Symposium on
Corporate governance

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The importance of corporate governance for emerging market economies is now widely recognized. Yet the debate often focuses on issues more relevant to the more advanced economies, such as board composition, executive compensation, hostile takeovers and shareholder activism. In emerging markets bank finance still dominates and most firms are closely held, often by strong families, and government interference is a pervasive feature. As North (1990), Landes (1999) and others have argued, European nations achieved prosperity because they embraced institutions that encouraged private initiative and innovation. This included imposing constitutional constraints on the ability of the government to expropriate, protecting private property against predation by other private agents and ensuring that contracts could be enforced in independent and impartial courts of law. In emerging markets and even more in less developed economies these issues are paramount in our understanding of present corporate governance challenges.

Corporate governance mechanisms thus relate to economic and legal institutions that can be altered through the political process. Reform of corporate governance is often a complex process. Firstly, the literature is often controversial: even in advanced market economies like USA, UK or Germany, there is a great deal of disagreement over the desirability of existing governance mechanisms (Becht, Bolton and Röell, 2003; Shleifer and Vishny, 1997). Secondly, in many developing and transition economies, corporate governance mechanisms are weak or even non-existent. It is not obvious where and how to start building better governance arrangements. Thirdly, governance reforms imply a limitation of powers of some stakeholders, and in the long term it might even be in their interest to resist.

Product market competition can sometimes substitute for weaknesses in corporate governance, but it is not a perfect substitute. While competition in principle forces firms to minimize costs and adopt rules (including some firm governance mechanisms)
and pushes them to raise external capital at lowest cost, there needs to be a mechanism ensuring that the firm responds. Corporate governance is meant to ensure that signals from input and output markets are channelled into corporate decision-making. Similarly, as highlighted in recent evidence from many developing and transition economies around the world, the process of privatization alone is unlikely to improve corporate performance. Improving corporate performance not only requires the provision of incentives for efficient behaviour, but also matching developments in the capital market, though this has not happened naturally in the process of privatization in many transition economies (Berglöf and Pajuste, 2003; Claessens et al., 2002). Privatization needs to be supported by a range of other policy changes and market supporting institutions if it is to create an environment for efficient firms to flourish.

It is important, however, to stress the importance of enforcement rather than regulations in undertaking an effective reform of corporate governance, especially in transition and developing economies (Berglöf and Claessens, 2006). Enforcement involves a range of private and public enforcement ‘tools’. The limited empirical evidence available suggests that private tools are more effective than public tools, at least in securities markets. However, public enforcement is necessary as well, as private enforcement mechanisms often require public laws to function. Unfortunately political economy constraints, resulting importantly from the intermingling of business and politics, often prevent improvements in the general enforcement environment, adoption and implementation of public laws in developing countries. Weak enforcement may also affect firms’ corporate governance, as it encourages concentrated ownership, thus weakening other corporate governance mechanisms, like the market for corporate control and board monitoring.

Clearly, corporate governance mechanisms depend on the specific institutional arrangements in a country. The papers published in this symposium raise a range of issues relating to the institutional characteristics in a variety of emerging market economies that remain much understudied.

Capital market developments are naturally crucial in the process of privatization in transition economies. It was expected that the managers of the restructured privatized enterprises in central and eastern European countries would rely on internally generated finance or external funds borrowed at competitive rates from the market. Unfortunately capital market developments lagged behind and, even after the reform, the companies were forced to use alternative strategies to secure necessary external finance. This had implications for corporate governance mechanisms. The paper by Filatotchev et al. uses unique survey data from large private Hungarian and Polish firms to argue that the managerial perceptions (rather than observed financial outcomes) of future financing strategies crucially depend on ownership and control patterns. In particular, domestic firms with controlling shareholders are most likely to rely on public equity while foreign-owned firms rely more on foreign banks.

A related question is whether debt financing can play a role in improving the quality of corporate governance. This possibility arises because high financial
leverage is associated with reduction of free cash flows, a greater probability of financial distress, as well as close monitoring by creditors. The paper by Estrin and Tian in this symposium, however, shows that the effects of debt financing on corporate governance also depend on the institutional setting of the country. Using a large sample of public listed companies from China, the paper finds that bank lending facilitates managerial exploitation of corporate wealth in government controlled firms in China, though it may mitigate managerial agency costs in privately controlled firms. In other words, failure of bank loans to improve the quality of corporate governance results from the common government ownership of lenders and borrowers in state-controlled commercial banks.

Financial intermediaries arise from the need to overcome the consequences of informational asymmetries between lenders and borrowers. One obvious way to overcome the informational asymmetries is to screen borrowers and impose strict monitoring. The paper by Chang in the symposium proposes an alternative mechanism, based on collective relationship banking in Korea that mitigates the informational asymmetries. In particular, the paper argues that a vertical ownership structure between a holding company and its subsidiaries can reveal private information via delegated monitoring by the holding company. While much of the existing literature highlights an individual relationship between a firm and a bank with long-term contracts, relationship banking in Korea often becomes collective and persistent within the network of a Chaebol, especially for subsidiaries in which the holding company has a lower stake.

The separation of ownership from control and management in large scale corporations may lead to the well-known principal–agent problem, thus necessitating an effective system of corporate governance to resolve these problems. The paper by Fidrmuc and Fidrmuc in this symposium argues that efficiency improvements after the introduction of managerial incentives and turnover in privatized firms in the Czech Republic not only depend on the skills and efforts of managers, but also on the closeness of their links to the executive authority of the firm. In particular, efficiency improvements are evident when managers are closely related to the executive authority, but not otherwise.

One important finding of this literature has been that the separation of ownership from control rights could lower shareholders’ value and may not be socially optimal (for example, Claessens et al., 2002; Grossman and Hart, 1988; Harris and Raviv, 1988). The paper by Driffield et al., however, argues that this general result may be reversed for the crisis-ridden East Asian countries, especially among family firms where incentive effects often dominate the entrenchment and risk-aversion effects, since management is closely linked to the controlling shareholders. This analysis thus highlights not only the distinction between family and non-family firms with respect to separation of ownership from control and management but also the institutional arrangements which explain the differential effects of ownership on both capital structure and firm value among the East Asian firms.
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References


