

CIRJE-F-230

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Haider A. Khan  
University of Denver / CIRJE

July 2003

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# **Corporate Governance: The Limits of the Principal-Agent Approach in Light of the Family-Based Corporate Governance System in Asia**

**Haider A. Khan**

**Revised, June, 2003**

I would like to thank particularly Akira Suehiro and other participants of the ADBI governance study group including Tetsuji Okazaki, Yukiko Fukagawa, Midori Kizaki, Yuri Sato, Kazuo Sakakibara and Moto Noguchi. Comments from some of my colleagues were also very helpful. Joseph Fan, S.Ghon Rhee, Toru Yanagihara, Masaru Yoshitomi and Juzhong Zhuang in particular read earlier drafts and gave detailed comments. Subsequent discussions with Katsuhito Iwai at Tokyo University led to my adopting a much clearer overall approach. I have also benefited from my discussions with Prof. Miwa at Tokyo University All remaining errors are my own.

### **Abstract:**

This paper develops a critique of the standard principal-agent approach to corporate governance by developing the idea of a family based corporate governance system (FBS). FBS is contrasted with the bank-led system (BLS) and equity market based system (EMS). Both BLS and EMS are closely associated with the dominant mode of corporate finance by banks and equity markets respectively. In the case of FBS, the financing can come from three different sources. Initially, family business is financed largely by internal funds. As the enterprise grows over time, the role of banks and outside equity becomes more prominent. However, the key difference between FBS as a governance system and BLS and EMS lies in the fact that neither the banks nor the equity markets ultimately control the family business groups. The control resides with the family groups in the final analysis.

The key hypothesis verified is that in economies at a lower stage of development FBS economizes on transactions costs. This holds especially when the share of external finance in the family businesses is low with corresponding low levels of agency costs. These factors help explain the successful performance of FBS during the Asian Miracle when specific government policies encouraged rapid industrialization. Theoretically, the standard principal-agent model seems to be inadequate in explaining completely the successes and failures of the FBS type of governance. A theory of firms as socially embedded organizations that respond to the needs of multiple stakeholders may be a better framework for studying the persistence of different types of governance structures-- often in the same country. Normatively, the ability of the different governance structures to serve the needs of the different stakeholders must be assessed within such a framework. A nonutilitarian, common good approach may be more suitable for this purpose than the existing neoclassical utilitarian approach. This is also consistent with the "realist" approach to corporate governance.

## **I. Introduction**

How can we frame the complex set of issues covered under the phrase “corporate governance”? Is there one overarching theory that covers all the diverse areas addressed by the phrase itself, or do we need a number of different theories? What should be the range and explanatory reach of a proper theory of corporate governance? The scandals of misgovernance in the US itself coming to light with the ENRON disaster gave new impetus to these questions which have practical significance going beyond the academic debates regarding corporate governance. Earlier in Asia, the financial crisis of the late 1990s served the same purpose. However, the overwhelming advice with a few exceptions<sup>1</sup> then was to follow the stockmarket driven model. To sketch the implications even in a rough fashion, we need to delve into at least two different ways in which corporate governance can be conceptualized.

Corporate governance in a narrow sense addresses the fundamental microeconomic issue of how the managers of the firm are induced by banks, equity markets, or other mechanisms to act in the best interests of its shareholders and hence to maximize the discounted present value of the firm. In a wider sense, corporate governance can or should address a whole host of issues for multiple stakeholders--- ranging from efficiency and equity to the promotion of economic and political freedom. Recently, Iwai(1999) has created a framework distinguishing between the realist and nominalist approaches that can address many of the larger questions and meta-questions about corporate governance.

The present paper tries to present a preliminary conceptual framework consistent with the realist approach within which to frame the salient issues regarding Asian corporate governance. An attempt is also made to address some significant issues for

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<sup>1</sup> See Khan, Haider(1999a), “Corporate Governance in Asia: Which Road to Take?”, Paper presented at the high level symposium at ADBI, Tokyo, Japan, December.

Khan, Haider(1999b), “Corporate Governance of Family Businesses in Asia: What’s Right and What’s Wrong?ADBI Working Paper No. 3, Tokyo, Japan.

reforming corporate governance in East Asia.<sup>2</sup> Finally, the limits of the most popular theoretical approach based on the agency costs are also explored. It is argued that a complete explanation for the successes and the failures of the family-based system of governance requires a somewhat different model than the one starting from the assumption of atomistic, utility maximizing agents. This alternative approach should also be able to explain the persistence of different corporate governance structures --- often within the same country.

It appears that the standard approaches that look at the firm as simply a nexus of contracts cannot completely account for the particularities of the relationship types of corporate governance found in East Asia. Therefore, this paper extends Berglöf's (1997) two-fold classification of corporate governance structure to a threefold one by analyzing family-based corporate governance structures.<sup>3</sup> Since large family business groups are quite prevalent in East Asian crisis economies, their corporate governance structures would seem to be of immediate relevance. The challenge, however, is to link this structure analytically to the two other types that can be called Bank-Led<sup>4</sup> and Equity Market-Based corporate governance systems.<sup>5</sup> Only by making the analytical links clear can one begin to consider the policy issues raised by the Asian crisis as well as by transition from one type of governance to another. This paper is organized as follows. The following section presents a new conceptual framework and typology including family-based corporate governance. Some important aspects, including financing, monitoring and performance of family businesses are discussed in section three. Next, in section four,

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<sup>2</sup> It should also be mentioned here that this paper is concerned about privately owned and controlled firms only. Many of the conceptual issues discussed here are, of course, similar. But SOEs form a distinct category and their governance should be analyzed separately. I am grateful to Sadrel Reza for helpful discussions with regards to SOEs.

<sup>3</sup> As Suehiro (1993, 1997) correctly points out "[t]he body of research ... confronting directly the phenomenon referred to as "family business" is surprisingly small in quantity and rather shallow in its theoretical consideration of the subject matter" (1993, p. 379). Within the scanty theoretical tradition, starting with Berle and Means (1932) and especially in Chandler (1977) the passing away of family enterprise and the rise of 'managerial firm' has been accepted as an indisputable stylized fact. In reality, however, family-based enterprises and family control have been remarkably obdurate, especially in Asia. See also the interesting work by Okazaki(2001) on the role of *Zaibatsu* in pre-war Japan.

<sup>4</sup> Prof. Miwa at Tokyo University has argued, based on his empirical research that in Japan, equity markets, rather than banks played a crucial role in financing (and perhaps governance also). This interesting and controversial research counters the traditional bank-based view of finance during early phases of economic development--- at least in the case of Japan. See Miwa nad Ramseyer (2000). For their views on the Japanese Keiretsu, see Miwa and Ramseyer(2002).

the transactions costs related to the institutional environment in which the family businesses operate are considered. In particular, the existence and enforcement of property rights laws are examined in order to see how these contribute to the incentive structures and performance of family businesses in East Asia. The final section presents some tentative conclusions and some suggestions for areas of future analytical and empirical research.

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<sup>5</sup> These terms are defined with greater precision in the next section. See also Rajan and Zingales (1998) and Zingales (1997) for a discussion of closely related conceptual issues. Kim and Rhee (1999) present some interesting empirical results.

## II. A New Conceptual Framework and Typology: Family Based Corporate Governance

It should be realized that despite a great push by its proponents it is not obvious a priori that there is only one kind or normatively, one “best” governance system. Even before the crisis in Asia extensive debate was taking place in Europe, US and Japan about the relative merits of different type of corporate governance systems. Broadly speaking, two general types of corporate governance structures have been discussed.

The first type can be called a shareholder or equity market-based governance model of the Anglo-American type (EMS). This is usually contrasted with the continental European or Japanese type stakeholder or relationship model. In the second type (for example, the Japanese main bank system) banks play a key role of monitoring the performance of corporations. Therefore, this type of governance structure could be called a bank-led governance system (BLS). Note that BLS can either be a Japanese style main bank system as mentioned above, or a German type of universal banking system.<sup>6</sup> However, the BLS and EMS are not the only two possible types of corporate governance systems.

In both Northeast and Southeast Asia there is a preponderance of family-based firms that are not necessarily controlled by banks or by equity markets. Nevertheless they do operate as economic entities within the context of a relationship-based system. Thus family-based corporate governance system (FBS) can constitute a third type of corporate governance.<sup>7</sup> A first attempt at theorization of the FBS type of governance was made in Khan(1999a, b) along the lines described in table 2.1 below. However, it should be noted

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<sup>6</sup> It should be pointed out that in order for the BLS to be an effective system of governance at all the banks must have the incentives and capacity to monitor the firms to which they lend. This clearly depends on the location (in a functional sense) and political power of the banks in the overall financial system. As some researchers (e.g. Suehiro for Thailand, Sato for Indonesia and Nam for South Korea) have pointed out in many Asian countries the banks themselves are family-based or are under the influence of government which may be more motivated by short-run political pressures rather than long-run economic interests. Clearly, under such circumstances banks are neither well-governed themselves, nor can they govern their debtor firms. One crucial precondition for moving to BLS is, therefore, to have effective governance of the banks themselves so that their position as monitors become viable.

<sup>7</sup> As mentioned earlier, even the family-based corporates are relatively little studied. Hence, it is not surprising that almost no attention has been devoted to a systematic study of their structure, conduct and performance until recently. Recent work by Khanna and Palepu (1996, 1999) on India and by Claessens, Djankov, Fan and Lang (1998, 1999) and Claessens, Djankov and Lang (1999) are important beginnings of serious research in this area.

that the agency problems developing at different stages of the FBS also are incomplete characterizations of the system as such from a social point of view of multiple stakeholders. More on this will be discussed later. For the moment, let us ask the following comparative question.

Given this threefold division,<sup>8</sup> what are the relevant dimensions in which these systems can be compared and contrasted? Berglöf (1997) developed a set of criteria to answer this question for comparing EMS and BLS types of corporate governance. In addition to Berglöf's original criteria for comparing the BLS and EMS, I have introduced here two additional features related specifically to corporate governance. The first is monitoring of non-financial enterprises by the system, i.e. how the managers of corporations are monitored by outside financiers such as banks and shareholders. This type of governance is intimately associated with how corporations are financed, i.e., corporate finance. Such monitoring by the firms' financiers is clearly an important function of the financial system. Secondly and more generally, the issue of self-monitoring needs to be addressed. This issue is particularly relevant to family business groups in which ownership and management are not clearly separated. This applies equally to both financial and non-financial firms. Table 2.1 compares and contrasts the BLS and EMS types of corporate governance. For reasons explained in the next paragraph we consider FBS in a separate setting in Table 2.2.

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<sup>8</sup> It should be mentioned that other forms of classification are also possible. For example, Lehman (1997) offers a six-fold classification comprising of the Rheinal, Mediterranean, Japanese Keiretsu. The Korean Chaebol, the Chinese bamboo network and the Anglo-American systems. It can be seen that most of his categories are sub-species of FBS and BLS systems. Thus, his classification is consistent with the above threefold classification with the exception that his conceptualization minimizes the growth potential of what he quaintly calls 'the Chinese bamboo network'. It is, of course, entirely proper and desirable to look into the sub-categories of FBS if and when necessary. In this paper Chaebols are treated as one such special sub-category of FBS. The key point is that the Anglo-American type EMS type of governance structure is not the only or normatively "the best" one in an obvious sense.



