Corporate Governance, the Big Business Groups and the G-7 Reform Agenda: A Critical Analysis

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Corporate governance has become an important issue of international significance since the Asian crisis of 1997-8. It forms a key part of the reform agenda of G-7 countries in their plans to institute a New International Financial Architecture to forestall future crises. This paper provides the essential background to G-7 proposals on corporate governance as the economic rationale for these proposals as suggested in the recent research on Law and Finance. The paper outlines the differences between corporate governance patterns among developed and developing countries; it also examines the relationship between corporate finance, the stock market and corporate governance in the form of crony capitalism does not explain the Asian crisis and that the Anglo-Saxon model of corporate economy and, indeed, for developing countries it is far from being the best way. This model's reliance on the stock market and consequently on that market's pricing process and takeover mechanism creates perverse incentives that can undermine long-term growth by accentuating the influence of short-term considerations. The last part of the paper addresses one of the key areas of controversy: the efficiency and viability of large conglomerate organisations in developing countries. In that context, particular attention is given to Korean business groups and to the international financial institutions' reform programme for these groups. The paper provides a critical review of these proposals.

Keywords: Corporate governance, Big business groups, Emerging markets, Asian crisis, G-7 reform agenda

JEL Classification: G30, G32, G33, G34

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[**Seoul Journal of Economics** 2002, Vol. 15, No. 2]

I. Introduction

Since the Asian crises which began in Thailand in summer of 1997, issues of corporate governance and corporate organisation in emerging markets have acquired an international dimension. They constitute an important part of the reform agenda of G-7 countries in their plans to institute a new international financial architecture which would forestall future crises. The central G-7 argument is that the proposed reforms of the corporate and financial systems of developing countries are essential to make the global markets function properly. The implicit suggestion is that the recent financial crises in these countries were not the outcome of market failures but rather the failure of developing country governments and institutions which did not provide accurate and adequate information to markets, as well as imposed other distortions on the latter. This thesis is not universally accepted by economists, but nonetheless, such reforms were pressed on the crisis-affected Asian countries as part of IMF conditionality and are now being advocated for other developing countries.

This paper[1] concentrates on the reform of corporate systems in emerging markets, an issue which has not received as much public and academic attention as the reform of the financial sector in these countries. The reform of the non-financial corporate sector necessarily involves issues of corporate governance and organisation including the role of the big business groups. The latter, as we shall see, are ubiquitous in emerging countries.

The paper is organised as follows. Section II provides the essential background to G-7 proposals on corporate governance which have their origins in the perceived structural weaknesses of the Asian economies on the eve of the crisis. Section III sets out the main proposals which are currently the subject of attention. Section IV provides information on the systems of corporate governance which prevail in developing countries and how they differ from those in advanced economies. Section V considers the contributions of the recent research on Law and Finance in relation to the appropriate model of corporate governance for the emerging

[1]This paper is based on Singh, Singh and Weisse (2003), and the author is grateful to UNCTAD for permission to use material from that paper for this article.

countries. Sections VI and VII consider the financing of corporate growth in emerging markets and how it affects corporate governance. Section VIII addresses one of the key areas of controversy: the efficiency and viability of large conglomerate organisations in developing countries. Section IX concludes and draws implications for economic policy.

This paper contributes in the following ways. It brings together relevant empirical and theoretical analysis from diverse fields – the theory of the firm, the theory of corporate finance, the theory of economic development – to bear on the issues under discussion. It also contributes by providing a critical analysis of the conventional wisdom and by outlining alternative perspectives on these issues which maybe useful to developing countries in their discussions with international financial institutions. Thirdly the paper contributes by furnishing new information on the financing of corporate growth in the 1990s and by documenting empirical anomalies in the financing patterns of both emerging and mature markets. Contrary to *a priori* expectations the paper indicates the important role of the stock market in financing corporate growth in emerging markets. It explores the relationship between corporate finance, corporate governance and stock market development. Lastly, the paper examines the implications of the analyses for the efficiency and reform of the third world conglomerates. In that context particular attention is given to the case of Korean big-business groups and the government reform programmes for these corporations in the wake of the financial crisis.

II. The Asian Financial Crisis and Corporate Governance

The impetus behind the quest for a new international financial architecture came from the crisis which erupted in Thailand in July 1997 and quickly spread to other Asian economies. Whereas previous crises had struck economies with a history of financial instability and low growth, such as Mexico in 1995, the Asian crisis devastated countries that were the fastest growing in the world economy and had solid achievements in technological upgrading and poverty reduction. The international financial institutions and private commercial and investment banks had frequently cited them as prime examples of the benefits of exportled growth and the "market-friendly" approach to development. The shock among policymakers and market participants was therefore acute.

After the initial shock of the crisis had worn off, however, an influential theory of the crisis emerged that argued that the deeper reasons for it could be found in the institutional structures of the Asian model. This view was succinctly conveyed by Larry Summers, then the US Treasury Under Secretary, who argued that the roots of the Asian financial crisis did not lie in bad policy management but in the nature of the economies themselves. Summers stated that "[this crisis] is profoundly different because it has roots not in improvidence but in economic structures. The problems that must be fixed are much more microeconomic than macroeconomic, and involve the private sector more and the public sector less (*Financial Times*, 20 February, 1998)." This view was echoed in slightly different terms by the Chairman of the US Federal Reserve, Alan Greenspan (1998).

This "structuralist" interpretation of the Asian crisis was highly influential in the design of the policy response of the International Monetary Fund. As a consequence, the IMF conditioned its emergency loans on deep structural reforms that went far beyond the usual stabilisation measures, encompassing fundamental changes in labour regulations, corporate governance and the relationship between government and business. The scope of the IMF's conditionality prompted the conservative economist Martin Feldstein to argue that the IMF "should not use the opportunity to impose other economic changes that, however helpful they may be, are not necessary to deal with the balance of payments problem and are the proper responsibility of the country's own political system (Feldstein 1998)."

In spite of such concerns, the "structuralist" interpretation has continued to underpin policy proposals and framed the academic debate on the issue. This view consists of several interlinked arguments. First, fragile financial systems resulted from relationship banking, weak corporate governance structures and lack of competition. Johnson *et al.* (2000) argue that measures of corporate governance and in particular the effectiveness of protection for minority shareholders, explain the extent of the exchange rate depreciation and stock market decline better than standard macroeconomic measures. Furthermore, the crony-istic relations between financial institutions, business and the government shielded the system from market discipline and encouraged the over-investment that led to the crisis. Second, and related to the first point, the high leverage ratios of Asian firms heightened their vulnerability and created the conditions that led to a sudden crisis. Thirdly, the lack of transparency and the poor quality of information in such an insider-dominated system led to informational asymmetries that exacerbated the crisis. Markets did not have adequate information about the true financial status of the corporations and the banks. Thus, once the market began to assess the true facts, there was a collapse of confidence, see Camdessus (1998).

To remedy these alleged faults in the Asian system, reformers sought to dissolve the close links between the state and business, create an arm's length relationship between banks and business and to promote greater transparency in economic relations.

The "structuralist" interpretation is not, however, the only account of the Asian crisis, nor the most persuasive. Singh and Weisse (1999) have argued that the "structuralist" interpretation is not credible for several reasons. First, it does not explain the previous exemplary success of the Asian economies. As Paul Krugman has remarked: "But if the system was so flawed, why did it work so well for so long, then fail so suddenly?" (Krugman 1999). Second, it does not explain why countries such as China and, especially, India, with similar dirigiste systems did not have a crisis.

A more credible explanation of the crisis that encompasses these facts is that the afflicted economies dismantled their controls over the borrowing of the private sector and embraced financial liberalisation. As a consequence, the private sector built up short-term foreign currency debt that often found its way into the non-tradable sector and into speculative real estate ventures. Accompanying financial liberalisation was the irrational exuberance and contagion that are always latent in private international financial flows. In sum, Singh and Weisse (1999), argue that the crisis occurred not because the Asian model has been flawed but precisely because it was not being followed. Thus, while Edmund Phelps identifies the crisis with the failure of Asian corporatism (Phelps 1999), it can be argued that in reality this system underpinned the most successful industrialisation drive in history and dramatically reduced poverty. The system, however, was vulnerable to the forces unleashed by financial liberalisation.

In this paper, two key elements of the Greenspan-Summers "structuralist" interpretation will, *inter alia*, be examined in detail. The first is the contention that there was poor corporate governance; secondly, there was crony capitalism and both these contributed to a disregard of profits in corporate decisions, and hence to over-investment and, ultimately, to the crisis.

