Also by Masao Nakamura

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12 Japanese Corporate Governance and Macroeconomic Problems[1]

Randall Morck and Masao Nakamura

INTRODUCTION

North American academics became interested in Japanese economic institutions in the 1980s, when rapidly growing Japanese firms were seizing significant shares of the global market (long dominated by established US and European firms) for cars, electronics, electrical and general machinery and precision instruments. Japan's success seemed to many to have been achieved at the expense of declining US manufacturing industries. Thus, North American business schools taught Japanese practices in industrial relations (for example teamwork), manufacturing methods (JIT), industrial organization (*keiretsu*) and bank-based corporate control.

While research into the Japanese economy has a long history in the North American and European academic literature (see for example Patrick and Rosovsky, 1976, and the references given there), the massive effort on the part of North American scholars, particularly those from business schools, did not begin until the 1980s. For example the number of articles on JIT manufacturing written in the United States increased from essentially zero in the late 1970s to over 700 in the period 1985–1990.

Transfer of business practices

Much of the academic research in these areas has been devoted to the question of whether or not Japanese practices could be successfully transferred to North American industries. For example Morck and Nakamura (1995), Romano (1993, 1995) and Tschoegl (1995) discuss

the feasibility of transferring Japanese corporate governance practices to the North American environment.

There is considerable empirical evidence that many aspects of Japanese manufacturing practices had been successfully adopted by US manufacturing industries by the early 1990s (see for example Nakamura *et al.*, 1998, forthcoming). But others were either unsuccessful or rejected. For example transplanting Japanese-style interfirm relations, such as supplier–assembler relations, has not taken place to any significant extent in the United States (not even in the case of Japanese transplants). Japanese long-term employment practice is also largely incompatible with the structure of the US labour market, and hence has not been widely adopted (Nakamura, 1993).

The generally perceived poor performance of the US economy, particularly in the case of certain key manufacturing industries, throughout the 1980s prompted scholars to question the effectiveness of the US system of corporate governance (see for example Jensen and Meckling, 1976; Mace, 1986). Critics of the US governance system argue that boards of directors are cosy reunions of old boys who are generally powerless to prevent, or even recognize, potentially disastrous corporate policies, and managers are self-interested, unhindered by effective board oversight and run corporations to suit themselves. Baker, Jensen and Murphy (1988), Morck *et al.* (1988, 1989, 1990) and many others, have found empirical evidence that many large US corporations suffered from corporate governance problems in the 1980s.

It is for these reasons that reformers began to speculate about alternative institutional frameworks that might work better.[2] The key theoretical argument for alternative frameworks is that the typical large US firm suffers from the lack of a large shareholder. Shleifer and Vishny (1988) argue that even a single large and sophisticated shareholder might provide a valuable counterweight to management. McConell and Servaes (1990) present some evidence that a large shareholder enhances firm value. Jensen (1989) compares the Japanese main bank system with (Leverage Buy Out) partnerships in the United States and argues that the joint ownership of debt and equity by large informed investors (such as Japanese banks) results in stringent managerial monitoring and creates strong incentives for managers to make value-maximizing decisions.

Outside the United States large shareholders are ubiquitous. Indeed the United States and Britain are the only countries in the world where widely held firms are prevalent. In Japan and Germany, banks control large blocks of shares in most large firms. In most

countries, including Canada, most of Europe and Asia and all of Latin America, wealthy families hold dominant voting blocks in most large corporations, either directly or through control pyramids. US antitrust and banking policies were explicitly aimed at dislodging such 'robber barons' and their families from positions of economic power, so returning to this system appears retrogressive to many Americans. Morck *et al.* (1998) present empirical evidence justifying this view. The German and Japanese systems have thus become the main focus of US researchers, spurred on by the outstanding performance of those economies.

Assessment of the Japanese corporate governance system

There is considerable variance in the assessment of Japanese and German corporate governance mechanisms. Shleifer and Vishny (1997, p. 739), for example, note that 'corporations in successful market economies, such as the United States, Germany and Japan, are governed through somewhat different combinations of legal protection and concentrated ownership. Because all these economies have the essential elements of a governance system, the available evidence does not tell us *which one of their* governance systems is the best.'

Because of the superior performance of the Japanese and German economies prior to the 1990s, some authors favoured their governance systems over the US system (see for example Aoki, 1990; Charkham, 1994; Roe, 1993). As the 1990s drew to a close, Japan's prolonged recession and floundering banking sector suggested that these assessments should be reassessed.

Morck and Nakamura (1995) and Romano (1995) argue that transfer of essential aspects of Japanese corporate governance practices would probably not improve North American firms' performance. Perhaps successful US firms quickly adopted those Japanese practices that made sense, and the remaining differences are Japanese practices that US firms found undesirable.[3]

Contemporary policy issues in Japan

Mired in a prolonged and serious recession, Japan now seems to be looking abroad for solutions to its economic problems. For the past few years the Japanese business press and Japanese bookstores have been filled with articles and books describing all aspects of US business practices. For example a Japanese best-seller entitled *Those*

Who Can Become Anglo-Saxon Will Succeed (Itose, 1998) argues that the United States and Britain currently set the global standard. It therefore encourages Japanese corporations and workers alike to adopt 'Anglo-Saxon' practices in industrial relations and employment behaviour, work practices, corporate control and other business management areas. This US triumph is echoed by many US government officials, including President Bill Clinton and Deputy Secretary of Commerce Larry Summers, who have both argued on many occasions that US-style capitalism is the only way to go for other countries.

It remains to be seen whether the transfer of certain US business practices to Japan will indeed successfully end Japan's protracted recession. Certainly, Japanese business practices have *not* been the chief suspects in many economic analyses of Japan's post-bubble woes. Rather, Japan's macroeconomic policy makers and bank regulators are routinely blamed for stumbling into Keynesian employment and liquidity trap problems. We do not dispute this view. However we argue that Japanese corporate governance practices may also have played a critical role, both in pulling Japan's economy into its current muddle and in keeping it there. Our reasoning meshes well with historical explanations of Japan's current problems. For example some historians argue that the present Japanese business and economic system served Japan well as it caught up with the United States and Western Europe during the 20th century, but that Japan now needs a new system.

The next section develops our argument by examining the evolution of corporate governance in Japan and elsewhere to see how Japan (and Germany) ended up with bank-centred systems while other countries did not. The third section considers how creditors' interests differ from those of residual claimants, and how assigning corporate control to creditors distorts firms' investment decisions. The fourth section shows how such distortions at the microeconomic level might lead to macroeconomic problems of the sort Japan is now undergoing.

HOW CURRENT JAPANESE BANK-BASED CORPORATE GOVERNANCE PRACTICES AROSE

Best practice in 19th-century banking and corporate governance

In the 1860s, when Japan reopened its economy to the world after centuries of self-imposed quarantine, banks in most countries owned equity in non-financial firms and exercised considerable influence over

the governance of those firms. The new Meiji rulers of Japan perceived these to be the best banking practices and adopted them in Japan.

The model for universal banks at the time was the Société Générale du Crédit Mobilier, established in November 1852 by Emile and Isaac Péreire, disciples of the utopian socialist Claude-Henri, Comte de Saint-Simon.[4] Banks, for these Saint-Simonians, were canals that could irrigate arid parts of the economy with capital. Crédit Mobilier took deposits, underwrote stock and bond issues, bought and sold stocks and bonds on its own account and for others, and securitized industrial loans as short-term bonds called *valeurs omnium*, which it sold to the public. To maintain its own share price, Crédit Mobilier routinely repurchased shares. Companies for which Crédit Mobilier underwrote securities had to maintain current accounts with the bank. It thus engaged in all the activities a full-service, one-stop financial services and banking firm would provide in the 1990s. Crédit Mobilier was a fully fledged universal bank.

Crédit Mobilier established replicas of itself in Amsterdam, Turin and London. Rival replicas were also established in London (the General Credit and Finance Company) and Paris (the Société Générale pour Favoriser le développement du Commerce et de l'Industrie en France and the Crédit Lyonnais). Heavy losses in equity investments by these banks (including Société Générale's 'guano affair' debacle in Peruvian bonds) and the spectacular collapse of Crédit Mobilier convinced French bankers of the wisdom of separating commercial banking from equity investment, and gave rise to the present division between *banques de dépôts*, such as Crédit Lyonnais, and *banques d'affaires*.

Imitators quickly sprung up throughout Europe. The Bank für Handel und Industrie was established in Darmstadt in 1853. The Rothschilds founded the Kaiserlich-Königliche Privilegirte Österreichische Credit-Anstalt für Handel und Gewerbe in 1855. Others include the Schweizerische Credit-Anstalt in Zurich (now one of the three main Swiss banks), the Allgemeine Deutsche Credit-Anstalt in Leipzig, the Vereinsbank in Hamburg, the Norddeutsche Bank in Hamburg, the Mitteldeutsche Credit-Bank in Meiningen, the Schlesischer Bank-Verein in Breslau, the Dessauer Credit-Anstalt, the Coburg-Gothaische Credit-Anstalt, the Preussiche Handelsgesellschaft in Königsberg and the Magdeburger Handelscompagnie.

