จุดเปลี่ยนของระบบธรรมาภิบาลบริษัทญี่ปุ่น: เส้นทางที่ต้องเลือก

The Dilemma of Japan's Corporate Governance*

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บทคัดย่อ

ระบบธรรมาภิบาลบริษัทประเทศญี่ปุ่นอาศัยธนาคารหลักค่อนข้างมากในการสร้างดุลอำนาจภายในกิจการนับเป็นระยะเวลายาวนานหลายสิบปี เมื่อไม่นานมานี้กิจการขนาดใหญ่จำนวนมากของญี่ปุ่นสามารถสะสมทุนภายในของตัวเองทำให้ไม่มีความจำเป็นต้องพึ่งพิงเงินกู้จากภายนอกซึ่งส่งผลให้มีความเป็นอิสระจากอิทธิพลของธนาคารหลัก อันนับเป็นการเปลี่ยนโฉมหน้าระบบธรรมาภิบาลบริษัทครั้งสำคัญของประเทศญี่ปุ่น จากการขยายตัวของตลาดทุนโลกทำให้รัฐบาลญี่ปุ่นพยายามหาทางฉกฉวยโอกาสดึงดูดเงินลงทุนโดยผลักดันให้กิจการญี่ปุ่นยอมรับหลักธรรมาภิบาลบริษัทตามแบบกลุ่มประเทศอังกฤษของเมริกัน ซึ่งมีมาตรฐานการแต่งตั้งกรรมการจากบุคคลภายนอกและความโปร่งใสเป็นสาระสำคัญ แต่ปรากฏว่ากิจการญี่ปุ่นจำนวนมากมองเห็นแนวทางดังกล่าวว่าเป็นการทำลายวัฒนธรรมองค์กรที่มีจุดเด่นในเรื่องความเป็นกิจการชุมชนของพนักงาน ซึ่งที่ผ่านมาได้ประสานเส้นทางอาชีพและโลกสังคมของพนักงานเข้าด้วยกันอย่างแนบแน่น ภายใต้กรอบทฤษฎีตรีมิติที่ถือว่าการคานอำนาจภายในกิจการคือเงื่อนไขสำคัญของการมีธรรมาภิบาลบริษัท การที่กิจการญี่ปุ่นไม่ยอมรับมาตรฐานธรรมาภิบาลบริษัทตามแบบอังกฤษขอเมริกาในขณะที่ธนาคารหลักได้ลดบทบาทลงนั้นได้ก่อให้เกิดช่องว่างของธรรมาภิบาลในกิจการญี่ปุ่นขึ้น ในขณะที่บรรทัดฐานความจงรักภักดีที่เหนียวแน่นของกิจการญี่ปุ่นอาจช่วยป้องกันปัญหาตัวแทนเนื่องจากดุลอำนาจที่เสียไป แต่ช่องว่างธรรมาภิบาลดังกล่าวทำให้กิจการญี่ปุ่นยังคงเสี่ยงกับปัญหาหลายประการซึ่งรวมถึง การตกแต่งตัวเลขรายได้ การยึดติดในกลยุทธ์

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ธุรกิจที่ผิดพลาด การบริหารงานอย่างขาดความระมัดระวัง และความผิดพลาดในการบริหารอื่นๆ ซึ่งเคยเกิดขึ้นกับสถาบันการเงินของญี่ปุ่นมาก่อนหน้านี้

Abstract

The internal balance of power sustained by main banks has been a pillar of Japanese corporate governance for decades. The accumulated earnings make large Japanese firms free from the control of main banks and causes a noticeable change in their corporate governance landscape. In light of the expanding international capital market, Japanese firms are urged to adopt Anglo-American corporate governance standard, which requires outside directorship and transparency. It is feared that such a standard will undermine the corporate culture of the community firm, with which employees' career paths and social world are integrated. The unwillingness to accept the governance standard amidst the declining role of the major banks contributes to a governance vacuum. The norms of organizational loyalty may help prevent the agency problem caused by the imbalance of power before a new equilibrium can be found. But Japanese corporate governance is still vulnerable to earnings managements, strategic traps, imprudent managerial decisions and other mismanagement. It has been proved once already that this can harm Japanese financial institutions.

Key words: Japan, economic governance, corporate governance, balance of power.
JEL Classification: G39, O17, O53.

