CORPORATE GOVERNANCE, CRONY CAPITALISM AND ECONOMIC CRISES: SHOULD THE US BUSINESS MODEL REPLACE THE ASIAN WAY OF 'DOING BUSINESS'?

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Abstract
This paper considers the Greenspan/Summers/IMF (GSI) argument that the Asian way of doing business was the deep cause of the Asian crisis. The IMF reform programme for the crisis-affected Asian countries suggested they should abandon the Asian business model and adopt the US corporate model. The main findings are: a) contrary to GSI doctrine, poor corporate governance and lack of competition are not common characteristics of the Asian business model; b) that the stock-market based US business model has severe limitations for developing country corporations, not least because of imperfect share prices and the imperfect market for corporate control.

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1. Introduction and Background

Corporate governance has attracted significant attention in developing countries only since the Asian crisis of 1997-1999. Arguably, this crisis and its analysis by leading US officials and by the IMF introduced it as a key issue on the international development agenda.

The Asian crisis came as a great shock to the international economic establishment. Countries with solid long-term records of fast growth, acknowledged as being fiscally responsible and to have good economic management were now faced with an unprecedented crisis, a virtual meltdown.[1] At the beginning, there was some advanced country interest in reforming the world economic and financial system in order to stop the recurrence of such crises.[2] Soon this concern evaporated as advanced countries (ACs) realised that there had not been any serious adverse spill-over effects on their own economies. Instead, leading U.S. officials (the then Chairman of the Federal Reserve, Alan Greenspan (1998), and the then Under-Secretary of the Treasury, Larry Summers (1998b)) as well as the IMF (1997, 1998a, 1998b) put forward a 'structural theory' of economic crisis in the Asian countries. They argued that the crisis may have been triggered by certain macroeconomic imbalances but that the fundamental causes were rooted in the deficient institutional structures of these economies. The latter were said to manifest themselves in the day-to-day microeconomic behaviour of households and corporations in these countries. Indeed, what was seen to be at fault was the whole Asian way of doing business.[3]

The most important defects of the Asian way were regarded as follows: (a) poor corporate governance, (b) poor state of competition, (c) close relationship between government, business and banks, which was termed as indicating crony capitalism. The essential argument of the Greenspan-Summers-IMF thesis (GSI thesis) was that poor corporate governance mechanisms and poor competition as well as crony capitalism enabled Asian firms to disregard profits in their pursuit of market share, leading to over-investment which in turn generated a crisis (due to excess supply and the consequent fall in profitability). In view of the close relationship between businesses and banks and the government, a few leading families were able to control corporate assets on a vast scale through various legal and financial devices. The large Asian conglomerates also had high debt-equity ratios that made them vulnerable to external economic shocks (to the extent that their debt was denominated in foreign currency).

On the basis of this analysis, IMF economists recommended changes in fundamental institutions of the crisis-affected countries. Essentially, developing countries were advised to abandon the Asian business model and adopt in its place the US model based on shareholders' wealth maximization subject to the discipline of liquid stock markets. Thus, they were expected to change their institutions of corporate governance, their labour laws, financial system based on 'relationship lending' and, more generally, the nature of the relationship between government, business and finance. In the IMF view, its advocacy of a US-type model was based on the ostensible superior ability of such a model to allocate resources and monitor corporate behaviour.

This paper provides a critique of the GSI critique of the Asian way of doing business. It also offers a critical analysis of the US corporate model and suggests that it is not only unsuitable for DC economies but, arguably, also inappropriate for the US economy itself.

The negative GSI view of the Asian business model has very recently been given a more solid base by theoretical and empirical research on corporate governance and crony capitalism (Morck et. al., 2005). Furthermore, the latter authors extend the GSI propositions by demonstrating that the questions at issue are not just microeconomic but also have major macroeconomic implications for the whole economy. These authors link this research with their theoretical and empirical critique of the seminal work of La Porta et al (1998, 2000) (LLSV) on law, finance and development. The implications of these analyses for corporate governance and for the broader issues of economic growth in developing countries are also discussed. In view of its importance for the main themes of this paper, this new literature is reviewed in Section 2.

The rest of the paper is organized as follows. Section 3 reviews the main features of Asian model of corporate governance, law, and finance in its idealized form on the basis of practice in Japan (during the period 1950-1973 when it resembled a developing country) and Korea. Section 4 reviews empirical evidence on whether or not corporate governance and deficiencies in the system of corporate finance have been the sources of economic crises, particularly the Asian crisis. This section also examines empirical evidence on issues relating to crony capitalism and the Asian crisis and suggests that there is no robust evidence for linking the two. Section 5 examines the main merits of the stock market based US business model as well as noting its shortcomings. Section 6 has a brief conclusion.