In the United States, banks were also directly involved in corporate governance. In 1912, when US GNP was $39.4 billion, 18 financial institutions sat on the boards of 134 corporations with $25.325 billion in combined assets (Simon, 1998).

Why other countries abandoned universal banking

Stock markets in the 19th century were prone to repeated panics and crashes, and universal banks were often ruined when the value of their equity holdings collapsed suddenly. Kleeberg (1995) counts 20 bank collapses, 15 bank liquidations, one forced merger and 10 narrowly averted bank collapses in Germany between 1850 and 1910. Universal banks elsewhere fared no better. The General Credit and Finance Company was liquidated after 90 per cent of its capital was wiped out in the panic of 1866. Crédit Mobilier itself failed in 1867 due to reverses in the stock market and a disastrous investment in the North of Spain railway, a real estate firm.

A perception arose in Britain that equity ownership destabilised banks. When the General Credit and Finance Company was recapitalized after its spectacular failure, its managers renounced all 'financing' and transferred all commercial banking activities to the General Credit and Discount Company of London. An informal separation of commercial banking from equity investments has characterized British banking ever since.

This informal separation was inherited by Canada and other Commonwealth countries. The Canadian and US banking rules differ in a number of ways. Unlike US banks, which are prohibited from owning industrial firms' equity for active investment (control) purposes, since 1967 Candian banks have been allowed to own up to 10 per cent (compared with 5 per cent in Japan) of voting stock equity in non-financial firms, excluding stocks of small companies and stocks obtained as collateral. Prior to 1967 there were no laws prohibiting Canadian banks from equity blockholdings. Nevertheless Canadian banks have shunned equity ownership in non-financial firms. Canadian banks collectively have very little equity (C$10.4 billion) out of a total equity base of C$800 billion. The reason Canadian banks and the Bank of Canada give for this is that equity ownership is not part of banking.

Over a number of decades, and especially during the Great Depression, country after country separated banking from equity ownership. In Italy, universal banking existed until the banking crisis of April 1931, when the government imposed a legal separation of commercial and investment banking and took over banks' holdings of non-financial firms' shares. These were placed in a state-owned holding company, the Istituto per la Ricostruzione Italiana or IRI, one of the largest conglomerates in Europe. Similar legislation was imposed in Belgium.

Simon (1998) provides empirical evidence that the eviction of banks from corporate boards, which took place around 1910 in the United States, depressed firms' value by about 7 per cent. The United States legislated the separation of commercial banking from investment banking with the Glass–Steagall Act of 1933. The Bank Holding Act of 1956 forbids US banks from holding more than 5 per cent of their capital in corporate shares, and the corporate shares they own cannot be used for purposes of control.

Germany and a handful of small European countries retained the older banking model

Germany also had a severe banking crisis in 1931. German banks had extended large loans in the 1920s to highly levered industrial firms, especially those controlled by the industrialist heir Hugo Stinnes. As these companies failed the German banks accumulated their equity, which had been pledged as collateral. German banks also spent large amounts of their depositors' money buying their own shares to maintain their stock prices in the late 1920s. Since the share prices being maintained were artificially high, this probably contributed to their later insolvency. By 1931, when all the major German banks were recognized as clearly insolvent, the Deutsche Bank und Disconto-Gesellchaft owned 27 per cent of its own shares, the Dresdner Bank owned 34 per cent, the Commerz und Privatbank 50 per cent and the Darmstädter-Nationalbank owned 60 per cent of its own shares.

To bail them out, the Weimar government took over these blocks, effectively partially nationalizing the banks, and established a committee in 1933 to consider banking reform. The committee quickly recommended against any changes when the National Socialist Party came to power (Kleeberg, 1987). Hitler toyed with the idea of fully nationalizing the banks, but never implemented such a plan. Following the war, banks in the Soviet occupation zone were 'temporarily' closed in 1946 (Kleeberg, 1987), while those in West Germany were privatized and had reattained their prewar structures by 1957.

Banking reform was also on the back burner in Switzerland, Holland and the Scandinavian countries. The trade war that followed the Smoot–Hawley tariff, passed by the US Congress in 1930, virtually shut these small nations out of international trade.[5] Given the economic devastation wrought in these countries by the cessation of international trade, public policy attention centred on trade initiatives such as the Oslo Agreement; banking reform was of negligible importance. Thus

various aspects of universal banking survived in these countries as well. In Switzerland especially, cosy cartels were established to protect the stability of the system. When barriers to entry were relaxed in 1990, 130 of the existing 625 either lost their independence or disappeared.

The circuitous history of Japanese banking and corporate governance practice

Despite the 1866 collapse of Crédit Mobilier, Japan's Meiji government chose to implement a universal banking system modelled on that of Germany. Economic historians such as Colomiris (1992) view heavy bank involvement in industrial firms in Germany as having played a key role in Germany's rapid economic development between 1870 and 1914. For example German banks were able to provide capital to industry during this period at a much lower cost than in the United States (about 4 per cent in Germany compared with 20 per cent in the United States).[6]

It is, however, unclear whether German bank involvement in corporate governance through equity ownership contributed to the fast economic growth in Germany during this period. Kleeberg (1987) presents evidence that German universal banks were remarkably poor at 'picking winners' during the country's industrialization, that they invested in a depressing series of financial debacles, and that they may actually have impeded Germany's development by sustaining poorly run firms. It is often argued in this regard that Germany industrialized rapidly because it was a latecomer and the path it had to follow was clear, not because of its universal banks.

In any case, Japan's choice of a universal banking system was certainly politically motivated as well. By owning a universal bank that in turn owned controlling stakes in a large number of companies, a Meiji family could magnify its wealth into control over corporate assets worth vastly more. Cross-holdings between controlled firms further reduced the actual values of the equity stakes the bank needed for control. Such family-controlled corporate groups, called *zaibatsu*, characterized Japan's economy until 1945.[7]

Like Europe and North America, Japan experienced economic crises in the 1920s and 1930s. The banks of the Mitsubishi, Mitsui and Sumitomo families survived this turbulence. They were well diversified, having invested their excess cash flows across many firms and industries. These banks also lent only 10–20 per cent of their loan funds to related firms. Other Japanese families had greater need for outside capital, and therefore used their banks primarily to raise

money for their own firms. These 'organ' banks were poorly diversified. For example 94 per cent of the Nakazawa Bank's loans were to insiders, as were 75 per cent of the Watanabe Bank's loans. Prior to their collapse in 1927, 72 per cent of the loans of Suzuki's captive bank, the Taiwan Bank, want to Suzuki companies and 75 per cent of Matsukata's Jugo Bank's loans went to Matsukata family firms. In the crisis of 1927, triggered by the financial frauds by Ione Suzki and the closure of the Tokyo Watanabe Bank, 37 banks failed. All were 'organ' banks. It is of note that organ banks typically held less equity (about 15 per cent of the value of their loans) than did the highly diversified banks of the surviving *zaibatsu* (about 21 per cent).

Another wave of bank failures occurred as the Great Depression took hold in Japan. In 1930, 19 banks failed; 33 closed their doors in 1931; and 13 more failed in 1932. Again, large diversified *zaibatsu* banks survived and more 'organ' banks failed. Equity ownership was again lower in the banks that failed.

After the Second World War the US occupation force in Japan oversaw a full-scale revamping of Japan's financial system. Banks were forbidden to underwrite securities. Although the US government exerted considerable pressure for a complete ban on bank ownership of non-financial firms' stock along the lines of US practice, the Allied Forces ultimately decided against this. Banks' share ownership in other companies was limited to a 10 per cent stake, and *zaibatsu* firms were ordered to disgorge their shareholdings in each other in 1950. As a result, shares of large Japanese companies were mostly widely held in the immediate postwar period.

Postwar reconstruction entailed high interest rates, which lowered equity prices. This, in concert with the disgorgement of banks' former equity holdings to public shareholders, led to a collapse in the share prices of former *zaibatsu* firms, as illustrated in Table 12.1. Sheard (1991) documents a series of hostile takeover bids against firms formerly in *zaibatsu* groups, including Taisho Marine, Mitsubishi Real Estate and Mitsui Real Estate.

