutions; the interrelationships in the various aspects of changes of corporate governance; and the relationship between corporate governance arrangements and firm performance. The book proposes that rather than simply losing a decade of the 1990s Japan experienced a major turning point of post-war corporate developments. From a homogenous relationship-oriented model since the 1960s to the 1990s, the cumulative process of institutional adjustments in the 1990s has resulted in a growing diversity of governance practices among Japanese enterprises.

Following a well-articulated overview of the entire volume synthesized by Jackson and Miyajima, the fourteen chapters are grouped into three sections by themes. The first section covers the external changes of corporate governance in ownership and finance in Japan in six chapters. The second section shifts to the internal aspects of Japanese corporate governance to analyze changes in organization, employment and corporate boards in another six chapters. The two chapters in the third section conclude the volume by concentrating on diversity and institutional change from empirical as well as theoretical angles. Overall, *Corporate Governance in Japan* is an informative and penetrating compendium of the recent changes of corporate governance in Japan. The editors should deserve credit for drawing together scholars from different disciplines including economics, management, sociology and law, who have committed to integrate empirical analyses drawn from various data sources with an organized and comparative institutional analysis of the Japanese firm. Bringing together both Japanese as well as international scholars specializing in Japanese corporate governance has also yielded an admirable combination to give a balanced synthesis of the latest scholarship. The outcome is thus an essential volume that should benefit any intellectual reader who is interested in corporate governance and management in Japan.

The present volume is the product of a research project on corporate governance at the Research Institute of Economy, Trade and Industry (RIETI) in Tokyo in 2002, followed by a RIETI Policy Symposium in 2004. The volume represents the well-integrated synthesis of individual research agendas at an impressive level of depth and detail. The carefully organized structure of the volume by topics and its considerable complementation by an elaborate introduction is a particularly significant strength of this book. An instrumental tool to systematize the entire research project is Aoki's comparative institutional analysis. The book as a whole therefore elaborates on and extends his framework of the stylized Japanese corporation, or the *J*-firm.

With the collective wisdom of assembled authors the book persuasively argues that several core features of Japanese corporate governance have changed considerably since the recession decade of the 1990s. These changes, the authors find out, are not uniformly encompassed across different facets of corporate governance. Moreover, those uneven alterations fall considerably short of the convergence onto the market-oriented Anglo-American variety of corporate governance. A central argument of this book is that the most significant changes have been detected in the external elements of corporate governance such as equity financing and market-oriented shareholders in a globalizing capital market. Debt financing carried out in the context of main-bank relational lending now plays a less critical role, while cross-shareholding among industrial firms and financial institutions has declined. The internal mechanisms of corporate governance has consequently accommodated to external pressures, yet in a more incremental and deliberate fashion. Large and listed firms have enhanced the principle of disclosure and transparency, but accepted more limited reforms in terms of shareholders' involvement in management through their active representation on the board of directors. The so-called "lifetime employment" has more or less survived, although the traditional convention of seniority-based pay and promotion shifted toward merit-linked compensation and advancement. Taken all together, the editors propose, the empirical examinations of corporate governance issues in the present research project imply and support Aoki's advocate of the new EMIL (external monitoring of internal linkage), or hybrid, model of Japanese corporate governance.

Given the vast scope of the topical coverage and the different approaches that various chapters employ, it is impractical to provide detailed comments on all the individual chapters. The present review thus concentrates on the overarching themes of the volume while liberally referring to the major points made in relevant chapters. First, a critical argument on the EMIL model elaborated on the last chapter should be carefully examined and criticized. There, Aoki proposes:

> "[I]f the management lets it be known as part of its business model that a proportion of the value created by the complementary linkage accrues to the stockholders according to a certain rule and if the stock market is informative, the fundamental stock value may be constructed as a summary statistic correlated to future values of the linkage. If the board of directors is entrusted to effectively replace or appoint top management contingent in the (expected) stock value, the management can be disciplined to create and sustain a valuable internal linkage. On the other hand, the stockholders themselves may be motivated to do a better job of monitoring if they can benefit from making good evaluative judgments. Therefore, there are complementarities between the creation and

> sustenance of internal linkage on the one hand and the stock market evaluation on the other. Complementarities can thus be dual; external as well as internal. In this model, the board of directors ought to act not as the agent of the returns-maximizing stockholders but as the "trustees" for the stakeholders including the employees and the managers... It would not force the management to increase the stock value at the sacrifice of the employees, because it would be likely to destroy the valuable internal linkage." (p. 440).

The argument suggests that, while internal linkage remains important, external monitoring should play a significant and complementary role in cases of low firm performance. Capital market may provide broad signals, but they are not adequate or forceful enough as disciplining management thus need to be translated into tangible internal mechanisms of governance. Aoki anoints independent board members to play that necessary and key role of enforcement in the case of large firms with limited or no bank loans. The shareholders and the board representing their interest are then suggested to appreciate and secure the internal linkage between the management and employees.