1. Introduction

The great success of the Japanese economy in the 1970s and 1980s prompted the question as to whether Japanese corporate governance model deserved to be considered as an alternative to the Anglo-American model. Some scholars inclined to believe it did (Porter, 1996; Shleifer, and Vishny, 1997; Whitley, 1999). The interest in the capability and governance system of Japanese firms can be dated to the era of post World War two when the integration of firm skills across functions had been promoted and became their business strength (World Bank, 1993; Whitley, 1999). The role of the government in the Japanese firm's capability has also been noticed. The Japanese government provided financial and other support to companies through the network of financial institutions, known as the "convoy" system, of which main bank played the central role. Along with the support the bureaucracy also coerced the firms to comply with "administrative guidance" to ensure the best national interest (Singh and Zammit, 2006: 223). The convoy system empowered the main bank to play a critical role in monitoring and partly disciplining Japanese firms in the past. The success of large Japanese firms and their internal capital accumulation since the 1960s has mitigated their financial dependence on local financial institutions, which then had to resort to other risky business transactions, including involvement with the securities and price-inflated real estate business. The role of main bank[1], which had been the strong pillar of Japanese corporate governance, has gradually disappeared (Aoki, 2001: 343).

Among the successful firms there were the failures, which sought bail-outs by the government through the convoy system, and particularly the main bank. The convoy system might have provided a faulty safety net. It possibly created a moral hazard and misled people away from their concerns over the soundness of an individual bank's management (Horiuchi, 2001: 92-3). The burst of the economic bubble in early 1999 that caused widespread bankruptcy in real estate firms and financial institutions has put the Japanese economy in the longest stagnation since the world war. Several corporate and governmental scandals were disclosed. There are evidences indicating that the Japanese government's interventions have been largely determined by parochial politics, in which large declining sectors exert disproportionate influence (Noland, 2007: 17). The strong criticism from the media against the alleged favoritism has brought the convoy system and governmental interference to a halt, along with the declining role of the main bank in the corporate governance landscape (Aoki, 2001: 343; Okumura, 2004: 3; Freedman, 2007: 39).

The long economic stagnation has come at a severe cost to Japanese employment. The traditional lifetime employment has taken a severe blow and it has been recently found to be shrinking (Robinson and Shimizu, 2006). The expansion of the international capital market has been a prominent feature of this new picture. Huge short term and long term capital flows are available for all countries. It provides a new hope for the Japanese government to revive its economy. Foreign interest in the Japanese stock market has been widely witnessed. It was found that foreigners' investments made a record high of trading value on the Tokyo Stock Exchange in the fiscal year 1998 (Ito and Patrick, 2005: 10). The Japanese stock market has showed signs of revival. The shareholding by individuals and foreigners in an arms-length manner kept increasing and it recently accounted for close to 50% of their total investments (Aoki, 2005). In an attempt to seize this opportunity, the Japanese government wanted to create more confidence in the legal protection. It revised and passed a new law in 2002 to encourage the improvement of corporate governance in Japanese listed firms by the adoption of outside directors to their boards of directors, appointments which had been traditionally reserved as a reward for successful employees. The initiative has met with strong reaction from many firms (Buchanan, 2007).

The analysis in this paper is aimed to show that the reluctance of many Japanese firms to adopt the outside directors amidst the waning influence of the main bank and the declining role of permanent employees is likely to create an unprecedented governance vacuum and subsequent exposure to the opportunism of high-level management. It is also intended to show that some countries' corporate governance systems, particularly Japan, may not be completely understood without incorporating perspectives of their wider national economic governance[2].

The rest of the paper begins with the argument in Section 2 that corporate governance centers on the internal balance of power. The balance is delicate under the influence of the country's economic governance. Therefore understanding the national economic governance system becomes the key. A framework to pursue this understanding is proposed in Section 3. Within the proposed framework, Japanese economic governance is analyzed in Section 4. The Japanese corporate governance system is then analyzed and its linkage to the country's economic governance is shown in Section 5. Major issues are briefed and their implications are drawn in Section 6. The conclusion of the content is provided in Section 7. In this article, the definition of corporate governance in this paper is based on Trimiti theory (Chaithanakij, 2006a), which was adapted from Zingales (1998), and defined as "*the balance of authoritative capability and control power under cultural consensus that shape the bargaining over the resource allocation and quasi-rents generated by the firm*." Meanwhile, national economic governance is defined as "*the balance of* *institutional influence that shapes that pattern of resource allocation and economic development of the nation.*"[3]

2. Internal Balance of Power as the Determinant of Corporate Governance

There are several arguments claiming that legal and market institutions are the determinants of corporate governance (La Porta et al., 1998; Jensen and Ruback, 1983) because they help prevent conspiracy among actors inside the firm (Thiele, 2007). While there are evidences showing the effects of those institutions on corporate governance, there are several evidences to disprove that those external institutions are sufficient determinants. Some firms in emerging economies appear to have some power to preclude expropriation of minority shareholder even if legal protection is inadequate (Mitton, 2002; Klapper and Love, 2003; Chaithanakij, 2006b). Meanwhile, several firms in the U.S. and U.K which have always been considered as having strong legal institutions may have poor corporate governance (Krawiec, 2003; Anderson, and Reeb, 2004; Arcot and Bruno, 2005; Lasfer, 2006; Tirole, 2006: 16-20). There is mixed evidence for the claim that the effects of external markets act as the enhancer of firm efficiency (Agrawal and Jaffe, 2002; Gillan, 2006). The market competition helps remove the cosy cash cushion enjoyed by monopolists and has beneficial effects on managerial incentives, but it may also create perverse effects. Competition will thus never substitute for a proper governance structure (Tirole, 2006: 29).

