Are cross-shareholdings of Japanese corporations dissolving?
Evolution and implications

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Mark Rebick

Editor

Are cross-shareholdings of Japanese corporations dissolving?

Evolution and implications

This paper is a summary of parts (mainly chapters 2, 3 and 4 of eight chapters) of the author's forthcoming book, *Cross-shareholdings in Japan: A New Unified Perspective of the Economic System*, which was written while the author was visiting St. Antony's College of Oxford University in the spring of 2001. He would like to thank Professor J.A.A. Stockwin for providing him a most congenial research environment, and to Jenny Corbett, Marcus Rebick, and Yishay Yafeh for useful discussions. The book is to be published simultaneously in English and Japanese languages in early 2002, the former by Edward Elgar Publishing, UK, and the latter by Keio University Press, Japan. This summary paper was written while author was a Visiting Scholar at the Carlson School of Management, University of Minnesota, USA.

Abstract

The paper focuses on one of the most important features of contemporary Japanese economy, namely 'cross-shareholding' or mutual shareholding between corporations. It discusses recent trends; points out the reasons for these trends; outlines the implications for the entire economic system; and provides a future prospect. It shows that the ratio of mutually-held shares to total issued shares has continuously declined throughout the 1990s, and asserts that this is due to the low profitability of cross-held shares and increased risk-consciousness of equity holding. Non-financial corporations, in particular, have actively sold off bank shares, leading to weaker ties with banks; while those shares sold off have been acquired mainly by overseas investors and Japanese institutional investors. The paper argues that the dissolution of cross-shareholding has weakened the importance of long-term transactional relationships which have characterized the Japanese economy, as seen in keiretsu relationship, the 'main bank' practice, and the long-term employment system. This is making the character of the economic and financial system of Japan more or less similar to that of the Anglo-American system and is expected to have several desirable aspects.

Key words: Japanese firm; cross-shareholding; corporate restructuring; corporate governance; main bank; keiretsu; long-term employment; Anglo-American financial system; institutional complementarity; path dependency.

1. Introduction

Generally speaking, how corporations are owned in a nation (ownership structure) determines not only the nature of corporate governance and the behaviour of corporations but also strongly influences the entire economic system, which includes the industrial structure, the financial system, and the employment system (Shleifer and Vishny 1997; Allen and Gale 2000).

In the ownership of Japanese corporations[1], we can point out two distinctive features. The first is that Japanese corporations (both financial institutions and non-financial firms or general business corporations) have a strong tendency to have their equity owned by the counter party corporation with which the firm has business transactions, on the one hand, and to own the equity of the counter party corporation, on the other. That is, two companies hold stakes in one another, by way of mutual shareholding or 'cross-shareholding'. In fact, when we look at the owners in terms of the market value of all the stocks issued and traded publicly at the end of March 2000, financial institutions (commercial banks, trust banks, and insurance companies) held 36.1 per cent, and non-financial firms 23.7 per cent. Thus the portion owned by corporations was about 60 per cent of all the stocks (Council of Japanese Stock Exchanges 2000. See Figure 1 for their movements). Although these figures only broadly show ownership within the corporate sector and not necessarily pair-wise or mutual shareholding of two particular firms, they do indicate the prevalence of corporate cross-shareholding in Japan.

The second feature is that shareholding by corporations, regardless of whether cross-shareholding or unilateral shareholding, is generally not intended for short-term gain in income but for longer term or stable holding, what is known as 'stable shareholdings' (<u>kabushiki antei hoyuu</u>). Therefore, in terms of motives for holding company shares, cross-shareholdings constitute a subset of stable shareholdings. This means that looking at stable shareholding allows us to shed light on an important aspect of cross-shareholding.

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[1] In this paper, the terms 'firm,' 'corporation,' and 'company' are interchangeable, unless otherwise specified.

These two characteristics of shareholdings in Japan have historical roots (Ito 1993; Tachibanaki and Nagakubo 1997). In particular, two periods in post Second World War history built up these features. One is the period soon after the Second World War, when zaibatsu, or prewar conglomerates of large corporations, rebuilt the human and capital network, although they were dissolved by the occupying army immediately after the War. The other is the period when managers of Japanese corporations prompted cross-shareholding, in order to prevent hostile takeovers by foreign investors and retain autonomy of the Japanese management, when Japan deregulated the international transaction of capital in 1964. See the rapid increase of inter-corporate shareholding ratio in the late 1960s and early 1970s (Figure 1).

On the other hand, one of the basic characteristics of Japanese economy since the high-growth period (1955-70) has been the existence of long-term transactional relationships between economic agents in various kinds of economic transactions. For instance, the keiretsu, that is a transactional relationship between business firms; the ‘main bank’ system between bank and business firm; and the employment between firm and employees. Cross-shareholding is, as this paper argues, apparently an underlying and linking factor of these unique features of the Japanese economy.

If such is the case, developments in cross-shareholding and the changes in the Japanese economic system may be said to be two sides of the same coin; thus the dissolution of cross-shareholding would mean the erosion of various characteristic features of the Japanese economy. This paper tries both to present a unified understanding of the Japanese economic system and to explain various developments by utilizing that framework. There are many issued raised by the dissolution of cross-shareholding; for example, the effect on the stock market. But here, we mainly focus on issues relating to the governance of Japanese firms, since it is one of the most important aspects of the present Japanese economy, particularly in connection with its troubled circumstances.

The structure of the paper is as follows. Following this introductory section, section 2 presents a simple model to understand cross-shareholding, together with a suitable statistics for this analysis. Section 3 documents the structure and recent developments in cross-shareholding. Section 4 points out various factors behind the recent ‘dissolution’ of cross-shareholding. Section 5 explicates the meaning of the dissolution of cross-shareholding in various aspects. Section 6 concludes the paper, with some prospects of cross-shareholding as well as appropriate public policy responses.

2. Various forms of cross-shareholding, and relevant statistics

When the term ‘cross-shareholding’ is used, it is not always clear what kind of firm issues the stock and what kind of firm holds the stock. Moreover, such expressions as ‘stable shareholding’ and ‘group shareholding’ are sometimes used, often without clear definitions, in relation to cross-shareholding. Therefore, we first need to clarify the meaning of cross-shareholding by differentiating the types of economic agents concerned and explaining the relevant terminology.

Various forms of cross-shareholding

When the ownership structure of corporations in a nation is discussed, two aspects are usually seen as key. First, what kind of economic agents or organizations, such as individuals, institutional investors, corporations or foreign investors, own the shares? Second, to what extent these shareholders own the shares, namely whether the concentration of ownership, for instance, lies with a small number of major owners or whether there are a large number of owners each having only a small amount. Of these two, cross-shareholding falls into the first category. It typically refers to the mutual ownership of each other’s shares by two corporations, A and B, as shown in Figure 2 (1).

Here, two remarks are in order. First, each of these two corporations can be either a financial institution or a non-financial firm (general business corporation). Both financial institution and non-financial firm (hereafter called ‘business corporation’ unless otherwise specified) are private agents, but it is necessary and important to distinguish these two entities in our analysis, since their role in the economy is fundamentally different. Second, there are cases that we may broadly call cross-shareholding where firms own shares of member firms within a group of firms, as shown in Figure 2(2). We use this terminology, although this is not a mutual shareholding when looked at as a pair of firms or in a narrow sense. This is a case of intra-group shareholding, and we may call it cross-shareholding in a broader sense. This means that, when we speak of mutual or cross-shareholding, the phenomenon should not be understood as a clear-cut, black or white matter but a phenomenon that has gradations and a wide spectrum.

A model of cross-shareholding between corporations

When we deal with inter-corporate cross-shareholding, it is theoretically useful and helpful for better understanding to introduce the two types of economic agents and, consequently, generate four categories of cross-shareholding. That is, we (1) distinguish two types of corporations, 'financial institutions' and 'business corporations,' and (2) allow for the situation where both financial institution and business corporation issue stocks, and both own stocks issued by either a financial institution or business corporation.

Using this framework, we can differentiate four kinds of inter-corporate cross-shareholding, as shown in Table 1. The first, Case A, is where the owner of the stock is a financial institution and that stock held in portfolio is issued by some other financial institution. The second, Case B, is where the owner of the stock is also a financial institution but the stock held is issued by a business corporation. This includes an important class of cross-shareholding between a bank and the client firm, a case where one observes the 'main bank' relationship. The third, Case C, is where the owner of the stock is a business corporation and the stock held is issued by a financial institution. Finally, the fourth case, Case D, is where the owner of the stock is a business corporation and the stock held is issued by another business corporation. In this last case, Case D, two kinds corporate groupings are usually involved. One is cross-shareholding between members of a horizontal corporate conglomerate (kigyou shuudan, or horizontal keiretsu), and the other is cross-shareholding that is indicative of business relationships between suppliers and customers (vertical keiretsu), as seen typically in the automobile industry. In the next section, we will utilize the above framework of shareholding categorization in our statistical analysis.

