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„The golden rule is that there are no golden rules.”
G.B. Shaw

In the aftermath of Enron and WorldCom scandals of 2001-2002, corporate governance (CG) has been put once again into the center of academic interest. Last time this happened in mid-1997, when a global financial crisis that began in Asia was widely attributed to appalling CG practices in Korea and Japan. Thus, for young readers this whole subject matter may seem to be an old hat. In reality, the term „corporate governance” has merely a 25 year long historiography. Systematic content analysis of the Anglo-Saxon press showed that the term CG arose first in the wake of the Watergate scandal. In the mid- to the late 1970s, public opinion suddenly discovered that major American corporations were involved in corrupt payments both at home and abroad. Prior to Watergate scandal, competitive markets and good governance of business enterprises had been regarded as two sides of the same coin. It was a tacit understanding that well-run companies are honestly run companies, and vice versa. Suddenly this equation was broken. Since then the fast-growing CG literature has had a moral loading.

Interestingly, management consultants and the army of glossy business magazines did challenge this equation long time ago, at least indirectly. When management methods in Japan were contrasted with standard Anglo-Saxon practices, readers must have realised that different CG schemes were equally compatible with the notion of the free market economy. But for decades, economic theory didn't react to this challenge. It took time to acknowledge the importance of looking behind the concept of „private ownership,” (Fama – Jensen 1983, Demsetz – Lehn 1985). Suddenly, it became fashionable again to distinguish between ownership and control, to see a conflict between the interest of shareholders and managers, as some authors already posited a few decades earlier (Berle – Means 1932, Galbraith 1967).²

In the 1970s and the early 1980s, this new wave of thinking hardly impressed serious economists in Eastern Europe. They grew up on Marxist political economy. For them the idea that *ownership matters* was fully self-evident. In a way, they could have tapped each other's shoulders by saying that „our Western colleagues now discover that we always knew,„. As collective ownership had always had a variety of sub-forms (state owned enterprises, industrial trusts, industrial co-operatives, state farms, agricultural co-operatives, etc.) and these sub-forms performed differently in terms of technological progress, productivity and quality, policy debates in the eastern countries always centred around the question of ownership.

From the present come-back of the term „CG” into the academic literature, two conclusions can be drawn. The most frequently stated opinion is that the fundamental messages of the accumulated CG literature were all corroborated by the events. According to this view, the managers of WorldCom, Enron *et al.*, as well as their auditors and the analysts which lulled investors' vigilance were all unethical or corrupt. They all knew what should have been the right behavior. The rules of

¹ A cikk az ISNIE hetedik, rendes évi konferenciáján elhangzott előadás írásos változata.

² In fact, the discovery of interest conflict between owners and manager can be traced back to Adam Smith. In a famous, and now often quoted passage, he said that "[T]he directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery watch over their own. Negligence and profusion, therefore, must always prevail." (Smith 1976:164-165)

CG were good, but the bad guys disobeyed. Some fine tuning, more stringent enforcement rules³ and more vigilance will solve all the problems.

This paper first offers an alternative conclusion. It will be argued that there is no such thing as „good” CG rules. It is simply not true that adherence to the prescribed CG principles can guarantee good business, or put it negatively, without outstanding CG capitalist firms cannot grow. It is equally misleading to hope that good CG can in any way seriously help to reduce macroeconomic volatilities. The second message of this paper is that size matters more. In the globalized world of business, size is the real guarantee of success.

Matter of definition?

All this may seem to be a matter of definition only. There is a rich literature advocating a *broad definition* of CG. The World Bank, for example, defines it as broadly as „the organizations and rules that affect expectations about the exercise of control of resources in firms”⁴. In 1992, the UK Cadbury Commission had a similar, simple starting definition: „the system by which companies are directed and controlled,,”⁵ *Williamson (1996)* postulates that governance is „an institutional framework in which the integrity of the transaction is decided”. Looking at this definitional richness from a post-communist perspective, one can only sympathize with this broad brush approach. Governance is about power. The purpose of CG is to exercise power within a corporation *and* by using the corporation as a source of power in the outside world. The communist past and the post-communist present supply abundant examples how many different ways are conceivable to exercise this power. However, once accepted, the broad definition excludes any normative conclusion from the very outset. Firms, if they exist, function and grow *are* governed somehow. The adjectives „good” or „bad” are simply meaningless.

Policy makers sometimes use the term in an *extremely wide* sense, positing that CG is important for overall market confidence, FDI absorption capacity and ultimately nations’ overall wealth and welfare.⁶ This all encompassing, broad approach doesn’t seem to be helpful in economic analysis, because it is often use in a reverse argumentation. In the first half of 1980s, the Japanese CG model ran high, *because* of the impressive growth figures displayed over two decades. Later, the German CG model came into fashion, for the very same reason. In fact, macroeconomic success and CG are not twin-brothers. As the 1997 Asian financial crisis and the ensuing Russian turmoil have demonstrated, capital markets are inclined to collapse with or without fundamental reasons at certain times and then restore themselves shortly after that even if no systemic improvement occurred in governance or legislation.