III. The New International Financial Architecture and Corporate Governance

In a move towards defining a New International Financial Architecture, the G-7 assigned the task of reforming corporate governance to the OECD and the World Bank. The main results so far of this initiative have been the following:

(a) OECD Principles of Corporate Governance;
(b) OECD/World Bank Compact on the Reform of Corporate Governance;
(c) The Corporate Governance Forum meetings between officials and businessmen;
(d) "Self-assessment" exercises in corporate governance carried out under the guidance of the World Bank and Asian Development Bank.
(e) The World Bank has been organising investor surveys asking domestic and international investors the private sector's response to the progress and credibility of reform.

The five basic principles of corporate governance promoted by the OECD/World Bank initiative have been summarized in the World Bank's main document on corporate governance, *Corporate Governance: A Framework for Implementation* (Iskander and Chamlou 2000). The study points out that the principles have been based on tenets of "fairness, transparency, accountability and responsibility."

> ***Protection of shareholder rights*** to share in company profits, receive information about the company, and influence the firm through shareholder meetings and voting.

> ***Equitable treatment of shareholders***, especially minority and foreign shareholders, with full disclosure of material information and prohibition of abusive self-dealing and insider trading.
>
> ***Protection of stakeholder rights*** as spelled out in contracts and in labour and insolvency laws, in a framework that allows stakeholder participation in performance-enhancing mechanisms, gives stakeholders access to relevant company information, and allows effective redress for violations of stakeholder rights.
>
> ***Timely and accurate disclosure and transparency*** on all matters material to company performance, as essential to market-based monitoring of companies, and shareholders" ability to exercise voting rights, with accounting according to quality standards of disclosure and audit, and with objective auditing by independent assessors.
>
> ***Diligent exercise of the board of directors' responsibilities*** to guide corporate strategy, to manage the firms' executive functions (such as compensation, business plans, and executive employment), to monitor managerial performance and achieve an adequate return for investors, to implement systems for complying with applicable laws (tax, labour, competition, environment), to prevent conflicts of interest and to balance competing demands on the company, and with some independence from managers to consider the interests of all stakeholders in the company, treat them fairly, and give them access to information.

The World Bank report does go to some lengths to point out that "there is no one-size-fits-all blueprint for corporate governance." However, the entire thrust of the report's arguments and its definition of "best practice" structures detailed in the appendices to the report, belies any assertion that the it treats the different models of corporate governance equally. It is indeed hard to find much daylight between the report's conception of "best practice" and the Anglo-Saxon model of corporate governance, which leaves little doubt that it is the preferred system.

To sum up, there is considerable activity in international fora with respect to identifying best practice codes for corporate governance. Developing countries know from past experience that today's best practice often becomes tomorrow's conditionality if a country has the misfortune of requiring IMF assistance. Advanced emerging markets in particular must, therefore, pro-actively engage in the proceedings of the Global Corporate Governance Forum and the Regional Corporate Governance Roundtables that the OECD and the World Bank have been jointly organizing.

IV. Corporate Governance in Emerging Markets: The Facts

The analysis of corporate governance structures in developing countries has long been hindered by a lack of detailed information. One silver lining in the Asian crisis and the focus of the international financial institutions on governance structures has been the assembling of a large body of evidence on corporate governance structures in developing countries at the World Bank. This has included information on the structure of share ownership and corporate governance laws. Thus, we are now in a position to construct a more informed picture of the governance structures in a wide range of developing countries.

A. Patterns of Share Ownership and Control of Large Corporations in Developed and Emerging Markets

A key insight to emerge from the new empirical studies is that the widely-held corporation described in the classic study by Berle and Means (1933) is an Anglo-Saxon phenomenon. As Table 1 indicates, among developing countries, the share of family-controlled[2] firms in the top 20 publicly-traded companies in Mexico, Hong Kong and Argentina are 100%, 70% and 65% respectively. In contrast, in the U.K. the top 20 quoted companies are 100% widely-held. However, among developed countries there is a diversity of structures. In Sweden and Portugal, 45% of the top twenty publicly-traded firms are family-controlled, while in Greece and Belgium the figure is 50%. Even in the United States the share of family-controlled, firms is 20% of the top 20 publicly traded firms.

[2]Note that control is defined as a 20% or higher share of equity.

TABLE 1

CONTROL OF PUBLICLY TRADED FIRMS AROUND THE WORLD, 1996 (PER CENT)

Economy	Widely held	Family owned	State owned	Widely held financial	Widely held corporation
OECD countries (non-Bank borrower)					
Australia	65	5	5		25
Austria	5	15	70		
Belguim	5	50	5	30	
Canada	60	25			15
Denmark	40	35	15		
Finland	35	10	35	5	5
France	60	20	15	5	
Germany	50	10	25	15	
Greece	10	50	30	10	
Ireland	65	10			10
Italy	20	15	40	5	10
Japan	90	5	5		
Netherlands	30	20	5		10
New Zealand	30	25	25		20
Norway	25	25	35	5	
Portugal	10	45	25	15	0
Spain	35	15	30	10	10
Sweden	25	45	10	15	
Switzerland	60	3		5	
UK	100				
USA	80	20			
Bank borrowers and others					
Argentina		65	15	5	15
Hong Kong	10	70	5	5	
Israel	5	50	40		5
Mexico		100			
Singapore	15	30	45	5	5
Korea, Rep. of	55	20	15		5

Source: Iskander and Chamlou (2001).

In terms of state ownership and control of large firms, the picture is similarly complex. In Israel and Singapore, nearly half (40% and 45%, respectively) of the top 20 publicly-traded firms were state controlled. In the major OECD economies, this figure ranges from zero in the US and the U.K., to 25% in Germany and 40% in Italy. Among the smaller advanced economies there is a similar range, with Austrian state-run corporations controlling a 70% share of the top 20 publicly-traded firms. It is therefore not surprising that Russia now has a higher degree of private ownership than many Western European countries.

Table 2 provides evidence from Asian countries assembled by Claessens *et al.* (2000) which is based on a very large sample of nearly 3,000 publicly-traded firms in nine countries. It indicates that when 10% equity ownership is defined as control, Japan is the only country with the Berle and Means-style system of dispersed share ownership (42% of publicly-traded firms), but with an additional 38.5% of firms controlled by widely-held financial institutions. At the 10% level, most other countries had systems dominated by families: Indonesia (68.6%), Korea (67.9%), Taiwan (65.6%), Malaysia (57.5%) and Thailand (56.5%). When control is defined at the 20% level, the Berle and Means widely-held system becomes more pronounced, as many families in Japan, Korea and Taiwan have family ownership of between 10% and 20% of the equity. However, even after redefining control, family-controlled corporations still account for 48.4% of publicly-traded companies in Korea and 48.2% in Taiwan. Moreover, in other countries the share of family-controlled firms (as a share of the total number of firms under "control") increases with the redefinition of control. In Indonesia the class of family-controlled firms increases at the expense of state, widely-held financial and widely-held corporate control. In Thailand, family control increases from 57.7% to 67.2% and in Malaysia from 57.7% to 67.2% with the change of definition for control (Claessens *et al.* 2000, p. 104).

An interesting variant is provided by the typical pattern of share ownership and control in large Indian firms – the Business Groups. Available evidence suggests that among the top 40 firms, directors and their families held only 22.4 per cent of shares. Financial institutions and banks held 27.9 per cent (Singh, Singh and Weisse 2003). Since all these financial institutions were

TABLE 2
CONTROL OF PUBLICLY TRADED COMPANIES IN EAST ASIA

Country	Number of corporations	Widely held	Family	State	Widely held financial	Widely held corporation
10% cutoff						
Hong Kong	330	0.6	64.7	3.7	7.1	23.9
Indonesia	178	0.6	68.6	10.2	3.8	16.8
Japan	1,240	42.0	13.1	1.1	38.5	5.3
Korea	345	14.3	67.9	5.1	3.5	9.2
Malaysia	238	1.0	57.5	18.2	12.1	11.2
Philippines	120	1.7	42.1	3.6	16.8	35.9
Singapore	221	1.4	52.0	23.6	10.8	12.2
Taiwan	141	2.9	65.6	3.0	10.4	18.1
Thailand	167	2.2	56.5	7.5	12.8	21.1
20% cutoff						
Hong kong	330	7.0	66.7	1.4	5.2	19.8
Indonesia	178	5.1	71.5	8.2	2.0	13.2
Japan	1,240	79.8	9.7	0.8	6.5	3.2
Korea	345	43.2	48.4	1.6	0.7	6.1
Malaysia	238	10.3	67.2	13.4	2.3	6.7
Philippines	120	19.2	44.6	2.1	7.5	26.7
Singapore	221	5.4	55.4	23.5	4.1	11.5
Taiwan	141	26.2	48.2	2.8	5.3	17.4
Thailand	167	6.6	61.6	8.0	8.6	15.3

Notes: Newly assembled data for 2,980 publicly traded corporations (including both financial and non-financial institutions) as based on Worldscope and supplemented with information from country-specific sources. In all cases, Claessens *et al.* collected the ownership structure as of the end of fiscal year 1996 or the closest possible date.
Source: Claessens *et al.* (2000, p. 103).

controlled by the government and in many of these largest corporations the government had, effectively, a controlling shareholding. However, traditionally, Indian financial institutions support the owning family unless the company performance was exceptionally poor.