Just before the end of the US occupation in 1952, Japanese firms began to buy up each others' shares with the explicit purpose of preventing hostile takeovers (Sheard, 1991). This resulted in a considerable increase in intercorporate share ownership between the former Mitsubishi, Mitsui and Sumitomo *zaibatsu* firms and banks in 1949–51. A renewed spate of takeover bids and greenmail payments in the late 1960s accelerated Japanese firms' intercorporate stock purchases, particularly between the firms and banks in the newly

Table 12.1 Estimates of Tobin's *q* for Mitsubishi and Sumitomo group firms, 1949–53*

	1949	*1950*	*1951*	*1952*	*1953*
Mitsubishi group	1.61	0.46	0.39	0.72	1.00
Sumitomo group	1.96	0.34	0.35	0.78	0.86

*The Mitsubishi group includes 13 manufacturing firms and two marine transport firms; the Sumitomo group includes seven manufacturing firms and one warehouse firm. Tobin's *q*'s for the corporate groups are value weighted averages of the *q*'s of their member firms. The firm *q* values were calculated using the book value of fixed assets. Since book value is likely to underestimate true replacement cost during this period, these estimates of *q* are probably too large.
Sources: Miyajima (1990) and Morck and Nakamura (1992).

Table 12.2 Equity cross-holding, 1945–66* (percentage of outstanding shares owned by group firms)

	1945	*1950*	*1952*	*1954*	*1958*	*1962*	*1966*
Mitsui	57.3	0.44	5.44	6.87	7.42	12.40	21.77
Mitsubishi	46.1	2.18	10.09	12.61	13.82	17.39	26.12
Sumitomo	44.0	0.00	10.49	15.00	18.19	27.62	30.05

* The 1945 figures denote total ownership of the *zaibatsu* group of firms by the family holding company, family members and other *zaibatsu* firms. Later figures are total ownership of the successor *keiretsu* by its member firms.
Sources: Miyajima (1990) and Morck and Nakamura (1992).

emerging Sanwa, Fuji, Daiichi and Kangyo groups. Table 12.2 documents this transformation for three major *zaibatsu*.

The result was the grouping of Japanese firms into *keiretsu*, groups of firms that together owned controlling blocks of each others' shares. Aoki and Sheard (1992), Morck and Nakamura (1999) and Sheard (1989, 1991), propose that *keiretsu* arose primarily as antitakeover barriers. The following warning, taken from a Japanese guidebook on making firms public, shows that this use of cross-holdings is still explicitly acknowledged:

> Large corporations, foreign investors, and speculative investment groups holding large amounts of capital can acquire a majority of the shares in your newly listed firm, resulting in your losing management control. To avoid such a takeover attempt, it is essential that you take the precautionary measure of locating stable shareholders [such as banks and related companies].
>
> (Kato and Matsuno, 1991, p. 51, our translation)

The potency of *keiretsu* as antitakeover defences is illustrated by the American financier T. Boone Pickens' bid for the Japanese firm Koito in 1990. Pickens accumulated stock on the open market until he was by far the largest single shareholder, yet he was unable even to gain a seat on the board. Together, other firms in the *keiretsu* owned a majority of Koito's stock, and acting in concert they blocked Pickens' every move. Thus Japanese banks and their main client firms are effectively insulated from shareholder pressure.[8] Public shareholders thus have little or no voice in Japanese corporate governance.

THE IMPLICATIONS OF ASSIGNING CONTROL RIGHTS TO CREDITORS

Why corporate control should be in the hands of residual claimants

A firm's employees, managers, creditors and suppliers have contractual claims against the firm's assets. These claims are for fixed, prearranged monetary amounts: wages, interest payments or invoice amounts. In contrast its common shareholders have only a residual claim on its assets: the shareholders are entitled to the residual value left over once all the contractual claims are settled.

Contractual claimants, in maximizing the value of their claims, in general seek to minimize the probability of the firm defaulting before their contractual claims are paid. Meanwhile residual claimants seek to maximize the value of their residual claims. In general this is equivalent to maximizing the value of the firm's assets.

A fundamental consequence in corporate finance is that control rights are assigned to residual claimants. This is because the residual claimants, when maximizing the value of their own claims, must see to it that contractual claimants are paid. In contrast creditors, or other contractual claimants, in minimizing the firm's probability of default, see no need to raise further the value of the residual. This is why most countries give creditors little voice in corporate governance except when the firm is or is near to becoming bankrupt and general creditors usually become residual claimants.

Japanese banks are creditors first and shareholders second

Japanese banks are both creditors and shareholders. The webs of equity cross-holdings among *keiretsu* firms make Japanese banks influential in Japanese corporate governance. Do they use this influence to advance shareholders' interests or creditors interests, or a mixture of the two?

There are many reasons for thinking that banks are creditors first. First, banks' equity stakes were limited to 10 per cent in non-financial firms in the 1950s, and this was reduced to 5 per cent in the 1980s. In contrast banks' loans to non-financial firms are not limited. Second, the main banks in Japanese *keiretsu* implicitly guarantee the timely repayment of loans made to *keiretsu* member firms by other lenders. They make no such guarantee in respect of dividend payments to other shareholders. Third, Japanese banks, as stable shareholders, implicitly commit themselves to holding on to their equity stakes indefinitely. They therefore have little direct interest in the value of those stakes.

Kang and Shivdasani (1995) and Kaplan and Minton (1994) show that new bank representatives are appointed to the boards of Japanese companies when their financial performance lags, and argue that Japanese banks may exercise a corporate governance role that in some respects substitutes for shareholder pressure. Morck and Nakamura (1999) show that Japanese banks act primarily to protect their interests as creditors, responding to potential and actual debt repayment problems rather than more general indicators of financial health.

How creditors' and shareholders' interests diverge

The essential difference between creditors' interests and shareholders' interests in corporate governance can best be illustrated with a simple example. Let $V = D + E$ be the value of the firm, where E the value of its equity and D the value of its debt. Shareholders want to maximize $E(V - D)$ whereas creditors want to minimize $Prob(V < D)$. Suppose the firm has an investment opportunity that costs C and returns P with probability p and zero with probability $1 - p$, and let $pP > C$. Clearly, risk-neutral shareholders want the project to go ahead. In contrast, the creditors are indifferent about the project if $C < V - D$, and are opposed to it if $C > V - D$. Myers (1977) argues that shareholders, given sole control rights, can exploit creditors by launching projects for which $C > V - D$, and that this raises the cost of debt financing.

If creditors have control rights and shareholders are merely along for the ride, such a project would clearly not be approved if $C > V - D$. The problem with giving creditors control is that it might not be approved if $C < V - D$ either. Indeed a new set of criteria might come into play. Creditors might exploit shareholders by charging the firm artificially high interest rates. They might distort the firm's investment decisions towards low-risk projects, especially if this keeps cash flows stable and thereby lets the firm use more debt financing. They might also skew the firm's investment decisions towards projects that provide lots of collateral. These possibilities should increase the cost of equity finance and depress share prices in proportion to the probability of their occurring.

These predictions are consistent with the observed behaviour of Japanese banks and the client firms in which they exercise corporate control. Hoshi *et al.* (1993) show that firms in bank-centred *keiretsu* pay higher interest costs than other similar firms. They also use more bank debt and show a worse financial performance. There is also some empirical evidence that Japanese firms affiliated with *keiretsu* groups and/or main banks pay higher interest rates on their loans from their main banks than unaffiliated firms (Nakatani, 1984; Weinstein and Yafeh, 1998).

If Japanese banks could in fact extract money in these ways from their client firms, we should not necessarily expect banks to show an abnormally high financial performance or bank shares to rise. Banks, like other firms protected from their shareholders by equity cross-holdings, would presumably retain free cash flows. A more plausible use for such funds might be greater organizational slack, higher salaries and the like. Table 12.3 compares the hours worked and pay scales of Japanese bankers with those of comparable employees of other firms – banking appears to be a substantially more attractive career.

Regulatory capture

Related to the figures in Table 12.3, another potentially serious cost of having powerful bank investors in industry is their ability to influence public policy making to their advantage. This is particularly so in the banking and finance industry, which is generally regulated heavily in all developed economies. Such influence might also explain the figures in Table 12.3.

The relationship between Japanese banks and their regulators, the Ministry of Finance and the Bank of Japan, has been quite close. For

Table 12.3 Wages and working conditions for male employees with university education at firms with at least 1000 employees, 1990

	Manufacturing sector	*Banking sector*
Mean age	37.4 years	35.8 years
Mean years of service	12.1 years	11.7 years
Mean scheduled hours per month	172 hours	157 hours
Mean overtime hours per month	18 hours	13 hours
Mean annual regular contract pay	6 271 900 yen	7 289 600 yen
Mean annual bonuses and other special pay	1 707 100 yen	2 324 000 yen

Notes: Manufacturing sector data includes only non-production workers. Banking sector includes banks, insurance companies and other financial firms.

example since July 1998 eight (10) of the 96 Japanese regional banks have had former MOF (BOJ) officials as their CEOs; six (two) banks have had former MOF (BOJ) officials as chairmen of their boards; and 31 (20) banks have had former MOF (BOJ) officials on their boards of directors or serving as auditors (Toyo Keizai, 1998).

