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Financial Regulatory Harmonization in East Asia: Balancing Domestic and International Pressures for Corporate Governance Reforms

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Abstract

Is the harmonization of financial regulatory regimes possible in East Asia? Focusing on corporate governance, which many see as a critical part of the 1997 Asian financial crisis, and which is also seen as unresponsive to calls for change, this paper argues that such harmonization is possible, but that it will not be according to the “best practices” advocated by the International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, and other international organizations. At present, actors generally feign compliance with these international rules and standards. But this creates potential long-term problems by allowing distortions to persist and accumulate over time. By identifying the key actors that determine regulatory outcomes, this paper points to an alternative regulatory framework that would be adopted more comprehensively. This alternative framework is a compromise between the “best practices” advocated by international organizations, and the domestic political realities of East Asia.

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1. INTRODUCTION

Despite numerous clear recommendations for East Asian countries to implement financial "best practices" by international standards setting bodies, many nations have failed to do so along some key dimensions. "Best practices" are generally taken to mean regulatory standards as advocated by the International Monetary Fund (IMF), World Bank, Bank for International Settlements, Organisation for Economic Co-operation and Development (OECD), and other international organizations in which high-income countries, particularly the United States (US) have disproportionate influence. In general, the recommendations advocate movement toward Anglo-American financial standards.

Financial regulations and coordination have progressed furthest in banking and data dissemination in East Asia, but have stagnated with regard to corporate governance and related accounting standards, although many see these as critical factors in the Asian financial crisis of 1997. Some of the specific corporate governance recommendations commonly made include minority shareholder protections, transparency, and independent boards. The aim is to replicate the American model of diffuse shareholding which allows for frequent mergers and acquisitions, and the possibility for hostile takeovers.

Numerous benefits are commonly cited as reasons for implementing these corporate governance reforms, including: (1) stronger protections for investors which would help to attract more foreign investment; (2) higher levels of market liquidity and a lower cost of financing for all firms, but especially for small and medium-sized enterprises; (3) reducing exposure to the actions of market participants outside of the region; and (4) reducing double-mismatch tendencies. Considering the numerous benefits, why have East Asian countries changed so little?

This paper argues that there are two similar types of regulatory models at work in East Asia, which correspond to: (1) Northeast Asia (Japan; Taipei,China; Republic of Korea); and (2) Southeast Asia. While nations and corporations in both regions want to appear to comply with the "best practices" advocated by the IMF and others in order to qualify for lower cost financing from international lenders, in neither region do they sincerely adhere to them. However, they deviate for different reasons. In Northeast Asia, democracy is more mature, allowing groups such as labor and farmers to wield political power and influence regulatory outcomes. In Southeast Asia, the wealthy elite, such as business owners, tend to dominate the political process; they favor a slightly different kind of regulatory framework. If regulatory harmonization is to be successfully adopted in East Asia, policymakers must be cognizant of the underlying political dynamics that may prevent, or allow, such policies from being sincerely implemented.

The paper is organized as follows: (2) literature review; (3) political determinants of corporate governance; (4) implications for East Asia: Japan, Republic of Korea, and Singapore; and (5) conclusions and policy implications.

2. LITERATURE REVIEW ON EAST ASIA CORPORATE GOVERNANCE

Prior to the Asian financial crisis of 1997, the macroeconomic policies of many East Asian countries were consistent with the liberalizing advice of the IMF and World Bank. Their fundamentals were strong, with high savings rates, low budget deficits, current account surpluses, low inflation, and high GDP growth rates. But these macro-level accomplishments hid numerous weaknesses at the microeconomic level. For example, banks were not liberalized and tended to operate as oligopolies with all the related problems due to the lack of competition. At the corporate level, ownership was concentrated in the hands of families who paid little attention to accountability and transparency. As a result, the macroeconomic

fundamentals tended to hide many problems that persisted and even became worse with the passage of time.

Walter (2008) reports that following the 1997 crisis, Indonesia, the Republic of Korea, Malaysia, and Thailand imported international standards of many kinds into domestic legislation and administrative frameworks, including special data dissemination standards (SDDS) in the area of macroeconomic data transparency, as well as banking supervision, corporate governance, and accounting, among others. In most cases these international standards were drawn directly from those promulgated by the main international standard-setting bodies, including the IMF, Basle Committee, OECD, and the International Accounting Standards Board IASB. Despite this clear movement in the direction of regulatory neoliberalism, the quality of compliance since the crises has varied considerably over time, across standards, and across countries (e.g.,Arner, Lejot and Wang 2009). Compliance has been more successful in SDDS and banking than in corporate governance and accounting; Walter (2008) points to private sector opposition in the latter two areas as the chief obstacle.

While the self-protective measures taken after the 1997 crisis—the reserve build-up and the cautious attitude towards financial liberalization—strengthened the abilities of Asian countries to fight the recent crisis with traditional monetary and fiscal policy instruments, they further hindered corporate governance reforms and the development of financial systems domestically as well as financial integration regionally. Nevertheless, the recent crisis has highlighted the need for corporate governance reforms for several reasons.

The first reason regards the over-reliance on banking. The savings-investment imbalance that mushroomed during the past decade was largely intermediated directly or indirectly outside the region, which created high exposure to the actions of market participants of, and the economic performance in, countries outside the region. This has led to vulnerabilities with respect to the drying up of international liquidity and trade financing, and has heightened the potential for double-mismatches. Further, even when savings were intermediated within Asia, they were done mostly through the local banking system, denying financial markets the needed liquidity to develop.

Deeper, more liquid financial markets have been shown to promote economic growth (Demirguc-Kunt and Levine 2004) and their development would promote financial integration in the region and may reduce financial vulnerabilities (Garcia-Herrero, Yang, and Wooldridge 2008). But such integration involves interdependencies with other integration efforts, notably monetary integration, regional coordination of financial sector policies, as well as regulatory and supervisory convergence, particularly with regard to corporate governance. The crisis has served as a reminder of the preconditions that must be met in order to achieve smooth and stable financial integration.