TABLE 3

HOW CONCENTRATED IS FAMILY CONTROL?

Country	Average number of firms per family	% of total value of listed corporate assets that families control (1996)				% of GDP (1996)
		Top 1 family	Top 5 families	Top 10 families	Top 15 families	Top 15 families
Hong kong	2.36	6.5	26.2	32.2	34.4	84.2
Indonesia	4.09	16.6	40.7	57.7	61.7	21.5
Japan	1.04	0.5	1.8	2.4	2.8	2.1
Korea	2.07	11.4	29.7	36.8	38.4	12.9
Malaysia	1.97	7.4	17.3	24.8	28.3	76.2
Philippines	2.68	17.1	42.8	52.5	55.1	46.7
Singapore	1.26	6.4	19.5	26.6	29.9	48.3
Taiwan	1.17	4.0	14.5	18.4	20.1	17.0
Thailand	1.68	9.4	32.2	46.2	53.3	39.3

Notes: Newly assembled data for 2,980 publicly traded corporations (including both financial and non-financial institutions). The data was collected from Worldscope and supplemented with information from country-specific sources. In all cases, we collect the ownership structure as of the end of fiscal year 1996 or the closest possible data. The "average number of firms per family" refers only to firms in the sample. To avoid discrepancies in the cross-country comparison due to different sample coverage, we have scaled down the control holdings of each family group in the last four columns by assuming that the firms missing from our sample are not controlled by any of the largest 15 families. The percent of total GDP is calculated using market capiotalization and GDP data from the World Bank.

Source: Claessens *et al.* (2000, p. 108).

B. Crony Capitalism

Claessens *et al.* (2000) also present evidence (reported in Table 3) on the ownership concentration of family owned firms. As noted earlier, the orthodox argument in the wake of the Asian crisis suggested that "crony capitalism" – the complex of relationships between large family capitalists and their government allies – created the conditions for economic collapse. However, the evidence indicates that there is no direct link between the share of GDP controlled by family firms and performance. In Hong Kong, the top 15 families controlled 84.2 percent of GDP in 1996 while in

Singapore and Malaysia the respective figures were 48.3% and 76.2%. Hong Kong and Singapore were both able to weather the financial crisis in Asia in 1997 while Malaysia experienced a sharp downturn and currency crash. Similarly, Taiwan's top 15 families control 17% of GDP and the country avoided the financial crisis while the top 15 families in Korea account for 12.9% of GDP and the country experienced a sharp contraction and currency depreciation in late 1997 and early 1998. A similar story applies when we measure the influence of the top 15 families by their ownership of corporate assets, although in this case the top 15 families control 38.4% of the corporate assets in Korea compared to 20.1% in Taiwan (this, however, reflects the more concentrated industrial structure in Korea and the dominance of large firms on its stock market).

It is important to note that such concentrations of economic power in a set of families is not necessarily antithetical to the efficient functioning, transparency and democratic accountability of the industrial system, as the case of the highly influential Wallenberg family in Sweden indicates. It is believed that the Wallenberg's control up to 60% of Sweden's industrial capital, and consequently, little is done in the country which does not have their approval. Furthermore, as Berglof and von Thadden note, crony capitalism is not a corporate governance problem in a strict sense since family owners are likely to have the right incentives in their firms (Berglof and von Thadden 1999). Crony capitalism is rather a product of the complex of relations between the business and political elites and could in principle arise in systems with widely dispersed ownership.

V. The Theoretical Foundations of the OECD/World Bank Proposals on Corporate Governance

The World Bank's preference for the Anglo-Saxon model of corporate governance is based on what they regard as "best practice." Conspicuously, it is not based on systematic theoretical analysis or rigorous empirical research. However, a recent series of papers by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer and Robert Vishny (hereafter referred to as LLSV) on law and finance has helped fill these theoretical and empirical *lacunae*.

A. The LLSV Thesis

The central proposition of the by now fairly extensive literature generated by LLSV and their colleagues is that there is a systematic causal relationship between the legal framework, the corporate financing patterns, corporate behaviour and performance, and overall economic growth.[3] More specifically, it argues that the greater the protection afforded to minority shareholders and creditors, the more external financing firms will be able to obtain. Through a variety of mechanisms this greater access to external finance modifies corporate behaviour and improves performance, which then has a positive impact on aggregate economic growth.

The LLSV analysis is based on an empirical and theoretical evaluation of different legal systems whose historical origins are exogenous (or, in the case of LDCs, they are a legacy of colonial rule). The studies differentiate between four types of law systems: Anglo-Saxon "common law" (as practiced in the US and other former British colonies), French "civil law," and German and Scandinavian legal traditions (which are in general closer to the French "civil law" tradition). The main analysis focuses on the differences between the common and civil law traditions.

A distinguishing characteristic of these contributions is their strong empirical emphasis. The empirical results presented by LLSV indicate that the predictions of the legal origin model are verified by the data. Specifically, they argue that the lack of protection for minority shareholders, as is the case in the French civil law countries, leads to concentration of share ownership, a point that the data indicate is correct. Similarly, they suggest that other things being equal, corporations in common law countries pay out more dividends and have higher share prices than firms in civil law countries. In addition, the evidence – in conformity with the theory – indicates that there has been a faster development of stock markets under a common law legal system than under the civil law system. In point of fact, however, their claim is even more ambitious: that the legal system provides a better classification of countries than the distinction between "bank-based" and "stock market-based" financial systems.

The policy implication that LLSV draw from this analysis is that

[3]La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997, 1998, 1999, 2000).

countries should move toward the more efficient common law system based on transparency and arm's length relationships. It is argued, however, that this would not be easy given the vested interests connected with concentrated share ownership who could frustrate any government attempt to dilute their equity stakes. Governments are therefore advised to carry out the reforms in a much more indirect and subtle way that challenges the influence of the conglomerates.

B. The Berglof and von Thadden Critique

There are two significant lines of criticism that can be directed against this body of thought. The first, articulated by Berglof and von Thadden (1999) finds the theoretical framework presented in LLSV far too limited for examining corporate governance issues in developing countries. At an empirical level, they argue that the LLSV characterization of corporate governance in these countries is not only too narrow but also misleading.

The focus of the analysis on protecting minority shareholders and creditors is too narrow, Berglof and von Thadden contend, to be even applied to most European countries, let alone developing countries. LLSV appear to be solely interested in the question of the protection of providers of external finance to the exclusion of other significant stakeholders in the firm. In particular, there is no mention of labour laws or the equally vital relationships between workers and managers, suppliers and owners/managers, local communities and the corporation as well as the government and the corporation. In effect, all these relationships are ignored while the promotion of external financing is placed, alone, in the centre of the analysis. Thus, any sense of the structures in which the firm is embedded and which determine its performance and competitiveness is expunged from consideration and we are led to place a disproportionate weight to one – potentially small – aspect of this structure. Berglof and von Thadden do not regard external finance as the only, or even the principal, constraint on firm growth (see, however, Section VI on this point).

Berglof and von Thadden also note that the reference point for the LLSV study is the widely-held, Berle and Means-type corporation which is prevalent mainly in the United States and the United Kingdom (as was indicated by the analysis in section IV).

In the developing country context, they point out that the LLSV paradigm is valid and relevant only for the case of transitional economies, which is not entirely surprising given the fact that some of the LLSV authors were intimately involved in Russian reforms in the 1990s. The former Russian state-owned sector has been dominated by owners/managers who have benefited from insider privatisations and who have often effectively expropriated outside investors who often have to play a central role in the implementation of painful restructuring (Berglof and von Thadden 1999, p. 24). In this context, Berglof and von Thadden argue, improved investor protection can be very useful in attracting outside capital and forcing restructuring.

The typical firm in developing countries, however, is family-controlled or closely-held by block holders, *i.e.* it has concentrated share ownership. The important corporate governance problem for this class of firms is not legal protection for outside shareholders but rather the problems of family succession and maintaining family control while raising funds from outside investors.

The LLSV argument is also susceptible to the fact that the direction of causality between legal system and financial structure could run in either direction. The legal system may lead to the formation of a certain financial structure, as LLSV maintain, but it is at least equally plausible that the financial structure may also lead to the creation of legal norms. In the latter view, the law accommodates larger structural changes taking place in the economy, financial markets and politics. To therefore argue, as LLSV do, for the primacy of legal origins in financial market development is to place the cart before the horse.