**Table 2.1: Comparing Equity Market-Based and Bank-Led System of Corporate Governance**

	Type of Corporate Governance System	
	Equity Market-Based System (EMS)	Bank-Led System (BLS)
Share of control-oriented finance	Low	High
Financial markets	Large, highly liquid	Not necessarily small but less liquid than EMS
Share of all firms listed on exchanges	Large	Not necessarily small
Investor orientation	Large	Concentrated
Investor orientation	Portfolio-oriented	Control-oriented
Shareholder rights	Strong	Weak
Creditor rights	Strong	Strong for close creditors but applied according to a "contingent governance structure" (Aoki)
Dominant agency conflict	Shareholders vs management	Banks vs. investors Workers may be important stakeholders as in Aoki's model of the Japanese firm
Role of board of directors	Important	Limited, but less so than in the case of FBS
Role of hostile takeovers	Potentially important	Quite limited
Role of insolvency	Potentially important	Potentially important; but possible systemic crisis may postpone bankruptcies
Monitoring of non-financial enterprises (NFE)*	Can be done through interlocking directorships, but equity market and threat of takeovers are the most important mechanisms	Mixed; with adequate regulations that are enforced and stable intra-group shareholding monitoring can be effective [Aoki's contingent governance]
Self-monitoring	Possible; but the mechanisms above apply for the most part	Possible, with oversight by government and members of the group Potential for abuse

\*Note: NFE is clearly a large but special category. However, frequently in the literature on corporate governance the governance of non-financial firms is the focus. In addition to NFE, the financial firms (who are sometimes the monitors) themselves need to be monitored.

Before presenting the characteristics of the FBS type of corporate governance in table 2.2 below, it may be useful to define family businesses more carefully. According to Suehiro (1993) the family business can be thought of " ... as a form of enterprise in which

both ownership and management are controlled by a family kinship group, either nuclear or extended, and the fruits of which remain inside that group, being distributed in some way among its members." (p. 378).

Suehiro draws his inspiration from Chandler (1977) who defines family business in the following way:

In some firms the entrepreneur and his close associates (and their families) who built the enterprise continued to hold the majority of stock. They maintained a close personal relationship with their managers, and they retained a major say in top management decisions, particularly those concerning financial policies, allocation of resources, and the selection of senior managers. Such a modern business enterprise may be termed an entrepreneurial or family one, and an economy or sectors of an economy dominated by such firms may be considered a system of entrepreneurial or family capitalism. (p. 9, quoted by Suehiro (1993) p. 378)

In discussing family business in East Asia in this paper the emphasis will be on control and de facto control rights more than formal ownership. Claessens, Djankov, Fan and Lang (1998, 1999) and Claessens, Djankov and Lang (1998, 1999) have pointed out in their recent studies of corporate control in Hong Kong, Indonesia, Korea, Malaysia and Thailand two important features of industrial organization in East Asia. These are:

- a) families have control over the majority of corporations
- b) such control is also magnified "... through the use of pyramid structures, cross-holdings and deviations from one-share-one-vote rules" (Claessens, Djankov, Fan and Lang, 1999, p. 3)

In appendix 1 the ownership structure for Thai corporations illustrates the first point. In appendix 2 the immediate control/ultimate cash flow rights diagram of the Lotte group, as calculated by Claessens et al. demonstrates point (b) above.

The evidence gathered so far demonstrates that ultimate control of the corporate sector in East Asia is, on the whole, family-based. One study shows that "...16.6% and 17.1% of total market capitalization in Indonesia and the Philippines respectively can be traced to the ultimate control of a single family (the Suhartos and the Ayalas)." It goes on

to point out that the top 10 families in Thailand, Indonesia and Philippines have more than fifty percent of the market capitalization.<sup>9</sup>

In the following table 2.2 a qualitative description of the FBS system is given. The reader should note that the relevant categories for comparison across the rows in this table are exactly the same as for BLS and EMS. In the next section a more detailed analysis of FBS is attempted with the help of some quantitative information and specific references to family-based corporations and corporate groups (e.g. CP Group in Thailand and Lucky-Goldstar Group in Korea).

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<sup>9</sup> Claessens, Djankov and Lang (1999), “Who Controls East Asian Corporations”, p. 3

**Table 2.2: Description of Family-Based System of Corporate Governance**

	Type of Corporate Governance System
	Family-Based System (FBS)
Share of control-oriented finance	High initially, but may vary as family groups get bank and equity financing from outside
Financial markets	Small, less liquid
Share of all firms listed on exchanges	Usually small
Ownership of debt and equity	Concentrated
Investor orientation	Control-oriented for family groups
Shareholder rights	Weak for outsiders
Creditor rights	Strong for close creditors Weak for arm's length creditors
Dominant agency conflict	Controlling vs minority investors
Role of board of directors	Limited
Role of hostile takeovers	Almost absent
Role of insolvency	Potentially important
Monitoring of non-financial enterprises (NFE)	Mixed; in the presence of strong regulations and government vigilance monitoring could be efficient. However, the presence of moral hazard and possibility of bail-outs could lead to lax monitoring.
Self-monitoring	Initially, self-monitoring is effective. At later stages there is a strong tendency for insiders to be predatory towards outsiders. Could still be efficient but efficiency depends on the performance of owner-managers.

The reader should note that both BLS and EMS are closely associated with the dominant mode of corporate finance by banks and equity markets respectively. In the case of FBS in East Asia, the financing can come from three different sources. First, FBS, especially in initial stages of development of family businesses could be financed internally for a large part. Second, as the enterprise grows over time, the role of banks becomes more prominent. Third, at some stage - perhaps overlapping with the second, i.e. bank financing - outside equity may become the most significant source of corporate finance. However, the key difference between FBS as a governance system and BLS and EMS lies in the fact that neither the banks nor the equity markets ultimately control the family business groups. The control resides with the family (or families) in the final analysis. As we shall see, this may not be without economic rationale, but ultimately FBS can run into trouble as well. This has been demonstrated with an insidious vividness by the Asian crisis.

As alluded to above table 2.2 is only a qualitative description of the FBS corporate governance system. Although it facilitates comparisons and contrasts with the other systems, we need to go into more detail with the help of as much quantitative information as is available at this point. With this in mind, the following section presents some important aspects, including financing, monitoring and performance of family businesses with special emphasis on asymmetric information and monitoring aspects of the FBS type of governance system.

### **III. Financing, Monitoring and Performance of Family Businesses**

Without being exhaustive, the essential aspects of the family-based system can be discussed under the following five headings:

1. Extent of family controlled corporations in East Asia
2. The dominant modes of financing
3. The key information asymmetries and agency conflicts
4. Problems of monitoring family businesses
5. Investment and capital accumulation by the corporations

These five aspects have been chosen because these are the most significant from the point of view of determining the problem of corporate governance in East Asia for family controlled corporations in practice. The first four are the most important elements of corporate governance structure, while investment and capital accumulation can be seen as the most important performance indicator for a late industrializing economy.

1. Ownership and Control:

#### *1.1 Overall picture of ownership and control*

Although empirical evidence is not widely available, at least for the companies covered in World Scope database, it is possible to calculate the percentage of total market capitalization controlled by families in East Asia.

According to a recent study by Claessens, et al., at the World Bank, the share of top 10 families in the total market capitalization in Indonesia in 1996 was 57.7 percent. For Philippines and Thailand this share was 52.5 and 46.2 percent respectively. For Korea the share of top 15 families was 38.4 percent and for Malaysia 28.3 percent.

This picture of concentrated ownership of corporations by a few (usually a number between 5 and 10) family groups is supported by individual country studies by Suehiro for Thailand, Sato for Indonesia, Taniura for Taipei, China and Korea and Koike for Philippines.

### *1.2 Ownership and control in the financial sectors*

Most of the private commercial banks and finance companies in Thailand are controlled by family business groups. For example, the top bank in Thailand, Bangkok Bank Limited, is controlled by the Sophompanitch family. The Farmer's Bank, which is the second-largest bank is, controlled by the Lamsum family. Of the 15 private domestic commercial banks and 53 finance or security companies before the crisis in Thailand, the great majority were controlled by the family groups. In Philippines and Indonesia also a similar system prevailed. In Indonesia before the crisis, of the 144 private commercial banks many were controlled by combinations of family groups. In Korea, there are explicit, fairly low limits (15% for regional banks and only 4% for all other banks) on ownership of stocks by a family or Chaebols in a particular company. Hence the formal degree of ownership is low, but control can still be exercised through member companies who own stocks, deviation from one-share-one-vote rule, etc. It is not known to what extent this is true in the financial sector, but the following table for the top Chaebols showing the extent of overall control by insiders is revealing.

**Table 3.1: Ownership of Korean business groups by insiders**  
(percent of common shares held)

Business group	Founder	Relatives	Member Companies	Total
Hyundai	3.7	12.1	44.6	60.4
Samsung	1.5	1.3	46.3	49.3
LG	0.1	5.6	33.0	39.7
Daewoo	3.9	2.8	34.6	41.4
Sunkyong	10.9	6.5	33.5	51.2
Sangyong	2.9	1.3	28.9	33.1
Hanjin	7.5	12.6	18.2	40.3
Kia	17.1	0.4	4.2	21.9

Source: The World Bank, *East Asia: The Road to Recovery*, 1998, p. 60

## 2. Financing:

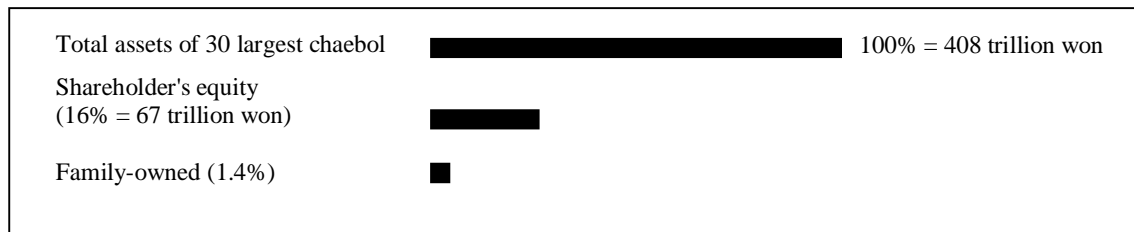
After an initial period of internal financing (Koike, 1993) many East Asian family-based businesses developed into highly leveraged firms. In 1996, Korea was the economy with the highest debt/equity ratio of 3.54. Thailand was the next with a ratio of 2.36. In some sectors such as construction the debt/equity ratio was double the national average. What is significant is that despite high debt, the BLS type of governance did not come into play. The lack of effective bank monitoring in the face of such seemingly high level of debt much of which is owed to the banks is indeed a puzzle. Some plausible explanations are discussed in the subsection on monitoring

Furthermore, in case of Korea, the overall share of family-owned equity is formally quite small as figure 3.1 below shows. The share of equity outside of families is also small (16%) but much larger than that of the families. It is surprising that seemingly there is no control by outside shareholders. Table 3.1 suggests a plausible hypothesis.



Actual control by the family groups far exceeded the formal ownership of chaebols, preventing monitoring by outside shareholders or their representatives.

**Fig. 3.1: Chaebol's average equity shareholding**



Source: Yuji Akaba, Florian Budde Jungkiu Choi, "Restructuring South Korea's Chaebol", The McKinsey Quarterly 1998, number 4

### 3. Information asymmetries and agency issues:

In case of FBS, initially the family members act as owner-managers. Then as the firm grows and is professionalized, there is still close monitoring of managers by the owners. When the family business is almost entirely financed "internally" (including financing from relatives and other informal networks, as in the case of overseas Chinese), and remains limited in scope and scale, the asymmetry of information and the consequent problem of adverse selection and moral hazard between the owners and managers is not usually very severe. This is true largely because there is no effective separation between ownership and management.

However, as family business grows there arises a conflict between the owner-managers and the financiers (whether banks or outside shareholders). This can give rise to possible failure of FBS due to private risk taking not validated by market results (moral hazard), for example investment in the wrong projects. It could also lead to the selection of the more risky (wrong) borrowers (adverse selection). Therefore, the FBS system works well when self-monitoring is present, or when banking and security market

(prudential and other) regulations and an effective legal system make the misuse of finances less likely.

#### 4. Monitoring:

As mentioned previously, the self-monitoring incentives for FBS may exist only at an earlier phase of growth. As Suehiro (1993) points out, following Nakagawa, “the development of family business could be the result of a rational choice by an entrepreneur in a backward or a latecomer nation, where the government had intentionally promoted industrialization”.

In all the East Asian economies this apparently had been the case. Many family enterprises, particularly under their founder-owners, showed tremendous flexibility during the period of accelerated growth. It is likely that family enterprises succeeded in economizing on scarce managerial resources. It must have been nearly impossible to function flexibly and effectively without constant self-monitoring, both ex ante and ex post, at this stage.

