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In retrospect, the early 1990s can be regarded as a threshold in the post-war history of Japan's political economy. In the political domain, the half-century-long, one-party rule of the Liberal Democratic Party (LDP) came to an end in 1993. By then it also became clear that the bubble in financial and real-estate markets had burst. These two events ushered in a period of unprecedented uncertainties, as well as various trials and errors in the polity and the economy in response to them. Economy-wise, this period is conventionally characterized as a prolonged deflationary phase¹ and many have blamed the faults of the macro-economic policy for the malaise. It became the fashion among the media, and even in academia, to dub the period a "lost decade," referring to the losses of wealth, growth potential, secure permanent-employment jobs and even social morale. Challenging this popular view, I have been maintaining for a few years by now that the past decade may be more properly characterized as *a decade of flux*, meaning an unfinished period of institutional change.²

Underlying the apparent depression, competition among firms became keener during the period and managerial responses to the challenge of deflationary pressures, as well as the rise of industrial China, the IT revolution and so on, have steadily differentiated the better performers from the laggards and losers in the industry. Through this process, economic practices have been undergoing various changes of substantial magnitude. In the political domain, the LDP eventually returned to the position of ruling

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¹ This popular characterization is somewhat mistaken in that the Japanese economy actually registered a positive growth rate in the mid-1990s.

² A series of my essays on this view were collected in Aoki [2002].

party in coalition with other parties, but the continuity of its power could no longer be taken for granted without electoral support. This competitive prospect in the polity has been ushering in gradual changes in the power structures of politicians and their relationships with various interest groups and bureaucrats.³ These changes in the economic and political domains have been mutually reinforcing each other. Thus, I posit that although there may not have been any single event signaling a dramatic institutional change in either the political or economic domain, the cumulative effects of incremental changes are already substantial and irreversible. This evolutionary process is still ongoing and it's likely to continue for some time, even for another decade or more, for the reasons I will soon argue.

A corporate governance institution, roughly understood as the accepted rules of the game among the corporate stakeholders governing the corporation, is not an exception. In this domain as well, there have been changes in formal laws, practices, relationships with the polity, etc., so that the old rules of the game can no longer be taken for granted, but new rules are still being sought and are in the process of evolving. However, this may be a good time for us to take stock of the cumulative changes achieved so far, and examine their implications and prospects with the help of the factual information and empirical analysis that has been assembled in preceding chapters of this book, as well as the analytical tools developed in comparative institutional analysis. This *Afterword* provides a tentative note in that direction.

It is composed as follows: Section 1 provides some illustrative evidence of changes that are taking place in Japan's corporate landscape. However, without a certain conceptual framework, the anecdotal evidence alone may not be sufficient for us to infer whether Japan's corporate governance is making a substantive institutional transformation; and, if it is, in which direction. Therefore in the following two sections, we make a detour into theoretical discussions. First, we discuss how corporate governance can be generally understood as an institution and thus its change as an institutional change. Second, we present four stylized analytical models of corporate governance and try to identify the conditions that could make respective models viable (i.e., institutionalized). Then in

³ See Toya [2005] for an early account of this process.

Section 4 we return to Japanese scene and examine the driving forces, as well as the historical constraints, of changes in the corporate landscape. By interpreting these factors in the light of previous theoretical discussion, the last section indicates that the nature of on-going institutional change in Japan's corporate governance can be interpreted as a possible transition from the traditional bank-oriented model to a hybrid model, which attends to possible complementarities between a managerial choice of business model, employees' human assets, and stock market evaluations. External monitoring by an informative stock market would help, if not exclusively, evaluate the valuable internal linkage between a managerial business model and specific human assets. Stock market signals summarize a variety of information, expectations and values prevailing in the economy. However, for effective corporate governance to be implemented, there needs to be a further firm-specific mechanism to translate those signals into a selection/replacement of management, whenever appropriate, which constitutes the core of corporate governance. In this regard, no single mechanism has emerged as a dominant pattern, but a variety of patterns seems to be evolving and a reason for it will be discussed.

1. Changing Corporate Landscape: Anecdotal Evidence

In order to highlight the changes taking place in the Japan's corporate landscape in the past decade or so, let us first quote the stylized features of the preceding system, -- which we will refer to as the *traditional J-system* for the sake of referential convenience.⁴ They are:

- Top management of the corporate firm was considered the pinnacle of the career ladder for permanent employees. The Board of Directors, almost exclusively composed of insiders, functioned as a substructure of top management (the representative directors).

- One of the main objectives of management was to provide steadily growing benefits to its permanent employees in the form of seniority wages, promotion opportunities, bonus and severance payments, fringe

⁴ See Aoki [1900], Aoki, Patrick and Sheard [1994] for a more detailed characterization discussion of the J-system.

benefits and so on, subject to a reasonable level of profits (the so-called “J-firm”).

- The main bank was the major supplier of funds to the corporate firm. Other financial institutions and investors expected the main bank to be a principal monitor of the firm (the so-called “delegated monitoring”). The main bank did not overtly intervene with the management of firms in excellent corporate-value state, but was expected to decide whether to bail out and restructure firms in a critical corporate-value state at its own cost, or liquidate them (the so-called “contingent governance”).
- The government regulated the banking industry to assure rents to individual banks according to their ranking. It also intervened, if necessary, to bail out financially distressed banks or arrange for their acquisition by healthier banks (the so-called “Convoy system”). More broadly, this system is embedded in the following unique political-economy institution.
- One-party rule by the LDP was taken for granted. Under such political stability, triadic coalitions among LDP politicians, interest groups and ministerial bureaucrats were formed in parallel along various industrial, occupational and professional lines to protect mutual vested interests of the incumbents (the so-called “bureau-pluralism or “compartmentalized pluralism [*shikirareta tagenshugi*]).