It is important to note that even on its own terms, maximising investor protection cannot be optimal. It will result in the dilution of efficiency advantages deriving from the lower agency costs of concentrated ownership. A system which is also more oriented towards investor protection may also lead to familiar problems of short-termism which often characterise firms in the Anglo-Saxon stock market economies which result in lower levels of investment and an emphasis on financial engineering (Cosh, Hughes and Singh 1990; Porter 1992; and Singh 2000).

C. The Glen, Lee and Singh Analysis

The second and rather different critical line of argument against the central LLSV thesis has been presented by Glen, Lee and Singh (2000). They suggest that over the past 20 years there have been major changes in corporate financing patterns and in stock market development in emerging markets. It would be difficult to attribute these enormous variations, as detailed below, to changes in corporate law or to legal origin. This will be illustrated by considering the specific experience of India, a pre-eminently common law based country. Despite this fact, in accordance with political decisions of the Indian leadership the stock market up to 1980 played hardly any role in the economy. Stock market capitalisation as a proportion of GDP was a mere 5 percent until then. The government began a change in its economic policy stance in the early 1980s and began to implement financial liberalisation internally. However, following the balance of payments and liquidity crisis of 1990-1, the government initiated a more full-scale internal as well as external liberalisation. The net result was that there was a stock market boom. Total market capitalisation rose from 5% in 1980 to 13% in 1990 and to 40% in 1993. There were two million mutual fund investors in India in 1980 but by 1995 there were over 40 million, second only to the US. The number of companies listed on the Indian stock markets rose to nearly 8,000, a figure bigger than that for the US, the largest developed country market. Hundreds of companies made IPOs as well as a large number of existing listed companies raised fresh equity finance on the stock market.

These enormous changes in stock market development and financing of Indian corporations occurred in a brief space of time without any fundamental changes in India's constitution or basic legal framework (see Singh (1998a)).

India, however, is not a special case. Other emerging markets (for example, Taiwan, Mexico, Thailand and Malaysia) in the 1980s also recorded enormous increases in stock market activity in the wake of financial liberalisation. Again, this was not a response to changes in the basic legal framework from a civil law to a common law regime (Singh 1997; and Singh and Weisse 1998). Rather it was the result of the deliberate change in economic policy. Laws were changed to accommodate economic policy decisions without altering their fundamental framework. Obviously, there will be examples of the opposite kind where the legal framework has led changes in economic institutions. There is thus likely to be a mutually interactive relationship between laws and economic policy. LLSV greatly overstate their case by asserting a one-way causal relationship.

The LLSV legal origin approach is thus unable to account for the huge changes in corporate financing patterns and stock market development within emerging markets over time. So that even if we accepted that legal origin may explain some of the cross-sectional variations between developing countries, it is not helpful in explaining the much more important structural changes that have been taking place in emerging markets over the last two decades.

Finally, the LLSV analysis also requires us to accept that countries with a civil law tradition and, consequently, less protection for outside investors, have been either willing to accept or ignorant of the economic costs of their legal system. If they had been rational, Germany and France would have imported a common law system decades ago and even experienced higher rates of growth. In view of the fact that over the last century economic growth in Japan and Germany was faster and that of France was comparable to those in the Anglo-Saxon economies, such an argument strains credulity.[4]

VI. Corporate Governance and Corporate Finance in Emerging Markets 1990s Versus 1980s

The last section touched on issues of corporate finance in the context of a critique of the LLSV approach to law and finance. Here we shall report more directly on corporate financing patterns in developing countries. As is implicit in the previous discussion,

[4]For a comparison of growth rates in advanced economies, see Maddison (1991). The comparison above was based on Table 3.1 on p. 49. French growth over the period 1870-1989 was 1.8% (annual average compound growth rate), which compares favourably with the U.K. (1.4%) and the US (1.8%). The argument in the text applies only to the LLSV thesis in its strong ahistorical form. The thesis can be expressed in a weaker version which would state that the Anglo-Saxon form of corporate governance is most conducive to growth under certain historical circumstances, but not in others. However, LLSV do not explicitly make any such historical distinction.

there is a close relationship between corporate governance and corporate finance. Indeed, Shleifer and Vishny (1997) define corporate governance in terms of the rules and procedures which ensures that external investors and creditors in a company can get their money back and will not simply be expropriated by those who are managing the company.

Two of the first large-scale empirical studies of the financing of corporate growth in emerging markets were Singh and Hamid (1992) and Singh (1995a) (henceforward, both studies will be referred to as S-H). The two studies arrived at surprising conclusions. One would have expected, *a priori*, that because of the underdevelopment and imperfections of developing country capital markets, firms in these countries would largely be self-financing. However, these two studies produced results that were quite contrary to these expectations. Large developing country firms, it was found, depended overwhelmingly on external rather than internal finance, and used equity financing to a surprisingly large degree (see Table 4).

Table 4 suggests that during the 1980s the average company among the 100 largest listed manufacturing firms in each country, in a sample of ten emerging markets, financed merely 40 per cent of its growth of net assets from retained profits. About 60 per cent of corporate growth in the sample of emerging markets was financed by external sources – 40 per cent from new equity capital and 20 per cent from long-term debt. Even though the equity financing figures were to some extent overstated by virtue of the fact that an indirect method of estimation was used (on account of lack of direct information), these figures were much larger than might have been expected *a priori*.[5] In advanced economies with well-developed capital markets, the typical large firm is thought to follow a 'pecking order' in which most of the needed finance for growth us obtained from retained profits. If additional resources are required, the firm would borrow funds and only as a last resort would it issue new shares in the equity market.

In explaining these results for emerging markets, Singh (1995a) hypothesized that the much greater recourse to external finance in developing country corporations was due to the faster growth of

[5]For a fuller discussion of these measurement biases see Whittington, Saporta and Singh (1997).

TABLE 4

THE FINANCING OF CORPORATE GROWTH IN TEN EMERGING MARKETS DURING THE 1980S

Country	Internal finance	External finance (equity)	External finance LTD
Brazil	56.4	36.0	7.7
India	40.5	19.6	39.9
Jordan	66.3	22.1	11.6
Malaysia	35.6	46.6	17.8
Mexico	24.4	66.6	9.0
Pakistan	74.0	1.7	24.3
Republic of Korea	19.5	49.6	30.9
Thailand	27.7	NA	NA
Turkey	15.3	65.1	19.6
Zimbabwe	58.0	38.8	3.2
All	38.8	39.3	20.8
F^1	20.0*	31.4*	21.2*
F^2	16.69*	18.93*	6.38*

Notes: 1) F-statistic for comparison of means across countries. '*' implies rejection of the null hypothesis of the equality of means
2) Bartlett-Box F-statistic for variance across countries. '*' implies rejection of the null hypothesis of equality of variance.
Source: Singh (1995a).

these firms relative to those in advanced countries and therefore had a greater need for external capital. On the supply side, such finance was forthcoming at least for the large developing country firms through government-directed finance, while it was the small firms that faced credit rationing. However, he explained the surprisingly high use of equity finance in conjunctural terms:

a) The direct role of the governments in stimulating stock market development in many emerging countries so as to facilitate privatisation;
b) External and internal financial liberalisation which often lead both to a stock market boom and to higher real interest rates; the former lowered the cost of equity capital whilst the latter increased the cost of debt finance.

Singh suggested that once these temporary factors cease to operate, the situation would revert to the normal low levels of equity financing. Most of the factors that lead corporations in advanced economies to avoid new share issues, such as asymmetric information apply, *mutatis mutandis*, to developing countries as well. In addition, the desire of wealthy families in developing countries to retain control over large firms also militates against the use of equity finance. Similarly, the greater volatility of share prices observed, as well as expected, in developing country stock markets should discourage the use of equity finance.

Have the corporate financing patterns in emerging markets changed in the 1990s compared with the 1980s? If so, have they changed in the direction indicated above – that is, do they suggest that the conjunctural factors have ceased to operate or are less applicable? Tables 5, 6a and 6b attempt to answer this question for four emerging markets. The tables are based on the WorldScope dataset for individual listed corporations for four countries, India, Korea, Malaysia and Thailand. The dataset provides information for only the 1990s so that a direct comparison of these results to those of Singh (1995a) and Singh and Hamid (1992) for the 1980s must be made carefully and with due regard to the intrinsic differences in the datasets.

