

CORPORATE GOVERNANCE AND FIRM FINANCING: THE ROLE OF POLITICS

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Abstract

This paper offers an explanation for why firms in different countries rely more heavily on bank lending or securities markets. I argue that market financing is more common when the firm is competitive with its foreign counterparts, and when a right-wing political party controls government. If the firm is uncompetitive with foreign rivals, or if a left-wing political party controls government, then bank lending will be more common. Evidences across OECD countries as well as analysis of France and Japan across the twentieth century support the argument. There are clear implications for the kinds of technological innovation pursued by firms across different countries, as well as for international mergers and acquisitions.

Keywords: corporate governance, firm financing, securities market, politics

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1. Introduction

Why do firms in some countries rely more heavily on securities markets for their external financing, while firms in other countries depend more on bank lending? For example, during the postwar period firms in the US, UK, and Canada have depended more heavily on securities markets while firms in Italy, France, Japan, and Germany have been more reliant on bank lending. Prior to WWII, however, firms in France and Japan relied more heavily on securities markets. This research question has implications for the kinds of technological innovation pursued by firms across different countries, as well as for international mergers and acquisitions. Whether firms use bank loans or raise money by selling securities on capital markets largely determines the structure of the overall national financial system. Which kind of external financing that firms use depends, to a large extent, on negotiations between the key actors that govern the corporation: labor, managers, and owners. While each of these actors has multiple interests, for this paper I focus on a key objective that each actor pursues: job security for labor, managerial autonomy for managers, and profit maximization for owners. Labor prefers bank

lending because long-term employment is more feasible when capital is provided on terms that are not sensitive to fluctuations in short-term profitability, as occurs with stock prices. Managers prefer markets because they are more likely to give rise to diffuse ownership (i.e., many shareholders with a small stake) thereby granting them greater managerial autonomy. Owners may prefer banks or markets: they prefer banks if their firm is not competitive relative to foreign firms since banks can offer the long-term lending necessary to make them competitive, otherwise owners prefer markets because they have lower transaction costs than bank lending. The distribution of power among these actors within corporate governance structures is determined by their political power in government, which makes the laws and regulations that specify these structures. Thus, I argue that the political power of these actors determines whether firms from different countries rely more heavily on bank lending or securities markets.

In the next section of this paper I explain why we should care about the choice between bank lending or securities markets. The third section reviews alternative explanations. Fourth, I examine evidence with regard to my argument. Finally, I summarily conclude.

2. Implications

Whether capital is raised via bank lending versus securities markets privileges alternative types of innovation, and affects the ease with which international mergers and acquisitions may occur. External financing via securities markets more effectively promotes radical innovation, while bank lending privileges incremental innovation. Because markets permit individuals to make different investing decisions, as opposed to banks where individuals delegate decision-making to an intermediary which requires investors to make a compromise, markets may have a significant advantage over intermediaries in situations where a diversity of opinion is important, such as the financing of new technologies.

For example, the internet revolution occurred in the United States partly because risk-acceptant individuals could easily invest their money in companies such as Yahoo and eBay.

Other industries that focus on radical innovations include biotechnology, semiconductors, and telecommunications. These industries have filed more patents per capita in countries where firms rely on securities markets such as the US, UK, and Canada. The longer-term financing available with banks, however, privileges incremental innovation, which has been of particular importance to industries such as consumer durables, machine tools, and transport. Patents from these kinds of industries are more plentiful in countries where firms depend more extensively on bank lending, such as France, Germany, and Italy.

International mergers and acquisitions is a second area of importance. In countries where arms-length financing dominates, shareholders exercise greater influence over the firm. In nations where bank lending predominates, firm ownership is more concentrated in the hands of one or a few owners, and banks and labor generally have more influence (e.g., Austria, Germany, France). Because shareholders' interests frequently differ from those of banks and labor, firms in the same industry but from different countries may differ in how they solve similar problems and how they weight various priorities.