In general, the problem of monitoring really arises once the firm acquires large external financing. It may become particularly acute when firms develop into conglomerates, investing in areas where they did not have much experience or expertise. It is difficult also to monitor such activities from outside because expertise may be lacking on the part of the external financiers as well. Even with a market for corporate takeovers this problem may persist (Hikino, 1997). In case of banks as monitors there is also the problem of who monitors the monitors.<sup>10</sup> In fact, this last question brings us back to the problem of understanding the origins of the banking crisis and corporate governance problems in Asia with which this paper began. Further research must help us understand better whether banks failed to monitor effectively because of state interference, or rapid deregulation, or influence from family businesses, or a combination of all these factors.

## 5. Corporate investment, accumulations and growth:

If the end of corporate governance is to enhance efficiency, then the right quality and quantity of investment in the appropriate sectors should be the right strategy for the firm. In these regards, the East Asian corporations registered impressive quantitative growth rates. For example, between 1988 and 1996 the median growth rate for a large sample of listed companies in Korea was 13.6 percent. Thailand's mostly family-based corporations showed an even more impressive rate of capital accumulation over the same period at 13.8 percent per year. Indonesian corporations were close behind at 12.7 percent. The sample includes both financial and non-financial firms. It would appear that mainly as a result of massive accumulation of capital, both types of firms grew rapidly. The earlier studies of family business groups such as Salim Group in Indonesia (Sato, 1993), Lucky Goldstar Group in Korea (Koike, 1993), Samsung in Korea (Khan, 1998, forthcoming) and CP Group in Thailand (Suehiro, 1993) have pointed out how family firms rapidly grew and diversified.

However, quite often the motive for diversification was to protect and enhance family fortunes, rather than build up productive capacity (Suehiro, 1993). Suehiro further pointed out that in the case of Thailand, much of the diversification was carried out in order to take advantage of existing tax shelters as well.

To summarize the argument so far, it is clear that family-based corporations have played a major role during the boom period of "East Asian Miracle". What went right during this period at the firm level as documented by the studies cited above is the economically efficient use of the flexibility of family-based management. The owner-managers, together with the professional managers they hired (e.g. the CP Group in Thailand, the Ayala Group in the Philippines, or Samsung and Lucky-Goldstar in Korea among others) met the challenges of late industrialization in many sectors by exploiting profit opportunities as they arose. These ventures were certainly helped by government

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<sup>10</sup> As pointed out by Yuri Sato during a discussion at ADBI, this problem became quite acute in the case of Indonesia before the crisis when the domestic banks borrowed from foreign banks and lent to their business

policies, including policies to build infrastructure. Finally, the family and kinship networks, especially among the Southeast Asian overseas Chinese, made “internal” (in the broad sense of the word) financing a source of expansion for a reasonable length of time initially. Self-monitoring may also have been effective during this period to a large extent. In addition, the family members in leading positions probably monitored the hired management closely as well.

Part of what went wrong – at the micro level – certainly came with the expansion of the family enterprises beyond the point where they could be financed primarily from the internal resources of the family groups. This resulted in highly leveraged debt-financing. At the same time the control of the firm – through means discussed earlier – was not shared with outside shareholders. As a result, neither BLS nor EMS type of governance could be exercised efficiently.

An important area of on-going and future research will examine the broad hypotheses advanced in the previous paragraphs in the context of late industrialization at the level of family-based corporate systems. It is possible, in principle, through further empirical work to ascertain whether FBS should be completely replaced with BLS or EMS (or some combination of both – a hybrid form of governance perhaps) or FBS can still be a viable form for some East Asian economies, particularly the ones at a lower stage of development (perhaps with GDP/capita of US \$ 3000 or below). Even if this hypothesis can be demonstrated to be true for the low or middle income economies in the aggregate, there is still the further question of whether diversification has reached beyond the economies of scope allowed by the level of development of the economy. If this is true, then diversification is now a drag on scarce managerial and financial resources of the corporations. In addition, the monitoring problems may also have become increasingly more severe leading to a failure of FBS. These significant issues require further empirical research using and building upon the conceptual framework presented in this paper. Given the limited scope of the present paper only some rudimentary analysis can be carried out here. Accordingly, in the rest of the paper I examine briefly the relation between transaction costs and the family-based system of governance by interpreting the existing evidence on the legal environment and diversification in the relevant Asian economies. Even this very preliminary investigation reveals some surprising features with

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groups without being monitored by anyone.

regards to the relation between different stages of development, legal systems and FBS. Furthermore, the relationship between FBS and diversification also turns out not to be as simple as is usually assumed in the literature. In particular, diversification seems to be more closely related to the internal management structure and the expertise of the firm, on the one hand, and the external industrial organization on the other, than to some formal structure of corporate governance per se. These issues are discussed in greater detail in the next section.

#### **IV. FBS at Different Stages of Development: Legal Systems, Transactions Costs and Diversification**

One way to make the hypothetical relationship between level of economic development of a particular country and the form of corporate governance for a family-based business more concrete is to think in terms of transactions costs. In particular, underdevelopment may be associated with not only incomplete markets but also imperfect legal systems where property rights are not well-defined nor the court system well-developed. Enforcement of such laws as may exist may also be haphazard. This latter phenomenon is related to weakness of governance in a broader sense. Given this type of weakness - legal and institutional - firms may be able to minimize transactions costs by using a flexible, relationship-oriented form of organization. Historically and culturally, in East Asia this form has generally been identified with the family businesses. Therefore, it is possible that FBS may be the paradigmatic form of corporate governance for the Asian countries at various stages of development. Naturally, this implies that Asian economies at different stages of development will have to address different problems with respect to their systems of family-based corporate governance.

In order to clarify whether this is indeed the case it is instructive to look at some common measures of how the legal systems perform in various Asian countries. Table 4.1 below gives some quantitative measures used specifically to assess the quality of legal environments (La Porta et. al. 1998). Using exactly the same measures as La Porta et. al. have introduced in the literature through their pioneering study of law and (corporate) finance, but applying them in the specific context of Asian economies at different stages of development we can draw a number of interesting conclusions.

Table 4.1 measures the quality of the legal environments that firms face in selected Asian countries. The relevant information is summarized in this table for the Asian economies that are of particular interest to us. Five measures of the quality of legal environment are used in table 4.1 below, namely efficiency of the judicial system, rule of law, corruption, risk of expropriation by the government, and probability of contract repudiation by the government. In addition, an assessment of the quality of a country's accounting standards is presented since accounting can play a crucial role in corporate governance.

**Table 4.1: Stages of Development and the Legal Environment in Selected Asian Economies**

Country	Enforcement variables					Accounting	GNP per capita (US\$)	
	Efficiency of judicial system	Rule of law	Corruption	Risk of expropriation	Risk of contract repudiation	Rating on accounting standards	1996	1997
Hong Kong	10.00	8.22	8.52	8.29	8.82	69	24,290	25,280
Malaysia	9.00	6.78	7.38	7.95	7.43	76	4,370	4,680
Singapore	10.00	8.57	8.22	9.30	8.86	78	30,550	32,940
Thailand	3.25	6.25	5.18	7.42	7.57	64	2,960	2,800
Indonesia	2.50	3.98	2.15	7.16	6.09	na	1,080	1,110
Philippines	4.75	2.73	2.92	5.22	4.80	65	1,160	1,220
South Korea	6.00	5.35	5.30	8.31	8.59	62	10,610	10,550
Taipei,China	6.75	8.52	6.85	9.12	9.16	65	13,310	14069

**Definition of variables**

Variable	Description	Sources
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country-risk rating agency <i>Business International Corporation</i> . It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980-1983. Scale from 0 to 10, with lower scores signifying lower efficiency levels.	Business International Corporation
Rule of law	Assessment of the law and order tradition in the country produced by the risk-rating agency <i>International Country Risk (ICR)</i> . Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order. (Scale has been changed from its original range going from 0 to 6).	International Country Risk Guide
Corruption	ICR's assessment of the corruption in government. Lower scores indicate "high government officials are likely to demand special payments" and "illegal payments are generally expected throughout lower levels of government" in the form of "bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans". Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher levels of corruption. (Scale has been changed from its original range going from 0 to 6).	International Country Risk Guide
Risk of expropriation	ICR's assessment of the risk of "outright confiscation" or "forced nationalization". Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher risks.	International Country Risk Guide
Repudiation of contracts by government	ICR's assessment of the "risk of a modification in a contract taking the form of a repudiation, postponement, or scaling down" due to "budget cutbacks, indigenization pressure, a change in government, or a change in government economic and social priorities". Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher risks.	International Country Risk Guide
Accounting standards	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, fund flow statement, accounting standard, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70 percent while financial companies represented the remaining 30 percent.	International Accounting and Auditing Trends, Center for International Financial Analysis & Research, Inc.
GNP and GNP per capita	Gross National Product and Gross National Product per capita in constant dollars of 1996 and 1997.	World Bank

Source: Modified from La Porta et al. (1998) pp. 1122-26 and 1142-43

Scrutinizing table 4.1 it can be seen that in general, countries with low GDP/capita such as Indonesia, Thailand and Philippines have relatively underdeveloped legal systems and uneven enforcement of laws. This would seem to imply that *ceteris paribus* firms in these economies face high transactions costs. NIEs such as Hong Kong and Singapore show scores on all the relevant variables that indicate a more developed legal structure and its enforcement. Among the NIEs South Korea and Taipei,China both rank lower in these respects than Singapore and Hong Kong. Surprisingly, Malaysia which is closer to the lower income countries in terms of GDP/capita actually has higher standing in terms of the efficiency of the judicial system than South Korea or Taipei,China.

Another interesting finding from table 4.1 is that the transparency and efficiency of accounting standards do not show much variation from one economy to another. For example, Thailand, with a score of 64, is in the same category as Taipei,China which receives a score of 65. Even Hong Kong has a score of 69, only slightly ahead of Thailand. One popular explanation of the failure of corporate governance in East Asia attributes it to the lack of transparency in accounting standards among other factors. The available evidence, however, raises doubts about the validity of this assertion. How is it possible that economies like Hong Kong and Taipei,China can have FBS type of governance that are seemingly successful, given that their accounting systems are not any more transparent than that of Thailand?

The data presented in table 4.1 with respect to specific factors such as the rule of law and efficiency of the judicial system are also consistent with the hypothesis that at a lower stage of development the legal systems are not so efficient, and other things being equal, present higher transactions costs. While more developed economies such as Hong Kong and Singapore score 10 out of 10 in terms of efficiency, less developed countries like Indonesia, Philippines and Thailand score much lower (2.5, 4.75 and 3.25 respectively). Therefore, it seems plausible that FBS can economize on transactions costs – given the inefficient legal systems – in these lower income countries.

What is really surprising is that some economies with efficient legal systems such as Hong Kong also have family-based system of corporate governance.<sup>11</sup> How can FBS function successfully in these economies? Are there features of FBS that remain relevant



even at higher levels of income in Asia? It could be conjectured that there are *specific* factors in each case that can explain the continuing relevance of FBS. For example, in Hong Kong the government and banks hold a negligible portion of the shares of the companies, making family control inevitable. However, competition in a more or less *laissez faire* environment where corporate and other laws are interpreted clearly and enforced reasonably well might explain why FBS is still a workable form of corporate governance in Hong Kong. Another interesting case is Singapore which has some large family-controlled firms and business groups, but a system of corporate governance that is influenced by the government through the government-linked corporations. In case of Singapore, the close guidance from government in a competitive environment might explain the relatively better performance of the family businesses there. These are, of course, conjectures that would require more careful formulation and further verification.

Finally, both S. Korea and Taipei,China have similar levels of development and family-based systems of corporate governance. Yet, S. Korean chaebols are undergoing restructuring after the crisis while Taipei,China's system continues to work relatively well. We need to ask what can explain the different performances of FBS in these two cases.