Specifically, the WorldScope dataset makes it possible to measure the extent of equity financing directly instead of using the indirect residual method employed in the S-H studies because of data limitations. The new dataset also allows us to undertake a more comprehensive analysis of sources of financing for corporate growth including both short- and long-term debt and working capital. The S-H studies only examined long-term debt which in the case of developing countries, as subsequent events demonstrated, is not an adequate reflection of their normal indebtedness. This is because developing country corporations use large amounts of short-term debt for long-term investment purposes. Such debt is normally rolled over, turning it into the functional equivalent of long-term debt, but creditors may refuse to roll over these debts in crisis situations, as exemplified by the Asian crisis of 1997-8. Therefore, the results reported in Table 5 are based on a methodology that differs from that of S-H in the following respects:

TABLE 5

BALANCED SAMPLE: SOURCES OF FINANCING OF GROWTH OF TOTAL ASSETS, 1992-6

	Korea*	India	Malaysia	Thailand
Retentions	23.1	25.3	13.3	5.7
External finance	76.9	74.7	86.7	94.3
Shares	31.2	14.6	9.6	16.1
Debt finance	43.3	51.0	70.8	80.6

Notes: Unweighted averages are the average of the sum (over companies) of each source of finance in each year divided by the sum of the growth of total assets. The balanced samples for the four countries are as follows: India=115; Malaysia=130; Thailand=98; and Korea=95. * Unweighted ratios for Korea are calculated over three years 1994-6. Some unusually large ratios for 1993 were omitted from overall average.

Source: WorldScope Database.

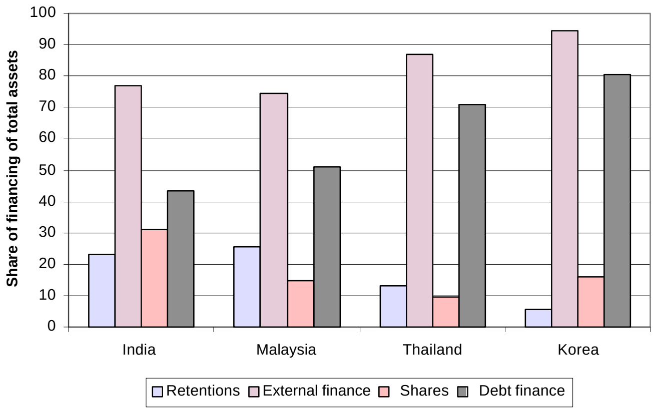

FIGURE 1

SOURCES OF FINANCING OF GROWTH OF TOTAL ASSETS, 1992-6
(UNWEIGHTED AVERAGE)

(a) By measuring the contributing of equity finance directly (as noted above, the WorldScope data provides that information);

(b) By including short-term debt as well as trade credit in external sources of finance. The earlier studies were only concerned with long-term capital employed in the firm *i.e.* the growth of net assets. The exercise in Table 5 includes all sources of finance – short term as well as long term.

(c) By including another category for revaluation reserves, minority interests, preferred shares and non-equity reserves.

The results in Table 5 confirm the main S-H result that developing country firms depend overwhelming on external finance to finance their growth. As expected, the contribution of external financing is, if anything, greater than in the S-H studies because of the inclusion of short-term debt and working capital in the sources of finance. In Korea, for example, nearly 95 per cent of the total sources of finance consisted of external finance; in Thailand the corresponding figure was 89 per cent; in Malaysia and India, it was 75 and 80 per cent respectively. The contribution of short-term debt to total sources of finance is also striking, ranging as it does from just under 30 per cent in India to well over 45 per cent in Korea.

However, the results for the equity financing variables are more mixed. Although only a rough comparison can be made, the results show reduced equity financing in some countries in the 1990s compared with the 1980s, and increasing equity financing in others. In the case of India, there is a ten percentage point increase in the contribution of new share issues to total sources of finance between the 1980s and 1990s. In Malaysia and Korea the proportions contributed by new share issues is smaller than in the S-H studies. Nevertheless, in both countries, the contributions of new share capital is more than 15 per cent which, contrary to the pecking order theory is greater than the share of retained profits (it is of course well above the figure attributed to new share issues in advanced economies (Mayer 1990; and Corbett and Jenkinson 1997).

The question remains whether the above results can be attributed entirely to the biased measurement of the equity financing variable in the benchmark S-H studies for the 1980s. To investigate this, both the Singh and Hamid residual method and the direct method were used to calculate the financing of net assets (*i.e.*, the long-term capital employed in the firm) in a sample of four countries over the 1992-6 period. The results reported in Tables 6a and 6b show that the direct method and the S-H

TABLE 6a

BALANCED SAMPLE: UNWEIGHTED AVERAGE SOURCES OF FINANCING OF GROWTH OF NET ASSETS: 1992-6

	India (%)	Malaysia (%)	Thailand (%)	Korea (%)
Net asset growth	37.2	32.9	39.7	20.6
Retentions	**36.9**	**56.9**	**48.0**	**13.7**
External finance	**64.9**	**46.8**	**55.6**	**96.5**
Long term debt	40.6	14.4	36.1	67.8
Shares	24.0	18.2	15.9	21.1
Other	0.3	14.2	3.6	7.6
Statistical adjustment	-1.9	-3.8	-3.5	-10.2

Notes: All cases where average annual rates of growth of net assets was less than one percent were rejected since low values of growth (the denominator) would lead to high values for the whole ratio. Internal and external finance were constrained to those between -100 per cent and +200 per cent (see Singh 1995, TP2). Internal and external finance were calculated as in Singh (1995, TP2, page 39). Note also that external finance of net assets by equity (new shares) was calculated directly as against the residual used in TP2. The statistical adjustments in the table arise from the constraints placed on the financial rarios. The balance samples for the four countries are: India=115, Malaysia=130, Thailand=98, Korea=95

TABLE 6b

BALANCED SAMPLE: UNWEIGHTED AVERAGE SOURCES OF FINANCING OF GROWTH OF NET ASSETS: 1992-6

	India (%)	Malaysia (%)	Thailand (%)	Korea (%)
Retentions	**36.9**	**56.9**	**48.0**	**13.7**
External finance	**63.1**	**43.1**	**52.0**	**86.3**
Long term debt	40.6	14.4	36.1	67.8
Shares	22.5	28.6	15.9	18.5
Total	100.0	100.0	100.0	100.0

Notes: This table was constructed using Singh (1995), TP2 residual metod. Retentions and long-term debt were calculated directly and new shares werethe reeidual sources of funds. The balance samples for the four countries are: India=115, Malaysia=130, Thailand=98, Korea=95.

Source: Worldscope Database.

residual method produce broadly similar results. For both India and Korea, the residual method slightly underestimated the contribution of equity finance while in the case of Malaysia it significantly overestimated its contribution. In the case of Thailand, both methods arrived at identical results. This analysis therefore suggests that in three out of four countries, the S-H method did not overstate the contribution of equity finance. Thus, in the case of these countries, the observed changes in the corporate financing patterns from the 1980s to the 1990s are likely to reflect the substantive factors discussed earlier rather than measurement bias.

VII. Corporate Finance, the Stock Market and Corporate Governance

In view of the large recourse to equity financing by developing country firms during the 1980s and much of the 1990s, the stock markets might be expected to significantly affect their behaviour and their corporate governance patterns. It is therefore important to ask how this pattern of corporate finance affects corporate governance. The stock market can affect corporate governance and behaviour either directly through movements in share prices, or, more indirectly, through the market for corporate control. We examine each of these in turn below.

A. The Stock Market Pricing Process and Corporate Governance

It is clear from the pattern of finance that stock markets may be expected to have a significant influence on large developing country corporations because of the scale of finance they obtain from these markets. Whether or not this is positive or negative development depends to a large extent on the position one takes with regard to the ability of the stock market to efficiently finance corporations. In traditional textbook treatments of the subject, the liquid secondary equity market results in a better allocation of funds that results in more efficient and dynamic firms obtaining capital at lower cost. Similarly, less efficient firms or firms in less dynamic industries face a higher cost of equity capital. The result is the movement of funds to more efficient, productive firms that results in higher degrees of technological progress and economic growth.

However, a more critical literature originating in the work of

John Maynard Keynes has pointed out that the pricing process may not be as efficient as the textbooks suggest, but may instead be dominated by speculation. James Tobin (1984) has distinguished two concepts of share price efficiency on the stock market: *informational* efficiency (in the sense that all currently available information is incorporated into the share price) and *fundamental valuation* efficiency (share prices must accurately reflect the future discounted earnings of the corporation). While real world stock market prices may reflect the former, the critical school maintains that there are strong reasons to doubt that it attains the latter, more important, criterion of efficiency. The reasons for this are found in the psychology of stock market participants.[6] As Keynes pointed out in his famous description of the beauty contest in the *General Theory,* often the art of the successful investor does not consist in appreciating fundamental values of corporations, but rather in guessing at the likely movements of other stock market participants. Such a process leads to herding, myopia and fads that can lead stock market values to diverge significantly from underlying values (for a current example, note the rise and fall of technology shares on international stock markets). The volatility associated with this process further reduces the capacity of share prices to transmit efficient signals to market participants.