For example, the merger between Daimler-Benz and Chrysler required more extensive negotiations and creative solutions regarding workers' rights and corporate governance issues than would have occurred between two firms from the same country. Resolving conflicts of interest arising from different corporate governance rules is becoming increasingly important as evidenced by the value of cross-border mergers and acquisitions in Europe, which increased from \$100 billion in 1994 to over \$300 billion in 1999 and 2000 (Credit Suisse First Boston, 2002). It would be unsurprising if this trend continues among other industrialized countries, and to developing countries as they industrialize.

3. Alternative explanations

I argue that the structure of a country's financial system primarily depends on the political power of owners and managers relative to labor. This argument differs from the other major arguments found in the literature, which I classify as incomplete contracting, legal systems, coalitional governments, and incumbency and openness arguments. I discuss each in turn.

The incomplete contracting perspective claims that as information technology and property rights improve, financing through capital markets becomes less costly and more feasible for smaller economic actors who would previously only transact through banks. Thus, not only can more actors transact via a marketplace as contractual incompleteness diminishes, but the costs also decline for actors who already participate in capital markets financing. Since information dissemination and analysis costs have constantly declined during the twentieth century, and property rights are, on average, no worse than they were at the beginning of the century (and likely better in most cases), we should expect countries to move steadily toward a greater reliance on capital markets financing. However, this has not happened. In the present period, there are considerable differences among OECD countries' financial systems, despite their similar levels of development (a reasonable proxy for their levels of contractual incompleteness). It is also difficult to explain the move from arms-length dominated to intermediation-dominated financing without any significant changes in information technology or property rights, as occurred most notably for France and Japan from pre to post-WWII.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 1998) seek to resolve this dilemma by turning to a legal systems explanation. They argue that common law countries are more market-oriented than civil law countries because of the legal protection they afford investors. In common law systems, judge-made law (common law) coexists with statutory law, which is found in Anglo-American states such as Britain, the US, New Zealand, Australia, and Canada. In civil law systems, by contrast, only positive law is considered legitimate, and is found in most other democracies, but is especially prominent in Europe. An important distinction between the two systems is that common law judges make law through application of the common law, interpretation of statutes, and review of legislation; civil law judges do not make, interpret, or review law—they merely apply the laws made by legislatures. Consequently, common law judges are portrayed as both more powerful due to their greater discretion; civil law judges are portrayed as disinterested, neutral civil servants who simply execute the will of the legislature.

Because common law judges can make rulings based on whether a defendant has violated the spirit

of the law, investors in these countries have greater protection from managers' actions that violate the law's intent. In civil law countries, on the other hand, if a manager does not contravene an explicitly detailed edict, courts have a more difficult time punishing the manager. LLSV provide impressive statistical evidence for the importance of legal systems across developed and developing countries for the contemporary period. However, their argument is not robust when tested across the entirety of the twentieth century since France and Japan, which both have civil law systems, were market-oriented at the beginning of the century. It is likely that legal systems are masking an underlying political explanation, at least

in developed democracies. Recent research on political influence in the American judicial system illustrates that politics influences court decisions even in a common law country (McCubbins, Noll, and Weingast, 1995; Spiller, and Gely, 1990; DeFigueiredo, and Tiller, 1996; Zuk, Gryszki, and Barrow, 1993; Zuk, Barrow, and Gryszki, 1996). Consequently, scholars have turned their attention to political institutions for an answer. For example, there is a strong correlation between a country's legal heritage and its electoral system. The following table illustrates that countries with common law also have a plurality electoral system; nations with civil law have proportional representation systems.