The traditional J-system characterized by these features started to ebb even in the 1980s.⁵ However, it was only after the bubble burst that changes became evident. In contrast to the above features of the traditional J-system, we now observe:

- Corporate Code reform in 2002 made corporate firms to choose between two options for board structure: the American-type system with independent subcommittees (on auditing, managerial compensation and nomination) or a modified traditional system with a semi-independent

⁵ An early account of this tendency by the author may be found in Aoki [1988], Ch. 7, particularly, pp.293-7.

statutory auditor's board (Gilson and Milahaupt[2004], Shishido [Chapter 11]). By 2005, more than sixty major companies (including Sony, Oryx, Toshiba, Hitachi, Nomura Holdings) had adopted the American-type system.⁶ ⁷Even among companies that opted for the second alternative, there seems to be some tendency toward including a greater number of outside directors, although the definition of independency of outside directors is not as rigorous as in Sarbanes-Oxley Act of 2002 in the U.S.

- The Boards and top management of listed companies are now increasingly exposed to the open evaluation of the stock market as a result of the unwinding of cross-stockholding (Miyajima and Kuroki [Chapter 4]). At the height of the bubble, the holdings of tradable stocks by financial institutions rose to almost fifty percent of total stockholdings. They are now down to around twenty percent. On the other hand, individuals and foreigners now hold close to fifty percent in a more or less arms'-length manner. Particularly, the propensity of foreign portfolio investors to trade shares more frequently strongly influences share prices and made exit a particular threat to firms (Ahmadjian [Chapter 3]). A noticeable number of bank and securities company employees, as well as bureaucrats, left their permanently employed jobs and joined/formed investment funds or other financial service companies to take advantage of their expertise.⁸

- Facing increasingly active and unpredictable stock market trading, the managers of listed companies are now much more alert to potential take-over threats. One incident, which attracted wide attention, was the take-over attempt of Nippon Broadcasting System, Inc. (NBS: No 1 in sales in the broadcasting industry) by Livedoor Co., Ltd. (LD) in the

⁶ The Japan Association of Corporate Directors, a voluntary organization of directors, academics, lawyers, accountants, and so on, is campaigning to increase the number of corporations adopting the American-type system to 300 within a few years.

⁷ A dramatic example of the consequences of these changes was the Sony's Board action to replace top managements in 2005 in response to poor corporate performance, which was reported to be pushed by the active involvement of independent directors.

⁸ A well known example is Mr. Murakami, a former bureaucrat of MITI, who manages MAC asset management funds worth several billion US dollars with aggressive American type stockholder activism.

winter of 2005.⁹ LD quietly acquired more than 30 percent of NBS's shares off the exchange floor, in lieu of open take-over bids, by taking advantage of a loophole in stock exchange regulations then. The management of NBS attempted to counteract to the threat by issuing new equity subscription rights amounting to 150 percent of issued capital and assigning them to Fuji TV Network, Inc., a friendly company that owned 12 percent of NBS. LD appealed to the court for an injunction. After widely publicized court debates, the Tokyo District Court judged that NBS's plan was "unjust". It stipulated that "the Board of Directors, which is nothing but the executive organ of the corporation, shall not decide the composition of corporate control," implicitly endorsing the doctrine of stockholder sovereignty. Although the one who elicited this stockholder-friendly court judgment was ironically LD which was indicted later for illegal stock trading, spreading of false financial information and accounting fraud, this case is noteworthy in that judgments of the court are becoming critical to settling corporate disputes.¹⁰ Now the public debate is under way regarding whether the so-called poison pill should be legally permitted and, if so, under what conditions so as not to provide unconditional entrenchment for incumbent managers.

- In 1995 bureaucrats at the Ministry of Finance (MOF) were busy figuring out ways to liquidate *Jusen* companies (Home Financing Corporations) which suffered from non-performing loans to land speculators worth seven trillion yen. Agricultural cooperative financial institutions were major lenders to these companies, while banks were major owner-cum-lenders. The agricultural interests were able to recover most

⁹ This company, founded by a then-college-student named Horie with Y6 million initial capital in the late 1990s, increased its market value to Y800billion in 2005. But in 2006 the top management was indicted by the Public Prosecutors Office for corporate account fraud and spreading false financial information.

¹⁰ Another legal case which may be considered even more important than the case of LD vs. NBS in the sense of involvement of established firms is the one in which Sumitomo Trust Bank (STB) appealed an injunction of the merger of two mega financial institutions, Mitsubishi-Tokyo Financial Group (MTFG) and UFJ, in 2004 on the ground that STB had a prior agreement to be merged with the trust division of UFJ. This appeal was denied by the court, but it is said that since the incident even traditional firms have become very careful about how to draw contracts with each other in order to avoid possible law suits.

of their loans to *Jusen* thanks to the infusion of public funds made possible by the powerful lobby activities of allied politicians. Their logic was that the main banks should be the ones to assume major responsibility, not other lenders. This case made the prospect of injecting public funds into the ailing financial sector enormously unpopular and the government grew timid about overtly engaging in it. Delays in injecting public funds certainly deepened and prolonged the magnitude of the financial crisis but it had the unintended consequence of eventually more or less alienating the financial authorities from the financial industries. The Banking Bureau and Securities Bureau of the MOF, which had formed exclusive collusions with respective industries to protect the vested interests of the incumbents, were made organizationally severed from the Ministry in the 1997 Administrative Reform and were reorganized as the Financial Services Agency (FSA). The Agency became pressured to be engaged in monitoring the financial soundness of banks in arms'-length manner, sometimes even in an adversarial manner. The restructuring of the banking and securities industries is now largely left to the private sector. In this way, an essential feature of the so-called "convoy-system" seems to have been laid to rest.

- Some of the overt attempts by the government to bail-out distressed firms did not yield good results, as was the case of The Daiei, Inc., a supermarket giant. Direct and discretionary intervention in industrial restructuring by the government is now increasingly looked on with suspicion. In response, the Industry Revitalization Corporation of Japan was funded with public funds for the purpose of more transparent public involvement in financially distressed firm, with its management recruited from the private sector.¹¹ Civil Rehabilitation Law (2000) introduced a Chapter 11-like provision and gives incentives to distressed firms to file for bankruptcy earlier. Foreign-owned equity funds, bank-related corporate revival funds and other financial services are in place and have replaced commercial banks as major players in

¹¹ The Industry Revitalization Corporation of Japan now plans to complete its tasks and dissolve itself one year ahead of schedule because its missions seems to be successfully fulfilled.

reorganizing/rehabilitating the financially-depressed firms (see Xu [Chapter 6] and Yanagawa [Chapter 7]). Markets for corporate assets are growing in a size and scope that was never seen before the burst of bubble (Kikutani, Itoh, and Hayashida [Chapter 8]). The number of M&A increased more than quadrupled between 1985 and 1995.

