The firm is an incentive mechanism where the autonomy of human capital providers and the monitoring power of monetary capital providers incentivize each other to maximize their own payoff. In post-war Japan, internal governance developed so strongly that it was called “company community”, while external governance was restricted by cross-shareholding. After the Japanese economic bubble of the 80’s, when conflicting interests between human capital providers and shareholders free cash-flow became obvious, the system began to malfunction. Since the mid-90’s, cross-shareholding has been declining and shareholder activism has been rising.

Now an increasing number of executives are ready for open dialogue with institutional investors. Japanese-style external governance will, however, be neither American-style institutional activism, nor British-style engagement. Japanese-style engagement will be even less confrontational than the British “behind-closed-doors”, and institutional investors will play the role of an internal catalyst inducing management’s initiative from within.

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