For our investigation, however, the *narrow definition* of CG focusing on limited liability, publicly traded, non-financial companies with relatively diffused stock ownership is the relevant one. In this context, CG evolves around the protection of minority shareholders from fraud and abuse, whether from managers with little ownership interest or controlling shareholders who dominate the management.⁷ Here normative statements might well appear to be in order: CG is good (accountable or effective), if the interests of minority shareholders are well protected. But this is a simplification.

First, it is perfectly legitimate to ask what happens in case of opinion conflicts between managers on the one hand and minority shareholders on the other. How do we know, what is the

³ See e.g. the hastily approved American Sarbanes–Oxley Act (July 2002) and similar other legislative actions on the continent, as well as the new wave of anti-money laundering efforts worldwide.

⁴ World Bank (2002: 6).

⁵ This definition has been re-used by the latest EU Communication (EU Commission 2003) pertaining to the issue.

⁶ See e.g. the statement presented by J. R. Shelton, Deputy Secretary General of the OECD (OECD 2001: 1).

⁷ E. g.: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” Shleifer–Vishny (1997).

„real” interest of minority shareholders? How numerous should they be, to take their points seriously? If only one minority shareholder complains, does this matter, too? Second, on what ground can one say that the interest of minority shareholders is more important than that of controlling shareholders? These objections can be handled only with the introduction of a new dimension into the debate, the dimension of time. Indeed, the CG literature often speaks of *long term interest of shareholders* and by doing so, it tacitly assumes that the interests of minority and majority shareholders might diverge in the short term, but they *are* necessarily aligned on the long run. We shall come back to this problem in Section 4.

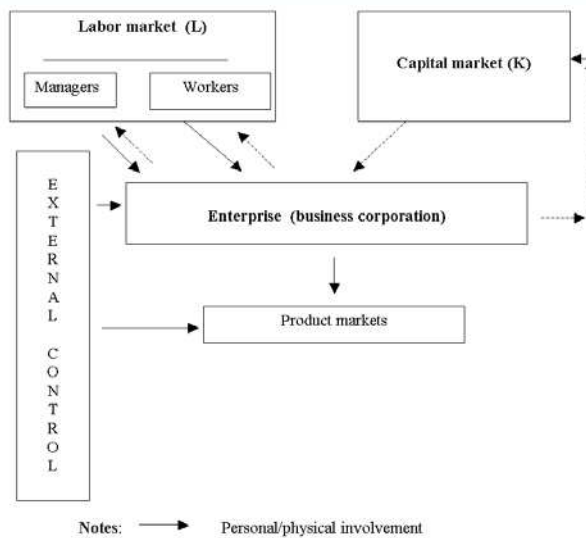
Behind the agency problem

It is customary in the CG literature to begin with a direct reference to the principle-agent paradigm and *Coase (1937, 1960, 1991)* seminal papers discovering the importance of transaction costs on competitive markets. The standard line of reasoning is that the divorce of corporate share ownership from control, first identified by Berle and Means in 1932, already implied a criticism of the microfoundations of the neo-classical paradigm. Firms are not seen anymore as a profit-maximizing black-box entity, as the neo-classical theory holds.⁸ Inside the firm, there is a deep conflict.

Chart 1.

The neoclassical model of enterprise

Firms are simultaneously controlled by two distinct groups of utility maximizing individuals, with different utility functions and risk perception. Thus, the interests of these two groups diverge. Investors, the suppliers of finance are single-minded. They are concerned only about the return on and the safety of their original investments. Managers running the firm aim at high salaries, job



⁸ It is impossible to overestimate the implications. As Coase (1991) rightly emphasized "most resources in a modern economic system are employed within firms, with how these resources are used dependent on administrative decisions and not directly on the operation of the market". In other words, Coase concluded, every firm is a little planned society.

security, and hefty work conditions. The latter group may have pet projects and in worst cases might even contemplate asset stripping.

The principle-agent problem, however, can be interpreted in a different way, too. I believe that the divorce of ownership and control doesn't overwrite the neoclassical paradigm, but only extends its borders. In a certain sense the neoclassical model was based right from the outset on the assumption that providers of capital are outsiders. Capital and labor are supplied to firms from the outside in the expectation of adequate returns in the form of profits and wages (Chart 1.) Managers – together with ordinary workers – are insiders, investors are outsiders. It is up to good CG to bridge the gap between them. This interpretation, in turn leads to a reformulation of our problem, by asking how typical is outside ownership. The short answer is: not very much.