The 2008 crisis has also reminded many policymakers that implementing Anglo-American corporate governance reforms and improving financial markets would help to attract foreign direct investment, especially during economic downturns. As Estanislao (2001: 4) remarks, "when stock markets are down, and there is little confidence by either local or foreign investors, if the former flee the local markets, so do foreign investors. If foreign investors come, then the locals also invest. Globalization means there is now very little distinction between foreign investor sentiment and domestic investor sentiment as both are attracted or diverted by the same considerations." Thus, in a world of mobile capital, sincere adherence to Anglo-American corporate governance rules can help to attract much-needed foreign investment.

A final reason for corporate governance reforms stems from the need for private sector companies to finance large-scale infrastructure projects, which would involve raising funds through capital markets (Plummer 2010). The development of railroads in the US and Europe was a central reason for the development of their equities markets in the nineteenth century.

According to numerous recent studies, including those conducted by the Asian Development Bank (ADB) Institute in Tokyo, ADB in Manila, and the Asia-Pacific Economic Corporation, much remains to be done in strengthening local markets (Plummer 2010). To summarize briefly some of the findings from these reports, market impediments encompass a range of issues that could be addressed through corporate governance reforms, including: lack of reliable yield curves and liquidity in the markets; lack of local institutional investors that are active in the market; underdeveloped clearing and settlement systems; weak protection of intellectual property; and insufficient protection and fiduciary responsibilities.

Why are regulatory changes to corporate governance so slow to arrive when there appear to be substantial benefits and the technical impediments are clearly identified? In short, politics.

Brown (2006: 338) points to some key political dynamics common to Southeast Asia that influence corporate governance outcomes:

Personal capitalism remains triumphant in Southeast Asia as it has been for much of the modern period. That triumph has not been disturbed, despite the emergence by the 1970s of state and institutional share ownership. Scale and scope of industrial production, too, has conformed to this continuity in personal capitalism. This is not a culturally induced differentiation but a development shaped by complex interactions between these business dynasties, the state and foreign capital, in a resource-rich environment where no constellation or web of institutional investors can usurp the pre-eminence of these capitalist barons. The commitment to personal capitalism is, ironically, assisted by the state, institutional shareholders and foreign multinationals.

This paper offers an argument that is consistent with Brown's, and also addresses two other issues, namely, regulatory outcomes across both Northeast and Southeast Asia and the four actors that explain those outcomes. In so doing, the paper seeks to answer the question: what are the chances for regulatory harmonization in East Asia?

3. POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE

When looking at the history of OECD countries during the last century, four actors have exerted a clear influence on corporate governance outcomes: business owners, labor, farmers, and institutional investors. In nondemocracies, business owners tend to wield disproportionate political influence, as in most Southeast Asian countries. When democracy arrives and successfully consolidates, the political power of labor and farmers commonly increases, as in Northeast Asia (Taipei,China; Republic of Korea; and Japan). Finally, institutional investors influence outcomes via their capacity to offer cheap financing, which is most influential for small open economies, and generally occurs through its influence on business owners. This section discusses what each actor wants, with an example illustrating the corporate governance outcome that emerges when they wield political power.

Business Owners Prefer Concentrated Ownership and Pyramidal Groups

Business owners can magnify their profits and the size of their business most effectively by retaining majority (concentrated) ownership while using a pyramidal structure, with a holding company at the top. In such situations, there are two main mechanisms by which a holding company magnifies profits for its owners: (1) economies of scale; and (2) pyramidal control. Economies of scale confer four profit-enhancing advantages. The first is due to the ability to expand production and/or services at a declining marginal cost per unit. In turn, these services can then be offered over a wider area (e.g., telecommunications, utilities, etc.) Insofar as the service is exclusively offered by that company, then monopoly pricing can cover a larger customer base, which is a second advantage. As a third advantage, lower financing costs are often possible through a holding company. Small companies usually are not well known, making buyers for their securities harder to find. A holding company can sell

securities of its operating companies at a lower cost of capital than if the operating companies tried to find buyers. As a result, holding companies may offer a saving in the costs of financing to their operating affiliates (Philips 1984). A final advantage is due to large-scale buying of supplies and equipment. Via the holding company, a number of small companies can pool their purchases and obtain discounts.

While holding companies confer substantial benefits through economies of scale, an additional and even more profitable component of the holding company structure occurs through pyramiding. Pyramidal business groups are able to magnify merely large family fortunes, or private wealth, into control over corporate assets worth vastly more. To see how this works, assume a family firm is worth one billion dollars. Now, suppose the family firm controls B1 and B2, firms also worth a billion dollars each, by owning a 50% block plus one share in each. This puts an additional two billion dollars worth of corporate assets under the family's control. The next tier multiplies control over these two corporations into control over four billion dollar corporations, and the next tiers multiply this into control over eight, then sixteen, and then thirty-two billion dollar corporations. By adding tiers, the family can lever its billion dollar fortune into control over the assets of an arbitrarily large group of operating companies in the lowest tier. As a result, *tunneling* often ensues (Johnson et al. 2000). This occurs when the controlling family tunnels resources between group firms, so profitable firms can subsidize individually unprofitable firms whose existence is nonetheless necessary to the group as a whole. However, tunneling can also enrich the controlling shareholder, which is denounced by corporate governance advocates as "expropriation" of public shareholders' wealth. This temptation to enrich the ultimate owners can lead to a variety of abuses in the management of the group and its firms, and especially in the pursuit of magnifying the holding company's earnings in order to bid up its share price.[1] For example, it can cause managers to neglect good management of operating companies, especially by failing to provide for adequate depreciation (i.e., artificially inflated values of stock and equipment) or via excessive write-ups. An example of the latter problem would involve inflating the prices of assets when company B acquires assets held by company A and then claims that they are worth far more than the investment that company A made for them. A second abuse involves the exaggeration of profits by unsound, deceptive accounting. A third problem regards the pursuit of exorbitant profits from service fees from subsidiaries. This occurs by the holding company charging excessive fees to its operating companies for services rendered by a controlling company to lower-tiered companies. The lower-tiered companies would then pass on the extra costs to the consuming public. A fourth abuse regards the disbursement of unearned dividends from the lower-tiered firms to the holding company which can greatly magnify the rate of earnings for the top holding company. And fifth, the promotion of speculation in the prices of the group's shares on the stock exchanges (Philips 1984).

