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Has Japan's corporate governance reform worked?

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The burst of Japan's massive financial bubble in 1990 caused the value of stocks, land and other assets to plummet. Japanese banks had financed their asset purchases using them as collateral. Many banks failed due to a combination of the collapse of asset values and their clients' inability to pay back loans.


[1]

Japanese manufacturers lost their traditional source of financing — bank loans. Shrunken product demand and persistent excess capacity caused deflation, which became endemic in Japan. Japan's traditional bank-centred corporate governance system was blamed for the nation's economic bust.

Noting the generally robust performance of the economies of the US, Australia, Canada, New Zealand, and the UK, the Japanese government decided to adopt a US (or, more broadly, Anglo-American) style corporate governance system over the last decade or so. A range of corporate governance reforms were instituted, aiming to facilitate market based transactions, competition, individual shareholder rights, as well as transparency and information disclosure. Japan's economic regulatory institutions were also reformed. New laws were introduced and existing laws revised, including company law, the commercial code, the anti-monopoly law, and the financial instruments and exchange act.

So, how have Japanese corporations reacted to new US-style practices and regulations?

The reforms transplanted into Japan a Western legal framework and institutions. The new Japanese corporate governance system allows firms to operate similarly to those in the US. A corporation can use a US-style board system with committees consisting of majority outside directors. These outside directors oversee firm performance in management and governance. The market for corporate control now also operates largely as in the West. A hostile takeover of a firm is generally possible. Firms must also disclose consolidated financial statements.

But have the issues that motivated the reforms been solved in the decade since they were adopted? Has the market for corporate control achieved competitive market principles, transparency and information disclosure? And was the share value maximization principle fully adopted by Japanese managers? The answer to these questions are mostly no. This was largely predictable given Japan's historical reaction to the transplantation of Western institutions over the long sweep of history since the Meiji Restoration in 1868.

Since Japan opened up to the West in the early 19th century, there have been repeated attempts to import Western political and economic institutions, laws, technologies and even cultural practices. But rather than being adopted in their original forms, Western practices have been selectively adapted to suit Japan's needs, tastes and preferences with varied success.

This is also true of the reforms adopted in the wake of the 1990 financial crisis. Even though all relevant US laws were essentially transplanted in Japan's corporate governance reform, modifications were made that have had important consequences for the outcomes of reform.

The interactions between existing Japanese business norms (such as consensus decision making and *keiretsu* business groups) and US corporate governance practices have resulted in several key areas where little change or economic efficiency gains have been achieved. The Japanese market for corporate control still does not operate competitively. There are many more friendly mergers, which typically occur between *keiretsu* and other related firms, than mergers based on hostile takeovers. Most hostile takeovers of poorly functioning firms or takeover attempts have failed.

Independent, outside directors have been put in place, but they do not seem to function as they do in the US. And, transparency and information disclosure have proven difficult to implement in many established Japanese firms. The continuing prevalence of Japan's *'dango'* practice (rigged bidding), for example, clearly violates the reforms' transparency and information disclosure as well as fair competition objectives.

There have been successes in corporate governance reforms. The recent revelation that, for the last few years, Toshiba Corporation inflated reported profits by using improper accounting methods (like underestimating costs) is a case in point. The scandal became public because one of Toshiba's employees reported their employer's illegal accounting practice to Japan's Securities and Exchange Surveillance Commission. The employee was able to report the illegal activity using the Whistleblower Protection Act of 2004, which was introduced as part of the reforms.

But the fact that the problem was continuing even though Toshiba had already implemented a US-style executive committee board system is an example of reform failure. Clearly their outside directors did not function as expected. And neither did the accounting firm that audited

Toshiba.

The problems that motivated the Japanese reforms are far from being solved. Foreign firms will still need to beware of the implications of this in doing business in Japan [2].

Corporate governance reforms to implement US-style practices are ongoing in other countries in East Asia, such as China and South Korea [3]. Large pyramidal business groups in both countries (that is, state-owned enterprise groups and *chaebols*) present serious challenges to those reform efforts too. Implanting institutions and practices from other countries [4]rarely succeeds. Japan's experiences, both successes and failures [5], may prove helpful to Western business practitioners and policymakers interested in understanding business conditions in East Asia.

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[1] : **http://www.eastasiaforum.org/wp-content/uploads/2015/10/20150722001158164252-minihighres.jpg**

[2] the implications of this in doing business in Japan: **http://www.eastasiaforum.org/2008/07/17/fdi-and-corporate-governance-in-japan/**

[3] South Korea: **http://www.eastasiaforum.org/2011/07/08/corporate-governance-reform-in-korea/**

[4] institutions and practices from other countries :
http://www.eastasiaforum.org/2015/10/22/the-unfinished-business-of-imf-quota-reform/#more-48096

[5] both successes and failures:
http://www.eastasiaforum.org/2012/11/17/removing-japans-barriers-to-trade-and-investment/

[6] here: **https://crawford.anu.edu.au/research_units/ajrc/publications/ajrc_pub.php?tb=3**

[7] Australia and Japan in the Region Forum:
https://crawford.anu.edu.au/research_units/ajrc/publications/ajrc_pub.php?tb=3#tb3