Experience from advanced countries suggests that the stock market may also encourage managers to pursue short-term profits at the expense of long-term investment since firms are obliged to meet quarterly or half-yearly earnings per share targets determined by market expectations. Any serious fall in performance will quickly be reflected in a lower share price making the firm vulnerable to takeover. In the late 1980s and early 1990s, numerous analysts in the United States ascribed that country's relatively poor comparative performance *vis-à-vis* competitors with bank-based financial systems such as Japan and Germany to the short-termist demands of Wall Street resulting in lower investment in technological upgrading and new capacity.[7] In a closely related but more general sense, the dominance of stock markets can also result in the ascendancy of finance over productive enterprise. The rules of the

[6]For recent modern treatments of the subject see Allen and Gale (2001) and Schiller (2000).

[7]See collection of studies in Porter (1992).

game are constructed in such a way that companies can rise or fall depending on their ability to engage in financial engineering rather than in developing new products or processes. This is often reflected within the firm itself in the dominance of managers trained in finance over those who come from other backgrounds such as engineering or marketing.

Thus, the benefits of having large corporations dependent on a highly liquid equity market are far from being unambiguous, particularly from the perspective of good corporate governance (see further Bhinde (1994)).

B. Corporate Governance and Takeovers

The market for corporate control is thought to be the evolutionary endpoint of stock market development. The ability of an outside group of investors to acquire a corporation, often through a hostile bid, is the hallmark of the stock market dominated US and U.K. financial systems. As noted above, the textbook interpretation of takeovers is that they improve efficiency by transferring corporate assets to those who can manage them more productively. Consequently, more effective managers emerge who can raise the firm's profitability and share price. Even if current managers are not replaced, an active market for corporate control presents a credible threat that inefficient managers will be replaced and thus ensures that the incumbent management actively seeks to maximize shareholder value and thereby raises corporate performance. Even if quoted firms were not directly susceptible to changes in share prices because they finance themselves almost exclusively from internal finance (as the pecking order theory implies and empirical evidence on developed country corporations confirms), the market for corporate control can still discipline managers. Furthermore, even if all firms are on the efficiency frontier, the amalgamation of some through the act of takeovers may lead to a better social allocation of resources via synergy.

However, a critical school has developed a multifaceted critique that has increasingly questioned the above textbook version of the market for corporate control. First, a number of analysts in the critical school have pointed out that in the real world the market for corporate control, even in advanced economies, has an inherent flaw in its operation: it is far easier for a large firm to take over a small one than the other way around (Singh 1971, 1975, 1992). In principle, it is possible that a small efficient firm may take over a larger and less efficient company (and to a degree this occurred in the US takeover wave of the 1980s through "junk bonds"), its incidence is very small (Hughes 1989).

This consideration is particularly important for developing countries like India where there are large, potentially predatory conglomerate groups (Singh 1995a). These could take over smaller, more efficient firms and thereby reduce potential competition to the detriment of the real economy. In a takeover battle it is the absolute firepower (absolute size) that counts rather than the relative efficiency. Therefore, the development of an active market for corporate control may encourage managers to "empire-build" not only to increase their monopoly power but also to progressively shield themselves from takeover by becoming larger (see further Singh (1975, 1992)).

Secondly, the efficient operation of the takeover mechanism requires that enormous amounts of information are widely available. Specifically, market participants require information on the profitability of corporations under their existing management and what its prospective profitability would be under an alternative management if it were taken over. It has been noted that such information is not easily available even in advanced countries and this informational deficit is likely to be greater in developing countries.

Thirdly, takeovers are a very expensive way of changing management (Peacock and Bannock 1991). There are huge transactions costs associated with takeovers in countries like the US and UK which hinder the efficiency of the takeover mechanism. Given the lower income levels in the developing countries, these costs are likely to be proportionally heavier in these countries. It should also be borne in mind that highly successful countries such as Japan, Germany and France have not had an active market for corporate control and have thus avoided these costs, while still maintaining systems for disciplining managers. Furthermore, there is no evidence that corporate governance necessarily improves after takeovers. This is for the simple reason that all takeovers are not disciplinary; in many of them the acquiring firm is motivated by empire-building considerations or even by asset-stripping.

Fourthly, there is theoretical work (see for example Stein (1989)) which suggests that even if managers wish to maximise shareholder wealth, it would pay them to be myopic in a world of takeovers and signal-jamming. Thus, takeovers could exacerbate the already present tendencies towards short-termism in a stock market-based system.

Fifthly, it has been argued that takeovers can be used as a device to avoid honouring implicit contracts developed between workers and the former management (Shleifer and Summers 1988). This abandonment of implicit contracts can be argued to be socially harmful in that it discourages the accumulation of firm-specific human capital by workers. The absence of strong worker-protection laws in many developing countries means that such considerations in these countries as well (Singh 1990).

These critiques of the market for corporate control have been based on the experience of advanced countries. There is every reason to believe, however, that they are likely to be even more relevant to potential takeover markets in developing countries. However, the takeover market in developing countries remains rudimentary because of the fact, noted earlier, that shareholding is not widely dispersed and standards of disclosure are not conducive to takeovers. It is therefore not surprising that hostile takeovers are rare in developing countries: *e.g.* in the last decade in India there have only been five or six such takeover attempts, not all of which were successful. This situation may change if large international MNCs are allowed to engage in takeovers in developing countries. Domestic firms, with their limited funds and relatively restricted access to international capital markets, would not be able to either compete or resist the MNCs.

There are also other potential factors that could lead financial liberalisation and stock markets to have a negative effect on corporate governance. Financial liberalisation establishes a strong link between two potentially volatile markets, the stock market and the foreign exchange market. The Asian crisis of 1997-8 demonstrated that there could be a strong negative feedback relationship between a falling stock market and a depreciating currency. As the stock market declines, investors pull out of the market and move their funds into foreign currency to. The depreciating currency, in turn, lowers real returns on the stock market which in turn propels the cycle.[8] Such a collapse in currency and equity values of course, ultimately may encourage

TABLE 7
CAPITAL STRUCTURE OF FIRMS IN SELECTED COUNTRIES, 1980-91

	Debt ratio	Long-term debt to total equity	Short-term debt to total equity
Developing Countries			
Brazil	0.560	0.139	0.421
India	2.700	0.763	1.937
Korea	3.662	1.057	2.390
Malaysia	0.935	0.284	0.639
Mexico	0.817	0.375	0.442
Thailand	2.215	0.518	1.769
Developed Countries			
France	3.613	1.417	2.108
Germany	2.732	1.479	1.188
Italy	3.068	1.114	1.954
Japan	3.688	0.938	2.726
United Kingdom	1.480	1.065	1.065
United States	1.791	1.054	0.679

Source: Demirguc-Kunt and Maksimovic (1996).

"fire-sale-type FDI" in the form of takeovers, (suggesting that the expected rate of return measured in foreign currency has increased sufficiently due to the steep decline in domestic share prices). This may overturn quite successful corporate governance structures and replace them with ones that are less suited.

C. Developing Country Corporations and High Gearing

It has been frequently observed that companies in developing countries are highly geared by international standards. This observation is dependent on what definition of gearing is used. If the ratio of long-term debt to equity is used, developing country indebtedness ratios are not high. However, if the more encompassing ratio of total debt to total equity is used, the gearing of developing country corporations is high (see Table 7). This reflects

[8]Of course, there is also a positive feedback loop between the two markets, with higher stock market valuations leading to capital inflows and an appreciating exchange rate. It is thus possible that a stock market bubble will lead to an overvalued real exchange rate that in turn affects the competitiveness of the tradeable sector.

the extensive use of more easily available short-term debt by many developing country corporations to finance their often rapid growth. In the wake of the Asian crisis and the evidence that the large amount of short-term debt contracted by conglomerates – particularly in Korea, but also in the other affected economies – had increased the vulnerability of these countries to a reversal of capital flows, the international financial institutions and governments have been calling for a reduction in gearing ratios. It should be remembered, however, that it is possible, *a priori*, to use high gearing ratios to improve performance (by creating an optimal contract that bridges the agency problem between owners and managers) and also serves to enable the creation of conglomerates in the first place. This is important since, as will be discussed in the next section, large conglomerates are instrumentally effective in late developing countries.

The key question at the heart of this issue is what defines the optimal degree of gearing. In theoretical terms this is not difficult – the optimal gearing ratio is the one that maximises shareholder value. Empirically, however, this is very difficult to determine.