It is not implausible that these linkages between politically powerful banks and their watchers might have further distorted capital allocation. The serious lack of independent regulatory power may also explain why Japan has been reluctant to deal with corrupt banking practices.

How creditors' interests and employees' interests converge

Employees, like creditors, are contractual claimants, not residual claimants. What is good for creditors is therefore likely to be good for employees. The low-risk environment fostered by banks made possible the Japanese practice of lifelong employment, the cornerstone of industrial relations in many Japanese firms. This practice inhibited movement of personnel between corporations and, it is argued, encouraged employees to invest in firm-specific human capital. While such investments may have enhanced internal efficiency, they may have inhibited the development of industry-wide or economy-wide standards. It is also argued that highly developed, firm-specific practices discourage firms from hiring workers in mid career from other firms, except in very special cases. For example new technologies might require personnel with specific expertise.

THE MICROECONOMIC FOUNDATIONS OF A MACROECONOMIC CRISIS

The conditions for an old-fashioned Keynesian recession

In a simple Keynesian model of the business cycle, excessive capital expenditure by firms leads to underutilized productive capacity and a consequent excess aggregate supply. Traditional Keynesian macroeconomic prescriptions are aimed at curing this imbalance by increasing aggregate demand with tax cuts, public works projects and the like.

It seems plausible that assigning control rights to creditors might produce precisely these conditions. Profitable capital projects might not be approved if they appear too risky. More marginal projects with lower but safer returns might displace them – especially if they provide abundant collateral. In short, creditor-controlled firms might excessively direct their capital investment towards the expansion of existing facilities, increased market shares in existing products, minor variations in product design and other low-risk, low-return ventures.

This strategy should work well as long as new markets open to provide a growing aggregate demand for such products. This characterized Japan's reconstruction during the postwar period and firms' explicit quest for market share rather than profits. It also explains the importance to Japan of the growing markets in East Asia in the 1980s as a source of increased aggregate demand, and the devastating impact on Japan of slowing growth in those markets and increasing competition from local firms.

Faced with persistent excess aggregate supply, Japanese firms have been forced to lay off huge numbers of workers in mid career. The practice of lifelong employment means that few firms know how to hire such workers. Consequently a serious social problem is developing.

Why not in Germany too?

German banks, like Japanese banks, are both creditors and shareholders in non-financial German firms. Why has a similar situation not arisen in that country?

German banks' corporate control role is arguably more explicit and more important than that of Japanese banks for several reasons. First, German banks' direct equity stakes are not legally capped. In contrast Japanese banks' equity stakes were limited to 10 per cent throughout most of the postwar period and are now limited to 5 per cent. Second,

insurance companies and other financial firms in Germany are subsidiaries of large banks, which vote their subsidiaries' shares. This is often true in Japan too, but exceptions are more evident there. Third, German banks vote the shares that back US depository receipts. Japanese banks have no analogous role. Fourth, independent stockbroker firms are not important in Germany. German banks also act as stockbrokers for German investors, and hold the shares owned by their clients in trust. In contrast Japanese banks are barred from the brokerage and investment banking industry. When all of these stakes are combined, large German firms that at first glance appear to be widely held are actually fully and directly controlled by the country's largest four or five banks, as shown in Table 12.4.

Table 12.4 Voting rights exercised by German banks in widely held German Corporations, 1992 (per cent)

	Banks' direct stake	*Subsidiary investment funds' stake*	*Bank-controlled proxy votes*	*Total bank control*
Siemens	–	9.87	85.81	95.68
Volkswagen	–	8.89	35.16	44.05
Hoechst	–	10.74	87.72	98.46
BASF	0.09	13.81	81.01	94.91
Bayer	–	11.23	80.09	91.32
Thyssen	6.77	3.82	34.98	45.57
VEBA	–	12.82	78.23	91.05
Mannesmann	–	7.78	90.35	98.13
MAN	8.67	12.69	28.84	50.20
Preussag	40.65	4.51	54.30	99.46
VIAG	10.92	7.43	30.75	49.10
Degussa	13.65	8.65	38.35	60.65
AGIV	61.19	15.80	22.10	99.09
Linde	33.29	14.68	51.10	99.07
Deutsche Babcock	3.22	11.27	76.09	90.58
Schering	–	19.71	74.79	94.50
KHD	59.56	3.37	35.03	97.96
Bremer Vulkan	–	4.43	57.10	61.53
Strabag	74.45	3.62	21.21	99.28
Average	13.02	10.11	60.95	84.09

Notes: Includes shares on own accounts, depository rights as proxies held by subsidiary investment funds expressed as a percentage of all shares represented at the general meeting.
Sources: Baums (1995) and Morck and Nakamura (1995).

Table 12.5 Votes in the five largest German banks controlled by the five largest banks, 1992 (per cent)

	Deutsche Bank	*Dresdner Bank*	*Commerz Bank*	*Bayr. Bank*	*Bayr. Hypo*	*Total*
Deutsche Bank	32.07	14.14	3.03	2.75	2.83	54.82
Dresdner Bank	4.72	44.19	4.75	5.45	5.04	64.15
Commerz Bank	13.43	16.35	18.29	3.78	3.65	55.50
Bayr. Bank	8.80	10.28	3.42	32.19	3.42	58.11
Bayr. Hypo	5.90	10.19	5.72	23.87	10.74	56.42

Notes: Includes depository voting rights and shares held by subsidiary investment funds. Figures are the percentage of all shares represented at the general meeting.
Sources: Baums (1995) and Morck and Nakamura (1995).

If German banks were to choose to run large non-financial firms primarily to maximize the value of their debt, no one could interfere. Moreover the banks are theoretically immune to shareholder pressure. This is because the banks collectively vote substantial majorities of their own shares, as Table 12.5 shows.

German banks have immense voting power in many large German firms, yet their actual ownership stakes are often trifling in comparison. German banks might therefore be even more likely than their Japanese counterparts to use their control rights to distort corporate decision making away from firm value maximization and towards the maximization of debt values.[9]

German law also assigns an explicit corporate governance role to employees. Employees' representatives make up half the members of the *Aufsichtsrat* (the supervisory board of a large German firm) and are represented on the *Vorstand* (the managerial board). Employees, like creditors, are contractual claimants. Their interests are largely aligned. Thus employee control rights should further distort corporate decisions towards stability and away from risk taking.

There are, however, some important reasons to doubt such a conclusion. First, West Germany was not forced to adopt a widely held US corporate governance system after the war. Coordinating policy across the French, British and US occupation zones proved too difficult. Consequently denazification left wealthy German families owning large blocks of equity in many companies. These may have provided corporate governance counterweights to banks that did not exist in large Japanese companies.

Second, German banks hold huge quantities of common shares in trust for public shareholders and foreigners, who invest in equities only via banks or their subsidiaries. Every time a shareholder buys or sells common shares, his or her bank charges about 1.5 per cent of their market value. One per cent of this is a commission fee, the rest is a stamp fee, theoretically paid to the stock exchange. In practice the bank typically settles customers' equity tradings against its own account and retains this fee. These brokerage fees are a significant part of total German bank revenues. Since these fees are proportional to the market value of the equities traded, German banks have a direct interest in high share prices.

In short the German model places bank equity ownership within a general regulatory context that gives banks a clear incentive to worry about value maximization as well as firms' creditworthiness. By imposing US-style separation of commercial and investment banking without permanently disabling banks' ability to exercise corporate control through equity markets, Japan's postwar financial reforms allowed an unbalanced financial system to develop over time. This is an example of the problem Romano (1993) warns of: business practices and laws are part of a system and may not work as expected when transferred piecemeal from one economy to another.

Prognosis

The standard Keynesian remedy for a recession caused by excess aggregate supply is to increase aggregate demand by lowering taxes, stimulating private consumption or undertaking public works projects. Such demand-side stimulation is also being prescribed by those who would inject large amounts of bailout money into the Japanese economy. Such prescriptions are valid, but may provide only short-term symptomatic relief rather than effect a complete cure.

Keynes argued that excess capacity results from bouts of 'animal spirits' on excessive optimism that lead to overinvestment. Such psychological factors were apparent in Japan's bubble economy of the 1980s. However we argue that Japan's excess capacity problem was also due to the dysfunctional corporate governance system's proclivity to encourage overinvestment in low-return, low-risk operations involving lots of physical assets. We propose that this microeconomic misallocation of capital triggered the overinvestment bubble in the first place and is now prolonging the resulting economic disarray.