Meanwhile, many arguments of legal scholars strongly support the claim that corporate governance is the result of voluntary acts of internal actors (Cadbury, 1992; Veasey, 2001; Coffee, 2001; Rock and Wachter, 2001). Many provisions in country–level investor protection laws may not be binding because firms have flexibility in their corporate charters and bylaws to either choose to "opt-out" and decline specific provisions or adopt any provisions not listed in their legal code (Easterbrook and Fischel, 1991; Black and Gilson, 1998). The corporate charters usually specify the procedures for selecting directors and officers, their power and the range of decisions that they may make without consulting the stockholders in very broad terms (Milgrom and Roberts, 1992). There are some empirical evidences suggesting that private enforcement tools are often more effective than public tools. However, some public enforcement is necessary, and private enforcement mechanisms often require public laws to function (Berglöf and Claessens, 2006). Have argued that the Trimiti theoretical framework, which relies on the internal balance of power as the determinant, has been proved for its validity in explaining the success and failure of U.S., German and Thai corporate governance (Chaithanakij, 2006a, 2006b, 2007a).

Since there is no evidence indicating otherwise, we can argue that the Japanese corporate governance still rests on the internal balance of power. The typical characteristic of the balance of power functioning in other advanced economies is evidenced by executive replacement, either through the board's decision or shareholder's resolution, when a firm performs poorly[4] (Tirole, 2006: 26). However, the external driving forces of governance can be different, particularly from the U.S. counterpart. While American corporate governance is much driven by the market value of the firm, Japanese corporate governance is driven by two related sources of power: the main bank and the employee. The former is much involved with the country's economic governance system, elaborated in the following section.

3. The Concept of National Economic Governance System[5]

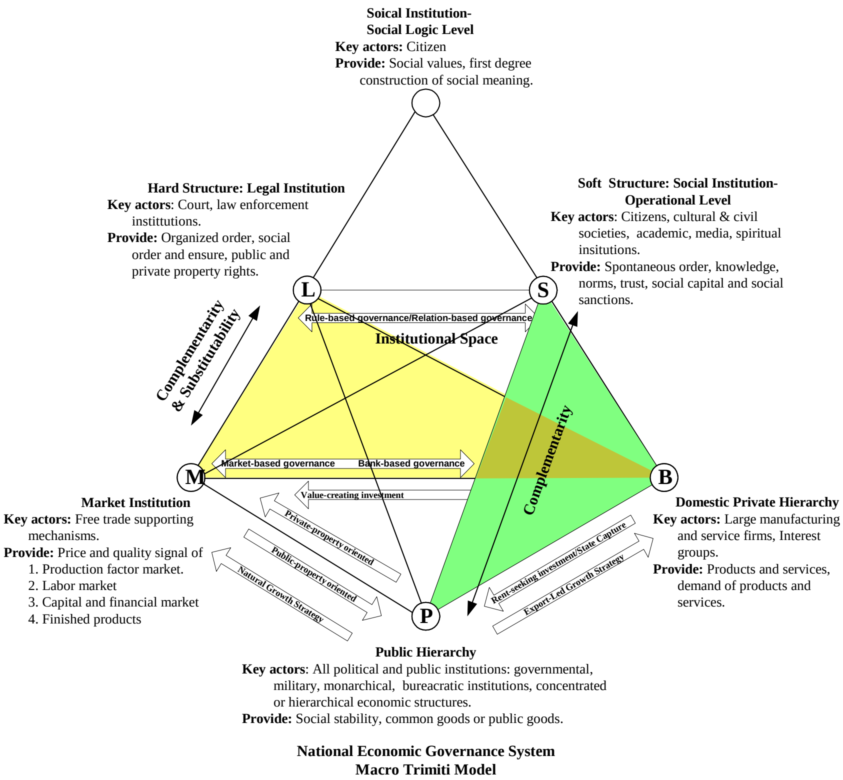
There have been several attempts to establish the concept of national economic governance to explain economic structure and performance (Whitley, 1999; Hall and Soskice, 2001; Boyer, 2005) but none seems able to provide a strong theoretical core to explain the different advancement of economies across countries (Foss, 1999; Kristensen, 1999).