An additional concept we need to clarify in relation to cross holding is 'stable shareholding'. Cross-shareholding is a concept relating to the owner of stocks, while stable shareholding relates to the motivation and duration of holding stocks. That is, stable holding means the kind of investment attitude in which an investor, once he has acquired stocks, does not sell them in principle and holds them for a long time, regardless of the market price of the stock after its acquisition. In other words, it means to hold shares for a long time for some other reason than for the purpose of short-term investment gains or for taking account of capital gains or losses. In this context, not only is cross-shareholding in a primary sense (in our narrow sense) stable shareholding, but also intra-corporate group shareholding (cross-shareholding in a broader sense) also exhibit this feature of stable shareholding.

Relevant statistics

For cross-shareholding, the most familiar statistics are the following three: (1) 'Survey of cross-shareholding' produced by the Nippon Life Insurance (NLI) Research Institute, (2) 'Share ownership survey' compiled by the Council of Japanese Stock Exchanges, and (3) 'Actual situation of corporate groups' published by the Fair Trade Commission General Secretariat. Of these three, we rely mainly on (1). This is because (a) the coverage is extensive and statistics are available for every year, (b) consistent time series data are available, and (c) the survey is comprehensive and data are available under various headings, for instance, the details on the 'six large corporate groups' in Japan.

3. Recent trends of share ownership and structural changes

In this section, we first take a broad look at developments in share ownership, and then focus on corporate cross-shareholding and trace recent developments and structural changes using the relevant statistics.

3.1 Share ownership and cross-shareholdings in recent years

Let us first summarize the recent trend of share ownership by utilizing the survey conducted by the Council of Japanese Stock Exchanges (2000), which has already been shown in Figure 1.

The most distinctive feature here is that shareholding by both financial institutions and business corporations increased rapidly during the period of the late 1960s to the early 1970s. Regarding developments in the 1990s, several points stand out. First, the share ownership ratio of financial institutions has continued to decline and, especially in the late 1990s, this tempo of decline has obviously accelerated. Second, the shareholding ratio of business corporations has been declining only marginally or has virtually levelled off over the last ten years or so, a sharp contrast with the case of financial institutions. Third, the shareholding ratio of foreign investors, which includes both individuals and institutions or corporations, has steadily increased to become as high as 12.4 per cent (at the end of Fiscal year 1999, that is, at the end of March 2000), its record level. Also, an increasing trend can be observed in the shareholding by annuity trusts in the 1990s, although the level itself is low.

To summarize the trends in the 1990s, shares owned previously by financial institutions and business corporations have been released from their portfolios, implying the dissolution of cross-shareholding. On the other hand, the shares sold in the market have been acquired mainly by foreign investors, whose active investment attitude stood out, as well as by Japanese institutional investors and individuals.

To grasp the broad trend in cross-shareholding, let us use the ‘cross-shareholding ratio’ as a measure, as shown in Table 2 which is based on the survey by the NLI Research Institute (2000). The cross-shareholding ratio is defined here as the ratio (expressed in per cent) of the value of cross-held shares (the market value of mutually held shares between two corporations) to the total shares publicly traded in the Japanese stock market. This table shows that the cross-shareholding ratio was 10.5 per cent in 1999; that is, roughly 10 per cent of the entire Japanese shares were cross-held (in the primary sense) within the corporate sector. And, regarding the trend during the twelve years between 1987 and 1999, two aspects are noteworthy: (1) the ratio has shown consistent decline, except for 1990, and (2) this decline became particularly marked after 1995 and accelerated in 1997-99. These tendencies are clearly shown in Figure 3.

Here, it is worthwhile mentioning the ‘stably-held ratio,’ the ratio of stable shareholdings. This ratio (1) was as high as 37.9 per cent in 1999, meaning that roughly 40 per cent of the entire Japanese stocks were stably-held, and (2) has also shown a declining trend between 1987 and 1999, as the cross-shareholding ratio (both ratios declined about 8 percentage points. NLI Research Institute 2000).

3.2 Structural changes in cross-shareholdings

(1) Trend decline of cross-shareholding

In order to utilize our model of corporate cross-shareholding (Table 1), we have re-aggregated the data of cross-shareholding originally compiled by the NLI Research Institute. The results are shown in Table 2 and Figure 3, from which the following points are apparent.

First, up to the first half of the 1990s (around 1994), shares owned either by financial institutions (about 8 per cent of the total) or business corporations (about 9 per cent of the total) do not show a marked decline. Hence, the cross-shareholding ratio of the entire stocks also remained roughly unchanged at a level of 17-18 per cent.

Second, after the mid-1990s, by contrast, both financial institutions and business corporations started and gradually accelerated a trend toward the dissolution of cross-shareholdings. Thus, both of these forces combined brought about the tendency of the dissolution of cross-shareholding in this period.

Third, in recent years, there has been a change in the leading role of cross-shareholding. If we look closely at Table 2 and Figure 3, we notice that business corporations started to dissolve cross-shareholding relatively early in the mid-1990s, while financial institutions[2] did not start the process till a little later, in

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[2] It needs to be noted that ‘financial institutions’ as defined in the above statistics include banks, casualty insurance companies, and securities companies (including security financing companies), as shown in footnote 2 of Table 2; however, in terms of statistical weight or importance, banks dominate. Thus, ‘financial institutions’ in our statistics may be understood as to be almost synonymous to the ‘banks.’

around 1997-98. As a result of this, the two levels of cross holding ratios inverted, making that of business corporations (4.5 per cent) lower than that of financial institutions (6.0 per cent).

(2) Structural change in cross-shareholding

Next, let us look at our four types of cross-shareholdings (Cases A, B, C, and D), and trace how the relative importance of each type has changed (see Table 2).

Cross-shareholding as a reflection of the main bank system

First, we point out that the most important cross-shareholdings, in terms of stock value, have been of two types, namely, Case B, the case where financial institutions hold the shares of business corporations, and Case C, the case where business corporations hold the shares of financial institutions. For example, in 1987, the contributions of Case B and Case C to the cross-shareholding ratio of the entire stock market (18.3 per cent) were 6.2 percentage point and 8.3 percentage point respectively. And the sum of the two (14.5 per cent) accounted for about 80 per cent of the entire cross-shareholding. On the other hand, the remaining two types had relatively small weight: the case where financial institutions hold shares mutually with other financial institutions (Case A) was 1.5 per cent, and the case where business corporations mutually hold shares (Case D) was 2.3 per cent.

In other words, when we speak of cross-shareholding, we really mean cross-shareholding between financial institutions and business corporations rather than between two financial institutions or between two business corporations, both of which represent only small components of the total.

The prevalence of Case B (the banks' ownership of business corporations) can be understood to reflect the pervasiveness of the main bank system, a practice whereby banks and business corporations maintain close, long-term relationships. This type of mutual shareholding is an important element of the system[3]. Similarly,

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[3] The main bank relationship between a bank and a business corporation is usually characterized by all or many of the following situations (Okabe, 1999; chapter 1). That is (1)

the dominance of another type of cross-shareholding, Case C, also implies another aspect of the main bank system (mutual dependence of a bank and a business firm). In these two respects, we should say that cross-shareholding and the main bank system are two sides of the same coin.

On the other hand, we need to exercise caution in interpreting the low level of Case A, mutual shareholdings between financial institutions. This is because major insurance companies, an important block of financial institutions, are mutual companies and hence do not issue equity stocks[4]. This means that they can and do hold shares of other financial institutions but cannot mutually hold shares with them. Accordingly, in shareholding by financial institutions, it is not the mutual shareholding but rather the unilateral stable shareholding that is more important, as we explain in Table 4. In particular, the unilateral holding of equities of banks by insurance companies is of enormous importance. Also, we cannot judge the matter by numerical weight alone in the other less important case, namely Case D, where business corporations hold shares mutually. This is because here the importance lies not necessarily in the weight itself but in its movement over time. This case displays a unique upward trend, implying a change in the behaviour of business corporations, as we see below.

Markedly different attitudes of financial institutions and business corporations

Second, business corporations and financial institutions have contrastingly different attitudes. Business corporations have rapidly decreased mutual shareholding with financial institutions (Case C), while hardly reducing mutual shareholding with peer business corporations (Case D), as seen in the last two columns of Table 2. By

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the bank has the largest share of lending of all the banks for the firm, (2) the bank is the top owner of the business corporation's equity, (3) the bank is the main performer of various financial services besides lending, (4) the bank dispatches its personnel as an executive of the business corporation, and (5) when the business corporation faces financial distress, the bank extends various kinds of assistance, including the making of an emergency loan (state-contingent governance).

[4] This implies that there is a separate issue of corporate governance of a life insurance company, an important institutional investor. On this issue see, for instance, the NLI Research Institute (1999).

contrast, financial institutions have reduced mutual share ownership (both Case A and Case B) only moderately. That is, the attitude toward cross-shareholding has been in sharp contrast: financial institutions have had a weak tendency to dissolve, regardless of the counter party, while business corporations have taken a sharply different approaches depending on who the counter party was.