While significant measures have been implemented to deregulate certain aspects of Japan's corporate governance law and its capital and foreign exchange markets since the mid 1990s, little change has been proposed for the role of banks as large investors (both shareholders and creditors) in Japanese industrial firms. For example no change in the antimonopoly laws has been proposed to end the long-standing stable shareholding or cross-shareholding practices. It is also far from clear that financial deregulation will make it unprofitable for banks and industrial firms to continue to engage in cross-holding. Also, except for a small number of failing firms being purchased by foreign firms, there seems to be no rush on the part of US or European corporations to purchase major Japanese firms despite their historically low market values.

Japanese banks appear to have used their lobbying influence to erect capital barriers and entrench their dominance over the domestic debt markets. Until 1972 Japanese banks actively opposed and successfully prevented the issuing of bonds without collateral. Thus only secured bonds existed. Japanese banks were the underwriters and primary buyers of these bonds, so they were essentially transferable bank loans. Securities firms, which had grown in relative power during the 1960s, won the right to underwrite unsecured corporate bonds in 1972, and Mitsubishi Corporation, Hitachi and Marubeni issued convertible debentures in that year. (Convertibles were allowed by the regulator – the Ministry of Finance – on the basis that they are closer in nature to equity than debt.) An active bond market has slowly developed since then. Unsecured straight corporate bonds became a financing option for Japanese industrial firms only recently. Such delay has forced Japanese firms to rely heavily on bank loans rather than capital market financing.

As this deregulation proceeded, high-net-worth Japanese firms began to raise significant funds in bond markets (Hoshi *et al.*, 1993). Thus the globalization and deregulation of securities markets appears to be eroding the financial hold that banks have on firms. These firms appear to have freed themselves from the corporate governance of banks.

Financial deregulation allowed Japanese banks to enter the securities business in the 1990s. They did so with vigour, and took a significant market share away from the traditional brokerage firms. This should increase banks' interest in promoting high equity values.

Thus banks are becoming less powerful in corporate governance matters in many firms, and at the same time are growing more

interested in high share values. We therefore propose that continued financial liberalization should gradually nullify Japan's corporate governance problems, and should therefore be a public policy priority.

CONCLUSIONS

Japan's prolonged economic problems are due to more than faulty macroeconomic policies. We do not deny the importance of bungled macroeconomic policy, but argue that deeper maladies in Japanese corporate governance made that country increasingly vulnerable to such problems. We argue that Japan's main bank and financial *keiretsu* systems left corporate governance largely in the hands of creditors rather than shareholders. Thus Japanese governance practices did not assign effective control rights to residual claimants. This, we argue, led to a widespread misallocation of capital that mired Japan in excess capacity and liquidity problems.

There is significant interest in Japan in identifying aspects of the Anglo-American corporate governance system that can be incorporated into the Japanese system. Some measures have either been taken or proposed for serious consideration. Holding companies are now legal for large industrial firms. Toshiba, for example has already announced its intention to become a holding company and all the present production divisions are to be reorganized into separate companies. Hitachi and Toyota will follow suit. It is now legal for firms to purchase their own shares to prop up their stock prices. Tax and other legal conditions are being revised so that firms can offer certain types of stock options to their executives. These measures have been taken to a large extent to tighten the connection between firms' performance and their stock prices, and because of the policy makers' belief that implementing these measures might improve firm performance and bring Japan out of its recession.

Notes

1. An earlier version of this chapter was presented at the UBC Conference on Japanese Business and Economic System: History and Prospects for the 21st Century, 12–13 February 1999. The Research was in part supported by the Social Sciences and Humanities Research Council of Canada.
2. Two major types of comparative corporate governance system presented in the literature are the market-oriented (Anglo-Saxon or Anglo-American) type and the bank-oriented (European–Japanese) type, with some variants for each of the two types (Morck and Nakamura, 1995; Shleifer and Vishny, 1997; Tschoegl, 1995). Additional classifications include outsider (market-oriented), insider (bank-oriented) and ultra-insider (bank-oriented with cross-holdings) types (Rybczynski, 1984; Walter, 1992). Market-oriented and bank-oriented systems are broadly associated with, respectively, common-law-based and code-law-based legal systems. These types of alternative system also embed general societal and business culture.
3. In the 1980s there was a massive effort devoted by academics, business and government decision makers in the United States to studying Japanese practices and adopting those aspects deemed likely to improve the performance of the US economy. Looking at their economic achievement, some Japanese interpreted the translation of Vogel's (1980) book, *Japan as Number One*, to mean 'Japan is Number One'.
4. Much of the historical discussion here closely follows Kleeberg (1987), who gives a fascinating description of the history of universal banking in Europe, focusing on Germany. His work is not well known to economists, but should be.
5. The 'beggar thy neighbour' devaluations after the September 1931 collapse of sterling and the adoption of imperial preferences at the Ottawa conference were also key events.
6. Ando and Auerbach (1988) argue that Japanese banks similarly provided low-cost capital to industry after the Second World War to finance Japan's high economic growth period. It is not clear, however, that the particular structure of Japan's banking system caused this. Japan's very high savings rate and barriers to outward capital flow may been the vital factors.
7. The discussion of the prewar Japanese banking system follows Hoshi (1995) and Morck and Nakamura (1992).
8. The largest shareholders of the major Japanese banks tend to be their affiliated life insurance firms. Since these firms have a 'mutual' ownership structure (that is, the policyholders are *de jure* owners) they are unlisted and essentially are management controlled.
9. German directors have much more job security than their American counterparts and the turnover of industrial firms' management boards is somewhat related to sliding stock prices, but more to very poor earnings (Kaplan, 1993).

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Comments on Chapter 12

Murray Frank

INTRODUCTION

This comment is an attempt to place Morck and Nakamura's chapter into context. First it will be argued that Japan's performance during the 1990s was not as bad as is widely believed. However it was disappointing relative to its performance during the previous few decades. Second, it will be suggested that the evidence does not support the popular idea that misguided macro economic policy is the source of Japan's problems – at least not in the IS-LM sense in which the argument is normally presented. Third, it will be argued that Morck and Nakamura's focus on corporate governance problems is reasonable, but incomplete as an explanation of Japan's disappointing performance in the 1990s. They have identified one element of a larger problem in the Japanese financial system. Thus it will be suggested that Morck and Nakamura have revealed an important element of the problem. If they are right, and if the recent financial market reforms have the effects that many analysts are suggesting, then the prognosis for Japan's performance over the next decade is quite optimistic.

The currently leading account of Japan's problems in the 1990s is provided by Krugman (1998). He has argued that the miserable performance in the 1990s was due to the poor macroeconomic policy making in the face of a liquidity trap. The misguided policy makers refused to generate inflation. If only they had done so, all would have been well. Morck and Nakamura accept that poor macroeconomic policy may have been a factor, but suggest that the real problem lay at a deeper level. The real problem is that corporate governance is creditor determined. Accordingly firms pay too much attention to maintaining their payments to debt holders, and not enough attention to generating high returns for equity holders. As a result firms have undertaken too many investments that are excessively safe. Thus oversupply and inadequate demand follow in an old-fashioned Keynesian sense. In Krugman's purely macroeconomic interpretation, the solution is more enlightened macroeconomic policy. In the corporate governance interpretation by Morck and Nakamura the solution is

to reform corporate governance so that corporate managers (and their bankers) will care more about generating high equity values.

HOW HAS JAPAN DONE IN THE 1990s?

Japan has not done nearly as badly as popular opinion seems to suggest. Consider Figure C12.1, which plots real GDP per capita for Japan and the United States for the period 1961–98. As is well known, Japan started very far behind the United States, but apart from a slowdown in the early 1970s it was closing that gap until about 1991. Over the period 1991–98 the US growth rate increased sharply while the Japanese growth rate declined. On closer examination it can be seen that Japan enjoyed an economic recovery during 1994–96, but it came to an end with the very sharp downturn of 1997–98. In 1998, for the first time since the early 1970s per capita GNP actually declined in Japan.

Where does this leave Japan? According to OECD figures for 1998, Japanese GDP per capita (purchasing power parity adjusted) was US$24 109. This was just behind Canada ($24 468) and just ahead of Belgium ($24 097) but significantly behind the United States ($30 514) albeit nothing like the poorer OECD countries such as Korea ($13 540) and Turkey ($6720) – to say nothing of the many poor countries in the world.

So Japan's the GDP per capita was not the stuff of tragedy, and neither was the unemployment rate. During course of the decade the unemployment rate very gradually drifted up from about 2 per cent to around 4 per cent, and by October 1999 it stood at 4.6 per cent. This may have been bad by postwar Japanese standards, but by international standards it was a remarkably good performance. The typical rate for the other OECD countries over the period was in the neighbourhood of 8 per cent.

