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FINANCIAL MARKET LIBERALIZATION AND THE CHANGING CHARACTER OF CORPORATE GOVERNANCE*

By

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1. Introduction

Corporate governance is concerned with the implementation of monitoring and disciplining devices that will ensure the efficient use of available resources by private corporations. It became a popular topic in the U.S. when observers lamented the apparent loss of industrial leadership to companies in Germany and Japan during the 1970s and 1980s. Today, the U.S. economy appears to be vigorous again and issues of corporate governance systems and their reform are widely discussed in the stagnant economies of Europe and Japan. This paper will attempt to contribute to this discussion by turning to the impact of the ongoing transformation of international capital markets on governance and its effectiveness.

We will start by providing different definitions of the nature and scope of corporate governance. Governance issues are conventionally discussed in the context of principal-agent (PA) models, which presuppose a distinction between ownership (shareholders) and control (managers) (Berle and Means 1932). The agency problem exists because managers might misuse their position and there are costs associated with prevention of abuse. According to this view of governance the crucial problem is to subordinate managers' interest to that of shareholders. Shareholders are put into this superior position because they have the greatest incentive to guarantee the company's success. This is the case due to the fact that they are the *residual claimant*, i.e. they receive the profit that is left over after lenders, suppliers and employees are paid. Similarly, they alone bear the *residual risk* because shareholders in contrast to lenders or supplier lose everything should bankruptcy occur. The following section will discuss Michael Jensen's approach to the agency problem.

Blair and Stout (1997) propose an alternative to agency theory with its narrow focus on shareholders as owners and managers as their agents. Following Alchian and Demsetz's (1972) seminal contribution, they argue instead that public corporations evolved primarily as a solution to the 'team production' problem. Team members face the problems of shirking and rent seeking which cannot easily be resolved by contracts, especially when team production processes are increasingly continuous and complex. Through a mediating hierarchy, members give up important property rights as well as inputs, such as financial capital and firm-specific human capital, to the fictional legal entity created by incorporation. According to the authors, the mediating hierarchy approach suggests that managers should not be under direct control of any particular stakeholder group—including shareholders. The corporation is then best seen not as a nexus of implicit and explicit contracts, but as a solution to complex decision-making processes. Many and varied individuals give up control over their firm-specific investments to an independent third party in hopes of sharing in the economic gains that can flow from team production. They thus dispute that shareholders are the only group that assumes the residual risk. Employees who invest in firm-specific assets also stand to lose from the company's bankruptcy.

Alfred Chandler's model of managerial capitalism is similar to Blair and Stout's view in that he also identifies a crucial role for managerial autonomy. In contrast to the principal-agent model as developed by Berle and Means, which interprets managerial autonomy as a passive response to dispersed stock ownership patterns, Chandler argues that managerial discretion developed in order to accumulate the organizational knowledge as a crucial ingredient for the growth and sustainability of the corporation, in particular, in the capital-intensive industries (Hikino 1997:483). The distinction between managers and owners is thus not just a nuisance, which is costly to overcome but a necessary competitive asset in modern capitalism. The next section will present a more detailed description of Chandler's managerial model.

The choice of governance mechanisms is by no means only a reflection of economic incentives. It is also inherently political, shaped by a regulatory framework that is set by the state. Moreover, it is subject to historical change. Fligstein (1990), for example, provides a historical account of corporate transformation based on a sociological framework for the case of the United States. For Fligstein, organizations are embedded in organizational fields defined in terms of product line, industry, firm size or suppliers, distributors or owners. The state sets the rules of behavior within which corporations employ strategies, structures, ad technologies, which shape and constrain their patterns of growth. These organizational fields are not benign but are set up to benefit their most powerful members. Thus Fligstein introduces the power dimension which is missing from the previously discussed approaches.

He argues that corporate strategy in the 19th century consisted of predatory competition. The manufacturing and managerial conception of control was developed by absorbing suppliers and marketing functions into their organization in an attempt to stabilize the production process through oligopolistic pricing. Finally, the currently dominant conception of the corporation emphasizes the use of financial tools, which measure performance according to profit rates. Fligstein demonstrates that corporate control mechanisms are not adopted because they are most efficient but rather they have come into existence as a result of a social and political process that defines and redefines the character of markets.

This paper will adopt a similar historical perspective on changes in the nature of corporate governance systems. We will argue that the deregulation and internationalization of financial markets has changed the macroeconomic incentive system in particular through raising the real interest rate. Higher interest rates are an expression of the increased power of creditors over borrowers in liberalized financial markets. In the United States this has lead to a shift from a corporate governance system with relative managerial autonomy to a system dominated by the financial interests of shareholders. Financial considerations are beneficial in some instances but damaging in others.

The argument will proceed in several steps. We will first compare and contrast the managerial with the agency view of governance. Secondly, the liberalization and deregulation of financial markets will be linked to higher real interest rates. Thirdly, it will be shown how higher real interest rates put pressure on managerial autonomy thus shifting incentives towards financial market dominance in the United States. Fourthly, we will examine the rise of the large institutional investors and discuss their ability to provide a solution to the governance problem. Lastly, we will present a brief overview of other countries' experience with financial liberalization and its impact on corporate governance.

2. Managerial autonomy vs. financial market dominance

The following section will compare the agency view of governance as proposed by Michael Jensen with Alfred Chandler's managerial model of capitalism. The former stresses the efficiency of financial markets as disciplinary whereas the latter sees a need for the relative autonomy of managers who are in turn kept in check by Schumpeterian competition in product markets.

Michael Jensen (1986; 1997), one of the foremost proponents of agency theory assumes the efficient market hypothesis (EMH) according to which financial markets process information efficiently thereby generating optimal asset prices. The strong form of the EMH states that security prices fully reflect all available information and thus makes the assumption of no trading costs. In the weak version, preferred by Jensen, prices reflect information to the point where the marginal benefits of acting on the basis of information—i.e. the profits from this action—do not exceed the marginal costs.