- Some major companies have gone through large-scale restructuring by reducing the number of their permanent employees without necessarily breaking the long-term employment commitment by using of transfers of their employees to their subsidiaries and related firms, hiring freeze/cut, as well as early retirement.¹² Macro-wise, between 1995 and 2005, the number of regular employees decreased by 4.1 million, while temporary employees in various categories increased by 6.5 million. It seems fair to say that many Japanese firms still commit to the permanent employment system, but the core has shrunk (Jackson [Chapter 10]).¹³
- In the 2005 election of the Lower House, Premier Koizumi led the LDP to a landslide victory by campaigning for the privatization of Japan Post. This one-issue platform was meant to be targeted at the so-called “reform-resisting power,” i.e., coalitions between politicians (both inside and outside the LDP), specific interest groups, and the bureaucracy. He succeeded in expelling those politicians opposing to the privatization from the LDP. Thus the institution of buraupluralism seems to face a critical phase.¹⁴

¹² For example, an integrated steel company reduced the size of permanent employees by more than half, although it was said to have cost them about thirty million yen per employee in severance payments and early retirement incentives. Partly through the employment reduction and partly through the recovery of markets, its market value increased fourfold in 2005.

¹³ Kato [2001] contrasted the job retention rates of Japanese and U.S. work before and after the burst of the bubble. It turned out that the job retention rates of Japanese employees did not fall significantly from the period prior to the burst of the bubble economy in the late 1980s to the post-bubble period.

¹⁴ After the end of the one-party dominance of the LDP in 1993, a change in the parliamentary election system from a multiple-seat district system to a single-seat district system was introduced and several elections have taken place since then in both the Upper and Lower Houses. In the old system, politicians from the same party representing different interest groups were electable in tandem in each district. Thus, interest mediation within the ruling party and through the administrative process (e.g., budgetary expenditures, entry-restricting regulations) became a political focal point,

The facts cited above are meant to be only illustrative at this point. But in taking them together, it may be hard not to have an impression of considerable changes in the landscape of Japan's corporate world and its environment. But is this impression substantiated? In other words, is Japan's corporate world in general, and corporate governance in particular, undergoing an irreversible change? If so, in which direction? Is the stock market discipline going to exercise a dominant impact on corporate management as in the U.S.?¹⁵ Can the management afford not to heed to the voice of the employees any more? Or, is the reduction in the size of permanent employees just an inevitable, temporary reaction to the prolonged deflation and does the old model still persist? Alternatively, is Japan's corporate sector in the process of an earnest search for a model of its own, adaptable to the evolving environment? If so, is it moving in a "good" or "bad" direction?¹⁶ In what way are changes in the corporate domain related to changes in the political domain? To consider these and related issues, it may be helpful to introduce first a coherent conceptual and analytical framework of institutional analysis, by which several prototypes of corporate governance structure, as well as associated fitting conditions, can be identified.

2. How Corporate Governance Can Be Understood as an Institution

leading to the institutionalization of bureau-pluralism. However, after the electoral system change, it has become increasingly difficult for politicians representing a particular interest group to be elected. Thus the power of the Prime Minister in policy-making and endorsing party candidates has been gradually strengthened. The 2005 election may be regarded as a spectacular manifestation of this on-going tendency.

¹⁵ Actually even in the U.S., some evidence seems to point to the rather weak stock market discipline (e.g., statistically significant yet economically insignificant pay-performance sensitivities and the "trouble with stock options"). To this end, the ongoing controversy between the optional contracting school (e.g., Murphy[2002]) and the managerial power school (e.g., Bebchuk *et al* [2002]) may be important and informative.

¹⁶ Such normative question is raised explicitly only by Dore [Chapter 13] in this book. Below I will not deal with the normative issue as such, but implicitly suggest ways by which evolving patterns could be improved for better corporate performance. My stance may appear somewhat at odds with Dore's critical position of the present trend, but this difference may be reduced to a difference in assessing whether the present trend is toward the American-type system (Dore) or not (myself).

An important conceptual issue was first raised in a seminal debate between Dodd and Bearle in the early 1930s regarding whether the corporation is the property of the stockholders, or if the board should owe fiduciary duties to the stakeholders in general. It does not seem that this issue has been resolved yet. One view became more powerful and prevalent at one time, but then to be replaced by the other in response to emergent business landscape, particular events (such as the Asian financial crisis, the Enron scandal) and so on. Notwithstanding this unsettled fundamental issue, corporate governance has been regarded for a long time as a matter of legal design. True, the kinds of recent changes in the structure and composition of board rooms in Japan, as referred to above, would not have been possible without formal changes in the Commercial Code. However, even if formal rules are written, there is no guarantee that they will be followed and/or enforced as the legislators intended.¹⁷ Visions of corporate governance implicit in a law will become viable and sustainable only if it generates the proper incentives, expectations and calculations on the side of the concerned parties (stakeholders). The case of the 2003 Commercial Code poses the issue in a straightforward and unique way. The purpose of introducing the options in board structures, which Gilson and Milhaupt call “an enabling strategy of reform”, may have been to experiment with diversity and let evolutionary selection occur. Law itself cannot implement diversity, however. Only decentralized decisions by corporate firms will do.