Table 1. Countries' legal and electoral systems since WWII

14 OECD Countries in my Sample	Legal System	Electoral System	Additional Countries	Legal System	Electoral System
Austria	German Civil	PR	Australia	Common	Plurality
Belgium	French Civil	PR	Colombia	French Civil	PR
Canada	Common	Plurality	Greece	French Civil	PR
Denmark	Scan. Civil	PR	India	Common	Plurality
Finland	Scan. Civil	PR	Ireland	Common	PR
France	French Civil	Majoritarian (except 1986 when it was PR)	Israel	Common	PR
Germany	German Civil	PR	New Zealand	Common	Plurality (1946-93) PR (1993-)
Italy	French Civil	PR	Portugal	French Civil	PR
Japan	German Civil	Semi-PR	Spain	French Civil	PR
Netherlands	French Civil	PR	Switzerland	German Civil	PR
Norway	Scan. Civil	PR	Venezuela	French Civil	PR (1958-88)
Sweden	Scan. Civil	PR			
UK	Common	Plurality			
USA	Common	Plurality			

Proportional representation electoral systems permit the formation of coalition governments. Accordingly, Pagano and Volpin (2000) argue that workers and entrepreneurs can reach a political agreement whereby low investor protection is exchanged for job security in countries that favor coalition governments, as in continental Europe. However, such bargains may be struck in countries that do not favor coalition governments, such as France, suggesting that the political power of the groups themselves, rather than the political institutions, play the crucial role. In this vein, Roe (2002) argues that left-wing political parties seek to mitigate the deleterious effects of capital markets on employees' employment stability by privileging blockholders over shareholders. It should be noted, though, that Roe's dependent variable is the diffusion of firm ownership across industrialized nations, not the choice between bank lending and securities markets. Finally, Rajan and Zingales (2003) argue that increasing international trade and capital flows give rise to a greater reliance on capital markets because incumbents' opposition weakens. The evidence offers support for their argument, but there remain theoretical and empirical problems. Theoretically, Rajan and Zingales's

argument suffers from an endogeneity problem: openness is determined by domestic political actors who may also have strong preferences regarding the structure of the financial system (Gourevitch, 1986). For example, capital-intensive industries in capital-abundant states may favor openness because of their comparative advantage, and they may likewise prefer market-dominated financing. A second problem regards the proper identification of the incumbents and assessing their political power. Empirically, we are faced with the puzzle of why the US and UK relied on capital markets throughout the twentieth century, regardless of the level of international trade and capital flows. And why do some countries continue to rely more heavily on banking finance than others, despite the general trend toward markets in the contemporary period? I now turn to my argument and the empirical evidence, which seeks to resolve these questions.

4. Argument and evidence

I argue that labor prefers bank lending because long-term employment is more feasible when capital is provided on terms that are not sensitive to fluctuations in short-term profitability (see endnote 1).

Managers prefer markets because they are more likely to lead to a diffuse ownership structure as capital providers seek to diversify their risk (the Berle and Means corporation). Owners prefer bank lending when the firm is uncompetitive with respect to foreign firms since banks can provide the long-term lending necessary to give the firm time to become competitive. Owners prefer markets when the firm is competitive since markets have lower trans-

action costs. In government, left-wing political parties generally cater to labor's preferences. Owners and managers of large corporations are usually represented by right-wing political parties. As the argument specifies, a conflict may occur between managers and owners when the firm is uncompetitive; the former prefers markets while the latter prefers banks. The following diagram illustrates the expectations derived from this argument

		Firm is:			
		Competitive	Uncompetitive		
Government is:	Left	Bank	Bank		
	Right	Market	<i>Owners Win:</i> <i>Banks</i> <i>Mgrs Win: Mkts</i>		

Owners are more powerful than managers in terms of their political clout since they have the money at their disposal with which to influence politicians. Also, managers would be in a difficult position to lobby in favor of securities markets when ownership is concentrated since they could be easily reprimanded by the owners. Thus, I start from the assumption that owners have greater political power in right-wing governments when firms are uncompetitive.

First, I will present evidence regarding the left column: firms are competitive with respect to their foreign competitors, and the financial system is more banking-oriented when the government is more left-wing. Second, I will illustrate that the financial system is banking-oriented when firms are uncompetitive and the government is right-wing.

Hypothesis 1: the financial system is more banking-oriented when firms are competitive with respect to their foreign competitors and the government is left-wing.

