

**Crisis and Aftermath:
The Prospects for Institutional Change in Japan**

Report of a Conference Held May 3, 1999, at Stanford University

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Asia/Pacific Research Center
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Preface

Impelled in large part by the nearly decade-long stagnation of the Japanese economy, institutions in Japan are undergoing fundamental changes. When Professors Masahiko Aoki, of the Stanford University Department of Economics, and Henry Rowen, director of the Asia/Pacific Research Center, were talking about these changes, they realized that an international conference on the subject would be useful and informative. With funding from the Asia/Pacific Research Center and the Institute for International Studies, a distinguished group of speakers, commentators, and participants was brought together for a one-day conference to look at institutional changes in three distinct sectors of Japanese society: the political system, the bureaucracy, and corporations.

Attended by more than one hundred guests from academia, business, and the press, the May 3, 1999, conference raised interesting and difficult questions and elicited enthusiastic participation. The schedule was as follows:

Changes in the Political System

Speaker: Mr. Yasuhisa Shiozaki, Member of the Japanese House of Councilors and former Vice Minister of Finance, Tokyo

Commentator: Prof. Daniel Okimoto, Professor of Political Science, Stanford University

Changes in the Bureaucracy

Speaker: Mr. Ryozo Hayashi, Deputy Director of the Bureau of Information and Machinery Industry, Tokyo

Commentator: Prof. Hugh Patrick, Professor of International Business, Columbia University, New York

Changes in Business

Speaker: Mr. Taizo Nishimuro, CEO & President of Toshiba, Tokyo

Commentators: Mr. James Abegglen, Chairman, Asia Advisory Services, Tokyo. Mr. Hiroaki Yoshihara, Senior Partner at KPMG, Mountain View, California

Panel Discussion on the Institutional Changes

Prof. Hugh Patrick, Professor of International Business, Columbia University

Prof. Tadao Kagono, Dean of the Graduate School of Business, Kobe University

Prof. Harry Rowen, Director, Asia/Pacific Research Center, Stanford University

Mr. Katsuhiro Nakagawa, Executive Adviser, The Tokyo Marine and Fire Insurance Co. and Former Vice Minister of MITI, Tokyo

Mr. Dan Sneider, National/Foreign Editor, *San Jose Mercury News*, San Jose, CA

This A/PARC conference report presents, in edited form, the speakers' remarks and the discussants' comments. Please contact A/PARC if you have any questions about the conference, or about the Center's work in general.

Session I: Changes in Politics

CONVENER: Prof. Masahiko Aoki
Professor of Economics, Stanford University
Director General, MITI Research Institute

SPEAKER: Yasuhisa Shiozaki
Member, House of Councilors and Former Vice Minister of Finance, Japan

COMMENTATOR: Daniel Okimoto
Professor of Political Science, Stanford University

PROF. AOKI: Good morning. Today we are going to discuss changes in Japan's business, politics, and bureaucracies in an integrated way. In the coming years changes in the business market will gradually affect the government. Progressive politicians will play a crucial role in setting the agenda for Japanese institutional change across the board, as well as altering the means through which different special interests are arbitrated, whether in business, politics, or government. I am happy to introduce such a progressive politician.

Mr. Shiozaki is a distinguished member of the Councilors of the Japanese Diet. Mr. Shiozaki graduated from the University of Tokyo, where he majored in American Studies. He worked at the Bank of Japan and subsequently attended the Kennedy School at Harvard University, where he took a master's degree. After Harvard, he turned to politics, being elected first as a representative of Lower House, and later, to the House of Councilors. Mr. Shiozaki is indisputably *the* authority on the financial problems among Japanese politicians, and he played a very crucial and instrumental role in the drafting and passing of the Total Financial Revitalization System. When Harry Rowen and I conceived of this conference, the dozens of scholars, bureaucrats, and scholars we consulted all recommended Mr. Shiozaki as the best person to discuss Japanese political change. Personally, I believe he will one day be Prime Minister of Japan. We are very, very fortunate to have him here today. Professor Daniel Okimoto, of the Asia/Pacific Research Center and the Political Science Department of Stanford, will comment.

MR. SHIOZAKI: Good morning, everybody. I'm very pleased to be here and to be invited to this conference with so many distinguished participants. I'm a little bit embarrassed by Professor Aoki's introduction. In order to be a Prime Minister, as you know, you have to be in the Lower House. I'm now in the Upper House, but I first got elected in the Lower House. Since we introduced a new system of single-seat election system, I have had a long struggle with another incumbent in my city, who is now a Minister of Construction. To be honest, I lost the struggle, and had to be temporarily transferred to the Upper House. In order to be a Prime Minister, I'll have to return to the Lower House and I'll have to ask the Minister of Construction to keep his word about exchanging the seats. There is a written promise but, as you know, politicians' promises—you never know.

Before I make the presentation, two caveats. One is that I was asked to speak this morning for fifteen minutes, but I returned from New York on the thirtieth and I received an e-mail telling me that I have to speak instead for forty-five minutes. I was shocked, and I'm not sure whether I can stretch my speech as long as forty-five minutes, but if I can't, I'll say more in the Q&A session. The second caveat is that I'm going to talk a lot about bureaucrats—the role of bureaucrats, what's good, and not so good about bureaucrats. I'm sure there are lots of bureaucrats here from the Japanese government, and Professor Aoki himself is affiliated with MITI, so please remember that what I'm going to say about bureaucrats is basically about the Ministry of Finance and *not* MITI. Please remember also that my father was a MOF bureaucrat and I myself was once a finance vice minister so I do know a lot about the culture of the Ministry of Finance, but I do beg the pardon of the gentlemen from MOF who I know is in the audience today.

Let me begin by thanking Professors Rowen and Aoki for inviting me to the conference. I'm not sure why a politician like me has been invited. I'm just a rank-and-file politician in the seventh year of a political career and may not be qualified to talk about the changes in polity. After being kicked out of the negotiations with the opposition parties last fall, together with my closest colleague Nobuteru Ishihara, son of the newly elected governor of Tokyo, I feel I'm not at the heart of either the political struggle or the policy-making process. But I would admit that I have been deeply involved in a series of reforms for the last several years, not just in finance, but in the way governance works in Japan. I may not be able to convey to you a deep academic analysis, as Professor Aoki did, of what is going on in Japanese politics, but I can offer some observations on possible changes we might be experiencing and some additional measures that we should introduce for the better governance of Japan.

Last summer, I determined that Japan must depart from the “too-big-to-fail” illusion of banks under the government's protection. Bureaucrats argued that the nationalization law might be unconstitutional. They insisted that section 29 of the Japanese Constitution states that private property, in this case ailing banks' equity, must not be compulsorily taken over by the government, and we politicians maintained that the Constitution recognizes expropriation as legitimate, such as compulsory land purchase by the government for the benefit of public welfare, and an exit of ailing banks clearly enhances public welfare. I can understand why the bureaucrats so seriously refused the enactment of the Banking Naturalization Law as to employ a constitutional claim. They didn't want to take any responsibility to order ailing banks to stop their banking business since they had kept forbearance policy on banking for a long time to leave fundamental problems unsolved. It was the conventional wisdom of continuity that governed the behavior of the bureaucrats. Therefore, we politicians had to replace the conventional belief with new wisdom.

This episode illustrates the simple fact that the bureaucracy cannot voluntarily admit its past policy errors and, even worse, it tends to continue to make mistakes in order to conceal other mistakes unless an outside power, namely politicians, can change it. Then I have a question: Is it a mere illusion that Japanese bureaucrats are supposed to be the most sophisticated and make no mistakes? Traditionally, the Japanese way of governance of the nation has long presupposed the relative intellectual sophistication of bureaucrats, businessmen, and politicians, and of course politicians stay at the bottom strata. The roles of each were given accordingly. The smart bureaucrats drafted policy, businessmen acted for not only economic rewards but also reputation within the policy framework drawn up by the bureaucrats and even their behavior was often guided by bureaucrats. The roles of politicians were limited. Politicians were usually preoccupied with the specific interests and troubles of their constituencies. Oddly enough, they lobbied the bureaucracy for their constituencies, especially at the Ministry of Finance, which drafts the budget. On rare occasions, they were given opportunities to decide upon issues difficult to solve because of conflicts within the bureaucracy as well as among supporters. Such political decision-making implies that the outcome did not result from deliberations, but often from valor and muscle.

Changes in “The Iron Triad”

The relationship between politicians, bureaucrats, and business leaders has long been referred to as the “iron triad.” In those days, the LDP enjoyed the comfortable majority in the Japanese Diet. Thus, a relationship like “you scratch my back, and I scratch yours” used to be observed widely in Japan. This was the old regime, which lasted for four decades, until 1993, when the LDP split, lost the majority, and stepped down as the ruling party.

Under the Hosokawa administration, the LDP was in the opposition and the “iron triad” started crumbling. However, even Prime Minister Hosokawa stated in his inaugural address that he would support past policies taken by the government, literally accepting the fact that bureaucrats have ultimately decided the policies of Japanese government for years.

After the LDP formed the ruling coalition in 1994, with the Socialist Party and Sakigake, the relationship between politicians, bureaucrats, and business leaders became somewhat elusive. Sometimes the relationship became jarring, as I experienced during the past few years when I was engaged in the legislation of financial service deregulation, the revision of the Bank of Japan law, and the establishment of the financial supervisory agency and the Financial Revitalization Law. The recent relationship between the LDP and bureaucracy is often accompanied by LDP politicians’ distrust of bureaucracy. In the hearts of LDP politicians lies such a feeling that stems from bad memories of the days under the Hosokawa administration when the bureaucracy seemingly tried to damage the LDP in the opposition. In my opinion, however, this is only a superficial part of the mistrust. Deep down in the minds of politicians, as well as business leaders and ordinary voters, there lies a far greater mistrust of bureaucracy, which has long been believed to be in the upper echelon of society. Yet it has not only been incapable of solving problems, but has also been at times the actual source of the problems.

In the 1990s, there were too many errors and mistakes made by bureaucrats. To name but a few examples, the Ministry of Finance pursued a forbearance policy that left the banking problem unresolved, which made the banking system more unsound and unstable than prompt resolution would have done. The Ministry of Health and Welfare was too slow to stop tragedies in acting against the transfusion of HIV-contaminated materials. The Ministry of Fi-

nance successfully persuaded the coalition parties into increasing tax and social security burdens in 1997 when there was only a nascent economic recovery and the Asian financial crisis erupted. As a system the ruling party, which has been the LDP for most of the time, has given the bureaucracy in nearly every case a de facto approval without any serious scrutiny into each issue, on the conviction that the bureaucrats never make mistakes. Now politicians as well as voters have come to realize a simple reality—that is, knowledge of bureaucracy does not ensure good governance of the country. Again, bureaucrats do make mistakes, surprisingly too often.

In my recollection, in the days of a total plan for financial revitalization, from April to July 1998, I believe a desirable relationship among politicians, bureaucrats, and businessmen emerged temporarily. Various constructive policy ideas were discussed in an open circle provided by the LDP, and politicians decided on directions and asked bureaucrats to act, even if the policy was against the bureaucrats' past direction. Such policy includes establishing due diligence practices on nonperforming loans and judicial reform. In the Diet session from July to October 1998, young politicians with better insights and expertise than those of the bureaucrats for banking issues, in both ruling and opposing parties, publicly conducted political debates, negotiated, and decided substantive political compromise without any bureaucrats' assistance, which was completely beyond the seniority-by-age practice in Japanese politics.

Corrective Measures in the Political System

In order to achieve better performance, Japan has to build a mechanism in which wrong policy is checked and right policy promoted. The past mistakes mentioned above illustrate the necessary steps for checking wrong policies:

- First, checks-and-balances among ministries as well as between politicians and bureaucrats must be established. In the old regime, the Ministry of Finance had extremely strong power and substantively controlled politicians and other ministries since it controlled the national budget, tax and customs, public sector financing, banking, the securities industry, macroeconomic policy, and international finance.
- Second, transparency of policy formulation must be enhanced. Bureaucrats have tried to monopolize the information and cover up the decision-making process.
- Third, an international institutional knowledge source, in other words, information power on the side of politicians, must be strengthened.

In these respects there have been fundamental changes in how policies work in my country. Let me go into details. In terms of check-and-balance mechanisms, recently the Bank of Japan became independent under the new law and the Financial Supervisory Agency was established. These are indeed important institutional changes where any wrong policy may be checked in front of the public. In my view, there are more important check-and-balance mechanisms now in place in Japanese policies. For one thing, there is the politicians' mistrust, more precisely, public skepticism, of bureaucracy, which I mentioned a minute ago. In addition, there is an emerging check-and-balance within the political circles. Publicly announced policies now carry with them far greater significance in party politics within the LDP than under the old regime. This is because under the new electoral system of single representation of the Lower House of the Diet, individual LDP candidates represent the LDP in their own election district, and therefore, they began talking about LDP policies while they

used to talk little about policy. The policy formulation process is becoming more transparent to voters than under the old iron triad. Because the LDP is still in a minority in the Upper House, all important policy issues are discussed and agreed upon by the coalition parties before they become policies of the government. This policy-making process began in 1994 when the LDP returned to the ruling party together with the Socialist Party and Sakigake. The LDP's partners have since changed to the liberal party for coalition and, depending on issues, to Komeito for alliance.

In each coalition government, policy discussion has not been made behind the curtain of the LDP but in the open arena. The upshot is that the political show goes on in front of voters or, more precisely, the press. For example, every Sunday morning, there are three TV channels which put on the air programs of political debate in which politicians appear and discuss issues. Interestingly enough, the lines of discussion of the parties often change their courses every Sunday by what is said on the TV by influential politicians. A decade ago, it was not politicians but bureaucrats who showed up on such TV programs. Amazingly enough, these programs now attract many more viewers than the bureaucratic shows of a decade ago. I'm not sure whether politicians are popular or simply more amusing to watch.

In addition, during the series of local elections just ended, there was a growing number of open policy debate contests for candidates, organized by students and volunteers all over the country. I strongly hope Japanese voters continue such grass-roots populist movements to exert more influence on our policy-making process. On the one hand, I believe such policy discussions contributed to formulating the right policy on a number of occasions during the past few years. For example, without discussions on the party level accompanied by alternative sources of information other than bureaucracy, I doubt that the reform of the Ministry of Finance would have gone as far as creating an independent banking watchdog. Legislation for banking nationalization and bridge banks of 1998 is another example. Without such open discussion there might still be a forbearance policy on banking today. On the other hand, under the old regime, certain behind-the-curtain negotiation was easier. There is now no big room for bargaining of apples for oranges, and it is less likely to find a quick, easy fix for any important policy.

Having said all this, I have to admit that there is still some inclination on the part of the LDP towards recidivism into the old bureaucratic supremacy. Let me remind you of the fact that most of the ranking LDP members established their political careers under the old regime—that is, with the aid of bureaucracy. Within the LDP you still have to be elected a number of times to get a senior position, for example, five times to be qualified for a minister. Since last year, when I was lucky enough to become responsible for drafting the banking legislation, I've been called a “new breed in the Diet” or sometimes “a brat in the Diet.” However, I am already 48 years old, a father of two brats in the university. Being a brat in the LDP, however, I always want to pounce upon LDP recidivism into bureaucratic control. I believe Japan has to institutionalize the recent changes in the policy-making process by furthering the effectiveness of the check-and-balance mechanism, a greater degree of transparency, and politicians' stronger knowledge power.

To avoid recidivism, we should begin by barring bureaucrats from appearing in Diet session, and by increasing the role of parliamentary vice ministers and junior ministers, so they may have better governance on bureaucracy. This is almost agreed between the LDP and other parties, and the law will hopefully be enacted in the current Diet session. I strongly hope that the policy competition mechanism among politicians will function and the seniority-by-age practices in politicians will disappear. Also, C-Net, just like C-SPAN in the United

States, and Diet Internet TV channel will surely increase each politician's exposure to the general public.

A second way to avoid recidivism is to make bureaucracy more accountable for its actions. The Bank of Japan began to disclose minutes of their policy-making processes and the Ministry of Health and Welfare has opened all their advisory boards to the press, ever since the HIV incident. Ministries can perhaps emulate these practices; all the minutes of advisory boards and councils should be disclosed. In addition, collecting public comments should be compulsory before any ministry recommendation becomes valid for policy considerations.

Third, we should promote the activities of independent policy research institutes, which cover not only economic policy but also areas from defense policy to social security policy. Actually, after close collaboration with my friends outside of politics, I am about to launch a parliamentarians' league to help introduce policy incentives to facilitate the establishment of think tanks for independent policy studies. This is because my own recent experience of the deregulating financial markets—which culminated as Tokyo's "Big Bang" and the drafting banking reform legislation last year—tells me that politicians need an able staff of legislative assistants, in and out of our offices, to work effectively. The problem is that current think tanks tend to represent specific interests with business groups—primarily on administrative turf. I was lucky to have several friends outside the bureaucracy to help me in my efforts drafting the Big Bang scheme and banking legislation on an ad hoc basis. Unlike U.S. senators or congressmen, however, we have only one permanent assistant for policy studies paid by the government, whereas I think senators have something like forty assistants and congressmen, I think, more than twenty assistants. Obviously a legislative assistance function in order to help write laws, as well as to collect independent information, must also be strengthened in both houses.

Fourth, a system of political appointees by the Prime Minister should guarantee better governance upon bureaucracy. This could be one of the answers to the question of why reform progress in Japan is so slow compared with other countries that adopt the same parliamentary system, such as England, New Zealand, and Australia. If bureaucrats independently appoint a private person to join their administration, which has occurred in the past and is now legislated, it only serves to help bureaucrats.

Fifth, by mobilizing bureaucrats beyond their particular ministry, we should establish a new recruitment policy that ensures the right nonelected elite in the right position with real concern about the nation's interests and strategies. It is my opinion that the current bureaucracy system is just like an octopus jar, in which the octopus (namely, bureaucrats) can only have a narrow range of vision for and interest in each ministry. I am from Ehime Prefecture where octopus fishing is very popular. To explain my metaphor, let me say that to fish for octopus, you put jars in the bottom of the sea, attached to a string, pull the jars up and you find fresh octopus in the jar. It's very good to have octopus sashimi, which I don't think many of you will know the taste of. But anyway, I hope having political appointees and enhanced mobility of bureaucrats can stimulate a nonelected elite with the highest IQs, and better chances to become true crusaders for Japan.