This tendency is all the more evident if we trace the share's stably-held ratio, which may be regarded as a cross holding ratio in a broader sense. If we view the stably-held ratio based on the issuer of the stably-held stock, as in Table 4, we notice that the proportion of the stable holding of bank-issued stocks has declined rapidly (from 55.7 per cent in 1987 to 45.5 per cent in 1999). We notice also that a contribution to this decline comes significantly from the negative attitude of stable holding by business corporations. This phenomenon is related to the recent tendency of business corporations, especially of large businesses, to reduce the number of banks with which they conduct banking. For instance, non-financial corporations listed in the First Section of the Tokyo Stock Exchange had banking relationship with, on average, 8.2 banks in 1994, but this number had decreased to 5.6 in 1999 (Kanda and Capital Market Research Group, 2001; p. 74).

In sharp contrast to the above, the stably-held ratio where the issuer of the stably-held stock is a business corporation declined only a little (from 29.7 per cent in 1987 to 27.9 per cent in 1999). The reason for this is that the tendency of business corporations to stably hold shares of peer business corporations has markedly increased in recent years (from 7.6 per cent in 1987 to 15.0 per cent in 1999), despite the fact that banks and insurance companies have shown a tendency to dispose of these shares from their portfolio. This phenomenal growth of mutual shareholding between business corporations seems to imply the active reorganization of the mode of business of these corporations. It is like initiating a new project by spinning off a part of the corporation and thereafter holding shares mutually, or undertaking a new project by establishing a new transactional relationship with other business corporations by way of mutual shareholding. Alternatively it may be a symptom of the process of reorganization of the entire industrial structure[5].

Great change in the structure of cross-shareholding

Third, the result of these changes in each of the four types of cross-shareholding has been a big structural change in cross-shareholding in Japan. In order to bring this change into sharp relief, the structures of cross-shareholding in 1987 and 1999 are contrasted in Figure 4.

By comparing the structures in these two years, we can all the more clearly see that during 12 years of 1987-99 (1) the overall cross-shareholding ratio declined, and, above all, (2) business corporations drastically reduced their holdings of shares issued by financial institutions. Furthermore, it is obvious that (3) the most important type of cross-shareholding has changed, from the case in which business corporations hold the shares issued by financial institutions to the case where financial institutions hold the shares issued by business corporations. In other words, the structure of cross-shareholding has changed during 1987-99 as a result of the different approaches to shareholding of financial institutions and business corporations.

3.3 Characteristics of member corporations of the six large corporate groups

We have up to now examined the entire population of (large-sized) corporations. But let us here focus more narrowly on the 'six large corporate groups'[6] and give an overview of the member firms of a group. Summary data for all six groups are provided in Table 3. In terms of the shareholding pattern of the corporate groups, we can point out two developments (Fair Trade Commission 1998).

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[5] Although there are many journalistic reports and anecdotes of these facts, it remains an important research agenda to empirically document whether or not these conjectures actually hold.

[6] If we take the relative size of the member firms that belong to the six large corporate groups in relation to the total firms in Japan, this is merely 0.0064 per cent in terms of the number of firms. But when we use other major measures, the member firms account for roughly 11-14 per cent of the entire corporations in Japan. For instance, they have a share of 14.1 per cent in terms of capital, 11.4 per cent in total assets, 12.5 per cent in total sales volume, and 13.7 per cent in ordinary profit (Fair Trade Commission 1998).

First, intra-corporate shareholding is, on average, gradually dissolving. This is evidenced by the intra-corporate shareholding ratio, which has been declining successively: 25.5 per cent in 1981, 22.7 per cent in 1987, 22.2 per cent in 1992, and 21.4 per cent in 1996. Second, shares owned by foreign firms have increased. The number of foreign shareholders ranking among the largest 20 stockholders was 264 in 1996, as compared with 65 in the previous survey conducted in 1992. And the portion owned by foreigners in 1996 was 2.7 per cent of all the stocks issued by member firms of the six large corporate groups. This implies that the six large corporate groups in Japan are gradually being internationalized, not only in business transactions but also in ownership, which in turn means that the management of these corporations will be more influenced by foreign owners. Both of these trends are characteristics of not only the six large corporate groups but also of the cross-shareholdings of all listed Japanese corporations.

3.3 Trends in the 'stable shareholding' ratio

The 'stable shareholding' ratio, which is the ratio of 'stably held shares' including cross-held shares, has shown a similar trend. The statistics, as summarized in Table 4 and Figure 5, show (1) that the level itself is quite high, much higher than that of the cross-shareholding ratio (the level remained at more than 40 per cent from 1987 to 1997 and stayed at 37.9 per cent in 1999), (2) that it remained broadly at the same level until the early 1990s and showed a declining trend after around 1993, and (3) that in business firms stable shareholding actually increased, although in financial institutions stable shareholding is declining. The reason for (3), as implied earlier, is that business firms have accelerated the restructuring of their lines of business by, for instance, spinning off a part of their business and at the same time holding the equity of the new corporation unilaterally. This unique movement in the stable shareholding ratio of business firms resembles the movement observed in the cross-shareholding of business firms, namely a relatively mild decline.

4. Factors behind the 'dissolution' of cross-shareholding

We can broadly summarize the previous chapter by saying that (1) generally speaking, cross-shareholding has shown a tendency to dissolve, especially in recent years, but that (2) when looked at more closely, there are marked differences between financial institutions and business corporations in selling off cross-held shares. Here, for the sake of simplicity, let us call the phenomena (1) and (2) jointly 'the dissolution' of cross-shareholding, and point out factors behind this 'dissolution'. The general explanation is that cross-shareholding has gradually lost its advantages and became more and more disadvantageous to maintain in the 1990s, particularly in the latter half of that decade.

Reasons for the dissolution of cross-shareholdings

The first reason for the decline in cross-shareholding is their low profitability. For both banks and business corporations, the direct rate of return generated by cross-held shares, which had traditionally been very low, decreased further or turned negative in the course of an unprecedented recession (Murase 2001; Kawamoto 2000, chapter 2). Moreover, there were additional incentives for business firms and banks to take capital gains from the permanent sale of cross-held shares during this period. Among the reasons were the need to offset depressed cash flows after a long recession (Scher 1999), to make up the shortage of reserves of annuity debt (NLI Research Institute 2000) and, in the case of banks, to secure funds to write off non-performing loans (Nikkei newspaper; 23 November 2000).

A second reason is an increase in risk-consciousness of equity holding. In circumstances where the Japanese economy is in a deep slump and stock prices record a large fall and increased volatility, both business firms and banks have increasingly become aware of the risk of holding stocks, thus triggering the sale of stocks (Tachibanaki 2000). In the case of banks, the increase in risk sensitivity of equity holding was more conspicuous. There are two reasons for this. One is that the decline of the value of portfolio stocks due to the fall of stock prices means erosion of a bank's capital base, thus increasing its anxiety of not meeting the international capital adequacy standard (Basle Accord)[7]. Another reason is that the

[7] According to the Basle Accord, an international capital adequacy standard, equities held in the banks' portfolio at historic cost can be revalued to reflect their current value, and 45 per cent of the resultant revaluation reserves ('latent' revaluation reserves) can be included in the capital base (Basle Committee on Banking Supervision, 1988).

decline of a bank's capital ratio necessarily drops the rating of the bank in the market, with the result that funding in the market becomes more costly or difficult due to an increased risk premium. Both of these factors added to bank's risk sensitivity and accelerated their sale of mutually held stock.

Third, although a once and for all factor, is a drastic reform in the Japanese financial reporting system. In Japan this reform, implemented during fiscal year 1999-2001, is often referred to as the accounting counterpart of the 'big bang' in the country's financial system reform. The new accounting standards aim at making the Japanese financial reporting system more compatible with international standard. It is by establishing a host of new guidelines so that the financial condition of a firm may be reported in a more transparent manner and can be assessed more precisely (for the details, see Fuji Research Institute 2000; Kawamura 1999). Since the reform has revealed the inherent corporate risk, it has hastened the sales of shares held in portfolios.

Reasons for different attitudes of business firms and financial institutions

Next, let us consider why we see rather contrasting behaviours in business firms and financial institutions in selling off cross-held shares.

First, why have business corporations sold off equities issued by financial institutions so actively? One reason is that the price of stocks issued by banks has fallen further than that of non-financial firms. This is because, in the 1990s, an increased amount of bank lending had turned sour (non-performing), thus increasing the credit risk of banks and increasing the probability of bankruptcy. This weakening of the financial position of Japanese banks lowered bank's share prices. Therefore, business corporations have targeted the shares issued by banks when they get rid of mutually held shares (Kanda and Capital Market Research Group 2001). Another reason is that business firms have become much less dependent on their main bank in obtaining necessary funds, because deregulation in both capital markets and international funding has made it easier to acquire funds, especially for large-sized firms. This is a result as well as a cause, and it has important implications for the transformation, if not the decline or collapse, of the main bank system in Japan.