Despite these figures there is a widely held perception that Japan has had a decade-long slump. Why is there such a perception? Most commentators believe that Japan could have done better. Krugman (1998) talks of a gap relative to potential output and claims that the gap is more than 5 per cent of GNP. But this is a purely notional calculation based on a particular theory of what might generate the potential. Potential output is not actually observable. Since the underlying theory is controversial, it is hard to know how much confidence ought to be placed in such calculations. It depends on your view of 'Okun's law', Hodrick–Prescott filters and other such things.

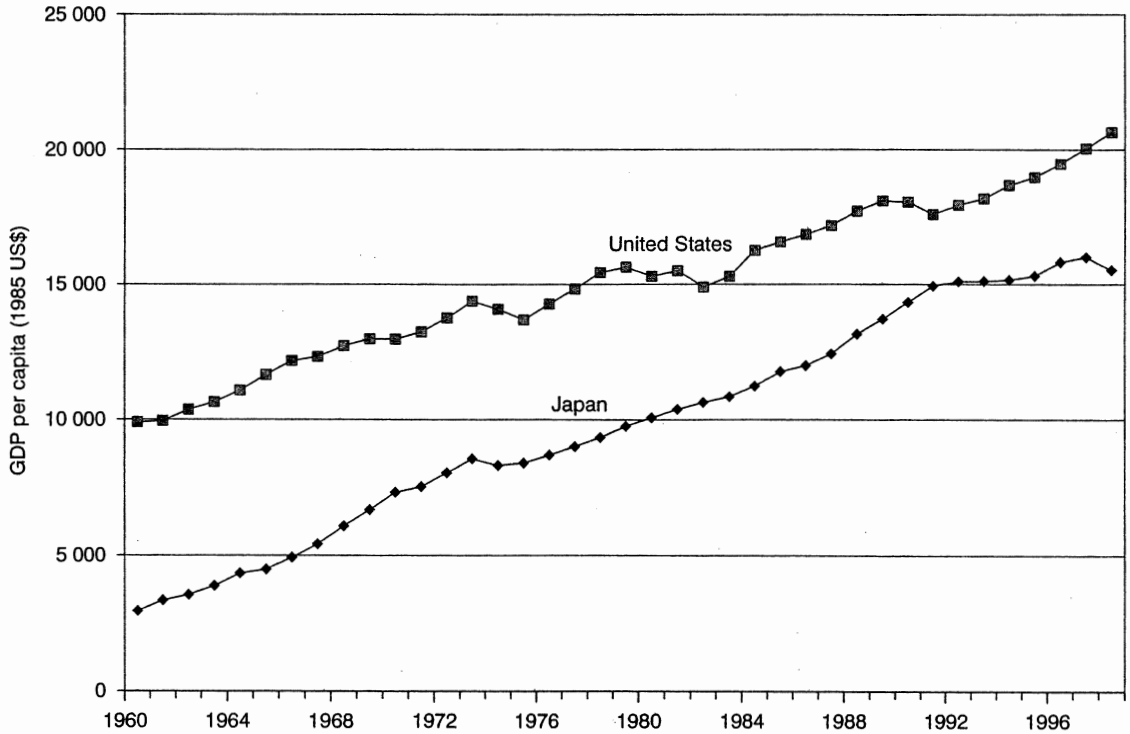

Figure C12.1 GDP per capita, United States and Japan, 1960–98
Source: Calculated data from Easterly and Yu (1999) and OECD (1999).

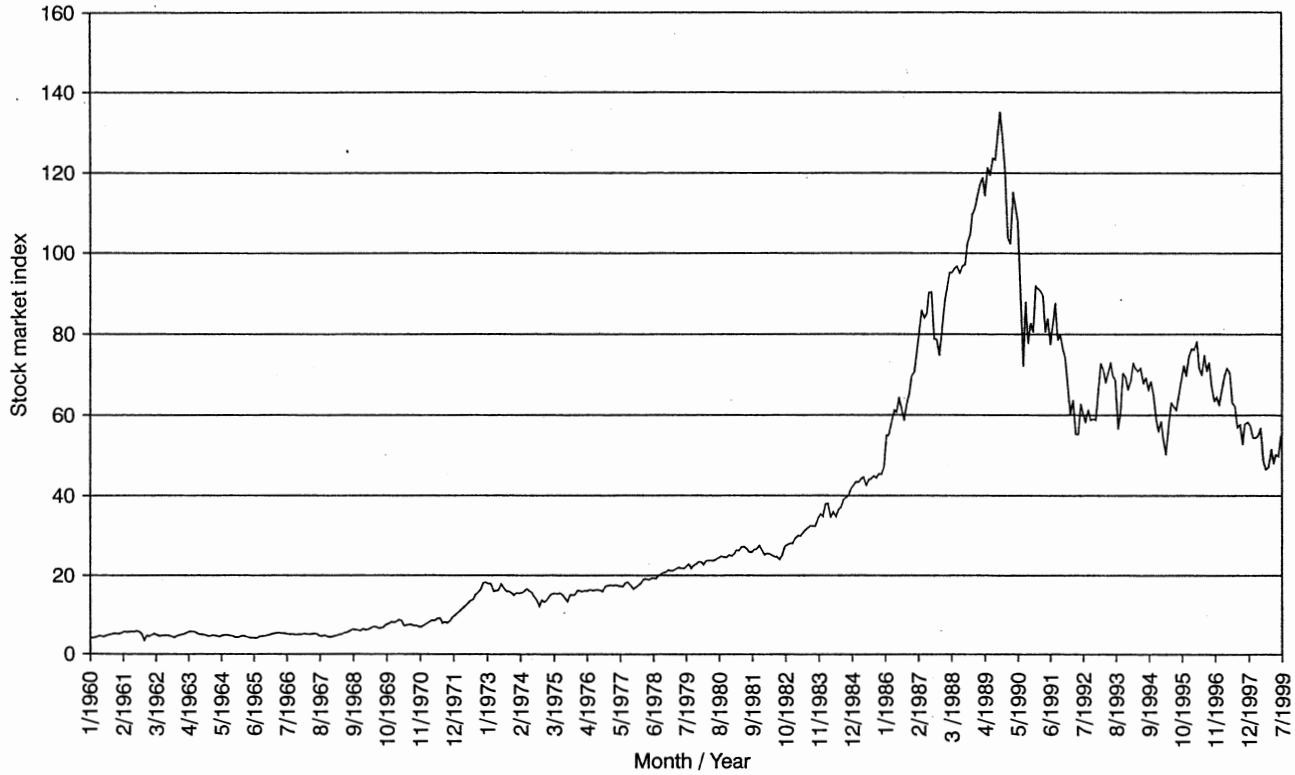

Figure C12.2 Stock Market index, Japan, 1960–99

However, as shown in Figure C12.1, there was a significant decline in the growth rate of GDP from 1991. What does have considerable policy resonance is a fairly simple calculation. If the growth rates of the 1970s and the 1980s had continued during the 1990s per capita GNP would have been much higher. Considerable attention has been focused on the bursting of the financial bubble in real estate and the stock market. As can be seen in Figure C12.2 the stock market had reached very great heights by the end of 1989, and ten years later it stood at less than half the peak value. The bursting of the financial bubble was accompanied by a sense of pessimism in popular accounts and the media. (there is a discussion of this change in mood in Chapter 12). So even if it was not a genuine tragedy, many find Japan's recent performance disappointing and they want it to do better.

MACROECONOMIC POLICY

Since there is wide spread disappointment about the performance of the Japanese economy in the 1990s, attention has naturally turned to the question of who to blame, and how to fix it. Morck and Nakamura appear to endorse the claim that Japan is in a liquidity trap.[1] In the IS-LM model there are two basic policy tools to get out of a slump: increase the money supply to shift out the LM curve, or increase government spending and government debt to shift out the IS curve. When an economy is in a liquidity trap, according to the textbooks the LM shift will not work because the LM curve is flat over the relevant range. So fiscal policy must be used.

In contrast to the textbook liquidity trap story, Krugman (1998) calls for a radical increase in the Japanese money supply in order to generate inflation. This is needed in order to have negative real interest rates. With a zero rate of inflation and an equilibrium requirement of a negative real rate of interest, the nominal rate of interest must be negative. But under the assumption that negative nominal interest are not permitted, inflation is Krugman's way out. The nominal rate can remain positive while the real rate turns negative. This actually happened in Japan in the early 1970s. Left inadequately explained is why the nominal interest rate cannot be negative. Why is the difference between 0.1 and 0 so very different from the difference between 0 and −0.1?[3]

As a matter of history there have been periods of negative nominal interest rates. These have often taken the form of service charges by

banks. Particularly during earlier periods, when the main function of a bank was to offer protection for the depositor's money, there was nothing terribly strange or odd about charging depositors for this service. It does not seem far-fetched to imagine that Japanese savers might prefer the security of money in the bank rather than money in a mattress where it might be stolen.

