

# Implications of the Japan model for corporate governance and management for China and other emerging economies in Asia

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## Abstract

**Purpose** – *The Chinese economy, among other developing economies in Asia, has experienced extraordinary growth in the last decade. Yet, for China and other newly emerging economies in Asia to grow in a sustainable manner, good corporate governance and management mechanisms must be in place. The authors aim to explore this issue in this paper. The authors also aim to particularly point out that Japan's experience both before after the Second World War will be relevant as a model for China's public and business development policy decision-making.*

**Design/methodology/approach** – *The authors apply well-established theories of economic development and organizational structures of business organizations to Japan's experience before and after the Second World War and then to contemporary China's experience. The analysis of Japan uses the substantial research findings on the development of that country available in the business history literature.*

**Findings** – *The paper's analysis shows multiple ways in which China and other emerging East Asian economies can take advantage of Japan's experience (which is called the Japan model here) for their own development policies and achieve sustainable growth in the long run. For example, it is expected that Japan's experiences may be relevant in areas such as: firm formation and the utility of business groups of various types; development of industrial relations and employment practices; interactions between business and government in the promotion of economic development; and how these factors relate to technology advances on a worldwide basis.*

**Originality/value** – *The findings reported in this paper also contribute marginally to the literature by considering the recent experience of Chinese private and state-owned corporations, including international joint ventures, in the context of Japan's experience in its economic and business development history.*

**Keywords** *China, India, Japan model, Asian emerging economies, Economic development, Developing countries*

**Paper type** *Research paper*

## 1. Introduction

For Asia's newly emerging economies to grow in a sustainable manner, good corporate governance and management mechanisms must be in place, as firms and industries are critical to economic growth[1]. To achieve this, China has been adopting new laws, institutions and practices in corporate governance from the US, Germany, Japan and other western countries[2]. At the same time, China and other Asian countries will adapt foreign inspired corporate governance and management systems to suit their own needs.

Despite significant differences in history, institutions and economic circumstances, China shares some common characteristics in its corporate governance and business practices with historical (pre-second world war) and contemporary (post-second world war) Japan. Some of these are listed below:

- A strong government role in planning corporate technology development, including policies about the transfer (importation) of foreign technologies.
- A heavy reliance on business groups and other forms of inter-firm organization, as we explain in detail in this and later sections.
- Concentrated patterns of ownership.
- Important roles for firm stakeholders in corporate governance practices.

As an example of (1) the Japanese Ministry of Industry and International Trade (MITI) carefully allocated Japan's scarce foreign exchange among purchases of competing foreign technologies based on its strategic plans in the post-second world war era, while the Chinese government has been requiring that foreign firms transfer technology as a condition of approval for western firms' joint ventures with Chinese local partners.

As examples of (2) and (3) above, inter-industry and intra-industry business groups of various types are an integral part of Japan's industrial organization and structure. Historically, pre-second world war *zaibatsu* were family owned and controlled (via holding companies) inter-industry business groupings. A variation, called *shinko zaibatsu*, appeared during the interwar years. These were heavy industry groups that sought to create economies of scale and scope in the upstream and downstream activities of tightly linked industries. Pre-second world war business groups should be distinguished from postwar *keiretsu* groupings, such as suppliers that cluster around Toyota, Nissan and Honda. Such groups were formed for the purposes of vertical integration but without concentrated ownership. Finally, there are bank centered, loose coalitions of inter-industry federations of firms (see below).

*Kigyo shudan* or *kigyo gurupu* (enterprise group) are often the restructured inter-industry remnants of prewar *zaibatsu* groups but they are no longer family owned using holding company control. Instead, one or several main banks are typically responsible for lending within a group; high levels of inter-group shareholding by member firms are common; and, some degree of group coordination is exercised by major firms. However, as these are inter-industry groupings, within-group transactions and executive rotation practices are correspondingly muted. In section 6 below we will further discuss these four types of business groups in detail.

In China the development of business groups and concentrated ownership are still new. Nevertheless they are already playing important roles in the design of modern Chinese businesses, as discussed later[3]. We note here that most major Chinese firms started as state-owned enterprises (SOEs). While many have been privatized in recent years, most privatized firms, particularly the large ones, still have the state as a dominant shareholder. By comparison, state ownership of enterprises is and has been extremely rare in Japan. Instead, large firms are owned by other industrial firms, banks, financial and trading institutions within the same group of firms. During the last 10-20 years, levels of within-group share ownership has fallen to relatively low levels – on the order of 10 to 20 percent. Hence, both countries share concentrated patterns of large firm ownership although forms of ownership and control are different.

Point (4) above is well recognized for Chinese firms which pay particular attention to their workers and creditors, a tradition they have carried forward from the days of SOEs. The welfare of stakeholders is important for Japanese firms for different reasons. In sum, stakeholders are an important part of the governance and management of firms in China and Japan, at least in comparison with their US counterparts.

### **1.1 Organizational characteristics and business groups**

Family owned and controlled business groups are sometimes called pyramidal business groups (e.g. Almeida and Wolfenzon, 2006). In such groups, family-owned holding companies control subsidiaries by owning majority shares (say 51 percent) in them; first-tier subsidiaries control their own subsidiaries by owning majority shares (again 51 percent) in them; second-tier subsidiaries control their own subsidiaries by owning majority shares

(again 51 percent) in them; and so on. This hierarchical structure of firms is called pyramidal and family holding companies typically lie at the top of the pyramid.

Holding companies own majority shares in first-tier subsidiaries, but typically not in lower tier subsidiaries. The remaining minority shares of subsidiaries are sometimes sold to the public. Since family ownership controls all major subsidiaries in its pyramid, they can and do make decisions in the interests of the family but not necessarily in the interests of subsidiaries and minority shareholders. For example, a holding company may order subsidiaries to pay dividends against the interests of the subsidiaries, so the dividends can be used for family purposes. Such tunneling practices often hurt minority shareholders of listed subsidiaries[4]. Of the four types of Japanese business groups discussed above, only pre-SECOND WORLD WAR *zaibatsu* groups formed pyramidal business groups. Indian business groups and Korean *chaebol* (Choe and Roehl, 2007) are contemporary examples of pyramidal business groups.

An aspect of business group behavior in Japan that the notion of pyramidal business groups does not describe adequately is a situation when ownership and control do not coincide. For example, relatively concentrated ownership but decentralized control occurs in Japan while in the US less concentrated ownership (given a traditional reliance on equity funding) but more centralized control (more professionalized management; more horizontal and vertical integration; more diversification within single firms (Fruin, 1992, Chap. 7) seem common.

We are interested in the organizational and behavioral similarities and dissimilarities between Japanese and Chinese firms. Possible implications for firms in China and other emerging economies based on the experiences of Japanese firms are the motivating reasons for writing this paper. The rest of the paper is organized as follows.