Hypothesis 2: the financial system is more banking-oriented when firms are uncompetitive and the government is right-wing.

Competitive firms and political partisanship

I examine evidence for this argument during the period 1976-1990 period across developed democracies. This period is sufficiently past the 'miracle growth' period of the fifties and sixties when many large firms in Europe and Japan were still catching up to their American counterparts. During the latter half of the seventies and into the eighties, large firms could no longer credibly claim to be handicapped by the devastation of WWII. In other words, this period controls fairly well for large firms' competitiveness with respect to their foreign counterparts.

The following figure depicts the correlation between left-wing political power and the bank-market orientation of the national financial system across fourteen OECD countries.

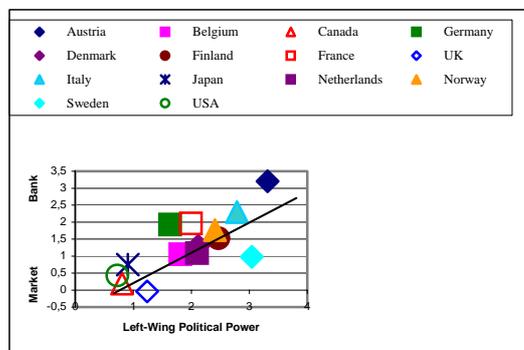


Fig. 1. Left-wing political power and bank-market orientation, 1976-1990

Data Sources: For Left-Wing Political Power I used the variable from Garrett (1998). For Bank-Market Orientation, I use the data from Beck et. al. (1999). I take the natural log in order to ease comparison among the countries.

Table 2. Left-wing political power and bank-market orientation, 1976-1990

DV: ln (Bank Assets/Stock Market Cap.)

Left-Wing Political Power	0.819*** (4.084)
constant	-.27 (-.654)
N	14
Adj. R-squared	0.54

Note: t-statistic in parentheses

*** significant at the 1% level.

There is a very strong, positive correlation, supporting the hypothesis that higher levels of left-wing political power correlate with more banking-oriented financial systems. The regression confirms the strong correlation observed in the figure. However, the statistical results are only suggestive of a causal relationship. I examine two critical moments in French history when left-wing political power rose to unprecedented heights to determine whether left-wing political parties caused firms to rely more heavily on banking finance: 1945 and 1981-82.

Firm financing and the left: the case of France

1945: The French Constituent Assembly (an interim legislature preceding the ratification of a new constitution and the election of the National Assembly—lower house of parliament—in October 1946) was organized under the leadership of de Gaulle at the end of 1944. A popular election was held in October 1945 sweeping the left into power as a reaction against business interests who had collaborated with the Nazis. One of the first items on the agenda was the nationalization of banks.

Banks were nationalized first because credit was a critical element for reconstructing and managing the economy. The scope of nationalization was limited, however, because De Gaulle, who was sympathetic to big business, was able to postpone action for fifteen months, allowing the fervor of the liberation to subside. He then used his authority to circumscribe the nationalization of credit so that investment banking was excluded. After his resignation, the MRP (Popular Republican Movement) - the party most closely associated with him - succeeded in persuading his successor, Gouin, to confine nationalization to a shortened list of sectors and then fought, with some success, to limit the measures within these sectors (Kuisel, 1981: 208).

The banking act that was eventually passed on December 2nd 1945 nationalized the Bank of France as well as the major commercial banks. All representatives from the left and center voted for it (461 out of 494 representatives from mainland France voted for the law; 442 from the left and center, and 19 from the right; 33 on the right voted against). The law structured French finance for the postwar period and “[gave] the government greater influence over the course of postwar economic

course of postwar economic development by placing the volume and allocation of credit firmly under its control” (Alhadeff, 1968: 138). The legislation established three agencies in charge of the financial system: the National Credit Council (CNC), the Bank of France, and the Control Commission. The CNC set the basic guidelines for credit policy, which were executed by the Bank of France. The CNC was headed by the Minister of Finance, as appointed by the prime minister, and comprised of representatives from the government and from various sectors of the economy. It had a broad range of responsibilities, including credit policy, establishing detailed regulations on bank interest rates and commissions, creating rules on entry or merger applications, imposing modifications on the financial and legal structure of banks, and levying sanctions on banks which violated its directives.