It has also been argued that high gearing ratios are only possible because the conglomerates themselves are considered by the state as "too big too fail" and so do not have to bear the cost of financial distress. However, this overlooks the mechanism by which discipline was instilled in the system. A failing conglomerate in Korea was not simply dissolved through the market (which might not place a value on the firm) but was rather taken over by another conglomerate. The conglomerate thus ceased to have an independent existence and the managers who ran it were dismissed. Again, in markets which are incomplete such a mechanism is efficient and reduces the losses associated with completely dissolving the conglomerate. These countries have maintained high growth rates despite such supposedly "inefficient" practices. In the wake of the Asian crisis there has been a chorus of calls for the establishment of an effective bankruptcy code in these countries. Given that capital account liberalisation has increased the presence of foreign banks and investors in Asian corporations, such a development is probably necessary. However, it does not answer the important question of which bankruptcy code to establish. Bankruptcy codes are very different throughout the OECD and developing countries will have to examine them closely to see which one is most effective in their individual circumstances.

However, high gearing ratios entail both benefits and costs for the firm. High ratios, as noted above, can help alleviate the agency problem that exists between owners and managers by compelling the latter to work harder to improve profitability and productivity. Furthermore, high gearing ratios also allow families that are reluctant to issue new equity to retain control of companies. Under normal circumstances, high gearing ratios do not present many problems since short-term debt is almost always rolled over, making it the functional equivalent of long-term debt. However, as the Asian crisis of 1997-8 demonstrated, high levels of debt can also be a source of vulnerability, especially if it has a short maturity structure and is denominated in foreign currency. In principle, this problem should be attenuated if the debt is contracted in local currency because the central bank can expand the money supply to reduce the real financing burden of the corporate sector.

VIII. Conglomerates and Economic Efficiency

Another issue closely connected with corporate governance and corporate finance in emerging markets is that of large family-owned conglomerates – an organisational form which is ubiquitous in the developing world. These have been blamed for the Asian crisis because of their lack of transparency, poor corporate governance, and inadequate accounting procedures and for not being focused. The owners are thought to be more interested in empire building than in pursuing share-holder value. It is also suggested that the giant third world conglomerates, or the business groups, are regarded by the governments as being 'too big to fail,' leading to moral hazard. The high gearing ratios of developing country conglomerates, such as those in Korea, are thought to reflect the cronyistic relationship between corporations, banks and the government. The business groups often have an in-house banks which it is alleged are used by the controlling families to undertake risky debt financed projects, or to create over-capacity.

This is however a partial, one-sided picture of Business Groups in developing countries that ignores the most recent theoretical and empirical research on the subject. It also overlooks the salient point that such firms have been playing the leading role in emerging markets in all continents notwithstanding the differences in institutional structures, cultures and government economic policies. Economic policy towards developing country conglomerates needs to be based on a full comprehension of their specificity rather than simply applying the lessons of diversified firms in the U.K. and the U.S.

The other side of the story is provided by Amsden (1989, 2000), in a series of papers by Khanna and Palepu (notably 1997, 1999), and Khanna and Yafeh (2000) as well as the earlier work of other scholars (see for example Leff (1978, 1979)). These scholars point out important differences between the third world conglomerates and their western counterparts. The latter, particularly in the U.S., were products of the huge takeover movements of the 1960s. At that time, the Anglo-Saxon stock markets convinced themselves that conglomerates added value: they became the glamour stocks of the period. However, the subsequent lacklustre performance of conglomerate firms led by the mid-1980s to stock market opinion moving decisively against these diversified firms. The same market professionals and investment banks who made money on assembling these conglomerates in the 1960s through the takeover process now profited from dissembling these through the same process – what Scherer (1988) called the “bustup” takeovers. Ignoring the social cost of these obvious mistakes of the stock markets,[9] the significant point is that developing country conglomerates are a different breed: they are normally not products of takeovers but in fact have usually grown and diversified organically. Many of them are, however, engaged in such a wide variety of products and industries, with no apparent technological connections between them, that they have been rightly called idiosyncratic conglomerates.[10] Historically, there were diversified firms in today’s advanced countries as well during the course of their economic development. However, this diversification was usually limited to the technologically closely related industries (Chandler 1977; and Amsden and Hikino 1994). The emerging market conglomerates are diversified far beyond such technological linkages.

[9]See further Ravenscraft and Scherer (1987) on this point.
[10]This is Guy Pfefferman’s phrase. See Singh (1995a).

Alice Amsden (1989, 2000) regards Korean chaebols as the engines of Korea's industrial development and of its enormous success in international markets. Khanna and Palepu in their papers cited earlier provide the theoretical rationale as to why these big business groups maybe more successful in emerging markets than in developed countries. Their argument is straightforward. Developing countries suffer from a large number of market deficiencies. They have incomplete or missing product markets, as well as those for labour and capital, far more so than would be the case in advanced countries. In addition, emerging markets do not yet have the whole gamut of information gathering and disseminating private organisations, regulatory institutions, professional bodies, all of which constitute the economic, social and legal institutional framework within which advanced country markets are embedded. In the absence of such a framework in emerging markets, conglomerate firms help fill this institutional void. To illustrate, in the absence of trained managers and training institutions for such managers, Business Groups would often have in-house training centres for the Group managers. Tata, for example, in India has a world class training program for all their Group managers. Similarly, in view of the many imperfections of developing country capital markets, it is more efficient for the Business Group central office to allocate capital directly through an appropriate internal allocative mechanism. Williamson (1975) is the classic reference on this subject.

In relation to international trade, developing country corporations are at a serious competitive disadvantage *vis-a-vis* those from advanced countries. The latter have well-established brand names, huge advertising budgets which constitute enormous barriers to entry for developing country firms. The Business Group gives these firms an institutional means of at least partially overcoming this handicap. Instead of promoting brand names for particular products as advanced countries corporations do, those in emerging markets attempt to build the image and reputation for high quality of the Business Group as a whole. Thus, the Samsung and Hyundai groups are promoted – rather than single product lines – as a strategic response to the market disadvantages which individual or unaffiliated developing country firms face. This has arguably been a major factor in the success of large Korean conglomerates in the international market place. The result is that by 1990, 11 Korean firms were represented in the Fortune magazine ranking of the world's top five hundred corporations, the same number as Switzerland. Twenty years earlier, there was not a single Korean company in the top five hundred.[11]

Amsden and Hikino (1994) put forward a different kind of argument to explain the existence and the efficiency of privately owned Business Groups in late industrialising countries. They suggest that in these countries Business Group managers become adept at choosing, purchasing and adapting relevant technologies from abroad. This kind of expertise Amsden and Hikino suggest is not industry specific and can be used in many different industries. Support for this hypothesis is provided by the Management Agency System, which prevailed in India for almost a hundred years. Under this system, teams specialising in modern management would offer to run firms on modern lines in different industries for a management fee. The system was ultimately abolished in India after independence, not on grounds of inefficiency, but rather on grounds of equity – the system was held to promote monopoly power and was at variance with India's "socialistic" pattern of development. Many of the leading present day Indian Business Groups are direct descendants of the Management Agency System.

There are thus powerful analytical arguments for the existence, survival and efficiency of Business groups in developing countries. In the absence of appropriate institution and markets which have taken a long time to develop, the dominant Anglo-Saxon strategies of "core competence" and "focus" are unlikely to be suitable for Business Groups in emerging markets.

A. Empirical Evidence

Turning now to empirical evidence, how do developing country Business Groups perform relative to unaffiliated firms? Are they so idiosyncratically diversified that despite the reasons outlined above they are nevertheless inefficient and need to be down-sized or abolished altogether? Some empirical research on this issue is summarised in Table 8. The table comes from Khanna and Yafeh's (2000) careful and painstaking study of Business Groups from 15 emerging markets. As the definition of what constitutes a Business

[11] See further Amsden and Hikino (1994) and Singh (1995b).

Group differs between countries in this research it is defined on the basis of local expert knowledge in each country.[12] The table pertains to various periods in the 1980s and 1990s. It indicates that in 9 out of 15 emerging markets, the average rate of return of the group-affiliated firms was greater than that of the unaffiliated firms. In 8 out of 15 emerging markets, the average standard deviation of the rate of return of the affiliated groups is smaller than that of their unaffiliated counterparts. Khanna and Yafeh conclude from the latter evidence that the "provision of risk sharing, to compensate for under-developed capital markets, is probably not the most important reason for the ubiquity of business groups around the world."

Khanna (2000) provides an overall review of the empirical studies on the efficiency of Business Groups. He concludes:

> ··· the existing evidence suggests that the performance effects of group affiliation are large and generally positive. There is substantial evidence that part of this is due to welfare-enhancing functions originating in the idea that groups substitute for missing outside institutions, but that part is also due to welfare-reducing minority shareholder exploitation (p. 748).