In the next section, section 2, we discuss how adaptation characterizes Japan's development process. By this, we mean that Japan absorbed Western technology, laws and institutions, management methods and other practices while accommodating local customs, routines and practices. In this section, we also discuss what are generally known as latecomer advantages and related issues. In sections 3-7, we discuss Japan's experiences in adapting to western practices in the areas of industrial technology; government-business relationships; corporate governance; business groups; and management. In each section, when appropriate, we discuss the potentially relevant implications for China. Section 8 concludes.

## 2. Adaptation to Western practices

Japan has long adapted to the west. Accelerated adaptation began around the Meiji Restoration in 1868 when Japan faced massive pressures, both domestic and foreign, to modernize every aspect of life. Fortunately, there are numerous major studies of Japan's institutional and organizational adaptations to the West and, thus, this is an area where implications for China and other countries' development can be readily drawn, because many of Japan's efforts at adaptation were unsuccessful (Westney, 1987; Dore, 1958; Dore, 1973). In some cases, selections of adaptations were poor, in others implementation; in some cases, efforts to readjust and realign adaptations proved successful, in others not so much.

For example, in describing Japan's design of its Tokyo police force in the eighteenth century, Westney (1987) points out Japan's choice of the French model represents a close fit between French traditions of centralization and political surveillance and the objectives of Meiji leaders. Westney further explains how Japan chose among numerous foreign institutional and organizational forms for various reasons, as follows:

- some forms were directly reproduced from the main western model;
- some were adapted from competing foreign models and grafted onto newly emerging systems being designed;
- some were taken from other emerging organizations of the Meiji government;

- some retained pre-Meiji features of relevant indigenous institutions; and finally
- some organizations represented innovative responses to the problems facing the creation of a new state and institutions in Japan.

Like Japan, China has long histories of private business activities coupled with government regulation and oversight. Business practices and methods developed in China naturally reflect their own institutions, cultures, methods, and the tastes and preferences of their owners, managers, workers and consumers. As in most places, the motivations for running businesses are to make money and perhaps maximize profits. However, ideas about how to make profits and use the proceeds vary tremendously around the globe.

China is able to take advantage of the global economy in its efforts to ramp up economic development. Massive amounts of outsourcing contracts, for example, have been given to firms in China creating unprecedented opportunities to modernize business operations. Globalized economic circumstances imply, however, that China will have to adapt modern methods of management, corporate governance, decision and policy making. In particular, to enhance total factor productivity (TFP) and to introduce more transparency in corporate governance – both of which are required to be internationally competitive – Chinese firms are compelled to move in these directions. Moreover, modern methods and more transparency are usually required by foreign firms moving capital to China in the form of foreign direct investment (FDI) and portfolio investment.

### *2.1 Late development: flying geese and product-life cycle models*

Gershenkron (1952, 1962) pointed out the strategic opportunities that latecomers bring to economic development. Latecomers must make up for lost time and their lack of resources (Abramovitz, 1986), but in doing so they also have certain advantages, such as access to the latest versions of available technologies and opportunities for creating new institutions and novel ways of harnessing capital and technology (Mathews, 2005). Germany in the nineteenth century, Japan in late nineteenth and twentieth centuries, and the East Asian Tigers in the late twentieth century are oft-cited examples of successful latecomers.

Fishlow (2003, p. 3) summarizes Gershenkron's approach as follows:

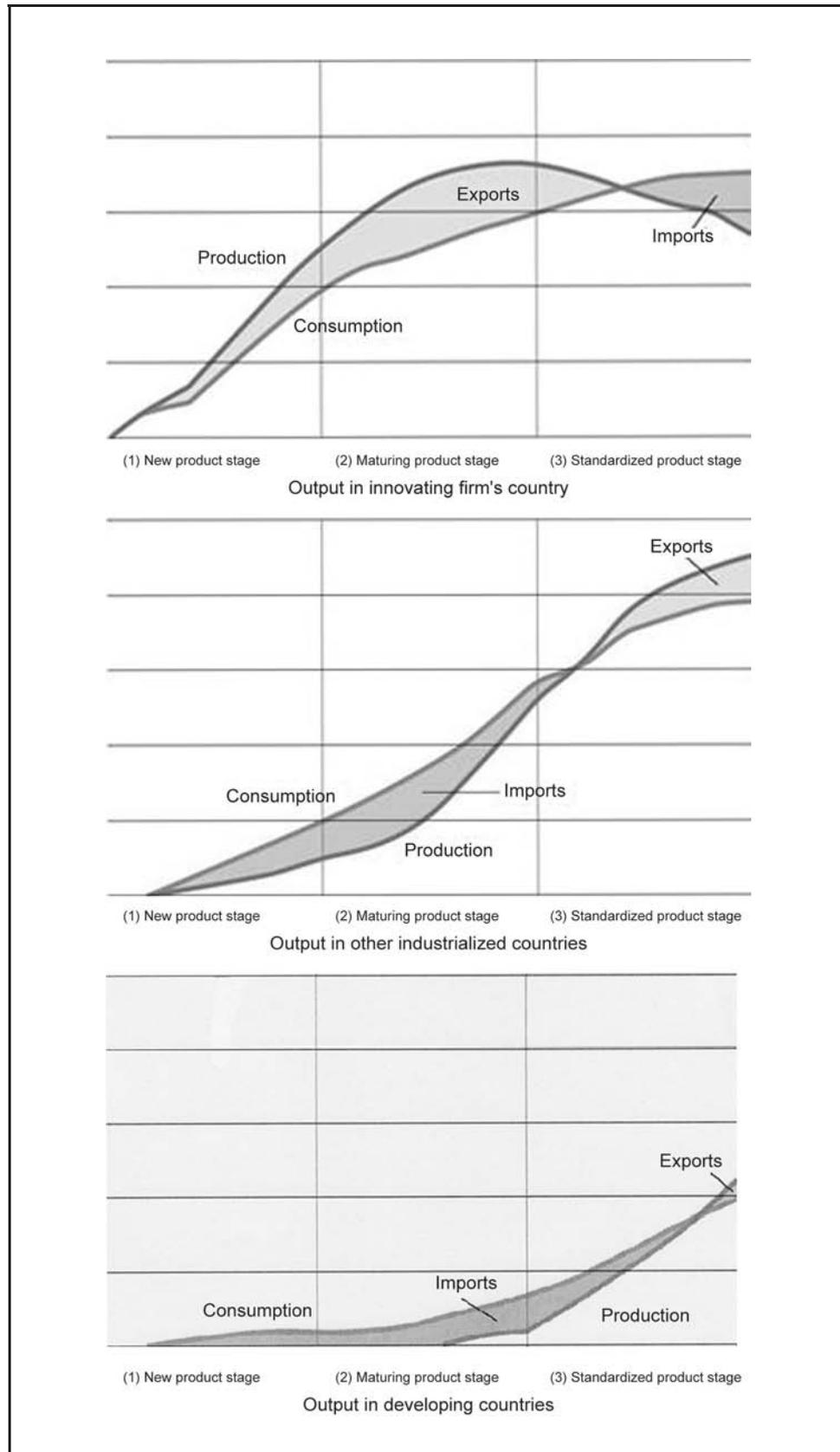
The central notion is the positive role of relative economic backwardness in inducing systematic substitution for supposed prerequisites for industrial growth. State intervention could, and did, compensate for the inadequate supplies of capital, skilled labour, entrepreneurship and technological capacity encountered in follower countries seeking to modernize. England, the locus of the Industrial Revolution, could advance with free market guidance along the lines of Adam Smith. France, beginning later, would need greater intervention to compensate for its limitations. In Germany, the key innovation would be the formation of large banks to provide access to needed capital for industrialisation, even as greater Russian backwardness required a larger and more direct state compensatory role.