Last but not least, the current single seat electoral system adopted in the Lower House might have to be reversed. While the single seat system had some positive effect in forcing candidates to talk about policies, typical candidates have to listen to all kinds of interests within their district. You have the same problem with Congress here in the United States, but what is different between the U.S. and Japan is the statutory power balance between the two houses. That is, our Lower House has much more power over the Upper House. That's why

all of the candidates have difficulties in gaining support for necessary reform programs such as postal savings reform. I don't think it is productive to continue an election system in which we cannot bar an expansion of postal savings (which inherently prevents risk-taking) to help new, growing businesses.

It is often pointed out that Japan is now at a critical juncture. I am of the same opinion, having seen drastic changes in the global, political, and economic landscape, prolonged economic recession at home, and political disarray during the past several years. History tells us that large institutional changes take place only within a short period of time, and that new institutional frameworks remain a long time. This was the case of the Meiji Restoration of 1868 and post-World War II beginning in 1945. On these two occasions, Japan sought to establish the nonelected elite to guide the country. Subsequent to drastic changes, both stability and prosperity were realized on that basis. However, that system of elite leadership planted the seeds for future problems. I now believe that democracy could avoid reaching a wrong answer more easily with an effective check-and-balance mechanism. Without it, Japan might commit the same mistake our predecessors made, in a catastrophic way, in the 1930s.

We have to be mindful of the current economic conditions, which resulted from the largest boom and bust of asset prices since the 1920s and 1930s. At the moment, in Japan, deflation is going on and the unemployment rate is reaching its record high in the post-World War II period, although it's much lower than the prewar record. It was only a few months ago that the rate became higher than in the United States. Under these circumstances, the Bank of Japan has implemented a monetary policy of zero interest rates, unprecedented even at the time of the Great Depression in the United States. The government of Japan has stepped up its fiscal spending, and as a result, the budget deficit is reaching 10 percent of GDP.

In recent months, Japan's economy appears to have stopped deteriorating, but I am not so certain if it will begin to recover anytime soon. Against this background, structural policy has drawn attention, with good reason. As I said a few minutes ago, I have been engaged in the legislation of structural reform in the financial system. Much more will have to be done. In this endeavor, I always keep in mind that a short-term remedy of a present crisis entails a model which will lay down the course of the future. In fact, a number of important laws were enacted in the wartime 1940s. We are still in the crisis and the policy we take will be tested in the future.

However, it is my regret that since the new coalition was made in autumn last year, there is no active policy debate among rank and file LDP politicians. Commonly, only a handful of higher ranking party leaders of the LDP, Liberal Party, and sometimes Komeito, decide most of the policies. These days, policies have been negotiated—and often motivated—to maintain the parties' political position. I seriously doubt that we can confront structural reform if the current policy-making practices continue.

Structural reform is a formidable task. Politicians must take the ultimate responsibility for any future results by effecting fundamental changes to Japanese social and economic structures. First, it is a political judgment to go through increasing layoffs and a possible reduction in real wages from workforce restructuring. Second, decision-making in the bureaucracy takes a long time and we may lose the chance for quick and real change. Third, the power balance among ministries can often distort the results of debate among bureaucrats. Therefore, I believe that the framework of decision-making taken in the total plan in April 1998, as I mentioned before, would be better.

Last week [April, 1999], in order to strengthen an effort by the Obuchi administration that initiated a "Competitiveness Commission," the LDP launched a "Special Study Team

for Economic Revitalization and Industrial Competitiveness.” I believe that it is up to politicians to determine whether the structural reform would succeed or not. I would appreciate the chance to learn from your wisdom as we go through our difficult times.

Commentary

PROF. OKIMOTO: Thank you very much, Mr. Shiozaki. It was an extremely thoughtful and candid set of comments. I would like to raise a number of questions based on your comments and add a few others, and I'd like to categorize them into three areas—openness, competition, and accountability. I think those were the three main themes that emerged out of your presentation. And let me say first that from an outside perspective, it is curious that in Japan, which has been in this economic crisis since 1990–1991, that the LDP has continued to maintain itself in power. Yes, it lost its majority in the Upper House; yes, it entered into a coalition government in 1993, but basically, from an outside perspective, and this is a question that an Australian political leader asked me, he said, “How is it possible that the LDP could preside over nine years of economic crisis without being thrown out of office?” He said, “Heck, we, the Labor Party in Australia, got thrown out of office even in good times, when the economy was doing well!” So he said, “you know, this is a very curious situation in an industrial democracy that the party would maintain itself in power for this long a period of time, when the economy was really in the dumps.”

Now the LDP, of course, presided over four decades of remarkable growth, from the 1950s through the 1990s. But one of the curious questions, and I think you've provided a number of answers here, is how it was that they were so slow and ineffective in dealing with the problems that rose to the surface in the 1990s. I found your comments on bureaucracies really fascinating, and maybe in the questions and answers, some of the bureaucrats present in the audience may wish to make a defense of their position, such as Mr. Takimoto from the Ministry of Finance. But we have other bureaucrats here and I think it will be interesting to get their perspective.

Now, let me ask you in these three categories a series of rather impolite, outrageous questions, and I apologize to the future Prime Minister of Japan that I am so impolite in asking these questions.

The first question is this: With regard to the LDP, how fundamental are the changes that you described that have taken place within the LDP and between the LDP and the bureaucracy? How fundamental and permanent are these changes, or were they really just temporary? I mean, the fact that you, as a younger LDP politician, emerged with your colleagues—well below 50, that's pretty young—is an interesting phenomenon and I wonder whether you continue, or the prospects are that you will continue to play an important policy-making role, a critical role, in Japan, as hopefully Japan moves out of this economic crisis. In other words, was this just a blip, a temporary response to the crisis, or was there something structural that took place?

Second impertinent question: Would it be good for Japan, for the LDP, to lose power and share power? That is to say, you mentioned in the Upper House that because of the coalition, because of the fact that the LDP now had to interact with the other parties, that there was greater transparency, greater communication, and greater openness in total policy-making processes. Now, perhaps, and I'm just asking this as a question, there would be a net gain if the LDP were to lose power, maybe temporarily? This area of political competition is one

that we haven't seen a lot of over the postwar period, because the LDP has dominated politics for so long, and so that's the second impertinent question.

Now, in the area of competition, you mentioned, I think quite correctly, that the bureaucrats have held on to power for too long and that they're risk-averse. They tend to try to dominate the processes and they don't own up to their responsibility for policy failure. That is, the political sector must hold the bureaucratic sector accountable. Now, if that's the case, you mentioned several ways in which this can be done, and I agree with all of them, but you didn't mention two areas. One is the area of *amakudari*, this "descent from heaven." Maybe one way in which the power of the bureaucracy can be diminished somewhat and greater accountability brought into play is by changing, altering this system of retirement from bureaucratic careers and parachuting into private sector positions of leadership. Or would this be much too revolutionary and disruptive for the system in Japan? And second, the bureaucrats often go into politics, and they often dominate in politics. Is this going to change, and would it benefit the national interest to see some restriction or change in this pattern?

Another area that is puzzling to outsiders of Japan is that the LDP has been, if you put it in a simplistic way, an aggregator of interests within Japan. And many of the most important political interests are from the inefficient, protected segments of the economy—the farmers, the construction industry, transportation, etc. Financial services, to some extent, may fall into that category. And so the big political question is this: Because the LDP is dependent on those very sectors which are inefficient, protected, and subsidized, is the LDP in a position to preside over fundamental structural change, because that goes against the grain of their political support?

Now, related to that is another puzzle to outside viewers or observers of Japan. The question is why consumers have not organized or been effectively represented in the political party system? Why isn't there an opposition party that has come out actively, aggressively to promote consumer interests? By consumer interests I mean not just the citizens that buy goods, but consumers in a broad public interest sense, and so this is another irreverent question that I would like to ask. Are the changes that are taking place, that you described within the LDP, for example, between political parties, going to lead to a system in which consumer interests become more effectively expressed or represented in the political processes?

And finally, let me list the series of challenges ahead that Japan will have to cope with, and I would broadly cluster these under the category of structural challenges. With globalization, it is possible that Japan's unemployment rates will remain relatively high, relative to what they used to be, not relative to Europe, but maybe in the 5 percent area, even with recovery. How will this affect politics and the policy-making processes? With globalization, income inequality may also increase. Japan has a very good track record in the postwar period, as Professor Aoki pointed out, of good income equality or indicators of income distribution within society. Is it possible that with globalization, in particular increased competition, you are going to see greater income inequality as you do here in the United States, and to a lesser extent, in Europe? Will the government be able to cope with the loss of Keynesian measures of demand stimulation? Certainly in the last nine years we have seen the limits of fiscal stimulus as a countermeasure to Japan's deflation problems, and with globalization, it is possible that Keynesian measures on which the government had relied in the past may no longer be an effective instrument. And, demographic shifts. Of course Japan is an aging population, as many people have pointed out, and in the next century, 2020, it's said that nearly a quarter of the Japanese population will be 65 years and older, even you! So this has

profound significance for the economy, for the political system, for the role of the state, and so forth. So, I wonder how Japan will cope with this issue and how it will affect politics.

And finally, let me mention that the regional security environment may be in the process of changing in very significant ways, and how the political system will deal with that shift, perhaps some of it dramatic and sudden, in the future, I think will be a very important issue as well.

So, I am encouraged by the themes of openness, competition, and accountability, and the changes that have come with those categories, but I wonder fundamentally whether and to what extent the changes will be structural, and more or less permanent.

Response

MR. SHIOZAKI: First is whether the change that we have been observing is temporary or not. I would say yes and no. As I said, Ishihara and I were kicked out of the negotiation table and will never be back in the same position, but still, there are a couple of reasons why we could act in such a role last year. One is that probably we knew as much as or more than the bureaucrats knew about the financial sector's problems, and we had more answers to those problems. Plus, financial problems are very technical, and ordinary politicians do not understand their essence, but I think we knew what the problems were. Of course Ministry of Finance bureaucrats also knew, but as I said, the conventional wisdom of continuity prohibited them from admitting that they had made a mistake. This kind of style should be reversed in order to prevent the wrong policy being continued. But anyway, that problem was a rather special case, and so we could tell that change was a little bit of a temporary matter.

Because I've been involved in the financial deregulation and Big Bang, you might think that the Ministry of Finance played a large role in these issues. That is not the case. In fact, these changes were initiated and decided upon by Prime Minister Hashimoto, and the draft was written by me, together with my friends outside of the Ministry of Finance. In that sense, last year's legislation was the result of a series of efforts that we made on the side of politics. Politicians like me, with the lesser number being elected, played an important role. That is very special, and so today, high-ranking politicians are making all the decisions now. But, I think the top leaders realize that politicians can decide if we have the knowledge and know the direction where we should go, so that's why I said yes and no.

Now, as to the question of whether the LDP should lose power or not. For the last two years, as the number of members in the Lower House grew, I think the LDP became arrogant again, and started not to listen to other parties' policies. In that sense, when we lost the Upper House election last year, we lost bargaining power completely. But I still believe that if the LDP had a comfortable majority or control of policy-making in the Diet, the LDP would tend to go back again to the old days of dealing with the questions you just raised about the inefficient sector's interests, and all that.

But why the LDP has been in power even when the economy is in bad shape, that's a very good question. The simple answer is other parties are less effective and LDP has a long history of aggregating all the interests and persuading or convincing people. People would be half satisfied—not totally satisfied—but at least half satisfied. They know the LDP has the expertise to do that, because it's a kind of small Japan itself, so to speak, and the village master can control all the different interests, and probably Mr. Ozawa is not too good at convincing people. He likes certain kinds of people but he dislikes other kinds of people, and you cannot tell those people whom you don't like to go out of Japan. We have to control.

Next, about *amakudari* and the bureaucrats becoming politicians. Compared to ten years ago, bureaucrats are having a hard time finding a place to descend nowadays. But you know, I think it's not fair for the bureaucrats to just take away the chances for *amakudari* right away without offering them some different alternatives. We need mobility, as I said in the presentation, mobility to go anywhere: into politics, or into academia, or into business or back into the bureaucracy, just as you do here in the United States. What is bad about our bureaucracy is that it is so rigid. The system itself is rigid, just like, as I said, the octopus jar. The young, incumbent bureaucrats cannot break the jar; they have to take care of their seniors. It's a kind of a family from ages 22 to 80, 90, 100 maybe, and that would distort the decision-making process often, I guess. That's why I'm advocating breaking the octopus jar. When we introduced the single seat system in Japan, I think it became more difficult for bureaucrats to become politicians. Because the strongest in the election in certain districts gets the party ticket, the newcomers have a hard time getting the party ticket, at least in the LDP. That's why we see more cases of bureaucrats going into the Democratic Party or Komeito and other parties. Komeito is a slightly different case, but lots of able bureaucrats go into the Democratic Party instead of the LDP because the LDP has strong local organizations and local politicians who are very strong in elections. The single seat system is a system where the strongest wins the party ticket. Nowadays bureaucrats go into the local mayors' posts and gubernatorial posts, because mayors and governors need not only to be strong in the election; they also need some knowledge and ability to govern certain districts. A young man from MITI just became mayor of Okayama at the age of 42. A Ministry of Agriculture bureaucrat just became mayor of Saga at the age of 39. And three ex-bureaucrats about my age ran for mayor of Iwakuni, which is not that big, about 100,000 people. So things are changing now for the bureaucrats' political future.

Session II: Changes in Bureaucracy

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MR. HAYASHI: Japan's high-cost economy and the financial crisis are caused by a massive number of nonperforming debts left over from the bubble economy. I emphasize the fact that what has caused a fatal delay in Japanese economic recovery is a decline in the Japanese economy's resource allocation ability at a time when several fundamental changes in the world economy—such as the huge IT infrastructure being built—were rapidly expanding market resource allocation functions. I was quite impressed by this phenomenon at the time of U.S.–Japan semiconductor negotiations, when both governments tried to stop dumping at the border. That was quickly circumvented by the change in procurement practices, as U.S. firms moved out of Japan for chips, and by the Gulf War, which closed 7 percent of the world crude oil production (the same amount as the first energy crisis). However, the confusion was quite minimal. Among other things, the petroleum market in London and New York continued to function. Responding to the market signal rather than government intervention, an uncountable number of individual decision-makers in a global market brought about a production increase, or a shift of fuel, and they successfully managed the crisis.

The expansion of such market functions was brought about by the rapid progress in computer network technology. At the same time, several rounds of trade negotiations contributed to the globalization of the market by further eliminating restrictions on the international flow of goods and business activities. As a result, the geographical size and scope of the markets were expanded. For example, the development of fiber material technology and the supply and demand of steel products, which heretofore had a very remote relationship, suddenly became closely interrelated. The dual expansion of geographical size and scope substantially increased the functional strength of the markets.

During this period, the Japanese monopoly in world-class process technology began gradually to weaken, as highly sophisticated products became commodities that were produced every year. This decline was accompanied by a shift towards intellectual creation of added value, including innovative product concepts and analysis and prediction of consumer demands. At the same time, office use of networked personal computers and the Internet spread rapidly in Japan. The value and the importance of these modes of development were brought home to me in a very personal way during my days at Harvard. The first class I had to take explained how to teach classes at Harvard; the second, how to use the university's information system. I had to take these two courses before I could start teaching. Plainly, both time and distance, as well as the nonintellectual parts of learning and teaching, can be reduced or eliminated through the use of technology.

This new infrastructure has made a significant difference in the competitiveness of national economies. Intellectual productive activities, in particular, have become the most important element in the competitive power of business. These developments, in turn, changed the fundamental premises upon which the current Japanese work system is based. For ex-

ample, in the oil industry, vertically integrated majors no longer control the price or flow of production. Originally they had exploration, refining, and retailing operations. They controlled the flow and did the pricing. Now, the market controls the pricing. In the IT area, IBM, who once dominated, through semiconductors, computers, operating and, in part, application software, was forced to follow the market in each segment. When IBM failed to respond to market developments, it experienced substantial losses.

These experiences illustrate the fact that it has become all but impossible, even with the best expertise, to consistently outsmart and predict future market development. The same is true picking the winning side in industrial policy. Industrial policy is built on the premise that the best allocation of resources and a full utilization of the best technology can improve the growth and competitiveness of a national economy, and that governments can play an active and positive role in this process. Prior to the 1990s, it was still standard practice for government agencies to support selected industries, and selected companies within them, by establishing a close government–industry working relationship, using advisory bodies to create visions and supporting those visions through tax incentives and low interest loans. In the late 1980s, such visions became less and less predictable, and emphasis was placed more on the qualitative than the quantitative. In the 1990s, these visions became difficult even for MITI to conceive, whereupon qualitative analysis emerged as an even more central part of the process.

Industrial policy also became less helpful in declining industries. In the past, Japanese industrial policy was successful in organizing the orderly reduction of excess capacity in declining industries without resorting to import restrictions. The same policies became unworkable as the role of imports increased and future trends became unforeseeable, especially at the company level, with the government designating the company. The industry-wide approach to declining industry capacity reduction became less desirable because a sense of fairness among companies does not necessarily eliminate the least efficient ones. Instead of industry-wide reduction, it has become more workable to emphasize the responsibility of each company's management to choose their own future.

In the new economy, competing market forces continually compel companies to be competitive and profitable. If they fail to be competitive, they cannot survive. Under this pressure, private companies have to function as they were originally designed; namely, to pursue profit. This raises the issue of corporate governance. The role of shareholders, management, employees, creditors, and customers should be redefined. Producing profit is, in a sense, creating value by properly utilizing resources. Corporate managers must correctly interpret the market signals, take them into their own cost structure, and rapidly commit the resources based upon rational judgment guided by this participation. Business in turn must develop management techniques and educate employees in order to realize these objectives. When they fail they have to go. Individual responsibility and risk management applies at the family level as well as at the corporate level.

In return for a more competitive business sector, government should prepare the means, the infrastructure, and the educational processes to maintain it. For example, the cost of doing business inevitably determines a company's production location, and private companies no longer create wealth exclusively for the nation to which they belong. Thus, in order to maintain and expand economic activities within their own borders, governments should create an environment conducive to business, taking into account the cost of fundamental services, taxes, social securities, and so forth. Of course, if they are to respond successfully to

market change, companies must make business decisions that fully utilize this positive environment.

The changes I have described illustrate the need to reexamine the role of the government in Japan. While individual resource allocation functions should be left to the private parties, government, as the architect and operator of the national economic system, should make sure that the national system is functioning as designed, that the players in the system are functioning as they are supposed to, and that the national system or infrastructure is at least as fair and friendly as that of competing nations.