These abuses were common among American corporations prior to the 1930s, and they contributed to the 1929 stock market crash. Railroads and utilities were the biggest culprits, while private bankers such as J.P. Morgan worked with the owners to expand their business empires (Chandler 1977; De Long 1991; Simon 1998; Carney 2010a). Who paid for these abuses? The costs were diffusely distributed among customers who bought the services (often at inflated or even at monopoly prices) and those who bought securities in the holding company or in the firms affiliated with the group. But in the context of the U.S., the diffuse costs were focused on actors with the capacity to overcome their collective action problems, namely farmers.

[1] On holding company abuses in the United States, see the Federal Trade Commission (1935).

Farmers Fight for Shareholder Protections in the 1930s United States, and get High Bank Deposit Rates in Post-World War II Japan

Farmers can have one of two opposing effects on corporate governance outcomes when they wield political power. On the one hand, they can press for stronger shareholder protections when they invest their savings in equities markets, as in the US. On the other hand, they may foster concentrated ownership when they provide funds via a banking system that offers them attractive deposit rates, as in post-WWII Japan.

At the turn of the twentieth century in the US, concentrated economic and financial might on the part of industry was detrimental to farmers as such oligopolistic power led to funds being drained out of the interior, raising farmers' costs of financing (Roe 1994). Further, the concentration of industry led to higher transportation, energy, and other business services costs as large firms took the best and cheapest resources, and charged customers (farmers) higher prices as a result of monopoly (Chandler 1977). And insofar as farmers' wealth was tied to potentially volatile commodities and land prices, they were more vulnerable to share price devaluations if they bought securities in good times.

Because of American farmers' sudden jump in political power following the stock market crash of 1929, the 1933 Securities Act, the Securities and Exchange Act of 1934, the 1935 Public Utilities Holding Company Act (which outlawed pyramidal ownership for utilities), and the 1935 Revenue Act (which extended the provisions in the Public Utilities Holding Company Act to other corporations) substantially strengthened protections for small investors in the US. Business owners vigorously opposed these acts, but farmers won the battle (Roe 1994; Carney 2010a). Together, these acts constituted the first federal securities legislation in the US, and they form the foundation for the Anglo-American regulatory model espoused by many international organizations today.

In Japan, by contrast, the government sought to mobilize savings from farmers via postal savings banks in order to finance rapid industrialization, via the Fiscal Investment and Loan Program, following WWII. To attract the vast pool of funds needed, generous deposit rates were offered. So long as the economy grew rapidly, the government could pay the high deposit rates. These funds were then lent to firms in strategic industries at subsidized rates, which enabled them to avoid diluting their ownership via the sale of equities. As a result, concentrated ownership, in the form of cross-shareholding among *keiretsu* firms, persisted. This is discussed in more detail in the next section.

Labor Favors Concentrated Ownership (alongside codetermination), as in Post-World War II Germany

Labor tends to favor more concentrated corporate ownership because it reduces pressure for managers to focus on short-term performance benchmarks (i.e., quarterly earnings reports) that often lead to layoffs during a downturn in the business cycle (Aoki and Patrick 1994; Dore 2000; Roe 2003). Moreover, the diffusion of corporate ownership facilitates mergers and acquisitions (particularly hostile ones), which likewise lead to layoffs (to cut costs). Because concentrated ownership fosters greater employment stability, pyramidal groups are likely to be tolerated (consider that they are common in Western Europe; Högfeldt 2005).

As income levels of workers permit more savings to be invested in equities markets, they, too, will favor stronger securities regulations (Höpner 2007). But during nations' early institutional development, workers' incomes are generally too low to inflame passions over securities markets regulations.

Looking back to Imperial Germany, the traditional view holds that banks were critical to drawing money out of the interior and directing it to productive uses that enabled Germany's rapid industrialization (Gerschenkron 1962). However, Fohlin (2005) convincingly

demonstrates that a symbiotic relationship existed between universal banks and active stock markets at this time with German markets displaying impressive development and performance, especially the principal stock market in Berlin. Calomiris (1993) and Tilly (1999) likewise illustrate that, over the period from 1883–1913, Berlin's capital markets were well-functioning and could meet the demands of industrial finance placed on them. This observation is consistent with the use of pyramidal corporations and their patterns of financing in other countries at this time (e.g., Japan and the US).

On 9 November 1918, a wave of revolution led by Soldiers' and Workers' Councils swept Berlin and the chief German cities in opposition to the Kaiser's government. On 15 November, the top three German employers met with top leaders of the three German trade union federations and signed an agreement called *Arbeitsgemeinschaft* (working community). It was a limited, but initial, form of codetermination which was equivalent to collective bargaining. It proclaimed the equality of unions and employer associations and gave the social partners the joint task of determining wages, hours, and working conditions in industry (Beal 1955). It was passed into law on 23 December 1918.

As the Nazis wiped the slate clean in May 1933 by dissolving unions, the Allies in May 1945 wiped it clean again by disbanding the German Labor Front (an arm of the Nazi party which all workers were required to join). Immediately following the war, German unions demanded labor participation "from below" (i.e., at the shop-floor and plant level), "in the middle" (in the company boardrooms) and "from above" (via national as well as state-level economic planning agencies which were to guide—if not totally control and/or own—the major segments of the German economy, as in France.)

This labor-friendly post-war environment enabled unions to build upon their post-WWI victories "from below" with works councils and "in the middle" with codetermination; however, they failed to make headway "from above" largely because of the start of the Cold War. While it would be wrong to blame the Cold War alone for the freezing of progressive reforms during the late 1940s, there can be no doubt that this geopolitical development represented a formidable obstacle to labor's goals.