Gershenkron called these innovations the special “institutional tools” that allow latecomer countries to take short cuts that might include financial innovations, such as a “mixed bank” and the power of the state itself, according to a country's degree of economic backwardness (Sylla and Toniolo, 1991). China and India, being the world's leading candidates for industrialization and economic development today, face the same challenges: inventing novel latecomer institutions and formulating growth strategies that are based on and consistent with the ongoing processes of a globalizing economy (Mathews, 2005).

There are predictable patterns of catching up, known as the flying geese (FG) pattern (Kojima, 2000; Okita, 1985; Schroepel and Nakajima, 2002), and an associated movement of foreign direct investment (FDI) from developed to developing countries based on the product life-cycle (PLC) theory (Vernon, 1966). For example, Okita (1985, figure on p. 21) illustrates how advanced technologies in certain industries spread from Japan to other developing nations in East Asia using the FG theory.

The FG pattern by which advanced technologies spread from Japan to developing nations in East Asia was made possible by Japan's massive FDI to these countries. Such movement of Japan's FDI is consistent with the PLC theory proposed by Vernon (1966). Figure 1

**Figure 1** Product life cycle model for international production



illustrates how PLC patterns might be observed in countries in different stages of economic development (see Okita (1985) and Schroepfel and Nakajima (2002), for example, for further references on these topics). The models (FG and PLC) may be particularly relevant when government policies allow for the development of large and well-educated labor forces and their movement to places and industries in need of labor.

Coupled with a country's ability to absorb technology-based inward FDI, transfer of productive capacities as described by the FG and PLC theories allow for relatively accelerated rates of economic development. These trends do not guarantee the development of new technologies or the appearance of innovative business processes, however. Nevertheless, they facilitate and enhance the operational capabilities of host country companies, making even greater economies of scale possible and attracting even more FDI. This is what happened in the case of the Four Tigers and what is surmised to be taking place in China today.

More recent developments, such as the appearance of fab-less semiconductor firms, like Qualcomm's, and entire design-develop-and-manufacture value chain outsourcing capabilities, like Apple's iPhone and iPad, suggest that traditional models of international production transfer might require updating. China can enter the international division of labor with more encompassing and higher value adding, upstream positioning. This enables Chinese companies to grow faster and be more profitable. Implications of this type of contract based manufacture of sophisticated consumer products for the economic development of host countries like China are not yet well understood. The implications of massive movement and creation of full service, offshore capabilities, from R&D to sales, to emerging economies are recasting what we think we know about international economic development.

## *2.2 Japan*

Japan's outward FDI has been substantial and directed not only to North America and Europe but also to Asia. In particular, Japan's outward FDI in Asia during the past few decades has been interpreted to follow the FG and PLC models. However, Japan never experienced the massive inflow of foreign investment that Asian countries are experiencing today. For some years following the Meiji Restoration of 1868, Japan had a relatively unrestricted free trade environment allowing US and other western companies to have free access in terms of FDI and trade. This liberal period ended with the termination of the so-called "unequal treaties" in 1930 (e.g. Morck and Nakamura, 2007). From 1930 until several decades following the second world war, Japan restricted inward FDI. Hence, in terms of the role of inward FDI in Japan's development, Japan's experience differs substantially from that of emerging Asian economies today.

## **3. Technology**

Japan's importation of western technologies took many forms depending on the industry, nature of products and product markets, and other factors. In general, while the Japanese government recognized the importance of technology for achieving catch-up with the west, it emphasized the importance of import substitution and the development of original technologies rather than depend heavily on technology imports. Although the Meiji government's efforts to develop state owned enterprises (SOEs) in many areas failed, the government must be credited with setting up a phalanx of new ventures across a wide variety of industries. These were subsequently sold off to *zaibatsu* business groups and other private interests.

Two characteristics are often noted by researchers of Japan's history of technology development and management: Japan was often successful in adapting foreign technologies to fit local requirements, particularly to the abundance of labor and shortage of capital; high levels of diffusion of new technologies were realized among companies in the same industries. Several economists have shown how Japanese firms were able to adapt technology, work organization, and product mix to local settings, especially locations with

abundant labor (Saxonhouse, 1977; Saxonhouse and Ranis, 1985). Yamamura also emphasizes the adaptive decisions of firms and prefectural and municipal governments in adopting Western technologies to the local conditions (Yamamura, 1986).

In the case of the cotton industry, it has been shown that the average level of technology in firms was high and firms in the same industries shared the same or similar technologies. Firms cooperated with each other on technical matters, and the industry trade association, *Boren*, published regular cost and performance data for almost every firm. This allowed firms to do cross-firm comparisons and identify the firms that were most successful in implementing new technologies (Saxonhouse, 1977).

Until the end of the first world war, one company, Platt Brothers, supplied weaving machinery for most firms. Users of Platt Brothers' looms shared the costs of their operations with Boren, and Boren provided technical information and performance data to industry firms. The unusually high levels of information sharing in the industry seem to have been motivated in part by relatively high levels of employee turnover. Companies wanted to perform at industry standards and workers wanted to be paid competitive wages, and information exchange via the trade association seems to have facilitated these objectives. When Japanese firms shifted their emphases to long-term employment relations, firms' incentives to share information and thereby invest in industry-level technical cooperation declined.