New Roles and Policies for the Government

The following are examples of important roles for government to play. As noted above, the corporate tax and social security fees are the major cost components for most companies in Japan. This year in Japan we have reduced the corporate tax to internationally comparable levels. To find the best balance between benefit and payment, social security reform is under discussion. Building appropriate rules for global markets is also essential. For example, there will be some discipline of pricing power, such as that found in the Robinson-Patman Act* in this country. Legal mechanisms have to be examined to ensure that private companies work effectively to allocate social resources even as they pursue profit. Building new infrastructure for productivity enhancement in intellectual, value-added work is also important. This includes construction of information infrastructures, organization, or higher education programs, adequate legal protection for intellectual property rights, and so forth.

Such changes are reflected in Japan's industrial policy, of which deregulation has now become a central part. Deregulation in information processing, telecommunications, and transportation brings cost reduction, efficiency, and convenience. Moreover, it is critical for the full utilization of market forces. Cost reduction can also be brought about through deregulation in other basic industries such as finance and energy. In each of the past fifteen years, new deregulation programs have been authorized and executed. As the approach has grown more systematic, results improve and substantial progress occurs in communications, energy, and transportation processes. Major steps have been taken in the financial sector and future progress is expected in many other areas.

While it is clear that deregulation is a starting point, it is not necessarily the end. It is essential to ensure that deregulation produces real competition that will in turn promote the maximum allocation of resources to the highest and best use. Government should develop the rule of competition and a safety net, and the government should design the legal mechanism that allows management to respond flexibly to market signals and to allocate resources accordingly. Fundamental policy requirements include solid accounting systems, the development of workable and stable capital markets, and the necessary revision of laws.

Technology is another aspect which MITI has emphasized. The technology development program originally focused on industry-wide commercialization as well as the national labo-

* The Robinson-Patman Act was passed by the U.S. Congress in 1936 to supplement the Clayton Antitrust Act. The act, advanced by Congressman Wright Patman, forbade any person or firm engaged in interstate commerce to discriminate in price to different purchasers of the same commodity when the effect would be to lessen competition or to create a monopoly. Sometimes called the Anti-Chain Store Act, this act was directed at protecting the independent retailer from chain store competition, but it was also strongly supported by wholesalers eager to prevent large chain stores from buying directly from the manufacturers for lower prices. (Source: *The Columbia Encyclopedia*, 5th ed. (New York: Columbia University Press), 1993.)

ratory programs, and the provision of incentives for private companies to spend more on their research and development. Gradually, as commercialization was taken over by fierce competition among companies and became difficult to coordinate, the focus moved to more fundamental research. Then, the international element was introduced to facilitate a good interaction among different values and thoughts, bringing together supplier and customer. This new market function allows new technology to be quickly commercialized through a venture business. Currently, major policy thought is being devoted to accelerating commercialization through the creation of proper research environments and the protection of intellectual property rights.

Changes in information industry policy are a good example of this phenomenon. The information industry is unique because it is a promising industry and also provides a basic infrastructure for the information society as a whole. Japan's information industry policy is said to be one of the most successful examples of industrial policy, having established a computer industry which created very effective competition in the Japanese hardware market. Japan succeeded—despite the worldwide dominance of IBM—by developing visions and creating industry-wide, commercial development programs, including the so-called VLSI (very large-scale integrated digital semiconductor leadership project).

Returning for a moment to MITI's IT policy, its objective had been twofold: building leading Japanese companies, and emphasizing the information society. The VLSI project is considered successful. Through a focus on the key technology, it created world-class semiconductor firms. A diverse selection of industries and companies created a good balance of cooperation and competition. The management skills were appraised along with the prospects for incorporating IT into a wide range of industries, especially in manufacturing processes. This brought a strong competitiveness to Japanese manufacturers.

In the 1980s, a fifth-generation computer project started. It had a character different to its predecessors. The more advanced areas were divorced from commercialization and the emphasis changed from hardware to software. It was a success, but more an academic than a commercial one. In the end, it produced quite a lot of good papers, but little for the computer itself.

And there were other attempts. MITI unsuccessfully fought the MPT (Ministry of Post and Telecommunication) to develop a deregulated, value-added network. On a larger scale, OSI, a standard for network protocol, was successfully created through the agreement of European, Japanese and American governments, but was subsequently taken over by TCP/IP of the Internet. In the 1990s, emphasis shifted further to software and networks and MITI tried to apply methods similar to those employed in hardware. Essentially, however, we found it almost impossible to identify the critical technologies and companies that bring both commercial success on the stock market and are viable for industry-wide joint research projects. These difficulties taught us that traditional supply-side policies could not work in software and the information service areas. With that we sought to establish a market for this type of industry, and the supply side became less direct. We started software education programs, protection of intellectual property rights, and grants and subsidy programs to which any interested party could apply.

At the same time, the principal priorities shifted to the development of information infrastructures in which economic activities can flourish. This demand-side policy occupies the central part of our effort now. It strengthens the productivity of intellectual work, and it opens a new path to the market, especially to electronic commerce, which further increases the resource allocation capability of businesses. Solid information infrastructures open the

global market for local producers, provided their products have competitive strength. We shifted our resources to projects like CALS or EDI, increasing the IT investment in areas like communication, medical care, and libraries. We are also focusing more on tariff rates in telecommunication, and legislation to prohibit unauthorized access. MITI now even enjoys a wonderfully good working relationship with the Ministry of Post and Telecommunication—another positive change. The WIPO [World Intellectual Property Organization] agreement implementation bill was sent to the Diet and the privacy protection mechanisms, introduced by the European Union, are being harmonized internationally and the appropriate civil law revision is being discussed.

In the area of corporate legal systems, we should first make sure that existing mechanisms are properly used. To be sure, this would force Japanese company management, employee creditors, and customers to accept a different type of corporate structure. It may not be comfortable for them, but the competition will force them to accept it.

Once existing systems have been reevaluated, the next stage is to prepare management for restructuring. The holding company's corporate structure—which was prohibited under Japanese antitrust laws—and other necessary revisions are being discussed and unnecessary tax penalties lifted. Japanese bankruptcy law will be revised so that insolvent companies can be reorganized or dissolved while preserving the maximum value, either as a growing concern or for the creditors. Mergers and acquisitions and corporate resolutions should likewise be reassessed.

When companies start performing as designed, then we have to face the employment problem. On the one hand, companies cannot continue to maintain employment as they have been. On the other, management is not expected to simply discharge employees. The issue of labor mobility requires careful consideration because the current system of lifetime employment is a unique fit in Japanese society and Japanese employees make a substantial personal investment on the basis of that system. The newly discussed employment system will increase worker mobility, but this more efficient deployment of human resources will not necessarily ensure satisfaction from an individual point of view.

Where, then, shall we start? There are compensation systems that have built-in incentives, disincentives, and pension payments for retirement. Usually determined by length of employment, pension portability is very limited. Companies are designed to receive compensation for not laying off workers and temporary employment services are restricted. Employment security law limits, and sometimes prohibits, a private company from providing employment subsidies and an on-the-job training system also has some of this incentive element in it. At bottom, any new employment system will force the individual employee to evaluate himself and his unique situation objectively before taking advantage of that system.

Let me give you an example in which all of the market forces and structures I have been discussing came together. It occurred in the petroleum industry, in which I spent time during the first energy crisis. All governments put controls on prices and production. In Japan we did it through administrative guidance, whose strong point is flexibility. We lifted the controls quickly afterward, while the other countries had a hard time doing so. Unfortunately, through informal business customs or implicit implementation of other laws, the regulations remained in place. Then, in 1996, the removal of import regulations completely changed the competitive environment. The liter price of gasoline fell by one-third, back to the comparable international level. The Japanese petroleum sector was shaken and confused, and managers of Japanese refineries and distributors continued to seek increased market shares. They were hoping that, eventually, the price would increase as they had experienced before. They

believed that if they acted as they had in the past, by fighting for increased market share, all would be well. What they failed to realize was that past profit margin resulted from a kind of managed competition. During this period, almost all petroleum companies recorded losses. The previous system unduly emphasized the market share. It produced higher prices and profit, but there were a huge number of gasoline stations, and excessive service employees working in them. In today's competitive economic climate, this artificial scenario should not exist. Every economic decision-maker in the petroleum industry must act according to market signals and seek the best way to utilize capital, human resources, land, and other valuable resources, instead of just seeking increased market share. Today, still, this is a work in progress.

This example also shows that the Japanese policy-making system should change, particularly in the area of administrative guidance. In the past, administrative guidance has been successfully utilized to avoid a mechanical application of written law and technical regulations to come up with the most suitable solution possible. Also, administrative guidance has contributed to the maintenance of policy flexibility. Administrative guidance contributed to the flexibility of a quick solution without going through the Diet process. If the parties agreed upon the terms, that was that. Interestingly, this process is now used to develop privacy matters with respect to electronic commerce with the European Community. The U.S. and Japan essentially support administrative guidance, while the Europeans prefer to have a law. Sometimes, administrative guidance is preferred even to legal action. But the decisions made and actions imposed through administrative guidance receive less scrutiny and, if abused in the name of consensus, may result in severe and unjust sanctions. They are also difficult to challenge because of the obscurity of their legal character. This lack of transparency, in cases associated with administrative guidance—one of the big topics in the U.S.–Japan semiconductor negotiations—works against the free market. Accordingly, transparency should be put in and consistency, predictability, and clearly understandable rules must replace vagueness. The administrative procedure role and the freedom of information act law will, I hope, take care of that.

On the administrative reform side, strong leadership is necessary to break deep-rooted rigidity. Persuasive and articulate leadership capable of rallying the Japanese people will be essential. In addition, active and open policy discussions should be encouraged so that ministries are not bound by narrow jurisdictions. Rather, they should be encouraged to advance policy suggestions when appropriate. This requires a strong policy coordination function within the Prime Minister's office. The transparency of this emerging system and the checks-and-balances within it will be very important considerations.

Currently, these considerations are not part of the decision-making culture. Our system was built on the urgent need to catch up to Western countries, to avoid being colonized as neighboring nations were. In those days, our leaders decided to import the Prussian parliamentary system and the bureaucracy. This historical background, value system, and institutional setting brought us to where we are today. The efficiency requirements generally justified a heavy emphasis on the executive branch and the ministries, and the parliamentary system delegated a generous amount of discretionary authority to the executive branch and the career bureaucracy. The rule of consensus was heavily utilized to safeguard against the abuse of discretion, as was the continental tradition of a legal system that limits the role of discretion of the judicial side.

Strengthening the Prime Minister's position—from being simply one of the ministers to sitting as chairman—is another element of reform. Now for the first time, the Prime Minister will have a clear role in the law and he will have a clearly defined, commanding position.

Active policy discussion among ministries will require the strong coordinating authority that is associated with that position.

Ministry Reorganization

Now I will discuss the issue of reorganization of Japanese ministries and major agencies. First, I should stress that a national consensus is essential on what the people want to build and the administrative mechanism they wish to employ. A central objective of any mechanism should be how best to utilize the market to maximize public good. At this moment, we are trying to minimize the role of government in the provision of services, and encouraging the private sector to take over that role. The private sector will be very involved in the concept of agency.

Much will depend on how well we put the ministries together. Our aim is to group them on the basis of a common mission and related expertise, and not to make them a prisoner of special interests. There is considerable discussion of the pros and cons of advisory bodies; information gathering and consensus confirm that they work, but they can also be used as an excuse. In the end, we still have huge discriminating power left in the executive branch and, from the viewpoint of the checks-and-balances and transparency, we think that is important.

I will try to finish quicker and leave time for questions and answers, so I will talk about what is happening with MITI later. But to conclude, I would emphasize that these are just a few of the challenges we now face and revision on paper alone cannot bring these changes about. People's minds must be changed, and that is not an easy thing to do. It may take a generation. This always reminds me of a conversation I had with Raymond Vernon (Clarence Dillon Professor of International Affairs emeritus) at Harvard. I stressed that Japan has changed. He replied that, "You are still there. Our generation is coming from the student movement—the kind that is very good at distorting things—but I don't know whether you are good at rebuilding anything."

My point is that the generation is changing and the center of gravity might have already moved. Whether we have changed or not, we have had a long dispute and we will continue to have a long dispute about it. All the same, this is one very important time in the past hundred years of Japan's history. Thank you.

Commentary

PROF. PATRICK: Mr. Hayashi has, I think, given us a very comprehensive and in many respects very detailed description of the evolution of the MITI-business relationship or government-business relationship as reflected in industrial policy, and how it's evolving. I found it fascinating and I took down lots of notes, but I can't comment on the details, as I haven't enough time. It seems to me to summarize what you said; MITI is powerful, will remain powerful, and will try to find a way to stay ahead of the curve so it will always be there. In a sense, you're talking about generational change to ensure the maintenance and continuity of MITI playing a constructive and useful role in Japanese society.

I wish I had the cleverness of Dan Okimoto to make a list of tough questions to ask you, but I don't really have that. What I really wanted to do was make a few observations, to note my reactions. It seems to me that first of all you were focusing mainly on the institutional relationship between MITI and business, and a bit at the end on policy-making as it's reflected through the bureaucratic process, and, unfortunately, you didn't have enough time to

develop that fully. I was in the embarrassing situation of being signaled from the back to hand Mr. Hayashi a note saying his time was up and he adjusted very well because he has the MITI flexibility.

I think what is important is that MITI is saying now, in the new world of global market competition, we no longer can pursue a traditional system of industrial policy, but we need to promote an institutional system, a structure which will enhance global market competition, and make sure the Japanese firms do very well in it. Technological innovation is obviously part of that. But essentially, if I understand what you're saying, MITI now defines its role and redefines its role to provide overall infrastructure for the economic system so that competition, market competition, will work on a global basis. You referred to intellectual property rights, bankruptcy law, and corporate governance. These are all issues that, in effect, business has to deal with, and you were saying that MITI's continued important role will be to establish the parameters in case that happens, to set the rules of the game. I was interested in the positive way in which you described administrative guidance as flexible and effective, but also, less positively, as secret and not transparent. You suggested that somehow, if you only make it transparent, it will work. I'm not convinced about that and indeed many argue that what you need are rules that are legal and clear. I'm not sure that leaves us much role for administrative guidance, but you certainly intend to keep it as you said. I think there's an inherent contradiction there that we'll be seeing a lot of in the future.

I want to turn a little bit away from what you said because yours was very comprehensive and thorough and I could argue about details but I think really that's not important. What is important is trying to understand for all of us, for me to remind you of some facts about the bureaucratic system in Japan. First of all, let me address what Masa Aoki referred to as the culture of a ministry. Each ministry has its own set of values, its objectives, its own set of established formal and informal relationships, and these are all very important in trying to assess what it's going to do. I've always been impressed that each ministry says that it's working for the nation and it defines the nation's interests in terms of its constituency. So the Ministry of Agriculture, Fisheries, and Forestry, for example, says the national interest is to protect farmers, fishermen, and companies that are in the forestry business. MITI has certainly always been very concerned about the industrial sectors. The Ministry of Finance has been concerned about the interest of financial institutions. As Dan Okimoto, I believe, pointed out this morning, all the ministries are essentially set up to protect, help, and support the interests of the producers in those activities, not so much the consumers of those activities. I think that's an important issue we have to understand. Of course, each ministry is also designed to protect its own turf. As you were remarking at the end, over time interministerial issues are becoming increasingly important. Telecommunications policy, information industry policy, and postal savings were mentioned earlier. These issues cut across ministries. And I gather that these issues will be resolved through this new policy coordination function of the Prime Minister's office will derive, which in effect will enhance or maintain the power of the ministry.

Just as an aside, Mr. Hayashi ended on the important point that a generational change is very important in Japan and that ministries, including MITI, will continue to change as the younger generation brings in new ideas and ways of thinking. Hopefully they will do that before they get captured and turned into clones of their seniors. In some sense, I feel very hopeful for MITI because as I mentioned to him at dinner last night, how many other MITI officials have hair as long as Mr. Hayashi's? And then ask the same question for the same people in different ministries: is there anybody in the Ministry of Finance at his level, deputy

director level, who has hair that long? Or any other ministry? I don't know. Certainly not in the Foreign Ministry, but that's a special subset of a strange type, so we won't worry about them. But it's really very good that the ministry in effect is saying, hey, these are the kinds of people we need in the ministry. In a sense you are a role model, through your hair as well as your voice.

I think our discussion this morning has really said implicitly that bureaucrats are incredibly powerful. They're really much more powerful than politicians, except occasionally when politicians will grab an issue and succeed in taking control of it, as Mr. Shiozaki and his colleagues did. Of course business is powerful but it's in its own domain. Why, one asks, are the bureaucracies so powerful? In part I think it's because they are indeed the politicians' brain trust; they have almost a monopoly not only on generating ideas, but also on generating legislation. There's almost no legislation that gets through the Diet that hasn't been drafted by bureaucrats in some ministry. It's not generated independently by politicians and that is in some sense, as Mr. Shiozaki pointed out this morning, one of the fundamental weaknesses still of the bureaucratic-political interrelationship. There are important issues that the bureaucracy simply cannot cope with, yet they regard it as in their domain. It would be very hopeful if in the future independent think tanks develop so that politicians have the intellectual apparatus (larger numbers of staff, etc.) to compete effectively in the formulation of policy issues.

Why are the bureaucrats still so powerful? Of course they're very smart, but even the best and the brightest make mistakes, as we found out to our dismay in this country, and as the Ministry of Finance has demonstrated so effectively through this last decade. I think both the power and the culture of each ministry were shaped by the fact that in the early postwar period, power was left in the hands of bureaucrats, first by the Occupation authorities and then by the political apparatus. As a rapidly growing follower country, Japan had an increasingly clear model of development and growth. This model incorporated great discretionary authority and power that was vested, as I said, first by the Occupation and then by the Liberal Democratic Party and the political leadership. On the whole, you can regard that first twenty years of rapid growth as a very substantial success in policy-making. Of course, what was real success and what was the covering up of mistakes? Due to rapid growth, this isn't clear, and because of that, the bureaucracy got established. However, as Mr. Hayashi pointed out very clearly the world has changed a great deal. The environment has changed and Japan is no longer a follower. It's a leader and it doesn't have any model to look to and that makes a policy, I think, a big difficulty. In particular, the shift from a regulated economy to a much more deregulated competitive market economy puts forth brand new issues that each ministry must respond to. The interesting thing, as far as I can see, is that the only one that has responded constructively has been MITI. MITI in the 1960s' mainstream was industrial policy. The anti-mainstream was international economic interactions, trade, and investment. By the 1980s, industrial policy was moved to the background and international economic relations became much more important, as we heard. If there's any ministry that is pro-free trade, or at least says it is, it's MITI. I can't think of any other. And that is a change that has kept MITI ahead of the times. Maybe you were lucky that your sectors were deregulated first. MOF faced a similar set of changes and market conditions, but was much less able to adjust and so the politicians have had to take it apart, or at least try to take it apart, to reduce its authority by shifting activities to the financial supervisory agency. How much of that will go on and in what other ministries is very unclear to me. But that's the sort of change that has to come about within each ministry as a response to this new environment.