Based on this believe in the efficiency of financial markets Jensen defends the role of capital markets in product market restructuring. In particular, he has been a staunch supporter of the Leverage Buy-Out (LBO) and Merger & Acquisition (M&A) activity of the 1980s. According to this view the market for corporate control is a fast and efficient mechanism by which firms are forced to exit mature markets where overcapacity persists. Product markets will also provide similar pressures if companies cannot produce the products customers desire and therefore will eventually be unable to generate sufficient profits. But, according to Jensen, the disciplinary effect of product markets operates much more slowly and therefore is socially wasteful. Bankruptcy procedures in the US, for example, are a long and drawn-out process, which strive to maintain the operation of the firm in order to protect creditors as well as employees.

Furthermore, internal control systems are also too slow to respond to market challenges. He cites the example of General Motors where the board intervened too late to change GM's high cost production structure leading to substantial losses in the early 1990s (Jensen 1997:31).

What he fails to mention is the success of GM and in fact the entire US auto industry to regain market share from the Japanese and their ability to design new products and streamline their production facilities over the last decade. In addition, the early 1990s were characterized by a severe business cycle downturn in the US, which certainly contributed greatly to the losses. The problem with Jensen's account of the US auto industry is his conception of the nature of product market competition. The appropriate strategy for Jensen would have been simply to cut cost by closing plants and firing managers and workers in order to adjust to existing worldwide overcapacity. But this assumes that cost and thus prices are the principal competitive assets in the automobile business. Instead, one could argue that the success is based on adopting a more long-term perspective, which took time to develop and implement. It is also reasonable to argue that the success was dependent on the cooperation of workers and their unions. Managerial capabilities, innovations as well as stable labor relations might go a long way in explaining the success of the US auto industry in regaining competitiveness.

There is also the case of the attempted takeover of Chrysler by a group of investors in 1994/5. The investors were after the cash that Chrysler had accumulated in the previous business upswing. The takeover group argued in typical Jensen style that the cash should be disbursed to shareholders instead of invested in sub-standard investment projects. Chrysler managers, on the other hand, were planning to invest the cash in costly new model development in order to strengthen the company's long-term competitive position especially vis-à-vis their Japanese rivals and as a financial cushion for the next downturn. The management position eventually won out not the least because management could convince larger institutional investors of the strategy's benefits to long-term shareholder value (Brancato 1997). Chrysler's remarkable comeback from near bankruptcy in the early 1980s based on an innovative product line certainly speaks for allowing management to pursue this forward-looking strategy. The question also arises at what stage a market is matured enough so that exit becomes necessary. The automobile example has shown that a relatively mature product like the automobile presents ample possibilities for innovation and growth (minivans, SUVs etc.). By stripping Chrysler of its cash flow the investor group might have damaged the company's ability in maintaining its competitive position.

There is also evidence that the recent downsizing wave in a variety of industries might have gone too far in some cases depriving companies of valuable managerial knowledge. A study by Wayne Cascio (cited in Blair 1996) on the effects of massive downsizing shows that three years after downsizing, sample companies had subsequent earnings increases of 183%. Comparison firms in the same industries that did not downsize had earnings increases of 422%; cumulative stock returns over three years were 4.7% vs. 34.3%. The study concludes that pension fund managers would be justified in encouraging a second look at possibly premature downsizing and 'exit' tactics.

Stock markets, of course, are always enthusiastic about such corporate restructurings because they promise more future cash flow that can be distributed to shareholders. This is also the main reason to explain the evidence that takeover activity is positively correlated with the business cycle; there is simply more cash flow available, which can be targeted by corporate raiders. The threat of hostile takeovers can thus act as a corrective device only in business cycle upswings when liquidity is abundant as in the takeover frenzy in the later half of the 1980s. Similarly, the occurrence of merger activity in waves again suggests the cyclical nature of takeovers as disciplining device. This suggests the existence of other incentives at play, which activate the market for corporate control. We will see in the next section that high real interest rates play a large role in the changed incentive structure.

In contrast to agency theory another strand of corporate governance theory focuses less on capital market discipline. Alfred Chandler's framework of managerial capitalism starts from the existence of an information asymmetry between managers who run the company and outside evaluators like shareholders or financial institutions (Hikino 1997). To succeed in constantly changing product market conditions management needs to accumulate knowledge about product and factor markets as well as production technology in the industries in which they operate. Management is in a superior position to gather and utilize such knowledge compared with shareholders, debt holders, customers, employees and government because management not only constantly gathers and evaluates information, it also continuously has to apply this information in order to run the firm. Outsiders simply do not have the time and resources to collect and utilize this type and amount of information (Taylor 1990).

For Chandler ownership per se is not necessarily the issue. The critical element is the long-term commitment and capacity of management including the compatibility of the managerial structure with the structure and business of the firm. The Chandlerian story is especially applicable to the growth of dynamic capital-intensive industries--Chandler's 'engines of growth'. Because firms in capital-intensive industries often face critical decisions of large-scale investments that are discontinuous and uncertain, they must create an organizational learning device to minimize risk and maximize the benefits of such investments (Chandler 1990). Hence, the ability of managers to exert discretionary power in strategic decision making is the key ingredient for the success of managerial capitalism.

But who controls these managerial decisions in order to avoid waste and corruption? Who ensures that managers will continuously invest in the accumulation of organizational capabilities? Given the tacit, fungible and non-patentable nature of this internal organizational knowledge of technology and markets, such knowledge does *not* realize its full potential in external market transactions (Hikino 1997; Winter 1993). The ability of capital market institutions to match this information-processing activity is limited because it requires actual and ongoing experience of production processes whereas external actor's knowledge will always be conceptual and theoretical. Technical knowledge of financial institutions will be helpful in devising investment strategies but cannot substitute for the accumulated, firm-specific knowledge of the manufacturing firm. Taking these fungible assets into account Jensen-style restructurings may damage companies in a way that is not measured by conventional financial indicators. Jensen therefore implicitly has to assume the existence of a conventional production function according to which factor inputs are turned into products by means of a given technology. Chandler's framework on the other hand incorporates the idea of learning and technological changes as endogenous processes with investment characteristics (Winter 1993).