While the argument sounds so much attractive on paper, in practice it is not clear how and why market-oriented investors and their representatives on the board understand and agree to this philosophy. Rather than achieving optimality for both the market-focused investors and relationship-oriented management and employees, the combination of the two opposing models of governance may result in the diminishing or even break-down of the coherence of internal linkage, which should create the dissatisfaction for all the constituents. Ironically, then, more the board incorporates outside members for the sake of effective monitoring, less the probability to keep cohesion of internal linkages. Further, however sincere and committed they aim to be in appreciating the internal linkages, external board members are unlikely to possess the adequate and appropriate capacity to monitor the strategic implementation by the management and employees. This is because they are not equipped with the capabilities in terms of knowledge in internal organization as well as external market and technology. Note that these capability-asymmetry problems in mixed or hybrid models still remain even in an improved condition of enhanced disclosure and transparency. Unless Aoki comes up with a concrete and instrumental mechanism to overcome these inherent troubles, some lingering doubts remain on the actual effectiveness of the proposed model. Aoki seems to recognize this issue, when he suggests: "How it (adopting a board structure with independent subcommittees or increasing the number of independent directors) will work has yet to be seen, but an experiment is certainly worthwhile." (p. 445). In addition to a philosophical and theoretical argument, then, dynamic empirical analyses to pin down the environmental conditions and intra-firm circumstances in which different governance mechanisms, hybrid-model, the US-model, or even *J*-model, function most effectively may bring more insights.

Second, further analyses and discussions seem necessary on whether the existing changes of Japanese corporate governance that the present volume collectively reveal are of a cumulating trend or a cyclic nature. This is particularly so, because most of the empirical treatments of the chapters cover the time span from the early 1990s till 2002, the period of the so-called Heisei Depression. Certainly, market globalization, financial deregulation, shifts in organizational architecture and legal changes regarding corporate governance should imply a signal of secular trend. Nevertheless, when the macroeconomic conditions improved since 2002, as long as demand factors exogenously pull up firms' performance, external pressures from market-oriented shareholders have lessened. In such environment, could Japanese companies hold back to their old governance style or could some of the cosmetic changes in certain aspects of internal governance mechanisms such as an independent board be stopped or even reversed? After all, don't corporate finance experts argue an optimal level of leverage, rather than advocating the all-out shifts toward equity? Even in business journalism stakeholder arguments sound much stronger now, while shareholder voice has somewhat diminished. The same group of authors may now come up with a different conclusion by incorporating the changes in corporate governance issues since the macroeconomic recovery of the Japanese economy after 2002.

Third, the underpinning reasoning for the superior performance of the hybrid governance model over others seems somewhat inconclusive. This is not simply because important figures regarding the performance comparison of the different types of governance models (given in Table 1.4 on page 34) is technically puzzling, since it is uncertain whether the given numbers of performance outcomes are actually different from each other at any statistically significant levels. (Regrettably, this important comparison of performances among firms adopting three different models of governance is not elaborated further in any chapters). But it is mainly because the actual mechanism for high performance achieved by hybrid firms is not fully pinned down because of reverse causality problems (Miyajima's Chapter 12 as well as Chapter 3 coauthored by Kuroki, a model of painstaking research and data examination, acknowledge those concerns). Information disclosure in general, which is highest in hybrid firms, is argued to boost performance. But it is possible that growing and prosperous firms do willingly disclose information to outside constituents, while slumped companies are understandably reluctant to commit to disclosure. Firms having market investors, highest in hybrid firms, are suggested to show better performance, as those enterprises may be pressured to change their strategies to boost their performance while keeping internal linkages intact and selectively incorporating several governance reforms. But also those market investors are found to invest in high-performing firms to start with. It is then unfortunate that product-market sides of corporate reforms in Japan do not receive an adequate attention in the entire volume. The impact of governance on corporate strategies, which may ultimately affect firm performance, is for the most part missing. Chapter 8 on business portfolio restructuring authored by Kikutani, Itoh and Hayashida is informative and interesting by itself, but that chapter somehow does not examine the critical issues of how corporate governance parameters affect strategy restructuring or vice versa.

Even with all the theoretical argument and empirical evidence provided in the volume, a concluding argument that proclaims the EMIL model to be alternative to the US-model of governance in terms of its effectiveness seems rather overstretching. The editors argue on page 40 that "hybrid groups have strong performance, and thus Aoki's EMIL model may quite possibly be a viable alternative to corporate governance based on shareholder value that is devoid of a stakeholder element." That logical extrapolation remains to be tested in future, because we do not have the appropriate and sufficient sample yet in Japan to measure the performance effects of US-type of governance relative to those of EMIL or any other models. It is interesting to note that Ronald Dore in Chapter 13, which adopts a different approach relative to all other chapters, brings up this concern, when he philosophically argues against U.S.-type shareholder-centered governance model. It thus remains unclear whether the combination of the internal linkage efficiency with external monitoring exemplified in Japanese corporations represents the best choice among available alternatives.

This volume in the end stands as an epoch-making achievement. It certainly succeeds in introducing international as well as Japanese readers to the evolving world of Japanese corporate governance. The aforementioned reservations and drawbacks should not undermine the significant and timely contributions collectively made by the authors of the present book. The utmost scholarship of *Corporate Governance in Japan* should remain a standard intellectual compendium for any future research on and practice of Japanese corporate governance for some time to come.