After tough bargaining between workers and employers (mediated by the Allied Powers), the Codetermination Act of 1951 was passed, granting workers parity representation on the supervisory boards of enterprises in the coal, iron, and steel industries (i.e., an equal number of shareholder and worker representatives), a dramatic increase in representation from the interwar period (Carney 2010b). The act also stipulated that the labor director in these companies—a member of the management board—could not be appointed against the wishes of the worker representatives. The resurrection of works councils was institutionalized by the Works Constitution Act of 1952. Like their interwar predecessor, these councils are elected by all blue-collar and white-collar workers in a plant and are designed to give labor the right to participate in and receive information about the management of the shop floor (O'Sullivan 1998). The 1976 Codetermination Law would extend equal employee representation on the supervisory board to all of the largest companies in Germany regardless of the industry sector.

Codetermination and concentrated blockholding fit together as complements and continued blockholding means diffuse securities markets are unlikely to develop deeply and well (Roe 1999). As Streeck (1989: 131) observes, the impact of strong worker representation in German firms has led them to, "have long-term profit expectations and performance standards and high intangible investment in marketing and research, which pays only over a long period…. The emphasis on production as opposed to distribution, as institutionalized in both the finance and the industrial relations systems, corresponds to a pattern of high value-added manufacturing, which in turn is conditional upon high skills and cultivation of a continuously employed work force." Among these firms, "financial strategies are conservative, with current profits and Hausbank credit being much more important sources of capital than equity" (Streeck 1989: 123). As a result, the structure of the modern German

financial system is intimately linked to the origins of its post-WWII codetermination arrangements.

Institutional Investors (Aided by Mergers and Acquisitions) Strengthen Shareholder Protections in the United Kingdom

Among many high-income countries, rules governing corporate finance were established in the 1930s or following World War II. As a result, domestic politics has had a preponderant influence over nations' financial structures and corporate governance regulations. But in today's world, money flows quickly and in large amounts. Small, emerging economies are the most vulnerable to pressure for shareholders' protections coming from the institutional investors who control these portfolio flows. Institutional investors desire strong shareholder protections, and they prefer to invest in those countries where they can be confident that their assets will not be expropriated. Thus, institutional investors can play a heightened role in pushing countries—particularly small, open economies—towards stronger minority shareholder protections.

According to Franks, Mayer, and Rossi (2004), the decline in family ownership of British companies was due to equity issues to acquire other companies. In the first half of the century, equity issuances occurred in the absence of minority investor protections; directors of target firms protected the interests of shareholders. Families were able to retain control by occupying a disproportionate number of seats on the boards of firms. However, in the absence of large stakes, the rise of hostile takeovers and institutional shareholders made it increasingly difficult for families to maintain control without challenge. Potential targets attempted to protect themselves through dual class shares and strategic share blocks but these were dismantled in response to opposition by institutional shareholders and the London Stock Exchange. The result was a regulated market in corporate control and a large, thriving stock market. Thus, while acquisitions facilitated the growth of family controlled firms in the first half of the century, they also diluted their ownership and ultimately their control in the second half.

4. IMPLICATIONS FOR EAST ASIA: JAPAN, REPUBLIC OF KOREA, AND SINGAPORE

As Katzenstein (1984) observed with regard to Europe's small democratic states, actors are more likely to forge an inclusive compromise when the collective good of the country is highly vulnerable to international markets. That logic certainly applies to the Republic of Korea and Taipei,China following democratization in 1987 and 1996, respectively. And despite being larger, Japan also forged a similarly inclusive bargain following WWII, though it was largely due to intervention by the American Occupation Authorities. This section examines Japan, the Republic of Korea, and Singapore to illustrate that corporate governance outcomes in these countries are mainly due to the actors identified above. It will be shown that, prior to democratization, corporate governance rules were primarily determined by business owners in Japan and Republic of Korea; the entry of new groups into the political process following democratization led to new corporate governance outcomes. But in both countries, their pre-democratic corporate governance regulations resemble those of many modern Southeast Asian nations. Singapore is examined as a Southeast Asian case because it (along with Hong Kong, China) appears to abide most fully with neoliberal corporate governance recommendations. But despite outward appearances, business owners still dominate regulatory outcomes. All are high-income countries, but they will be shown to not comply sincerely with the usual "best practices" recommendations.

Japan

Pre-WWII: Zaibatsu Pyramids

Japan's pre-war financial system was highly dependent on equity finance, which began with a privatization wave from 1874 to 1896. The predominant corporate structure for the largest enterprises—the *zaibatsu*—was pyramidal. Not until wartime financing occurred (beginning in 1937 with the Sino-Japanese war), did the financial system begin to change into a more bank-dependent one (Hoshi and Kashyap 2001).

Japan's politics exhibited strong links between the rapidly growing business sector and government officials. Political institutions entrenched power in the hands of the oligarchs who surrounded the emperor (the Genrō and the Privy Council) with some political power accorded to the upper house of the Diet (the House of Peers). These institutions kept policymaking out of the hands of popular influence (e.g., labor and small farmers), and thereby cemented the power of the elite—particularly the business elite and the wealthy *bushido* leaders. Consequently, they determined domestic economic policy, and ensured that equities markets and corporate governance rules were favorable to the *zaibatsu* owners.

In the pre-war period, labor had almost no influence on the financing decisions of large firms, nor on the financial system more broadly. Although labor gained some concessions during the interwar period, when it was strongest, the most significant pieces of legislation which would have legally protected labor unions, the Labor Union Bills of 1926 and 1927, were never passed by the Diet. Likewise, small farmers had virtually no political influence.

Post-WWII: Keiretsu Cross-Shareholding and the Fiscal Investment and Loan Program

When the war with People's Republic of China began in 1938, a series of laws were passed to put the allocation and control of finance firmly under government control, resembling similar actions performed by other countries during WWII (e.g., France, Germany, and Italy). To this end, banks were consolidated. The 424 ordinary banks at the end of 1936 were consolidated to just 61 in 1945 with four major *zaibatsu* banks controlling almost half of the capital of Japan's financial institutions (Adams 1964; Hoshi and Kashyap 2001).

American General Headquarters (GHQ) viewed the business elite within Japan as having been strong proponents for the war effort, and sought to eliminate the *zaibatsu*. *Zaibatsu* dissolution was originally envisioned to include 83 companies, but in the end only 30 firms were dissolved. The others were required merely to eliminate their holding-company structure. The *zaibatsu* financial institutions emerged from the process completely unscathed. However, the pre-war structure of the *zaibatsu*—characterized by holding companies, layers of subsidiaries, and family stock ownership—was largely ended (Hoshi and Kashyap 2001).