The upshot of the whole discussion is that concrete case studies of corporate governance of these economies must be done in order to assess the workability of the FBS in each particular case. Among other things, this should also help focus attention on the feasible policies for making the transition from FBS, if necessary, in economies such as South Korea.

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<sup>11</sup> Singapore also has some large family-controlled businesses. However, on the whole, the government-linked corporations, the relatively well-functioning banking system and the presence of multinationals are the major factors in corporate governance. See also Linda Lim (1983)

## **Development of Family Businesses, Transactions Costs and Diversification:**

A significant factor that may at least partly explain the differential performances of FBS in different Asian economies is the extent of corporate diversification. What is the relationship between the family-owned firms and diversification in Asian economies? How should we test the various formulations of what may be called the diversification hypothesis?

One way to formulate the diversification hypothesis that addresses directly the concerns of this paper is to look at the relationship between diversification and family-owned firms.<sup>12</sup> At a low level of development, diversification may be a way to lower transaction costs by diversifying in order to create internal factor markets. We can call this the 'internal market hypothesis' (Claessens, et al., 1999).<sup>13</sup> Here, internal factor 'markets' can refer broadly to within-firm allocation of raw materials, labor, and financial capital.<sup>14</sup>

Existing empirical work on the reasons for diversification of family-owned firms leads to the conclusion that at low level of development diversification increases profitability. However, as legal systems become more transparent and efficient with increasing GDP/capita there is actually a 'diversification discount'. In other words, further diversification actually leads to a loss of value.

Claessens et al. (1998) present some interesting econometric evidence regarding the relationship between different stages of development in Asian economies and corporate diversification. They find a positive effect of diversification on corporate performance at an earlier stage of development. They also try to estimate the influence of family group membership on diversification. One of their main findings is that family group membership can be linked to excessive diversification. They also find diversification at an earlier stage of development adding value to the firm while at a later

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<sup>12</sup> Testing such hypothesis would require micro, firm-level data. There are several databases of this type, including the World Scope Database including more than 2500 observations for East Asian firms.

<sup>13</sup> Of course, there are alternative hypotheses as well. Two of these are the reduction of firm-specific risk and expropriation of wealth from minority shareholders.

<sup>14</sup> This usage of 'market within the firm' is not literally true, of course, unless a market simulation via shadow pricing is attempted. I have conformed here with the standard literature (see, for example, Williamson, 1985; Khanna and Palepu, 1997; Claessens et al., 1999) rather than coin another, less metaphorical term.

stage there is a negative impact of diversification on the value creation. Their overall estimate of this so-called ‘diversification discount’ is about 5 percent on the average.

Here again looking at seemingly successful FBS governance in Hong Kong, and Taipei, China raises the question of whether diversification discounts really exist for these economies as well. Since the study cited uses cross section data from a limited sample this question can not be answered without further careful econometric work. Single country studies using time-series data are needed to determine if and to what extent diversification discount exists in each case.

However, it can be conjectured *prima facie* that the diversification discount, if it exists at all in the above cases, must be much smaller than that in the crisis economies. A hypothesis that can explain the seemingly better performance of firms in these economies through concentration in general, in their core competencies would emphasize the greater professional expertise and internal efficiencies of these firms together with the industrial organization aspects, particularly the existence of greater market competition. For the present let us call it the **influence of industrial organization** or **IIO hypothesis, keeping in mind that factors internal to the firm such as managerial and professional expertise are also included**. According to the IIO hypothesis diversification is less a function of corporate governance per se than these other strategic efficiency-driving factors. Without competent management with strategic vision and market competition corporate governance by itself may not be of much influence. Of course, to the extent that good corporate governance creates incentives to develop a competent, professional management structure it will be of particular relevance as well. In addition to the commonly expressed concerns with corporate governance IIO should usefully focus the attention of policy makers on the nature and extent of managerial expertise and incentive structures within the firm. It should also direct the policy makers’ attention to the extent of competition in the markets in which the family-businesses participate. Therefore, it will be important to test a suitable formulation of this hypothesis for various Asian economies at different stages of development on a case by case basis. One particular form that can be called the (governance) parity hypothesis would attribute equal importance to both corporate governance and to factors included under the rubric of industrial

organization above. Specifying the parity hypothesis as a null hypothesis and testing this against various alternatives statistically could throw more light on the relative importance of corporate governance in determining corporate performance in Asia.

### V. A Mathematical Model of Corporate Governance and Financing of an Entrepreneurial Firm: The Limits of Principal- Agent Model

In this section, I discuss a model of corporate finance and show the limits of the principal-agent framework in the Asian context. The model is presented in several steps as follows:

1. In a private ownership economy consider the owner's choices regarding investing in projects. At the initial period (called period 0) a fixed amount  $I$  has to be invested. Let  $e$  denote the personal effort expended for the project. Let Unit cost of  $e$  be equal to 1. Consider 2 more periods and the dynamic choices as follows with two possible states of nature, Good and Bad, denoted as  $G$  and  $B$  respectively.

<u>Period 0</u>	<u>Period 1</u>	<u>Period 2</u>
Investment $I$ made	State realized	Payoff in good
state = $X$		
Effort $e$ after the investment	In good state the project	Payoff in bad
state = $X$	can continue. In bad state	with probability
$P_B$ and	the project is liquidated	zero with probability
	For $L \leq I$	$(1 - P_B)$ .
		Assets become worthless

2. **Banks** enter the market in each period to acquire information and make loans. By making loans, a bank gains access to the internal records of the firm. The bank monitors the firm's accounts. Information is 'soft' and can not be communicated to the

outsiders even if the firm wants to do so. Costs of monitoring are assumed to be negligible.

3. **Equity market, or arms-length investors** lend in period zero and collect payments in period 2. Even if they lend they do not examine the books either because the private cost of monitoring is high or because the size of loans is small.
4. **Information Asymmetries:** Everybody in period zero knows about the state of project at the time. However, once the project starts only the owner knows the effort  $e$ . The owner also learns about the state before deciding to continue with the project. The 'inside' bank is informed also. It learns about the effort provided and the state at the same time as the owner. 'Outside' banks and equity holders can only have public information.
5. **Contracts:** Following Diamond (1991) and Gale and Hellwig (1985), without loss of generality, it is sufficient to consider only pure discount debt contracts (see also Rajan (1992) which is followed closely here). The firm borrows an amount  $A_t$  at period  $t$  and is required to make one payment  $D_{t+i}$  for convenience and to add some realism contracts over only one period would be called a "short-term contracts". Longer than one period contracts are called "long-term contracts". Any debt contract can be written as a convex combination of both short-term and long-term contracts.

In this model the borrower decides on what type of lender to select and the length of the debt contract. He must also decide on the level of effort  $e$ . After writing the contract in period 1, the borrower must decide whether to continue or quit (and liquidate).

The lender in this model offers the contract at period zero under given terms and conditions. In period one the lender must decide whether to renegotiate, stop the supply of credit, keep the old contract, or offer a new contract in the next period.

## 6. Optimal Contracts

Expected surplus to the owner at period zero:

$$q(e, y)(X - I) - (1 - q(e, y))(I - L) - e$$

where  $y$  = common knowledge information about project quality in period zero and  $q(\cdot)$  is the probability of the good state. This is a function that is increasing in both its arguments.

It is clear that the project should be financed only if the surplus is positive for some

effort level. The effort level which maximizes the surplus can be found by solving:

For  $e^* = e$

$$q_1^*(e, y) = \frac{1}{X - L} \quad \dots(A1)$$

The optimal contract must possess the following features:

- 1) The owner should receive the incentive to quit voluntarily in the bad state. The same purpose will be served if the lender has the ability and the incentive to coerce the owner to do the above.
- 2) The incentive structure and the environment should be such that the owner will get all the surplus in  $G$  and bear all the losses in  $B$ .

It is a deep result of the contracts literature that no rational contract can simultaneously achieve objectives (1) and (2) above.

### 6.1 Arm's-Length Contract

An amount  $I$  is borrowed at period 0. It is promised to be repaid in period to as a sum

$$D_{02}$$

The owner chooses the optimal effort level by solving

$$\max_e \quad q(e, y)(X - D_{02}) + (1 - q(e, y))(P_B(X - D_{02})) - e \quad \dots(A2)$$

Let  $e_a^*$  solve the corresponding FOC.

The lender must conjecture that the (ex post) effort level will be (say)  $e_a$ . He will lend, as long as

$$D_{02} \geq \frac{I}{[q(e_a, y) + (1 - q(e_a, y))P_B]} \quad \dots(A3)$$

In a rational expectations equilibrium the lender's conjecture must be self-fulfilling.

Hence

$$e_a = e_a^* \quad \dots(A4)$$

If the credit market is competitive (A3) holds with equality. If an optimal contract exists, it is defined implicitly by the following equation when  $e = e_a^*$

$$q_1^*(e, y) = \frac{1}{[X - I - \frac{(1 - q(e_a^*, y))(1 - P_B)I}{q(e_a^*, y) + (1 - q(e_a^*, y))P_B}]}(1 - P_B) \quad \dots(A5)$$

However,  $e_a^* < e^*$ . The reason is simple. The owner continues in the bad state. This forces the lender to demand a higher face value thus reducing the amount of surplus available to the owner in the good state. The inefficiency arises from the inability of the owner to commit to quit in the bad state.

Also for low values of  $y$  (reflecting the intrinsic poor quality of the project) the face value demanded could be too high. Generally, the returns to the lender could also decline with an increase in face value because this would reduce the incentive to provide effort (minimize  $e_a$  in equation (A3)). Credit will then need to be rationed.

## 6.2 Bank Contracts

### *6.2.1 Short term Bank Contract*

Here in period one if the state is  $B$  the project can be liquidated. The bank recovers  $L$ . In state  $G$  the bank can use discretion and demand a share of the surplus in return for further lending. There is thus a bargaining game to be solved. In equilibrium the owner gets

$r(X - L)$  and the lender gets  $(1 - r)(X - L) + L$  where  $0 \leq r \leq 1$ . Here,  $r$  denotes the share of the unallocated surplus going to the owner after bargaining. Although assumed to be exogenous here it can be made endogenous. However, at this stage this will only make the model more complicated without adding too many insights. We can think of  $r$  as the "bargaining power" of the owner. Let  $q_{sg}^*$  denote the probability of reaching the good state.

$$q_1(e, y) = \frac{1}{r(X - L)} \quad \dots(A6)$$

is the FOC for the owner's 'best' effort decision at period 0.

When  $e = e_{sg}^*$  and the condition for individual rationality holds we have,

$$\left[1 - \frac{I - L}{q_{sg}^*(X - L)}\right] - r \geq 0 \quad \dots(A7)$$

This is the non-negative profit condition for the bank. With a value of  $r$  close to 1 the bank may not be able to cover the depreciation losses. On the other hand, if the value of  $r$  is low (i.e. close to 0) then the owner, facing poor incentives, will not exert much effort. In either of these two extreme sets of cases the rational bank will not lend. For intermediate values, the bank may lend; but there will be suboptimal effort.

It is to be noted, however, that by constraining bargaining sufficiently by means of an external nonrenegotiable mechanism the incentives for providing optimal effort can be restored. One possibility is for the bank to commit lending at a particular interest rate. At the same time the bank should have the option to pull out whenever the effort observed is lower than optimal. Aghion, Dewatripont and Rey (1994) and Hart and Moore (1988) discuss various constraining options of this type.

### 6.2.2 Long-term Bank Contract

In this case in period 1 the loan can be renewed automatically and in period 2 the required repayment is  $D_2$ . Let us see what may happen in between. In period 1 if the state is  $B$  it is best to abandon the project. However, the bank can not do this when the contract is long-term. During renegotiation the surplus from closing down is  $(L - P_B X)$ .

The owner will get  $P_B(X - D_2) + r(L - P_B X)$



The bank will get  $P_B D_2 + (1-r)(L - P_B X)$

The first term in each expression is the amount specified in the initial contract.