The main contribution of this paper is to bring together the several different literatures on corporate governance, finance, law, institutions and development so as to examine recently available empirical evidence concerning corporate governance, competition and crony capitalism in emerging markets. The latter includes the author's own recent collaborative research (Glen, Lee and Singh, 2003, Glen and Singh, 2005a, 2005b). Analyses of IMF policy programmes during the Asian crisis have been mainly been concerned with traditional micro- and macroeconomic policy recommendations. The present critique is more fundamental and relates to the institutional engineering advocated by the IMF. In addition, it provides a stringent analysis of the almost universally acclaimed US business model. The paper further contributes by linking these literatures directly to the international policy agenda on development.

2. Corporate governance, crony capitalism and wider institutional analysis

In a recent important contribution Morck et al (2005) greatly extend GSI's critique of corporate governance and crony capitalism in Asian countries. They argue theoretically, as well as on the basis of empirical evidence, that crony capitalism has far wider economic implications than is implied in the GSI analysis. Morck et al define crony capitalism in terms of the control exerted over a large part of a country's corporate assets that are held by a small group of families. The ownership of assets by the latter is typically much smaller than the extent of their control due to the use of pyramidal control structures, cross-shareholdings, super-voting rights and similar devices. In many countries this leads to high concentration of control of the country's resources in the hands of a few families. In principle, this allows the controlling families not only to influence economic processes at the micro level but also to exert influence over the country's overall economic and political processes. In theoretical terms this means that institutional development in terms of property rights and protection of minority shareholders become endogenous variables. This is in contrast to LLSV who consider legal origins (which is their primary determining variable of the corporate legal system) to be an exogenous variable.

This formulation enables Morck et al (2005) to resolve some of the well-known anomalies arising in the LLSV legal origin analysis, such as the inability of the latter research to provide an explanation for what Rajan and Zingales (2003) call the 'great reversals'. For example, before the First World War the French stock market system was more developed than that in America, whereas now the situation is quite the reverse. The LLSV theory, because of its strong path dependence, is particularly unsuited to explaining changes in phenomena over time.

Morck et al assert that, because dominant control rights are vested in families who often have little of their own capital invested, these ownership and control structures lead to problems at both the micro- and macroeconomic levels. They argue that, at the micro-level, this situation results in agency problems, and therefore resource misallocation. At a macroeconomic level, it leads to low innovation rates, economy-wide resource misallocation, and low economic growth. It is further suggested that the influence of this controlling elite may distort public policy regarding the protection of property rights, regulation of capital markets, and other institutions

Elite control over public policy can, however, lead either to policies that are unfavourable to the general public or to policies that advance social welfare. The authors term the former as ‘economic entrenchment’ or ‘oligarchic capitalism’, and the latter as ‘diffuse capitalism’ of the Anglo-Saxon variety. They suggest that the former can be a sub-optimal equilibrium. Further research is needed to explore the political economy of the distribution of corporate control.

Another point central to the vision of Morck et al is their orthodox view that asserts that freely functioning perfect capital markets constitute the best means to achieve the most efficient allocation of resources and are therefore the key to economic development. Thus they regard economic growth as being critically dependent on institutions that restrain entrenched elites, who might otherwise dominate the capital investment decisions of an economy to the detriment of the citizens. Morck et al’s line of reasoning suggests that as long as capital markets are not subverted by the controlling elite, but are allowed to function freely, they constitute the best means of achieving economic growth.

This position may be contrasted to that of J. M. Keynes who was extremely critical of the capital investment decisions of an economy being left to a freely functioning stock market. As he put it, one should not be surprised that if the capital investment decisions of an economy are left to a gambling casino the job will be ill-done (Keynes, 1936). These contrasting views of the stock market are an important theme in this paper and are taken up in the last section.

The Morck et al type of analysis extolling the virtues of free capital markets and also, implicitly, of corporate governance of professionally managed firms whose shares are widely held has underpinned IMF policy programmes for developing countries following the Asian crisis. It is, of course, also a key foundation of the US corporate model in its ideal form. It is important to note that Morck et al’s representation of the virtues of the freely functioning stock market is an idealized picture and is only a “maintained hypothesis” not put to empirical testing. This maintained hypothesis is critically examined in the second half of this paper both iin theoretical and empirical terms.

3. The Asian Way of Doing Business

It is useful at this point to outline the main differences between the Asian way of doing business and the standard US business model, drawing on broad practice in Japan between 1950 and 1973 and in Korea before financial liberalization in the early 1990s, which set the model for other Asian countries (Singh and Weisse, 1999; Singh, 1998b, 1999a).