Outsider ownership, as an important form of ownership means the diffusion of stock ownership and large share of institutional investors. But these two conditions are rarely met simultaneously. In fact this description fits only to present day US type non-financial, publicly held corporations. Who are those outside investors? Primarily large pension funds, mutual funds and similar saving vehicles (Table 1). In the past, even these institutions didn't need to prepare themselves against managerial self-dealings and similar threats until they ventured to go abroad. This is a new phenomenon. Before 1985 only the UK and the Netherlands had significant equity investments abroad. By 1998, however, the picture changed, when already 12% of US funds were invested in foreign equity. Everywhere else, however, *insider ownership* has been more widespread all the time. Internal owners may not necessarily hold majority positions, but they are in a dominant role by possessing a significant amount of stocks. Conventionally it is assumed that dominant owners can create all the conditions to keep managers accountable. Thus, our preliminary conclusion should be that CG is not an issue for dominant owners.

Table 1

Financial assets of institutional investors, as a percentage of GDP

Source: OECD data, quoted in Nestor – Thompson (2001: 22).

We can speak of insider ownership when firms are owned by identifiable individuals or a known family. In fact, this is the classical capitalist model, so eloquently depicted by Adam Smith,

	1990	1997 (or latest)
Australia	49.3	83.9
Canada	58.1	102.0
France	54.8	90.6
Germany	36.5	57.5
Italy	13.4	53.2
Japan	81.7	75.3
Korea	48.0	37.2
Netherlands	133.4	183.8
United Kingdom	114.5	193.1
United States	123.8	202.8

Schumpeter and Keynes. This model have been dominating the corporate sector of newly modernizing Asian economies, such as Korea (*chaebol*) or Indonesia since their interceptions, and continue to prevail in some European economies like Italy or Sweden. An important form of internal ownership is state ownership, where the state lives in symbiosis with firms. The state provides capital and sinks deeply in the firm's management. Cross-ownership of banks and firms also falls under the category of internal ownership (Germany, Japan), as well as the case where the state controls the big banks which in turn intertwined with firms (Germany, Italy, Greece, Turkey). The

diverse forms of employee ownership, not very popular today in fully-fledged forms like ESOP⁹, belong to this class of ownership as well. In a mitigated, indirect version – through workers' representation on company boards –, employee ownership is identifiable in many countries of continental Europe, as well as in virtually all post-communist economies.

The acknowledgement of employees' rights at par with shareholders' interest is the most important message of the so-called stakeholder or „corporate social responsibility” literature. As a UN study (*UN ECE 2003*) succinctly demonstrated much of the debate between these schools is overemphasized. The issues at stake are partly cultural, partly linguistic and ill-apt to proper economic formulations. 1) Shareholder value maximizing company managers are everywhere and always required to obey numerous laws, among which laws protecting employees, environment, human rights, product quality, honesty of information, etc. are of prime importance. 2) In the same way company managers are bound by legal provisions and contractual obligations to the protection of creditors – i.e. banks which are all profit maximizing corporations themselves. 3) Separating the shareholder and the stakeholder model is difficult due to the latter's frequent reference to the long-term interest of society. In defense of the stakeholder model, it is argued that this model actually facilitates the social acceptance of that kind of long-term corporate strategy which rational shareholders should also pursue in the long term. The question of „long-term” interests is analyzed in Section 4.

Finally, the US and UK markets also exemplify two important variants of internal ownership. At the beginning of the 1990s, when rising share prices induced corporations to buy their own shares. Often such transactions were direct, in other cases corporations' pension funds have started to accumulate the stock of the company concerned. The other form is the widespread use of stock and stock option allocation to the upper echelon of managers running the corporation. Like ESOP, these financial innovations were introduced in order to align the interest of (inside) managers to goal of (outside) shareholder value maximization. The results are known. In worst cases, stock options give an incentive to the management to manipulate company performance reports through questionable accounting, to corrupt politicians in order to lift share prices during the time when they wanted to exercise these options. In better (non-criminal) cases, the alignment of managers' interests with share prices leads to short-termism, meaning that financially motivated actions promising quick results are preferred to long-term physical investments or market expansion.

Rarely mentioned in this context, that the incentivization of company managers and workers in profit growth was actually a communist innovation. The Soviet reform economist *Lieberman (1962)* proposed first that the salary of key enterprise managers should be topped by a bonus, directly linked to the rise of profitability. Later this method was widely used in all communist countries and in some countries it was extended even to ordinary workers.

Here the conflict between dominant and minority investors manifest itself. Pension fund managers, for example, are known to be very sensitive to quarterly company reports and the ensuing share price fluctuations. Since their work is often assessed against short-term benchmarks, they have to exert pressure on company managers to deliver ever improving results (or „stories”, as the financial markets calls it), otherwise they have to sell the stock.