We may say then in analogy with the game that the law defines the formal rules, but what we should ultimately be concerned with are the “ways by which the game is actually played,” or what we may call the endogenous rules of the game. The players may not necessarily follow the formal rules of the game; the referees (law enforcers and regulators) would not, or may not be competent to, enforce the formal rules; and the spectators (public) may

¹⁷ For example, the old Japanese Commercial Code was exceptionally generous to the stockholders in that a proposal for the election and replacement of the board members could be made at a stockholders’ meeting by any stockholder who owned at least one percent of the stock. However, this statutory provision provided incentives among the managers to devise countermeasures to preserve their autonomy: such as implicitly colluding among themselves to hold stockholders’ meetings on the same day of each year or implicitly or secretly bribing professional trouble makers, called *sokaiya*, who collected minority shares. Such practices are now fading, however, because more stringent law enforcement and increasing public awareness of corporate social responsibility reinforce each other.

jeer at the players/referees in one way or another. Simplifying the game-like discussion, let us first consider only the following four generic classes of stakeholders as the players of the game: the investors who invest in financial instruments issued by firms; the employees who invest in organization-specific human assets; the manager who directs the use of these financial and human resources in “non-contractible” events,¹⁸ but who may have interests of his or her own (e.g., income, career concerns, perks, prestige, social reputation, etc.); and the consumers who collectively assess the activities of the firm by buying or not buying its outputs (i.e., the market). Depending on its market performance (i.e., market evaluation by the consumers), the firm may be roughly in either of three states in producing value: excellent, normal, or depressed. The gross value added by the firm may be distributed among the investors, the employees, and the manager according to certain rules (by contracts, conventions, discretion, etc.). Each of them may be happy or unhappy with the outcome. In response, the investors and the employees will strategically choose their actions. In particular, in the depressed corporate-value state, they may choose some punishment or non-cooperation against the manager, possibly with the help of other parties (such as the court, take-over raiders, reorganization specialists, industrial unions, the government, etc.). In anticipation of these responses, the manager will adapt his behavior and choices in the use of financial and human resources under its command beforehand.

We can then identify a firm’s corporate governance mechanism with a set of rules (formal or informal) that regulate the action choices of the stakeholders contingent on the value state of the firm. In particular, the crux of such a mechanism may be in the managers’ behavioral beliefs regarding the plausible strategic reactions of other parties in the depressed corporate-value state.¹⁹ Such beliefs would in turn constrain and discipline his or her action choices *ex ante* (in other contingencies). If such a set of rules is believed to operate generally across firms, we refer to it as a

¹⁸ The rights to control assets in uncontractible events, called the “residual rights of control,” are reckoned as the essence of property rights and are made the focus of the property rights theory of contracts and governance as represented by Hart [1995].

¹⁹ The point that the crux of governance lies in the manager’s selection is mentioned as early as Knight, who argued that “in organized activity the *crucial* decision is the selection of men to make decisions. all of which follows from the very nature of large-scale control, based on the replacement of knowledge of things by knowledge of men.”([1921] p.297)

corporate governance institution. This corresponds to a situation in which typical parties will not expect a unilateral deviation from it to be beneficial so they will comply with it.²⁰ Rules embodied in statutory law can constitute part of a corporate governance institution if every concerned party expects that the enforcer himself finds it beneficial to enforce them (fearing the loss of social reputation, punishment, public criticism, etc.). But there are self-enforcing rules not necessarily enforced by the law enforcer. Examples of these are customs, self-enforcing contracts and agreements (due to reputation concerns, trust, etc.), implicit collusions among a subclass of concerned parties, and so on.

I claim that this institution-as-self-sustaining-rules view has several advantages.²¹ Particularly, we can identify multiple sets of rules that are viable under certain conditions, thus a diversity of institutions, rather than enumerate them on an ad hoc basis or regard only a certain particular set of rules viable and/or normatively correct. Certainly a set of rules to guarantee the “maximum returns to the investors” as the only “owner of corporate property”²² could be one possibility, but it may not be the only one. Furthermore, we can identify conditions, such as the institutional characteristics of the polity, prevailing social norms, labor relations, historical legacy and so on, that fit each of the possible models so that we can predict which kind of institution is likely to emerge under certain conditions.

3. Four Prototype Institutions of Corporate Governance

In the literature various types of corporate governance structures are discussed and their advantages and disadvantages are compared. In this section I briefly describe four stylized models of corporate governance. All of them except for the last are derived from rigorously formulated game-theoretic models.²³ Thus all of them are bound to have unrealistic features in certain respects as a description of an actual corporate governance institution. However, they can be useful for pinpointing

²⁰ This corresponds to the “institution-as-equilibrium” view. See Aoki [2001] and Greif [2006] for this view.

²¹ For more detail, see Aoki [2001] particularly Chapter 1.

²² This main-stream view of corporate governance is surveyed by Shleifer and Vishny [1997].

²³ See Aoki [2001], chapters 5, 11 and 12.

conditions of technology, institutional environments of corporate governance, etc., that would make them viable and efficient in the use of human and physical resources.

- *Stockholder-Sovereignty (SS Model)*. This is the most widely discussed model, as well as the most widely supported, in the orthodox literature. An authoritative economic-theoretical foundation for this model can be found in the writings of property-rights theorists as represented by Hart, who argued for the inseparability of ownership and management as a starting point.²⁴ A crucial assumption of his is that of complementarities between the managerial ability that is malleable with his/her effort and the right to control the use of physical assets in non-contractible events. That is, the value of the manager's incremental effort is assumed to be enhanced, if (s)he has discretionary rights for deciding how physical assets are to be used. If this is the case, then it follows that it is more efficient for the manager to own physical assets, provided that (s)he is not financially constrained. The employees may be contracted according to the level of firm-specific skills in which they invested. The value that the firm produces net of the contractual payments to the employees accrues to the owner-cum-manager as profit. This is the case of a neo-classical proprietor-run firm. If the manager is financially constrained and needs to rely on equity financing, then (s)he has to yield fundamental control rights to the stockholders and be subjected to an incentive contractual arrangement as an agent of the stockholders. The present value sum of expected streams of profit accruing to the stockholders is called the fundamental stock value [Note the distinction between the (gross) value-added by the firm inclusive of contractual payments to the employees and the stock value of the firm as residual after them]. The fear of replacement in the job in the event of a financially depressed state (i.e., career concerns), as well as the prospect of incentive payments in the event of an excellent corporate-value state, motivates the manager to make the best effort. Under this scheme, an investor who conceives of a new business plan to enhance the stock value may

²⁴ The following is an interpretation of the main points analyzed in Hart [2005] in the present context. See Aoki [2001], p. 119-23.

take over the firm through open bids in the stock market and replace the management. This event can occur, even if the implementation of the plan induces the reduction of gross value-added of the firm and accordingly the breach/termination of (implicit) contracts with the employees. The role of the government in this model could be that of the liberal state which would not interfere private employment contracting but only enforce private contracts as a third party.