The feasibility condition here is:

$$X \geq \frac{I - (1 - q_{LB}^*)(1 - r)(L - P_B X)}{q_{LB}^* + (1 - q_{LB}^*)P_B} = D_2$$

The R.S. gives the face value demanded by the bank so that it can break even. The inequality says that the project return should be enough to meet this requirement in the good state.

It is now time to ask how far this type of models can take us in evaluating governance. Clearly, monitoring aspects come out as crucial, and this is a major insight of this approach in understanding the agency problem of capitalist organizations and finance. Yet, there are several aspects in the Asian context that are overlooked by this approach. In particular one can make the following three observations:

- (1) In the Asian context the owner may not have much of a chance to choose between contracts.*
- (2) International environment may give firms incentives to borrow short-term.*
- (3) Most importantly, in order for this stylized framework to be relevant, an enabling environment of supporting network of institutions and administrative apparatus for enforcing contracts must exist.*

It should also be emphasized that a “realist” view of the corporation would recognize the contextual nature of the problems of Asian corporate governance. At the same time, it would highlight, as I have done here, historically and logically, the problem of fiduciary responsibilities of the corporate form of capitalist organization. Clearly, such responsibilities can and should be discussed in a larger domestic and international socio-economic context that includes the evolution of legal institutions and international economic relations as well. Both the positive and normative aspects are equally important.

That is why after raising many specific questions regarding corporate governance in the Asian countries affected by the financial crisis, I raise two overall questions:

1. Ultimately, given the current political and economic situation and the existing institutional structures in the affected countries, what system of corporate governance will be the most efficient? Will the firm become a stakeholder firm (with managers, employees, shareholders all playing a role) or an Anglo-American type firm? Or will some kind of hybrid governance structure be the best?
2. Once we determine the answer to the above question, what specific policy measures will strategically be the most significant in helping the financial system navigate its way towards the normatively optimal system from an overall social point of view?

These questions are relevant for any economy with a corporate form of economic organization. It is simply begging the question to assume that the EMS type is already or always the best institutional design.

## **VI. Conclusions and Suggestions for Future Research**

In this paper I have tried to analyze some basic conceptual and theoretical issues related to corporate governance. Concretely, this was done by studying the historical development of corporate governance systems in East Asia, and their vulnerability to financial crisis. The three-fold division of corporate governance systems presented in this paper seems appropriate from the perspective of a realist approach to the nature of the corporation and its governance. On this view, the “historic mission” of the corporation as site of capital accumulation may require different types of governance structures under different historical conditions. In particular, in the East Asian context, the FBS structure has played an important role in the initial phase of capital accumulation in the East Asian countries. Indeed, its prevalence in Asian economies at all levels of development makes FBS almost a paradigmatic feature of corporate organization and governance in Asia. Complex questions, however, arise with regards to how appropriate this system is currently in both Northeast and Southeast Asia. At present, one proposal is that it should be replaced by BLS. For instance, the new bank-based governance could be modeled after either the Japanese or the German type of corporate governance. For this to happen, however, bank restructuring and recapitalization and an improvement of prudential regulation, accountability and transparency will be essential. A competing proposal is that the transition should be towards an EMS type of corporate governance. It should be recognized that the problems here are even more formidable. The thinness of both bond and equity markets is one problem. In addition, there are the usual problems of lack of adequate regulatory structures, transparency and accountability. The proposal for self-monitoring by Stock Exchange of Thailand (SET) is an example of how difficult it is to have an EMS type of governance in Southeast Asia. In particular, the limited expertise and other institutional resources make the implementation of such proposals (which really should be self-enforcing) problematic. Still, future empirical work should focus on the appropriateness of each one of these structures using whatever systematic quantitative and institutional information is available.

Another important aspect of family business in East Asia is their ability to adapt and reform. As Suehiro (1993, 1997) has pointed out, one rationale for the FBS-system is their flexibility in terms of managerial decision making process and their efficiency in

capital accumulation in the context of latecomer industrialization. The question that arises in the context of the crisis in East Asia is whether for the Southeast Asian economies in particular, the process of catch-up growth is still continuing. If that is the case, the transition process from FBS to either BLS or EMS may need to be slower. In Northeast Asia, however, as some researchers have shown (Khan 1997, 1998, forthcoming) the period of catch up growth has largely ended and global competitiveness must be increasingly based on organizational and product and technical innovations. Here the transition from FBS may need to be effected more speedily. However, as emphasized earlier, much more empirical research using detailed micro data sets with country, sector and firm specific information is necessary before reaching any definitive conclusions. In this context, the suggestion that the firms' managerial expertise as well as the industrial organization can be just as important as the form of corporate governance in determining their performance should also be taken seriously.

An important area of investigation for such future research should be Asian economies with strong family-based corporate groups that weathered the crisis relatively well. Economies such as Hong Kong seem to have a large presence of family-based corporations and yet have managed to maintain their economic vigor. What explains the seemingly better performance of FBS in these economies? This is the subject of ongoing research. Following a methodology that combines fieldwork, statistical analysis of existing data bases and an examination of the legal and institutional environment will lead to a better understanding of corporate governance and performance. Contrasting findings of this type of research with the findings about corporate governance in the crisis economies is a necessary condition for discovering the right road to reforming corporate governance in Asia. It is also clear that there is no single royal road to reform. Rather, a case by case approach that takes the institutional histories and their path dependence in each economy seriously is necessary.

In a critical approach to reform, an intriguing question is how relevant from a perspective of long-run growth will corporate governance be in the future. Such a question is motivated by the need to distinguish between 'normal', growth-inducing macro-institutional environment and periods of crisis. It may be that during normal periods of growth when many institutions and policies are creating opportunities for growth, a few badly managed firms would not matter. An extreme form of this hypothesis,

of course, is that even with systemic bad corporate governance, under favorable aggregate macro economic and other institutional conditions growth is not hindered. A counter-hypothesis is that prior to the crisis some economies such as Korea had a reasonably well-functioning corporate governance system; but matters changed some time prior to the crisis. From this perspective, in the particular case of South Korea it may be hypothesized that the early 90s were such a watershed period when the external environment of chaebol regulations changed, making bad governance inevitable. If this is true then just internal reforms of governance may not be sufficient to induce the corporations to produce efficiently. On the other hand, the first hypothesis does not see such reforms as being even a necessary condition for future Asian growth. Clearly, given the different implications of these various hypotheses it is important to test them fully before recommending appropriate policies for corporate governance reform in East Asia.

Finally, the analysis presented in this paper shows both the scope and the limits of the principal-agent approach to corporate governance. Given multiple stakeholders and longer time horizons for at least some of these principals, the agency problem needs to be recast in terms of more explicit social goals. Such an approach does not start from the atomistic agents, but rather from the concept of the firm as a socially embedded hierarchical system. Bounded rationality, uncertainty and transactions costs can then be modeled quite naturally. For normative analysis, such a theoretical approach can also use a nonutilitarian approach to welfare such as Sen's capability approach.<sup>15</sup> In this context, the issue of the fiduciary responsibility of the corporation assumes the utmost importance. The recent ENRON and other scandals in the US show that this is an issue of positive and normative salience not just in post-crisis Asia but in every economic system with corporate form of organizational structure.

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<sup>15</sup> See for example, A. Sen, *Development as Freedom.*, and H. A. Khan, *Technology, Development and Democracy* for a discussion of this alternative normative approach.

## Appendix (1)

### Family-based Businesses in Thailand

Table A 1.1: Characteristics of Top Shareholders in Large Thai Corporations, 1979 and 1988

Top Stockholders/Equity Percentage	1979	%	1988	%
(1) Individual:	72	(33.0)	74	(29.7)
1-9%	3		4	
10-29%	35		43	
30-50%	29		23	
51-100%	1		4	
Foreigner	4		0	
(2) Family investment company:	26	(11.9)	16	(6.4)
1-9%	3		5	
10-50%	17		9	
51-100%	6		2	
(3) Thai corporation:	37	(17.0)	67	(26.9)
1-9%	3		5	
10-29%	15		24	
30-50%	10		19	
51-100%	9		19	
(4) Foreign corporation:	78	(35.8)	81	(32.5)
10-48%	32		26	
49-50%	10		11	
51-98%	10		13	
99-100%	26		31	
(5) Government bureau	3	(1.4)	8	(3.2)
(6) Crown Property Bureau	2	(0.9)	3	(1.2)
Total	218	(100.0)	249	(100.0)

Sources: Calculated by Suehiro (1993, p. 388) using the following directories: for 1979, Pan Siam Communication Co., *Million Baht Business Information Thailand, 1980-81* (Bangkok, 1981); for 1988, International Business Research Thailand Co., *Million Baht Business Information Thailand, 1989* (Bangkok, 1989).

Notes: 1. Large corporations indicate firms with 0.3 billion baht (1979) and 1 billion baht (1988) in terms of total annual sales.  
2. Public corporations have been excluded.

**Table A 1.2: Top Three Stockholders in Thai Large Corporations,  
1979 and 1988**

<b>Top Three Stockholders</b>	<b>1979</b>	<b>%</b>	<b>1988</b>	<b>%</b>
(1) Individuals (Thai):	60	(27.5)	61	(24.5)
Belonging to the same family	21		33	
Belonging to multiple families	39		28	
(2) Individuals plus corporations:	38	(17.4)	32	(12.9)
With group companies <sup>a</sup>	14		13	
With non-group companies	24		19	
(3) Thai corporations:	22	(10.1)	48	(19.3)
Belonging to the same group	4		17	
Among different groups	15		19	
Holding-company type <sup>b</sup>	3		12	
(4) Foreign corporations:	90	(41.3)	97	(39.0)
Exclusively foreigners <sup>c</sup>	33		38	
With Thai corporations	43		51	
With Thai individuals	14		8	
(5) Government bureaus	8	(3.7)	11	(4.4)
Total	258	(100.0)	249	(100.0)

Source: Calculated by Suehiro (1993, p.389) same as Table A 1.1.

<sup>a</sup> Group companies are members of the group of companies that the stockholders in question own and operate

<sup>b</sup> Siam Cement Co., Ltd. and Suramahakhun Co., Ltd.

<sup>c</sup> Includes a single firm with 100 per cent stockholdings.

**Table A 1.3: Family Stockholders and Management Control  
in Thai Large Corporations, 1988**

Top Management	Equity Percentage of Largest Stockholder			Total	%
	1-9%	10-49%	50-100%		
Presidents / general managers:					
(1) Same family with the largest stockholder	3	33	55	91	59.5
(2) Same families with 2 <sup>nd</sup> or 3 <sup>rd</sup> stockholders	2	8	1	11	7.2
(3) Different families <sup>a</sup>	4	22	11	37	24.2
(4) Foreigners	2	11	1	14	9.2
Sub-total	11	74	68	153	100.0
(5) No data available	---	3	2	5	
Chairmen of board:					
(1) Same family with the largest stockholder	1	21	34	56	62.9
(2) Same families with 2 <sup>nd</sup> or 3 <sup>rd</sup> stockholders	1	4	---	5	5.6
(3) Different families	7	13	5	25	28.1
(4) Foreigners	1	2	---	3	3.4
Sub-total	10	55	39	89	100.0
(5) No data available	---	39	31	71	
Presidents (P) / chairmen (C):					
(1) Both of P/C belonging to the same family with top three stockholders	2	14	29	45	50.0
(2) Either of P/C belonging to the same family with top three stockholders	2	19	8	29	32.2
(3) Others	6	8	2	16	17.8
Sub-total	10	57	39	90	100.0
(4) No data available	1	38	31	70	

Sources: Survey by A. Suehiro (1993); same as table A.1.1

Notes: 1. Figures cover large corporations with annual sales of 1 billion baht in 1988