Interestingly, the same conflict was well-known in the centrally planned economies. There was

⁹ *The Employee Stock Ownership Plan concept was developed in the 1950s by lawyer and investment banker Louis Kelso, who argued that the capitalist system would be stronger if all workers, not just a few stockholders, could share in owning capital-producing assets. US federal legislation promoting ESOPs appeared much later, most importantly the Employee Retirement Income Security Act of 1974 (ERISA), which governs employee benefit plans and established a statutory framework for ESOPs. There are now about 11,000 American ESOPs and similar plans (stock bonus plans) covering over 8.5 million employees. ESOP is also widespread in Japan. For some companies, their fund is one of the largest shareholder. These structures are often prepared by the management in order to create a stable shareholder.*

a similar conflict between finance ministries and the branch (or line) ministries of production. The former one tried to focus on short-term profitability of enterprises, while the latter ones had pursued long-term technical development motives.

The motives of the recurrent waves of mergers and acquisitions (M&A) are rooted here, too. As many case studies showed, M&As are often pursued only for their calculable short-term impacts on share prices. It would be a gross simplification, however, to blame the managers' insider motivation for the often foreseeable misfortunes following an M&A deal. Precisely because the interests of insiders *and* outsiders are aligned in US and UK type listed companies, all shareholders – i.e. including minority shareholders – were meant to benefit from a such a deal, if they all sold their shares in the right moment.

Modern markets have developed sophisticated institutions to protect the interest of outside investors *vis-a-vis* inside managers. There is a legion of investment banks, auditors, and advisors helping the providers of finance. Information gathering and critical analysis are prime functions of the financial press. In the growing complexity of capital market transactions, however, these outsiders have partly become insiders themselves. Audit firms accepted incentivised consulting contracts, all-purpose banks became IPO advisers of their lending clients, analysts enriched themselves through insider trading, etc.¹⁰ As Soros (2002) angrily stated, there has been a dramatic rise in conflicts of interest. To make matters worse, the financial press often went along out of sheer herd instinct, even if there wasn't any conflict of interest. Remember, the Fortune magazine had voted Enron „the most innovative company of the year” for 2000. And this had not been meant to be a joke at that time.¹¹

The long-term horizon and the question of information asymmetry
The preceding analysis has led us to the conclusion that meaningful statements on „good” CG can be formulated only, if the dimension of time is included into our concept. Indeed, formulations prioritizing long-term interest versus short-term interests can be increasingly more often read in the literature.¹² This move of precision, however, creates more problem than it solves. First, one can cynically say by paraphrasing Keynes' famous dictum that „in the long run corporations are all dead”. Companies come and go – this is part of business life. Even successful, well run corporations can disappear, if more successful or more resourceful competitors acquire them. Who can say that Digital or Compaq were bad IT companies, or Creditanstalt was a bad bank, simply because they were swallowed by stronger market players? Company extinctions do not necessarily imply that minority shareholders were abused in any sense. On the contrary, M&A transactions usually take place with the formal consent of the shareholders of the acquired company. However, when shareholders vote with „yes”, their decision is usually based on short-term considerations – a comparison of daily share prices.

In this context, it is worthwhile to make a historical detour and reflect upon the lessons learned from the fate of Soviet-type state owned enterprises (SOEs). As a Hungarian economist wisely noted – Nagy (1991) – from a CG perspective, the socialist state was not a bad owner of these firms. The state worked night and day to guarantee the survival of these SOEs, by protecting the markets

¹⁰ Ten of Wall Street's largest investment banks indirectly acknowledged such accusations, when they signed a 1.4 bn USD restitution agreement with the US Securities and Exchange Commission. Commenting the agreement, SEC Chairman W. Donaldson was quoted as saying "These cases reflect a said chapter in the history of American business – a chapter in which those who reaped enormous benefits based on the trust of investors - profoundly betrayed that trust." (Financial Times, April 29, 2003)

¹¹ See the malicious comments of The Economist, March 9, 2002.

¹² As recently, as January 2003, the US Conference Board's blue ribbon Commission on Public Trust and Private Enterprise literally filled its recommendation with the expression 'long-term' in an entirely indiscriminate fashion. E.g. "Boards and shareowners must focus on the corporation's long-term success. ", "compensation arrangements for portfolio managers that encourage a long-term rather than short-term focus", "incentives for investors to hold their shares for the long-term".

with administrative rules, by soft loans, recurring bail outs, etc. From the perspective of the SOEs, the state was actually a good owner, capable to guarantee the long-term survival of these firms. Indeed, many socialist SOEs lived for decades without any major change. From a higher or broader perspective, of course, this kind of state policies had disastrous consequences. By eliminating or fettering market mechanisms, the economy as a whole became rigid, uncompetitive, corrupt, etc. But this is a different story.