Nevertheless, large firms were able to reconstitute themselves as *keiretsu* through share purchases to form horizontally-integrated alliances across many industries. The major *keiretsu* became centered around one bank, which lent money to the *keiretsu's* member companies and held equity positions in them. Each main bank exerted considerable influence over the companies in the *keiretsu* and acted as a monitoring and bail-out entity. This cross-shareholding structure proved especially useful for preventing hostile takeovers, especially by foreign (American) corporations, and fostered the use of patient capital, which was amenable to the newly powerful labor movement.

Immediately following the war, the labor movement surged. The Socialists proposed a system of state control of key industries (Colbert 1952), as well as the establishment of a Supreme Economic Council to determine general economic policies, subsidiary councils for each industry, and at each level of planning or supervision, trade union representatives, as well as representatives of business and government would participate. The long-term financial program of the Socialist Party called for the socialization of all banks and insurance companies, entailing the establishment of a Banking Control Committee to be headed by the

Finance Minister and to be responsible for the utilization of funds. Additionally, it proposed that half of each banks' managers would be selected from among its employees (Colbert 1952). The similarities to post-WWII France, Austria, and Germany are striking (Carney 2009).

At first, GHQ actively promoted labor unions, but as the Cold War began and the communist threat increased, GHQ modified its policies. The implementation of the Dodge Plan led to firings and layoffs on a large scale, causing the elimination of a large sector of the militant left, and to the reorganization and strengthening of oligopoly capital. Although the Dodge program involved expanding big industry and therefore employment in big industry, the reorganization was used carefully to weed out militant workers and to weaken the union movement. To retain the loyalty of the remaining workers, managers offered remaining employees lifetime employment. At the same time, the Japanese main bank system developed strongly after World War II (Hoshi and Kashyap 2001).[2] The main banks' ownership of stock in industrial firms expanded, making them main bank stockholder-creditors. They monitored firms, and acted as firms' main source of external financing for several decades after the war. Although this banking-oriented financial system remained out of the control of labor, it neatly matched their initiative for financing arrangements that would offer employment stability. Lifetime employment and the main bank system acted as stable complements, even if one did not induce the other.

At the same time, farmers were vaulted to a politically powerful position through a variety of new institutional mechanisms, including universal male suffrage, the executive-legislative balance, the electoral system and accompanying malapportionment.

Farmers' dramatic increase in political influence was initially due to two changes: (1) the lower house was granted substantially more power than during the pre-war era; and (2) land redistribution alongside universal male suffrage. As a result, farmers comprised nearly half of the total electorate in 1950 and constituted an economically powerful group. The new candidate-centered electoral system—the multi-member district single non-transferable vote system—created incentives for politicians to develop a loyal group of supporters (personal vote coalitions) by wooing them with pork in exchange for votes (Cowhey and McCubbins 1995). In Japan, farmers' power became entrenched and magnified as the key members of these local vote coalitions. Creeping malapportionment has led to farmers' disproportionate influence in subsequent decades.

With such an overwhelming proportion of the electorate following the war, agricultural interests had sufficient power to elect Diet members outright and to propose and pass legislation following the war. As a result, farmers secured a generous deposit rate for themselves via the postal savings banks, and as long as economic growth remained high, they could be sure that the banks could pay that interest rate. This led to a high accumulation of funds for the government, which were used to finance industry via the Fiscal Investment and Loan Program, and saved these firms from diluting their ownership via share sales on the equities market and via mergers and acquisitions. In this way, farmers contributed to Japanese firms' reliance on patient capital. However, this system also contributed to the development of Japan's dual economy consisting of competitive export-oriented firms alongside non-competitive, inwardly focused enterprises.

Contemporary Japan: Institutional Legacies

From the mid-1970s onwards, Japanese firms began turning to capital markets with increasing frequency to meet their financing needs, first in London and then returning to Tokyo as Japanese banks began offering competitive investment banking services (Rosenbluth 1989; Hoshi and Kashyap 2001). However, the cross-shareholding patterns that preserve a longer-term corporate strategy remained intact. Indeed, modern Japan continues

[2] Hoshi (1995) shows that post-war main bank relations grew directly out of the authoritative wartime allocation of defense companies to particular banks.

to display institutional rigidities emanating from the bargain struck after WWII. As Gourevitch and Shinn (2005: 177) attest, "Among the major industrial countries, Japan seems the least responsive to the supposed Darwinian pressure of international capital flows in forcing governance reform toward the shareholder value model."

Recent developments in the corporate sector reflect the general resistance to change, and the implementation of new mechanisms to defend to it despite pressure from institutional investors. For example, in reaction to takeover battles heating up in the past few years (e.g., Livedoor's bid for Nippon Broadcasting System in 2005), civil servants from the economy, trade, and industry ministry (METI) advanced 'right plans' —i.e., poison pills—as part of a new set of corporate-takeover rules.[3] When METI crafted its guidelines, it broadly defined four categories of 'harmful bidders', including greenmailers (a strategy used to generate a large amount of money from attempted hostile takeovers), asset strippers, and those wishing to engage in 'scorched-earth' management.[4] The four tests outlined by METI show the focus is on corporate interests in the wider sense rather than purely shareholder interests. As further evidence of protecting the post-WWII bargain, in late 2006, the government began encouraging companies to buy each other's shares as a protective measure against hostile takeover attempts.[5] In the first half of 2007, more than 15% of listed companies (over 300) installed poison pill defenses.[6] And on 6 September 2007, the government implemented the most radical overhaul to Japan's inward investment regulations in 16 years with another barrier against foreign takeovers that imposes tough controls on non-Japanese acquisitions of more than 10% of domestic companies that have technology that can be used in weapons systems. They replace a non-specific technology-protection regime with a list covering 137 products including technologies involving titanium, batteries, and semiconductors. The rules apply for the first time to blue chip companies such as Nippon Steel, which has advanced titanium technology, and electronics groups such as Sony, Toshiba, and Sharp because of their semiconductor and battery interests. Foreign observers are concerned that the new rules are being used to block politically sensitive foreign takeovers, rather than to protect national security.[7] In essence, Japan appears to abide by the "best practices" but it fails to implement rules that would lead to sincere compliance with them.