In the post-second world war period, as companies tried to hold onto their personnel, especially those with science and engineering backgrounds, new methods were devised for promoting the diffusion of technologies among industry firms. Non-governmental institutes focusing on diffusion of new statistical and management techniques within industries appeared, such as the Japan Union of Scientists and Engineers (JUSE, Nikka Giren). JUSE and the Japan Productivity Center (Nihon Seisansei Honbu). Business groups, both inter-industry and intra-industry groupings, benefited from technology diffusion in a number of ways. For example, supplier firms in vertical *keiretsu* groupings, centered around a large core assembler, like Toyota, were expected to gather and refine information about appropriate technologies and diffuse them to lower-tier firms in the group. Indeed, one of the principal functions of supplier associations in *keiretsu* style grouping are information exchange and upgrading of technological capabilities (Fruin, 1992, 1997).

The Union of Japanese Scientists and Engineers (JUSE, Nikka Giren) and the Japan Productivity Center are just two examples of the large number of government and non-government sponsored associations and institutes that were dedicated to technology diffusion and upgrading of existing technologies. In this way, modern management and statistical quality control methods were broadly and deeply diffused throughout Japan following the second world war.

The government also initiated research associations and invited selected large firms to participate. Invited firms were able to collect and assess information about the technologies and technology levels of rival firms, work on developing new managerial methods in industries and technologies, and occasionally develop in concert new processes and products. The very large scale integration (VLSI) project is perhaps the best known of these government initiated research associations.

Research associations addressed the development of manufacturing methods that were essential intermediate steps in new technology commercialization. Since all companies in an industry are required to develop such intermediate manufacturing steps in order to commercialize technologies, the incentives to join and participate actively in research projects and associations were obvious. Generally, such associations excluded basic research efforts and the design and development of final products, and in these ways participants' incentives did not conflict with company-specific strategies in basic R&D or market oriented sales (e.g. Nakamura *et al.*, 1997).

Japanese firms have played a prominent role in taking home developed technologies overseas. The Japanese auto industry may be the best known example in this regard as Honda, Toyota and Nissan's efforts at establishing overseas assembly and parts supply operations, particularly in North America, have been well studied, but much less is known

about the technology transfer efforts of Japanese firms in Asia. Moreover, to open and operate successful semiconductor foundries and other advanced contract manufacturing facilities, like Foxconn's in Taiwan and China, different models of organization and management, as compared with Japanese auto and electronics plants in North America and Asia, may well be needed.

#### 4. Government-business relations

The Japanese government played a prominent role in creating and implementing policies for economic and industrial development both after the Meiji Restoration in 1868 and after second world war. In the Meiji period (1868-1912), the objectives of Japan's central government were clear: to catch up with the west and to prevent a western takeover of Japanese territory or institutions. Japan had witnessed what had happened elsewhere in Asia.

Even so, the Meiji government's initial efforts to catch up were not successful. The performance of many government-funded state owned enterprises (SOEs) was no better than average, and often less so, and SOEs put a severe financial burden on the Meiji government's finances. Following the privatization of non-strategic SOEs, including the 26 largest enterprises, between 1874 and 1896, private sector firms and industries realized significant economic growth. From the late nineteenth century to the 1930s, Japan's economy was mostly unregulated. Relatively free trade and abundant inward FDI were hallmarks of the era.

Family-owned *zaibatsu* business groups which bought many of the former SOEs, flourished. The activities of group member companies were an important component, perhaps the major element, of Japan's big push in economic development that took place in the 1910s and 1920s (Morck and Nakamura, 2007). Free trade and abundant inward FDI helped in the big push.

Following second world war, the goals of the government's development policies were again clear: catch up the US and Europe in terms of global competitiveness. The government subsidized firm and industry development, particularly in heavy industries and other technology-driven sectors. Foreign exchange was strictly controlled and rationed at the time, and it became a frequently used tool to direct investment and make decisions about which development policies to support. At the level of firms, government decisions often affected which firms could import and license what technologies. Inward FDI was severely restricted and joint ventures with foreign firms were strictly controlled by the government.

Government control was extended to finance and banking. Japanese banks were strictly classified according to what sorts of transactions were allowed and banking activities of all manner were heavily monitored and regulated. Banks were not allowed to compete, but banks were also not allowed to fail. This was quite unlike the open market, high growth era at the turn of the twentieth century. Because equity and debt markets were highly regulated, firms became increasingly dependent on indirect finance. Business groups came to rely on so-called main banks, principal banks through which most of the group's finance and banking was channeled. Mutual shareholding by other companies within groups became common; together, with main banks and major firms, 50 percent and higher levels of ownership were retained within business groups, freeing most Japanese firms from hostile takeover attempts.

Pro-active government intervention in business affairs and industrial development continued until the early 1980s and the effects of government-led policies continued throughout the 1980s. Although Japan's development is often classified as a state-led development model, in fact, the economy grew during distinct oscillations in government policies. For the first 25 years of the Meiji era, state intervention was active and obvious, followed by another 25 to 30 years of low regulation and intervention, followed by a postwar era of three decades when government regulation was considerable, and another 30 years of much less regulation.

Government driven policies seem more successful when catch-up was the goal. Foreign exchange, investment and licensing controls work well when the central government is charged with getting the country back on its feet and there is broad acceptance of that mandate in the land. In the second half of the twentieth century, in many parts of Asia, the preferred model of economic development was the Japanese model of government led industrialization associated with the goals of rapid catch-up and gaining international competitiveness (Perkins, 2005, p. 184). The Japanese model was applied with varying degrees of success in Singapore, South Korea, Taiwan, Malaysia, Indonesia and, after 1978, China. But government interventions become less effective when catch-up is being realized, and firms and industries believe that they know better than the government what is needed.

## 5. Corporate governance

### 5.1 Corporate governance reform in Japan

Japan's corporate governance practices have been subjected to substantial reform following the post-bubble recession of the 1990s. The Japanese government passed new laws, various ministries and agencies enacted reforms, and the stock exchanges issued new official and semi-official guidelines. The reforms, as a package, were intended to transform Japan's traditional inward-looking, bank-centered corporate governance system into a more transparent, market-oriented and shareholder-centered system.

More than a decade has passed since corporate governance reform began in Japan. It appears that almost everything that could be done legally and institutionally has been done<sup>[5]</sup>, but recent research suggests that most Japanese firms have not fully adopted US style practices. For example, not all firms have chosen to implement US style executive committees based on boards of directors. Instead, where the new laws allow, firms have become more selective in the choosing the type of corporate governance methods that they will pursue. That is, firms are approaching corporate governance with a menu of selections in mind, some of which are more traditional and some of which are more recent. Firms appear to be making selective adaptation of new corporate governance practices; the government and courts are likewise applying new corporate governance policies selectively (Nakamura, 2011).

Japan's selective adaptation of corporate governance mechanisms seems driven by a number of factors that are not widely present in the US, for example. In Japan, stakeholders are viewed broadly and somewhat equally, and they include employees, suppliers, related firms, creditors, and customers. In such a context, shareholder value maximization is not considered the sole or even primary objective pursued by management. Even though US style corporate governance or, more broadly, the Anglo-American model of corporate governance, is recognized as the global standard in Japan and elsewhere<sup>[6]</sup>, for various reasons as described above, Japan's corporate governance system does not appear to be converging towards that of the US. This may be of interest in China, for example, where corporate governance reforms are in place.