I'm not sure, frankly, how fast they will do this and I'm not sure about the degree to which the Ministry of Finance—I'm sorry, the Liberal Democratic Party—will push for more than a superficial sort of change.

Amalgamating a lot of ministries into one may just create one big monster out of a lot of little monsters, or it may bring about a real transformation in policy and thinking. I suppose the hope is that when you effect institutional change within the ministries and the ministerial bureaucratic structure, you also bring about generational change that will make it a happier world ten or twenty years from now. Thank you very much.

Discussion

- Oliver Chubb, Kingdon Capital, stated that it seems that the other ministries will continue to have vested interests supporting them and if MITI is encouraging deregulation and does not have the same vested interests behind it, it loses some of its bureaucratic power. He asked how MITI would compete against MPT in dealing with the Internet and deregulation.

- Annalise Mock, Nomura Research Institute, asked a question about the likelihood of both private and public financing developing in Japan and if it has anything to do with MITI's approach to global competitiveness.

MR. HAYASHI: First of all, we [at MITI] will continue to be influential as long as we are doing right and if we are wrong, then we will be out. That is quite a natural development and I think many of us just take it for granted. Regarding cultures, MITI is in some sense unique. It keeps changing; it went from Agriculture and Commerce, to Commerce and Warfare Ministry, to Ministry of Commerce again, and to Ministry of Trade and Industry and we also made a change in 1973, even though the name did not change. We just keep changing. We have been exposed to the foreign situation for quite a long time. That keeps educating our institutions by pushing us to respond and explain what we are doing to the world and to people in the domestic context. We deal with too many things. Even the Director General or the Deputy Director General are taking care of twenty, thirty industries, so the younger generation, the men in their thirties, have the competitive advantage vis-a-vis the ones who can not spend their 24 hours on one subject. The power tends to go down to the younger generation and we also have Mr. Amaya or Mr. Kuroda. They are role models who are very articulate and they often go before the public. So we started with price control, then administrative guidance, and then tried to discuss those policies. The direction we want to take is towards software, the new check-and-balance, questioning to what extent elected and permanent officials should be taking charge.

Political decisions should be a reflection of the voters' will. If we can succeed and have a competitive situation in the policy options and policy-making, we will undoubtedly have better solutions. Whatever we do now, I am certain that the transparency which will be imposed on us through the Information Freedom Act of Japan will change the situation and we will have a different style of administration within a few years.

Going to the specific questions, first about the fight against MPT: that has completely changed. Twenty years ago, the Japanese economy was just the size of this table and Kasumigaseki and Nagatacho controlled the central part. Now, the Japanese economy expanded to maybe the size of this room and we are still somewhere around here (this corner). Is it interesting to fight over some small piece of territory? The guys of our generation in the Ministry of Post and Telecommunications share these views, so we have a completely differ-

ent reaction than a few years ago. My hope is that this will continue to be the case. And as far as administrative guidance goes, I recently found a very interesting example through talks with the European Union. The CO² emission controls imposed on the auto manufacturers within the EU are done through administrative guidance or contracts with associations of European automobile companies. Whatever they agree on becomes the law. There is an Anglo-Saxon tradition of a legal system where an agreement by two parties creates a law—the rule creation mechanism—and this is why I think that this function of administrative guidance will continue to be around.

In terms of the IT and capital markets, we like to see this, but these are the kinds of areas that we have not succeeded in changing. We have been arguing for the legalization of foreign currency exchange for fifteen years. Every time we come up with certain recommendations we move ahead one or two meters while we still have one kilometer to go. Again, though, the changing involvement makes me hopeful that the capital market will change too. An important part of the functioning of the capital market is the mindset of the players. We need market players who have the expertise to utilize the environment and the mechanism. Otherwise there is nothing. So, while we stress the importance of the capital market and of discipline, how can we bring the discipline in? I think this is one of the most important focuses of our ministry.

PROF. PATRICK: I have a question about what you just said. I thought it was fascinating that instead of fighting other ministries, you're going to create alliances to solve big problems rather than little problems, thereby continuing to be significant players in the policy process. Clearly this is a model for the maintenance of bureaucratic power in the decision-making process. It may be very constructive and you're never going to give up administrative guidance.

The other point that I want to comment on is that I think it's very important, as you said, that markets don't operate in a vacuum. They need rules. We need rules of the game and somebody has to define the rules. MITI is very happy to play that role and—to the extent that the politicians and others accept that—I think that is a very useful role. Are there other questions? Do you want to respond to that? You agree with me, of course.

MR. HAYASHI: Yes. At the same time, I would like to stress transparency again. We do not like to deal in a closed room with even the politicians. The power balance between the politician and the bureaucracy is not necessarily that the bureaucracy is stronger than the politicians. Politicians can be stronger than bureaucrats, but the process itself must be transparent. I think that eventually the quality of the public itself will decide the system and that we will have a system which is equivalent to the level of the public. That's only way we can do it.

- Mr. Hayashi then responded to a question from Tom Heller from the Stanford Law School regarding whether the structure of costs and remedies that are available will really encourage people to take advantage of more decentralized monitoring. Also, to the extent that one begins to talk about shifting power to the legal system, what are the implications of a more fundamental reform at the procedural level?

MR. HAYASHI: As far as the administrative reform, I will discuss it with you at a later time. The other changes are judicially deep-rooted. The conservative forces would try to limit the discretion of the judiciary. So it is not necessarily easy. The change in price for bringing class actions a couple of years ago created a huge number of lawsuits. That is, bringing an ordinary situation to the court will give a different view and that would be very good to educate

the public. These small steps taken in the procedure side will gradually change the role that judiciary plans play. But essentially, as we said, we have to develop software. I don't have any good answer. The elected official, the permanent official, the executive, legislative, and judicial branches: there are so many institutions, such deep-rooted, implicit principles that will take time [to change], but again, competition and other kinds of transparency will force us to move ahead. That is the way I see it.

Session III: Changes in Business

SPEAKER: Taizo Nishimuro, CEO and President of Toshiba

COMMENTATOR: James Abegglen, Chairman, Asia Advisory Services

COMMENTATOR: Hiroaki Yoshihara, Senior Partner at KPMG

PROF. AOKI: We are now going to move from politics and the bureaucracy to the business domain and as I said earlier, I think the change in the business domain will have the most important impact on the future of Japan. The keynote speaker today is President Nishimuro from Toshiba Corporation. When we started to plan this conference, our first choice was President Nishimuro and actually, one of the panelists here, Mr. Yoshihara, asked me, "How did you get Mr. Nishimuro, it's almost a miracle!" He is one of the most talked about executives in Japan today, together with Mr. Idei of Sony and Mr. Okuda of Toyota Corporation. Toshiba's road is not as smooth as you might have thought, but on this rough road Mr. Nishimuro has engineered a remarkable performance and he is implementing a bold business restructuring plan at Toshiba. The stock market responded to his strategy by doubling the stock price of Toshiba since last summer. We are very much looking forward to hearing about what's going on in Toshiba.

There are two discussants. One is my old friend, Jim Abegglen, and most of you will be familiar with him. He received a Ph.D. in psychology and anthropology from the University of Chicago; he used to teach at MIT, Chicago, and Sofia University in Japan, and his work on the Japanese factory, which was written in the 1950s, is a classic treatise on Japanese business organizations. He's one of the founding officers of Boston Consulting Companies and he is now running his own consulting company, Asia Advisory Service. He wrote a very interesting article in the Nikkei last September about how Japanese corporations should restructure. With his deep understanding of Japanese and Western business cultures, he made a very interesting proposal and I recommend that all MITI bureaucrats read his article. I'm glad that he joined us.

Mr. Yoshihara graduated from the University of Osaka, and subsequently joined the KPMG Corporation, where he was elected senior partner. He's the youngest senior partner, I understand. He's also the first Asian partner and he's in charge of KPMG's operations in the Pacific area. The company is in Japan, Korea, and China. So he's one of those people who is really familiar with how Japanese organizations are operating and what their problems are. We are looking forward to hearing from these three experts. It should be a most exciting session. Thank you.

MR. NISHIMURO: Thank you very much, Professor Aoki, for your very kind and extensive introduction. You referred to two other names. One is Mr. Okuda of Toyota and Mr. Idei of Sony is the other. The difference between those two gentlemen and myself is those two companies are still making money. Toshiba recorded the first negative earnings in 48 years this first half of last year, so there's a big difference.

Before going into my presentation I have apologize to all of you for being late. This is Golden Week for Japan, and Golden Week is one of the busiest weeks for Japanese executives, ironically, because there's nothing going on in Japan. Even the Prime Minister is in the United States. Everybody wants us to be out of Japan and working somewhere else. Last week, I was down in Southeast Asia visiting Singapore, Kuala Lumpur, and Bangkok. Before I left Japan, I checked the Japanese script of the presentation and then it was translated into

English and they have added a tremendous amount of materials to it. If I go through this material, I will need two or three hours, so I have to skip some of those slides. That is not because I'm hiding something, but because I'm saving time. That's one thing. Also, in the course of translation some of the word choices are not suitable to express what I want to present—so I'll have to make some corrections.

[Mr. Nishimuro used a series of slides as the structure for the following comments.]

First of all, I would like to touch on the review of the Japanese economy and current business situation. Historically, as I list here, Japan's economy has overcome many difficulties. The first one could possibly be the Nixon shock, which Professor Aoki touched upon this morning. That was back in 1971, and we have since gone through the oil crises in 1973 and 1979. We had many trade conflicts with the United States and European Union, and also a very drastic appreciation of the yen after the Plaza Accord of 1985. Those were the difficulties we faced then. Now, fortunately, Japanese industries have shown strength, mostly based upon a mass production system for standardized products and manufacturing (not technology)—efforts toward quality control, total quality management, zero defect. "HM"—"half movement"—is the peculiar word that describes this process. It is Toshiba's invention and was also cited by Jack Welch of General Electric Company in his 1996 or 1997 annual report. This is the method for cutting costs in half, a just-in-time-system.

Japan's real strength has been with goods which have been sold outside of Japan, from early stage electronics, to automobiles, to precision machineries. Those industries are very strong now worldwide, whereas we have many industries which are closed within the Japanese society or Japanese economy. That closed system means that there are reasons to protect; Japanese-style management has been kept and also the Japanese custom-oriented business infrastructure like the distribution system (*keiretsu*), or nonbarriers on everything. These have made it possible for the Japanese economy to weather outside difficulties, the Nixon shocks and oil shocks and so forth.

Changes have been taking place in the global arena. One, naturally, is globalization. The other is very fast and widespread development of information technology. Also, the service economy is moving up so now almost all countries, especially the United States, are heading towards a service economy or service industry. Japan has no choice but to open up its economy; deregulation or Japanese-style management has to be changed. "Global standards" is the phrase I really hate to use. I really don't think there are any global standards, but "globally acceptable standards" are what we have to use. We have to face an open economy, and those portions which have been closed and protected in Japan have to be changed.

The problems that Japanese companies are facing at this point include surplus production capacity, surplus employment, and large debt which constrains cash flow. We are short of information technology investment in comparison with the United States and we have to do something to cure or save Japanese industry.

There are things we have to do now. One is to strengthen core businesses. We have to screen the business mix. In other words, we have many businesses in our industry, but we have now to find our core business and develop new businesses in order to maintain growth. Growth cannot be expected for those businesses which are traditional to each individual company. We also need to reform the management system and structure.

In the case of Sony, they adopted a virtual in-house company system in 1994 and recently announced that they will merge three major subsidiary companies into Sony itself, effective January 2000. They are entering the next-generation network communication market. In

addition, they are entering financial and securities markets. They are counting on the new launch of PlayStation 2, which is scheduled to be in the Japanese market before Christmas 1999.

In the case of NEC, many changes have recently been announced by new management. For example, they are talking about management reform, one of which is reform of the Board of Directors. An in-house company system will also be adopted. They will consider entry into new businesses which will extend their current business. One area they plan to explore is high value-added business, solutions for restructuring unprofitable businesses. I hate to use Packard Bell as an example, but they have recently announced a restructuring: they are reducing 15,000 people (a consolidated basis) in a three-year period. They also announced that they are going to cut their bids.

In the case of Toyota, they are investing into new businesses for future growth—shifting to value-added service business that is mostly in the financial end. Of the new investments, one is environment-related and the other is an intelligent transportation system or ITS. They have also started to procure from outside of their *keiretsu*, including foreign companies. Toyota is very eager to make changes to have their subsidiaries act as real subsidiaries, and to group management as advocated by Toyota.

In the case of Nissan, few details are currently known of their arrangement with Renault of France. For the time being, they have made an alliance, with financial help available from Renault. Nissan claims that they are going to change from full-line automobile supplier to a specific niche type of automotive supplier. In addition, they are talking about drastic restructuring, including large layoffs, sales of head office, and closing overseas subsidiaries.

Although it has recently been talked about loudly, most Japanese industrial companies have been reducing their total employment considerably from 1994 through 1997. The biggest number occurred with NTT, the communication giant. Nissan, Nippon Steel, Hitachi, and Toshiba, are also listed. These layoffs have happened without any noise or attention. But from here on in, we have to do more.

Toshiba's Restructuring

So far I have talked about the other companies and the overall situation of Japanese business. Now I'll discuss Toshiba's company reform in more particular terms. We are making reforms in three parts. One is to reshape management structure, two is to change business structures, and three is to change corporate culture and enhance management efficiency. Reshaping management structure means management system change. Such changes include the implementation of a new executive office system. This means that we have reduced the number of the Board of Directors from thirty-three to twelve, and named new executive officers. This is a new concept for a Japanese company, and twelve is a fairly small number compared to thirty-three. We also intend to put outside directors into our Board of Directors; so far, we only have one outside director.

The second element in reshaping management structure is in-house company systems: specifically, reducing the headquarters size, which took place April 1999. This will give each business segment the autonomy and responsibility necessary to become more competitive. The third element of the management restructuring is synergy as a group. Though each business must be competitive on its own terms, Toshiba, as a group, must act as a group, not as individual companies.

For introducing in-house companies, the main objective is to implement a system that enables decentralization at any time. This morning, Professor Aoki explained that there's a move to go to the holding company system. In preparation for this, we are establishing a new in-house company, which consists of eight companies plus one outside joint venture with Carrier Corporation. I'm going to explain this a little later. This new plan will permit the following: (1) a future holding company will be easily available, and (2) smaller headquarters, to prepare for the holding company, will become possible. Smaller headquarters are very important.

We had approximately 700 people in our headquarters. We reduced the number to 300 and stated that there are only two things they have to do. One is strategy planning and resource allocation and the other is auditing. Although the total number of auditors has been reduced drastically, we have enhanced our auditing power. We also introduced a new accounting system, creating responsibility and placing a greater emphasis on a cash-flow management system. We reassigned the executives between in-house companies—effectively rotating them among the companies—so that they can be trained as real management.

Toshiba's new in-house companies are as follows. We have information on an industrial systems company, a semiconductor company, and digital media equipment. Those three are the core of the company. Others include display devices, power systems, medical systems, escalators and elevators, and home appliances. The last company is Toshiba–Carrier Corporation, a joint venture with Carrier Corporation of United Technologies of the United States. As I explained, this is a core business and other businesses have been distinctively separated. Up to now, in-house companies have had their own subsidiaries. Going forward, we will rank subsidiary companies necessary for the future growth of the total corporation on the same level as in-house companies. In other words, subsidiary companies which have been treated as individual entities will become Toshiba group companies. This is a new system for which the purpose is apparent: to accurately understand and judge changes and risks from the Toshiba groups' perspective; to ensure a grasp of Toshiba's business portfolio; and to develop strong leadership capabilities that can stretch and practically reshape that portfolio.

We have instituted other changes in our efforts to reform Toshiba's business structure. In considering reforms, we pay close attention to focus and foresight. Which businesses are the important ones? Which ones are not? What is really necessary for the future? We are developing service businesses in answer to this last question.

How have these changes affected Toshiba? First, we completed a merger of Toshiba Glass Company with Asahi Glass. Toshiba's origin was as a lamp manufacturer, for whom glass was a basic material. Glass had been a traditional business for us, but we finally concluded that Toshiba, as a group, could no longer grow this glass business. In January 1999, we put Toshiba Glass under Asahi Glass Company, the largest glass company in Japan, a change that made both employees and management very happy. This was a very unusual step for Japanese industry.

Another notable change occurred with Shibaura Engineering, one of Toshiba's original companies. Half of their business was in compact motors and we sold that business to Nidik, which is now a compact motor specialist. This second divestment took place in October 1998. Also last October, we established a joint venture with the United States' General Electric Company for a gas turbine packet. We met all the requirements from General Electric Company and Toshiba and made two joint ventures. One is in Japan and one is in Mexico. The large site's precision-type machinery is all built at our Japanese factory. Mass production will take place in Mexico. In taking these steps, we are able to reduce the production costs of

this turbine by approximately 30 percent, which translates to at least a 10 percent reduction of the total material cost.

The integration of our copier business into Toshiba Tech also took place in October 1998. Tech, a subsidiary company, had been in the business of fax mills and printers, in addition to the original business of POS. As digital technology develops, copy machines, printers, and fax mills have integrated into one product. Therefore, we have decided to integrate our copier business into Toshiba Tech, although this business has been profitable for us.

The next big change for Toshiba was the joint venture with Carrier Corporation of the United States. Carrier is a subsidiary of United Technologies, the world's largest air conditioner manufacturer. The air conditioner business has long been an unprofitable one for us, as it had been for many others in the industry. After analyzing all the factors needed, we concluded that in order for our air conditioner business to survive, we needed global coverage both in marketing and production. If we had global coverage, we reasoned, we would be stronger, and better able to capitalize on different seasons and climactic conditions around the world. In the case of Carrier Corporation, their technology was weak for smaller size air conditioning units. Our technology was weak for large size air conditioning units. Our strength was their weakness and vice versa—a superb opportunity for a joint venture. In Japan, the joint venture is 60 percent Toshiba and 40 percent Carrier. Outside of Japan, it is the reverse—Carrier has the majority portion and Toshiba holds the minority stake.