Figure 1 shows the analytical framework of national economic governance system, called Macro Trimiti[6] (Chaithanakij, 2007b), which is much supported by the inductive result in response to Dixon's (2003) four cultural solidarities, namely hierarchist, enclavist, fatalist and individualist. From the framework, each country's economic structure is under the influence of four major types and five sub-types of institutions generally accepted for societal analysis (Acemoglu and Johnson, 2003; Roland, 2004): social logic system (Bourdieu, 1990: 125) or ground rules (Pistor, 2005); social institutions, which may appear in cognitive forms such as customs (Aoki, 2001; Greif, 2005) or vertical and horizontal organizations such as civil societies (Evans, 1995; Bloom, Steven, and Weston, 2004); legal institutions (La Porta et al., 1998, 1999; Dixit, 2001; Pistor, 2005); market institutions (Hayek, 1945: 524-5; 1976: 65; Coase, 1991: 55), which provide signals of price, quality, volume (Spence, 1973; Stiglitz, 1994: 168; White, 2002) as well as support by the system for repeated transactions (Furubotn and Richter, 2005: 314) and disciplined pluralism (Kay, 2005: 18); private hierarchies, which allow the accumulation of productive capabilities (Landau, 2003), such as Japanese *keiretsu* groups (Boltho, 2001: 122; Buchanan, 2007: 32-3); public hierarchies, which particularly refers to bureaucratic and governmental organizations. The bureaucratic and governmental organizations provide the basic protections of property rights and, in some cases, subsidize the national technological development for chosen private sectors (Von Tunzelmann, 2003) widely evidenced in North Eastern Asian economies (Martin, 2001: 98 ; Ahrens, 2002; Breznitz, 2005a) and other countries (Breznitz, 2005b; McCahery and Vermeulen, 2006; Malerba, 2006; Rangan, Samii, and van Wassenhove, 2006) though transparency often becomes the issue calling for attention (Belloc and Pagano, 2005).

I take the view of society as a composite of six interactive institutions in contrast to the four institutions proposed by Boyer (2005). My framework shows more segregation of institutions than the framework of Hollingsworth and Boyer (1997) and Boyer (2005) by two sub-categories – social logic and legal institutions, which are important for extensive explanation – e.g. institutional persistency and the main characteristic of Anglo-American capitalism respectively. In this framework I also strongly assume the balance of institutional influence as the necessary condition for equilibrium (March and Olsen, 1995) to fulfill the objectives of economic development, e.g. growth, income distribution, welfare. Though the distribution of power among institutions and their modes of coordination proposed by Hollingsworth and Boyer (1997) may help to explain the different characteristics among forms of capitalism, they do not explain the difference between the rich and the poor, and the high growth and the low growth economies.

In one aspect, an economy functions similarly to a production system, in that all of its units must operate in concert. However, it may consist of many institutions, some of which seek to expand their influence. The economy should be considered as having governance only if the balance of influence among institutions can be such that it can keep the economy on the course chosen by its majority constituents. Though the coordination quality among institutions is important for the smooth functioning of society as proposed by Hollingsworth and Boyer, the balance of influence among institutions is more important. The balance is necessary for preventing any attempt by any institution to dominate others, which may cause disruptions in its course to prosperity. In this perspective, each of the societal institutions provides certain governance elements to society for its continuous functioning, for the benefit of its constituents, and for continuing harmony.

Figure 1



Source: Created by Surasak Chaithanakij (2007b) to present the national economic governance model. The four institutions – legal, market, social and hierarchy - are deduced results in response to Dixon’s (2003) four social solidarities. Bourdieu’s concept (1990) of the social logic system provides the foundation for social logic institutions, which are claimed to underpin the developmental path of all other institutions. The role of the private hierarchy is separated from that of the public hierarchy to reflect the increasing role of firms as the source of national capability. The MBL plane denotes U.S. economic governance whereas the PBS plane denotes the Japanese.

Under this framework, each of the institutions plays a different role in promoting the governance. The social logic institutions provide informal general guidance. The legal institution stipulates formal rules whereas the social institution renders informal rules. The market institution facilitates the exchange mechanism and efficiency discipline. The public hierarchy delivers most of the public goods whereas the private hierarchy produces most of the private goods for internal exchange or export to other societies. The market competition, internally and externally, puts pressure on public as well as private hierarchies to accumulate productive capability and effectively and efficiently deploy it for production. Each society maintains different institutional combinations; some may find the right balance leading to economic governance; others may not. It is still impossible to completely characterize the balance with present evidence. However, two patterns of economic governance systems have emerged for comparative analysis: the market-oriented system and the hierarchy-oriented system.