### 5.2 China

The 1904 Company Law introduced limited liability corporations in China. The law was largely based on Japanese and English company law and contained many features of modern corporate governance thinking. But the law was not fully implemented and did not have much influence because of a lack of enforcement and other reasons. Government-supervised merchant-managed firms, the main form of business firms in China, continued to prevail<sup>[7]</sup>.

US style corporate governance practices have also been introduced into China recently, and these have affected the corporate governance systems of SOEs and non-SOEs alike. These can be seen in the China's 1994 Company Law, Securities Law, CSRC Code of Corporate Governance and Guidelines, and 2005 Company Law. Goo and Carver (2008) point out a number of issues that interfere with the introduction of US style corporate governance practices. One is that the US system focuses on establishing the integrity and legitimacy of

outside directors. While shareholders' welfare is important, more important is the welfare of stakeholders. Goo and Carver (2008) emphasize that Chinese firms do not trust outside directors, and outside directors are, of course, cornerstones in the US system of corporate governance.

Although a few Chinese companies were incorporated early in the twentieth century and survived the occupation, wartime years, and Communist reforms, inadequate corporate governance practices are the norm (Goetzmann and Köll, 2005). "Poor disclosure and weak regulations are well-known and persistent problems of companies and the stock market in contemporary China. Tumultuous shareholder meetings with angry minority shareholders are not unheard of"[8]. Acceptance of outside directors, the enforcement of minority shareholder rights, and promotion of shareholder value maximization are exactly the kinds of stated new corporate governance policies that Japan has been trying to implement in its recent corporate governance reform efforts (Nakamura, 2011). Perhaps this is an area where Japan's experience has much to offer China.

### ***5.3 Corporate governance practices***

*China.* Modern corporate governance mechanisms were introduced into China beginning in the 1980s modeled on various German and Japanese corporate governance practices (Yang, 2008). The primary focus at this time was reforming SOEs[9]. SOEs relied on internal control. That is, the employees and majority shareholders (government in China; banks and corporations in Japan) made and ratified decisions. Because the economy was mostly a planned economy, an internal control model of corporate governance was compatible with many aspects of German and Japanese models of corporate governance[10].

Despite China's continuing economic growth, enterprise reforms in the 1980s were not viewed as satisfactory. Perceived problems included: a serious lack of performance incentives at SOEs, and a lack of basic conditions that would be needed for the sound operations of a corporate governance system, such as market mechanisms and the separate of ownership and control (Yang, 2008). A second phase of China's corporate governance reforms started in 1993 and it addressed issues raised above. New laws and measures introduced in this phase include: the Company Law (1994), the Labor Law (1995), the Securities Law (1999), and the Rules on Corporate Governance of Listed Companies (2002) promulgated by the China Securities Regulatory Commission. In this phase, corporate governance reform measures were mostly modeled after corporate governance practices in the US and the Anglo-American model in general.

The Labor Law of 1995 allowed Chinese corporations to abandon lifetime employment practices and all employment decisions, for all practical purposes, now dictated by employers. Nonetheless, the importance of stakeholders' welfare continues to be emphasized. Though employees have lost their power and representation as formal members of firm supervisory committees, many critics argue that employees need to be taken seriously as parts of a Chinese corporate governance system.

Large Chinese corporations are organizationally structured like their Western counterparts, consisting of shareholders (owners of the firm) and the management being the principal and the agent, respectively, and employees working under the management. In addition, two important outside stakeholders of corporations in China are creditors and the local communities. Compared to Western corporations, however, employees, creditors and local communities tend to have more bargaining power relative to the management (Yuen and Zhang, 2008). Another characteristic of most Chinese corporations, as noted earlier, is that their largest (and majority) shareholder is the state (national or provincial) and hence these corporations are typically SOEs. Finally, a shortage in outside directors is also considered a serious shortcoming in China's corporate governance system which calls for outside directors. Chi and Wang (2008) also point out that the state majority ownership of SOEs implies Chinese SOEs' efficiency levels in their operations are lower than their counterparts in the west.

*5.3.2 Japan's experience.* Despite differences in stages of economic development between China and Japan and in spite of all of the differences in institutional and organizational arrangements in the two countries, both countries appear to be pursuing selective adaptation strategies in importing US corporate governance practices. Stakeholder welfare continues to be important in Japanese corporate governance. Major stakeholders include employees, suppliers, customers, creditors as well as affiliate and related firms in both inter-industry and intra-industry business groupings. Japanese firms' ties to banks and major creditors did not diminish as much as expected after the corporate governance reforms of the 1990s, except in some instances where firms have been able to raise direct financing from capital markets on their own. This is another area of firm experience in Japan that Chinese firms may find instructive.

Japan's corporate governance reforms stress the importance of outside directors. New Japanese laws give firms the right to choose between traditional Japanese style boards of directors and US style executive committee-based boards, wherein the majority of directors of the three executive committees comprising boards must be from outside the firm. Two issues have been raised by the reforms. First, a choice between two different styles of boards has introduced a note of ambiguity that did not exist previously, and, second, there is a scarcity of true outside directors in Japan. Many so-called outside directors are often employees of related companies, banks and financial institutions.

#### *5.4 Bank ownership and firm performance*

Japan's banks often retain ownership in client firms for control purposes; currently, banks are allowed to have up to 5 percent of equity in client companies. Many researchers have argued the merit of having large, informed institutional shareholders, like banks, owning large blocks of equity in industrial firms. Large, informed investors may improve performance by bringing to bear a superior oversight on company operations. However, there is little empirical evidence to support such a contention (Inoue *et al.*, 2008; Morck and Nakamura, 1999; Peek and Rosengren, 2005). Despite concerns about the role of banks in corporate governance, Japanese anti-monopoly laws, allowing bank ownership of client firm equity up to 5 percent, were not changed in recent corporate governance reforms.

## **6. Business groups**

### *6.1 Japan, business groups and corporate governance*

Japan has a long history of business groups of various types. As we noted in the Introduction, there are, broadly speaking, four main types that can be distinguished in several different ways. In this section, we discuss details of these business groups by classifying the types as to when they appeared, in the pre-second world war or post-war second world war periods, and whether the groups are composed of firms in different or similar industries.

Following the Meiji Restoration of 1868, family owned and controlled businesses, called *zaibatsu*, were the first business groupings to appear; they played central roles in the growth of the Japanese economy to the end of the Pacific War. Although family-based business groupings before 1868 grew in related business areas, for example, the Mitsui group in retailing and the Sumitomo group in mining, when the national government decided to sell off SOEs in the 1880s, existing business groups bought former SOEs and thereby transformed themselves into broader, inter-industry groups, termed *zaibatsu*[11].