- There was a close relationship between government and business in which the government did little or nothing without consulting business and vice versa. Such close relationships were conducted through sectoral 'deliberation councils' which were used to coordinate investment plans. Government assistance to firms was linked to strict performance standards regarding exports and technological standards (Amsden, 2001 and Evans, 1987).
- Much government intervention was carried out by means of a system of 'administrative guidance' rather than through formal legislation that required a certain degree of discretion and autonomy on the part of the senior levels of the civil service. The latter acted as guardians of the national interest to a much greater degree than did their counterparts in other industrializing countries such as Brazil (Chang, 1998).
- The relationship between corporations and the financial system - the so-called 'main bank' system - involved long-term relationships between firms and banks. This enabled Japanese or Korean managers to take a long-term view in their investment decisions. Hence, company managers were not constrained by the threat of hostile take-overs as occurs in Anglo-Saxon countries (Aoki and Patrick, 1992, Odagiri, 1994).
- East Asian companies pursued internal practices that differed from those of US and UK companies, as, for example, maintaining a co-operative relationship between management and labour, epitomised by the system of lifetime employment. In orthodox terms this resulted in considerable imperfections in the labour market (Aoki, 1990; Dore, 1986). However, the cost of these imperfections were thought to be far outweighed by the gains obtained from such co-operative relations, including in particular the willingness of workers to accept technical change and indeed to actively participate at enterprise level in proposing technical improvements (Best, 1990).
- Competition in product markets has not been regarded by the East Asian authorities as an unalloyed good: there was no dictum that "the more competition the better". Rather East Asian governments took the view that, in promoting investment and technical change the optimal degree of competition was neither perfect competition nor maximum competition.

Competition was therefore managed and guided in a purposeful manner. (Amsden and Singh, 1994).

- East Asian governments did not seek ‘close’ but what might be called ‘strategic’ integration with the world economy. They integrated fully, for example, in relation to exports but much less so with respect to imports; fully regarding science and knowledge but much less so with respect to external finance and inward multinational investment (Chakravarty and Singh, 1988). In other words, they integrated to the extent that it was useful for them to do so in building up their economy.
- Surveys of company managers in various Asian countries reveal that in East Asia managers had and continue to have rather different goals regarding company objectives than do those in Europe and in particular the US (Yoshimori, 1995; Allen, 2005). To illustrate, Yoshimori’s study found that only 3 per cent of Japanese corporate managers regarded shareholders’ interests as being paramount.

Although there have been individual country specificities, this ’ideal type’ Asian business model reflects a broad commonality of approach distinguishing it from the US business model. While in recent years there have been important changes in Asian business practice due to liberalization in the context of globalization, there is, nevertheless, significant path persistence.

Those who attribute the East Asian crisis to this Asian way of doing business are faced with two immediate difficult questions. First, to be convincing, their analysis must be able to explain not just the failure of the system, but, importantly, its previous success. It should be able to explain why for example a model that, for so long, was able to generate sustained industrialization and historically unprecedented growth yet then became the root cause of a precipitate and devastating economic crisis. Second, if the crisis is to be attributed to the Asian model it is incumbent on the critics of the Asian model to explain the suddenness of the financial and economic crash. It will be argued below that there is a more plausible explanation for the Asian crisis, which is also compatible with the known facts.

4. The Asian model and its critics: learning truth from facts

This section presents an appraisal of the influential GSI critique of the Asian way of doing business that formed the basis of IMF policy recommendations. As the IMF (1998b) noted that its programmes and policy advice to the Asian crisis countries placed particular emphasis on “wide-ranging structural reforms of the financial and corporate sectors, competition and governance policies and trade regimes.” (p.105, Box 3.2). These reforms were implemented even before the GSI propositions were fully specified, let alone verified empirically (Feldstein, 1998).

Even though the GSI thesis concerning the Asian crisis has difficulty in explaining its suddenness, it can, nevertheless, be argued that a weaker form of the hypothesis is plausible. Thus, it could be argued that, following Morck et al, over time crony capitalism could reach a stage at which it becomes counterproductive, though these authors do not provide any guidance as to how and why such a stage may be reached. This is very much an empirical question and the available facts will be reviewed below. Apart from crony capitalism, available evidence on a number of other relevant issues will be reviewed in order to assess their compatibility with the GSI critique of the Asian model of capitalism or with Morck et al's perspective on the dynamics of crony capitalism.