The last business we recently sold was that for ATMs (automatic teller machines) for banks. Almost all the electronics companies in Japan have been engaged in this business, and Toshiba has 10 percent of the market share. Although the business requires a total redesign of the product every four to five years, the percentage or penetration in market share does not change, because banks are traditional and prefer to stay with their current vendor. Oki and Fujitsu have 30 percent each and the rest of us have 10 percent. ATMs are a small market, and with only 10 percent of the share, we could not profitably compete. We abandoned this business, and sold it to Oki in January 1999.

In the business development arena, we have recently announced a joint venture with Sony Computer Entertainment for their PlayStation 2 CPU, which goes by the name of “Emotion Engine.” This is a very powerful processor, approximately three to five times more powerful than the most updated Intel Pentium. Sony Entertainment had the idea and the specifications and asked us to design and fabricate the unit. A perfect solution for a project requiring such a large capital investment.

We have formulated a similar collaboration with Fujitsu, for the development of next-generation semiconductor memories. This deal has been signed, as has, in October 1998, a small joint venture with Sinidair Electric of France for low voltage power distribution and control products. We have announced a large size motor joint venture with Mitsubishi Electric. In the total global market, we have been a very small player. In joining forces with Mitsubishi, we can be number three in the world, and compete in a larger arena.

Finally, and most recently, we received the Japanese FTC's approval for the joint venture for nuclear fuel production and marketing between General Electric Company, Hitachi, and Toshiba.

Part three of our business changes at Toshiba focuses on revamping corporate culture and enhancing management efficiency. Internally, we call it Management Innovation 2001. There are many objectives. We have an implementation plan which calls for a top-down approach, involving all the employees. Using the Six Sigma methodology, all training and current programs should be integrated. That is very important to us, as we would like to change the total

culture of the company. In setting up a profitable business structure, we stress the importance of a database and the application of information technologies. A customer-oriented, “customer first” vision must underpin the culture of our future.

Now, on to so-called productivity movements. We started “zero defect” back in 1965; “QC,” or quality control corporate activities, started back in 1967. “TP,” total productivity, started in 1985, as did logistics total productivity. “Half movement,” which I have explained previously, started in 1994. We have created a very strong base as a manufacturer, but the aforementioned activities are separately implemented case by case or production floor by production floor. Total integration had been very difficult for us to achieve. Finally, we decided to use Six Sigma, which had been developed by Motorola back in 1980s and also successfully used by General Electric Company, as Jack Welch kept telling me. Overall, what we seek to accomplish is accelerated agile management to minimize the working process. We have made many changes: through these changes, we wish to show Toshiba as an example of reform and to show the world tangible proof of our development.

In addition to all of the above, we have corporate projects. Y2K, Marketing Innovation 2001, and electronic commerce are all grouped under the umbrella. In addition, we have a corporate development center, which covers those businesses which do not fall into the individual internal companies. Among other things, this corporate development center covers software and media/broadcasting—we have many ventures going on in media content networks. We have specialty support and services and a research and development center. Corporate headquarters and corporate strategy planning divisions are a part of our new small headquarters. All these projects are related, and we have to reestablish our corporate divisions between them, which has been an everlasting effort. The organization system and structure must be addressed and changed from time to time. In particular, it is very important for us to empower human resources. It is true that the employees are overhead, but they are also assets. The knowledge they accumulate while at Toshiba is precious to us. Empowering them is therefore very important. I feel strongly that in-house education and also mobility within the company are essential for this purpose.

Toshiba continues to accelerate corporate restructuring together with long-term strategy development—it is natural. But as I have explained to you, we have a three part reform strategy. One is changing the structure of the company and also reevaluating, changing, or reshuffling, if necessary, the contents of our various businesses. In doing this, however, particular Japanese customs and culture should not be ignored. Fortunately or unfortunately, we are headquartered in Japan. We wish to change the things that need to be changed, but we must also understand the limits of what we can do. We will continue to lead in reform, with many Japanese companies following our way, and to remain a front runner company in the domestic and world markets. Thank you.

Commentary

MR. ABEGGLEN: You would see from this presentation that Mr. Nishimuro has really become the symbol, the hero, the pinup boy of industrial reform in Japan. I can hardly convey to you the amount of press attention, *Nikkei Business* and the rest, that have featured his speeches, his ideas, and as you see, his results. I’m not quite sure where to come at this, at one point that was not made explicit, but perhaps a footnote to his presentation. Please do observe that of the numbers of moves that Mr. Nishimuro has brought about in Toshiba’s portfolio, a significant number cross the traditional boundaries. You would be aware, I’m

sure, that traditionally Toshiba has been a Mitsui company. You will have noted that one of the ventures in glass is with Asahi Glass, a leading Mitsubishi company, and another venture is with their longtime traditional archenemy, Mitsubishi Electric and Heavy Motors. Another is with their rival Fujitsu. In other words, these moves are being made and those of you who aren't following Japan's businesses closely, be aware that you can make much too much of the romance of the groups. When push comes to shove, the group identities tend to diminish substantially, as they clearly have in the case of Mr. Nishimuro. I think too much is made of the romantic *keiretsu* notion in American parlance and it doesn't help the discussion.

I thought what I might try to do is put the Toshiba case in a bit of context, if I could take a few minutes on that. First of all, there has not been a prolonged slump in Japan, so let's get away from that. Over the last ten years, Japan has performed economically about the same as Germany and about the same as the United States. There is a crisis now. It is a two-year crisis dating from early 1997, badly handled and against the problems of the financial system. But one can more usefully describe this as a transition for Japan—a very difficult transition from a historically long, sustained high growth to maturity, maturity both economically and demographically. Those have compounded each other since they came simultaneously.

Let me remind you of some of the things that have happened under high growth that become inappropriate in a mature economy. For example, companies having a market share objective is appropriate in high growth, yet it becomes inappropriate in a slow growth set of industrial relations. In high growth, you have a very high use of debt because it is inexpensive capital and you need massive amounts of capital investment. In a low growth period, you're more concerned with a strong balance sheet, and you take capital investment down sharply because you're already probably in a state of overcapacity. In a high growth economy, you have many entrants. You will have noted that Japan's industries have, almost without exception, an extraordinarily large number of competitors. Growth is an umbrella for the competitor—as the growth comes down, the marginal companies go to the wall—and you have fewer companies; you have an oligopoly, in fact. In a high growth system, you want very high personal savings and probably relatively high government savings, and in a low growth economy you want very high consumption and you would probably hope the government would balance its books, more or less.

In a high growth economy, you also focus on industry—industrial investment and industrial technology. In a lower growth economy, you shift to focus on services. And I think what we're seeing in Japan and this industrial restructuring point is a very difficult transition out of a heroically high historic growth rate (making Japan a very rich country indeed) into a mature, very rich country. But it's not so much fun. It's more fun when you're a high growth, rich country than when you're a slow growth Switzerland, or whatever.

In thinking about companies, I'd like to make the point that we really need to disaggregate. One of the difficulties of focusing too much on the heroic work of Mr. Nishimuro is that you begin to think that all Japanese companies are going through the same transition. It varies with industry. Take a mature industry like the auto industry: mature technology, no growth in the world markets, simply too many competitors. The problem there is not the kind of problem that Mr. Nishimuro is wrestling with, it's simply that some people have to go to the wall. They may go bankrupt, or they may merge, or perhaps they can find a friendly foreigner who will throw a few hundred million dollars over the wall every now and then and help Mazda and Nissan in their troubles. But, it's essentially an industry that has too

many producers and that's true of quite a number. But that is different than restructuring as we're discussing it here.

There's another set of industries and Toshiba is a very positive example: Mitsubishi Electric, Hitachi (a less positive example), Sharp, a long list of trading companies that are massively overdiversified. The head of planning for Itochu told me it had 900 subsidiaries. One would have thought that ninety would be too many. Clearly impossible, clearly overdiversified, they clearly must focus. They will sell some of them off. This is the process Mr. Nishimuro is leading in Japan and making a great success with his company. He's out in the front, way out ahead of everyone else on that. That's the difference—that is the real restructuring. I think that we should be careful to disaggregate the industrial sector and not assume that all of those industries have the same success. Indeed, be mindful too that there are some very important companies in Japan, most of them not known to you. Companies like Advantest, like K-ons, like Fanic, that are rated Japan's most excellent companies; with respect, Toshiba is not. Advantest has been the last few years. These are large companies, two to three billion dollars in sales, exceedingly profitable by any standards and simply not reported on. So as you think of Japanese industry, please disaggregate. Some sectors are doing very well indeed. Some sectors, like petroleum refining, are as they should be: dying. Some company sections, like autos and consumer electronics, there are simply too many producers. Air conditioners. There are nine producers of air conditioners? Three is probably one too many; nine is absurd. They won't all survive, and they're not surviving.

This is a very different set of restructuring problems, and I offer again the view that you might do well not so much to think of Japan in this crisis term, which I find inappropriate. A recession is a recession and it's difficult, painful. It's not a massive national crisis, but a transition, and a very difficult, drawn-out transition. It's hard to teach people not to save if they and their parents have spent their lives learning how to save and being rewarded for it. And indeed, savings not for earnings on the savings, but savings for the security of the savings. That's a very long transition. Don't expect it to happen quickly. We're back to the generational point that Mr. Hayashi was making. It will be a generational change in those regards, and that's the change that seems really to be going on.

In the restructuring sector, overdiversified companies like Toshiba, like Hitachi, the great names of Japanese industry, really are restructuring and you've had a superb display and analysis of how they're restructuring. And once again, perhaps a final note, "Will companies change?," which is a little bit of the theme here. There have been a series of legal changes. We've talked several times about the holding company act, which is terribly important and indeed Mr. Nishimuro is one of the first executives in Japan to get out in front with that discussion. That won't be completed until the tax laws are changed to allow consolidation on tax reporting. But we will be marking to market on the balance sheet as of this year, which means they will have to bring all of those assets up to market value. The better companies are going to look better and the poorer companies will look a hell of a lot worse.

We have stock options now available, and we have corporate buy-backs available, stock buy-backs. All of these things are legal changes that will not have any immediate effect, but will, over time, shift attention back to the shareholder. I hold no brief, but this American nonsense that the shareholder owns the company will probably restore a balance there: employee and shareholder. These regulations are very real and will change. I think the real restructuring will take place after the holding companies are in effect, after there has been a consolidation for tax return purposes, and companies like Toshiba, and executives like Mr.

Nishimuro can sort out the strategies of the many, many businesses that their companies have got themselves into.

I don't want to make all of this too dramatic. I think it's a long process which is very well underway. The process will be very different from industry to industry and please be careful not to overgeneralize. Thank you.

MR. YOSHIHARA: As, according to Professor Daniel Okimoto, I'm the young kid on the block, since I'm under fifty years old, and as a business consultant who deals with many Japanese companies internally, I would like to share some thoughts on changes in business, especially Japanese business.

I would like to start with a quote from a speech. This is a New Year's resolution speech made on January 5, 1999. "To all employees," the speech says, "This year is a year of implementing, executing change. The company will accomplish this transformation over the next couple of years, although this type of fundamental transformation took GE ten years. We shall not be worried about the change, but we shall be worried about not changing." This quote comes from President Nishimuro at the New Year's Resolution Meeting of all employees. This kind of statement in a presentation is very unique among Japanese top executives. They tend to make very generous, vague statements to the employees, "Just feel good about it." When you go to the annual meeting in January, although I don't particularly understand what he said, Mr. Giants Nagashima's response to the interviewers was infused with so much *katakana* English [English words pronounced in Japanese script] that at the end of the media coverage, nobody knew what he said, but everybody liked it. In Mr. Nishimuro's presentation, he precisely speaks his mind. With such strong leadership, no wonder he was elected as one of the top three CEOs in Japan, together with Mr. Idei of Sony and Mr. Okuda of Toyota.

What I would like to comment on is the wonderful transformation Toshiba is undergoing and the sudden increase in stock price they are enjoying. In the last six months, the stock price doubled. This is unbelievable, although the company is losing money. I'm trying to state a fact here. This is no degradation, I'm actually commending Mr. Nishimuro's leadership to convince the stock market to justify those P/E ratios. When you compare that to other Japanese companies, this is a real change. I see two particular groups coming out of the recession. One is the company that is going through true change with substance. The other is the one that treats this change as a fashion. When you look at companies that are going through a fundamental transformation—like Toshiba, Sony, and Canon and other high performance global companies, or future high performance global companies—they have a clear vision, a blueprint. In the next several years, what kind of company are you going to be? The test you can do, if you go to the middle management, or lower management group, is to ask them, "What is your future direction? What is your vision for the company?" I have personal experience with these excellent companies. Normally, 99 percent of the time, they will come back with the same answer. Also, the leadership is very tense and they feel that they are pressed to perform and lead the organization with a specific road map for the future. The strategies are clear.

As you can tell from Mr. Nishimuro's presentation, he specifically decided where to compete and where not to compete. He specifically decided where he is going to put management resources, on which product, and where. That kind of clear resource management is not heard of among many Japanese companies. Most of the CEOs' attitude is still, "I'm going to be the CEO for the next six years or four years. I'm not going to do anything because I don't

want to be accused of making any major changes.” And of course, that’s not an acceptable mindset for the leaders of cutting edge companies. When you look at the mindset, some of the companies tell you that, for example, you should go to Honda. Although the founder is no longer with the company, entrepreneurship still exists. Canon and Sony are the same way. That kind of mentality is driving the company in the right direction, away from people thinking that they can just sit still, pretend they are busy, not challenged by anyone on what is valuable to the company’s mission or goal.

When you look at companies who are doing changes as a fashion, they consider this recession to be a temporary storm that will eventually go away. Let’s put the blanket over our heads. Let’s not do anything. Also their stance is sometimes, “Okay, let’s look at my competitors. I like the idea of standing side by side. If my competitor is doing this, I might as well do it too, because it sounds good, and also announcing, let’s say, a 2,000 employee reduction over the next three years.” The fact is, these companies hire 600 to 700 people every year. If you reduce the number of new hires, you can basically control the employee headcount by just accepting natural retirements. There is no substantial change there. Sometimes in those companies, top executives think announcing change is implementing change. They understand the concept of the management of change. Change is a continuous process and the CEO and the top executives, as well as leaders in the middle management, really need to understand that they need to drive these transformations. Unfortunately, some mediocre performance companies tend to have a naked king, who happens to be CEO, surrounded by yes-men, and they are marching along with a return equity of almost 1 percent or 2 percent, compared to the American public companies’ return equity of over 20 percent. Western European public companies have a ROE of more than 15 percent. So being young and kind of a brat, I’m allowed to say whatever I want to say, but later on, if I mention something wrong about your company, I want to apologize to you in person.

Future Directions

Talking about the future direction of Japanese companies, let’s look at the current Japanese economy overall. The Japanese government spent 10 trillion yen over the last seven years—mainly in the construction sector—and its interest rate is almost zero. The monetary policy of this fiscal stimulus package is showing unimpressive results. When you look at the budget deficit, it reaches almost 10 percent of the deficit and by the year 2000, Japanese public debts will be 140 percent of the GDP. Also, many local governments are broke.

When you look at the corporate sector, the financial sector has identified troubled loans of \$870 billion, but the way that these scandals are happening, troubled loans can be over \$1 trillion. Goldman Sachs estimated that potential unfunded pension liability for the corporations is over 80 trillion yen. These overcapacities are unbelievable. I’m sure you know that in the 1980s and early 1990s, Japanese companies invested about 18 to 20 percent of GDP money in new plants and capital equipment. Even last year, 1998, the Japanese spent 15 percent of GDP on new plant and equipment machineries. During these times, the rest of the G7 countries, on average, only invested 10 percent of GDP. No wonder we have a 40 trillion or 50 trillion yen demand and supply gap. When you look at that history of the cross shareholding situation, by the way, the bank owns 25 percent of the entire stock exchange. So as long as the bank is healthy, most of the Japanese companies tend to pour their money into the investment side and put off focusing on the profitability side. Corporate government in Japan was nonexistent as long as you showed profit and paid the interest to the banks.

However, when you look at the figures, 80 trillion yen liabilities, what's going to happen now is that Japanese public companies own about 130 trillion yen cross holding shares. This means they are not going to sell this 130 trillion yen they own. However, as soon as March in the year 2001 hits, new accounting disclosure requirements tell a company to disclose how much unfunded liability they have in their financial statements. Since they are not profitable, and don't own much cash to speak of, what is likely to happen is the companies are going to contribute these cross holding shares to fund the pension and ask the foreign fund management to manage it. You basically ask for a better performance and you will get very close to true capitalist government. Suddenly, your shareholders are going to make noise. Eventually, you have to transform yourself to respond to that kind of governance. As Mr. Nishimuro mentioned, GE has been successful, but just like Toshiba they have been challenging their own business model every year. GE decided last year that a global economy is a deflationary economy, so they need to focus on the service instead of the hardware. So GE calls themselves nowadays a global service company with products, growing internationally.

This trend is the same with the automotive industry. The Ford CEO says, "we are a global consumer company with automotive products, but a consumer company." What they mean is that whenever they deal with consumers, they have a definite interest in getting into those businesses. Dell Computer, which maintains an unbelievable P/E ratio, over 70, believe that they are the solution providers. They don't call themselves PC companies. So, based upon a different business model and environments, you really need to reinvent yourself and some of the Japanese companies are obviously successful. Toshiba's presentation clearly states that they are revisiting all the corporate visions based upon different environments. Sony and Canon are doing exactly the same thing. Going back to the very basic questions, "Why are your customers buying your products?"

A more important question is, "Why aren't your non-customers buying your products?" Because you believe you own a 40 percent market share, the reality is 60 percent of the people don't like your products. You have to take a look at the whole situation in a very different way. GE, for example, started a very interesting thing. Their famous philosophy is, "We are not going to compete unless we are number one or number two." Nowadays, what they do is redefine industry segments so that GE's market share won't be more than 10 percent. This means that GE's market share could be 9 percent. It used to be a smaller, narrower industry segment. Their market share could be 40 or 50 percent, but they wanted to redefine their company by redefining the industry segments. They said their market share is 9 percent, so they had to come up with a strategy to be the number one leading global company.