In the Chandlerian model the ultimate disciplinary of management is the constant pressure from Schumpeterian competitors in domestic and international product markets. These markets decide whether managers have invested wisely and adopted the right strategy or whether the company is unable to provide the right product for their customers at a competitive price. While Jensen might have a point in that this type of restructuring takes longer and incurs higher 'measurable' cost it nevertheless ensures that crucial managerial or otherwise firm-specific knowledge is maintained during the restructuring process. In fact, since organizational capabilities do not show up in conventional accounting numbers the flow of resources into maintaining them may be confused with truly wasteful expenditure which does not add value to the firm. Hence, the amount of free cash flow that triggers Jensen-type restructurings is not easily determined and might be overestimated. The observable shareholder gains resulting from takeovers might thus simply result from cuts in investment in intangible, non-marketable assets or wage concessions.

Similarly, Blair (1995) argues that owners view employee wages as a cost to be reduced, yet, the return on firm-specific human capital is part of what society as a whole should want to see maximized. Employees are much more likely to participate in cost cutting and innovation if they are confident they will share in the wealth created. Corporate governance discussions need to recognize the importance of employees to wealth creation. Kreps (1990) develops a model in which the firm's sole asset is its reputation not to exploit business partners. Owners have an interest in maintaining this reputational capital because it allows for profitable transactions based on mutual commitment of the transactions partners. This model underscores Blair's previous point that firms have to induce employees to share some of the costs of firm-specific training due to the uncertainty about future returns on this investment. The point again is that these fungible assets play a large role in creating firm competitiveness but are absent from financial accounting and other conventional performance measures.

Hikino (1997:490-1) interprets the differences between Jensen's agency approach and Chandler's model of managerial capitalism as resulting from differences in their analysis of economic change. Chandler focuses on the ability of the large managerial enterprise to enter new markets by building upon accumulated organizational knowledge in medium and high-tech sectors. In contrast, Jensen emphasizes the ability to shift capital out of maturing industries in order to shed overcapacities. Capital market discipline thus assures timely exit from low-tech sectors in which the importance of organizational skills is likely to play only a minor role. This interpretation suggests that one perfect all-purpose governance mechanism doesn't exist but that its design and efficiency is dependent on the character of the industry and in particular the share of intangible assets such as organizational competence.

3. Deregulation, interest rates and the changing nature of corporate governance

The previous section attempted to show that there is no single optimal governance mechanism. Instead, governance is dependent on the nature of the production process and the character of technological change. But it is also likely that the relationship between shareholders and managers is influenced by a number of macroeconomic incentives. In this section we will identify the real interest rate as a crucial macroeconomic variable influencing the nature of governance. Financial liberalization has created an environment, which raised interest rates leading to a shift from relative managerial autonomy to a proliferation of financial goals in the 1980s. The awakening of the market for corporate control in the 1980s is a direct response to this shift rather than a response to managerial failure.

Let's start by investigating the link between financial globalization and rising interest rates. The process of financial globalization is not simply the outcome of technological change, as many observers seem to assume implicitly. Technological advances in information and transport technologies, according to the conventional story, have lowered the transaction cost of international market transactions, which created the basis for the growing integration of our economies. The challenge for market actors—governments, enterprises and workers alike—is to adapt to these new technology-driven opportunities in order to reap their full benefits (OECD 1997). A free market environment is generally identified as the best institutional arrangement to achieve the full potential of globalization. In that view the capital-market based governance system in the US is an optimal institutional response to the challenges and opportunities presented by more efficient international financial markets.

In an alternative, institutional account, the proliferation of new technologies has gone hand in hand with the conscious creation of global markets through market deregulation over the last 25 years. Eatwell (1996) for example argues that pressures for deregulation mounted after the collapse of the system of Bretton Woods. Under the Bretton Woods rules, all other countries' currencies were pegged to the U.S. dollar, with their governments bearing the implicit risks. Most of the time, businesses did not have to be concerned with fluctuating values of their asset holdings, costs, and sales in different currencies, because they were tied securely to one another by the fixed rate system.

A period of fluctuating exchange rates ensued after the U.S. de-linked the dollar from gold, and both non-financial and financial enterprises were forced to cope with the resulting risks. Volatile exchange rates provide an important playing ground for profit-seeking speculation. Regulatory structures, however, inhibited flows of capital and were consequently challenged as inefficient and against the national interest; they were dismantled and the 'infrastructure of speculation' was constructed (Eatwell 1996). Speculation, while certainly possible in a system of fixed exchange rates, became more lucrative after 1973 under the new regime of deregulated currency prices. Since its objective is to earn short-term capital gains from correct guesses about future price movements, this activity thrives on market instability.

The incentive to deregulate international capital flows was powerfully reinforced by the need to hedge against the costs which fluctuating exchange rates imposed upon the private sector (Edey and Hviding 1995). The need to absorb and cover foreign exchange risk demanded the creation of new financial instruments (derivatives such as currency swaps, options and futures contracts) which in turn required the removal of the regulatory barriers limiting the possibilities of laying off risk. There has to be a restructuring of financial institutions. The various new instruments also attracted speculators by allowing them to trade large amounts of currency with little capital. This is why today currency speculation is a significant source of profits for many banks and corporations.

In the US mounting pressures for deregulating financial markets can also be interpreted as the financial sector's response to falling profits and stagnant securities markets during the volatile 1970s. The squeeze on banks was especially severe when negative real interest rates prevailed in the US. During the 1970s ease of credit maintained spending levels but increased the level of overall inflation. This process sustained real capital accumulation but at the direct cost of financial capital (Guttmann 1997). Stock and bond markets, for example, remained stagnant between 1968 and 1982. Inflation involves two opposite price movements, rising output prices in industry and, by pushing up nominal interest rates, falling prices for financial securities. Inflation also hurt lending activity because borrowers could repay their debts with devalued dollars.

The new situation contributed to higher interest rates as banks saw themselves competing for deposits with other intermediaries. Banks then tried to maintain profits by investing these funds in higher-yielding, but riskier assets like junk bonds, real estate, developing countries etc. Deregulation is also one of the main reasons behind the rise in real interest rates since it shifted the balance of power from borrowers to lenders. One indicator for this shift is the fact that banks have tended to move aggressively into variable interest rate loans shifting risk to the borrower.