Since the crisis, there has been an enormous amount of research on this subject, much of it done by the international financial institutions themselves, that provides empirical evidence on a number of issues bearing on the GSI theses. Below, a summary overview is provided of evidence drawn from a variety of countries on a) the nature of share-ownership b) ownership, control and company performance, c) crony capitalism, d) the relationship between corporate governance and the stock market, and e) the state of competition in product markets.

a) Share-ownership around the world

Research since the crisis on share-ownership around the world confirms that Asian corporations are more likely to be family owned, or have a concentrated pattern similar to that observed in many continental European countries (La Porta et al., 1999a). This is in contrast to the type of American corporation characterized in Berle and Means (1933) work as having widely dispersed share-ownership and separation of ownership from control.

The family-based systems of corporate governance are often associated with relationship banking. A priori, there is no reason to believe that such systems are necessarily inferior to the arm's length stock-market based Anglo-Saxon model. Both have positive and negative features. To the extent that the former systems are better able to resolve agency problems and suffer much less from the short-termism and speculative bubbles associated with the stock market based model, they are arguably more conducive to the long-term economic development of emerging countries. Empirical evidence suggests that, under these systems, both emerging markets and European countries such as Italy, Sweden or Germany, have had successful records of fast long-term growth that is superior to those of Anglo-Saxon countries (Singh, Singh and Weisse, 2000; see however La Porta et al., 1999b).

b) Ownership, control and performance

How does family-ownership and control of large firms affect performance at the microeconomic level? A range of studies for Asian countries reviewed in Glen and Singh (2005) suggest a mixed picture. On the one side Suehiro's (2001) detailed study of Thai corporations indicates that the group of corporations with no ultimate owners (that is, widely-held firms) have the worst business record (in terms of a variety of indicators) of the listed companies surveyed. It will be recalled that such companies are regarded by the IMF as models for good corporate governance.

On the other hand, the Joh (2003) study of Korean firms found a cubic relationship between ownership and firm profitability, controlling for firm and industry characteristics. In other words, profitability generally increases as ownership by controlling families increases. Profitability is reduced when ownership is either too high or too low. Joh reconciles the varied results by observing that the business group structure found in Asian countries is helpful at low levels of economic development as it allows an internal capital market to allocate resources more efficiently than an underdeveloped external capital markets. However, at a higher level of development the advantages of an internal capital market are outweighed by those of an external market.

c) Crony capitalism

Claessens et al (2000) provide extremely interesting information on the concentration of ownership by top families in 9 Asian countries in 1996. Their data is reproduced in Table 1. This table indicates that there are indeed a small number of families that control a large proportion of listed corporate assets in these countries. Assets as a proportion of GDP controlled by the top fifteen families amounted to 84.2 per cent in Hong Kong and 76.2 per cent in Malaysia. The data in Table 1 does broadly indicate a generally high concentration of control in leading Asian countries. However, the important point is that the differences between countries that suffered economic crisis and those that did not is *not* associated with the degree of control concentration, that is, with crony capitalism as is conventionally measured – see further below. Thus there is no robust association between crony capitalism and financial crisis, let alone a causal one.

It is also important to observe that high concentrations of control are not simply an Asian phenomenon or necessarily wholly negative in terms of overall social and economic welfare. By the normal empirical definition used to measure the phenomenon of crony capitalism, that is concentration of a nation's assets held by a few families, Sweden, with almost 60 per cent of industrial assets controlled by the Wallenberg family, would be a prime example of crony capitalism. This has not, however, led to the widely assumed misallocation of resources through corrupt relationships, or resulted in economic crisis. This accords with the Morck et al (2005) analysis that elite control over assets can lead either to favourable or unfavourable outcomes. Whether crony capitalism leads to corruption or misallocation of resources is a product of the complex of relations between business and political elites. Moreover, crony capitalism could in principle arise in systems with widely dispersed share ownership (Berglof and von Thadden, 1999).

d) The relationship between corporate governance and the stock market

In orthodox analyses of corporate governance the stock market plays a central role. It is thought that the best way to bring about an optimal allocation of resources is for corporations to maximize shareholder wealth subject to the constraints of a liquid stock market. In their analysis of the East Asian crisis, the IMF and the World Bank regarded the low level of development of stock markets as a major negative feature of these countries as this obliged firms to raise capital from banks, normally state-owned, that led to high corporate debt-equity ratios thereby making them vulnerable to economic shocks. However, contrary to these prognostications, there is evidence that, surprisingly, large corporations in developing countries raise a large part of their finance on the stock market, indeed their reliance on such finance is greater than that of developed country firms (Guggler *et al*. 2003; Shleifer and Vishny 2003; Singh 1995, 2003). Furthermore, contrary to the expectations of the international institutions, the stock markets in the emerging countries in Asia expanded at a historically unprecedented rate in the 1980s. Many small Asian stock markets achieved the same level of market capitalization as small and medium size European countries (Singh and Weisse, 1998). However, whether such involvement in stock markets and stock market development is helpful for the economy and for firms is a question that is returned to in the next section dealing with the merits of the stock-market based US business model.