The U.S. economy may represent the society that leans toward the end of the market-oriented economic governance system whereas Japan, leans toward the end of the hierarchy-oriented economic governance system. This kind of comparison has appeared on several occasions since Hall and Soskice's work (2001) though most of these comparisons have been shown to be without strong theoretical support. U.S. economic governance relies on the fair balance among the market institution, private hierarchy and a strong legal institution as represented by the MBL triangle in figure 1. Meanwhile, the Japanese economy tends to rely on a different balance of institutional influence.

4. The Japanese Economic Governance: the System in Transition

4a. General Characteristics

The Japanese economic system is characterized as coordinated capitalism by Hall and Soskice (2001). Business firms tend to rely more on bank financing or financial market than on the stock market. The Japanese firm, the most important actor in Japanese economy, has long been described as a social institution whose mission extends well beyond mere profit or stock value maximization (Berglof and Perroti, 1994). The Japanese firm can be categorized into *keiretsu* or non-*keiretsu*. Firms that are tied as a group of companies known as *keiretsu* usually have a cross-shareholding, director interlocking, and trade and lending network. Firms in the same keiretsu usually share the same main bank. When one member of the keiretsu is in trouble, the main bank or other stronger members are supposed to bail-out the one that fails. However the intervention to bail-out other firm members waxes and wanes with temporal fluctuations in *keiretsu* cohesion (Lincoln and Gerlach, 2005: 287). After a lengthening period of economic stagnation, the influence of *keiretsu* is declining. There have been a number of cases in which there was no bail-out (Higgins, 2004: 99) and firm liquidation ensued (Aoki, 2001)[7].

4b. Former Strong Intervention by Government

In contrast to U.S. economic governance, in which governments have been relatively reluctant to intervene unless the economy is in crisis or in imminent danger of crisis, Japanese corporate environments from the end of the world war until the long stagnation have been tightly shaped by government regulators who institute industrial policies for the private sector (Katz, 1998). Government interference is characterized by Ahrens (2002: 463) as the Flexible Market-enhancing Governance Structure (MEGS), which required the legitimacy transparency of government to promote demand-motivated R&D. From the 1950s to 1980s, the Japanese bureaucracy showed an apparent continuity of supporting the industries, which were characterized as high future income elasticity of demand, a high potential for productivity growth and, increasingly, a high use of advanced technologies (Itoh et al., 1988).

The Japanese government also strictly regulated banking industry to assure rents to individual banks according to their ranking. It also intervened, if necessary, to bail out financially distressed banks or arranged for their acquisition by healthier banks (Ito and Patrick, 2005: 2-3). Though the government agencies – the Ministry of Justice and the Bank of Japan – provided supports including soft loans to ailing banks and bailed out financially distressed banks and other financial firms (known as the convoy system), they also punished the failed management by replacing it with their own officers or other trusted bankers. This provided a credible discipline on management of financial and non-financial firms (Aoki, 2001: 340).

Bureaucratic control once worked through the system of “administrative guidance” instead of formal legislation. This required a certain discretion and autonomy on the part of the senior level of civil service, which could act as the guardian of national interest (Singh and Zammit, 2006: 223) and its Ministry of Finance applied pressure through affiliated companies, suppliers, acquaintances, retired officials serving as directors in the firm, and bank boards. Until recently, a variety of organizations in Japan operated in the so-called convoy system, where businesses were protected by the government as are a convoy of ships by a warship (Higgins, 2004: 98-101).

4c. The Balance of Institutional Influences

Besides having a mission of extending beyond profit maximization (Berglöf and Perroti, 1994), Japanese firms tend to have a close system of human resources. The concept of community firm and the corporate hegemony are predominant in Japanese corporate managerial system. The concepts are supported by internalism, which comprises lifetime employment for regular employee, pay biased towards seniority and reliance on internal promotion (Okuno-Fujiwara, 1999: 272; Buchanan, 2007). The employment security has been the corner stone of Japanese economy and the rationality for the governmental support provided to its private sectors. Meanwhile the consensus-based culture has been dominating the decision-making process in Japanese companies (Higgins, 2004: 109). Widespread consultations (*nemiwashi*) before decisions were taken became the norm. This allowed responsibility to be shared broadly as well as rewards. Rapid responses might be difficult but implementation was highly effective once a decision was taken (Freedman, 2007: 26). “Good faith and fairness” are also the norms governing relationships in Japan, partly held as a substitution for formal contract (Kobayashi, 2006: 117-8). Social institutions in Japan do not exert their influence through the formal organizations of civil societies like in the West. Instead, they are embedded in the people’s way of life and shown in the subtle influence in their decision-making processes.

