Discussion

1. Mitsuhiro Fukao

Prowse's study compares the corporate finance and governance systems of major industrialised countries, including the United States, the United Kingdom, Japan, Germany, and Australia, and discusses their relative advantages and disadvantages. The author then examines the pressures for change in each system and their implications for the future evolution of financial systems.

The major points of Prowse's study are as follows:

- the large differences in corporate finance and governance systems among major countries mainly stem from differences in their legal and regulatory environments. In this context Prowse points out three key factors: the ability of financial institutions to play a role as active owners of firms, regulations and taxation of securities markets, and rules on disclosure requirements;
- the Australian corporate finance system is much closer to those in other Anglo-Saxon countries than to Japan and Germany;
- changes in technology, globalisation of financial markets, and the increasing importance of small firms and institutional investors in many economies have all contributed to pressures for change, but those pressures are much stronger on the Japanese and German systems than in Anglo-Saxon countries; and
- the changes analysed in the paper are moving the financial systems of the industrialised countries closer together. Japan and Germany are deregulating their securities markets and firms' access to non-bank sources of finance. At the same time, Anglo-Saxon countries, which have traditionally restricted the ability of financial institutions to behave as active owners of firms, are removing restrictions in that area.

Prowse's paper is a very ambitious one and he succeeds in conceptualising the major underlying currents for changes in corporate finance. I agree with his analysis of the general direction of change. Institutional investors are becoming more active as shareholders in many countries. The securities markets in Japan are gaining importance relative to bank-intermediated credit as a result of the removal of regulations. Large Japanese companies have shifted their source of funding from banks to securities markets and banks are trying to maintain their assets by increasing their lending to smaller companies. Disclosure requirements are gradually being standardised internationally and, sooner or later, the Japanese accounting system is likely to move towards the GAAP or IAS based system.

However, I have one reservation regarding Prowse's thesis on the convergence of corporate finance systems. In my view, there is an important complementarity between labour market and financial market institutional structures. In countries such as Japan and Germany, long-term employment plays an important role based on implicit contracts between employers and employees, a system that has both advantages and disadvantages.

While this system may allow Japanese and German firms to invest more in firm-specific human capital building, it would also make it more difficult for these economies to redeploy human resources from declining sectors to growing ones. But as long as a company wants to take advantage of long-term employment, it has to adopt a corporate structure that is compatible with this arrangement. The contract of long-term employment usually takes the form of an implicit contract because it is extremely difficult to write an explicit contract of long-term employment without adversely affecting the incentives of employees. Since the effectiveness of an implicit contract depends on the ability of management to give a credible commitment to employees, any firm which uses implicit contracts extensively has to have a financial structure that is consistent with this ability.

In Anglo-Saxon countries where the stock market functions as the market for corporate control, the management of a publicly listed company may suddenly be replaced with a new one due to a hostile takeover. As a result, the employees of the company cannot take the commitment of the existing management at its face value. For example, if the current management cannot ensure the continuity of commitment beyond its own tenure, employees would not invest their time and effort to acquire firm-specific skills. On the other hand, in Germany and Japan, the management of firms is better protected from the pressure of hostile takeovers. In Japan, for example, extensive cross shareholdings among firms, including financial institutions, make it very difficult to succeed in hostile takeovers.

This complementarity of labour and capital market structures is likely to continue. As long as the labour markets of Japan and Germany are fairly sticky, their capital markets, especially the market for corporate control, cannot be highly flexible. In my opinion, this is the fundamental reason for the absence of active markets for corporate control in Japan and Germany.

Finally, I would like to add two points on the corporate governance structure in Japan. First, in the Japanese corporate tax system, companies can avoid taxation on their dividend income under certain conditions. This relief from double taxation on corporate income is more generous in Japan than in the United States and may have facilitated the maintenance of a high level of cross shareholdings among companies. Second, the main customers of Japanese banks are now small companies because larger companies are shifting their sources of funding to securities markets. As a result, the equity stake held by banks is becoming less effective in affecting the management of customer firms. This is because banks cannot hold more than 5 per cent of the issued shares of Japanese companies, and this limit is rather small for closely held small companies.

2. General Discussion

There were two main themes of the discussion:

- the adequacy of finance for small business; and
- the relative performance of Anglo-Saxon financial systems compared with those based on the ‘universal banking’ model.

On the first issue, participants emphasised the importance of small businesses in the economy. One speaker compared the present period of economic development to the Industrial Revolution, when a wave of innovation had taken place on a similar scale. As had been the case then, small firms are currently playing a leading role in developing and applying new technology. Continuation of this process will require the availability of adequate finance.

Traditionally small businesses had relied mainly on banks for external finance but it was noted that a number of alternatives were emerging, giving some small businesses an expanded range of financing options. For example, several small to medium-sized Australian firms were now listing on NASDAQ in the United States. This was a market with a number of innovative features that seemed conducive to raising equity finance for smaller firms. Also noteworthy has been the rapid growth of initial public share offerings in Australia, particularly for mining ventures.

Notwithstanding these developments it was noted that non-bank sources of finance for small business were much less developed in Australia than in the United States. This was true with respect to both debt and equity finance. Particularly noteworthy was a lack of corporate bond markets in Australia. Some of the larger companies were able to issue corporate bonds on overseas markets but this vehicle was not really available to small firms. There was considerable discussion as to what might be the obstacles to further development of markets for small business finance in Australia.

Some participants emphasised that structural differences between the US and Australian economies contributed to the different levels of development in small-business finance. For example the US economy is much larger and inevitably had much bigger securities markets. Also significant was that utilities in the United States were often privately owned and were big issuers of debt securities, which then played an important role as benchmarks for the pricing of other private securities. It was suggested that a similar pattern might emerge in Australia if utilities are privatised, which could stimulate the growth of corporate bond markets more generally.

It was also suggested that financial institutions in Australia were not sufficiently innovative to take advantage of possibilities for developing small business finance. On the other hand, some participants thought that small business owners had unrealistic expectations. One comment was that they expected what was effectively equity finance at a debt return. In a similar vein it was suggested that small business needed to be educated as to what could be expected from financial markets. Their main need was for equity finance, and they needed to understand that the use of equity finance means giving up some control.

The second theme of discussion related to the performance of ‘universal banking’ systems, typified by Germany and Japan, in which banks have a much wider scope to provide equity finance to businesses than is the case in Anglo-Saxon systems. The important public policy issues were as follows.

- Which type of system gives the best results?
- Can it be assumed that market forces will ensure convergence to the best system?

It was commented that some recent studies have pointed to benefits of the Anglo-Saxon system in terms of generating higher rates of return on capital. Others argued, however, that the evidence was not conclusive: there were numerous studies in the literature giving conflicting results. Several participants noted that there were tendencies for the different systems to converge. The internationalisation of financial markets meant that firms could increasingly tap international sources of finance where they were not available domestically. This in turn put pressure on the authorities to standardise disclosure requirements to ensure their companies were not disadvantaged in these markets. Notwithstanding these signs of convergence, the United States remained a big outlier in international terms, with much more developed small business finance markets than in other countries.