Surprisingly, the Japanese economy of the 1980s suggested a similar conclusion for American observers. „The Japanese model – wrote *Prowse (1994)* – may be better from the view of maximizing firm value, it may have other costs that undermine it in the long run”.

References to „long-term” interests are problematic also, because there can be no agreement what time length does constitute long-term. Is it 3 years, or 5 or 10? After a short-lived crash in 1987, share prices on major markets rose almost continuously for 13 years.¹³

It is often said that the principal-agent conflict between investors and managers is additionally burdened by asymmetric information. Within the abstraction of a „perfect markets” it is assumed that all players have access to the same timely, accurate and free information, and as a result allocative efficiency can be achieved. In practice this rarely happens and in most cases market participants have access to different amount of information. Nobody has perfect information, but with specialization and repetition, some agents – e.g. managers within a given corporation - are significantly better informed than others. According to the standard interpretation, good CG is aimed to eliminate this information asymmetry from corporate life. Is this possible? As *Akerlof (2001)* noted, on some markets the problem is easily soluble by repeat sale and/or by reputation. The markets of second-hand cars represent the classic example, where this is problem is solved at everybody’s satisfaction. Inside large business corporations, however, the most important decisions are not repetitive. The reputation of managers is also less quantifiable than that of second-hand car dealers. The reputation of external institutions, such as auditors, investment banking firms, etc. is a stronger guarantee, but as discussed above, these external players could become biased themselves through long-term contractual agreements with the firms they supposed to vouch for quality. As a result, the information asymmetry between insiders and outsiders constantly regenerates itself.

Note also, that the principal-agent relationship is essentially vertical, while asymmetric information might well arise among horizontal partners – e.g. between heads of different divisions – or among different investor groups. The one who works more on an issue, is likely to know more on the matter, hence information asymmetry is generated. There is simply no panacea, no full solution to the problem. It is the intrinsic result of specialization, the social division of labor. In reality, the problem is even more complicated since there are no sharp border lines between opinion conflicts arising from

- asymmetric information (as described above),
- division of expert opinion over the sources and causes of risk¹⁴ and
- the different perception of individuals concerning risk in general.

Therefore, *in real life it is extremely difficult to distinguish irresponsible risk taking from dishonest management.*¹⁵ Long-term investment projects or voluminous M&A transactions are examples, where *ex ante* assessment of profitability held by management and outside shareholders can substantially diverge for all three reasons. As *Keynes (1936)* sarcastically noted in a famous

¹³ *Amazon.com* – for example – was a rising stock between 1994 and 2000. The collapse from almost USD 120/share to less than USD 10/share came only after six spectacular years.

passage of the *General Theory* „Business men play a mixed game of skill and chance. (...) If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation.”

Size matters more

The CG literature generated over the last decade didn't miss any opportunity to lecture East European policy makers about the importance of „good” CG. In the middle of transition, an *EBRD* (1997) report summarized this mantra, as follows: „The main factors governing growth are the same for both transition economies and market economies.” In my view, however, such statements were mostly flawed. In reality, it should have been said already in 1989, that the 5-10 thousand middle-size and large SOEs of Central and Eastern Europe didn't have the slightest chance to become successful global corporations. It should have been publicly acknowledged and propagated that the viability and international competitiveness of de-etatized SOEs does not depend on their willingness to adopt good CG. The truth is that *already in 1989, the companies of Central and Eastern Europe were hopelessly disadvantaged in the worldwide size competition vis-a-vis the existing, large transnational corporations (TNCs)*. In itself, the capability to produce „high quality – low price” goods is not a guarantee to find markets. The fast growing part of world trade is intra-industry trade. The East European countries have no chance to increase their exports if they keep continue selling manufactured end-products. In the context of growing globalization, export-led growth can be achieved only through the integration into the network of TNCs.

Politically, of course, such a message would have been difficult to embrace by the respective Central and East European governments. However, it was quite visible already at that time, that the former managers of SOEs had intuitively understood all this. Many of them resisted privatization, precisely because they new that their firms, be they big and powerful on the protected domestic market, were all ridiculously small in comparison with their international competitors. As the president of Hungary's largest company said at one point: „The oil multies of the world are bigger by three orders of magnitude than the largest East European oil company. At some point, the multies will „hoover up” us all.”