In summary, there is no way the Japanese economy will recover this year. I would say the Japanese economy will remain in an unpleasant situation the next three or five years. But that won't be an excuse for the Japanese companies not to perform well, because most Japanese companies should be paying attention to economic boundaries instead of political boundaries. Boundaries are set only by the competition. You shouldn't be focusing your energy on the political boundary, depressing industry in Japan. Japan needs a very good leadership development program to put a leader in every single level of the company. As long as they pay attention to the leadership development side, they will reap the rewards of the great intangible assets in Japanese companies: very loyal employees, high education, and a great work ethic—workers who love the company. They are waiting for the new leaders to strongly show the new direction. When you look at these intangible assets, patents, manufacturing processes, and knowledge, under this pension-liability driven new corporate governance,

more focus is on the profitability. When the Japanese companies transform themselves in a global market, they are going to be formidable competitors in the marketplace with a great attitude—but a different attitude.

Questions

- Yves Tiberghien, a Stanford Ph.D. student in political science: First, how will labor and Japanese society respond to an end of the lifetime employment system? Second, with the interests of major corporations and the political system diverging in Japan, will Mr. Nishimuro continue to support the LDP or will he be pushing for change in the political system?

MR. NISHIMURO: Well, we are advocating that lifetime employment has been a great tradition of Japanese industry, but we have to change the name “lifetime employment” to “stable employment.” If lifetime employment means automatic pay raises every year and equal rank for all employees irrespective of when they join the company, then we have to change it. The reason we say stable employment is that we also value the employee as an asset of the company. Lifetime employment, both in name and in practice, is changing.

The second question is whether the major companies of Japan will still support the LDP. Yes, we will. This is not because Mr. Shiozaki is here. We have to support the Japanese political system to be more effective because young energetic statesmen like Mr. Shoizaki are appearing in the LDP. We see the future in the LDP better than the other political parties. That is the basic reason.

MR. ABEGGLEN: I’m going to use a panelist’s prerogative and jump in on your first question. I have the sin of authorship on the term, “lifetime employment,” which was first used in a book of mine in the mid-1950s and which came into the Japanese language as *shushin toyosei* in its translation by Professor Arabe of Kobe. To put it slightly differently than has just been done by Mr. Nishimuro, usually the employment system was described as having three pillars, one of these Japanese cliché things. One was the so-called enterprise union, with all the employees being members of the same union. The other was seniority, and in *kojouretsu* of the seniority pay and promotion system, and the third was what probably should be called a social contract, being a little less than lifetime employment. I was only thirty when I wrote the book and I was a little naive.

Remember as you look at the numbers on attrition rates in these companies: if a company is growing slowly for some sustained period, its labor force is aging because it’s not hiring. That is, you’re not hiring laterally at all. So the steel industry of Japan, which is in the process of some excess capacity reductions, loses half of its employees in the next ten years through retirement. You go from sixty to thirty thousand. That’s not untypical. Several of the heavy electrical industry companies like MHI have the same, so people tend to be careless in their understanding of the term. The term has more dynamism in it, both positive and negative for a company, than is implied when you simply say lifetime employment. The seniority system, as was suggested by Mr. Nishimuro, is being abandoned. And clearly, if you have the demography of Japan, you do abandon it. Indeed you will wind up paying more for the younger people than you will for the older people, I suppose, because the marketplace will drive it. There are too many older people and not enough younger, and you need the younger people, and you’ll pay more to get them. Every society has age rating, but it’s largely being diminished in its importance.

MR. YOSHIHARA: Can I touch on the issue of lifetime employment? People are assets and employees are assets. I agree with both of the comments made, but when you look at the substantial issue in this lifetime employment, it's obvious how you develop your human resources in a company. When you look at most of the companies, I don't know anything about Toshiba, there are many employees literally sitting there very few productive activities. All of us want to be contributing members of the company, and the Japanese are no exception. So unfairness in the equal treatment exists in Japan. However, when you look at the development programs most Japanese companies have, they need a lot of improvement. If you stay at Motorola University, or HP, or GE for ten years, and if you climb up the ladder accordingly, your market value is very high. You get 40 or 50 percent more than you would be paid in the same company. But I couldn't say the same thing in Japan. If you stay in one of the steel companies for ten years, you can make exactly the same money, but it's more uncertain because Japanese companies tend to focus on educational systems. The educational systems need to develop a personal value. Personal value happens to be a great cornerstone for companies' success. Japanese companies need to acknowledge that and pay their employees accordingly.

- Question from Mike Mile, Graham and James: What is the time frame for the changes that have been talked about, particularly in the business sector? Will they really result in significant change in the short term, or should the kind of change that is looked at in Japan be generational change?

MR. NISHIMURO: Well, I really cannot speak for the total industry, but in our case, we are saying that unless we can show the results, our plan for change and reformation does not mean anything. We believe that our result will be visible by the year 2001. That leaves a year to complete some level of the reforms. Toshiba's Management Innovation 2001 specifically calls for 2001 as the year. And by that time, our total corporation will be in very different shape. That is our belief and I think we can do it.

- Question from Mu Yang, Ph.D. candidate, economics, Stanford University: Please elaborate on the empowerment of human resources, as well as the status of small businesses in Japan and their prospect for development.

MR. NISHIMURO: In case I didn't touch upon what we are doing internally at Toshiba, I'll start with that. Last year, in November, we completed our training center, the Toshiba Educational Institute. It houses approximately 3,000 people at one time, a very large facility. The real purpose is to give our employees a chance for continuous education, and also for managers as they go up the ladder, who attend the courses that we provide for them. Through this and also through mobility inside the company, we will be able to nurture a group of people who can manage those individual businesses. And ultimately, what we are dreaming of is that we could be one of the sources for the future management of Japanese industrial companies.

Talking about small businesses in comparison with Taiwan or Silicon Valley, Japan lacks that type of vigorous activity. There are smaller companies in Japan which are growing, and Mr. Abegglen has cited some of the names. There are companies coming up, especially in the areas of media and software. We are still hopeful that Japan is changing and that even the small enterprises will grow and develop.

MR. ABEGGLEN: May I say, I think we're not well served. We, as you're reading only English, are not well served by the reporting on Japan in these respects and there is far more

small company activity in the software sector, than I, even reading Japanese press, had any occasion to know until I became associated with a company that's trying to do M&A in that field and is making the list. There are lots. Somehow it does not get reported, or it's underreported.

- Question: How might the new corporate strategy of the top-down approach collide with the so-called classic bottom-up approach, considering that current staff were schooled over time with the bottom-up approach? Might bringing some people from the outside be required?

MR. NISHIMURO: Our current strategy is certainly different from our traditional bottom-up approach. But we decided that it is necessary for the change. If we wait for the bottom-up system to instigate change, it might take a tremendous amount of time. That is the reason why we clearly say that a top-down approach is necessary. The most important thing for the top executive of a company to do is to make a statement repeatedly until everybody's bored hearing it, so I'm telling everybody. To do something quickly, top-down is essential. Agility is very important for change and also for the future growth of the company.

- Question: Robert Crow, Visiting Scholar, Asia/Pacific Research Center, asked about the parts of the Japanese economy that are not internationally competitive. What reforms, if any, are going on in industries like construction, and what trends in these industries have been sheltered from international competition?

MR. NISHIMURO: Toshiba has a very peculiar answer to your question. As I described, Toshiba's need for change springs from having so many diversified businesses within the company. Some of the businesses are very competitive globally, but some of the businesses have been confined to Japan and have been good as a Japanese industry only, such as power generation businesses. Even for those protected industries, we are feeling that the opening up of the Japanese economy forced us to make changes. That is the reason for our transformation. It is not because our international businesses are not competitive. It is because of our traditional Japanese protective industry. Even the construction industry has felt the pressure, and the distribution is also changing.

MR. ABEGGLEN: I quite agree. The construction industry is going through something not unlike what is happening in life insurance and in some parts of banking. They are having to put the bad debts up, declare them, write them off. Companies like Sato Kogyo, which were once riding high, are as near on bankruptcy as makes no damn difference. Some are being bailed out by the banks as write-offs and debt, and some aren't, and some are disappearing. I'd say that that's not unlike the other deregulating sectors. Distribution, you mentioned—I'm surprised. Distribution has been going through massive changes in the wholesaling sector. Somehow that gets overlooked. In pharmaceuticals, for example, which you may know is littered with bodies, the numbers of wholesalers has dropped by more than half in the last decade and there just was a massive merger of three of the largest. And that's true across wholesaling, I would say.

MR. NISHIMURO: Yes, probably that's physical distribution in a sector which is very protected.

MR. ABEGGLEN: Trucking. Very expensive. And that will get blown open, I have no doubt. Deregulation is sweeping. Mr. Hayashi talked about the freeing up of refined petroleum products—we now have Mitsubishi Oil and Nippon Oil merging. It's a very inefficient indus-

try. Refineries are being closed. But 60,000 gasoline stations exist and we need only about 30,000, at the outside. Consequently, they are disappearing.

This is rather more dramatic, I'd say, than you may have had an opportunity to appreciate. You heard about the price in gasoline dropping by a third, almost like that. Obviously it doesn't make headlines and so it doesn't get reported. I mean good news isn't news, it's the bad news that's news.

MR. YOSHIHARA: The construction industry actually has the support of the government. They just want to leave it alone for a while, because it has so many problems. Some of the bigger companies went bankrupt, and the government is now thinking about introducing a debt stock swap so they don't have to declare bankruptcy; the banks can't write off any more. This construction sector has a significant impact on the health of the financial sector as well, so the Ministry of Finance and the government are trying to manage the process to avoid chaos. The energy area is also rapidly transforming; as you know, Niseki and Mitsubishi merged. I mean, this was unheard of five years ago. So the transition is there. Distribution, if you are looking at the form of *tonyasei*, which is manufacturing distributors—those guys are getting restructured just to have a better supply chain management. It's getting there.

- Questions from Gordon Turnbull, a student at the Wharton School: Will tools used in the West, such as incentive compensation, be used increasingly to make change happen at the government, institution, and corporate levels? Also, will we see an increasing number of women in significant positions of leadership in Japanese corporations?

MR. NISHIMURO: Well, to have results, we have to have some incentives, although in our case, we have not implemented any stock option offerings to anybody in the company. I'm rather against this stock option scheme. I'll get into the details a little bit. On the one hand, if we are heavily compensated by the stock price, our way of management could possibly be different. We would prefer to stick to stakeholder value. That is important for the benefit of the employees, the customers, and the society. On the other hand, we have to compensate for the employees, provide a fee to encourage their activities and our bonus system has been changed dramatically. Now the bonus is in accordance to the performance of individuals and also the performance of the sectors they are in. So that is the way we are compensating.

As far as the equal opportunity side, that is developing, although it is slow. There is abundant evidence that we now have women as managers, although not at the executive level. Even so, that is increasing.

MR. ABEGGLEN: We are all pleased to see that a lady got elected mayor in a Japanese city the other day, which I think was the first woman mayor. There were also a number of candidates for various local offices. In a system that has been quite stable and largely age-oriented, by definition the period of time between women embarking on careers and becoming visible in senior ranks is a longish one, as witnessed in the Japanese Civil Service. The Civil Service examination is of course sex-blind, and over the last few years, women have held very important posts in the Labor Ministry, Justice Ministry, etc. This is a very complicated topic for me because of my wife's friends. My wife is Japanese, and many of her friends are quite important executives in nonmanufacturing sectors, service sector companies. They have founded companies and have done very well. I'm very much impressed by the fact that you have women in Japanese society with careers who will do about as well as they want to do. If you're familiar with public opinion polls of women, there still is a very strong tendency for the woman to believe that her first obligation is rearing children. So she drops out of the

labor force and then goes back in. This is in very sharp contrast to, say, Swedish opinion polls. There's a complex interaction between what is undoubtedly a disadvantage in the structure and the motivation of the individuals.

On the issue of compensation, the Japanese company remains a village in which people are rather more equal than in your villages. I see no logic in history as to why the company is perceived to belong to shareholders. Is capital that much more valuable than labor? I don't take that view, so there's an Anglo-American view that all the company, and all of its rights and properties, are the property of the shareholder. That strikes me as inappropriate and I would say, unless Japanese society changes profoundly, if Japanese companies were to adopt the Anglo-American style of organization and compensation, they would almost certainly destroy themselves.

MR. YOSHIHARA: Improving corporate behavior or employee behavior to obtain vision, I think issues should be aligned among goals, vision, the reward system, and the measurement systems. So instead of seniority-based systems, many of the leading companies, best-practice companies like Toshiba, are trying to change to implement performance-based compensation systems. These alignments are very important because some of the companies have the vision to be growth companies and to invest in the future. However, their measurement system is based upon how many costs you cut, and employees in the company get completely confused. So many companies are trying to align those elements. In terms of stockholder value, as Nishimuro-san mentioned, many measurement indexes are getting introduced like EVA [economic value added] and free cash flow concept. We have had retirement equity in Japan for the last ten years. It is getting there; however, it depends on the company—some adjust very slowly and others very aggressively.

Equal opportunities. Let me just put it this way. I think the speed of the female professional career-focused mindset is transforming faster than society. It means that although the society is trying to accommodate those female professionals, the government is making progress. I think that's a fair statement.

Session IV: Afternoon Panel Discussion

MODERATOR: Henry Rowen, Director, Asia/Pacific Research Center

PANELIST: Tadao Kagono, Dean of the Graduate School of Business, Kobe University

PANELIST: Dan Sneider, National/Foreign Editor, *San Jose Mercury News*

PANELIST: Katsuhiko Nakagawa, Executive Advisor, The Tokyo Marine and Fire Insurance Co., and Former Vice Minister of MITI

PANELIST: Hugh Patrick, Professor of International Business, Columbia University

PROF. ROWEN: I'm going to moderate this panel, not going to make a presentation. We have four distinguished presenters. I'd like to begin at this end with Dr. Tadao Kagono, Professor of Business Policy and Dean of the Graduate School of Business of Kobe University. He was educated at Kobe and at the Harvard Business School. His principal areas of research are cross-cultural comparisons of management, strategy formulation, and implementation. And I was told in particular about a book of his which is attracting a lot of attention. The book, in English, is *Strategic versus Evolutionary Management*. And another book of his is *How Japanese Companies Work*. So we're very pleased to have Dr. Kagono here.

Next to me is Dan Sneider, who has been the National Foreign Editor of the *San Jose Mercury News* since last November. For quite a few years, he was the foreign correspondent and national correspondent of the *Christian Science Monitor*. He served in Japan, he served in Moscow, and he's done domestic coverage. He was in Tokyo from 1985 to 1990; he was a Tokyo correspondent for the *Monitor* covering Japan, Korea, and East Asia on economic issues. Earlier, he was based in New Delhi, covering South and Southeast Asia. I should say that he has a degree from Columbia University and, like a substantial plurality of the people who have appeared on this panel, also from the Kennedy School of Government.

Here is Mr. Nakagawa, who's a visiting scholar at A/PARC. He's a former vice minister of MITI, the organization that's gotten a lot of attention today, properly so. He's a graduate of Tokyo University. He went to Harvard, guess which school? And he worked in New York for some time. I'm very pleased to have Mr. Nakagawa here. And on the far left is Hugh Patrick, whom you've met before. The order of presentation will be the order of introduction.

PROF. KAGONO: It's my pleasure to be invited here to talk about the transformation of Japanese corporations. I thought I was invited because I happened to be here on my way back to Japan, but after attending this conference I found that I have an important role because I am one of the few people quite critical of the present reform in Japan. So today, I'd like to talk about one issue that Japanese companies are facing.

From a business point of view, the most difficult issue for Japanese as well as European and American corporations is the difference or divergence of critical resources for business. One is human resources, the other is financial resources. On the one hand, money is traded by computer or telecommunications. The speed or mobility of money is quite high. For instance, theoretically, money moves around the earth 7.5 times in a second. According to recent research by Mitsubishi Research Institute, money moved across borders just for investment is 55 times larger than the money moved across borders for the transaction of goods and services. That creates a volatile environment for the business community. On the

other hand, the human resources are quite slow to change or to move. Because people are embedded in cultural and social networks, it's quite difficult to change them because—as Professor Aoki said—institutional complementarity prohibits people from changing quickly. For instance, to move across borders and work effectively in a different culture setting, you need at least two or three years. But business organizations need both resources, human and financial, and due to the very large differences in the speed of change of the mobility, many managers face the serious choice of which direction to follow.

There are two basic alternatives for business managers. One is to follow the money. In order to follow the money, you have to make your human resources more mobile, like the American labor market. The other way is to follow the people's speed. In that case, capital and money will escape from your company. Recently, Moody's downgraded Toyota, because Toyota sticks to lifetime employment. This is a typical mobile escape of capital from companies. So Japanese companies face the dilemma of which direction to take. Of course, according to today's presentation by the president of Toshiba, Toshiba is somewhat following the way the money is going and sticking to the traditional Japanese way of management to a certain extent. A majority of American companies follow the way money is going. Even in Japan, a lot of people talk about the global standards. Those people most interested in global standards are mostly from the financial sectors and other graded sectors in which resources are quite mobile. I think this dilemma of the difference of speed of change, of speed of movement, is exemplified in governance of Japanese corporations. I think there are at least two alternative views in Japan.

The first, strongest view is that Japanese companies must be governed by stockholders like American corporations. The other view, which only a few, including me, propose, is that Japanese companies should be governed in a different way so that they keep or build their strength on the global market. At the core of the governance issue is the allocation of financial resources and various kinds of securities and deposits. So on this chart, I wrote the distribution of ownership of equity in Japanese companies. You shouldn't trust this figure too much. I just show it to give you a sense of the issues facing Japanese companies. In the upper half, the stockholdings by owner categories are shown. By the fiscal year of 1997, that is May 31, 1998, the total market capitalization to market value of Japanese stock market is 308 trillion yen. Of this 308 trillion yen, 130 trillion yen stock is owned by financial institutions. But in some respects, this is too much because this amount is four or five times larger than the equity of banks. That means banks buy stock by borrowing money from consumers, so traditionally banks have enough capability to absorb risks, but recently due to the decline of the power of banks, they cannot cover this by themselves. If you compare the 1997 and 1998 figures, you realize that the amount of stock held by banks was reduced in a year. At the same time, individuals have 59 trillion of Japanese stock, so this is relatively small compared to the others. In this, only two sectors increased holding of Japanese equities. One sector is foreign investors. Foreign investors played a very important role last year. The other sector is trust banks increasing their stock ownership. So, to what extent do equities have various categories of owners?

The bottom half of this chart shows the choice of individual households, which kind of financial assets they are choosing. In Japan among security stock, Japanese consumer households just sell at 60 trillion yen. Most of their financial assets are in cash and deposits to the banks, so there is discrepancy between the choice by household and the needs of the financial markets. Traditionally, banks played an important role as risk absorber because households didn't want to take risks, but company sectors need some capital that takes risks. The critical

issue for Japanese companies is how to close this gap. Because, as I said and also Professor Aoki said in the first section of this conference, Japanese banks are losing the power to absorb this gap between investor needs and company needs and investor choice.