The Bank of France would enforce the policy directives of the CNC, and share policymaking powers through the governor of the Bank of France, who would be ex officio vice president of the CNC. The third agency, the Control Commission, would exercise technical supervision over banks’ loan and investment operations. It would also supervise the banks to ensure compliance with all bank regulations, including regulations issued by the other two agencies. The Bank of France would be represented on the Control Commission by the governor of the Bank of France, who would also be president of the Control Commission.

The law nationalized the four largest deposit banks (or commercial banks: these held around half of all banks’ assets and were the only banks with nationwide branch networks) and extended minor regulations over private investment banks. The largest insurance companies were also nationalized.

With these newly nationalized institutions, the government could control the flow of funds to firms. The special deposit-taking institutions (including the postal savings banks, *Crédit Agricole*, the major national banks, etc.) would collect a substantial proportion of the economy’s savings. Only a very small fraction of their deposits are lent directly to final users. These deposits would instead flow to the specialized lending institutions including the *Crédit National*, *Caisse des Dépôts et Consignations* and others (see Zysman, 1983: 118). These government-

controlled institutions would play a role in determining which bank loans would be eligible for the various government subsidies and privileges. Additionally, the rate of growth of the money supply was set by a system of direct quotas on bank lending, known as the *encadrement du crédit*; certain industrial sectors were often exempted from its lending limits. In essence, the additional step from saver to borrower allowed the government to stand between the savings and the investment institutions and thus to influence the allocation of funds (Zysman, 1983, 1977; Morin, 1974; Cohen et al. 1981).

The left-wing coalition in the Assembly overwhelmed political resistance to these measures by business interests who tried to obstruct or shape the Dec. 2 1945 legislation by exerting influence on the MRP. However, business had lost its prewar national employers' federation, the sympathetic political parties of the Third Republic, and most of its friendly press. By mid-1946 the most significant structural reforms were enacted and determined how large French businesses would raise external financing during the post-war era.

1981-82: The dire economic straits of the 70s, culminating with the second oil shock of 1979 and the consequent inflation, austerity measures, and high unemployment levels, caused a backlash in the electorate, who thought that the Socialists might be better able to deal with these problems. In the 1981 general election the Socialist Party (PS) achieved an unprecedented share of seats in the National Assembly (37.8 percent of the vote and 59.5 percent of the seats), partly benefiting from Mitterand's overwhelming victory in the presidential election just prior to the general election. In 1981, the PS emerged as a temporarily center-left party which was able to capture votes on its left and its right; resembling UDR's victories from 1958 to 1968. The Socialist coalition was largely comprised of workers, but also attracted small business and many farmers. According to the argument, there should consequently be a sizeable move toward banking-oriented finance.

The keystone of the new Socialist government's economic agenda was the nationalization program completed in February 1982. Many of the ideas came from the Common Program, written in 1972, which was motivated by the dislocation and hardship that workers endured as a result of the Gaullist initiative to pursue industrial growth to the detriment of the social welfare of employees and small business. The Common Program proposed nationalization of the entire financial and banking sector and nine industrial groups, as well as the acquisition of shares in many other major concerns in strategic sectors of the economy (see endnote 2). As a result of the oil shocks, business bankruptcies, and rising unemployment, workers again sought help from the state in the early 80s. The left saw nationalization as a means toward various ends: the implementation of workers' control, the elimination of private profit,

the strengthening of unions, employment stability, and even the rescue of France's industrial base which appealed to the business community. Nationalizations ensured that several sectors of French business continued to invest heavily despite the world recession.