IS-LM analysis, in either its textbook variety or its Krugman variety, calls for fiscal expansion, monetary expansion or both if we want to increase Japanese output. What has the Japanese policy stance been on each of these dimensions?

Perhaps surprisingly, given much of the rhetoric about misguided Japanese macroeconomic policy, during the 1990s Japanese fiscal policy was highly expansionary in the IS-LM sense. Using OECD figures for 1990 the general government gross public debt as a percentage of nominal GDP was 61.4 per cent in Japan and 55.3 per cent in the United States; the corresponding figures for 1997 were Japan 84.7 per cent and the United States 59.1 per cent. For 2000 it is forecast that Japan will surpass Italy on this dimension at 117.6 per cent while the United States will reach 51.7 per cent. Similarly, Japan's total government outlay as a share of GDP grew over the period from 31.3 per cent to 35.1 per cent and it continues to grow, while that in the United States fell from 35.2 per cent to 33.6 per cent and continues to shrink.

Thus by any reasonable standard Japan followed an extremely expansionary fiscal policy throughout the decade and failed to grow. The United States lacked an expansionary fiscal policy and yet it grew sharply. Looking at other countries makes the case even stronger. For example over the period 1990–98 Ireland had the highest average annual GDP growth rate of the OECD countries at 7.3 per cent in real terms. This compared with 3.0 per cent for the United States and 1.2 per cent for Japan. In 1990 the Irish debt to GDP ratio was 105.4 and by 1997 it had *fallen* to 66.9. There are many examples of intensionally expansionary fiscal policy, ranging from France under the socialists to the Canadian provinces of Ontario and British Columbia under left-wing parties. The record of these attempts to shift out the IS curve has not been pretty. During the late 1990s Japan seemed well on its way to adding another example to this sad list. It is very far from clear that increased government spending and government debt really serves to increase economic activity in the manner depicted in the textbook IS-LM model.

What about monetary policy? In the US Great Depression of the 1930s, M2 collapsed near the start. Many economists think that much

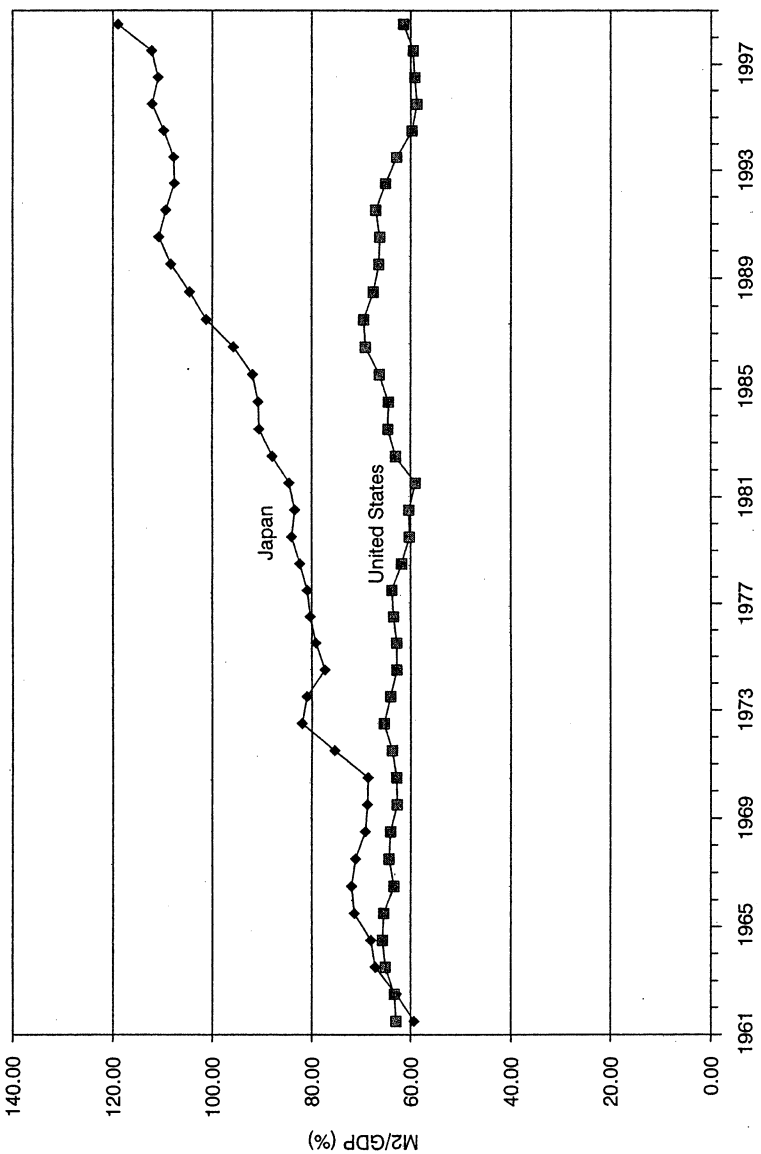

Figure C12.3 Ratio of money supply (M2) to GDP, Japan and the United States, 1961–98

of the devastation of the period could have been avoided if M2 had not been permitted to collapse by a third. Japan has not witnessed a major collapse of the money supply like that seen in the US depression. An indication of the Japanese monetary policy stance can be see in Figure C12.3, which plots the ratio of M2 to GDP. On average, since 1961 Japan has increased its money supply more than the United States has done. In the early 1990s both Japan and the United States decreased this ratio slightly, and from 1994 Japan increased the ratio to a greater extent than did the United States. In 1998 the Japanese even increased the ratio while experiencing a serious recession. From this evidence it seems hard to believe that US GDP per capita rose faster during the 1990s than Japanese GDP because of monetary policy. As with fiscal policy, these data would suggest that Japan ought to have performed at least as well as the United States over the period.

Thus the evidence suggests that Japanese policy makers in fact followed some thing not unlike textbook Keynesian policy measures to deal with the slump. The data really does not suggest that an IS-LM style remedy is really what has been missing in Japan. If one believes that increasing the money supply will generate real output, then the real mystery in Figure C12.3 is the US economic performance during the 1990s! And the real fiscal policy conundrum is why Ireland boomed while Japan did not during the period.

Perhaps in an effort to avoid controversy, Morck and Nakamura 'do not deny' the importance of poor macro policy in Japan. The evidence suggests that the Keynesian criticism of Japanese macroeconomic policy over the period is misplaced. The Japanese policy makers were more expansionary in the textbook Keynesian sense than were the Americans during the same period. It may even be that the textbook IS-LM models have the wrong signs on the fiscal policy variables, but this is not the place to investigate that possibility. The point here is that the main macroeconomic-oriented explanations that have been offered to account for Japan's performance over the period do not seem plausible. But is Morck and Nakamura's focus on corporate governance better?

THE CORPORATE GOVERNANCE PROBLEM

Morck and Nakamura provide a very interesting historical discussion of how the Japanese governance system developed. The incentive

properties associated with *Keiretsu* have been widely discussed. In contrast to many of the discussions, Morck and Nakamura find the system problematic. For instance they state that 'Firms in bank-centered *keiretsu* pay higher interest costs than other similar firms.' In general they consider that firms pay too much attention to the interests of debt claimants and not enough to the interests of equity claimants. As a result firms overinvest in excessively safe projects. Thus there is excess supply. They interpret these incentives as feeding an 'old-fashioned Keynesian recession'. While they believe that stimulative macroeconomic policy will be helpful in the short run, they argue that it cannot cure the problem since it does not address the source of that problem. To fix the problem would require a change to the mode of corporate governance, in particular making changes that would result in banks becoming more interested in high equity valuations.

My concern with their approach is the question of timing. A complete story would explain why the economy did so well from 1960 to 1989. It would explain why the economy recovered so much better in the early 1970s. Why did the bubble burst? How was this related to the changes in unemployment and per capita GNP? To me their approach seems incomplete. While they do suggest that there is a connection, they do not explain how the connection works. Why did the bubble burst when it did? The timing is particularly odd since at about that time Japan's major export market (the United States) entered a period of particularly robust growth. As can be seen in Figure C12.2, between 1973 and 1975 the financial market also suffered a significant decline. Yet a couple of years later Japan resumed its high growth rate in per capita GNP. So why did it take so long in the 1990s? This seems to me to be the biggest missing piece in their otherwise rather convincing discussion.

It is not clear how best to answer these questions. On a speculative note, one possibility is that for many years the investment opportunities available were so rich that minor errors in judgement hardly mattered in most cases. As the easy pickings are reduced, it makes a much bigger difference if bad decisions are made. Under this interpretation, after the bubble economy it may have been that the available domestic investment opportunities became much leaner (although it is not clear why this happened). The initial reaction was to invest more in Asian countries. That turned out poorly when the Asian crisis hit. Overall the weaknesses of the Japanese financial system became much more apparent.