There are five alternatives to close this gap. One is to let it be done by the market without intervention. In that case, I guess the foreign investor plays a more important role in the Japanese securities market. Recently, most stock prices are influenced by the movement of foreign investors in business in the Japanese securities market. This instability creates problems for Japanese companies' governance because it has been characterized by stability which brought forth the distinctive strengths of Japanese companies, including keeping good relationships with employees. Also, the employees thought their companies were their own and Japanese executives had a longer-term perspective than American executives.

The second alternative is to write off stocks, excess stocks, because the cross holding stocks are thought of as excess stock in the Japanese securities market. So one alternative is to write off, but this creates further instability of ownership of the corporation. I think this alternative is not a promising one. In the last year, *Keidanren* thought this idea was the most promising, but it recently declined to pursue it.

The third alternative is to use the money of the pension funds to buy these cross holding stocks. Mr. Yoshihara said, "In the near future, Japanese companies will face the serious problem of losses due to future pension payments." Some loss might be paid by this kind of pension fund money. I think this is a promising alternative, but too weak to convince the executives of Japanese companies.

The fourth alternative is to use holding companies to shift stock from financial sectors to nonfinancial sectors. Using the leverage of holding companies, you can absorb the excess resources from financial institutions to nonfinancial institutions.

The fifth alternative, which is what I propose, is to organize an employee holding company and let them hold the shares, excess shares. In these cross holding corporations employees can diversify their stock holdings. It's another kind of pension plan but some employees can represent the holding of these stocks. I think the distinctive Japanese governance system for corporations is based upon this reorganization of the Japanese stockholding. Because of this distinctive system, I hope it can establish a distinctive strength of Japanese corporations. Otherwise, it's quite difficult for a Japanese company to compete on the global market based upon the Anglo-American system of corporate governance. In my study of strategy, it's hard for corporations to build upon their strengths or build upon competitive advantage. Usually, in order to build upon strength, you should improve your strength rather than improve your weaknesses. This is a typical formula for succeeding in the business community.

MR. SNEIDER: This has been for me a really terrific conference and very stimulating. It's a challenge to try and follow all these people, particularly as a journalist without the kind of expertise that I've seen displayed here. But let me try and fulfill the expectations in one sense of a journalist by being both a little bit provocative and skimming across the surface of a broad range of issues.

I want to start by reflecting on my experience, which is that I was a correspondent in Tokyo from 1985 to 1990. In fact, I arrived just at the moment that the Plaza Accord took place and I left in early 1990, a few months before the collapse of the bubble. My experience of Japan was the Japan as the emergent superpower, and that was the huge debate that was going on in the media and elsewhere. Was Japan going to take over the world? A lot of very flamboyant imagery was thrown around at that time—not by me, of course. In my discus-

sions with Japanese, though, I saw that they themselves were thinking in those terms. To some degree they were reflecting the imagery of Japan from the outside in their own self-perception.

I then had the interesting experience of going from Japan to the Soviet Union. I spent the next four years in Moscow, watching the collapse of the other superpower, and watching people go through a truly wrenching experience of having their own self-image, if you will, as a superpower, be dramatically shattered by the rapid collapse of the Soviet Union.

And the end of this story is the following. A couple of years later, after I had left Moscow and I had come here, I went back to Japan—for the first time, actually. I not only saw the evidence of the recession and the slowdown in economic activity from the sort of boom years I had seen; more importantly I found the most striking thing was in conversations with Japanese friends. I found an incredible crisis of confidence, not unlike the kind of crisis of confidence that I saw in the Soviet Union. I don't mean to compare the two countries, or the two experiences, but the psychology of the moment was in some sense quite similar. After having been convinced that they held the secret to success and to superpowerdom, they were now confronted with the idea that everything that they thought that had worked so well didn't work at all. People were simply at a loss as to what to do. I found more than anything else just a lack of sense of direction and confidence. I think in the last couple of years we've seen a little bit of a movement out of that, but still I think there was a profound change that had taken place. I say this in order to introduce what I'm going to say, which is that I think that it would be wrong to underestimate the degree of crisis in Japan. I have to use that word despite Jim Abegglen's cautions. It's the only word that seems to me to describe the situation, both in psychological and political terms, but also, obviously, in economic terms.

Let's remind ourselves that Japan is experiencing its third year in a row of negative growth, and I think we're probably headed to at least a fourth year of negative growth. There's no other major industrial country that has gone through such a deep recession since the Great Depression. I think that's just a fact that has to be kept in mind.

Now there are, I'm told by friends, a variety of theories and characterizations of theories to explain this. There is the anxiety theory, as one of my friends calls it, that this is all the result of a lack of consumer confidence and once consumers have overcome their anxiety everything will be okay. That theory, I'm told, was quite popular in Tokyo, probably until somewhat recently. The second is the macroeconomic view, which is that this is a question of macroeconomic stimulus, that we're experiencing a classic business-cycle recession, perhaps one deeper than normal, but that a proper amount of stimulus applied competently will again take care of the problem. The third is the sort of structuralist view of which I think we've heard quite a bit today, which is that even with macroeconomic stimulation you cannot get change without fundamental structural reform, including of the economy, and that includes dealing with the issue of power structures, which to some degree perpetuate the resistance to reform.

I would like to go beyond that, in my pessimistic journalist role, and say that in fact I don't think we're just looking at one crisis. I think we're looking at three crises, all of which are interrelated. The first is the exhaustion of the Japanese model as some have said. I didn't disagree with the way Jim Abegglen put it—that there is a transition from a high growth economy to a slow growth economy. But I do believe there are questions of the system involved as well as just transition of growth rates.

The second is the end to the postwar system of political power. While I agree that the LDP has been able—remarkably, as someone pointed out—to maintain an incredible degree of

political power, I do think that the kind of unchallenged monopoly it enjoyed is gone forever. We have entered into a period of political instability of which we have not by any means seen the end.

The third crisis, which has not been talked about much, is the strategic crisis that Japan is in that was triggered by the end of the Cold War. Even before the collapse of the Soviet Union (and I saw this as a reporter in Japan in the 1980s), the American relationship to Japan was to focus on security issues and to allow Japan to function under that security umbrella pretty much as it wished as an economic power. That had already begun to end by the late 1970s, but certainly in the 1980s we had seen the shift of American policy towards an emphasis on economic security rather than just on military security. That shift, in turn, changed the way Japan perceived itself, not only its alliance relationships but how it could look upon the world. What were the bases of its own security? In recent years, we've added to that in recent years the emergence of new security challenges, such as the role of China as a regional power, and issues like North Korea.

All these crises, I think, were building from the 1970s, when the oil and Nixon shocks hit. But we can probably date the triggering moment of the last period (I don't just say this because that's when I arrived in Japan) to the Plaza Accord, which did set in motion the remarkable asset bubble in the stock and real estate markets through the end of the 1980s. It hit in 1989-1990, and three things converged there. One, the upper house election of 1989, which was the first in which the LDP's monopoly on political power was going to be lost; two, the fall of the Berlin Wall; and three, the beginning of the collapse of the Soviet Empire, followed by the collapse of the bubble in 1990. Although it's hard sometimes to see these things as linked, I think that together, they created a tremendous crisis of confidence in Japan. We've seen a succession of attempts, very faltering attempts, to deal with this deepening crisis. To a large degree, there has been an attempt to ignore it (until recently), or at least an attempt to adopt measures which didn't involve really major restructuring, both in terms of the Japanese economy and Japanese decision-making. The hope was that somehow this was a business-cycle problem that would correct itself.

When you add to this scenario the collapse of the 1993 political events, you realize that the Japanese have had to deal with a crisis in their economic system just as they are facing tremendous uncertainty about the future global environment in which they will be acting. And I think that tends to make it even more difficult to engage in the kind of long-term planning necessary to confront this crisis head on.

Under these circumstances, it's not surprising to me that the movement towards change has been one of fits and starts. In some respects I think the scale of this crisis, and this was referred to earlier, represents in a large sense the kind of momentous change that we've seen in Japan only two or three times previously in its history. What people refer to, of course, are the Meiji Restoration, the end to the Occupation, and World War II, but you can also refer to earlier moments in Japan. In those periods of change (and this is not unique to Japan), the old order to some degree must exhaust itself thoroughly before forces of change can fully assert themselves. I'm not pessimistic about the process of change, but I think to be realistic one must look at this as a very extended process. People talk about five or ten years.

There are some underlying forces of change that are going to force the process no matter what the resistance is, whether in the existing political system, the bureaucracy, or elsewhere. I would say that there are four forces: the global, which is obvious, the generational, the demographic, and the technological. Although the global is somewhat obvious I think it does bear stating. My experience in Japan goes back to the 1950s when I went there as a child,

and I think one of the biggest changes that has taken place is the experience of Japanese living and working abroad. This is unprecedented in Japanese history; and we are only beginning to see its impact on Japanese behavior, in corporate governance and in politics. Part of that is because of generational change. People usually talk of globalization in more abstract terms, but I think in personal terms it has an extremely large impact on the way change takes place in Japan.

The other aspect of this, and I think it is undeniable, is the growing foreign presence in Japan. Of course we've seen the presence of foreigners *per se*, which has changed dramatically within Japan. But I'm also referring to the phenomena such as financial deregulation. I do believe that ultimately foreign direct investment and foreign capital, and the involvement of foreign capital firms in the Japanese market, are probably the most powerful catalytic factors for changing the economic system. We've hardly begun to see the impact of this. It's already been stated in the discussion of the stock market, and the discussion of issues having to do with the pension fund, even down to the behavior of Japanese consumers in depositing their money. The fact that the financial deregulations are already having tremendous impact on the way the Japanese capital markets work, and I suspect that will ripple out through the entire economy in ways that we haven't really truly understood. It's driving the privatization of the postal savings system, which is one of the most important political issues, I think, in Japan today and one which, of course, the LDP would like to avoid at all costs, but one with which they're going to be compelled to deal.

The generational change to me is equally powerful. The passing of the wartime generation from power is now taking place. Again, it has very large cultural, political, and economic implications. The U.S.–Japan relationship is already being transformed, I believe, by this change. Let me add a personal note. My father was a longtime American diplomat who worked in Japan. He comes from that generation of people who were involved, who fought in the war, were involved in the occupation of Japan, and there's a whole generation of people in the American government, and around the American government, who largely made American policy towards Japan who came out of that group. They have their counterparts in Japan whether they're in the *Gaimusho*—the Foreign Ministry—or elsewhere. That generation is, for the most part, out of power in real policy-making terms. And I have now seen a younger generation of people on both sides who do not operate from the framework of the war. The war is not their frame of reference—they're looking at it in very different terms. And I don't know, I think there are probably good and bad sides to that. But leaving aside the evaluation, it nonetheless has a very transforming effect. I think that in the new generation coming to power in Japan, we see this dramatically displayed. I was really struck by the presentations we've had; the speakers have a level of international exposure and experience, again, that was not true of the previous generation. Their children are even more globalized than they are, less wedded to traditional institutions, and we talked about institutional change. I think we have to understand that's the kind of cultural dynamic that underlies such changes.

Then there is the demographic crisis. I wanted to speak about two aspects of that which I think are not generally spoken about very often. One is that although we are now seeing unemployment, I believe eventually we are going to see a serious labor shortage. That labor shortage has two interesting effects which we've already seen. One is the entry of foreign workers, particularly from Asia into Japan. I saw that a lot in the late 1980s. It's slowed down somewhat but that has a tremendous effect on Japanese society. Again, it's not one that you see very visibly but it worked its way into the core of Japanese society, changed the way

Japanese see themselves, changed the way Japan relates to the rest of Asia, and it's going to be a very powerful force for change. The other, which has already been mentioned, is the entry of women into the management of governmental and economic institutions. While I know Americans are often frustrated by what they see as the lack of progress of women in Japan, I think you have to see things in relative terms and I believe there's a tremendous change underway again. We're only beginning to see the beginning of that.

Lastly, and I have to say this because I'm in Silicon Valley: technology. I find very interesting the comments that were made about small Japanese firms developing software. People you speak to in Silicon Valley will tell you that ten years ago, when Japan was the superpower; they were terrified of Japan. They were terrified of what Japan represented technologically as an economic competitor. Now their disdain for Japan is so manifest that they can't even conceal it when they want to. They simply do not see Japan as a competitor anymore. And the main reason is Silicon Valley itself. This place used to be driven by the semiconductor industry. It's not anymore. It's driven by software. It's driven by the interaction between software and hardware. An entire transformation's taken place. The whole approach to the way that technology drives economics: the Japanese don't even begin to get it, in the view of people in Silicon Valley. They are still basically hardware manufacturers. The profit margins for hardware are dropping all the time. Money is being made mainly on the software side and I think this is going to be a tremendous challenge for Japan. I think Japan has got to go in this direction because that's what going to drive the global economy. But again, I think this is a powerful force for change. It all needs to be done to be understood.

PROF. PATRICK: You opened up a large can of worms there at the end in Silicon Valley, which I suspect we should not follow up on. I just want to make one comment. This word "crisis" troubles me too. Just on the facts of the economy, Jim Abegglen was right. A related fact is if you take 1992 to the present, productivity growth in the United States has averaged about two percent a year per person, per worker. And in Japan it's averaged about one percent over that period of time. That's not so different. It's true in the last three years it's been underwater. It's been underwater a couple of percent a year which is bad, it's very bad. But don't compare that with what's happened in the case of the former Soviet Union—it's down by one-half. Or the United States during the Great Depression—it was twenty percent. In Indonesia today, it's probably twenty percent. In Brazil this year it's going to be five percent, in Korea five. But it's certainly nothing like what a real economic crisis is. I mean by comparison with expectations, earlier expectations, I'm sure you're right. But in any case those are the issues.

MR. NAKAGAWA: Well, I'm a retired bureaucrat, not so young as Mr. Hayashi is. I've been a reformist in MITI for many years, but since many people here have talked about MITI's role and its changes in bureaucracies and other areas, I won't go into that discussion. All the speakers stressed the need to change and real change is actually happening. Will institutional change be successful? How many years would it take to complete these reforms? Are there many vested interests against changes? Aren't bureaucrats opposed to deregulation? Isn't there a lack of political leadership? Having stayed in the United States for a while and seen the buoyant Silicon Valley economy and at the same time seen real, prolonged, serious Japanese economic recession, I sometimes feel inclined to be pessimistic about the Japanese future. I know that there is serious doubt about Japan's ability to change because the speed of the reform always looks very slow and gradual. Western journalists are always saying that the need to change has been talked about, but that real change has not become visible.

Today, I would like to point out a sort of optimism about the Japanese future. As Mr. Sneider pointed out, every time Japan faced a real crisis, it finally succeeded adapting itself to the changing environment. Think about the Meiji Restoration after the *kurofune** came to Japan, the high economic growth from the devastated economic conditions after World War II, and the remarkable energy conservation after the oil crisis in 1973. I think Japan has what I would call a strong crisis springboard. Each time we face a real crisis, I think the remarkable adaptability appears. I would like to rely on this flexibility of the Japanese society at this point in time.

Among all three areas we talked about, changes in politics, bureaucracies, and businesses, I think changes in politics will come last. The market forces will easily bring about changes in bureaucracy and businesses. I would like to offer some comments on these issues.

First, about changes in businesses. Japan really has two economies. One is the manufacturing industries that have been exposed to fierce international competition, helped by MITI's deregulatory efforts. As a result, some of them now are world class MNCs, multinational corporations, like Toshiba, Sony, Toyota, and so on. The other is the inefficient nonmanufacturing industries such as construction, banking or financial institutions, insurance, transportation, and farming. These industries have been heavily guided by the government for many years and unfortunately they have not been exposed to international competition, because of tight regulations, and the nature of the industries.

Ironically, because of the failure of financial institutions and the Ministry of Finance to solve the battle on issues, the introduction of the free market economy has been really inevitable and it's continuing. By deregulation, what we call the Big Bang, activities of financial institutions have started to be relaxed and will be drastically relaxed at least by the end of 2001. Global standards in accounting and disclosure of financial information have also been introduced and will be introduced more drastically at least by the end of 2001.

Market forces are now working in Japanese business activities and of course the financial sector is the core of the economic activities. The changes in the financial sector will inevitably bring changes in other industries. For example, because of the almost collapsed so-called main bank system, instead of borrowing, most of the companies must rely on equity markets to raise their funding. In order to get investor confidence in the equity market, they have to make profits and keep stock prices high. To reduce costs and make business more efficient, many companies must restructure their businesses. Company management inevitably, as Mr. Nishimuro already suggested, must restructure their businesses. For that purpose, companies must be in some sense forced to engage in reducing work forces—a kind of layoff system that we've seen in the States. In other words, most companies will have to value stockholders above stakeholders. Whether they like it or not, I think this system will be introduced in Japanese business activities, and that it will change the activities of the Japanese economy, especially in the nonmanufacturing sector.

In the increasingly globalized economy, any company that wants to survive in the fierce international competitive environment will have to try very hard to change. To sum up, the market forces will accelerate changes in businesses. That's why the changes in business will come faster than in the other two areas. Of course, the changes in the three areas are at the same time intertwined, so the speed of the reforms might be different.

Now, about changes in bureaucracy. Because of the failure of the Ministry of Finance and financial institutions, a so-called convoy administration or governmental intervention has

* This refers to the "black boats" of the first foreigners who appeared on the Japanese coastline in the second half of the 19th century.

been replaced by the market economy. A drastic deregulation has finally begun as IT development, especially Internet commerce, spreads and globalization advances. Naturally, market forces will dominate economic activities so that the bureaucratic grip on economic activities will ease. That's the natural stream of the world market forces.

In addition, because of an aging population and a growing government deficit, it is really inevitable for Japan to have a smaller government. With that purpose, administrative reforms are now going on and that is the first step to decrease the number of agencies. Probably the reforms will be introduced more fiercely in the future. Of course I'm not denying the role of the government. The government still remains a facilitator to make the market economy work more effectively and to provide the infrastructure for the market economies. That's quite different. I'm not saying that we should import all of the Anglo-American system to Japanese society, but to the degree of importance of the free market economy, the first thing that we have to advocate is introducing free market economies and decreasing the power of the bureaucrats. Changes in politics are quite difficult since vested interests, which are affected by structure reforms, of course, will want to rely on politics. Usually the defeated or the weak in the market appeal to politicians by voicing dissatisfaction and complaints about the reforms.