With these evidences, it is fairly safe to argue that Japanese economic governance relies on three pillars – private hierarchy, public hierarchy and social institution – which are denoted by PBS triangle in figure 1. The form of coordinated market has been adopted in Japan to restrain the uncertainty tied to the liberal market institution (White, 2002: 7) and allows the private hierarchy to gain strength and accumulate capability. The system was in balance and worked well. Government protection combined with cheap funds encouraged fast and steady industrial development (Freedman, 2007: 24). The Japanese corporate governance has been integrated into its larger economic governance system.

Analysis under the Macro Trimiti framework indicates that when the Japanese government allows the capital market to take larger a role in its economy, it apparently fails to convince the private sectors to move in the same direction causing an institutional imbalance. The social institutions of Japanese society are apparently too obstinate to accept the Western standard of corporate governance. But the Japanese social institutions may not be only the cause impeding the change. It appears that the private hierarchy may have won its fight over adapting to the new balance.

5. The Dilemma of Japanese Corporate Governance System

The Japanese corporate governance has been much exposed to the influence of its national economic governance system. The impact can be distinguished particularly from the firm's objective and its business strategy.

5a. Objective of Japanese Firms

There has been an increasing amount of evidence indicating that the Japanese firm has been going for a long-term profit (Porter, 1996). Whereas Japanese firms lack focus on current performance, one of their main objectives was to provide steadily growing benefits to its permanent employees (Aoki, 2005). The traditional policy of "retain and reinvest" had been widely distinguished (Lazonick, 2002: 227). From the 1990s until 2002, whereas the U.S. and U.K. firms demanded shorter-term returns, Japanese and German family companies remained satisfied with far longer-term returns and had scarcely converged to the U.S. model of strategic planning and hardly adopted the financial instrument of discounted cash-flow method for their financial decisions (Carr, 2005). The firm objective of long-term profit is compatible with the economic governance system that hold firm such as the social institution (Berglöf and Perroti, 1994), whose philosophy may not suit short-termism and arms-length relationships, predominant traditions of the stock market.

5b. Japanese Employee, Business Strategy and Corporate Governance

The Japanese business strategy of cost leadership is found to be compatible with high productivity. Top Japanese firms in autos, steel, machines tools, and consumer electronics demonstrate much higher productivity than U.S and European counterparts beating world-class productivity benchmarks by 20 %. (Robinson and Shimizu, 2006: 70). Japanese firms have extremely high productivity compared to other major OECD countries (Ito and Patrick, 2005: 4). Undoubtedly cost leadership is found to be the dominant strategy mostly adopted by Japanese firms (Song et al., 2002; Allen et al., 2006) among three strategies under Porter's (1985) business strategic typology.

It is quite convincing that the marked superiority of Japanese productivity is ascribed to the human resource system, in which life-time employment and internalism are predominant. A recent survey shows continued commitment to the long-term employment policy (Miyajima, 2005). To encourage the highest participation of employees to improve the productivity, Japanese firms have to allow the employees to have an expansive role in low and middle management levels. The joint labor-management consultation session is such a typical role (Jackson, 2005: 62). Under this system, managerial authority is balanced to a certain extent by the employee. The slow employment adjustment in Japanese firms (Abe, 2002) and moderate executive compensation naturally come as the result (Freedman, 2007: 32). The convoy system supported by the government through main banks was intended to provide employment security, which in turn encouraged total devotion by employee. Vitols (1995) suggests that the regulation of labor markets is the key factor influencing company's choices between price and quality-competitive strategies.

5c. The Recent Development

During the early years of the burst of the bubble economy which was followed by the long economic stagnation, the Japanese government rushed to bail out the failing financial institutes. The bank bail-out was criticized as favoritism. More scandals both in the Ministry of Finance and the banks were found. The convoy system was kept at bay. The Bank of Japan and the Ministry of Finance have had to keep a distance from banks and securities companies (Aoki, 2001: 343). Four financial institutions were left bankrupt and a credit crunch ensued. The role of main banks as a countervailing power to management in the Japanese corporate governance landscape has been found to steadily decline (Okumura, 2004: 3). The corporate scandals in the 1990s led to a general consensus at the principle ministries involved that corporate governance reform was necessary. The Japanese government introduced the Committees system in 2002, as a formal governance option, to promote corporate governance for large companies. The system rests on the fundamental concepts that a degree of supervision by external directors is necessary for good governance and that supervision should be separated from execution to enhance objectivity. The government initiative drew a strong reaction from *Keidanren*, the Japanese Business Federation as well as several incumbent managers. The social underpinnings of the community firm and the corporate hegemony in Japanese firms proved too strong and changes to the Committees system are thus expected to be marginal (Buchanan, 2007).