Republic of Korea

Like Japan, the Republic of Korea's chaebols were organized as business enterprises with families retaining concentrated ownership while using a pyramidal corporate structure. Following democratization, labor fought and won more influence in firm decision-making, though they did not seek to change the prevailing concentrated ownership arrangement. Only with the entry of the IMF following the 1997 Asian financial crisis did the neoliberal corporate governance reforms favored by institutional investors get implemented. Nevertheless, domestic politics remains paramount in determining regulatory outcomes; thus, a full-fledged shift toward an Anglo-American model never occurred.

Pre-1987 Democratization: Chaebol Pyramids

Chaebols, defined as, "groups of large and diversified firms vertically integrated under the ownership and managerial control of a particular family," have dominated the Korean economy for almost a half century (Jwa 2002: 2). These large business groups were created in the 1950s and benefitted from the government's industrializing strategy following the

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[3] "Shaking up Corporate Japan" in The Economist, 23 March 2005.

[4] "Defences rest on shaky foundations in Japan, poison pills could act to entrench existing management" by Mariko Sanchanta in The Financial Times, London Edition, 19 April 2006, page 23.

[5] "It's Sayonara Koizumi, Welcome Back Japan Inc." by William Pesek in The Financial Times, London Edition, 18 September 2006.

[6] "Land of the rising sums" in The Economist, 12 July 2007.

[7] "Japan turns to weapons systems for defence from foreign bidders" by Michiyo Nakamoto and Mariko Sanchanta in The Financial Times, 6 September 2007.

Japanese colonial period. *Chaebols* prospered as a result of the sales of assets left by the Japanese government: the transactions were mostly based on the “personal preferences” of upper-ranking government officials and channeled to their relatives and friends at preferential prices and favorable payment terms (Chang 2006). This cemented family-dominated ownership of the *chaebols* and led to the concentration of wealth in the hands of a few.

The ambitious industrializing plan of the Park Chung-Hee government in the 1960s subsidized and accelerated the expansion of *chaebols* in selected strategic industries, such as refined oil, steel, chemicals, and electric machinery (Jwa 2002). Funds came from a high domestic savings rate, with farmers as the main source. Entry and exit barriers to multinational corporations and foreign direct investment as well as financial and tax supports further advanced the growth of *chaebols*. Amsden (1989: 81) describes the industrialization of Republic of Korea as a, “joint venture between the state and large business.”

Democratization and Labor’s Assertiveness: 1988–1997

The harmony of the government-business nexus based on “co-evolutionary dynamics” subsided over time (Carney 2008). The escalating militancy of labor and the subsequent fall of authoritarian rule in 1987 eroded the dominance of the *chaebols* in the political process, engendering government policy changes that emphasized market mechanisms (as opposed to preferential treatment) and drastically decreased direct financing to business (Chang 2006). A series of revisions to the Monopoly Regulation and Fair Trade Act[8] effectively curbed the *chaebols* with direct interventions into their corporate structure. Firstly, regulations on mergers and acquisitions and large business groups were introduced in 1986. Subsequently, restrictions on market concentration and cross-debt guarantees among *chaebol* affiliate firms were introduced in 1990 and 1992, respectively (Jwa 2002).

These new regulations sought to limit *chaebols’* monopoly power in the domestic market without undermining their concentrated ownership arrangements, which was consistent with labor’s push for improved employment conditions following democratization in 1987 (this episode offers an interesting contrast with American farmers in the 1930s who pressed for the reduction of monopoly pricing *as well as* the dismantling of corporate pyramids.) For example, the civilian government of Kim Young-Sam (1993–1997) passed the Employment Security Act of 1994, which dictates that, “an employer shall not dismiss, temporarily layoff, suspend, transfer, reduce the wages of, or take other punitive measures against a worker for unjustifiable reasons” (Park and Lee 1995: 47). The Employment Insurance Act of 1993 also provided benefits for the unemployed and the Employment Insurance System launched on 1 July 1995 was designed to, “prevent joblessness, promote employment and improve workers’ vocational skills” (Ministry of Labor 2008: 31). Another significant development was the official establishment of the Korean Confederation of Trade Unions in November of 1995, which reorganized powerful individual unions into one and promoted labor rights and workplace democracy.

Shareholder Protections Following the Asian Financial Crisis

The full-scale introduction of American-style corporate governance rules by the IMF—in essence, acting in the interests of institutional investors—occurred as a consequence of the crisis; they emphasized minority shareholder protections, transparency, and independent boards (Jwa and Lee 2004). If we consider the growth of the Republic of Korea’s stock exchange as a reasonable indicator of whether the reforms have worked, we can observe

[8] The Monopoly Regulation and Fair Trade Act was first enacted in 1980 and the Korea Fair Trade Commission (KFTC) was established in 1981 in supervision of the Act (Jwa 2002: 28): “The purpose of this Act is to promote fair and free competition, to thereby encourage creative enterprising activities, to protect consumers, and to strive for balanced development of the national economy by preventing the abuse of Market-Dominant Positions by enterprisers and the excessive concentration of economic power, and by regulating improper concerted acts and unfair business practices” (Monopoly Regulation and Fair Trade Act).

that they have been highly successful. Table 1 presents information on East Asian stock exchanges for 1996 and 2007; countries that exhibited the largest increase in the number of firms listed, and market capitalization, include the Republic of Korea, Hong Kong, China, and Singapore. The Minority Shareholder Protections Index offers a rough guide to the level of protections across countries; however, it is based on several sources that use data closer to 1996, and thus does not include the substantial changes that occurred in the Republic of Korea following the Asian financial crisis.