- *Corporatism-Codetermination (D model)*. In the previous model, the employees are provided with incentive contracts for investment in firm-specific skills. Let us consider an alternative situation in which firms are situated in an institutional environment of social-compact corporatism where the wage rates are regulated according to standard job qualifications through collective bargaining between the industrial association and the industrial labor organization, while the government allows bargaining outcomes to be legally binding to all firms in relevant industries. Then an individual employer's ability is constrained in inducing the employees to acquire and use firm-specific skills with the promise of firm-specific payments. In such a situation, even if the interests of the manager and those of the employees are basically opposed in the distribution of control power over work (and the use of physical assets as a corollary), the sharing of control rights (e.g., in the form of the work council) will become of mutual interest. A sharing arrangement can be extended to the stockholding company as co-determination in which the board members are shared between the representatives of both the investors and employees.²⁵ This model is reminiscent of some basic aspects of corporate governance institution in Germany (thus the D-model referring to Deutch). Contrasting this model with the previous one suggests that there are institutional complementarities between corporatism and codetermination, on one

²⁵ In this setting, more external financing will be made in the form of long-term debt contracts than in the SS model. This is so, because in the context of co-determination, the investors and the employees have common preferences for debt-contacts in order to control the risky behavior of the manager, while the manager prefers to limit the residual rights of control by the stockholders. See Aoki [2001] pp.287-291 for a rigorous analysis. A proof of institutional complementarities between codetermination and the corporatist state is also given there.

hand, and between private employment contracting and the liberal state, on the other.

- *Relational Contingent Governance (RCG model)*. Instead of an exclusive complementary relationship between managerial effort and control rights over physical assets, assume that contributions to the gross value of the firm by the manager and the employees are mutually indistinguishable, while the physical resources supplied by outsiders are non-specific. In this case, an efficient governance structure dictates that the insiders (the employees and the managers) ought to hold control rights in excellent and normal corporate-value states, as well as receive residuals after contractual payments to the outsiders (the investors). As contributions of individual insiders to the total value are not clearly distinguishable, however, payments to them need to be regulated by organization-specific rules (such as payment by seniority, simple sharing, etc.) rather than as individual performance-based payments. In financially distressed state a particular monitoring agent ought to gain control rights and decide whether firm-specific human assets should be bailed out for continuation value or punished by the termination of the firm in the worst case, depending on the nature and magnitude of the crisis. Since the control rights shift between the insiders and the monitoring agent, contingent on the corporate-value state of the firm, this model can be called the contingent governance model.²⁶ As bailing out is often costly than liquidation in the short run for the monitoring agent, some rents need to be assured for it to be induced to assume the costs when necessary. Such rents can be guaranteed, if the agent can expect stable fees from long-run relationships with multiple firms and/or be insured for the monitoring costs by the government. Thus the position of the monitoring agent in this model vis-à-vis the firm as well as the government is relational so that the model may be characterized as the relational contingent governance (RCG). However such arrangements may lead to a soft-budget tendency for the monitoring agent, i.e., it may tend to bail out firms that should be punished by the termination,

²⁶ See Aoki [2001] chapter 11.3 for rigorous conceptualization and proofs of various properties claimed here.

because it could be less costly for them with the government protection. Although this model is a purely theoretical construct, the traditional Japanese governance structure emulated some basic aspects of it with the so-called main bank playing the role of the relational monitoring agent.²⁷

From the above three models, we can deduce that three factors may be crucial in determining a viable form of corporate governance: the nature of manager/employees' human assets and their relationships with physical assets and the government. Namely, in the SS and D models, the individual skills of the employees, either firm-specific or general, can be identifiable and are made individually contractible, while in the RCG model they are not and their rewards can contain elements of firm-wide sharing of values/losses. Secondly, the SS model presupposes complementarities between the manager's human assets and his(her) exclusive control over physical assets (that is, manager's human assets becomes more valuable when (s)he is endowed with exclusive control rights over physical assets) through the stockholders' agency relationship, while in the other models, the control of physical assets may be complementary to both the employees' and the manager's human assets (as in the D model) or to the employees' and manager's human assets combined (as in the RCC model). Thirdly, in the former two models, the role of the government may be characterized as "neutral" in the sense of a third-party contract enforcer (the so-called liberal state as in the SS model) or that of enabling employees' and employers' organizations to jointly attain the status of quasi-state organs (the so-called "enabling state"(Streeck [1977]) as in the D model). In the RCG model, the role of the government may become relational vis-a-vis the monitoring agents (banks) in assuring rents for them to make the model viable as an institution. From these observations, the following fourth model may be suggested as another possibility.

➤ *External Monitoring of Internal Linkage (EMIL Model).* Somewhat

²⁷ Some aspects of the relational contingent governance model may also be found in the relationship between the venture capital and the entrepreneurial firm, although it is not embedded in the protection of the government. See Aoki [2000] and [2001] p.302 and chapter 12; and Kaplan and Stromberg [2003].

analogously to complementarities between physical assets and managerial human assets in the SS model, consider possible complementarities between the *managerial business model* and employees' human assets. The managerial business model is a set of managerial constructs composed of such things as: organizational architecture, market strategies, an organization-specific reward system, relations with the labor union, the design of work environments, and the formulation of organizational mission codes to be shared by the employees. To repeat, complementarities imply that the employees are better off through being voluntarily associated with the relevant business model, while the business model can generate greater gross value by attracting and maintaining the employees willing to develop human assets specific to it.²⁸ The function of the management of the firm can be considered as the creation and sustenance of this productive internal linkage. Different from the SS model, the role of physical assets is regarded as secondary in that employed physical assets are composed of general-purpose machines, or relatively small in value in comparison to human assets. If 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 on 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 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

²⁸ The importance of similar complementarities between the firm and the human assets are emphasized by Rajan and Zingales [2000]

managers (Blair and Stout [1999]). 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. This model will work better if the government helps infrastructural services for stock markets to process corporate information more accurately and facilitate fair and equitable stock transactions.