Free capital markets also severely restrict the ability of governments to pursue independent monetary policies, which could be used to lower interest rates and boost activity. Sensible monetary policies have also arguably contributed to stability in the pre-1973 period. After the deregulation of interest rates there has been a shift from targeting monetary aggregates to interest rate targeting as the dominant monetary policy instrument in OECD countries. In a liberal financial environment, according to Felix (1996), monetary authorities are confined to manipulate the short-term rate. The effect the interest rate policy will have on nominal income is then largely dependent on how the foreign exchange and long-term bond markets respond. The general market response to lower short rates has been to move funds from long-term bonds into domestic equities and foreign securities. This raises share prices and depreciates the exchange rate but increases longer-term interest rates, which runs counter to the initial attempts to stimulate activity.

In contrast, during the era of capital controls, long bond holders, correctly or incorrectly anticipating higher inflation from a credit easing, could shift to shorter-term domestic bonds and equities, but not easily into foreign securities. The reactions of long bond holders thus helped lower short-term rates, reinforcing the effectiveness of manipulating the short-term rate. In the era of financial globalization, however, shifts between domestic and foreign bonds identify and document causal links from financial globalization to these real economic trends (Felix 1996).

The behavior of the bond market is a good example for the increasing dominance of financial market considerations in designing economic strategies. As we have just pointed out the bond market appears to determine its operations on the basis of a presumed link between activity and accelerating inflation. This behavior is based on the idea of a natural rate of unemployment, which suggests that the economy exhibits a persistent tendency to gravitate towards its equilibrium position at the natural rate. But only if we assume that this theoretical model does indeed represent the adjustment mechanism of the economy will a systematic upswing in activity cause accelerating inflation. The frequent re-estimations of the natural rate for the case of the United States seem to imply that the 'natural' rate simply shadows the actual unemployment rate. If the natural rate hypothesis doesn't hold macroeconomic policy might well be successful in stimulating activity in order to raise employment levels. But the possibility of a short-term increase in inflation alarms the bond market and negates the expansionary effect.

How and why do higher interest rates effect governance? Blair (1995:108-10) points to the relationship between the increased activity in the market for corporate control and the high real interest rates in the decade of the 1980s. High real interest rates drive up the opportunity cost to investors for investing in corporate equities while simultaneously reducing the number of attractive investment opportunities for corporations. In the presence of low interest rates companies have an incentive to retain cash flow and reinvest it quickly. When real interest rates are high, however, investing the cash flow is less likely to be optimal for shareholders that put their cash into safer, high-yielding securities. Graph 1 plots the relationship between profit and real interest rates.

In discussing Chandler's model of managerial autonomy we have seen that he justifies the built-in growth drive of managerial enterprises as long as it results from the application of accumulated organizational skills in new but related markets. This model thus has a strong explanatory power in the context of growing markets and in sectors in which technological change is endogenous to the large enterprises (Hikino 1997:491). We have already mentioned the importance of low interest rates relative to profit opportunities in providing a macroeconomic incentive system to sustain this growth orientation. In addition, the rate of growth of demand in general can be identified as a variable representing the desirability of reinvesting company cash flow instead of distributing it to shareholders. The early 1980s therefore not only put financial pressure on managers via higher real interest rates but also because of slowing output growth. In fact, comparing real output growth rates to real interest rates might serve as a proxy for the viability of the growth-oriented managerial model. Graph 2 plots this relationship for the period 1960-1997. There is an apparent break in the early 1980s; growth rates were generally above real interest rates before 1981 and have been consistently below real interest rates since then. In spite of the fall in nominal interest rates and the recovery of profits shown in graph 1 the macroeconomic incentive system continues to put pressure on the managerial model of governance in favor of financial interests.

The merger threats of the 1980s can thus be interpreted as the shareholder response to a changed incentive structure brought about by high real interest rates and low growth. Clearly, macroeconomic factors play a role and should therefore be part of a systems approach to corporate governance. Blair and Stout (1997) argue that "[T]he shift in the balance of power in boardrooms toward shareholders is the result not of directors' sudden recognition that shareholders are 'owners' of the corporation, but from changing economic and political forces that have improved shareholders' relative bargaining power vis-à-vis other coalition members." This interpretation is also compatible with Fligstein's (1990) historical account mentioned in the introduction.

Blair and Schary (1993) present sectoral evidence on the relationship between profits and cost of capital as a proxy for investment opportunities. In order to test Jensen's free cash flow hypothesis this proxy is compared to the rate of cash generation in these industries. The authors conclude that free cash flow was indeed present largely due to the steep rise in the cost of capital in combination with stable or slowly falling cash generation. Their findings also complement other empirical studies, which found higher takeover and merger activity in low tech sectors. Higher real interest rates put more pressure on mature industries with a broad base of revenues from past investments but little room for expansion (tobacco, food processing, retail). Equity prices for these companies would benefit from higher leverage. Fast-growing high-tech companies, on the other hand, are not subject to the same pressure because they usually need more cash for investment than they can generate internally.

There is also considerable evidence linking increased activity in the market for corporate control--especially in the form of leverage buy-outs--to low q-ratios (stock market valuation divided by the replacement cost of real assets) at the beginning of the 1980s (Long and Ravenscraft 1993). Again real interest rates play an important role in explaining stagnant stock markets for three reasons. First, funds get diverted from the stock market to less risky bonds as yields become more attractive. Second, interest costs reduce companies' gross income and thus create lower profits. Third, higher interest rates reduce the capitalization of anticipated income flows, which underlies the calculation of current share prices.

Deregulation of financial markets also contributed to finance-driven governance in a different way. After consolidation in the early 1980s the major Wall Street securities firms began to look aggressively to new profit opportunities. Merger activity became a key source of profits for the financial sector (Guttmann 1994:308-10). Takeovers were also dependent on the willingness of investors to buy new and risky instruments like junk bonds, which were increasingly used to finance these takeovers.

There is also evidence that the merger frenzy towards the end of the 1980s took on a life of its own without responding to any real underlying pressures or incentives (Blair and Schary 1993a). This seems to confirm Keynesian views of financial markets as generating volatility endogenously. What had happened? In the second half of the 1980s stock markets were booming partly as a result of the takeover activity. Takeover activity itself became a powerful vehicle for speculation. Speculators started to invest in stock not because of positive expected earnings or other traditional measures but because the companies might become takeover targets promising quick and large rewards. A company's value was not assessed based on its future earnings ability but by valuing its assets if it were to be dismembered and its parts sold off (Guttmann 1994:311).