Politicians such as Mr. Shiozaki are brave enough to promote the structural changes that might affect the vested interest groups. That might be supportive for his election but unfortunately there are not so many politicians who dare to plunge into harsh reforms by themselves. In a democratic society, I think it's quite natural for voters to appeal to the politicians to protect their interests. But the idea that people in a democratic society should be protected is probably carefully pursued, otherwise politics will not be changed so drastically. And talking about the relationship between the bureaucracy and politics—since I'm a retired bureaucrat, I'm free to say anything—it seems to me the Japanese public—I mean voters—have not expected the role of the politicians in formulating policy, partly because Japan has been successful in achieving such a high economic growth. We did not have serious political leadership in the period of high economic growth. Instead, the Japanese bureaucrats have been expected to formulate the policies under a stable political system. But now, because of the globalized economies where many conditions are changing the current economic system adversely, I think some of the Japanese bureaucrats have not played their roles as remarkably as they are expected to. That's why the politicians must start coming to the policy formulation areas. I think that movement itself is a really welcome to change Japanese politics. But I'm afraid that this movement just started. Some of the really young, able politicians like Mr. Shiozaki are doing the right things but I question how many Japanese politicians are following his lead. That's my concern.

PROF. PATRICK: I will be brief. I want to make some comments about risk-taking in Japan. The future is always uncertain and that's true for every individual, every corporation, every bureaucrat and its ministry, and indeed every politician and his party. They all face the risks of an uncertain future: the risks of job loss, corporate restructuring, or failure. A lousy retirement job possibly. Not being reelected or having your party lose power. Japan, in the postwar period, has developed an institutional system, in the broad sense that Masa Aoki was talking about, to reduce and transfer these risks. For instance, permanent employment is a system to transfer the risks of job insecurity to the stockholder. The stockholder bears the cost of job insecurity because people are kept securely in the firm even if they're redundant and even if profits are low.

In agriculture and small business, inefficient sectors are in effect protected not only by regulation but by a pricing mechanism which transfers resources to them from consumers and subsidies from taxpayers. The convoy system for banks and insurance companies, the underpricing of risk in the long bond, and other financial markets in effect transferred funds from strong companies that paid fairly high interest rates relative to the risk, to weak companies that paid relatively low interest relative to their risk. In general, in these sets of institutional arrangements, the strong have paid the costs of protecting or ameliorating the economic conditions of the weak. This has been made easier by the creation, quite often through various regulations of profitable market niches, of excess profits—or economists would call them rents—which have been used to handle what are in effect cross subsidies from the strong to the weak.

In moving to a more deregulated, less controlled market economy, opportunities for greater efficiency, effectiveness, and resource allocation and their use increase, but so do the risks. Japan is entering a riskier world as it deregulates. And in a slow growing economy the risks are higher; indeed, in the last couple of years the risks have become quite high and are reflected in household anxiety about the future and consumer caution.

What's happened in Japan in the last decade or two, and particularly in the last few years, is that those who used to be strong can no longer subsidize the weak. That means there's a change in the way risk is going to be allocated in the future, and that's one of the reasons why so much emphasis is put on financial markets, which are a way of pricing risk and allocating risk.

One of the dangers of the system that Japan has encountered in dealing with risk is in insulating companies and people by developing institutions that ensure against risk. You develop a system in which everybody, the individuals, bureaucrats, and companies, may seriously misperceive the degree of risk and engage in much riskier investments than they think they're actually engaging in. That was the essence of the bubble economy. I don't think that banks thought they were making high risk, high yield loans on real estate. They were making loans on the safest collateral in Japan. That's what everybody believed. Land prices will never go down, they believed, so it's very safe to make loans based on land as collateral. That was an immense misperception of risk. These sorts of major misperceptions occur in every society. We won't lose a war—that's the U.S. in Vietnam or Japan prior to World War II. The prices of two kinds of assets will never diverge that much; they'll tend to converge. That was the problem of long-term credit management. We've got everybody misperceiving the future and misperceiving the risk. And so that is one of the dangers of the system that Japan has been in. Another danger has been that these risk-ameliorating institutions may actually raise the cost of taking risks in certain areas. This is particularly the problem in venture capital and high tech enterprise start-ups.

The absence of anything resembling Silicon Valley in Japan is indeed striking, as we all notice. You don't have to be in Silicon Valley to realize that. There are many reasons for this but money is not one of the reasons. Money is certainly available. I mean, the Japanese put money into Silicon Valley. They certainly would prefer to put it in Japan if they had the equal opportunities. The major problem is that it's very risky for individuals to leave their safe, secure jobs and go and start up an enterprise in Japan. Why would you do that? In the United States it's not very risky. Your project fails, you move to another job, maybe at a better salary. In Japan, the project fails, you can't go back to your large company. You can't go back to your university. You can't go anywhere. That is therefore such a high cost, that from the

viewpoint of a potential entrepreneur you really are paying, you're taking much more risk than you would in the institution arrangements in this country.

Finally, let me end with a point that I think our panel has made and Mr. Hayashi made this morning about the change in generations. My sense is that the generation that is now in power in Japan grew up in an environment of the loss of World War II and really considerable poverty. They became quite risk-averse. It's not surprising that they looked for secure jobs and a stable economic future. Now, how about their kids? How about the people who are a little bit younger than you, Mr. Hayashi, and even younger? They grew up in an affluent society. They haven't suffered through the poverty. They've heard their parents talk about how terrible it was after World War II and all of that and they sort of remember that, yeah, yeah, yeah. Like we used to talk in the States about the Depression and our parents talking about the Depression. But this is a new group. They have had a much safer environment to grow up in. Because of that—because they had more assets and better education—they're going to be able to take much more risk, and they will.

PROF. AOKI: I would like to address Mr. Sneider's comments. When you visited Japan, not the first time but in the late eighties, my countrymen were pretty much indulged in a Japanese triumph and I actually was feeling very ashamed. But when I was listening to you I felt a bit of the same kind of American triumph, so I would like to argue with you about two points: one is finance and the other is software.

In Japan, of course, the presence of foreign financiers is going to be a catalyst for change, but I don't think it will change everything. Global financiers are operating basically on digitalized information, corporate statements and so forth. They access digital information flows in an instant and they react by computer network in a second. Not everything is in this domain. One good example is Silicon Valley here. Why there is a cluster of entrepreneurs here is the presence of venture capitalists who have knowledge and the competence to judge new enterprises or start-up firms which cannot be assessed by digitalized information. This is why American institutional investors like pension funds don't invest directly in those companies. They delegate this monitoring to venture capitalists. That's one example.

The second example is the relationship between small and medium firms in this country and banks. There is a good study by Professor Manju Puri at the Stanford Business School and Professor Ratsine at the University of Chicago about this. The reputation of the relationship of U.S. firms and banks is just like the Japanese main bank system. They maintain long-term relationships and in this way, small and medium enterprises who cannot raise the funds in the security market are nurtured by those banks and they pay higher interest rates. But when they merge they can go to a market earlier than the companies who do not have this kind of relational banking.

The third example is Deutsche Bank. The Deutsche Bank is now trying to internationalize, globalizing their financial operations, but the most profitable operation of Deutsche Bank is lending to small and medium enterprise firms. They rely on their ability to monitor and assess the capability of small firms. The one big problem of, for instance, this East Asian crisis, was that those global financiers didn't have the ability to assess or monitor the indigenous firms, so they lent the money through the banks. And when they felt that something went wrong, they very quickly withdrew the money because they didn't have the expertise to monitor those companies. In spite of the activities of global financiers, I think that financial actors who can process tacit knowledge still play a very important role. I think it is not institutionalized in Japan yet, but this kind of knowledge—to judge that your technological

expertise is there, the resources are there to establish companies—is highly necessary. A new type of financial institution has to emerge, but I don't think these globalized foreign financiers are going to dominate the Japanese financial market. This is one point.

The second point is about software. The conventional knowledge is that Japan is very weak in software. But as I mentioned this morning, particularly in the game software industry, Japan is very strong. As computerized technology becomes more and more mature and more usable, people will not necessarily type on a keyboard. They will interact in a more visual or verbal way. This is where the Japanese software industry has fairly strong expertise.

Mr. Nishimuro mentioned PlayStation 2. The adults here don't play games, but this PlayStation 2 is going to be a rather revolutionary product. As you probably know, the capacities of visual processing ability are four times or five times that of the most advanced computers. This kind of graphic processing might become important and as mentioned this morning, there's also a very important philosophical change between Microsoft and the Japanese computer industry, including Sony. Microsoft is trying to develop an operations system based on a centralized system, namely Windows control of all other applications. Another model is a more decentralized approach based upon simpler processors and a more decentralized operating system, in which appliances interact with each other. All of us have experienced the nuisance of changing our computers every two years and changing all the applications. When computer technologies are getting more popular and young and old people alike have more access to them, these technologies become more decentralized and easier to use. That may be a possibility. So you can't dismiss Japanese capability in the software industry either.

MR. SNEIDER: Let me respond briefly, because I don't want to halt the conversation. I don't disagree with what you said about the financial sector. My point is whether you want to call it *the* catalyst or *a* catalyst. I believe the entry of foreign firms—particularly at the retail level and not just in terms of corporate finance—into the Japanese market has a very transforming effect. For one thing, it forces a whole level of competition in terms of market return. It also, I think, offers Japanese consumers financial services that they didn't have access to before, such as when you see Japanese consumers shifting their bank accounts to Citibank because they believe they get better service from Citibank, of which I've heard countless examples. They trust Citibank more than they trust the Japanese bank they had a deposit in before. That's an interesting change, because believe me, ten years ago I couldn't have imagined such a thing. I think also that the way that investment capital is moving into Japan has a very important effect, although there's probably more hype than there is reality in terms of merger and acquisition activity and purchase of distressed assets and so on. I think it introduces a level of competition into capital markets which wasn't there before and that in turn changes a lot of the way corporations, whether they're small and medium-sized businesses or large businesses, go to the market for capital as one.

Two, I'm not a software expert, but I believe that what I'm reporting to you can be confirmed by those who work here in Silicon Valley. It may well be that it represents a degree of arrogance. Look at ten years ago—when the Japanese electronics industry heavily invested itself in its ability to produce first of all in the semiconductor industry and then to produce superior consumer electronics, superior hardware—and look at the investment. For instance, MITI engaged in the 1980s in fifth-generation computers. Now, compare that to what has happened here with the transforming effect of the Internet explosion. Probably the key industry right now in Silicon Valley is networking. I mean, there is probably no company more

important than Cisco Systems. There is no comparable company that I know of—if there is, I'd like to hear it—in Japan in that industry, and that industry is probably the center of where the whole information industry is going. You're missing components like that: you cannot name a major development, a breakthrough development in operating system technology or in globally significant software systems we're seeing that tie systems together, that comes out of Japan. It's coming from here.

PROF. ROWEN: Or out of Europe, for that matter. I mean, it's not just Japan.

MR. SNEIDER: Although people in the industry here will tell you they see more activity in Europe than they do in Japan.

PROF. ROWEN: But there still hasn't been this kind of advance there.

MR. SNEIDER: That may be true as well and I think probably Japan and Europe have more in common with each other.

PROF. ROWEN: I wouldn't pick on Japan so much on some of this because it's true of other places. The continent of Europe doesn't have a Silicon Valley either.

MR. SNEIDER: Well, all I'm saying is I believe that's the reality of what is going to drive—to a large extent—technological change and economic activity in the next fifty to a hundred years. Japanese and Europeans have significantly dropped behind in about a ten to fifteen year period. That, I think, is a force for change. I think the Japanese understand that. I think they're trying to cope with it. I think they will eventually cope with it in a positive way. I'm not presenting this as an argument for why Japan will fail. I'm saying it's an argument for why Japan will change.

PROF. ROWEN: I think this distributed computational power, the point you're making is likely to see a lot of alliances between Silicon Valley firms and Japanese firms, against Microsoft's more centralized model. It's not just Japan versus Microsoft around here. It's the decentralized model in effect.

Questions

- Question: My name is Stephen Bronte. I run a Japanese hedge fund. I want to address myself to Dr. Patrick's comments on the pricing of risk in Japan, which I thought were very interesting. I thought that one of the biggest problems with the old Japan, the Japan that existed until about two or three years ago, was that it didn't punish failure and it didn't reward risk. It didn't reward success adequately. If you look at the compensation levels in the United States of those who fail and those who succeed, the difference is enormous. You have at the top-end CEOs who earn hundred million dollar compensation packages and on the bottom people who work for companies that go bankrupt, as you pointed out, and get jobs on Monday morning. And I thought this was possibly the result of the democratization of Japan that took place after World War II and they really became too successful. I mean, the difference between the highest paid and the lowest paid individuals in Japan is tiny. Successful CEOs of major corporations in Japan only make a couple hundred thousand dollars a year. So my question is: Would there be any effect on the increase in entrepreneurialism in Japan if you took an American style compensation system and made it more widespread in Japan? Paid the successful people amounts of money that would make them rich beyond their dreams of avarice, and fired all the failures?

PROF. PATRICK: We have two extreme models, the U.S. case and the Japanese case. Neither of them is very good. It seems to me that in the case of America a lot of the compensation is pure rent. That is to say you're paying a lot more to the CEOs than you really need to get the same amount of effort from them, okay? On the Japanese side, you certainly don't have a system that creates great wealth for CEOs. Now, the CEOs in the rapid growth era were willing to make all kinds of good investment decisions with relatively low salary increments. My interpretation as to why you have this sort of low multiple within a company between the CEO salary and the average worker salary in Japan is really a labor bargain, or a management/labor bargain, in which management says to the workers: you be loyal to us, you don't strike, you join the enterprise union, we have a good relationship, and we won't exploit the company or you. We will take a decent wage, a good wage. We'll take a lot of expensive counts because it's outside the tax system. But essentially we're not going to get super-rich. We're all in this together. And if that's what you mean by democratization, I think that's been the deal.

Now, I think that has not created perhaps as much of an incentive for entrepreneurial activity, but I'm not sure that if you increase stock options for senior management that would necessarily change their performance or their behavior all that much. We just don't know. I was very interested in the comments of Mr. Nishimuro that he really rejected going to stock options as an effective device and precisely for the reason that that in effect is the Japanese system. He's not concerned about simply maximizing shareholder value. He's interested in maximizing stakeholder value. Given that difference in the set of values between American and Japanese CEOs, you're bound to end up with different kinds of institutional arrangements.

How can one encourage Japanese CEOs to be more entrepreneurial, take greater risks? I'm not quite sure. Probably compensation would help a bit. I don't think you have to pay Mr. Nishimuro a hundred million dollars a year or a hundred million dollars ever to get the amount of effort out of him that Toshiba's getting out of him.

- Question by Yukio Yoda: As a member of the Japanese audience, I raise one question. My question goes to immigration policy, as one academic pointed out on several occasions. The reasons I raise this issue are threefold. Number one, why can Japan keep a homogenous society while business sectors talk globalization and politicians talk about Japan in terms of global leadership? Number two, to create more innovative and energetic business activity, we need a more multicultural system or multicultural spirit, as in Silicon Valley, as you discussed. And number three, as Professor Aoki pointed out, the institution must include nation or race. So, if we should change an institution, this issue should change simultaneously and I think we are now in the times when we should discuss this sincerely in Japan. So, I'm happy to get some comments.

MR. KAGONO: I want to respond to the first question: why Japan can internationalize or globalize while keeping homogenous companies and a homogenous society. I think many Japanese companies are successful because of the homogeneity in each company's culture. The typical example is Toyota and Honda versus Nissan in the U.S. market. Nissan tried to adapt to the local cultures and Nissan's way is "in Rome, do as the Romans do." But Toyota and Honda spent a lot of time in transplanting their distinctive cultures, their distinctive way of management, a very homogenous one. They succeeded. So in order to compete in the different market or an alien market you have to rely on your strengths rather than your weaknesses. The Japanese companies built their strengths best upon the cultures and the

infrastructures that brought forth their roles and their strengths. So Japanese companies succeeded because they are homogenous, quite a different formula for success against U.S. corporations.

MR. NAKAGAWA: I don't agree with Professor Kagono. Success came not through the homogeneity of the Japanese society but through very skillful management. I think that the failure of Nissan—and it has not turned out to be a failure yet, as some companies are now helping it to survive—resulted from management leadership differences between their businesses. In the increasingly globalized economies worldwide, and of course there are many multinational companies of Japanese origin which now have many plants and branches all over the world. I think probably in the near future, it's already happening, that many foreign managers will be employed by those MNCs and will then have to adapt themselves to the globally internationalized common management strategy whether they like it or not, and regardless of whether a closed management system is coming.

PROF. PATRICK: When comparing electronics firms' operations in Mexico and in Southeast Asia with American firms, the fascinating result was the extraordinarily wide variance in the success rate of Japanese firms. This was mostly due to the quality of the particular managers of those operations and also to the high variance of American firms, and we tried to sort it out. It was very hard to say that Japanese firms did worse or better because there was so much variance, and I would say that that's the kind of heterogeneity, not of culture of management quality, that shows all over the place.

- Question by Kiyo Oishi: My name is Kiyo Oishi from GEO Networks. I'm a typical Japanese coming to work for an American software company and I found the comments of Dr. Patrick very interesting, talking about Japan's crisis coming from the risk aspect. Having experienced this myself, I totally agree that there is no liquidation in terms of human resources. Once you get out of the company, there is practically no way of going back if you fail. Adding to that is the nonstandardization of job factors in Japan. For example the CEO of Nabisco becoming the CEO of IBM is totally impossible in Japan. My personal gut feeling tells me that kind of job management or top management standardization is necessary, but I am not sure. So I guess my question is, is that kind of cross-company management function standardization necessary for Japan and if so, what is needed? What could be the trigger to make that happen?

PROF. PATRICK: What has always impressed me about Japanese companies is how different they are from each other and how embedded their own specific corporate culture is. If you're a Mitsui something man, you can't become a Mitsubishi anything. Therefore, I found it fascinating that Toshiba is selling parts of itself to Mitsubishi. Maybe this is really changing. One of the reasons that it is very hard to have transfers of middle management, much less top management in Japan, is the embedded nature of the network relationships that are specific within the company. These rely upon all kinds of tacit signals and knowledge and information that help accelerate decision-making within the company, so long as you stay within that frame, and they make it very difficult to change that frame. That is why it takes a very strong leader, probably a top-down sort of action, like we heard about at Toshiba, to change the basic frame of operations. Under those circumstances I don't think it is very easy for Japanese managers to change from one company to another. You asked a very interesting question: Is it necessary for the Japanese economy? Nothing is necessary, everything is desirable.

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