e) Competition in product markets

There is very little empirical evidence on the state of competition in emerging markets, despite the fact that many of these economies have been following market oriented policies of deregulation and privatization for nearly twenty years. In the absence of hard evidence, there are different views among economists as to how intensive competition is in emerging markets (see Laffont, 1999; De Soto, 2001; Porter and Sakibara, 2004).

The small amount of data available on an international comparative basis suggests that many leading developing countries have high three or four-firm concentration ratios compared with advanced countries (World Bank, 1993). On the other hand, it is also the case that developing countries tend to have a very large proportion of small firms employing less than ten workers.

In order to overcome the well-known difficulties with static measures of concentration, Glen, Lee and Singh (2001, 2003) have used time-series analysis of corporate profitability in seven emerging markets to discover the dynamics and the intensity of competition in these economies relative to what has been observed for advanced countries. Both Glen, Lee and Singh papers have employed the same methodology of the persistence of profitability (PP) studies (pioneered by Dennis Mueller and his colleagues (1990) which has been widely used to study competition intensity in developed countries.

Surprisingly, the results indicate that developing countries have, on the whole, lower persistency coefficients (λi) than those observed for advanced countries, even when allowance is made for the shorter time series available of corporate profitability for developing than for advanced countries. Further, the proportion of firms for which long-term profitability is significantly different from the norm, either in the positive or negative directions, is also much lower for developing than for advanced countries. (See Tables 2, 3 and 4)

Table 1: *How concentrated is family control?*

		% of total value of listed companies that families control (1996)				% of GDP 1996
Country	**Average Number of firms per family**	**Top 1 families**	**Top 5 families**	**Top 10 families**	**Top 15 families**	**Top 15 families**
Hong Kong	2.36	6.5	26.2	32.2	34.4	84.2
Indonesia	4.09	16.6	40.7	57.7	61.7	21.5
Japan	1.04	0.5	1.8	2.4	2.8	2.1
Korea	2.07	11.4	29.7	36.8	38.4	12.9
Malaysia	1.97	7.4	17.3	24.8	28.3	76.2
Philippines	2.68	17.1	42.8	52.5	55.1	46.7
Singapore	1.26	6.4	19.5	26.6	29.9	48.3
Taiwan	1.17	4	14.5	18.4	20.1	17
Thailand	1.68	9.4	32.2	46.2	53.3	39.3

Note: Newly assembled data for 2,980 publicly traded corporations (including both financial and non-financial institutions). The data was collected from Worldscope and supplemented with information from country-specific sources. In all cases, we collect the ownership structure as of the end of fiscal year 1996 or the closest possible date. The "average number of firms per family" refers only to firms in the sample. To avoid discrepancies in the cross country comparison due to different sample coverage, we have scaled down the control holdings of each family group in the last four columns by assuming that the firms missing from our sample are not controlled by any of the largest 15 families. The percent of total GDP is calculated using market capitalization and GDP data from the World Bank. Source: Claessens et al. (2000), p.108.

Table 2. *Developing countries: mean values of λ_i and proportion of significantly positive and significantly negative Y_{iLR}*

	Mean λ_i	**Positive Y_{iLR}**	**Negative Y_{iLR}**
Brazil	0.013	1 / 56	3 / 56
India	0.229	2 / 40	4 / 40
Jordan	0.348	1 / 17	0 / 17
Korea	0.323	7 / 82	2 / 82
Malaysia	0.349	4 / 62	7 / 62
Mexico	0.222	0 / 39	0 / 39
Zimbabwe	0.421	0 / 40	4 / 40

Source: Glen, Lee and Singh (2002)

Table 3. *Persistence of Profitability Studies for Industrial Countries*

Author(s)	Country	Sample Period	Observations per firm	Number of firms	Sample mean (λ_i)
Geroski and Jacquemin (1988)	UK	1947-77	29	51	0.488
	France	1965-82	18	55	0.412
	Germany	1961-81	21	28	0.410
Schwalbach et al. (1989)	Germany	1961-82	22	299	0.485
Mueller (1990)	US	1950-72	23	551	0.183
Cubbin and Geroski (1990)	UK	1948-77	30	243	0.482
Khemani and Shapiro (1990)	Canada	1964-82	19	129	0.425
Odagiri and Yamawaki (1990)	Japan	1964-82	19	376	0.465
Schohl (1990)	Germany	1961-81	21	283	0.509
Waring (1996)	US	1970-89	20	12,986	0.540