Although the largest French banks were already under state control, the Government nationalized 36 smaller banks, two investment banks, Suez and Paribas, and the remaining minority of private shares in the *Crédit Lyonnais*, *Banque Nationale de Paris*, and *Société Générale*. It also acquired 100 percent of the shares in six industrial conglomerates (see endnote 3). State debt in the two major steel firms, *Sacilor* and *Usinor*, was converted into a majority shareholding, and the government acquired 51 percent of the shares of two arms and aeronautical manufacturers, *Dassault-Greguet* and *Matra*, as well as control over the computer firm *CII-Honeywell-Bull*, and the pharmaceutical house, *Roussel-Uclaf*. The state subsequently owned 13 of the 20 largest firms in France and a controlling share in many other French companies. State holdings accounted for 24 percent of the employees, 32 percent of the sales, 30 percent of the exports, and 60 percent of the annual investment in the industrial and energy sectors of the French economy. The government was also now in direct control of 96% of all deposits.

Funds for investment were made available to each enterprise through the state-controlled banks in return for signing a 3-5 year 'planning contract' with the Ministry of Industry. Almost half of these funds went to the steel and chemical sectors alone. The nationalized banks were subsequently instructed to lend 6 bF to the nationalized industries, purchase 7 bF in state debt during 1983, and maintain their industrial lending rates at 14 percent (Hall, 1986: 205-6). Small and medium-sized enterprises were also expected to benefit from these loans. Ultimately, the state used its control of finance to support businesses during the recession to avoid layoffs. In contrast to the Gaullist period, Socialists used its control of finance to improve the welfare of workers.

In 1983 international capital mobility forced the Socialist government to liberalize its economy by privatizing firms and banks, and passing legislation intended to bolster domestic securities markets. And this has occurred across all OECD countries during the past two decades. However, regulations still exist to limit the potentially deleterious effects of these market-enhancing reforms on labor in particular.

Uncompetitive firms and right-wing government

The clearest illustration of right-wing government favoring banking-oriented finance is the 'miracle growth' era following WWII. I focus on France and Japan since their economies greatly suffered during the war: France because of the war on its own soil, and Japan because of the war with China (starting in 1937) and the Pacific War. Firms in both countries

started at a definite disadvantage relative to their main foreign competitors.

Firm financing and the right: the case of France

As discussed above, the left dominated postwar politics in France, and nationalized the major commercial banks as well as the Bank of France. These actions placed the majority of deposits directly under government control, with the rest of the financial system largely under indirect government influence. In 1958, the right-wing Gaullists came to power, and remained there until the 1970s. They are noted for using the government control of finance to subsidize lending to the largest firms in order to evolve them into 'national champions' that would be competitive with firms in the European and eventually the global marketplace.

From the beginning of the new Gaullist government, policymakers forged an alliance with the largest enterprises in the fastest-growing sectors of the economy. Investment funds available in the 1960s were channeled to large, dynamic enterprises. The banks were directed to pursue policies that "favored the development of large enterprises rather than the accession of medium-sized enterprises to the level of the big ones" (Warnecke and Suleiman, 1975: 38). By 1965 France had the highest rate of mergers in Western Europe.

In 1965-66, reforms were instituted to make the banking system a more effective instrument of government policy in furthering the Fifth Economic Plan (1965-70), especially with regard to raising the level of investment for large firms. The commercial banks were assigned a key role. As the country's major financial intermediaries, they were strategically located to carry out the dual roles of collecting the public's savings and supplying business finance. To prepare the banks for a larger role in the financing of business expansion, government authorities took steps to improve their competitive position with respect to savings deposits. One important handicap had been the prohibition against deposit banks accepting deposits for more than two years (from the Banking Law of 1945). This prohibition was removed (along with restrictions on investment bank operations in demand deposits or deposits fixed for less than two years). Another handicap was the commercial banks' inability to offer rates as favorable as those the savings banks could offer which was also eliminated by authorizing the commercial banks to offer savings book accounts (*comptes sur livrets*) with identical limits and identical rates as the savings book accounts in the savings banks.