Table 1: An Overview of East Asian Stock Exchanges in 1996 and 2007

Country	Stock Exchange	Est.	Number of companies 1996	Number of companies 2007	Change (%)	Market cap. (US$ million) 1996	Market cap. (US$ million) 2007	Change (%)	MSP[a] Index
Hong Kong, China	Stock Exchange of Hong Kong, China	1891	583	1,241	112	449,258	2,654,416	490	70
Indonesia	Indonesia Stock Exchange	1977	253	383	51	91,016	211,693	132	21
Japan	Tokyo Stock Exchange	1878	1,749	2,414	38	3,106,108	4,330,922	39	37
Republic of Korea	Korea Exchange	1956	760	1,757	131	138,817	1,122,606	708	37
Malaysia	Malaysia Exchange	1964	621	986	58.7	307,179	325,290	5.8	67
The Philippines	Philippine Stock Exchange	1965	216	244	13	80,649	103,007	27.7	35
Singapore	Singapore Exchange	1910	266	762	186	153,234	539,177	251	84
Taipei,China	Taipei,China Stock Exchange	1962	382	703	84	273,608	663,716	142	35
Thailand	Stock Exchange of Thailand	1975	454	523	15.1	99,828	197,129	97.4	33

[a] Minority Shareholder Protections (MSP) Index from Gourevitch and Shinn (2005). The MSP Index best corresponds to the 1996 data.

Source: data available from national stock exchanges.

Table 2 provides summary data on corporate ownership across nine East Asian countries for 1996, and across eight of these countries for 2007 (Taipei,China is temporarily excluded due to the incompleteness of the data). Corporations in which the primary owner—the state, a family, a widely held financial company, or a widely held corporation—retains at least 10% of the outstanding shares are included in the table. If no owner controls at least 10% of the shares, the company falls into the widely held category.

Looking at the extent of change in state ownership across countries, it is clear that all countries, except Singapore, increased. The Republic of Korea exhibited the smallest increase (2.5%), suggesting an unwinding of government-business ties.

The next column provides data on family ownership. A particularly striking result is that the Philippines is the only country to exhibit a substantial increase (+37.2%). While most countries exhibited substantial declines in family ownership, the new levels indicate that family ownership remains the dominant form of ownership among all countries except Japan (13.2%) and Thailand (34.3%); though in the latter case it is nearly equivalent to the level of state ownership. The Republic of Korea displays a substantial decline.

Looking at changes in widely held ownership across countries reveals that there has been a substantial increase across all countries except the Philippines (-0.8%) and Malaysia (+6%). The Republic of Korea's increase (+31.5%) has been quite dramatic since the proportion of companies with diffuse ownership in 1996 was nearly zero. In general, the data suggest that the IMF's reforms—which correspond to the preferences of institutional investors—have had the intended effect of bolstering shareholders' confidence in the health of the Republic of Korea's largest firms, though concentrated ownership remains important, and is bolstered by domestic political support.

Table 2: Control of Publicly Traded Companies in East Asia

Country	Year	Number of corporations	State (%)	Family (%)	Widely held (%)	Widely held financial (%)	Widely held corporation (%)
10% cutoff							
Hong Kong, China	1996	200	3.5	72	0	7	17
	2007	126	23.8	57.9	15.8	1.5	0.8
			+20.3	-14.1	+15.8	-5.5	-16.2
Indonesia	1996	178	10.1	76.4	0	1.1	12.3
	2007	75	25.3	40.0	26.7	1.3	6.6
			+15.2	-36.4	+26.7	+0.2	+5.7
Japan	1996	200	1	10.5	8.5	74.5	5.5
	2007	83	8.4	13.2	54.2	14.4	9.6
			+7.4	+2.8	+45.7	-60.1	+4.1
Republic of Korea	1996	200	8	71.5	0.5	8.5	11.5
	2007	123	10.5	43.9	32	0	5.6
			+2.5	-27.6	+31.5	-8.5	-5.9
Malaysia	1996	200	12	76	0	2.5	9.5
	2007	133	42.1	48.9	6	0.8	0.8
			+30.1	-27.1	+6	-1.7	-8.7
Philippines	1996	120	4.1	51.7	0.8	9.1	34.1
	2007	108	8.3	88.9	0	0.9	0.9
			+4.2	+37.2	-0.8	-8.2	-33.2
Singapore	1996	200	33	51	0.5	4	11
	2007	77	26	27.3	24.7	6.5	11.7
			-7	-23.7	+24.2	+2.5	+0.7
Thailand	1996	167	8.9	74.2	0	5.3	11.3
	2007	99	37.3	34.3	19.1	1	2
			+28.4	-39.9	+19.1	-4.3	-9.1
Taipei,China	1996	141	3.0	65.6	0	10.4	18.1

Source: Claessens et al 2000 and author's calculations.

Singapore: Concentrated Ownership and Pyramids

As opposed to the widely held impression of Berle-Means firms in the US and UK, Singapore can be characterized as a combination of family and state capitalism (Tsui-Auch, 2004b; Morck and Steier 2005; La Porta, Lopez-de-Silanes, and Shleifer. 1999). The state maintains substantial ownership of the corporatized state-owned enterprises as well as a list of wholly owned subsidiaries through its holding companies (Temasek Holdings, Ministry of National Development Holdings, and Health Corporation of Singapore) and statutory boards (Low 2006). The major local firms have controlling shareholders with substantial power over the firms, mainly through pyramidal cascades of companies which accord the ultimate owners the benefits of diversification while retaining control over a large sweep of the economy, or through direct participation in the management. Contests for corporate takeovers are rare in Singapore, much like Japan and continental Europe, but in contrast to the US and UK (Wang, Qi, and Poh-Kam. 2002; Financial Times 27 February 2007). The difference with Japan and Europe is that poison pill and dual-class shares are not used in Singapore. Its company law provides for and enforces a one-share, one-vote rule. Nonetheless, the pyramidal structure of ownership achieves the same end in the control of firms as dual-class shares (The Economist 17 March 2007; La Porta, Lopez-de-Silanes, and Shleifer. 1999).

Moreover, the state's practice of acting as an informal guide over mergers and acquisitions transactions could also have dented the frequency of takeovers (Economist Intelligence Unit 2006; Gourevitch and Shinn 2005).