In summary, the pressures generated by the collapse of the Bretton Woods system lead to a broad transformation of the financial sector in the form of deregulation and internationalization. After the turbulent decade of the 1970s, which was characterized by high inflation and bearish securities markets, the 1980s saw what Smithin (1996) calls the 'revenge of the rentier', a broad-based re-empowerment of financial interests. This shift and not managerial failure caused the frantic activity in the market for corporate control especially via the channel of high real interest rates and low growth. In the following section we will look at another development in deregulated financial markets, the growth of the institutional investor and its impact on corporate governance.

4. The rise of institutional investors

The growth of the institutional investor (pension and mutual funds, insurance companies, investment companies) is one of the driving forces behind structural changes in both the process of corporate governance and the structure and character of capital markets in the OECD. One of the leading factors behind the growth of financial investors is the deregulation of the banking and securities industries, which has heightened the competition between banks and other financial institutions. Under these pressures banks have increasingly moved into the insurance and investment fund business in search of new activities that generate earnings in the form of commissions and fees.

In the United States the growth of the institutional investor has also been encouraged by the aging population in combination with the existence of capital-based pension schemes. This development is contributing to the creation of an equity culture, including greater scope for the market for corporate control and direct control via equity. Henwood (1997), for example, points out that institutional investors frequently supported and financed hostile takeovers in the 1980s.

What is the evidence that institutional investors have the incentive and ability to intervene to correct corporate governance failures? Why should they 'voice' rather than 'exit'? Institutional investors are likely to hold only small share stakes in individual companies (around 1-3 percent) in order to spread risk in their portfolios. Under these circumstances any direct involvement depends on the ability to marshal additional support from other investors and the required costs of doing so. There is also obviously a free-rider problem, which works against these collective shareholder actions. Increasing use of indexed funds, however, tends to limit the shareholders options for exit and forces them to play a more active part.

There is also the question of “who monitors the monitor”? Jenkinson and Mayer (1992:2) rightly ask: “Why precisely managers of institutional funds are supposed to be so much better at administrating non-financial enterprises than the management of these enterprises themselves, or why similar problems of corporate governance do not afflict the funds themselves are questions that are never clearly answered.” Coffee (1991), for example, argues that there are reasons to believe that institutional investors are more accountable to their owners than are corporate managers to their shareholders, and argues that traditional governance mechanisms are limited. Self-administered pension funds are immune from takeover mechanisms. The shareholders, the company’s or public employees are for obvious reasons unable to sell their stakes in the fund if its performance is below average.

This is especially relevant in the context of recent allegations against CalPERS, the nation’s largest public pension fund and a leader in promoting shareholder activism. The Los Angeles Times (2/2/98) reports of investment decisions that apparently hinged on individual board members being lobbied by investment firms. Examples include a $60 million investment in a real estate partnership that employed the son-in-law of a board member as well as a $75 million investment to a Los Angeles firm co-founded by the mayor. The problem with the latter is that a pension fund trustee was also a top deputy in Mayor Richard Riordan’s administration.

Brancato (1997), a supporter of more institutional shareholder involvement proposes that companies define their strategic targets first and then target a specific shareholder segment. Markets in this view might not generate the best results for companies. She specifically differentiates between traders with a short-term horizon and investors looking for a more long-term commitment. Traders have only a short-term interest in the company and don’t exercise any voting rights but provide liquidity to the market. Investors on the other hand are attracted by the compatibility between their goals and those of the companies they invest in. She provides evidence to support her claim of differences in strategy and time horizon among the diverse group of institutional investors.

Because of the variety of investors and their goals Brancato (1997:102) concludes that

> "Investor targeting challenges the conventional wisdom that markets are efficient and that management should just tell their story and let market forces operate. Rather, it forces companies to clarify their strategy and enables them to communicate their goals to those investors who share their objectives. Companies that successfully employ their investor targeting enjoy less stock price volatility and a lower cost of capital, enabling them to make the in-depth investments necessary to achieve sustained growth."

Like Chandler, she therefore acknowledges the importance of managerial autonomy in devising an appropriate business strategy and then form ties with actors in financial markets.

5. Comparative country experience

The previous discussion has focused narrowly on the case of the United States. Financial systems, ownership structures and therefore corporate governance mechanisms are, however, different across countries (Zysman 1983; Franks and Mayer 1997; Pollin 1995). Thus it is likely that the transformation of international capital markets will have different effects depending on the existing financial system. We will now turn to a brief discussion of this hypothesized differential impact focusing on the cases of Germany and Korea.

Germany

In the financial systems literature the German economy is typically characterized as a bank-based system (Zysman 1983) in which banks are playing a dominant role in financial intermediation as well as in the monitoring of corporations. In contrast, in the U.S. economy both corporate finance and control are market-based. Recent evidence, however, suggests that this view of the German system has to be modified. First, empirical studies based on flow-of-funds data has shown that private investment in Germany is internally financed to a similar degree as in the United States (Corbett and Jenkinson 1996). In fact, U.S. banks have provided a larger share of finance than their German counterparts since the 1970s. Second, in a comprehensive investigation of the monitoring role of banks, Edwards and Fischer (1994) conclude that banks play only a minor role in management shake-ups especially when compared to the active role of Japanese banks. This has led some observers to suggest that the crucial difference between the American and German system of governance can be traced to the different ownership structures and not to the role of banks per se (Franks and Mayer 1997; Mayer 1996; Edwards and Fischer 1994).

According to Mayer (1996), the German system of ownership and control is best described as an *insider system* compared to the *outsider system* in the United States. As we have seen during the previous discussion the U.S. system is characterized by dispersed ownership and sophisticated financial markets including an active market for corporate control. In Germany's insider system financial markets are relatively underdeveloped and stock market capitalization is low relative to GDP. In addition, there simply doesn't exist a market for corporate control and hostile takeovers are almost unheard of. The key feature of this arrangement is a concentrated ownership structure in which a large share of corporate equity is retained within the sector through a sophisticated system of cross-equity holdings creating large corporate groupings (Franks and Mayer 1997). These groupings are reinforced by representation on each other's supervisory boards. Banks are part of these groupings via their direct ownership stakes as well as their proxy voting rights (Edwards and Fischer 1994). In the context of inter-corporate shareholdings the application of the principal-agent problem does not make sense but firms are more appropriately viewed as coordination devices for aligning self-interest with the collective good of several parties (the stakeholders). Arguably, this system has generated relative managerial autonomy from financial interest and has allowed firms to pursue a strategy of strengthening their long-term competitive position (Porter 1992).