Second, why have financial institutions been relatively reluctant to sell off business firms' equity? One reason is that banks have been expecting to maintain or strengthen transactional ties with client business firms, large and small, in the future. Moreover, a new Bank Holding Law enacted in 1993 might have been conducive to holding more shares or avoiding selling off shares, since it allows up to 15 per cent shareholding in client firms, as compared with the preceding statute which stipulated the maximum share holding of 5 per cent.

Third, why has cross-shareholding between non-financial business corporations remained relatively unchanged? It is probable that the main reason for this is, as alluded to previously, that Japanese business corporations have been strategically restructuring their entire businesses as well as their business relationships with existing clients. This takes various forms, as suggested by the NLI Research Institute (2000). It includes such actions as reassessing----in some instances resulting in scrapping----the keiretsu buyer-seller relationship, reorganizing the firm by spinning off relevant divisions and in turn acquiring shares, or establishing close business relationships with new buyers and suppliers domestically and internationally by mutually holding shares. All these tactics are likely to increase, not decrease, mutual shareholding between non-financial business firms.

5. Functions of cross-shareholding and effects of the 'dissolution'

In this section, we will first take a look at how corporations view the role of cross-shareholdings. Next we evaluate the perceived role played by cross-shareholding in light of the efficiency and equity of the system. After that, we summarize effects the dissolution of cross-shareholding and attempt to evaluate the consequences.

5.1 Functions of cross-shareholding as seen by corporations

First, let us look at how corporations see the benefits and costs of cross-shareholding, by using the results of a questionnaire survey conducted by the Economic Planning Agency (1999a). See Figure 6. On the benefit side, business firms point to the prevention of hostile takeovers, and the maintenance of long-term transactional relationships with clients. On the cost side, corporations mention the increase of corporate risk (or destabilization of the capital base) and inefficient allocation of funds.

5.2 Cross-shareholding as a device for corporate stability

If we interpret these benefits in terms of economics, cross-shareholding can be understood to provide a 'mutual risk-sharing scheme' between firms (Nakatani 1984; Ito 1993; Flath 1996), and to reduce transaction costs and information costs by maintaining long-term relationships. On the other hand, however, if firms hold shares mutually, the corporate monitoring function associated with owners of shares does not take place or is weakened (Sheard 1994). A resulting problem is that cross-shareholding hinders firms from being managed efficiently, whether the firm is a financial institution or a non-financial business firm. Recent research supports this hypothesis. Let us look into this aspect in some detail.

Resulting in a vacuum in corporate governance and in inefficiency

With cross-shareholding or stable shareholding, managers did obtain strong discretionary power in the corporate control system, but without an effective monitoring mechanism they tended to lose a sense of responsibility to stakeholders in the firm, and there was an inevitable lack of transparency in the decision-making process.

We can provide a few different theoretical interpretations of this phenomenon. One interpretation is to regard the managers of both firms in effect 'colluding' with each other, in the sense that managers of neither firm blew the whistle on or monitored the other (Tachibanaki and Nagakubo 1997). Another interpretation is that cross-shareholding has similar effects to forming an 'internal capital market' within the corporate sector, so that the monitoring function of the overall capital market over the entire economy did not effectively reach this sector (Zhai 1999).

Whichever interpretation one takes, we can say that under this condition there emerged a 'vacuum in corporate governance', meaning that companies enjoyed unusual freedom to make strategic decisions for themselves. It is very likely that this environment distorted the efficiency of the Japanese economy, especially in the 1980s and 1990s. Further, it is undoubtedly contributed to destabilizing the economy by accelerating the asset price bubble, and it also created new problems in the distribution of income and wealth. The vacuum in corporate governance can thus be said to have caused serious problems for the Japanese economy, although regrettably the degree of seriousness is not widely recognized (Okabe 1999; chapter 2). In order to assess the extent and the severity of this problem, we need to conduct various empirical studies. Suffice it here to cite some earlier research regarding the effect of weakening corporate governance on the efficiency of the economy, in particular excessive capital investment and inefficient use of capital, resulting in low profitability.

There seems to be increasing empirical evidence of this kind of inefficiency. In the case of (non-financial) business corporations, the evidence includes Nitta (2000), Zhai (1999; chapter 5), Yonezawa (1995), and Yonezawa's paper in the Kanda and Capital Market Research Group (2000), as well as an older study by Lichtenberg and Pushner (1994). We may acknowledge, on the one hand, that cross-shareholdings between corporations are likely to have some positive effects, like risk sharing, and reducing the cost of capital and transaction costs. These factors contributed to the growth in sales volume or the growth of Japanese firms, as seen especially during the bubble period. On the other hand, we should note that various studies have suggested that these aspects have not contributed to the longer-run efficiency or profitability of the firm or the Japanese economy.

As to effects on the efficiency of financial institution, there does not seem to exist any full-fledged study that directly estimates these effects after controlling for other variables. However, Table 5, which compares the productivity of financial and insurance industries with all other industries in Japan, is rather indicative. The table shows that the value of domestic production or operating profit per employee in the financial industry exceeds that of all other industries. This is partly because in the former industries the ratio of highly qualified employees (college graduates, for instance) is higher than in the latter. If, however, return on equity (ROE) is compared, financial industries trail far behind all other industries. Moreover, the

ROE of Japanese banks is strikingly low in international comparisons (Okabe 1999; chart 10.3).

Why is the productivity of Japanese financial institutions so low? We can point to two major reasons for this. One is the effect of tight regulations, as a study by Weinstein and Yafeh (1998) strongly suggests. The other likely reason for low productivity is cross-shareholding, as in non-financial firms, which has led to slacken corporate discipline and resultant low productivity (Yonezawa 1995).

5.3 Cross-shareholding with a bank as a financing mechanism

Next, let us take up a special case where one of the parties to mutual shareholding is a bank. This is the case where a firm and a bank have a close and long-term relationship, commonly called a 'main bank' relationship, and corporate governance is closely related to the functioning of the bank. This kind of bank, the main bank, is usually understood to have the following three functions: (1) efficient provision of funds to the client firm, (2) monitoring and, when necessary, controlling the client firm, and (3) provision of 'insurance' against the client's financial distress (mutual risk sharing)[8].

Since corporate governance is probably one of the most important issues at present for the Japanese economy, we will here take up (2), namely the role of the bank in monitoring the client firm on behalf of the firm's shareholders. According to recent research, this kind of corporate governance function of a main bank has been positively identified (Lichtenberg and Pushner 1994; Kang and Shivdasani 1995, 1997).

However, the system is in some respects flawed (Weinstein and Yafeh 1998; Yafeh 2000), and has not completely substituted for the corporate monitoring function performed primarily by the capital market. There are two reasons for this. Firstly,

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[8] Research on the main bank system has been accumulated quite abundantly especially since early 1990s; the first monumental book is probably the one by Aoki and Patrick (1994). For the research developments in this regard and various issues pertaining to the main bank, see Okabe (1999; chapters 1 and 2).

the main bank system appears important in times of the financial distress of a client firm, but it is less important when a firm is doing well ('state-contingent' governance, or one-sided governance). As a consequence, during the bubble period of the late 1980s, banks failed to monitor business firms in inducing the efficient use of the capital and, in effect, assisted in inflating asset prices by extending further loans to client firms. Secondly, the functioning of this governance mechanism is much more limited (fragility of the governance mechanism), since it depends on the health of the bank (the monitor), and the regulatory environment (the 'monitor' of the monitor). In other words, when the bank has a large amount of non-performing loans and does not have enough resources to spare for monitoring client firms, the governance function is naturally limited. The same is the case when the monitor (the Ministry of Finance) behind the monitor (the bank) loses its reputation and authority.

5.4 A support to the long-term employment system

A system of stable shareholding and cross-shareholdings may also be understood as complementary to the Japanese employment system. The most striking feature of the Japanese system has been, of course, long-term or 'lifetime' employment. The reasons for the complementarity are as follows.

When a firm is insulated from competition in the market for corporate control, managers enjoy considerable freedom to manage and operate the firm according to their own intentions. At the same time, the majority of Japanese corporate executives are recruited and promoted from within the firm. This system of executive appointment creates a perception among both managers and employees that the firm is 'owned' not merely by the shareholder but by all the stakeholders, including the firm's managers and employees. It is natural, then, that managers tend to run the company not solely for the shareholders but rather for the employees from whose ranks they came (and future managers will come). This results in the long-term employment practice, in which the formation of firm-specific skills becomes important as an efficient way of producing and developing products. In this way stable shareholding can be seen as one of the factors that sustains the maintenance of long-term employment by insulating corporate management from the pressure of capital markets.