4. Factors Triggering Changes in Japan's Corporate Governance

As mentioned already, some stylized features of the traditional J-system as summarized in the beginning of Section 1 are reminiscent of the RCG model with the main bank serving as the relational monitor. In the light of theoretical proposition in the previous section, it makes sense in that the sharing of information between the management and the *genba* (work spots), as well as among the *genba*, was an established custom within the J-firm facilitated by its practice of ambiguous job demarcation, job rotation, life-time internal career development, etc.²⁹ The RCG model-like, information-sharing practice co-evolved with the permanent employment system (the absence of active labor mobility), the main bank system, and bureau-pluralism as complementary institutions.³⁰ On the other hand, contrary to frequently-made casual references to the “Rhein model”(Albert [1991]), the German-Japanese model of relational financing and the like, the comparison of the D model and the RCG model helps us understand that the Japanese main bank system and the German codetermination system cannot be simply lumped together in the same class of corporate governance. They operated on quite different mechanisms in terms of industrial relations, contractual arrangements, selection/ replacement of management and so on, not to mention their differences in statutory legal arrangements. Therefore we expect that there have also been path-dependent differences in their responses to changes in market and technological environments that have started to accelerate since the 1980s. Let us briefly review some basic impacts of these changes on the Japanese system.

First, the gradual opening of financial markets which started in the early

²⁹ For information-sharing within the J-firm, see Aoki [1988] Chapter 2, [1990].

³⁰ For these institutional complementarities and their historical origins, see Aoki [2001] chapter 13.

1980s allowed better-run firms to rely on various financial instruments including bonds and equity issues abroad. Japanese banks steadily lost better corporate clients and failed to adapt to this new market environment. As is well known, their soft-budgeting tendency was blown up into becoming one of the major driving forces of the bubble in the late 1980s, culminating in their own crisis after it burst. However, the eclipse of the main bank system and the globalization of financial markets eased constraints for the management of the J-firm to experiment on various business models (see Jackson and Miyajima [Chapter 1]). This is because institutional complementarities between a financial institution and other institutions (in employment, innovation, supply relations, polity, etc.) imply that a change in one of them can trigger changes in the other and create momentum for cumulative, mutually reinforcing changes – the phenomena conceptualized as dynamic institutional complementarities. The presence of institutional complementarities is one reason for the robustness of institutional arrangements, but also can become a source for generating over-all institutional adaptations if the complementary linkage is broken somewhere.³¹ More on this to follow.

Second, as product markets became more mature and globalized with technological innovation progressing at an unprecedented rate, the structure of industrial competition became more complex, making the expansion of shares in an existing market obsolete as a corporate objective as well as corporate evaluative criterion. Competition over managerial business models becomes fierce across markets, continuously creating new markets. So a new mechanism of evaluating corporate firms has become a necessity. It became evident that banks, entrenched in relational financing, could not perform a proper monitoring role in this respect. Instead, as we have noted already in Section 1, management of the corporate firm is more watchful than ever of stock market performance as an external evaluative mechanism.

Third, the progress of communication and information technology introduced dramatic impacts on the value of (tacit) information-sharing among agents within an organization, as well as within a particular collusive

³¹ See Aoki [2000] Chapter 10 for analytical treatments of dynamic institutional complementarities and Chapter 10 for their application to the Japanese economic history since the 1930s. Also, see Aoki [2006] for a summary exposition.

group. As far as a primary reason for exclusive information sharing was the limit of available information channels, it has been steadily overcome by the increasing capacity of digitalized communications and the associated social demands for information disclosure and transparency. Even some of the tacit know-how at work spots has become digitalizable through computer-guided design, computer-controlled machines and the like. People no longer need to spend most of their time communicating face-to-face with a fixed number of partners to gain useful information. Mobile phones, the internet, e-mail and so on have dramatically changed the patterns, scope and range of communications among people. These impacts of information and communication technology can be considered as one of most important reasons for the apparent erosion of competitiveness of Japanese firms, which were able to take advantage of the value of tacit information-sharing in the pre-IT revolution era of the 1980s.³²

In spite of all this, however, there still seems to be valuable information which cannot be digitalized, at least within a short period of time, but can be shared among a small number of people with particular common interests and complementary areas of competence, and are potentially valuable in generating new ideas (such as business strategies, technological innovation, work improvement on spots (*kaizen*), etc.).³³ The paradox is that such information sharing in a niche could become potentially more valuable precisely because it is novel and scarce in the context of the increasing amount of information widely shared in the public domain.

Indeed, we have observed divergent responses among Japanese corporate firms in this regard. The better performers often belong to the type of firm that continues to foster and utilize valuable information-sharing among its employees in combination with the complementary use of emergent information technology. This type may look superficially similar to the traditional J-firm, but there is a non-negligible difference that was shaped during the past decade or so in that the leadership of management

³² See Aoki [1988] and [1990] for the view that the competitiveness of the Japanese manufacturing industry up to the late 1980s was very much reliant on the use of tacit knowledge shared among the workers on the shop floor, as well as between the workers and the management, the R&D organization and the shop floor, and the prime manufacturer and suppliers.