Later on, in the early twentieth century, as Japan shifted more toward heavy industry and transportation based and electrical equipment industries, making goods associated with the second and third industrial revolutions, such as primary metals, synthetic fertilizers, motor vehicles, and diesel engines for land and water locomotion, business groups began to rely more on public capital markets for both equity and debt. Significant capital investments were needed as more integrated foundries and plants were required.

As a result, family ownership remained important but it was diluted by public share offerings; science and engineering trained graduates were hired in large numbers to run large scale, vertically integrated plants associated with later stages of industrialization. The business groups that were associated with this stage of industrialization were called *shinko zaibatsu* or new *zaibatsu* and they differed from the earlier sort by their less concentrated ownership structures and a more pronounced separation of ownership and control, consonant with the emergence of a professional management class and the need for higher levels of technological knowledge and capital investment consistent with the vertical integrated primary metal, petroleum and process-oriented chemical industries of the early twentieth century.

During the Allied Occupation of Japan, concerted efforts were directed toward breaking up the concentrated economic power of the prewar *zaibatsu*. *Zaibatsu* family wealth was confiscated, holding company control was severely limited, shares in *zaibatsu* ventures were sold publicly, cross-shareholding within groups limited, and many groups were restructured under Allied policies to reduce concentrated economic power and to democratize the economy. So-called *kigyo shudan* or *kigyo gurupu* (enterprise groups) were the result.

For the last half of the twentieth century, there were six big federations of firms called enterprise groups; these groups because of their size and success are well known. Three groups continued on with their prewar names in spite of their restructuring and new laws limiting concentrated ownership; they were the Mitsui, Mitsubishi, and Sumitomo groups. Three groups were renamed and were amalgamations of firms from various prewar groups that no longer existed or had been reorganized in various ways; they were the Dai-ichi, Fuyo (Fuji), and Sanwa groups. All six groups were large amalgamations of firms from many industries, often one to two hundred companies strong.

Another sort of postwar group appeared, one that was analogous with the *shinko zaibatsu* of the prewar era. These were groups that formed to advance economies of scale and scope in related industries. The economic logic was one of vertical integration. The outputs of one firm were the inputs of another; this type of group is called *keiretsu* in Japanese. Not surprisingly, the most rapidly growing postwar industries, like transportation and electrical equipment, were the industries where this type of business group flourished, and the most famous group of this sort in the postwar era was undoubtedly the Toyota group of companies. But the same sort of intra-industry group structure is found among other auto industry companies, like Honda and Nissan, and across most of the electrical, non-electrical and transportation equipment industries.

In *keiretsu*, ownership is not the basis of group formation. Linking and integrating technologies in order to achieve elevated economies of scale and scope are the bases of group formation. Of course, ownership levels in member firms may vary from one group to another, but in the Toyota group of companies, one of the business groups that has been most researched, Toyota invests little in companies to which it is linked vertically. Actually, there are three levels of firms supplying Toyota; Toyota is the final assembler and the suppliers deliver parts, components, sub-assemblies and assemblies to Toyota. The three levels correspond with size: small companies make relatively few parts, delivering them to larger companies that assemble them as components; larger companies deliver components to even larger companies that assemble the components into systems and sub-assemblies. They, in turn, send them onto Toyota. In this tiered model of assembly, Toyota invests in no more than 10 percent of first tier suppliers, less than 20 firms. Toyota invests nothing in 90 percent of first tier suppliers and nothing in lower tier suppliers.

While ownership in *keiretsu* like Toyota's may be low, control is not. In the case of Toyota, suppliers are required to follow its famed Just-in-Time production and distribution system. Larger suppliers belong to the Toyota Supplier Association and are required to share information and develop new products and processes with other companies in the Toyota group of companies. In these ways and others, high levels of control are realized in the

Toyota group of companies without correspondingly high levels of ownership and investment.

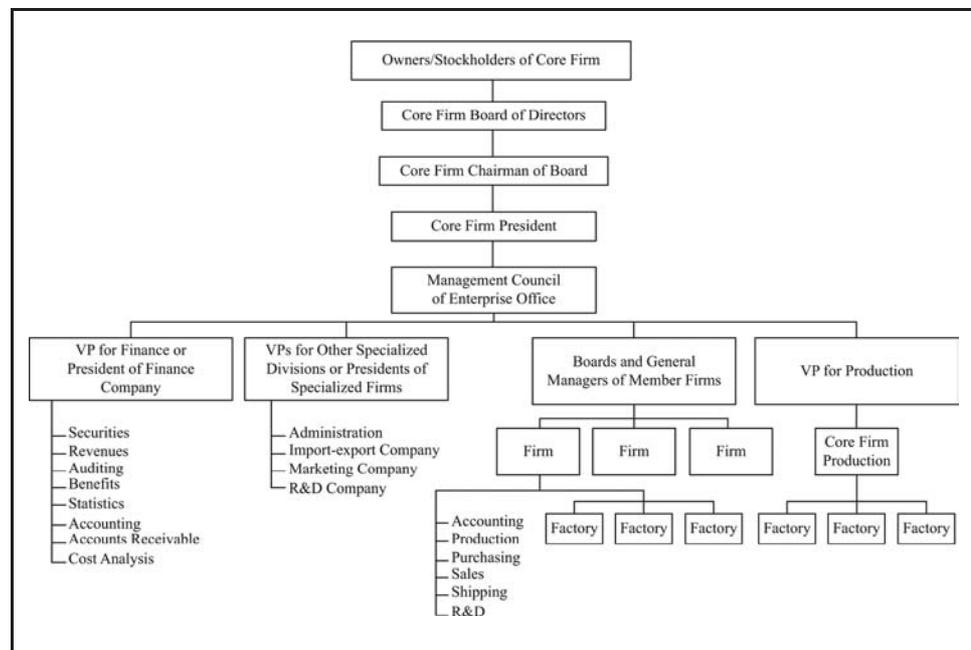
The *keiretsu* type of business group may be particularly relevant in cases where rapid technology development is desirable but capital is insufficient to maintain or sustain high levels of ownership and investment. This situation may well fit the circumstances of rapid firm and industry growth experienced recently in China and India. In terms of business group models, Japan offers a variety of models, both prewar and postwar, that vary importantly in terms of levels of ownership, control, and within-group coordination requirements. Most notably, inter-industry and intra-industry business groups are structured differently to achieve different purposes; economic behavior and action within the two groups vary systematically and, hence, the relevance of different business groups will vary with the purposes in mind[12].