2. Foreigner 100 per cent controlled and government partially owned companies have been excluded

3. Subsidiaries of Siam Cement group and Suramahakhun group have been excluded

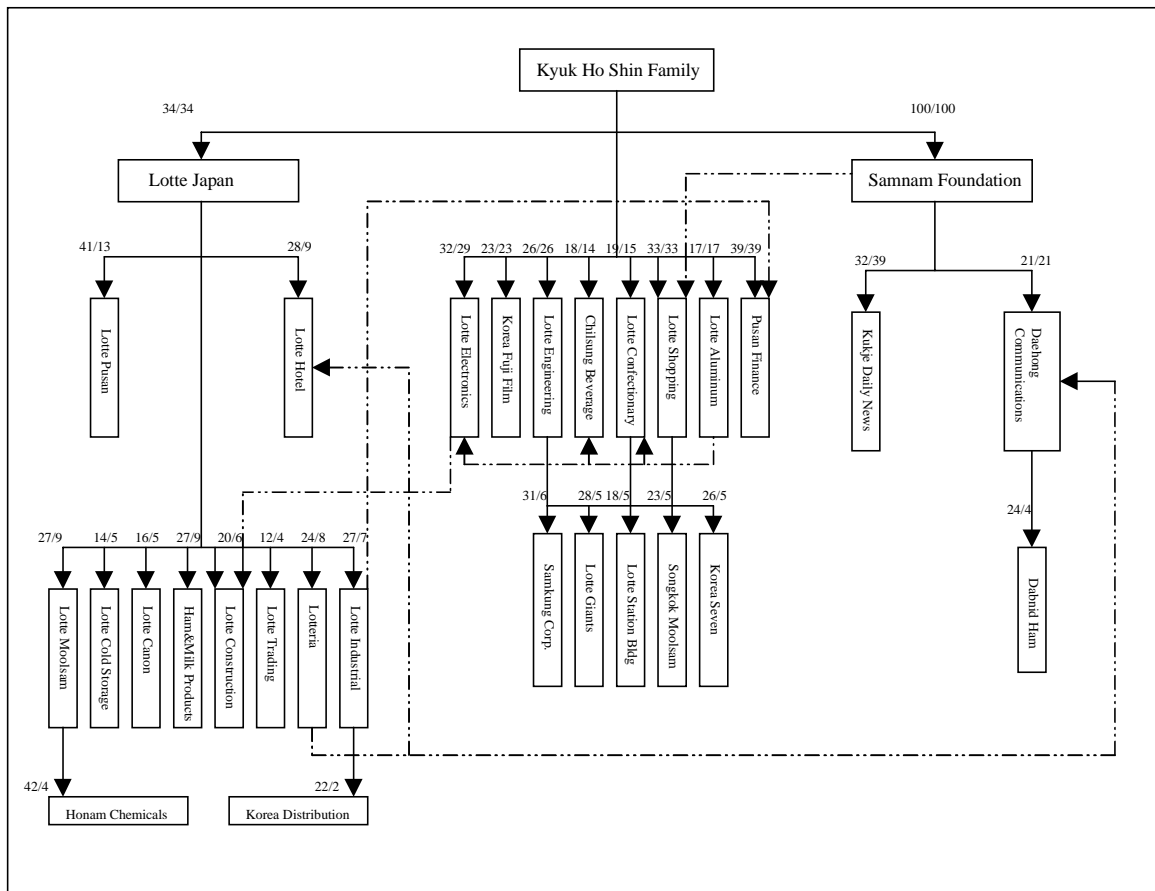
<sup>a</sup> Figures include non-identified presidents or chairmen



Appendix (2)

Enhancement of Control in the Family-based (FBS) type of Corporate Governance

Figure A.2.1: The Lotte Group  
(Immediate Control/Ultimate Cash-Flow Rights)



Source: Stijn Claessens, Simeon Djankov, Joseph P.H. Fan and Larry H.P. Lang (1999, p.12)

Appendix (3)

**Abolition of Regulations Protecting the Chaebols**

**Table A.3.1: Abolition of Regulations Protecting the Chaebols**

External Shocks	Expected Changes	1998	1999	2000
Cross-shareholdings	Likely to be phased out to increase transparency	▲ 1998 Limited to 25% of net worth for top 30 chaebols		
Protection from M&A threats		▲ February 1998 Tender offer obligation abolished ▲ May 1998 Ceiling on foreign ownership abolished		
Lack of minority shareholder rights	Enhanced shareholder rights and monitoring system will provide disciplinary mechanisms	▲ 1998 Cumulative board voting expected	▲ 1999 Shareholder derivative lawsuits likely to be legalized	
Ability to grow via financial leveraging	Securing capital will become more difficult for chaebol Debt-to-equity ratio needs to conform to international standards	▲ 1998 No new cross-guarantees	2000 ▲ Cross-guarantees to be phased out	
Strong coordination via chairman's office	Dissolution of group chairman's office may lead to vacuum of control and coordination	▲ 1998 At least one outside board member ▲ 1998 Group chairman's office dissolved; each legal entity required to form its own board	▲ 1999 At least 25% of board to be outsiders	

Source: Yuji Akaba, Florain Budde and Jungkiu Choi, "Restructuring South Korea's Chaebol", The McKinsey Quarterly 1998, number 4

## Appendix (4)

### **Performance of East Asian Corporate Systems: Growth, Financing and Liabilities**

In order to answer the question: what is the appropriate corporate governance system for East Asia after the crisis, we need to understand the performance of the corporates before the crisis. Generally, it appears that the high debt and leverage ratios were source of potential problems. They became sources of actual problems with the capital account liberalization without adequate attention to the problems of short-term debt structures of the corporation.

One hypothesis about the recent financial crisis, as alluded to already, has been that it was caused - at least in part - by the weak performance and riskiness of corporate ventures. Before one can test the hypothesis in a rigorous way it is necessary to look at some basic indicators. In this appendix I will look at six salient indicators. These are:

1. Real return on assets (RoA)
2. Sales
3. Investment and capital
4. Leverage
5. Long-term debt
6. Interest coverage

Nominal Rate of return on assets is measured as the ratio of EBIT (earnings before interest and taxes) at the firm level and total assets. Real rate of returns is the nominal return adjusted for rate of inflation.<sup>16</sup>

$$RoA = \frac{EBIT}{TA} - \pi \quad \dots(1)$$

---

<sup>16</sup> There are, of course, other measures of RoA, for example operational margin. This measure shows less cross-country differences. But again, Singapore and Korea turn out to be relatively lower margin producers. On this, see Claessens, Djankov and Lang (1998)

where  $RoA$  = real rate of return on assets at the firm level  
 $TA$  = total assets at the firm level  
 $\pi$  = annual inflation rate

Table 1 below shows the median RoA in percentage terms for eight Asian economies. It displays quite a bit of variation across these countries. For example, in Hong Kong, Korea and Singapore the RoA is, on the average between 4 and 5 percent. These rates are quite low compared with those of Thailand, Philippines and Indonesia. For these countries RoAs vary between 8 and 10 percent per year. Malaysia and Taipei, China occupy an intermediate position. These rates are measured after expressing all terms in the identity (1) in local currencies. Measuring them in foreign currencies (for example dollars) would simply show an upward adjustment for real exchange rate appreciation.

**Table A.4.1: Return on Assets for Eight Asian Countries(assets measured by book value)**  
(%, medians, in real local currency)

Country	1988	1989	1990	1991	1992	1993	1994	1995	1996	'88-'96
Hong Kong	5.1	5.3	4.9	4.8	4.5	3.8	3.9	3.9	4.1	4.6
Indonesia	n.a	n.a	9.4	9.1	8.6	7.9	7.4	6.2	6.5	7.1
Korea	4.4	3.9	4.1	4.0	3.9	3.6	3.4	3.6	3.1	3.7
Malaysia	5.4	5.6	5.4	6.2	6.0	6.5	6.3	6.1	5.6	6.3
Philippines	n.a	n.a	n.a	7.1	6.4	8.1	8.5	6.8	8.4	7.9
Singapore	4.9	4.5	4.2	3.9	5.2	4.6	4.5	3.9	4.0	4.4
Taiwan	n.a	n.a	n.a	5.1	6.2	6.5	6.8	6.5	6.6	6.7
Thailand	10.8	11.0	11.7	11.2	10.2	9.8	9.3	7.8	7.4	9.8

Source: Claessens, Djankov and Lang (1998)

Table 2 below gives the sales growth on a year-on-year basis for these eight countries. They also show quite a bit of variation over time. On the average most of the corporations registered high sales growth. The MIT (Malaysia, Indonesia and Thailand) economies show very high average rate of growth, respectively; Taipei,China and Hong Kong are close behind with a 9.3 and 9.2 percent growth on the average respectively. In 1996, however, Thailand, Indonesia, Taipei, China and Singapore showed a slower rate of growth. The export slowdown in 1996 is at least partly responsible for this.

**Table A.4.2: Real Sales Growth (Year-on-Year) for Eight Asian Countries**  
(%, medians)

Country	1989	1990	1991	1992	1993	1994	1995	1996	'88-'96
Hong Kong	10.1	11.6	10.2	12.4	9.8	9.4	9.7	11.8	9.2
Indonesia	n.a	n.a	n.a	10.7	12.1	12.4	9.4	8.3	10.6
Korea	8.4	8.7	8.2	8.3	7.6	7.3	7.2	8.6	8.2
Malaysia	9.7	12.3	11.8	12.7	13.1	12.6	11.7	11.9	11.9
Philippines	n.a	n.a	n.a	8.4	6.7	7.6	10.6	12.2	8.2
Singapore	8.4	8.6	8.1	9.4	11.6	11.8	10.2	7.7	8.7
Taiwan	n.a	n.a	n.a	7.1	11.3	10.3	9.7	8.4	9.3
Thailand	11.6	10.3	10.8	9.6	8.3	10.1	10.7	5.7	9.7

Source: Claessens, Djankov and Lang (1998)

Closely correlated with the high sales growth rate is the high volume of capital accumulation resulting from high rates of investment. Table 3 demonstrates this proposition. Investment growth is measured as the ratio of new investments to existing fixed assets from 1988 – 1996. Indonesia, Korea and Thailand maintained remarkably

high rates of investment. Malaysia, Philippines and Singapore also registered investment growth rates of over 10 percent. In retrospect, questions have been raised not about the quantity but the quality of some of these investments in the crisis countries.

**Table A.4.3: Capital Investment by the Corporations in the World Scope Sample for Eight Asian Countries, 1988-96**  
(%, medians)

Country	1988	1989	1990	1991	1992	1993	1994	1995	1996	'88-'96
Hong Kong	14.3	16.6	8.3	7.6	7.2	19.8	7.6	5.8	9.3	8.3
Indonesia	n.a	n.a	n.a	12.4	13.4	8.6	15.8	13.8	11.8	12.7
Korea	15.6	13.8	13.2	19.2	11.6	11.2	12.2	12.4	13.7	13.6
Malaysia	8.6	7.6	8.9	9.6	11.3	13.4	15.2	14.6	16.1	10.7
Philippines	n.a	n.a	n.a	9.1	8.9	7.8	13.5	14.1	14.5	10.8
Singapore	7.8	7.6	7.4	8.8	9.6	11.3	13.4	12.5	13.5	10.4
Taiwan	n.a	n.a	n.a	14.3	8.2	8.4	8.7	11.2	8.6	8.7
Thailand	10.4	12.9	12.3	15.0	14.9	15.0	14.7	14.5	5.8	13.8

Source: Claessens, Djankov and Lang (1998)

In retrospect the data also show the degree of riskiness inherent in the liabilities incurred by the corporations, especially in the crisis countries with relatively low RoAs. Some of these countries (e.g. Korea) turned abroad for financing. Surprisingly even countries with high RoA such as Indonesia and Thailand also borrowed heavily abroad. Domestic Bank lending which has also become a characteristic of the East Asian Miracle has naturally been high also. Table 4 gives the leverage ratio (i.e. debt over equity) for the eight countries. Interestingly, the ratios are not the same in all countries. Korea's average of about 3.5 is about 4.5 times as high as that of 0.82 for Taipei, China. Indonesia, Thailand and Hong Kong also show high leverage. However, the case of Hong Kong shows that high leverage may not necessarily result in systemic financial crisis, although the aftermath of crisis in Asia has certainly weakened its economy.

