BOOK REVIEWS*


Paul Sheard deserves a lot of credit for helping to make Japanese business practices comprehensible to economists and providing nontechnical readers with an understanding of Japanese industrial organization that is devoid of the usual nonsense about unique Japanese cultural practices which makes most such studies unbearable. Over the past hundred years, various scholars have treated us to the Japanese version of Frank Capra's *Mr. Smith Goes to Washington*. In these books, Washington is replaced by Japan, and the part of Mr. Smith is, of course, played by Adam Smith, who, believing in the purity of neoclassical economics, is almost destroyed by the machinations of Japan. Unlike the Frank Capra character, who is eventually saved by the goodness of the common person, our Mr. Smith can only be saved by the aggressive unilateralism of the U.S. trade representative. Many of the authors in *International Adjustment and the Japanese Firm* have set about to rewrite this story of Japan, replacing Mr. Smith with the two Olivers (Hart and Williamson), and find that while the story is less dramatic, it is far more believable.

The book contains 11 chapters aimed at both providing a general introduction to some of the insights of contract theory and attempting to apply this framework to specific Japanese markets. The theoretical framework underlying much of the analysis is laid out in 2 chapters, one by Paul Sheard and Christopher Findlay and the other by Masahiko Aoki. Sheard and Findlay provide a nice summary of the work of Coase, Hart, Holmstrom, Williamson, and others and give us a sense of how this work applies to Japanese corporate organization. Their basic point is that in order to understand the nature of corporate organization, one must first understand the theory of contracts and organizations. The argument put forward is that while the theory of perfectly competitive markets is probably not

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a good paradigm for understanding the behavior of Japanese firms, a tremendous amount of insight can be gained by trying to understand Japanese corporate organization through more recent theoretical constructs.

No one has done more to bring Japanese industrial organization into the fold of mainstream analysis than Aoki, and his chapter provides a nice critique of some of the earlier work on Japanese firms as well as a discussion of some of Aoki’s more recent work. Aoki’s approach to the Japanese firm is to view it as the result of a “nexus of contracts,” both implied and explicit, among workers, managers, and creditors. He argues that any analysis that leaves out the interests of any of these parties, especially those works that have focused primarily on the interactions of workers and managers, is likely to miss many important features of Japanese firms. For example, he points out that despite all the talk of how Japanese firms do not worry about shareholder interests, with the exception of the recent crash, the performance of the Tokyo Stock Exchange has been one of the best in the world. This fact clearly demonstrates that despite the conventional wisdom that the Japanese firm cares principally about the interests of the workers, the interests of shareholders are clearly not being ignored. In fact, as Aoki shows, caring about workers’ welfare is not necessarily at odds with the interests of creditors and can improve the overall performance of the firm.

In contrast to the first three chapters covering the more theoretical issues, Chapters 4 through 11 provide a series of case studies that are inspired by the recent advances in contract theory. Motoshige Itoh tries to explain Japan’s distribution market in terms of Coase’s theories. Sheard examines two issues: first, what role does the general trading company play in the Japanese economy and, second, how did the Japanese banks and government cope with the decline of the aluminum industry. Colin McKenzie provides an interesting treatment of why life insurance companies, which are not stock companies, are stable shareholders in other companies. Banri Asanuma discusses manufacturer–supplier relationships in the automobile industry. Ken-ichi Imai presents his thoughts on Japanese strategies toward the development of international networks. Christopher Findlay, James Crowley, and Melissa Gibbs have a chapter detailing the complexities of exporting produce from Australia to Japan. Finally, Peter Forsyth and Neil Smith present a detailed discussion of how the Japanese tourist industry operates.

These chapters differ quite substantially in terms of how well they integrate economic analysis with the cases that they seek to analyze. Of the later chapters, I would like to highlight a few of those that I found the most convincing. Sheard’s treatment of the general trading company has already appeared as an article in this journal and really is the most coherent treatment of trading companies that I have seen. Sheard argues
that these institutions essentially diversify default risk between buyers and sellers who do not know each other. Since firms without established reputations may not be able to credibly commit to either paying or delivering goods, using an intermediary, like a general trading company that has the ability to credibly punish defaulters by not handling any more of their sales, may facilitate short-term transactions between parties who will not repeatedly deal with each other. But why do trading companies handle sales between companies who repeatedly deal with each other? Here, Sheard argues, the primary role of the trading company is to provide trade credits "by allowing the length of credit on the purchaser side to be longer than that on the supplier side." This argument neatly ties together how trading companies can reduce the transaction risks and resolve capital market failures. One issue that I would have liked Sheard to have spent a little more time grappling with is why trading companies are quite common in Japan but are less important elsewhere. Other countries have developed other types of institutions to deal with these markets failures and some discussion on the differences between institutions would have strengthened Sheard’s analysis. These comments notwithstanding, however, Sheard’s analysis is the most compelling that I have seen.