Reflect for a second about the fate of former East Germany – once the most developed socialist country. East Germany was legally integrated into what used to be the former West Germany through constitutional changes enacted on a single day. In this newly created legal environment, the former East German SOEs swiftly adopted western type CG structures. Nonetheless, most companies themselves were simply „swallowed” by their hungry West German competitors. Small countries are small markets, there is no room to grow. This was and remains the crux of the problem. The suggested and often implemented round-about ways and means to „fix” this shortcoming by creating privatization intermediaries, supporting cross-ownership with banks¹⁶ solved little at best and caused irreparable harm at worst.¹⁷

In retrospect, it is quite obvious that size matters not only on the export markets of manufactures. From the very beginning of the transition, the existing large foreign firms could easily penetrate and capture the traditional domestic markets of the former SOEs as well. In some countries, the penetration took place first on the traditional industrial markets, while services, including the financial sector were taken over later. In other countries, - e.g. the former GDR, the

¹⁴ Recent examples of hardly quantifiable risks include the commercial viability of third generation mobile phones (UTMS), the sustainability of the Euro, as a single currency for so many different countries or the acceptable level of window-dressing of corporate accounts.

¹⁵ Soros (2002) rightly complained: “Everybody knew that the best companies, such as General Electric and Microsoft, were massaging the numbers to maintain the appearance of a steady progression of earnings. Indeed, investors put a premium on management's ability to do just that.”

three Baltic countries or Hungary – the insurance and banking sectors were concurred already at an early stage.¹⁶

Due to the scale effect unit costs are considerably lower in TNCs, which is a big advantage. Larger size also implies stronger financial power, which in turn can be used as a collateral to bank loans in supporting capital formation, new projects and research. Larger companies are more attractive to school leavers. They can offer higher salaries and a more promising carrier path. Established trademarks, such as Coca Cola or Citibank greatly increase the chances of success in marketing and public relations.

In this context, it is particularly instructive to remind us what happened in the banking sector. In the former East Germany, West German banks took over 100 per cent of the market literary on the very first day of economic transition (i. e. with the introduction of the D-Mark on July 1, 1990). In the Baltic countries, it took 3-4 years for the Nordic neighbors to settle themselves. In Eastern Europe, the first post-communist Hungarian government had resisted for four years to sell banks to foreigners and only the costly and painful lessons of bank failures forced the second government to allow the foreign domination of the Hungarian banking sector. After the Hungarian „capitulation” in 1995, the Czech and the Polish governments followed the lead, while the former Yugoslav republics, Bulgarian and Romania remained temporarily behind. By now, the banking sector is predominantly foreign owned everywhere.

Practice showed also that once the penetration of TNCs begins into a certain market segment, it is difficult to find a „right” balance between TNCs and domestic firms. In the case of the banking sector, for example, the point-of-no-return was quickly achieved, when clients had to make a decision with whom they want to bank in the future. Will they keep their accounts with a domestic bank and risking another bank failure, or rather they switch to an „AAA”-rated OECD bank, where the mother company will guarantee their deposits under all circumstances? In the case of production firms, this tendency has been further strengthened by the fact that TNCs operating in the manufacturing sector prefer to bank with the same bank worldwide. In this logic, the preference of the local management to bank with a locally owned bank simply doesn't make sense.

Corporate governance in Eastern Europe

At this point, a new element needs to be introduced into the argumentation. The importance attached to CG hinges crucially on the neo-classical assumption about single-layer company operation. If this is the case, the conflicts between investors and managers need to be attenuated, as it is described in the CG literature. But the fact is that even the *largest* privatized Central and East European companies are not self-contained single level entities. They are merely subordinated units of a TNC, headquartered somewhere else in the world. From the perspective of the TNCs, these Central and East European operations are neither fully-fledge companies, nor profit maximizing entities. Although these entities do have well defined goal functions - production and/or distribution and sometimes even research and development -, but it is not expected from them to develop a complete set of enterprise activities. Another consequence of the multi-level character of TNCs, that within these Central and East European companies, the principle-agent contradiction – i.e. the conflict of investors and managers – doesn't manifest itself at all. There is no need for governing bodies (board of directors, supervisory board) either. One or two designated expatriate managers directly represent the interest of the foreign owner(s).

¹⁶ This was explicitly recommended in an important study of the EBRD (Phelps et al 1993)

¹⁷ Recent economic history knows only one counter-example: Nokia. But the success of the Finnish company, as a Hungarian proverb says, is only an exception which confirms the rule.

¹⁸ For a recent overview of developments, see the proceedings of a series of UNCTAD conferences under the title *Privatization and Greenfield FDI in Central and Eastern Europe: Does the Mode of Entry Matter?* in Kalotay (2001).

Following the logic customary in the literature, one can argue that introduction and propagation of good CG is important for the transition economies, even if this can apply only to the domestic-owned *small and middle-size* companies (SMEs). This argument can be developed further in three ways.