The last clause in Khanna's conclusion suggests that there are also negative effects of Business Groups. Specifically, the Groups are known to exploit the minority shareholders in the Group companies (see further Claessens *et al.* (1999) and Johnson *et al.* (2000)). However, notwithstanding anecdotal evidence about rent-seeking and monopolistic behaviour of Business Groups, there is very little systematic empirical evidence on this subject.

B. Policy Issues: The Chaebol Reform in Korea

The most important and immediate policy issues with respect to the Business Groups in emerging markets arise in relation to the *chaebol* conglomerates in Korea. *Chaebol* reform constituted an

[12]In some countries, Business Groups are organised along the lines of holding companies, *i.e.*, the leading company either directly or through pyramiding holds a controlling equity stake in the affiliated company. In other countries, the affiliated companies are not bound by large equity stakes, but more by social ties, ethnic origin or firm history (such as the Japanese *keiretsu*). For a fuller discussion, see Khanna (2000).

TABLE 9

DEBT-EQUITY RATIOS OF KOREAN CHAEBOLS (MILLION WON)

Company	Total assets	Debt	Debt/equity ratio
Samsung	50,856.4	37,043.6	268.2
Hyundai	53,183.7	43,319.3	439.1
Daewoo	34,205.6	26,383.2	337.3
Lucky-Goldstar	37,068.4	28,765.6	346.5
Hanjin	13,904.5	11,787.7	556.9
Kia	14,161.9	11,890.9	523.6
Ssangyong	15,807.2	12,701.4	409.0
Sunkyong	22,726.6	18,040.3	385.0
Hanwha	10,967.7	9,718.8	778.2
Daelim	5,793.3	4,586.5	380.1
Kumho	7,398.0	6,117.9	477.9
Doosan	6,402.0	5,594.0	692.3
Halla	6,626.5	6,320.8	2,067.6
Sammi	2,515.4	2,593.3	3,329.0
Hyosung	4,124.4	3,252.8	373.2
Hanil	2,628.1	2,231.8	563.2
Dong-Ah Construction	6,287.9	4,905.8	355.0
Kohap	3,653.6	3,123.6	589.4
Jinro	3,940.5	3,865.2	8,598.7
Dongkuk Steel	3,697.5	2,536.4	218.4

Source: Finance Times, August 8, 1997 reproduced in Singh (1998b).

important element in the IMF conditionality for Korea following the financial crisis on 1997-8. Reforms involved improvements in corporate governance, greater focus, reducing the level of diversification and reductions in the debt/equity ratio. This was envisaged to be a part of the structural reform of the corporate sector from close relationships between the government, business and the banks to an arm's length relationship between the three entities. After initial hesitation, the new Kim Dae Jung government evidently supported these reforms (Krause 2000).

The most serious economic criticism of the *chaebol* was that they had invested recklessly in unprofitable projects on borrowed money. It is indeed true that the top *chaebol* had, at the time of the crisis, high debt/equity ratios (see Table 9). The top five *chaebols* had an average debt/equity ratio of 458% in 1997. Under the government's reorganisation plan, imposed on the *chaebol*, they were supposed to reduce these ratios to 200% by the end of 1999.

It will be appreciated in the light of the theoretical and empirical discussions above that the case for such reforms on grounds of economic efficiency are rather thin. As Khanna and Palepu (1999) note, abolishing or restricting the *chaebol* may be inefficient in the absence of a range of market institutions that will take time to develop. There is also no reason to believe that the optimal debt/equity ratio for the top five *chaebols* is necessarily 200%, rather than any other arbitrary number. Other countries with different financial systems than those of the U.K. and the US also have high debt/equity ratios, for example, Norway (500-538%), Sweden (555%) and Finland (492%). In Japan the debt/equity ratio in 1991 was measured at 369%, while in France and Italy it measured 361% and 307% respectively. Moreover, there is reason to believe that the debt/equity ratios of US corporations are rising as they are buying up their own equity by borrowing money (*Economist*, Jan.22-Feb.2, 2001, Survey of Corporate Finance).

However, as Singh (1998b) notes, the more significant point in relation to the high debt/equity ratios of Korean *chaebol* is that these corporate financial arrangements were functional within the traditional Korean system. These arrangements were particularly useful during Korea's industrialisation drive, as the corporations were induced by the government to enter into new technological areas involving huge risks. Left to themselves, the corporations may not have been able to undertake such risks, but with the government becoming in effect a co-partner through the banking system, such technological risks were effectively "socialised." However, this system became dysfunctional when the government introduced financial liberalisation and abolished economic planning in the early 1990s in preparation for its membership in the OECD. By permitting Korean companies and banks to raise money abroad without the traditional supervision and control, the authorities were unable to control – or even monitor – the rapid accumulation of short-term, foreign currency denominated debt. In this connection, it is interesting to note the case of India, since Business Groups there are also highly geared. However, despite the fact that the country's fundamentals were, if anything, weaker than those in Korea, a crisis did not develop because the government maintained strict controls on the foreign-currency exposure of the private sector. Thus, India's very limited and deliberate moves towards some capital account convertibility have not increased the vulnerability of the rupee to sudden shifts in investor sentiment and to speculative attacks.

There is very little empirical evidence in support of the view that Business Groups in developing countries must be drastically reformed or even abolished. However, there remains theoretical and empirical support for the view that large Business Groups play a key role in late industrialisation by compensating for structural gaps in developing country capital, product and labour markets. Given the paucity of evidence and studies in this area, it is appropriate to adopt a more cautious stance with regard to these groups than the current orthodox policy consensus allows. As Khanna (2000) notes in the conclusion to his study: "What seems clear is that an extreme characterization of groups as purely socially harmful or purely socially welfare enhancing appears unsupported by the evidence (p. 756)."

It is also pertinent to point out that the charge that Business Groups are large bureaucratic organisations that thwart innovation and small firm entry is not supported by analysis and evidence. On the contrary, Khanna and Palepu (1999) note that in the absence of specialised venture capital firms, the Business Groups in emerging markets help fill this institutional gap. Evidence from India – a successful IT country – suggests that the top 25 Indian exporters and producers of IT were mostly off-shoots of big Business Groups (Singh, Singh and Weisse 2000).

In relation to the reform of corporate governance, the international finance institutions view is to restructure the *chaebol* towards maximizing shareholder value, giving greater power to minority shareholders, increasing the representation of non-executive directors on the board – in other words, to look and act more like Anglo-Saxon firms. However, Singh (1999) and Chang and Park (2000) have argued that this is not the most desirable reform agenda, let alone the only possible one. An alternative strategy has been proposed by Singh (1998b). This envisages reforming the relationship between government and, business by making it more inclusive and extending it to other social sectors, particularly labour and civil society. Very briefly, one way of doing this may be to establish the German type system of corporate governance with two-tier boards where management, labour and, in the Korean case, the government would be closely involved in all major decisions of the corporation. Such co-operative relationships with respect to the governance of corporations and the society at large are more likely to help in the current crisis than arm's length relationships between government, business and labour. This is because the former are more in accord with the Korean traditions and customs and their preferences for co-operative social relationships. Structures based on arm-length relationships have a tendency to degenerate into adversarial relations during times of crisis that can make the desired economic and social changes more difficult to achieve.

Finally, it is important to observe that in the Korean context it is not just the economics of the *chaebol's* crisis and reform that are relevant but also evidently their politics. Leading chaebols are regarded by many people as being implicated in the repression during the period of military rule. If so, it is necessary to make a distinction between the owners of the particular chaebol who were involved in repression and the chaebol as an organisation form.[13] Proceedings should be taken against the Chaebol owners for their misdeeds rather than punish or abolish the Chaebol themselves. For the reasons given above the latter have still a great deal to contribute to Korea's economic development.

IX. Conclusions

To sum up, this paper has argued that there is a diversity of corporate governance systems that have proved effective in different national contexts. The continental Europeans and the Japanese have prospered with alternative corporate governance systems that have given a larger voice to stakeholders in the firm and have afforded relatively less protection to outside investors. The system of corporate governance in the US and the U.K. is clearly not the only way to effectively and efficiently run the corporate economy and, indeed, for developing countries it is far from being the best way. Its reliance on the stock market and consequently on that market's pricing process and takeover mechanism creates perverse incentives that can undermine long-term growth by accentuating the influence of short-term considerations.

In place of a drive by international organizations to promote the Anglo-Saxon system of corporate governance around the world,

[13]I am grateful to Professor J. Crotty for this point.

what is needed is a genuine recognition that there are many competing systems of corporate governance and it must be left to developing countries to decide which one is optimal for their particular circumstances. Above all, what is required is an analysis of corporate governance structures underpinned by a solid factual understanding of these systems in economic development. It must be free of the ideology and prejudice that reflexively argues that conglomerates are bad, and that any corporate governance system other than the Anglo-Saxon model is intrinsically flawed.

(*Received 29 August 2002; Revised 22 February 2003*)

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