³³ See Cowan *et al* [2000] and Aoki [2001] Chapter 12.1 for a taxonomy of knowledge by which some type of tacit knowledge may be regarded as economically valuable.

plays a much more active role in terms of the design of organizational architecture that fits the new information technology (e.g., a flatter, modular structure³⁴; spinning-off of affiliated firms rather than a large integrated firms³⁵), a reward system to elicit employees' cooperation and individual initiatives in a balanced way and so on. Even on-site *kaizen* (work improvement) movement has been reformed with more emphasis on the active role of the local leadership.³⁶ In these firms the sustenance of the permanent employment system is still regarded as important,³⁷ although it has been modified in terms of promotion schemes and reward systems with a certain degree of competitive elements (Jackson [Chapter 10]). On the other hand, there seem to be two types of mediocre to problematic performers. Some of them were hasty in emulating the so-called Western style reward system based on individual performance evaluation, destroying the spirit of valuable information sharing.³⁸ The others are led by old-fashioned managers who confine themselves to passively mediating various interest groups within an organization rather than taking the initiative in formulating a competitive business model in response to the new informational and market environments. They often try to rely on outdated collusive networks within the framework of ebbing bureau-pluralism in an attempt to hold on to losing ground.³⁹

5. The Emergence of a Hybrid Model?

In facing the challenges described above, Japanese firms have been strenuously trying to adapt their business models, human assets, and

³⁴ For the innovativeness of the modular organization in a complex system, see Baldwin and Clark [2000]. See also Aoki [2001] Chapter 4, where the value of information encapsulation (modularization) is discussed.

³⁵ Kikutani, Itoh and Hayashi [Chapter 8] analyze this tendency of Japanese firms.

³⁶ For example, a field work by Kato (unpublished) shows that there is a more advanced and sophisticated case which introduced a full-time kaizen support group whose main job was to assist various kaizen teams by doing experiments for them.

³⁷ Consider the case of Toyota Motor Corporation that was downgraded by international bond rating companies immediately after the Asian financial crisis because of its permanent employment practices, but is still enjoying one of the highest stock values in the manufacturing industry.

³⁸ This type is conspicuously found among laggards in the electric machinery industry, once considered the most competitive industry.

³⁹ Miyajima and Kuroki [Chapter 4] detected that low-performing firms tend to sustain main bank relationships with mutual stockholdings.

associated corporate governance mechanisms in one way or another. As a result, the traditional RCG-type institution appears to be in eclipse as the behavioral beliefs and practices characterizing it cannot be taken for granted anymore. On the other hand, a clear alternative pattern has not yet emerged as the universally accepted rules of the game regulating the interactions of the corporate stakeholders. However, if we interpret the anecdotal changes described in Section 1 in the light of the theoretical models in the previous Section, we may interpret the emergent pattern as somewhat analogous to a hybrid between the EMIL model and the RCG model. In general, the presence of institutional complementarities is thought to preclude the possibility of a hybrid institution.⁴⁰ But, as discussed in the last section, the opening of financial markets has eased the constraints on institutional choice in other domains. For example, some action choices that were not supported by the traditional main bank system may become viable in Japan.

Indeed, diverse patterns are being observed, and will be observed for some time, in the areas of organizational architecture, employment practices, market strategies, supplier relations, industrial relations, and so on.⁴¹ Those diverse business models need to be compared and assessed in terms of the values generated in possible cooperation with the employees' human assets. As a mechanism of evaluation of the value of the internal linkage between a business model and human assets, product market evaluations (thus current profit) are fundamental. However, the product market can evaluate only the present outcome of the internal linkage, not possible outcomes in the future. Also, a valuable internal linkage takes time to build. In the previous section, I suggested that the bank may not be up to the task. Although they may still be in a good position to find a worsened financial state of the firm relatively early, but their time-horizon may not be far enough in the evolving complex environments. Instead, stock markets may be potentially in a better position to predict future outcomes by aggregating dispersed information, expectations and values prevailing in the

⁴⁰ It is because the presence of complementarities normally involves the non convexity of sustainable choice combinations. See Aoki [2001], chapter 8.3.

⁴¹ These diversities (particularly in organizational architecture) are described and their implications for institutional change are discussed by Jackson and Miyajima [Chapter 1] and Sako [Chapter 14].

economy if they can filter noises to a reasonably degree.⁴² Of course, the last condition, which I will come back to shortly, is a long way from being taken for granted.

Even if the stock market is hypothetically assumed to be informative for a moment, a corporate governance structure may not be complete with just that, however. One more critical question still remains to be resolved: How can a stock market evaluation of an individual firm be used effectively in the selection and replacement of management at the firm level? Remember the crux of corporate governance lies in the way in which management is selected and replaced when necessary. In the RCG-like institution of the traditional J-system, the control in this respect was arranged in a contingent manner. That is, in excellent and normal states of gross corporate-value of the firm, the mechanism was firmly gripped by the insiders (the top management was selected by internal promotion without any outside intervention), while in the critical state control rights shifted to the main bank. In the currently evolving situation, the insiders seem to retain effective control as far as the corporate-value state seems to be without problem. But who will exercise the disciplinary function in critical state of corporate-value? No single solution seems to have been established yet.

For small and medium-sized firms, as well as large firms with large bank loans, there may be still cases in which banks can perform major monitoring and disciplinary functions. But for large firms with rather limited bank loans, not to say of those with no bank loans, the ability of the banks to correct poor management before a real crisis becomes evident is definitely limited, even if they play certain roles in arranging a bail-out or liquidation of failed firms *ex post*.⁴³ Even in this case, the banks are not embedded in the protective framework of bureau-pluraism any more, as we noted already, so that their involvement may be more passive.⁴⁴ One possible alternative to the bank's disciplinary role would be to transform the board of directors from the traditional status of a management substructure into a

⁴² In fact, market prices cannot be completely perfect. If all information available in the economy can be immediately and completely reflected in market prices, then nobody would be motivated to collect information. Grossman and Stiglitz [1980].

⁴³ Xu [Chapter 6] provides evidences of the tendency for banks not to bail out distressed firms until bankruptcy is filed.