To allow the outside directors onto the board will definitely send a strong signal to all employees that the firm is departing from the once shared-belief of internalism and lifetime employment. This action will mark the acceptance of the influence of stock market on the internal affairs of the firm. This clearly implies an end to internalism and lifetime employment eventually. It is obviously not helpful to improve the morale of employees. In exchange for gaining a good reputation in complying with the code of corporate governance, firms may have to suffer losses in morale and productivity.

6. Discussions: Balance of Power as the Risk Management System

The declining role of the central bank, which once used to be an effective control mechanism for firms (Aoki, 2001: 331-2), has caused an unprecedented risk in Japanese corporate governance landscape by putting the high-level corporate power structure out of balance. Mark Roe (2002, 2003) shows that the explanatory power of the law can only be limited. He decomposes the managerial agency costs into two categories: (1) the first is associated with “private benefits” that managers can try to appropriate in accordance with their opportunism; (2) the second is linked to managerial errors and frauds, based on the ability of managers to exploit investment opportunities in the best interest of shareholders. If the law is able to efficiently reduce the first category of the costs, then it is revealed as incapable of eliminating the other costs. The behaviors associated with first category of risk can be easily noticed by a loyal employee, so they are unlikely to pose a threat to the Japanese firm. The second category is more sophisticated in nature because it is involved with numerous assumptions that require judgments. In the past the main bank, with its financial expertise and knowledge of the firm, had the capability to function as the countervailing power to minimize this sophisticated kind of risk whereas the employee may not have this capability. But it becomes clear that the Japanese corporate governance is losing the role of the main bank.

A recent study on Japanese firms exposed to capital market pressure tends to support Roe’s argument on the second category of risks. The recent empirics indicates that strong employee participation via labor-management councils had no positive or negative impact on information disclosure and shareholder rights, and had a positive effect on board reforms (Miyajima, 2005). It implies that Japanese employees may be incapable or unwilling to take an active role in deterring unethical activities, such as earnings management and dubious investment, as long as the activities do not show a clear evidence or immediate threat to the employee's interest although they may do this to outside shareholders' interest or firm in the long term.

Moreover, the countervailing power of the Japanese employee may be in question due to the change in managerial culture and shrinking permanent employment. There is a research finding which indicates that the decision making in Japanese firm becomes more top-down than middle-up-down as well as less hierarchical with fewer levels of management. From1995-2005, the number of regular employees decreased by 4.1 million, while temporary employees in various categories increased by 6.5 million. Many Japanese firms still commit to the permanent employment system but the core has actually shrunk (Robinson and Shimizu, 2006).

The Japanese employee may have a strong loyalty toward the firm. But the culture of loyalty might not help in preventing or disclosing potential fraud at all in Japanese context. Scandals at the largest brokerage house, Nomura Securities, and at one of the major banks at that time, Dai-ichi Kangyo, in late 1995 and early 1996 would be unthinkable for the firms that prioritized the corporate loyalty. It was found that a basic "protection racket" was transferring funds to *yakuza* (organized crime) in the form of loans never intended to be repaid and stock purchases with no downside risk (losses were made good by the brokers) (Freedman, 2007: 39). Chikudate (2002: 304) posits that the socialization for organizational loyalty is a two-edged sword. Socialization, cultural leadership and other techniques of human resource development used to be the key managerial techniques to induce the loyalty and productivity of Japanese employee. But this can turn out to be a double-edged sword of disciplinary power. Managers could become mundane reasoners. In this way the corporate culture may facilitate the slide into collective myopia and increase the potential for unethical activities.

The recent Japanese corporate code reform in 2002 also made firms choose between two options of board structure: the American-type committee system and a modified traditional system with semi-independent statutory auditor's board. The amendment was combined with a shift in securities regulation, shareholder activism, and the notion of lifetime employment. The change marks the adoption of an optional Anglo-American standard of transparency as well as formalization of the Japanese norm. However the new concepts of corporate governance appear incompatible with Japanese cultural values of hierarchy and collectivism. The initiative has drawn a strong reaction from Keidanren, the Japanese Business Federation (Buchanan, 2007).

Even if the Japanese firm chooses to comply with the new code, the outside directors, unfamiliar with the firm's environment may not completely substitute for the departing role of the main banks, which have accumulated knowledge on the firms for decades. Meanwhile since corporate governance is of the internal balance of power, the recent improvement in legal protection and enforcement in 2002 (Buchanan, 2007) may induce the appearance of more cooperation from Japanese managers but it can hardly catch the reality of the internal power imbalance soon enough. A recent study indicates that the out of court restructurings ending in 2005 tended to fail to gain the trust of the market because of their procrastination in implementing fundamental solutions. Without their party's intervention, no fundamental changes can be expected from the restructuring (Inoue et al., 2007) indicating the Japanese firm can not be expected to change easily. It is likely that the more "outside" the directors are, the less likely they are to have adequate access to information, and thus their effectiveness may be compromised (Sarra and Nakahigashi, 2002: 330).