Cross-shareholding and long-term employment are complementary in another way, too. Under long-term employment, risk for an employee over business cycles is relatively low (he or she is not likely to be laid off, as is the case in the US). But a risk of dismissal may arise when the firm goes bankrupt or is taken over by a foreign firm. If the firm's main bank enters the stage at this point and extends financial and other assistance to the financially distressed firm or mediates between two firms, the risk of dismissal for an employee is likely to be moderated substantially (Osano 1996). In this way, cross-shareholding underlies both the main bank system and the long-term employment system and makes the two mutually reinforcing.

In summary, cross-shareholding in Japan not only provides the foundation of business-to-business long-term transactional relationships, including keiretsu relationships, but it also plays an important role in sustaining business-to-bank relationships (main bank relationships) and business-to-employee relationships (the long-term employment system). These systems exist by mutually supporting each other. This is what Aoki (1995) and Aoki and Okuno-Fujiwara (1996), among others, termed the phenomenon of 'institutional complementarity'.

5.5 Effects of the 'dissolution' of cross-shareholding

The dissolution of cross-shareholding means that the above-mentioned functions disappear or are transformed. One of the changes is the decline in corporate monitoring role played by a main bank, reflecting the underlying trend of 'farewell to banks' phenomenon by business firms (especially large-sized firms). And, at the same time, there is the increased influence of foreign investors and Japanese institutional investors on corporate governance of Japanese firms, as a result of their increased importance as shareholders of the Japanese firms.

The reason why this change in share ownership affects the management of the Japanese firms is that foreign investors and institutional investors place great emphasis on their return on investment, as demonstrated by Kusumi and Kawakita (1998). Accordingly, business firms have no choice but to attach importance to efficiency indexes, such as return on equity (ROE), in place of traditional indexes relating to business growth. This change may be regarded as a correction of the vacuum of corporate governance in Japan and a shift toward an efficiency-centred corporate governance. Thus, it is a welcome development.

Another important change is the gradual transition of the Japanese financial system from a traditional bank-based system to a market (security)-based system or Anglo-American type of system. According to recent research (Allen and Gale 2000, chapter 13; Mayer 1998), as seen in Table 6, we can evaluate financial systems from the viewpoint of information processing and allocation of risk in the economy. And we can say generally that a bank-based system is more suited to 'process innovation' (in terms of industries, automobiles and electric and electronic appliances industries), while a market-based system is more suited to 'product innovation' (the computer industry). Therefore, recent changes in the sphere of corporate finance and governance may be appraised as desirable for the Japanese economy where new investment for innovation has been stagnating for a long time.

It should be noted, however, that such a change does not necessarily mean that the Japanese financial system will come to resemble that of the US or the UK. This is because such a complex system as a nation's financial system is usually composed of various elements each having a unique history, so that it cannot be changed in a short period of time. If we use recent terminology in the literature, the system has 'path-dependency'[9]. This is exemplified most clearly by the unusually large size of public financial intermediaries in Japan (the postal savings and many government financial institutions) representing the prevalence of indirect financing.

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[9] Current institution (Zt) is inevitably formed more or less depending on that of the past (Zt-1). It is important in public policy discussion to recognize this point because it relates to the feasibility of the policy. We must be cautious, however, not to over-emphasize this aspect, since it might risk leading to defeatism. In general path-dependency can be expressed as:

$$Zt = \alpha + \beta Zt\text{-}1 \qquad (0 < \beta < 1)$$

where Zt is a function of Zt-1. The value of parameter β may be regarded as the nature of public policy in structural reform: in the case of gradual policy, the value of β will be near 1, while in a drastic structural reform, it will be closer to zero.

The changes associated with the dissolution of cross-shareholding can be expected to penetrate still further, as far as the labour market. If directors of corporations are no longer appointed from among the company's former employees on the basis of their seniority (length of service with the company), then the practice of long-term employment will be eroded and greater mobility in the labour market and employment will surely result. In short, the dissolution of cross-shareholding will melt down one of the pillars of the Japanese economy, the 'long-term transactional relationship'. If we try to capture this transition in a phrase, then we might call the change in the Japanese economy as a shift from 'relationship capitalism' to 'market capitalism'.

6. Concluding remarks: future prospects and required public policy

There is a possibility that in the future the speed of dissolution of cross-shareholding will accelerate somewhat, as Figure 7 shows. This is because some new factors promoting dissolution have been added in recent years, such as the decline of the importance of the long-term relationship as a result of the diffusion of online and internet-based transactions. Moreover, changes in each of the mutually dependent systems have been taking place recently, so that, if each change exceeds a certain critical point, we may observe accelerated and drastic change in cross-shareholding and other related systems. This may be called the possibility of a 'retro-firing' of institutional complementarity.

The dissolution of cross-shareholdings is expected to produce many favorable results for the Japanese economy, yet there is an important role for public policy to induce changes to achieve a desirable outcome and make the process smoother. Concretely, such a policy agenda includes, among others, (1) institutional improvements so that institutional investors can play an increased role, (2) making more use of holding companies, and (3) improvement of Japanese corporate governance structure so that employees (important stakeholders in the company) can formally participate in company management. Regarding (3), the German system is reasonable and provides a useful model that would permit employees to formally participate in their company's supervision and decision making (Okabe 1999b).

In describing cross-shareholdings, we have tried to accurately outline the available statistical evidence. We have also developed various arguments by reviewing past research and, in some cases, by adding conjectures to reinforce a unified understanding. Yet there are a host of issues left to be either proved empirically or without a clear solution. Additional empirical and quantitative analysis is indispensable for the full assessment of the reasons for the dissolution and the preservation of cross-shareholding. Also important are the roles of trading companies (sogo shosha) and securities companies in the formation as well as in the dissolution of cross-shareholding, especially in relation to corporate groups. More broadly, the question remains as to whether continuing dissolution of the cross-shareholding system and the globalization will cause the Japanese system of corporate finance and governance to converge on some internationally prevailing model norm or whether the Japanese financial system will retain some unique or distinctive features. These are issues of great interest and importance for future research.

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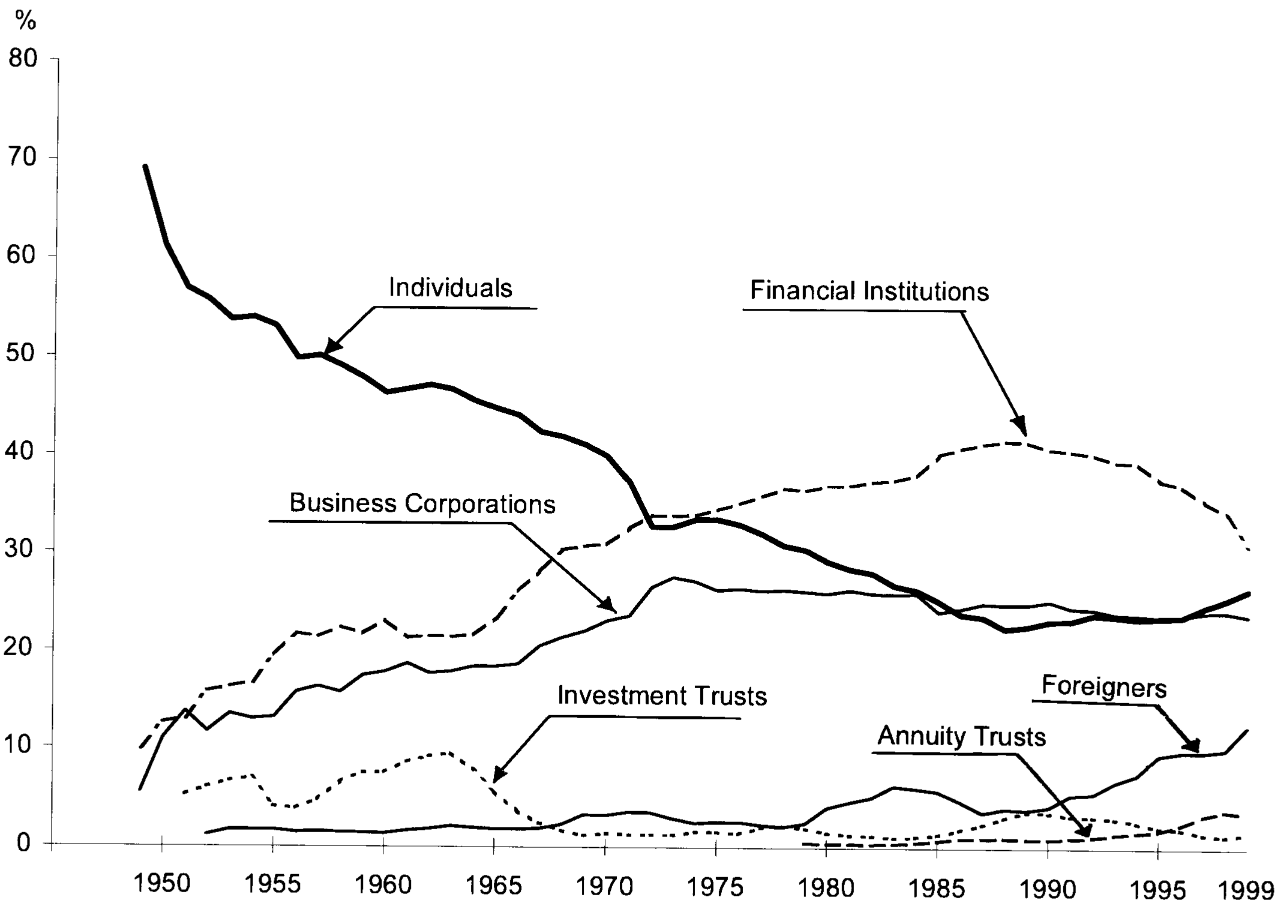
Figure 1 Distribution of share ownership: Fiscal year 1949-1999

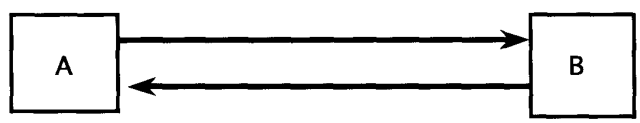


(Notes) 1. Survey has been conducted on a "Unit-of-Share" basis since 1985 Survey.
2. The number of Financial Institutions excludes that of Investment Trusts and Annuity Trusts

(Source) Council of Japanese Stock Exchanges (2000).