**Table A.4.4: Leverage (Debt/Equity) for Eight Asian Countries**  
(%, means)

Country	1988	1989	1990	1991	1992	1993	1994	1995	1996	'88-'96
Hong Kong	1.832	2.311	1.783	2.047	1.835	1.758	2.273	1.980	1.559	1.902
Indonesia	n.a	n.a	n.a	1.943	2.097	2.054	1.661	2.115	1.878	1.951
Korea	2.820	2.644	3.105	3.221	3.373	3.636	3.530	3.776	3.545	3.467
Malaysia	0.727	0.810	1.010	0.610	0.627	0.704	0.991	1.103	1.176	0.908
Philippines	n.a	n.a	n.a	0.830	1.186	1.175	1.148	1.150	1.285	1.129
Singapore	0.765	0.922	0.939	0.887	0.856	1.102	0.862	1.037	1.049	0.936
Taiwan	n.a	n.a	n.a	0.679	0.883	0.866	0.894	0.796	0.802	0.820
Thailand	1.602	1.905	2.159	2.010	1.837	1.914	2.126	2.224	2.361	2.008

Source: Claessens, Djankov and Lang (1998)

It is also noteworthy that long-term debt has been low during the period under consideration. This is illustrated in Table 5 below. With the exception of Philippines, the share is less than 50 percent for all other countries; Malaysia, Thailand and Taipei,China have the lowest share (between 29.2, 30.9 and 35.9 percent respectively). In most cases there has been a decline in the share of long-term debt beginning with the early 90s.

**Table A.4.5: Long Term Debt Share for Eight Asian Countries**  
(%, medians)

Country	1988	1989	1990	1991	1992	1993	1994	1995	1996	'88-'96
Hong Kong	59.7	59.5	53.8	56.5	44.7	44.7	40.7	37.3	36.4	44.9
Indonesia	n.a	n.a	n.a	52.4	40.8	39.6	41.6	41.8	43.3	43.1
Korea	55.7	47.2	49.8	49.8	44.2	43.7	41.4	40.4	41.5	43.7
Malaysia	35.8	35.5	32.5	27.1	26.9	26.6	27.2	27.8	29.9	29.2
Philippines	n.a	n.a	n.a	57.2	53.1	50.3	50.2	49.8	51.4	52.2
Singapore	57.2	55.4	54.1	33.8	33.8	33.9	40.2	38.6	41.1	43.3
Taiwan	n.a	n.a	n.a	53.9	44.4	32.8	34.6	34.3	38.9	35.9
Thailand	58.1	49.8	38.8	34.3	25.2	26.4	27.6	32.9	32.8	30.9

Source: Claessens, Djankov and Lang (1998)

Debt, even short-term debt, by itself does not imply that anything is seriously wrong as long as the ability to pay is not questioned by the creditors. It is useful to look at measures such as interest payment coverage (IPC) to see if there were indications of problems in this regard in the corporate sectors of some of the Asian economies. Interest payment coverage is defined as follows:

$$IPC = \frac{EBITDA}{InterestExpenses} \dots(2)$$

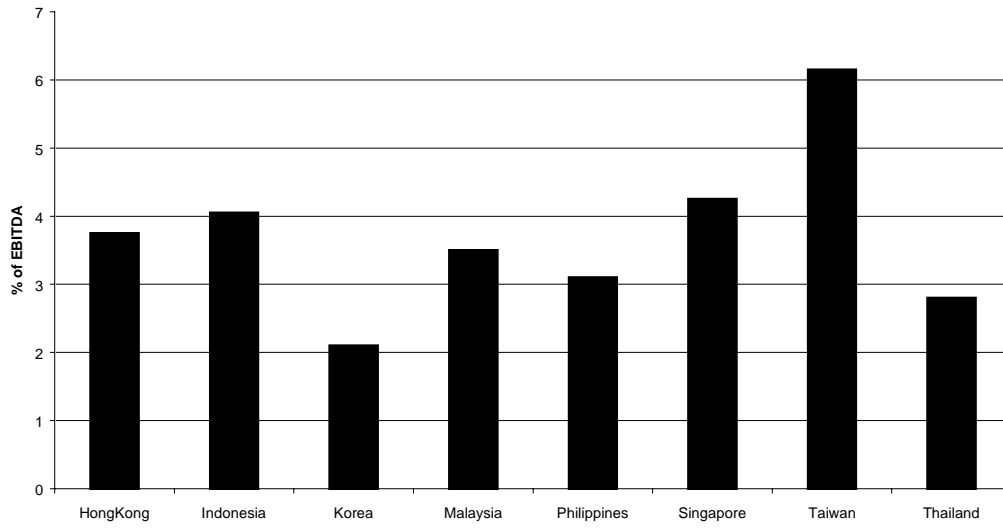
where EBITDA = earnings before interest and taxes but adding back depreciation

IPC is a measure of how adequate operational cash flows (given by the size of EBITDA) are as compared with interest payment obligations. The fact that the Thai and Korean corporations had very low IPCs (2.7 and 2.1 respectively) should have signaled (and probably had signaled in 1997) to the creditors that the corporate financing system was getting fragile. In Taipei, China, on the other hand an IPC of 6.1 looked quite secure.

However, fragility of corporate finance depends not only on leverage ratios or IPCs, but also on the actual performance of corporations. The performance, as measured by sales and (to some extent) RoAs, did not seem problematic until the crisis. Since then, the link between corporate *performance* and corporate *governance* has become a major issue.



Figure 1: Interest Coverage in Eight Asian Countries



Source: Claessens, Djankov and Lang (1998) (Interest payment coverage is equal to EBITDA/interest payment obligations)

## Appendix (5)

### **Policy and Institutional Questions**

Once we have the typology offered in section two of this paper it becomes possible to raise questions related to corporate governance structures for East Asia in a serious way. This is the task of this appendix. In particular, a set of policy and institutional issues can be raised clearly.

Within the general framework presented in section 2 the most important question is: what corporate governance structure is the most appropriate for particular Asian countries, given the present stage of development and the present institutional structure in that country? In order to address this question properly a number of fairly concrete questions will need to be answered. The following list of institutional questions tries to do this without being exhaustive. This is done in three steps. First, a series of concrete questions related to the possible transition from a FBS to a BLS governance is listed. Second, some specific questions related to a possible transition from a FBS to an EMS governance structure are listed. Finally, a two-part question addresses the general policy issues for institutional restructuring. It is hoped that these questions will give specificity to the reform agenda, force one to think more clearly about concrete resource requirements, and most importantly, underline the problems of institutional change in the real world. As emphasized at the beginning, the purpose of the current paper is not to answer all these questions, but to use these to ascertain in a tentative and preliminary way what the significant problems are for transition to a better form of corporate governance in East Asia.

#### **A. Questions related to Family-based System (FBS) and Bank-led System (BLS)**

1. What circumstances may lead to overexposure of banks and non-bank financial institutions (NBFI) under the FBS to risky sectors (e.g. real estate) and risky projects?
2. What conditions can ensure that the transition from FBS to BLS and to a system of financial restraint (as Stiglitz and others have described it) will not lead to overlending to the risky sectors and projects?

3. Are there problems that arise when the monitoring of corporations is primarily the responsibility of banks without being complemented by other financial institutions (Indonesia, South Korea)?
4. However, weak NBFIs also can cause problems (e.g. Thailand). What kind of policies and institutional reform can ensure that a transition from FBS to BLS in a country like Thailand will not cause the system to become vulnerable? Are there “cultural” factors (e.g. with respect to how laws are interpreted or applied) that may also be important here?
5. It has been claimed that unbalanced financial systems led to a lack of risk diversification in Asian economies. How will transitions to a BLS from FBS solve this problem?
6. Will allowing more foreign banks entry into the financial system make governance of BLS better? How?
7. What should be the optimal capital - adequacy ratios for banks over the relevant time horizons (e.g. during the crisis period, medium-term, long-run)?
8. How can legal lending limits be designed to be more adequate than they are now?
9. How can the enforcement of the legal lending limits be strengthened?
10. How can asset classification systems be improved?
11. How can provisioning rules for possible losses be better designed and enforced?
12. How can the now universally acknowledged poor disclosure and transparency of bank operations be improved?
13. a. How can the lack of provisions for an exit policy for troubled financial institutions be addressed?  
b. More specifically, is there a need for completely specifying an orderly workout procedure? If so, how to do it? (There may be issues related to legal institutions of specific countries that are relevant here. So institutional studies by legal experts will be necessary for answering this question)
14. How to improve bank supervision, and the compliance with prudential regulations in general?
15. It has been shown that much of the lending was done on a collateral basis, rather than on a cash flow basis. This obscured the need for analyzing the profitability and riskiness of underlying projects. How can this lending practice be changed?
16. In the recent past, credit tended to flow to borrowers with relationships to government or private bank owners and to favored sectors. How much of this was productive?

What would be the best way to ensure that finances go to productive sectors and efficient firms after moving from FBS to BLS in these countries?

17. How can banking practices be moved towards proper evaluation of illiquid vs. insolvent firms, lending based on projected cash flows, realistic sensitivity analysis and recoverable collateral values?
18. What should be the optimal liquidity requirements (one presumes that in most cases it should be higher) for the banks in the affected countries?
19. How to address the problems of special categories of weak financial institutions, e.g.
  - a) state banks in Indonesia
  - b) merchant banks in Korea
  - c) many other commercial banks in East Asia
  - d) finance companies in Thailand
20. If the relationship between leverage and profitability is negative in East Asia, as some studies claim to have found, does this mean that BLS may not be the proper corporate governance structure in East Asia after all?
21. How best can the problems of non-performing loans and bank-recapitalization be handled so that a move from FBS to BLS is a realistic option in the economies affected by the crisis?

**B. Questions related to the possible transition from FBS to an Equity Market-led System (EMS)**

1. The World Bank (1998) states: "The main lesson from the South East Asian crisis is that it is important to take an integrated approach to the issues of corporate governance and financing." Will transition to an EMS, under the existing conditions lead to this type of integrated approach and consequent "market disciplining" of corporate governance?
2. In particular, given ownership concentration in business groups and control by a few families, how can credible reform be carried out rapidly?
3. Claessens, Djankov, Fan and Lang (1998) have shown that interlocking structure of share ownership and pyramidal share ownership lead to greater effective block ownership and control in East Asian firms. How can this be changed?<sup>17</sup>
4. Given the thinness of bond markets, what is the realistic time-frame in order for the countries of the region to be able to develop such markets with diverse type of bonds and sufficient market depth?<sup>18</sup>

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<sup>17</sup> For some interesting evidence on shareholder activism in the Japanese context see Kim and Rhee (1999)

<sup>18</sup> This, in fact, is one of the most important policy issues in the medium run for Asia. I am grateful to Hitoshi Nishida and Toshio Karigane for helpful discussions regarding the development of bond markets

5. What kind of regulatory reforms are necessary for reducing the agency costs and protecting the minority shareholders (and creating "shareholder value" in general) in an "institutionally-feasible" EMS structure of governance in East Asia?
6. Will increasing foreign presence in the equity market - especially the institutional investors - improve market discipline? Are there conditions such as 'bailing in' that may be important here? [Simply abolishing some laws, such as Thailand's Alien Business Law may not be enough]
7.
  - a. How helpful will the inclusion of outside directors (now being tried in South Korea, perhaps following the Cadbury and Hampel reports in U.K.) be in improving governance of the financial sectors and in turn the monitoring of the non-financial firms?
  - b. How will it improve the governance and performance of non-financial firms directly?
8. Are the Takeover Codes adequate? If not (most likely they are not adequate) then how can these be improved? How long will it take?
9.
  - a. How long will it take to review Securities Law adequately and suggest real changes (not just a hasty, window-dressing job)?
  - b. How long will it take to clarify and enforce ownership rights in equity markets and creditor rights in the bond market?
10. How to ensure that creditor rights are protected and management is appropriately disciplined in case of failure?
11. How can bank shareholders be forced to bear the risk of bank failure and be encouraged to monitor the banks?
12. Are proposals such as the one put forward by SET in Thailand for self-governance and monitoring put forth in 1997 credible? Can we compare with the Chilean reforms in corporate governance to get some clarity? How to evaluate the role of proposed rules (by outside experts) such as supermajority?
13. How to carry out reforms such as de-leveraging through divestiture or sale of assets, streamlining of business units, operational restructuring and new equity infusion efficiency?
14. Will reviewing the process of appointment of commissioners to the SEC and similar administrative reforms help? How to make these credible and feasible?
15. Some institutional aspects (such as the slow speed of foreclosure as a result of slow court procedures and lack of registries in Thailand) make rapid reform difficult. How to speed up the pace of desirable reforms, esp. in areas such as bankruptcy procedures, DIP type of arrangements etc.?