The strength of this system is the committed relationship among company stakeholders including suppliers, banks, workers and the larger community. Commitment and trust are more easily sustained under concentrated ownership structures compared to the Anglo-Saxon outsider systems where shareholders can sell out anonymously and without costs. According to Mayer (1996) commitment and trust are particularly important where productive activities depend on the involvement of and investment by a large number of stakeholders (including workers' investment in firm-specific human capital). Complex manufacturing processes, which require several different supplier and purchaser arrangements may be particularly dependent on ownership patterns that promote commitment and trust.

Based on this analysis, Mayer (1996) argues that it is likely that neither the German insider nor the American outsider system is universally better. They are each to be viewed as being designed to accommodate specific circumstances and industries, with insider systems better suited to cases where commitment to other stakeholders is important. Outsider systems are more appropriate in cases where there is rapid and radical technological progress, which also rapidly devalues the stock of intangible assets as an important competitive asset. This suggests that governance mechanisms are not only effected by macroeconomic incentives but also by the character and speed of technological change.

This interpretation is compatible with the managerial model since Chandler (1997; 1990) has always stressed the superior position of the managerial enterprise in applying its managerial resources to new products in *related* sectors. It could be argued that the current period is characterized by radical technological change brought about by computer technology, software and biotechnology. Here success might not be dependent on accumulated organizational knowledge but on entrepreneurial talent and serendipity. In radically new technologies capital markets might be superior to managerial talent in assessing the value of the new enterprise precisely because of their ability to compute large amounts of information (Allen and Gale 1995), spread risk and provide venture capital. Sophisticated financial markets might thus provide the flexibility to respond to these challenges.

There is still the question of what mechanism ensures that committed relations don't invite collusion and inefficiency in the absence of financial market control as well as direct bank monitoring? As in the Chandlerian model the answer seems to be relentless product market competition. In the German case firms are exposed to strong competitive pressures in particular in export markets. Compared to its size the German economy is relatively open and has traditionally been export-oriented in capital- and/or skill-intensive sectors such as electrical machinery, industrial chemicals, and luxury cars (Wengenroth 1997; Carlin and Soskice 1997).

Its success is likely to be one of the reasons for the remarkable stability of this system in spite of the financial globalization pressures that we talked about in section 2. Like in the United States the early 1980s were characterized by rising interest rates and falling rates of return. Similarly, real growth rates started to fall below real interest rates at around the same time. We should point out that Germany has been one of the laggards among OECD countries in adopting financial liberalization measures. Equity markets in particular remain underdeveloped due to high securities transfer taxes as well as weak disclosure and insider trading rules (Edey and Hviding 1995). Germany has therefore not been subject to the increasing securitization, i.e. the increased use of securities in the intermediation of finance, which has been one of the major implications of financial liberalization in the United States.

In other areas the German financial system has always been relatively unregulated. Germany abolished capital controls early in the 1960s and did not implement regulation Q-type interest rate controls as in the United States. Again in comparison to the United States, the German system has kept interest rates positive even in the turbulent period of the 1970s mainly due to low rates of inflation. Smithin's (1996) 'revenge of the rentier' in response to negative interest rates has not been a factor in Germany. Furthermore, the stability of the system has also been supported by stable and high spreads between lending and inter-bank rates, which have bolstered banks' profits. The spreads have been consistently around 4 percent since 1960 compared to differentials of around or even below zero in the US under regulation Q. They have since then edged up to 2.4 percent in the early 1990s (Edey and Hviding 1995:41).

In spite of the system's stability there are signs of change associated with the process of financial liberalization. German banks have started to reduce their equity stakes in non-financial enterprises in order to adopt a more 'value-oriented' approach. Deutsche Bank, for example, is keen on selling part of its 23 percent stake in Daimler-Benz, Germany's largest industrial conglomerate. At present, high German capital gains taxes prevent Deutsche Bank from making this move. In a Financial Times (FT 2/16/1998) interview Deutsche Bank chairman Rolf Breuer expresses his dissatisfaction with the bank's share portfolio which is primarily German and heavily biased toward automobile production. This attitude change is driven by investor pressures on bank management to increase the value of the shares of the banks. It is not clear what impact this change will have on German corporate governance structures in the light of the previously mentioned evidence that banks do not play a large role in corporate restructurings and that bank finance does not amount to a large share of corporate financing in Germany.

Similarly, a number of large German corporations have started to list their shares on the New York Stock Exchange beginning with Daimler-Benz in 1993. Hoechst, the chemical giant, wanted such a listing in order to tap into the liquid US capital market in support of its global strategy (Financial Times 11/5/97). The company CEO is well aware that this move will go hand in hand with a greater emphasis on shareholder values.

In Germany, the pay-as-you-go pension system has so far restricted the availability of funds to be invested in pension and mutual funds an is thus the main factor in explaining the relative underdevelopment of such institutions. Blommestein (1997:49) argues that a switch to a funded pension system would probably give a big boost to both the development of capital markets and equity-based corporate governance channels. In short, such a major institutional change would contribute to the proliferation of shareholder value culture in Germany. In fact, there are signs of a change in corporate pension plans. At present most German companies provide for their employees' pension by putting money into book reserves (Pensionsrückstellungen) to cover accrued benefits. This money is typically invested in the company's plant and equipment in order to raise profits to allow the company to pay pensions from existing cash flow. These reserves have facilitated continued investment and smoothing earnings even in hard times. Taking the reserves off the balance sheet would mean a sudden drop in free cash flow forcing companies to rely on more expensive forms of finance in the stock and bond markets.