Figure 2 Cross-shareholding: the primary sense and a broader sense

(1)Cross-shareholding in a primary sense



Corporation A: Financial firm, or non-financial firm.
Corporation B: Financial firm, or non-financial firm.

(2)'Cross-shareholding' within a corporate group

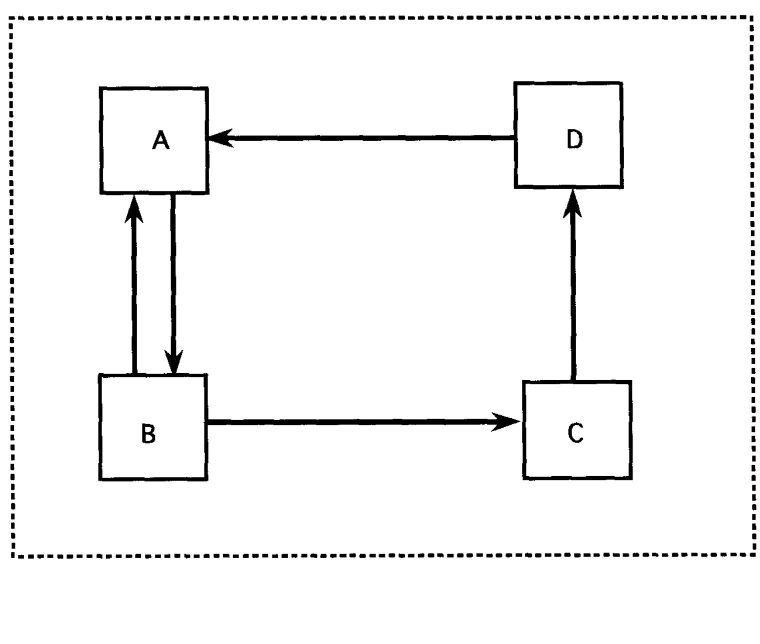


Figure 3 Cross shareholding ratio and its composition: end of fiscal year 1987-1999

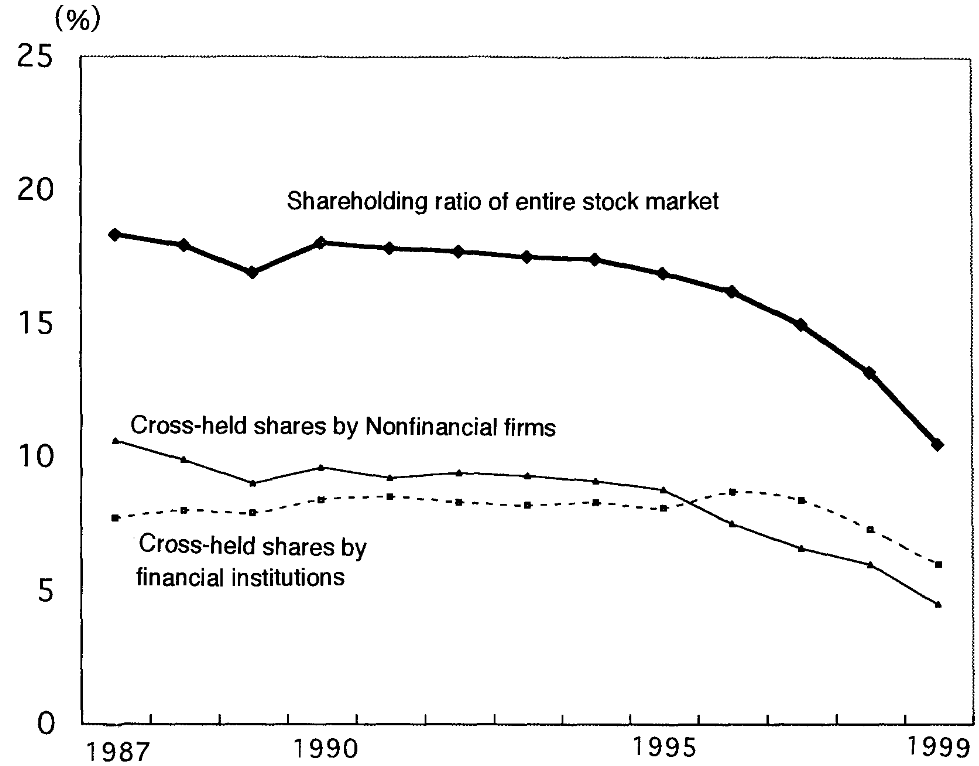
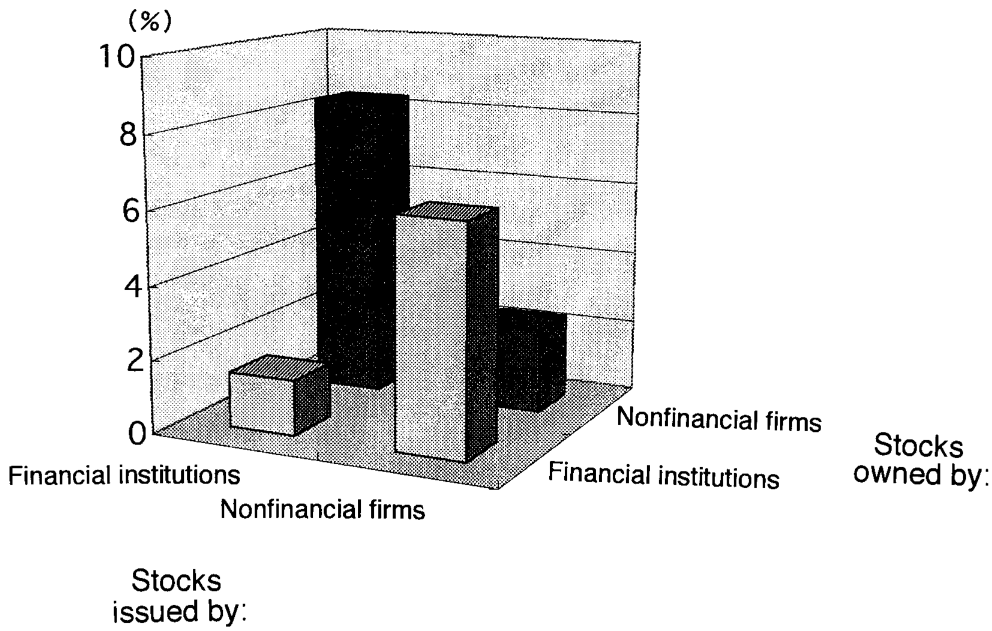


