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Corporate Governance: Editor's Introduction

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Corporate Governance: Editor's Introduction

This special issue includes seven papers presented at the 26th NBER-TCER-CEPR Conference on "Corporate Governance" organized jointly by the Tokyo Center for Economic Research (TCER), the National Bureau of Economic Research (NBER), and the Centre for Economic Policy Research (CEPR). After having a preliminary meeting at the Development Bank of Japan (DBJ) on December 8-9, 2016, the conference was held at Kojima Hall in the University of Tokyo on June 22, 2017. The papers have gone through the regular refereeing process of the journal and have been revised on the basis of comments and discussion at the conference, as well as comments from anonymous referees.

Economic research on corporate governance used to focus on the potential conflict of interest between the managers of corporations and the shareholders. Recent research expanded the set of entities that could be adversely affected by corporate actions (or inactions). For example, Shleifer and Vishny (1997) defined corporate governance as "the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment." Suppliers of finance includes not only shareholders but also banks and other creditors of corporations. The notion of corporate governance was broadened even more by Tirole (2001), who defined it as "design of institutions that induce or force management to internalize the welfare of stakeholders." This stakeholder view (as opposed to the shareholder-centric view) is now standard in the modern discourse on corporate governance.

According to the stakeholder view, companies are operated with full recognition of responsibilities to a range of stakeholders, which includes not only shareholders and other financiers but also employees, suppliers, customers, local residents, and sometimes society in general. Corporate governance is the system by which a company is directed and controlled to fulfill such responsibilities. It consists of the rules, practices and processes through which corporations' objectives are set and pursued in the context of the social, regulatory and market environment. Interest in the corporate governance practices of modern corporations, particularly in relation to accountability, increased following the high-profile scandals of a number of large corporations during the last decades. In recent years, initiatives for the corporate governance system have significantly accelerated in many advanced economies. Further improvements of corporate governance, e.g., making the governance function not only formally, but also effectively, continue to be a major agenda for many policy makers and international organizations. Such efforts would succeed, however, if a virtuous economic cycle is established.

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The papers in this issue tackle some of these questions and provide the most recent attempts to answer those. The paper by Allen, Carletti, and Grinstein studies firm level decisions in response to the 2008 financial crisis. Using firm-level data in France, Germany, Japan, the UK, and the US, they find significant differences between the responses of US and non-US firms. The differences are, in general, explained by differences in financial leverage, but the differences in corporate governance between the US firms on one hand and the firms in Germany and Japan on the other drive these responses. US firms are more prone to cut labor costs and reduce leverage compared to German firms and Japanese firms in order to obtain larger profits and cash-cushions in the short-run.

The paper by Miyajima, Ogawa, and Saito examines the turnover of top executives in Japanese firms during the period 1990-2013. They find that top executive turnover sensitivity to corporate performance has not changed despite recent skepticism on the corporate governance of Japanese firms. On the other hand, there is the shift from return on assets (ROA) to return on equity (ROE) and stock returns as performance indicators that turnover is most sensitive to. They suggest that this shift could be partly attributed to the increases in foreign institutional investors' ownership, indicating that they began to play a disciplinary role.

The paper by Morck and Nakamura shows that Japan's successful industrialization in the late 19th and early 20th century largely exhausted its abundant natural resources. They show how laissez-faire government successfully transplanted classical liberal institutions, including active stock markets, and exorcised a natural resources curse that undermined its prior state-led industrialization strategy in the pre-WWII Japanese economy. They argue that Japan's post-WWII reconstruction relied little on natural resources and more on bank financing. The state continued to exercise influence on the economy, but their involvement was not as direct as that during the initial industrialization.

The paper by Ikeda, Inoue, and Watanabe empirically tests the "quiet life hypothesis," which predicts that managers who are subject to weak monitoring from the shareholders avoid making difficult decisions such as risky investment and business restructuring, using Japanese firm data. They find that entrenched managers who are insulated from the discipline of the stock market indeed avoid making difficult decisions such as large investments and business restructures. When managers are closely monitored by institutional investors and independent directors, however, they tend to make difficult decisions more often.

An important aspect of corporate governance is the assessment of managers. When managers vary in ability, determining who is good and who is not is vital. But the assessment of managers would be more complicated if the assessors suffer from one of many well-documented cognitive biases. The paper by Hermalin explores this issue by considering the consequence of one such bias, the base-rate fallacy, for two of the canonical assessment models: career-concerns and

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optimal monitoring and replacement. He finds that although firms can suffer from the base-rate fallacy, they can also benefit from this bias.

The paper by Hoshi, Koibuchi, and Schaede assesses changes in the role of the main bank in guiding corporate turnarounds of distressed firms in Japan between 1981 and 2010. They also investigate the economic consequences of these changes. They find that even though the frequency of distress did not decline, restructuring of such firms became less frequent after the 1990s, indicating a decline in the governance and rescue role of the main bank. The findings underscore changes in Japanese corporate governance, in particular regarding the decline of the monitoring and restructuring function of the main bank.

The paper by Motta and Uchida examine the impacts of "Principles for Responsible Investment (PRI)" on the Japanese firms. They find that institutional ownership in 2005 is positively related to the probability of subsequent improvements in environment ratings for Japanese firms. The result is especially evident for domestic institutional shareholders who signed up for the PRI. These results suggest that government setting principles for institutional investors can enhance responsible business practices even without legal enforcement.

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