## 6.2 China

As part of policy of industrial reform, the Chinese government began to encourage firms to form business groups in the mid-1980s. The idea was that financial performance and productivity would be enhanced by business group formation. Keister agrees that a policy of gradual regulatory reform was instrumental in the formation of business groups in China (Keister, 1998, 2000). A diagram of a typical business group in China is shown in Figure 2.

Using 1988-1990 panel data on China's 40 largest business groups and their 535 member firms, the presence and predominance of interlocking directorates and finance companies in business groups improved the financial performance and productivity of the groups' member firms. In addition, firms in groups with non-hierarchical organizational structures performed better than firms in hierarchical groups, suggesting that complete integration into hierarchical styles of organization was not an optimal strategy (Keister, 1998). In Taiwan, by contrast, sweeping liberalization and deregulation of the financial and several industrial sectors led to a strengthening of formerly weak and fragmented business groups (Brookfield, 2010; Chung, 2006; Luo and Chung, 2005).

**Figure 2** An example of a Chinese business group



## 7. Management

One of the enduring questions of management science is, “which organizational forms and management practices allow firms to achieve the highest levels of efficiency?” During the 1970s and 1980s as Japanese manufacturing firms became globally competitive, this question was asked with increasing frequency and intensity. While some studies found that Japanese firms respond to pretty much the same external and internal factors than Western firms do[13], others found considerable variation in factors that might explain the performance differentials of Japanese firms. These include many features of cross-country comparative analysis, such as cultural, economic, institutional, organizational and technological differences and, in fact, there is a literature associated with each factor that purports to explain “the Japan difference”.

### 7.1 Japanese management practices and productivity

The rapid diffusion of certain productivity enhancing practices among Japanese firms since the 1950s is particularly noteworthy. Without major government involvement, many firms, stakeholders in firms and business groups worked toward developing and improving new systems of industrial relations, manufacturing operations and organizational behavior (Fruin, 1992; Fruin, 1997). Such developments facilitated across the board improvements in management methods, standards for decision making, and the nature of the social agreement about how corporate profits should be measured and distributed within large firms. Most notably, the two most widely followed measures of productivity became productivity measured at the micro level and calculated in narrowed defined product lines, and productivity measured at the macro level and calculated in terms of sales volume and market share to analyze long-term earnings power.

With such a convergence in standards for calculating profits and performance, the distinction between management and labor, particularly in terms of the contributions of each to profits and performance, became less important, especially in large Japanese firms. US style them-versus-us, labor versus management confrontation was replaced by more integrated organizational decision making processes involving both management and labor. In large industrial firms, most employees were also members of the labor union, and the labor union worked closely with management.

In time, the well known pillars of Japanese industrial relations and personnel systems in large firms became established; these were lifetime employment, *nenko* or length-of-service wages, and enterprise unionism[14]. On shop floors, small team activities, including quality control practices, Just-in-time (Toyota style) production and distribution techniques, supplier management methods, among other practices, became well developed and widely diffused. While some of these practices have Western roots, such as statistical quality control[15], the practices implemented widely in Japanese factories since the 1950s are clearly based on indigenous efforts to upgrade, enhance and transform labor and management practices found in Japan.

The result was an organizational system that was singular in many respects. While the structure of firms was hierarchical with numerous levels of authority and responsibility, work was carried out horizontally with strong shop floor teams and productivity enhancing activities. Small group activities require a substantial levels of information sharing and data exchange within and between teams, sections and departments, and traditional distinctions between the work of managers and workers were lost. It was common to see banners on the walls of Japanese factories proclaiming, “everyone a manager”.

While Japanese firms successfully transitioned to a new organizational design and various performance enhancing routines and practices, western firms, after many years of study and efforts to make similar sorts of changes, have not been nearly so successful[16]. Other organizational and behavioral aspects of the high performance of Japanese firms, such as Just-in-Time production and distribution methods and supplier management techniques have not been implemented as successfully overseas as they have been in Japan. In such cases, successful replication requires not only new work design and behavior on the shop

floor but also the initiation of interfirm knowledge sharing and cooperative working relationships. Perhaps these features of the high performance record of postwar Japanese firms may not be so easily duplicated outside Japan.

### *7.2 Cooperation and diffusion of new technology and management methods among competitors*

Non-governmental organizations like the Union of Japanese Scientists and Engineers (JUSE, Nikka Giren) and the Japan Productivity Center (Nihon Seisansei Honbu) have been involved in the diffusion of scientific management methods and QC practices among Japanese firms following second world war[17]. JUSE annually awards Deming prizes to industrial and commercial firms for their excellence in achieving high levels of management and quality performance. The awards are considered prestigious and the efforts to be so recognized are vigorous, determined and nationwide[18].

### *7.3 Toyota production system (TPS)*

Toyota advanced its famed just-in-time based production and distribution system to high levels of performance by the late 1960s. For the achievement, Toyota was awarded the first Japan Quality Medal in 1970, which is regarded as the most prestigious of the Deming prizes in the area of quality control and management. Following this award, Toyota began documenting its TPS and *kanban* methods for publication outside the firm. Later on, during the 1970s, Toyota diffused its methods and approaches to quality production and distribution to other firms in the auto industry and ultimately to firms in other industries. While few firms have realized Toyota's levels of performance, Toyota's quality and management methods have been widely diffused during the last quarter of the twentieth century.

### *7.4 Productivity and organizational change*

Many of the manufacturing practices advanced in Japan during the 1970s and 1980s emphasized bottom-up decision making processes carried out by shop floor teams, the empowerment of multi-skilled workers, demand-pull and horizontal information flows based on the decentralization of decision making. These processes included JIT production and distribution and quality management practices, including quality circles (QC) and total quality management (TQM). While these practices proved to be effective over the course of two decades, the drastic appreciation of the Japanese yen since the mid-1980s and the prolonged recession following the bursting of the bubble in the 1990s forced many Japanese manufacturers to adopt new and even more efficacious methods to improve production efficiency. One such method was total productivity management (TPM).

Unlike JIT and TQM, TPM requires a top-down approach (Fruin and Nakamura, 1997). TPM strategies create a direct and recurring linkage between corporate-wide objectives, such as cost reductions, and business operations. Such strategies may have contributed greatly to the recent success of some Japanese manufacturers in reducing their total costs of operations. The TPM implementation process may be interpreted as a macro-process of organizational change (Fruin, 1997), following Etzioni's notions of organizational compliance cycles (Etzioni, 1965, 1975) wherein organizations undergoing large scale change will follow four phases: education and promotion; commitment; performance; decline and withdrawal.

The strategy of employing organizational compliance cycles to advance a firm's performance requires a good balance between identifying and setting goals, moving ahead to implement them, monitoring progress along the way, and then resetting goals and starting over again. The cycle of compliance is implemented at every level in a firm and in every section and department at each level; hence, top-down coordination of the processes of goal setting, implementation, measuring and monitoring is mandatory.