Figure 4 The structure of cross shareholding and its change: 1987 and 1999

(1) 1987



(2) 1999

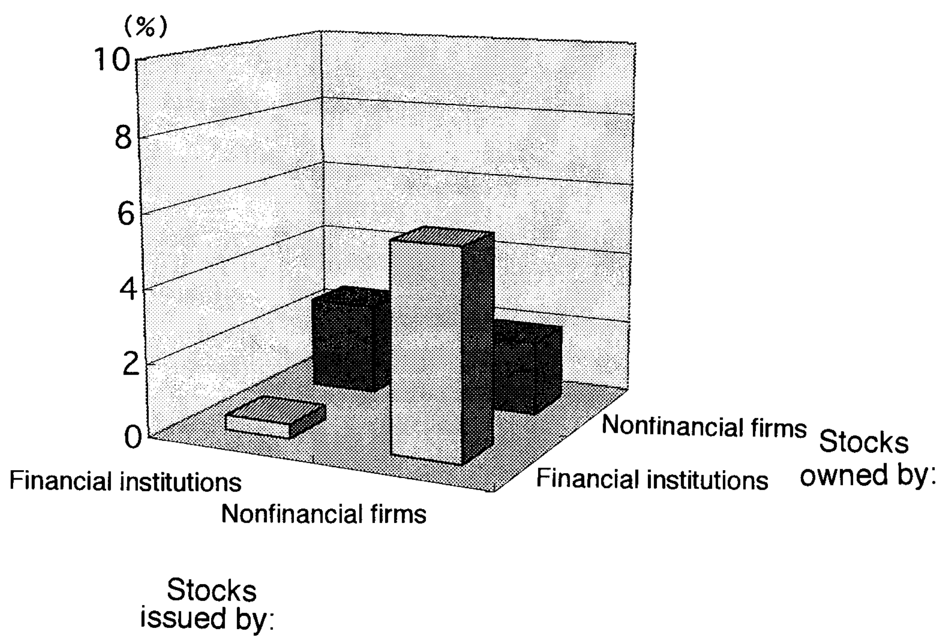
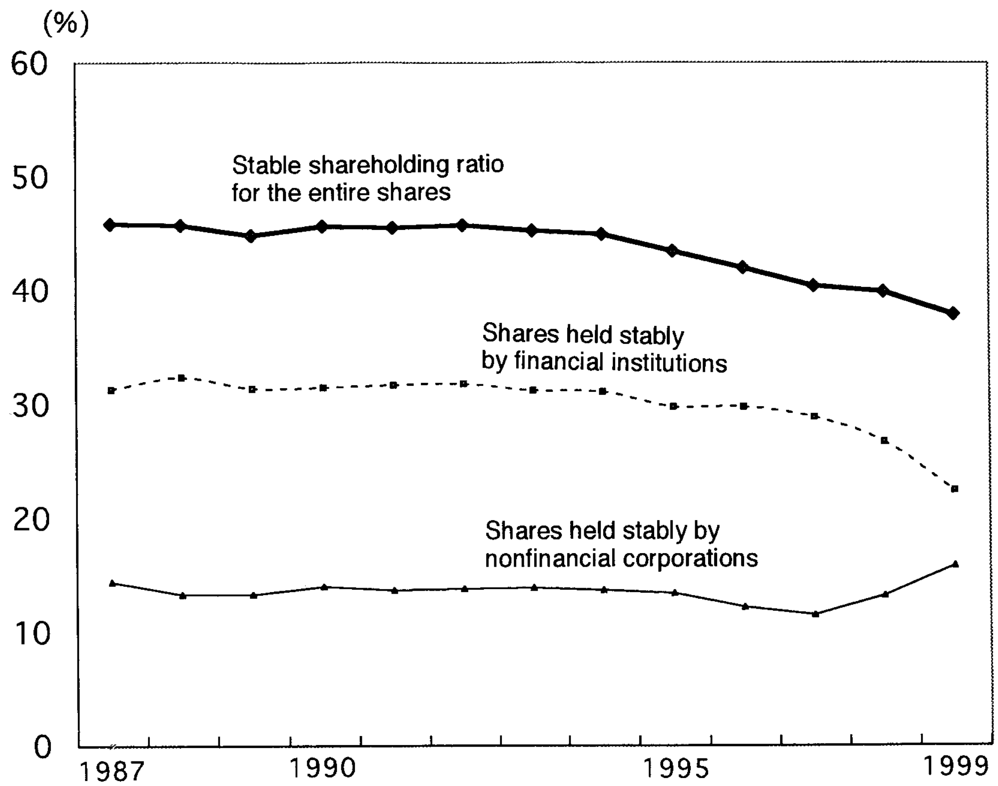
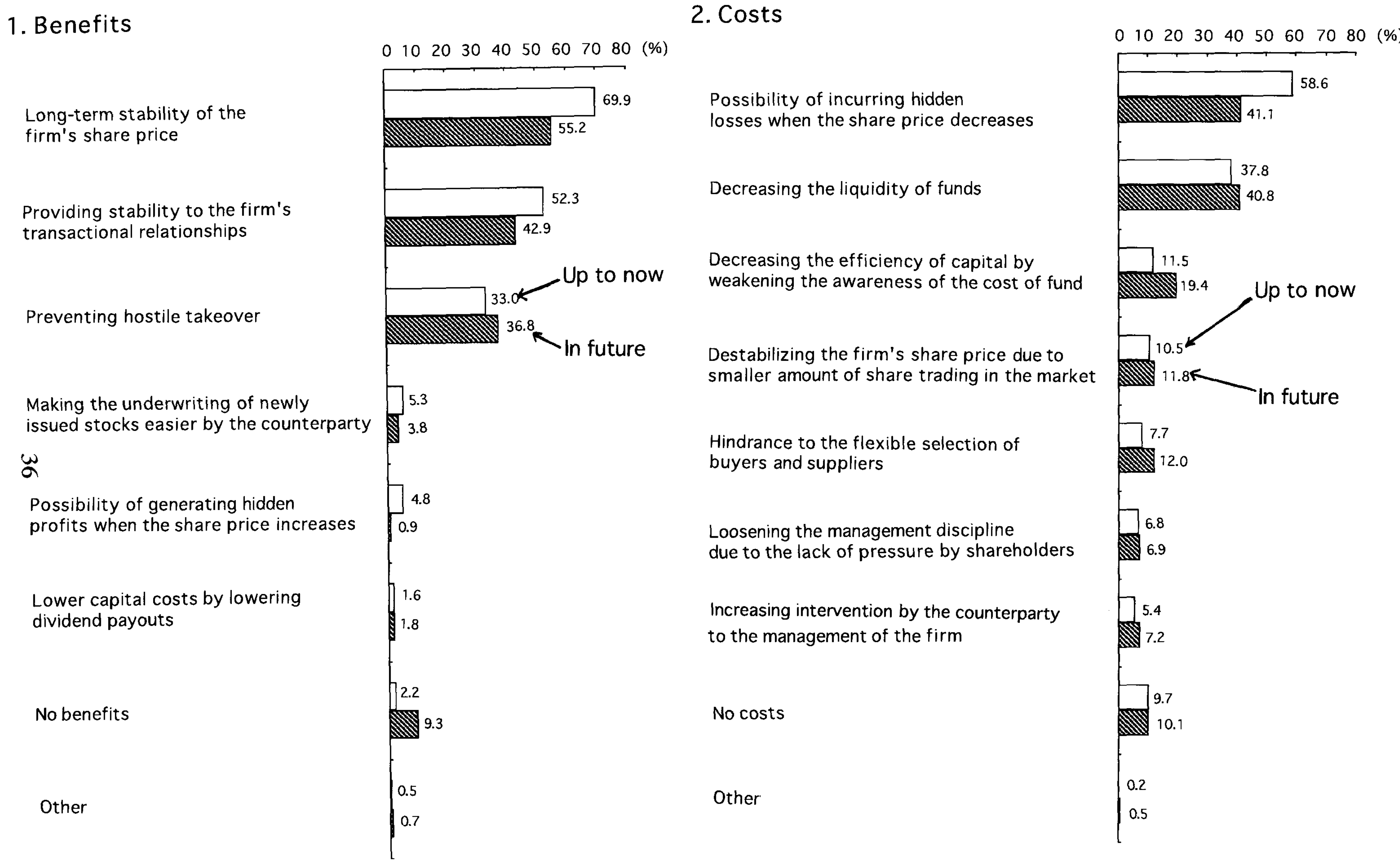


Figure 5 Stable shareholding: by shareholders, end of fiscal year 1987-1999



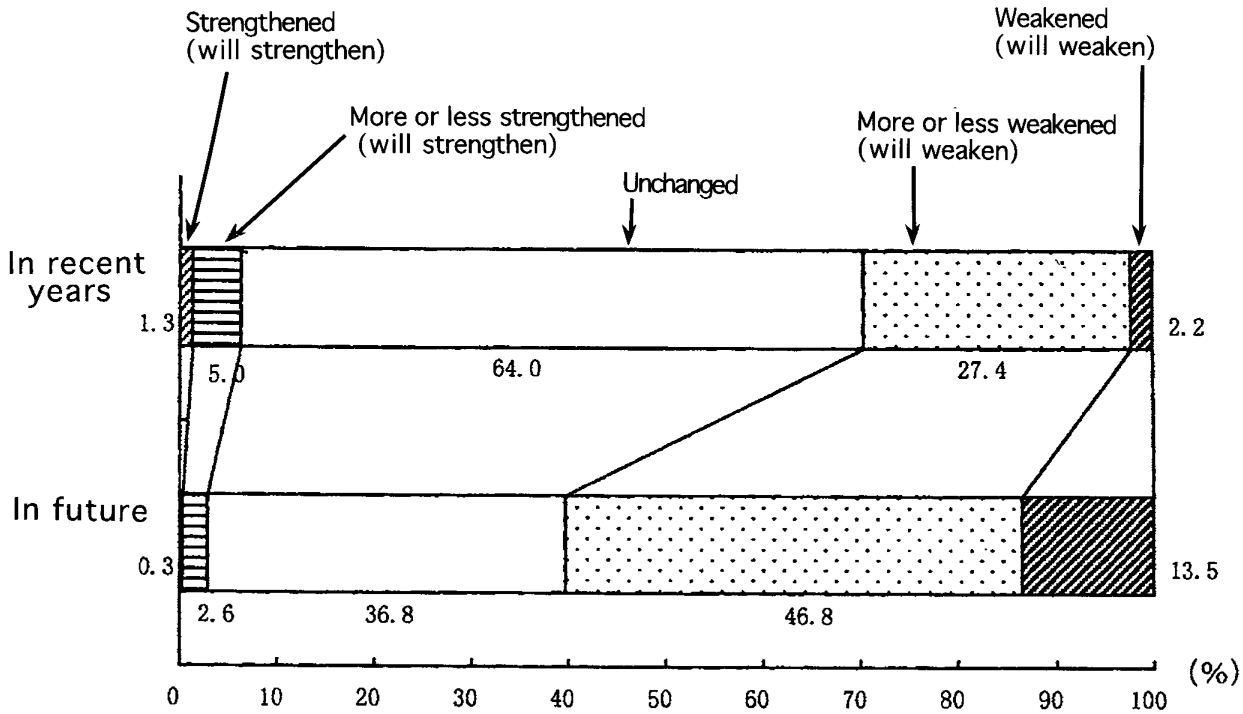
(Source) Compiled from Table 2 in NLI Research Institute (2000).