### **C. Overall questions**

3. Ultimately, given the current political and economic situation and the existing institutional structures in the affected countries, what system of corporate governance will be the most efficient? Will the firm become a stakeholder firm (with managers, employees, shareholders all playing a role) or an Anglo-American type firm? Or will some kind of hybrid governance structure be the best?
4. Once we determine the answer to the above question, what specific policy measures will strategically be the most significant in helping the financial system navigate its way towards the optimal system?

## Appendix (6)

### **Some Theoretical Issues: Incomplete Contracts and Transactions Costs**

While during the last two decades the term corporate governance – often associated with phenomena such as takeovers, financial restructuring and institutional investors’ activism- - has entered the business and economics vocabulary, it is curious to note that the standard classical textbook theory of the firm has no place for the term. This is because in this theory the firm is an entity that maximizes profit (by duality theorem, minimizes costs) subject to technological constraints given by the production function. The firm itself is really a black box that connects inputs to outputs efficiently. No assumptions are made with regards to the ownership of the firm beyond that of a general private ownership economy (Debreu, 1959). Therefore, possible conflicts between ownership and management identified by Berle and Means (1932) do not arise. Furthermore, under competitive conditions there is no economic rent to be divided among various parties ex post. Therefore, the issue of governance system – defined by Williamson (1985) as the set of constraints shaping the ex post bargaining over the quasi rents generated in an enterprise also does not arise.

Do things change if the firm is defined in a more realistic manner? Curiously, in a perfectly functioning contractual capitalism the answer is also no. Consider the definition of firm as a nexus of contracts. This is certainly a move towards greater realism. So the definition looks quite plausible, especially in the way that Alchian and Demsetz (1972) develop it. Yet, if all contracts could be specified completely then there would be nothing unique left to the concept corporate governance. A complex set of contracts, written ex ante, would specify how to deal with every contingency, including the distribution of quasi-rents.

Faced with this difficulty some economists have defined the firm as a collection of physical assets that are jointly owned. This definition, introduced by Grossman and Hart (1986) and Hart and Moore (1990) starts from the position that not all contingencies can be covered by the initial set of contracts. Therefore, some way has to be found to confer rights of making decisions under exactly those contingencies that are unspecified in the initial contract as these contingencies are realized later. Therefore, ownership may matter

precisely because it legally entitles the owners to make such decisions. Owners are thus the residual rights holders (hence the approach has been also called the property rights view of the firm) and can appropriate the quasi-rents. It leads to a non-trivial definition of corporate governance, since the non-contractual element (i.e. the allocation of ownership) differentiates corporate governance from contractual governance, which can not be done within the complete contracts framework. Only in a world where contracts are incomplete – perhaps because some of them are contingent on future observable variables and either costly or impossible to write in advance – can there be some scope for governance ex post. In the world of incomplete contracts there are quasi-rents that must be divided ex post. This will involve real decisions to be made in the future. This contrasts sharply with the Arrow-Debreu world where all decisions (production, consumption and distribution) are made ex ante and no contracts can be renegotiated.

Notice that in the Arrow-Debreu context a very relevant real world question such as “in whose interest should the corporate directors act?” can not even be asked. The initial grand contract specifies completely how the board of directors should act under all contingencies. In the real world, as shown dramatically by the Asian crisis, the question has to be asked all the time. This makes the incomplete contracts and other related theoretical approaches relevant and appealing. In the Grossman-Hart-Moore view the residual rights of control are crucial because they allow ex post bargaining that can affect efficiency as well.

There are three principal ways in which corporate governance systems can affect efficiency. These can be called:

1. Ex ante incentive effects
2. Bargaining efficiency effects
3. Risk aversion aspects



### Ex ante incentive effects

A classic example in business history discussed by Chandler and others is the Fisher Body case. In the 1920s this auto body manufacturer was asked by GM to locate its plants in close proximity to GM plants. The cost saving from lowered transportation costs and on-time delivery was quite obvious. However, locating close to GM would have meant that Fisher Body could not supply the other car manufacturers quite as easily and hence would have been in danger of becoming a 'captive' of GM. Possibly, its weakened bargaining power under these circumstances would have led to a lower share of quasi-rents generated by its relationship with GM (Klein et al. 1978). The dilemma was resolved ultimately when GM acquired Fisher Body. This acquisition, which changed the governance structure, led to more efficient plant location. Without a proper governance system individually rational agents will not devote the right amount of resources to value enhancing activities because they will not see their efforts as being properly rewarded. The phenomenon of managerial shirking can also be explained the same way.

Even more important perhaps is the fact that under an inappropriate governance system, rational agents will utilize resources in wasteful activities. Shleifer and Vishny (1989) point out that a manager may inefficiently force the firm to specialize in activities that he is best at running because this will increase his share of ex post rents. Milgrom(1988) draws attention to the fact that even subordinates without decision making power will waste resources trying to curry favors with their superiors. Empire building by managers and their subordinates can at least partly be explained this way. Chandler's (1966) description of capital allocation under Durand at GM as "a sort of horse trading" hints at this kind of problem. The move to the M-form, or multidivisional structure increased the responsibility and autonomy of the divisional managers. Their pay-offs from inefficient rent-seeking were reduced considerably.

Milgrom and Roberts (1990) discuss the presence of "influence costs" in many complex organizations. Organizational governance rules must be devised to minimize these influence costs. In a similar way Rajan and Zingales (1996, 1998) discuss the problems of inefficient "power-seeking". They argue that the more a firm's divisions have diverse investment opportunities the more severe is the problem of "inefficient power-seeking". Not surprisingly, one of their findings is that the value of a diversified firm is

negatively correlated with the diversity of the investment profile of its divisions. This type of analysis may be directly relevant to an understanding of the East Asian conglomerates.

### Bargaining Efficiency Effects

Here we need to consider the problems of free-riding and of coordination costs, problems of information asymmetry between the different parties and liquidity constraints.

Consider a large and dispersed set of owners. Free-rider problems and the resulting failure to arrive at a collective decision may leave the managers free to appropriate the rent giving rise to 'agency and free cash flow problem' (Jensen and Meckling, 1976; Grossman and Hart, 1980). One can also think of allocations of control rights under which no compensating transfers a la Coase theorem can be made because one of the parties is facing a liquidity constraint. (Aghion and Bolton, 1992). Rajan and Zingales (1996) also consider the possibility when there is no binding liquidity constraint but some agents have the alternative opportunity to invest in power-seeking activities. It is, therefore, quite possible that unless the governance structure generates the right incentives ex post bargaining could be inefficient. I will show later that this is a real possibility in the prevalent form of corporate governance in East Asia, under some circumstances.

### Risk Aversion Aspects

A governance system may affect both the level and allocation of risk in the economy. Any contract (for example an insurance contract) written in nominal terms generates some risk with respect to the future rate of inflation. If diversification of portfolio is impossible the expected value of surplus generated by the contractual arrangements will decrease.

Fama and Jensen (1983a and b) offer an interesting perspective on the generation and allocation of risk under different forms of organizational arrangements and corporate governance. According to their analysis the efficiency of a governance system can be measured by how well it allocates risk to the party most willing to bear the risk.

The upshot of the above discussion is that a corporate governance system could be judged to be efficient from several points of view. Optimally, in order to enhance the total value creation by the corporate organizational form, the governance structure must create incentives for maximizing productive investments. Incidentally, this will also involve minimizing inefficient power seeking, and inefficiency in ex-post bargaining. A good governance system should also generate a minimal amount of risk and allocate this to those parties that are most willing and able to bear it.

The incomplete contracts framework of corporate governance is illuminating in underlining the value of governance. However, strictly speaking it applies only to entrepreneurial firms that are governed through shareholder activism. In order to understand the role of alternative governance structures we need to turn to alternatives that build on the insights of the incomplete contracts approach. In particular, relationship based forms of corporate governance need to be understood in the context of their being embedded in a larger non-contractual institutional matrix of social relations. To concretize matters we need here an expanded typology and conceptual framework. The idea of a family-based corporate governance system in the East Asian context discussed in section III is a preliminary step in this direction. In order to proceed more logically in this direction, however, some further distinctions must be made to begin with the difference between reforming exclusively the rules of corporate governance in a formal way and actually changing the institutional arrangements in practice must be recognized. In particular, the critical role of transactions costs in effecting institutional changes must be understood clearly.

### **A Transactions Cost Perspective**

It is important to realize fully the strategic nature of the transactions costs during the transition period. As Williamson (1995) has pointed the choice during transition is not between two sets of idealized institutions, but rather between an existing set and different strategies to change the systems to a better one. Khan and Lippit (1993a, b) also

emphasized the role of uncertainty and bounded rationality of agents in defining any kind of after reform steady-state institutional set up.<sup>19</sup>

As the text points out (section 4) the enabling environment of either a transparent and effective legal system or a workable relationship between the government and business is necessary for corporations to perform efficiently. When legal institutions are not well-developed transaction costs are high in dealing with market situations. It may be necessary to have relatively large family groups with their particular modus operandi in order to function in this environment. For example, through their intra-group network and their relationships with the government bureaucracy the family groups may be able to economize on transaction costs.

A similar argument applies with respect to the 'diversification discount' issue. In the literature on diversification in the developed economies the empirical findings show that on the average a loss of value of about five percent is recorded by companies that diversify beyond two segments. This loss, which has been called the 'diversification discount' is attributed to the loss of efficiency when a firm goes beyond its core competencies. However, in the Asian context, at an earlier stage of development transactions costs may be minimized by internalization through diversification. In other words the boundary between the firm and the market are extended from the firm which grows 'inclusively' by acquiring other firms.

Beyond this specific hypothesis, theoretically, the transactions costs economics (TCE) regards transaction as the basic unit of analysis (Williamson, 1988). The incomplete contracts approach discussed earlier, and agency theory (AT) in general takes the individual agent as "the elementary unit of analysis". Both offer micro-foundations of economic behavior; however, TCE "leads naturally to an examination of the principal dimensions with respect to which transactions differ". (Williamson, 1988, p. 571). This is crucial in analyzing institutions with different enabling (or disabling) environments. Thus adaptation (or maladaptation) to a specific environment becomes a key institutional issue, as does governance with respect to specific structure of firms, their asset specificities, and the interrelation of the various stakeholders. All these must be thought of in the real world policy context of concrete institutional analysis and the

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<sup>19</sup> Khan and Lippit (1993 a, b) consider the specific problem of defining a steady state under environmental constraints. However, their treatment of bounded rationality and uncertainty can be carried over to other

various transactions costs.<sup>20</sup> Given the costs of failed (or even successful) reforms it is important to pay attention to these costs. As Williamson reminds us: “All over the world, we’re launching projects that have great potential for doing irreversible *economic* and *political* damage... We can’t afford the experiment of developing five countries in five different ways and seeing which four countries get ruined. Instead, it will cost us much less in the long run if we hire *institutional economists* to find out what happened the last time.” (Williamson, 1995, p. 194)

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relevant contexts.

<sup>20</sup> Williamson (1988) discusses four types of *ex post* costs. In his words: “[t]hese include "(1) the maladaptation costs incurred when transactions drift out of alignment in relation to what Masahiko Aoki refers to as the 'shifting contract curve', (2) the haggling costs incurred if bilateral efforts are made to correct *ex post* misalignments, (3) the setup and running costs associated with the governance structures (often not the courts) to which disputes are referred, and (4) the bonding costs of effecting secure commitments ...".

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