⁴⁴ However, Arikawa and Miyajima [Chapter 2] detected some evidences of soft-budgeting tendency toward laggard firms in the early 1990s.

quasi-independent body that could discipline top executive management in critical state of corporate-value. As noted already, some firms may be heading somewhat in that direction by adopting a board structure with independent subcommittees or increasing the number of independent directors.⁴⁵ How it will work has yet to be seen, but an experiment is certainly worthwhile.⁴⁶ For start-up firms which are not mature yet for stock market evaluation, venture capital firms that act as sort of market surrogates in a relational manner are gradually gaining visibility.⁴⁷ For the time being, a variety of mechanisms may be tried for using stock market signals for the governance of individual firms, subject to evolutionary selection.⁴⁸

Even if stock market evaluation progresses in Japan, it is unlikely that Japan's corporate governance institution will transit to an SS-type model reminiscent of the American system, however. For one thing, a transition from the RCG to the RCG-EMIL hybrid model would imply a shift from the practice of *sharing* of information, responsibilities, and outcomes between the management and the employees, to the development of firm-specific *complementary* relationships between the two. To repeat, these relationships presume more autonomous leadership roles of the management in designing business models than in the old CGS-like model, yet require specific employees' human assets fitting, and associated with, the models. This shift appears to be evolutionarily fitter than a shift to a clear demarcation of the management and the employees through individual contractual relationships as in the SS model.⁴⁹ Therefore, it might be quite

⁴⁵ One of the proposals that seem to be widely supported in the current discussion on corporate governance reform is that the provision of poison pill might be allowed if the board of directors, with a majority of outside directors, approves it. Such a stipulation might provide incentives for the company to make the board more open and independent.

⁴⁶ Gilson and Milhaupt [2005] suggests that, at least as currently structured, we should not expect too much from these committees. p

⁴⁷ See Hatta, Ando and Ishii [Chapter 5]. See also Aoki [2000], Kaplan and Stromberg [2003] and Rajan and Zingales [2000] for the nature of the corporate governance role of the venture capital firm.

⁴⁸ Another alternative is the model in which the founder family, albeit of relatively small holdings, exercises effective control over the executive management. Practices akin to this model can be found in companies like Toyota Motor Corporation and Suntory, Ltd.

⁴⁹ Abe and Hoshi [Chapter 9], as well as Jackson [Chapter 10], provide some empirical support for this prediction. They find that an increase in foreign ownership does not necessarily lead to a distinctive modification of human resource management, even

possible that the voice of employees, implicitly or overtly, will continue to play a part in the managerial formulation of business models, if not directly in the mechanism of corporate governance as in the D-model.⁵⁰

Finally, I will add a few words regarding the relationships between corporate governance and the polity. Needless to say, in order for an informative stock market to evolve, there must be an effective mechanism to filter the noise in processing corporate information and forming a fundamental stock value from it. For that to occur, there must be shared beliefs among market participants that regulatory rules are formulated and enforced in such a way that corporate information will be disclosed transparently, but not in a way that stifles active trading among a broad range of informed participants. Furthermore, these beliefs must be supported by an infrastructure of various competent professional services (e.g., accounting, the law, system engineering, financial analysis, academic theorizing and analysis), as well as trade-facilitating, information-processing technologies. In these respects, Japanese practices have yet much to be improved. Even though some reforms have been achieved in the past decade, noticeably irregular events have also emerged, such as the LD case, generated by deficiencies in regulatory rules as well as those revealing the inadequacy of the stock exchange infrastructure technologies.⁵¹ It would not be possible to entirely control the misconduct of some players who seek profits regardless of violating the law or take advantage of loopholes in regulatory rules in a shrewd manner. But such incidents ought not to prevent nurturing the important function of corporate monitoring by the stock market. There does not seem to be a better mechanism for evaluating and predicting uncertain corporate performances that summarizes economically valuable information dispersed in the economy, so we cannot help but try to make markets work better.

In this regard, the changes in the polity occasionally referred to above may be relevant. In the traditional J-system, the primary role of regulatory

though there may be some modifications of certain aspects.

⁵⁰ See an interesting contribution by Sako [2006] which documents and analyzes the emergent diversity in corporate organizational structure as a result of strategic interplays between the management and the enterprise union at the firm level.

⁵¹ Immediately after the arrest of top executives at LD in January 2006, there were a tremendous number of sales bids, particularly by individuals of small holdings, which exceeded the system capacity of the Tokyo Stock Exchange and forced it to shorten trading hours for a few consecutive days.

agencies was to assure the stability of the bank-oriented financial system. They did so by providing rents to banks in rather opaque forms of entry- and rate-regulations, as well as through backdoor agreements among parties concerned in bailing out financially distressed firms. In these arrangements, the interests of bankers and their employees, and those of regulatory bureaucrats and politicians, were intricately interwoven. But, as noted, the framework of bureau-pluralism in which such schemes were embedded is now in eclipse. In fact, the waning of bureau-pluralism in the polity and various changes in economic and social domains mutually reinforce each other, making the reversal of either one alone less likely.

Better-performing corporate firms and new entrepreneurial firms do not need the paternalistic, specific protection of politicians and the bureaucracy. The associations of life-time occupation holders (such as doctors, nurses, post-masters, contractors, etc.) are losing their organizational integrity and thus political influence, because the members of younger generations are more diverse in their values, expectations, and behavior. These are some basic factors undermining the bureau-pluralism institution.⁵² Thus, demands for deregulating rules aimed at protecting particular interest groups are rising, as well as demands for implementing rules assuring a broader spectrum of public interests (e.g., pension reform adapted to the rapidly aging population, remedying public finance deficits) and public safety (e.g., health, construction standards, child protection) are. The gradual transformation of the Finance Service Agency from an institutional agent of bureau-pluralism to a regulator sustaining an arms'-length relationship with the constituent industry, is nothing but a symptom of a bureaucratic response to these trends. Such tendency may be more conducive to the development of an institutional environment for the stock market to become more informative. The reason is that rules for stock market transactions, the disclosure of corporate information, and the like must be formulated and enforced in a neutral, arms'-length manner vis-à-vis concerned interested parties, but not by government in collusion with the incumbents in the financial market.

⁵² However, there is a danger that the protective framework of bureau-pluralism will be replaced by protective legislation enacted at the urging of the business community, in tacit alliance with those segments of the public who are disillusioned and indignant by some misconduct in the stock market and corporate world. I owe this comment partially to Milhaupt. Also see Rjan and Zingales [2002] for related discussion.

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*Corporate Governance in Japan:
Institutional Change and Organizational Diversity*

edited by Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima.

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