The decreasing role of main banks in Japanese firm has started to seclude the firm's power structure from its economic governance system. Meanwhile internalism and its incompatibility with cost-leadership strategy are expected to make it harder for the Japanese firm to fully embrace the outside-director system. Under the Macro Trimiti framework in Figure 1, feeling the opportunity from the expanding international capital market, the Japanese government has put an effort to move its economic governance system from the existing plane PBS toward MBL plane. However the internal governance system of its firm does not seem ready for such adaptation. The strong culture of internalism that has supported the growth miracle of Japanese economy has appeared to impede the change, and unintentionally create a governance vacuum. The limited scope of authority and weakening power of lower-level employees are likely to cause an inability to cope with some risks taken on by management. Some Japanese firms are therefore vulnerable to earnings managements, strategic traps, imprudent managerial decisions and other mismanagement, which already been proved to harm the Japanese financial institutions, at least until a new form of power balance is found.

7. Conclusion

This paper has presented a new economic governance model that can help explaining the dilemma of Japanese corporate governance, whose balance had been maintained in two separate levels – the upper level by the influence of governmental agencies through the main bank and convoy system, and the lower level by employees through management-labor consultation. The business success has provided the larger firms with an internal source of fund. The self reliance of larger firms, coupled with declining influence of main bank and governmental agencies, has shifted the balance of power away from the precedent economic governance system, in which human resource and strong government are predominant. The recent governmental and corporate scandals have forced government agencies to keep a certain distance from the private sectors. The influence of Japanese government through the convoy system and main banks has come to a halt. With the disappearing role of the main banks as a countervailing power, coupled with the reluctant establishment of the substitute countervailing mechanism under the new code, Japanese corporate governance is vulnerable to risks associated with the decisions of high-level management, including earnings managements, strategic traps, imprudent managerial decisions and other mismanagement.

It has also been shown that Japanese corporate governance may be analyzed in isolation to understand its efficacy. However if we want to understand more about its evolutionary aspect, we may not succeed if we lose sight of the country's wider national economic governance, and vice versa.

Notes

1. Each large Japanese firm maintains a long-term relationship with one large bank, known as its main bank. The main bank is normally a large commercial bank, which has special roles to act as outside monitoring institution beyond a financial service provider. It is found in Japan and Germany. The role of Japanese main bank as a monitoring agent lied in its capacity of bail-out or liquidation of trouble-laden firm. The role was indirectly supported by the central bank and other governmental agencies through convoy system.

2. The incorporation of the national economic governance concept in this article is intended to help building a complete picture of Japanese corporate governance dynamics. Its argument is kept at minimum, just sufficient to convey the idea. It is not intended to serve as a supporting evidence for any conclusion. For full content, please see Chaithanakij (2007b).
3. Several work in the pasts - e.g. Vitols (1995), Dixit (2001), and Boyer (2005) - directly dealt with the economic governance but none provides the definition of economic governance. By overlooking the definition, one actually can save some effort debating the boundary of the unit under analysis - whether it should be society, country, nation or just system. Although these three words contain minor differences of meaning, in this article the words "society" "country" and "nation." are used interchangeably because such simplification does not seem to pose any threat to the validity of my argument in this article. I also decide to define the economic governance differently from the general meaning of "governance" provided in the United Nation Development Program (UNDP)'s and other public agencies' websites, e.g. the Canadian Centre for Philanthropy, which usually defines "governance" in a broader way. There are at least seven ways of defining "governance"- e.g. capability, interactive process, manner of power exercise (Siriprachai, 2007), but none of them provides any analytical perspectives.
4. Though the executive replacement by SEC or a public prosecutor is legally possible, but it has been such a rare case, of which we have never heard. I thus claim the legal institutions have only a minimal direct influence in the matter.
5. The full content is presented in Chaithanakij (2007b), which articulates that pro-society value is a major, if not the most influential, underlying force of societal institutions.
6. Named after Trimiti corporate governance theory (Chaithanakij, 2006a), which share the balance-of-power concept and similar three-major sources of power.
7. The bail-out is a mild form of influential exertion. According to Aoki (2001), the threat from main bank to liquidate the firm's assets and lay-off all employees played the key part in disciplining the failing firm. In this regard, the bail-out by the *keiretsu* member may be far less influential than the dual roles of bail-out and threat of asset liquidation played by the main bank. The role of the *keiretsu* member in Japanese corporate governance is thus totally ignored in this article.

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