Source: Goddard and Wilson (1999)

Table 4. *Statistics on Long-Run Profitability: Advanced Country Corporations*

	(1) Positive Y_{iLR}	(2) Negative Y_{iLR}
United Kingdom 1951-77 (243 firms)	37 (15.2)	37 (15.2)
United States 1950-72 (551 firms)	125 (22.7)	149 (27.0)
United States 1964-80 (413 firms)	66 (16.0)	137 (33.2)
Sweden 1967-85 (43 firms)	7 (16.2)	8 (18.6)
Canada 1968-82 (161 firms)	33 (20.5)	23 (14.3)
Fed. Rep. of Germany 1961-82 (290 firms)	53 (18.3)	50 (17.2)
France 1965-82 (450 firms)	NA	NA
Japan 1964-82 (376 firms)	62 (16.5)	56 (14.9)

Note: Figures in brackets are percentages.
Source: Odagiri and Yamawaki (1990)

Complementary evidence to that of Glen, Lee and Singh (2003) is provided by other research which also bears on the dynamics of the competition process but uses a different methodology. Studies in this genre have recently been summarized by Tybout (2000) and Caves (1998). The results indicate that compared with advanced countries there is greater mobility, as well as entry and exit of firms, in the small number of emerging markets for which such studies have been carried out.

Glen, Lee and Singh (2003) suggest that these results on the comparative intensity of competition in emerging and mature countries are wholly plausible in economic terms. This is because, although there are many structural features of developing countries and the policies of their governments that are anticompetition, there are also equally strong, if not stronger, structural factors favouring competition.

Assessment
The above review of research on the ownership and control of firms, on crony capitalism and on the intensity of competition in emerging markets indicates that microeconomic behaviour and corporate structures in emerging markets provide little evidence in support of the GSI structuralist thesis. The available data on corporate governance structures in developing countries does not support the view that deficits in this sphere were responsible for the crisis. Family controlled large and small emerging market firms have been seen to be often more efficient than widely-held firms. Crony capitalism was as much as feature of the non-crisis economies as of the crisis economies. There is also evidence of intense competition and rivalry among firms in product markets.

Here is not the place to review theories of the crisis, but it is, nevertheless, worth noting that there is a straightforward alternative hypothesis which, in sharp contrast to the GSI thesis above, has strong and robust evidential support. This hypothesis attributes the Asian crisis to precipitate financial liberalization, that a number of crisis-affected countries had embarked on in early the 1990s. Moreover, it is a fact that corporate governance and the state of competition did not alter much before the crisis, whereas financial liberalization was a new phenomenon in crisis-affected countries such as Korea and Thailand.

Empirical findings contradict orthodox theory that suggests that financial liberalization and new financial instruments should lead to consumption smoothing rather than crises, which has been the observed outcome of many episodes of financial liberalization in developing countries in recent decades (Kaminsky and Reinhardt, 1999). The reasons for the observed disjuncture between theory and reality in the context of financial liberalization are now well understood. The more important reasons include a) the inherent volatility of capital flows due to irrational exuberance or unwarranted pessimism on the part of investors; b) increased competition among banks following liberalization, leading to risk-taking and bank failures; c) the changes in the global financial system and the short-termism of the leading international actors.

In theoretical terms, the conflict between textbook theory and reality in relation to financial liberalization has been explained by emphasizing the differences between the former and trade liberalization, that is, free trade. The latter is thought to lead to a Pareto optimum allocation of resources under certain well-known conditions. The analogous case of Pareto optimality for financial liberalization is not valid because such liberalization is dominated by informational asymmetries, problems of moral hazard, and adverse selection among other factors. Some of these factors are also present of trade in goods but are not a dominant feature.

In less abstract terms, the case for attributing the cause of crisis to financial liberalization is backed up by the experiences of India and China. These two countries were at the time thought to be prime candidates for the Asian contagion. Their corporate sectors had some of the same characteristics as those of crisis-affected countries. Indian corporations' debt equity ratios were among the highest in Asia and the country did not have strong macroeconomic fundamentals as compared with some of the crisis-affected countries. Yet China and India escaped the crisis, which suggests that one way to escape crisis is to maintain extensive capital controls (Singh, 2003a; Singh and Zammit, 2000).