First, it can be said that good CG is also good for the health and stability of domestic companies. After a closer inspection of the accumulated evidence, however, the reverse argument appears to be equally logical. It seems that *the strength and the viability of middle-size domestic firms are based on non-formalized, quick decision-making, where the business instincts of a single decision-maker prevails over collective deliberations*. It is a fact, that these domestic companies are extremely secretive towards all stakeholders, with the important exception of banks. There is little disclosure beyond the legal minimum¹⁹, company managers refuse to talk to the press about substantive matters, and even employees are not informed about company matters. Although, the lack of formal decision-making structures and the vehement rejection of transparency may sound primitive for sophisticated model-builders there is no alternative for domestic, middle size firms, if they want to survive. Let us face it, flexibility, quick decision-making, secret operation and close links to creditors are the only specific factors rendering Ricardian comparative advantage to these middle-size firms *vis-a-vis* the very large TNCs.

In abstracto, a second line of the same argument can be pulled out from our sleeves. Even SMEs would be better off, if they rely on equity financing rather than loan financing, and then accept a strict CG control of outside investors. Here the scale effect argument creeps back again. The volume of capital requirements are too small, thus the unit costs implicated by an IPO and the subsequent presence on the stock market have proved to be prohibitive in many Central and East European countries. It is simply more cost-effective to borrow money from banks.

A third way of arguing in favor of transparent CG is to look at the motivation of domestic financial investors. Indeed, this proposition had been discussed at the beginning of the transition (Kornai, 1990, UN ECE 1994:16.), and the conclusion was that foreign investors would not enter the Central and East European markets *until* they see that the domestic investors are fairly treated and well protected. Actual developments showed that the sequencing was reverse. In the Czech Republic, Hungary and elsewhere, domestic investors were unwilling to move until foreign dominant shareholders and a few institutional investors appeared. In retrospect, the explanation is quite simple. Only these very large foreign funds were able to generate sufficient liquidity for the stocks and thus a relative stability to the securities markets as a whole. Without the participation of foreign funds, markets bound to be extremely volatile.

The economic success of the Baltic countries illustrates another interesting point. Due to the particularities of their post-1990 transition paths, the very smallness of these three countries almost equally impacted their equity and government securities markets, as well as their foreign exchange market (Sutela, 2002). There is simply almost nothing to invest in. These countries inherited zero debt from the USSR, central government balances have been quite good and pattern of foreign investment was in favor of long-term strategic investors (as opposed to financial investors). The example of the Baltics reminds us to the fact that asset markets are integrated in a horizontal way, too – once again a consideration missing from the neoclassical paradigm. In other words, the lack of sizeable bond and foreign exchange markets reduces the motivation of foreign investors to participate actively at the equity markets, even if these latter markets are perfectly liberalized and transparent (as it happens to be the case in the Baltics).

¹⁹ In Hungary, the company law requires that a copy of the annual tax report has to be deposited with the Court of Registry within 30 days after the closing of the tax reports. Many companies deliberately break this law year after year and the prefer to pay a fine instead.

Geography matters

Western observers, teaching and preaching CG to Eastern Europe underestimate geographical considerations. Geography matters.²⁰ As the eye moves eastwards on the map of Europe, the appetite of TNCs is continuously weakening. There are several factors working here: increased transportation costs, language and cultural differences. Landlocked countries have an additional disadvantage. In sum: bad location is a big handicap that even perfectly implemented corporate government reforms could not counterbalance.

The scale effect and the location effect often reinforce each other. The Central and East European experience shows that it matters a lot, which country is chosen first as an investment opportunity. Once a major investment takes place, say in the Czech Republic, it makes little sense for the same TNC or even for a competitor of this TNC to start business in the neighboring Slovakia.

Geography matters in another sense as well, and most of the CG literature targeting Eastern Europe overlooks this point, too. In analyzing the dangers of expropriation, the term „investor” is used without distinction between domestic and cross-border investments. Once again, this is a consequence of their uncritical approach to the neoclassical vision of capital markets. In reality, *the danger seriously threatening the interest of foreign investors is not the minority shareholder position*. For cross-border investors, three other risks are far more important:

- country risk,
- exchange rate risk and
- regulatory risk.

To make the matter even more complicated, the first two types of risks have to be considered in a regional, if not worldwide perspective. Financial investors are driven by herd behavior, which is a cause and a consequence of the contagion of crisis from one market to another.²¹ Regulatory risks are important, because TNCs concentrate their activities in network industries (which in turn yield increasing returns). The network industries, however, are usually regulated by national governments and/or supranational organizations.²² If these regulations are not neutral or – for any other reason – severely constrain the freedom of the investor, this can do much more harm than the lack of sophistication in CG.

Russia and China

All the above said needs qualifications, when the lessons of Central and Eastern Europe are transposed to the two largest former communist economies, Russia and China. Potentially both countries possess large markets. Russian and Chinese domestic companies have a chance to reach dimensions comparable to established TNCs. Indeed, successful companies reaching the critical mass for a TNC do emerge in both countries, in spite of the fact that they do not exhibit too much interest in the swift adoption of internationally recommended CG rules.