In the 1980s Japan was doing well and many in the West looked to Japanese methods for guidance. But in the 1990s it ran into difficulties, and now we are told that what had been seen as strengths (in particular the *keiretsu* system) may in fact have been weaknesses. According to Morck and Nakamura, Japanese corporate governance was inducing a poor choice of investment projects all along. However until the bursting of the bubble the problem had been hidden.

FINANCIAL PROBLEMS

It seems to me that there is good reason to believe that there are broader financial system problems in Japan than just the corporate governance problems identified by Morck and Nakamura. To understand this it is helpful to recall some basics.

What is a financial system supposed to accomplish? What can we expect to observe if the system is performing its tasks well? What kinds of things would indicate potentially fixable problems? In essence any financial system has two tasks. The most basic task is to take people's savings and invest them in productive opportunities. A good financial system is one that leads to high-value projects being undertaken, and low-value projects not being undertaken. This is vitally important to the welfare of a nation. It is the most fundamental of financial problems, and it arises whether or not there is any 'risk' in the system.

Of course there really is plenty of risk in the system. Thus the second basic problem that a financial system must resolve is how to allocate the risk. It is desirable that those people who are more capable of bearing the risk do so. This needs to be accomplished without doing too much damage to the effort incentives present in the system. It also needs to be accomplished without doing too much damage to the project choice decisions made by the people in the system. As might be imagined, coping with moral hazard and adverse selection are delicate problems.

In the real world all financial systems grapple with these problems. Sometimes the problems are solved better than at other times. In some countries the problems seem to be solved better than in other countries. When conditions change, what had previously appeared to be a good solution might suddenly appear to be a bad one.

How does the Japanese financial system fare on these basic dimensions? Not all that well. It has been difficult for individual investors to move their savings to higher-paying opportunities abroad for

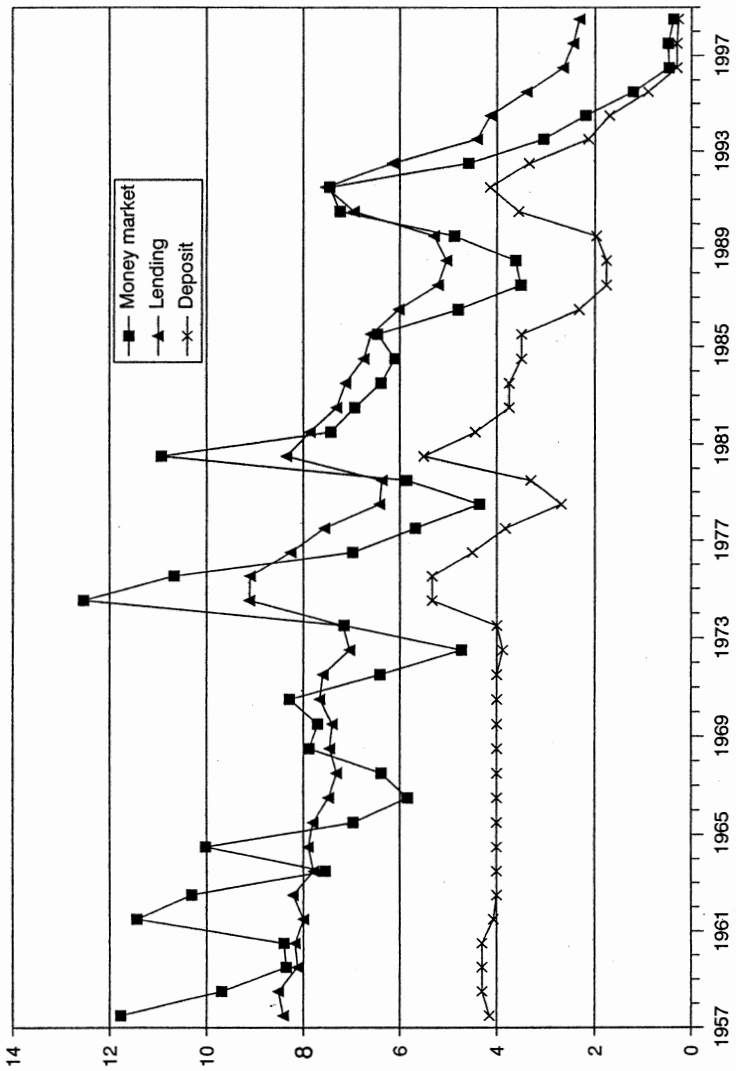

Figure C12.4 Interest rates, Japan, 1957–98 (per cent)
Source: Complied from IMF (1999).

institutional reasons. Since considerable saving was still taking place in the period in question the net effect was that interest rates declined substantially. Figure C12.4 shows the interest rates for Japan from 1957–98. By IMF definitions the money market rate is a short-term rate, the lending rate is a long-term rate and the deposit rate is what an individual can get on typical bank deposits. As can be seen, the short rate and the deposit rate came very close to zero towards the end of the 1990s. At the same time the US Treasury bill rate was about 5 per cent and the comparable rate in Britain was around 6 per cent. Thus better interest rates were available abroad. Yet the Japanese banks and other domestic financial institutions remained flush with funds throughout most of the 1990s.[3]

Thus a basic problem with the Japanese financial system is that it has not been offering investors as good a rate of return as possible. This is a crucial issue for the future welfare of the country. Turning to Japanese equities would not easily have solved the problem for Japanese investors either. Cai *et al.* (1997) have shown that Japanese mutual fund managers perform remarkably poorly.[4]

While the Japanese continued to save it may be that domestic investment opportunities worsened. As the available investment opportunities declined, borrowers were much less interested in borrowing since they did not have so many good uses for the funds. The banks had resources to lend, but they found less in the way of good investment opportunities. This may have been particularly acute for the types of investment opportunities in large firms that the banks had good experience in assessing.

As is well known, Japan had very serious banking problems in the late 1990s and this attracted considerable attention. Hoshi and Kashyap (1999) argue that the Big Bang deregulation played a big role in the Japanese banking crisis. They argue that large corporations quickly switched from depending on banks to relying on capital market financing. This suggests that the top managers will become more concerned about equity values, as indicated by Morck and Nakamura in chapter 12. When the financial market transition is complete in 2001 the Japanese financial markets will apparently be as unregulated as the US financial markets.

CONCLUSION

The evidence suggests that Japanese policy makers have not been nearly as naive as some seem to think. They have attempted to expand

their economy in an IS-LM sense. Unfortunately the IS-LM model may be giving misguided policy advice. More stable fiscal policy might have served better than seemingly unsustainable fiscal 'expansion'. The money supply has not collapsed in the way it did in the United States during the Great Depression. Indeed it remained surprisingly high during the serious recession.

More importantly the policy makers do seem to be taking steps to reform their financial system. I think that Morck and Nakamura have probably correctly identified an important part of Japan's disappointing economic performance during the 1990s. They have certainly provided a much more believable explanation than the current high-profile macroeconomic policy explanations. Indeed I think that they err in giving too much credence to the macroeconomic policy interpretations. However their explanation as it stands is incomplete. They have not accounted for the timing and why the early 1990s differed from the early 1970s.

Suppose that Morck and Nakamura have correctly identified a crucial part of the problem. Suppose that they and Hoshi and Kashayp (1999) are right about the behaviour of large Japanese firms in reaction to the Big Bang. Then it may be that the first decade of the 21st century will again see a much better performance by the Japanese economy. We shall see.

Notes

1. 'A liquidity trap may be defined as a situation in which conventional monetary policies have become impotent, because nominal interest rates are at or near zero – so injecting monetary base into the economy has no effect, because base and bonds are viewed by the private sector as perfect substitutes' (Krugman, 1998).
2. In Krugman (1998) the answer has to do with people switching between alternative financial assets. The fact that such a massive switching of assets has not been observed, as a zero nominal interest rate has been approached over the last few years, ought to call the underlying model into question. Instead Krugman takes the fact that the nominal interest rate has not actually fallen below zero as evidence that it cannot do so.
3. It is worth noting that for the top income earners, Japan (at least in 1998, according to the OECD, 1999) gives a much bigger tax break for investors who get their returns in the form of interest on bank deposits. This may have encouraged continuing bank deposits, and been nice for the banks. But it does not seem to be a good way to encourage savings in forms that will generate the highest future per capita GNP.

4. It would seem that an important policy issue for Japan is to make better savings vehicles available to the citizens. An easy way to do this would be to encourage the creation of a menu of index funds based on a range of international stock and bond indexes. These should probably be offered both with and without exchange rate insurance clauses, so that individuals can decide whether to undertake such a risk. It is important that these indexed investment vehicles should be offered by financial institutions the Japanese people have long experience with and can trust. Unfortunately this is not the right place to go into greater detail about this issue.

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