Figure 6 Benefits and costs of cross-shareholding: up to now, and in the future



(Note) A survey of 1361 non-financial business firms listed at Tokyo, Osaka, and Nagoya Stock Exchanges.
(Source) Economic Planning Agency (1999a).

Figure 7 Changes in cross shareholding relationships



(Source) Economic Planning Agency (1999b) ; originally from Economic Planning Agency (1999a) .

Table 1. A model of cross-shareholding: four cases

		Shares held by:	
		Financial institution	Non-financial firm
Shares issued by:	Financial institution	A	C
	Non-financial firm	B	D

Table 2. Cross shareholding ratio and its composition: end of fiscal year 1987-1999

Year	Shareholding ratio of entire stock market	Shares cross-held by financial institutions			Shares cross-held by non-financial institutions		
			Financial institutions stocks (A)	Non-financial firms stocks (B)		Financial institutions stocks (C)	Non-financial firms stocks (D)
1987	18.3	7.7	1.5	6.2	10.6	8.3	2.3
1988	17.9	8.0	1.2	6.8	9.9	8.4	2.5
1989	16.9	7.9	1.0	6.9	9.0	6.5	2.4
1990	18.0	8.4	1.2	7.2	9.6	7.0	2.5
1991	17.8	8.5	1.2	7.3	9.2	6.7	2.5
1992	17.7	8.3	1.2	7.2	9.4	7.0	2.4
1993	17.5	8.2	1.1	7.1	9.3	6.8	2.4
1994	17.4	8.3	1.2	7.1	9.1	6.6	2.5
1995	16.9	8.1	1.1	7.1	8.8	6.2	2.5
1996	16.2	8.7	0.9	7.8	7.5	4.9	2.6
1997	15.0	8.4	0.7	7.7	6.6	4.2	2.4
1998	13.2	7.3	0.6	6.7	6.0	3.6	2.3
1999	10.5	6.0	0.4	5.6	4.5	2.5	2.0

(Notes)

1. Each ratio is expressed in percentage when the total market value of listed stocks is 100%.
2. Financial institutions include banks, casualty insurance companies, and securities companies (including security finance companies).

(Source) Re-aggregated figures by the author of Table 3 in NLI Research Institute (2000), using the model of Table 1 of this paper.

Table 3. Share ownership situation within the six large corporate groups: fiscal Year 1996

■ Share holding by member corporations within a corporate group		
(1)	Share ownership ratio	55.1%
(2)	Average share holding ratio	1.4%
(3)	Intra-group share holding ratio (of which owned by financial institutions)	21.4%
(4)	Share ownership ratio	(92.7%)
(5)	Average share holding ratio	(12.4%)
■ Ownership of shares issued by financial institutions		
(6)	Share ownership ratio	85.1%
(7)	Intra-group share holding ratio	21.2%
■ Top share holders		
(8)	Percentage of member corporations whose top shareholder is a member corporation	62.4%
(9)	Percentage of member corporations shares owned by member corporations that rank within the top 10 shareholders	36.5%
(10)	Number of foreign investors that rank within the top 20 shareholders	264

(Notes) 1. Figures of (1) through (9) are the average of the six large corporate groups. That of (10) is the total of the six corporate groups (in 1992 this figure was 65).

2. Definitions of various ratios are as follows.

(1) If the share of a member corporation is owned by a member corporation in the same corporate group, the share ownership ratio is the ratio of the number of the former corporations to the number of all the corporations within a group.

(2) The average share holding ratio is the percentage of the corporation's entire shares owned by one firm in the above case (1).

(3) The intra-group share holding ratio is the ratio of the shares owned by member corporations to the entire shares issued by member corporations. Refer also to footnote 3 of Table 3-5.

(4) The share ownership ratio (shares owned by financial institutions) is the ratio of the number of member corporations whose shares are owned by group-member financial institutions to the number of all the corporations within a group.

(5) The average share holding ratio (shares owned by financial institutions) is the percentage of the corporation's entire shares owned by one group-member financial institution in the above case (4).

(6) The share ownership ratio (shares issued by financial institutions) is the ratio of the number of member corporations that own shares issued by group-member financial institutions to the number of all the corporations within a group.

(7) The intra-group share holding ratio (shares issued by financial institutions) is the ratio of shares issued by group-member financial institutions and owned by member corporations to the entire shares issued by group-member financial institutions.

(Source) Compiled from the main text and data tables 7-19 of the Fair Trade Commission (1998).

Table 4. Stable shareholding: by the issuer of the shares, end of fiscal year 1987-1999

Year	Stable shareholding ratio of bank shares				Stable shareholding ratio of shares issued by non-financial corporations			
		Owned by banks	Owned by insurance companies	Owned by non-financial corporations		Owned by banks	Owned by insurance companies	Owned by non-financial corporations
1987	55.7	5.1	16.2	34.4	29.7	10.1	11.9	7.6
1988	55.3	5.2	16.0	34.1	29.3	10.1	12.1	7.0
1989	52.9	5.8	15.3	31.8	29.0	9.8	11.1	8.1
1990	54.6	5.9	15.5	33.1	30.0	10.5	11.2	8.3
1991	54.0	6.4	15.7	31.8	30.6	10.7	11.6	8.3
1992	54.8	5.7	16.0	33.1	30.3	10.6	11.5	8.2
1993	54.4	5.5	15.7	33.1	29.9	10.2	11.0	8.6
1994	53.5	5.7	15.6	32.1	29.4	10.1	10.8	8.4
1995	53.3	5.1	15.1	32.9	28.7	9.8	10.3	8.6
1996	51.2	5.3	15.2	30.5	28.3	10.2	9.8	8.4
1997	48.6	4.9	14.8	28.8	27.2	9.9	9.0	8.4
1998	47.0	3.3	14.9	28.8	27.1	8.3	8.0	10.9
1999	45.5	2.8	14.2	28.5	27.9	6.7	6.2	15.0

(Note) Figures for insurance companies are the sum of life insurance companies and casualty insurance companies.

(Source) Table 4 in NLI Research Institute (2000).

Table 5. Productivity comparison of Japanese industries: financial industry vs. all other industries, 1991-95 yearly average

	Gross domestic product per employee (Thousand yen)	Operating surplus per employee (Thousand yen)	Return on equity (%)
All the industries excluding financial and insurance industries	904	251	13.0
Financial and insurance industries	1146	347	4.6

(Notes)

1. Return on equity = operating surplus / (Shares issued + net worth)

2. Calculated using Economic Planning Agency, Annual Report on National Accounts, 1997.

(Source) Okabe (1999), Table 6.3.

Table 6. Two Types of the financial system and their properties: Anglo-American model and Japanese-German model

	Anglo-American model	Japanese-German Model
Main financial transaction	In the open market	Bilateral transaction
Main funding instrument	Securities	Loan
Dependence on banks	Low	High
Nature of bank loan	Short term	Short term and long term
Importance of internal funds	High	Low
Shareholding by banks	Not important	Important
Major shareholders	Households Institutional investors	Banks Inter-corporate Shareholding
Block share trading	Frequent	Not frequent
Corporate control	Stock market	Banks (main banks)
Information processing	Market acquires and distributes diversity of opinion and risk; Information cost is low	Intermediaries excel in acquiring less diversified information, and enjoy economies of scale in information acquisition
Performance characteristics	More responsive to change	Superior at implementing corporate policies
Suitable economic activity	Developing new industries and new technologies (Product innovation)	Improving the production process and efficiency of existing products (Process innovation)
Industry examples	Railways and computer	Automobiles and electronics

(Source) Okabe (1999) Table1.2; with the bottom part of the table expanded incorporating Allen and Gale (2000; chapter 13), and Mayer (1998).