McKenzie’s chapter seeks to answer the question of why life insurance companies are stable shareholders in other firms even though the usual arguments for cross-shareholding cannot apply since these firms are mutual companies. He argues that the Ministry of Finance regulations on life insurance premiums create rents for these companies. Since price competition is not allowed, these firms compete for group policies with firms by offering to become stable shareholders. Once again we see that features of the Japanese economy which might appear irrational to someone unfamiliar with the legal or regulatory environment of Japan are easily explainable if one understands economics and the institutional framework in which Japanese agents act.

Next, Itoh takes on the thorny issue of whether the Japanese distribution system is efficient. Itoh argues that the Japanese distribution system can better be understood in terms of contract theory than as a means of keeping out imports. He presents evidence showing that distribution margins in Japan are actually lower than those in the United States. While I think that this kind of information is suggestive of a lack of monopoly power on the part of distributors, I am less convinced about what this information says about efficiency. If inefficiencies in Japan produce an excess number of small stores and thereby raise costs, this may raise prices but also may result in lower margins. Even so, I think that Itoh is on the right track in stressing that before we can come to any conclusions about the relative efficiency of distribution in Japan, we must obtain a better understanding of the economics of relational contracting in this sector.

As an economist involved in empirical research on Japan, I cannot help
but say that the book left me a bit hungry for some econometric exercises backing up the claims. Some of the authors, like Asanuma, have done a number of empirical studies of these topics, and it would have been nice to have had the authors test whether the data bear out their contentions. For example, if trading companies serve an important role in providing trade credit, do we see liquidity-constrained firms relying more on trading companies than other firms. Similarly, if stable shareholding is costly to life insurance companies, do we see more changes in shareholding during periods when the rents due to Ministry of Finance policy are unusually high? Kiyohiko Nishimura’s recent work on Japanese distribution suggests that the Large Scale Retail Law alters the size distribution of stores in Japan. Is there some way that we can estimate efficiency losses due to these and other regulations governing this sector? While empirical chapters would have rendered the book more technical, they might also have made the arguments stronger.

A second issue which never became clear was why the title emphasized “international adjustment.” With the exception of Imai’s chapter, most of the chapters have very little to do with international adjustment. Some deal with Japanese exports and some deal with imports but one does not get a good sense about how Japan’s increasing integration into the global economy through liberalization of financial and product markets has changed the very structures that the authors seek to explain. Imai provides a treatment of the decision to source from abroad from a management consultant’s perspective, but we get little sense about how Japanese firms themselves have been changing. Many of the arrangements discussed in this volume are the direct result of capital market failures. As financial markets have been liberalized, many of these failures have been mitigated, resulting in substantial changes in the way that Japanese firms are likely to operate in the future. For example, deregulation of the Japanese insurance market is becoming an increasingly important component of U.S. trade policy toward Japan. If the United States is successful, this is likely to have a profound impact on the rents that McKenzie argues are important in making life insurance companies stable shareholders. Some discussion of how life insurance companies are likely to adjust to these pressures would have been nice as well. Similarly, one might expect some of the capital market liberalizations to also affect the importance of trading companies in Japan.

Finally, like many edited volumes, it is hard at times to find a theme in the various chapters. The first six chapters seem aimed at explaining Japanese institutions to economists in a nontechnical fashion. The last five chapters seem to be more concerned with describing the specifics of particular Japanese institutions. Perhaps the objective was to show how far many types of transactions are from the world of perfect competition,
but, to be honest, I found the detailed discussions of some of the transac-
tions involved in international trade at times too detailed for my taste. 
Had these discussions been more closely tied to theory or to distinctive 
outcomes, I think that the chapters would have been more successful. I 
imagine that most readers are going to want to pick and choose which of 
the chapters they will read and those interested in garnering a general 
understanding of the issues at hand will focus on the first half of the book 
and those more interested in particular markets will focus on the later 
chapters.

Overall, however, International Adjustment and the Japanese Firm is 
an enjoyable book that provides a solid introduction into the recent re-
search applying modern industrial organization theory to Japan. I would 
certainly put it on my required reading list for students and others inter-
ested in getting an introduction to recent work on the Japanese economy.

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