5. The US business model: a critical examination

The US business model, stock markets and technology

The US business model of shareholder wealth maximization subject to the constraints of liquid stock markets has risen from the shadow of strong criticism as being responsible for the sluggishness of the US economy to acclaim for having engineered the US lead in the information and technology revolution and to faster growth in the US economy. The extent to which the US corporate model facilitates technological dynamism is perhaps the central issue in any assessment of its merits.

Porter (1992) reported on the findings of a US blue ribbon commission (comprising 22 leading US economists including Larry Summers) on the country's business model and the associated system of allocating capital. The Commission made serious criticisms of America's capital markets, indicating that they were misallocating resources and jeopardizing the American position in the world economy. It is indeed true that the US economy stagnated between 1973 and 1995, registering hardly any overall increase in productivity growth.

However, since 1995 it is now widely acknowledged that there has been an increase in the US economy's long-term rate of growth by 1 percentage point from 2.5 to nearly 3.5 per cent a year. This strong performance is attributed by leading scholars such as Jorgenson (2001, 2003) to the US lead in information technology. This success, in turn, is widely attributed to the pivotal role played by US stock markets and venture capital markets in financing this technological revolution. It is suggested that not all economies with stock markets are able to achieve these feats. Black and Gilson (1998) have argued that other advanced economies such as Germany have tried to imitate the US venture capital market but have not been successful. The American success is due in part to its having a highly efficient and effective market for corporate control. This allows a timely ‘exit option’, making it possible for the American-type venture market to flourish. There are also other advantages attributed to the US stock market, as, for example, the widespread use of stock options in technology industries that bring individual’s incentives in line with corporate objectives.

Larry Summers (1998a, 1999b), who in the past was critical of the short-term focus of the stock market, had a change of heart and was suggesting that the increasing stock-market pressure for performance has played a key role in the US economic success. Further, the huge investment in new technology firms in the US during the technology boom of the 1990s, despite their zero or negative short-term profits, is regarded as an obvious refutation of the short-termism alleged by critics of stock markets.

Nevertheless, a critical examination of the functioning of the stock market in the last ten years, even taking into account the above facts, raises the following questions. Does the experience of the last decade warrant a complete reversal of the conclusions reached by Michael Porter and his colleagues in 1992? Does the so-called ‘new’ US economy constitute a conclusive proof of the superiority of the country’s financial system over all others’? Is there adequate analysis and empirical evidence to indicate that the Anglo-Saxon model of corporate governance outlined above is the one that all countries, including developing ones, should adopt? Singh et al (2005) have carried out a detailed analysis of these issues and they report the following conclusions:

- The experience over the last decades in the US capital markets provides little justification for revising the unfavourable 1992 verdict of Michael Porter and his colleagues, although the reasons for this are not necessarily the same now as they were then.

- Instead of maximizing shareholder wealth, developing country companies should pay no attention to their market valuations. Rather, they should pursue their traditional objective of increasing market share or corporate growth within the overall framework of the country’s industrial policy.

- The stock-market based model of shareholder wealth maximization does not represent the ‘end of history’ or the epitomy of corporate law as some suggest.

The main reasons for these conclusions lie in the severe deficiencies of two market processes, which are central to the efficient operation of stock markets, first the pricing process and second the market for corporate control. It will further be appreciated that the last decade of applause for the US stock market must at leas be tempered by the fact during this period there was not only a boom but also a very significant bust. The NSDAQ index of share prices of new technology companies is still well below half the value that it reached at its peak in 2000.

The pricing process on the stock market

It will be observed that during the last two decades the orthodox efficient markets hypothesis concerning share prices has suffered fundamental setbacks. This specifically due to the following events: (a) the 1987 US stock market crash, (b) the meltdown in the Asian stock markets in the 1990s and (c) the recent bursting of the technology stocks bubble. Following Tobin (1984) a useful distinction can be made between two kinds of efficiency of stock markets. First, there is 'information arbitrage efficiency' (IAE) that ensures that all information concerning a firm's shares immediately percolates to all stock market participants, ensuring that no participant can make a profit on such public information. Second, there is 'fundamental valuation efficiency' (FVE), that is, share prices accurately reflect a firm's fundamentals, that is, its long-term expected profitability (Tobin, 1984). The growing consensus view is that stock market prices may at best be regarded as efficient in the first sense above (IAE), but are far from being efficient in the economically more important second sense (FVE; Singh, 1999b) This point hardly needs labouring today in the light of the bust of the technology bubble in the western stock markets and almost two decades of stock market stagnation and decline in Japan. It will be difficult to preach an EMH gospel to citizens in Thailand and Indonesia who suffered a virtual meltdown of their stock markets during the Asian crisis.