The case Russia already illustrates both the strength and the weakness of this line of thinking. First, it is noteworthy that the existence of all the large Russian companies is built on raw materials - chiefly gas and oil (e.g. Gazprom, Yukos, Sibur). For this reason, the financial success of these very large companies is much more dependent on the caprice of world market prices than on governance and management. Another factor that has already manifested itself in Russia is the

²⁰ The importance of geography was strongly emphasized by J. Sachs at a 1999 CASE conference, celebrating the 10th anniversary of Polish economic reforms.

²¹ To make the matter even more complicated, recent evidences suggest that the herding behavior itself is not constant. It is a variable of the equation. In 1998, the Russian bond market crisis had far reaching contagion effects, three years later a disaster of major magnitude in Argentina sent much smaller shock waves around the world.

²² The importance of national price and tariff controls are only the trivial examples in the energy and telecommunication sectors, but the role of the WTO, the ITU and the BIS are also important in determining profit-generating possibilities in the pharmaceutical, the broadcasting and the banking sectors, respectively.

vulnerability of the very large companies. In the financial crisis of 1998, the capital base of the existing very large banks melted like snow within weeks.

The case of China is less clear. While the size of the market is potentially even bigger than in Russia, for historical and cultural reasons it is less likely that the Chinese capital market will be opened soon for US-type foreign managed funds. If the recent past is any guidance for the future, it seems more likely that mainland China will continue to attract capital from Hong Kong, Taiwan or Singapore along ethnic lines, rather than along purely commercial considerations based on relative factor prices and capital affordability.

Conclusion

Spectacular corporate failures in the 1980s, such as BCCI and Robert Maxwell's Mirror Group News International led to the creation of the UK Cadbury Committee in 1991. That committee and numerous similar ones set up during the next decade were all mandated to design new internal and external rules to prevent the recurrence of such business failures. In the eyes of policy makers and legislators, moral considerations were always present – dishonest businesses deserve to go under – , but the fate of these corporations themselves were secondary. The prime concern was the overall stability of capital markets. It was – and remains to be – a widely held assumption that dishonesty and incompetence of few company managers can undermine the stability of capital markets. Improved corporate governance is meant to be the medicine.

However, as recent history has confirmed, capital markets remained volatile despite the enfolding corporate government revolution. In 2001, the longest unbroken expansion in modern US history was interrupted by corporate scandals very similar to those of the 1980s. As every child could learn from Winnie-the-Pooh, unpleasant events always come unexpected: *„I'm not saying there won't be an Accident now, mind you. They're funny things, Accidents. You never have them till you're having them.”*

This paper presented a provocative position about the relevance of CG for economic stability and growth. First, it was shown that if the term „CG” is understood in a broad sense, it is almost entirely meaningless. If the term is used in a narrow, specific manner meaning the set of rules defining the operation of publicly traded, large shareholding companies, then the basic message is misleading. The assumption, deeply rooted in the neoclassical doctrines, according to which stock prices reflect fundamentals and *therefore* must display stability, doesn't hold water.

As *Keynes (1936)* already explained, capital markets are inherently volatile and very responsive to short-term external shocks. If there is any rule, it is more realistic to assume that stock markets follow something close to a random walk. Corporate governance – good or bad – has very little impact on this.²³

The efforts reflected in the CG literature to shift both regulatory and analytical work away from short-term considerations towards long-term thinking is also in vain. There are always enough market players, who don't care about CG, because they are short-term driven. Keynes was right on this point, too. Liquidity is the name of the game. Without sufficient liquidity capital markets can't work. On sufficiently liquid markets, however, outside investors can easily afford passivity and continue to look at corporations as a black box. For such individual investors, be they as large as a US pension fund, or as small as an option-holding manager, an investment is reasonably safe over short periods and hence over a succession of short periods, if they can revise their earlier judgment and sell the investment, before there has been time for much to happen.

From the perspective of the post-communist economic transition, at least two painful

conclusions can be drawn from the above said. First, the economic conclusion: on small securities markets, such as the exchanges of Hungary, Poland, Slovenia, etc. the lack of liquidity is an additional impediment of growth for domestic business corporations. While aligning local CG rules with those of recommended for Wall Street players might help a tiny bit, the lack of sufficient liquidity will continue to remain an unsolvable problem. The second conclusion has a moral loading. The success of business corporations is fundamentally determined by market size. There is no compelling reason to believe that well run, successful companies are going to be honestly run companies at the same time. As long as there is a credible promise of above-average returns, there will be always investors willing to accept unusual risks of all kinds.

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²² It would stretch the borders of this paper too far, if we included into the analysis the short-term fluctuations of currency markets and the long-run boom/boost cycles of property markets. Quite clearly these movements are also unrelated to CG.

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