Japanese manufacturing firms today are successful to the extent that they deploy a thoughtful blend of bottom-up and top-down management, quality and productivity enhancing processes, including TPM, JIT and TQM as well as what is known as total productive maintenance. Some believe that MRP and JIT practices employed by US manufacturers amount to substantially the same thing (Schroeder, 1993, Chapter 18).

### 7.5 Toyota production system transferred to China

The first introduction of the Toyota production system (TPS) into China occurred at the First Automotive Works (Diyi Qiche Jituan Gongsi or FAW), a representative Chinese automotive maker, in 1977 and 1981 by Taiichi Ohno, one of the early proponents of TPS in Japan (Lee, 1998; Chen *et al.*, 1997). Later in the 1980s, FAW with the technical assistance of the Hino Motor Company undertook the building of a transmission plant using the so-called “lean production system” or TPS model on a large scale. FAW’s transmission plant integrated disparate elements of Japan’s advanced management and manufacturing systems, realizing for the first time in China a fairly systematic implementation of the Toyota production system.

## 8. Conclusion

The history of capacity building in Japan’s firms and industries was rather different than that pursued by western firms. Japan’s path was one of selective adaptation, choosing among many models and methods from a variety of countries. Choices were made in light of Japan’s relatively scarce natural resources, consistent with the institutional and organizational practices that were already in place, and geared toward building a strong and modern nation in a short period of time[19].

While Japan’s selective adaptations were extensive, they were also evolutionary. The history of capacity building was one of making selective and sequential changes in light of environmental circumstances. There are advantages as well as disadvantages to late development. The advantages of late development are obvious – that one can learn from the mistakes of others and, in the best of circumstances, leapfrog ahead. A key disadvantage is assuming too much – that capacity building will be timely and appropriate. That so many of Japan’s selective adaptations appear to be successful is probably misleading, as there are likely to have been as many failures as successes[20].

Nonetheless, the performance of Japan’s firms and industries represents one of the great, come-from-behind economic development success stories of the twentieth century. Japan must be considered as a pioneer and precursor of modern managerial and organizational methods in Asia, and its successes in these respects should be regarded as of major importance for Asia’s firms and industries and the global economy of the twenty-first century.

## Notes

1. We use the phrase, “firms and industries,” in the sense that industries are aggregations of firms. While firms and industries are not treated as independent terms, we do not always use them together.
2. The primary focus of this paper is the modernization of China as it relates to the West in the late 20th to early 21st centuries.
3. We note also that, though business groups play an important role in the business systems of China, India and Japan, there are important differences in their organization, function and behavior. For example, while Japanese business groups exhibit varying degrees of risk sharing behavior, business groups in India apparently do not (Khanna and Yafeh, 2005). Another observed feature of business groups in India is a high level of turnover in ownership, which has not been observed for other Asian countries, including Japan (Khanna and Pelepu, 2005).
4. See Morck and Nakamura (2007) for Japanese zaibatsu groups’ positive role in Japan’s big-push based development in the Meiji period.
5. The relevant areas which Japan’s corporate governance reform addresses are: share value maximization, the role of outside directors, competition in the market for corporate control, transparency and information disclosure and protection of minority shareholders (Nakamura, 2011).
6. This is in part because of the large influence the US economy has on its global partners. It is usually advantageous for businesses to share the same system of governance when they trade with each other.

7. Goetzmann and Köll (2005), Perkins (2005).
8. "Let 1,000 casinos wither" in *Far Eastern Economic Review*, October 18, 2001.
9. Major laws enacted include: General Principles of Civil Law (1988), the Bankruptcy Law (1988), and the Law on Industrial Enterprises Owned by the People of China (1988).
10. China introduced both supervisory boards and boards of directors as the body of governance for its corporations. See Nakamura (2008) for this and other corporate governance issues in China.
11. *Zaibatsu* groups' contributions to Japan's big push development process is described in Morck and Nakamura (2007).
12. Two reasons that prevent the formation or proliferation of both vertical and horizontal type keiretsu groups in the US might be: (1) US anti-trust laws and practices are not likely compatible with keiretsu structures, for example, powerful assembler firms' interference with their small suppliers' management decisions being judged as anti-competitive; and (2) entrepreneurship of owner-managers of small US supplier firms would not necessarily be compatible with their firms being subjected to keiretsu's group-wide planning decisions. In both China and India, institutional and cultural circumstances similar to those of the U.S. do not seem to exist for their businesses.
13. These include firms' responses to certain market signals like prices and also some internal organizational factors.
14. E.g. Nakamura (1993).
15. It is well-known that Deming's work brought to Japan in 1950 inspired Japanese interest in QC in industry. See below.
16. This may be in part due to different experiences workers in Japan and the US get from their education and training backgrounds. For example, Japanese engineering schools emphasize teamwork more than their US counterparts (Lynn, 2002).
17. JUSE, established in May 1946, was authorized as a juridical body by the Science and Technology Agency (reformed Ministry of Education, Culture, Sports, Science and Technology) of the Japanese Government. The objective of JUSE is to promote systematic studies needed for the advancement of science and technology, whereupon to contribute to the development of culture and industry. The field of science and technology that JUSE has been involved belongs to "Soft Technology" where mathematical and statistical methods are applied to the corporate management. Quality control has been a primary subject of JUSE and great efforts have been bent to develop and disseminate the technology. Today, JUSE is widely known in and out the country as a "Center of Quality Control in Japan".
18. JUSE has managed the Deming Prize, which has been well known in the field of the Total Quality Management. During recent years, more than 20,000 people including 500 senior enterprise managers have taken part in Education and Training Courses in the following fields. 1. Quality Management, QC Circle; 2. Reliability Engineering; 3. Multivariate Analysis, Design of Experiment; 4. Marketing Analysis, Sensory Evaluation, Products Liability; and 5. ISO Management System(QMS, EMS), OHSMS, ISMS and others. Only corporate members comprise JUSE, as it accepts no individual members. Besides manufacturing corporations, many construction and service industry firms have joined recently. The activities of JUSE are implemented with the support of about 1,700 persons from academic fields, industries and governmental institutions, being members in 200 different committees. JUSE's income is mostly derived from its undertakings with member companies. No financial support by the government is received (see [www.juse.or.jp/e/profile/39/](http://www.juse.or.jp/e/profile/39/)).
19. For example, we can say frugality drives the Toyota production system. It continues to be important an element in many industrial firms and households in Japan (e.g. Fruin, 1983, 1997; Garon, 1998, 2000).
20. For example, Japan's post-second world war political institutions, amalgamations of selective adaptations based on various western models, appear ineffective and occasionally dysfunctional.

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