According to a Deutsche Bank report these pension liabilities account for nearly one fifth of total ancillary personnel costs in the mid-1990s (Global Investor, June 1996). Fund managers are eager to get their hands on the estimated $200 billion in corporate pension funds to stimulate the fund management industry which in 1994 had funds amounting to $124 billion (about 1/3 of the per capita fund ownership in the US). Fund managers are also eager to scrap the existing limitations on equity investment, which is currently at only 25 percent of total assets for pension funds. Note that the large banks support these changes since they are all major players in this emerging sector with various subsidiaries. Equity investments is attractive because management fees on equity-oriented funds are normally 20 to 30 basis points higher than the meager 0.1 percent management fee levied on bond funds. At present however, a typical portfolio has 80 percent invested in bonds and only 20 percent in equity. Several factors limit the expansion of equity finance besides regulation. Germans are traditionally risk adverse and are unwilling to accept high volatility patterns of their investments. They are also very wary about investing overseas even on equity portfolios.

Korea

Amsden (1989) provides a managerial model of governance updated for the case of late industrialization in Korea. She argues that the state has to play an active role in late industrialization to overcome the challenges of backwardness; it needs to nurture domestic companies to give them the time to accumulate the necessary 'Chandlerian' managerial assets to eventually become competitive in world markets. According to her and others (see, for example, Wade 1990) the Korean state played a pervasive role in the country's industrialization drive in the form of protecting and subsidizing industry. In particular, the government channeled cheap credit to capital-intensive enterprises it perceived as crucial for long-term growth and competitiveness; it literally 'picked the winners'.

This model presents serious governance problems for obvious reasons. Why should Korean companies invest in managerial assets and otherwise invest efficiently if they are shielded both from international product market competition through protective tariffs and from the monitoring role of financial markets? The answer Amsden provides is that the state also assumed the role of disciplinary. Financial support and protection from foreign competitors came at a price. Nurturing was offered only in exchange for specific, easy-to-monitor export targets. In addition, the government allowed a number of domestic chaebol to enter the same sector so that they each faced stiff domestic competition. What is now sometimes called "crony" capitalism has provided an incentive system, which has turned Korea into one of the leading industrial economies in record time. In terms of our governance focus, the crucial ingredient for the success of this model is the state's selective use of market forces to provide necessary disciplinary pressures while at the same time circumventing markets, especially foreign competition and market-based credit supply, if they are deemed destructive or insufficient for the development of industrial capacity.

A tight government control on financial markets is a key element of this strategy. The bank-based finance of industry will necessarily lead to high debt-equity ratios compared to Western conventions. This causes a certain amount of fragility for the financial system since firms will be vulnerable to shocks that disturb cash flow or bank finance because debt payments have to be made at a fixed level whereas dividend payments are a residual after cost (Wade 1998).

A theoretical model developed by Peterson and Rajan (1995) might serve to explain the fact that financial market competition might be counterproductive under these circumstances. Their model refers to the case of new small firms, which tend to have low cash flow but the potential for high future profits. But it might as well be applied to fast-growing companies in developing countries when retained earnings are also insufficient to finance this level of growth. Creditors might be inclined to lend to these companies only if they are guaranteed a share of their future profits. This guarantee is unlikely under the assumption of competitive markets. Firms will simply not have an incentive to remain with their initial provider of funds if they can access cheaper resources from competitors. In fact, because of the higher risk associated in investing in these new (or developing country) firms interest rates in competitive markets will be very high. In the presence of committed relationships banks have the assurance to spread the gains over time—making a loss at the early stages of firm growth and larger gains when the firm is able to generate more cash flow.

Based on these assumptions, Peterson and Rajan (1995) develop a formal model and provide an empirical analysis for a sample of small US firms. They conclude that "credit market competition imposes constraints on the ability of the firm and creditor to intertemporally share surplus. This makes lending relationships less valuable to a firm because it cannot expect to get help when most in need (1995:845)." We have seen earlier that in Korea the state assumed the role of bank AND disciplinary in order to let firms accumulate competitive assets and subsequently share surplus intertemporally.

Wade (1998) argues that financial market liberalization and especially the recent financial crisis present a severe shock to this 'commitment-and-trust' system of governance. The refusal of international banks to roll over loans to Korean banks has forced them in turn to call in their loans to heavily exposed chaebol. This breakdown in lending in combination with extremely high interest rates to protect the currency have led to widespread insolvency and bankruptcy. The IMF-imposed adjustment measures prohibit any cushioning of the shock by continuing to provide subsidized credit to companies. Instead, Korean companies are increasingly forced to sell assets to foreigners to lower debt levels. According to Krugman (1998) this sell-off has already reached 'fire-sale' dimensions. Wade (1998:22) argues that the "combination of massive devaluations, IMF-pushed financial liberalization, and IMF-facilitated recovery may even precipitate the biggest peacetime transfer of assets from domestic to foreign owners in the past fifty years anywhere in the world (…).”

Is this a beneficial reallocation of ownership titles? The answer to this question depends on the favored interpretation of the state-led development model. Observers who now discredit the Korean system as ‘crony’ capitalism will welcome the ownership transfer as efficiency enhancing. In this view, the crisis will also have the cleansing effect of finally ‘getting the prices (especially the interest rate) right’. High debt-equity ratios, subsidized credit and close state-bank-industry relations were unsustainable and are rightly supplanted by more market-based allocation mechanisms. Another view derived from the work of Amsden and Wade suggests that the highly successful Korean model was derailed by premature financial liberalization (Chang 1997). Deregulation did not only raise interest rates but also sharply reduced the government’s control over the banking system. Consequently, banks were able to increase their short-term borrowing abroad at low interest rates and re-lend it at a sizable profit to the local chaebol. The now frequent accusations of overinvestment might not be a result of too much state involvement as the crony capitalism view would suggest but of diminishing state-imposed discipline as a result of financial deregulation. The financial crisis was thus also accompanied by a crisis of governance.

6. Conclusions

This paper attempted to link changes in international capital markets to the character and change of corporate governance structures. It was argued that financial deregulation and rising interest rates have led to a shift from relative managerial autonomy to a predominance of financial interests in the United States since the early 1980s. While this tendency might have been beneficial in redirecting funds from stagnating companies and sectors to more dynamic ones it arguably did not improve corporate governance mechanisms in general. Alfred Chandler’s managerial model of capitalism assigns a crucial role to managerial autonomy in the dynamic growth of companies and the economy as a whole. The imposition of financial goals on managers through hostile takeovers or linking their renumeration to stock performance might have induced a slowdown in investments in important fungible assets such as organizational skills and firm-specific investments by employees.