Owners decide key managerial appointments, set the strategic directions of firms and monitor performance as insiders. An amendment to the Companies Act in 2003 explicitly provides that, "the business of a company shall be managed by or under the direction of the directors" (Singapore Companies (Amendment) Act 2003, Section 157A). In Singapore, the Directorship and Consultancy Appointments Committee under the Ministry of Finance appoints the boards of directors among the government-linked companies from the civil service, and increasingly from the private sector. Low (2006: 217) observes that, "cross-interlocking directorships among a few top, trusted bureaucrats who are in the inner circle of decision-makers, is not uncommon." As in bank capitalism in Japan and Germany, this preponderance of private blockholders and the insulation of firms from hostile takeovers results in the provision of patient capital.

In the words of Morck and Steier (2005), the managers are "hired helps," subservient to the powerful family owners and the state. As such, they do not possess the unilateral decision making power of their counterparts in the US and UK, who generally have dispersed shareholders and largely passive boards of directors to deal with.

Much in line with Japan and Germany where banks perform the job of insider monitoring and provide long-term financing, the incentive for managers in Singapore is to avoid breaking with the past in corporate strategies. Furthermore, the cadre of professional manager-bureaucrats who move back and forth between the private sector and the civil service plays a significant role in the management of government-linked companies in Singapore.

Although concentrated ownership is favored by labor, it is only to the extent that it supports employment stability. However, the labor market in Singapore is highly fluid. There is no law prohibiting the firing of workers and no minimum wage. The Global Competitiveness Report finds Singapore as the second easiest place in the world to hire and fire, just behind Zambia—in other words, the easiest among the more developed countries (Lopez-Claros et al. 2006). These conditions are hailed as critical for attracting foreign direct investment. The government holds considerable discretion in determining the supply and costs of labor; for example, through setting the Central Provident Fund contribution rate or adjusting the quota of foreign workers which is kept secret, or from labor (Bhaskaran 2003; Low 2006).

Trade union movements are brought under the aegis of the National Trades Union Congress (NTUC), led by a technocratic elite co-opted by the government with a cabinet post (Khong 1995:122). "The NTUC's purpose appears to be to explain government policy to union members and mobilize their support behind government initiatives. The wage-negotiating function...has been appropriated by the National Wages Council, which meets in close-door sessions with employers and government" and releases recommendations on wage changes. A 1983 amendment of the Trade Unions Act has broken up large unions into industry-based unions, and then into small in-house unions with management participation. An incident of voting out in 2003 by the Airline Pilots' Association of Singapore of its entire executive for being seen as siding too much with the management in a deal prompted the government to amend again the Trade Unions Act. It, "remove[s] the need for its elected leaders to seek members' approval before concluding collective agreements or settling disputes with management" (The Straits Times 21 April 2004; Financial Times 2 December 2003; Rodan 2006:157). The government later on revoked a pilot's 26-year permanent residency status as a punishment for instigating the campaign and as a reminder of the potential consequences for other union militants. Labor in Singapore has a weaker voice compared to Japan and Germany. Thus, the tripartism in Singapore, much lauded by its leaders despite the conspicuous top-down features (The Straits Times 25 January 2007; Budget 2006), differs markedly from the tripartism in other small and corporatist OECD

countries such as Switzerland and Austria, or its Asian counterpart Republic of Korea (Katzenstein 1984).

5. CONCLUSIONS AND POLICY IMPLICATIONS

What are the chances for regulatory harmonization in East Asia? The evidence in this paper suggests that, for most countries, compliance with Anglo-American global financial standards is unlikely to occur with the same sincerity as exhibited in the Anglo-American models themselves. For such a level of compliance to occur, three conditions must be met: (1) strong democratic institutions, (2) politically mobilized agricultural interests, and (3) early economic development. Most developing and middle-income countries lack two or three of these conditions. Indeed, in many (if not most) emerging economies business owners wield disproportionate political influence. The evidence from political battles over the creation of securities regulations in the US suggests that in countries where business interests dominate the political process (as in Southeast Asia), it is unlikely that they will favor US-style financial regulations. Thus, the paper offers an explanation for why Southeast Asian countries have exhibited mock compliance in the wake of the 1997 Asian financial crisis. And it also offers an explanation for why crony capitalism is so widespread and entrenched in these countries.

In Northeast Asia, labor is more politically influential thanks to the successful consolidation of democracy. As a result, corporate governance reforms that would introduce diffuse shareholding are blocked since they increase employment instability. At the same time, these countries have sought rapid economic development, which indicates that savings are likely to be mobilized from rural areas via banks. Insofar as farmers receive attractive deposit rates for their savings, the banking system will be bolstered and deny liquidity from flowing to corporations via equities markets. As a result, both farmers and labor will tend not to press very hard for stronger shareholder protections.

The primary impetus for sincere compliance with neoliberal corporate governance reforms comes from institutional investors, who are largely external to the domestic political economies of these countries. While they can have some influence, especially in the wake of a financial crisis, their political power is swamped by the domestic political demands that policymakers care about most.

Thus, East Asian regulatory harmonization is unlikely to converge on the kinds of standards recommended by the IMF and other international organizations. Because cheaper financing is available if firms feign compliance with these standards, however, they will do so; sincere compliance will nevertheless be lacking.

More realistic regulatory harmonization, and sincere compliance with it, is likely to occur on a model that balances the domestic political interests of business owners with those of institutional investors who are external to Asian political economies. While this model does not explicitly recognize the role of labor, or of farmers (to the extent that they matter), it does not deviate too far from the corporate governance outcomes that emerge when labor wields political influence, making it relatively easy to accommodate such regulatory variations.

At present, this is the outcome that has emerged, but it is not explicitly recognized. The lack of formal acknowledgement of this outcome causes problems insofar as it creates incentives for businesses to hide information or to potentially mislead investors into believing they are acting in a way that they are not. It would make more sense to recognize the differences explicitly so that information problems do not generate excessive and unwanted outcomes (e.g., “irrational exuberance” or excessive pessimism). After all, financial markets are well known to go through bubbles and busts even when information is perfectly known; as deviations from full information grow, markets tend to exhibit higher highs and lower lows when the truth is finally revealed. The short-term benefits of feigning compliance with the

neoliberal model may ultimately be outweighed by the longer-term costs (in the form of a financial crisis or market crash) as persistent distortions build up over time.

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