The market for corporate control

There are good theoretical reasons as well as a large body of empirical evidence to suggest why the markets for corporate control in advanced countries, including the UK and the US, do not work at all well. A central point is that the take-over selection process does not simply punish poor performance and reward good performance. The evidence indicates that selection in this market does not take place entirely on the basis of performance but much more so on the basis of size. A large relatively inefficient firm has a greater chance of survival than a small efficient firm (Singh, 1992).

Further, there are good theoretical reasons as well as empirical evidence for suggesting that take-overs may lead to 'short-termism'. In addition, more broadly, they may also result in economic rewards being given for financial engineering rather than for entrepreneurial effort in improving products and cutting costs. The take-over disciplinary process is thus seen by many to be arbitrary and haphazard (Ravenscraft and Scherer, 1987; Scherer, 1998; Tichy, 2001; Singh 2000). The deficiencies of the pricing and takeover processes are compounded in the case of developing countries because of their regulatory deficits and relative immaturity of their stock markets. Singh (1998a) argues for restrictions on the development of a market for corporate control for these countries. Rather, he suggests that developing countries should find cheaper and less haphazard mechanisms to change managements than the above stock market process.

The technology boom, the mispricing of shares and the market for corporate control

It is widely acknowledged that there was widespread mispricing of shares of shares during the technology boom of 1995-2000. There was also a huge over-investment in technology companies. Importantly, in addition to the foregoing there was perhaps a greater resource misallocation through the working of the market for corporate control. In essence grossly overpriced technology companies bought up underpriced old economy companies to the detriment of both and to the detriment of social welfare. Jensen (2003) drew attention in this context to the case of Nortel, a large US company that between 1997 and 2001 acquired 19 companies at a price of US$ 33 billion. Many of these acquisitions were paid for in Nortel shares whose value had skyrocketed during that period. When the company's price fell 95 per cent in the technology stock bust, all the acquisitions had to be written off. Jensen observed "Nortel destroyed those companies and in doing so destroyed not only the corporate value that the acquired companies - on their own - could have generated but also the social value those companies represented in the form of jobs, products and services." (pp.15)

Although Jensen suggests various ways of reducing the mispricing of shares, in Keynesian analysis such mispricing is inherent in any share pricing process via the stock market. In this paradigm, stock market players base their investment decisions not on the basis of fundamentals but on speculative and gambling considerations. With such pricing, shareholder wealth maximization is clearly not a useful objective for corporate managers who have the firm's interest in view. Kay (2003) therefore rightly suggests that corporate managers should pay no attention to the stock market at all. Indeed, the creation of shareholder value should not be a corporate goal. The Keynesian view of pricing process is supported by a large body of analytical and empirical studies.[4]

6. Conclusion

This paper has outlined the main issues involved in assessing the comparative merits of the stock-market based US corporate model and that of the traditional Asian model, based on close cooperation between government, business and finance. These have been examined here from the perspective of developing countries. Evidence provides little support for the GSI view that the fundamental causes of the Asian crisis lay in weak corporate governance and poor competitive environment in these emerging economies. There is much more evidence to suggest that the crucial factor was precipitate financial liberalization. This suggests that the IMF's policy prescriptions for the crisis affected Asian countries involving enormous institutional changes were doubly unfortunate. Not only were the grounds for rejecting the Asian was of doing business totally inadequate, but the recommended policy of adopting essentially the American model was not solidly grounded (Stiglitz, 1999). A reformed Asian model that extended also to labour and other social groups the cooperation between business and government would much more likely to be conducive to economic development and broad-based social welfare than the speculative and conflictual US corporate model.

Notes

[1] The Financial Times reported on February 20 1998 that in the less than eight month period from 1 July 1997 to 18 February 1998 Indonesia for example suffered a more that 80 per cent fall in share prices and an almost 75 per cent fall in the value of the currency against the US dollar.

[2] Thus the then US Treasury Secretary Rubin coined the phrase "the new international financial architecture" to signal the desirability of international financial reform to forestall future crises. See further Singh, Singh and Weiss, 2003.

[3] See further, Glen and Singh (2004, 2005). The present paper is a sequel to Glen and Singh (2005). It also draws upon other papers by Ajit Singh and by Ajit Singh in collaboration with others (Singh, 2003; Singh et al 2005).

[4] Earlier reviews of this literature are contained in Camerer (1989) and Journal of Economic Perspectives (1990). For a more comprehensive list of recent references see footnote 19 of Singh (1997). For the latest contributions and assessments see for example Shiller (2000) and Shleifer (2000).

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