We then turned to a discussion of governance systems in other countries to assess their changes due to financial liberalization. The German insider system, which is characterized by committed relationships among long-term stakeholders, was shown to exhibit a remarkable stability in spite of similar macroeconomic pressures than in the United States. The Korean system on the other hand has recently plunged into a severe crisis. It is still too early to fully assess the changes brought about by the continuing financial crisis but it seems certain that the previous, highly successful model of state-led finance and governance will be substantially modified to accommodate greater financial openness and foreign ownership. Our discussion raised some doubts about the expected benefits this change will generate for the Korean economy.

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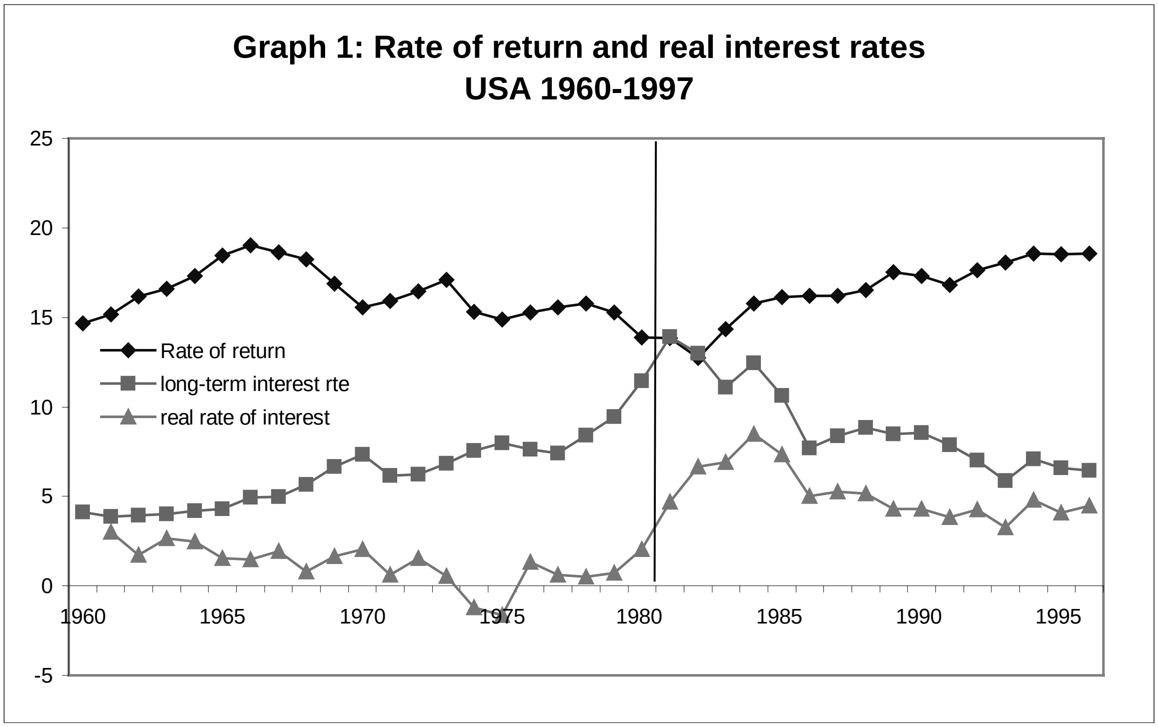
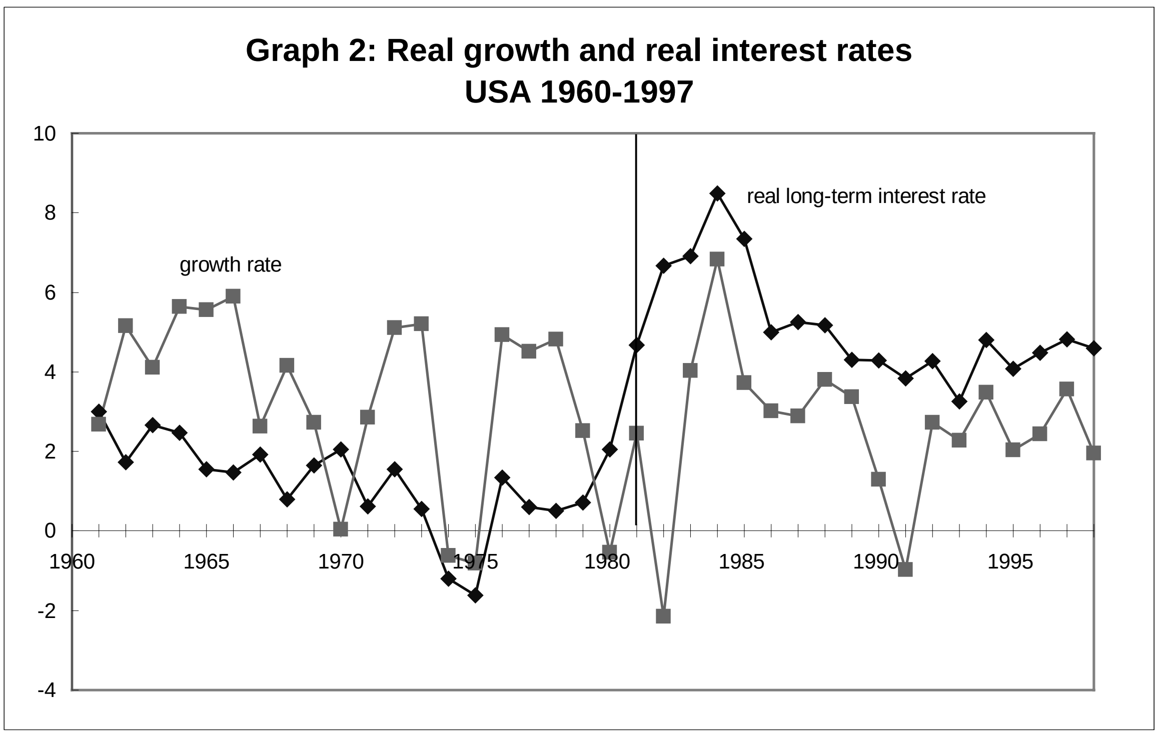


Graph 1: Rate of return and real interest rates
USA 1960-1997



Graph 2: Real growth and real interest rates
USA 1960-1997

Source: OECD