The abolition of restrictions on deposit maturities in commercial banks was also intended to increase the effectiveness of the commercial banks in their role as suppliers of funds. There were never any legal restrictions on commercial bank loan maturities, but because of the limitations on their deposit maturities, the banks had traditionally refrained from

placing more than a small part of their funds in longer-term assets. As a result, the commercial banks did not perform as effectively as the Gaullists would like in financing investment, construction, or exports. By removing the restrictions on deposit maturities, the authorities hoped to increase the banks' flexibility and to encourage them to extend more medium and long-term credit (Alhadeff, 1968: 158-9).

Firm financing and the right: the case of Japan

The right wing has dominated Japanese politics since 1949. Because American authorities became worried about the growing popularity of left-wing political parties sympathetic to Communism, they sponsored actions to weaken the Socialists and the inchoate labor unions in the late 1940s. These actions were very successful; ever since, the right-wing has dominated Japanese politics.

The U.S. occupying authorities viewed the business elite within Japan as having been strong proponents for the war effort. Consequently, they sought to eliminate the wartime *zaibatsu* conglomerates, thereby ending the dominance of a small group over a large number of firms, and to decrease concentration by limiting the size of any one firm within its industry. However, capital scarcity and the necessity of rebuilding basic infrastructure forced the government to direct available credit, via banks, to essential industries. This, in addition to the weak enforcement of policies aimed at dissolving the *zaibatsu*, allowed these large firms to evolve into the postwar *keiretsu*—largely preserving their original structures. A typical *keiretsu* included a big bank, several industrial firms, and a general trading company. The bank plays the critical role during expanding business conditions by supplying capital to the members, and the trading company plays the critical role during contracting business conditions by importing raw materials on credit and fiercely promoting exports of products that cannot be sold domestically.

On June 25, 1950, the U.S. declared war on Korea. With this, the US began to place extensive orders with Japanese firms for ammunition, trucks, uniforms, communications equipment, and other products (see endnote 4). This windfall, however, created financial difficulties for Japanese firms who could not obtain investment capital fast enough to meet the orders that the Americans were placing. Additionally, their working capital was frequently insufficient to keep them in business if even a few of their contracts involved delays in payment of six months or more. It ultimately led to the two-tiered structure of government-guaranteed city bank overloaning and newly created government-owned 'banks of last resort.' These latter institutions, particularly the Japan Development Bank, became powerful institutions as a result of their decisions to make or refuse 'policy loans' (Johnson, 1982: 200).

During the capital shortage, government loans to city banks (the twelve national banks to which the Bank of Japan extended loan privileges) were increased, and they in turn distributed the funds to the industrialists who were clamoring for money to expand their facilities. This started the process of central bank 'overloaning' that led to the nexus between city banks and industry.

Overlending involved a group of enterprises borrowing from a bank well beyond any individual companies' capacity to repay, or often beyond their net worth, and the bank in turn overborrowing from the Bank of Japan. Since the central bank is the ultimate guarantor of the system, it gains complete and detailed control over the policies and lending decisions of its dependent 'private' banks. Additionally, the financial risks associated with high debt levels are reduced since the central bank acts as an implicit guarantor of the debt positions of major Japanese companies.

The Export-Import Bank of Japan was created on December 15 1950 to deal with the lack of adequate banking facilities to handle longer-term loans than were commercially available for the export of capital goods. In April 1952, when the Occupation ended, the government renamed it the Export-Import Bank of Japan and gave it the additional task of lending Japanese importers the funds they needed for advance payments for commodity imports approved by MITI (Johnson, 1982: 208).

Of the six government banks established between 1949 and 1953 (plus two more from the pre-war era), the most important for industrial policy was the Japan Development Bank (JDB), created in March 31, 1951, which was the successor to the Reconstruction Finance Bank (see endnote 5). The JDB was to provide long-term equipment loans to private enterprise when the commercial banks were unable to assume the risks involved. The bank was placed under the Ministry of Finance's administrative jurisdiction, but MITI exercised a predominant policy-making influence because it was given the duty of screening all loan applications and making annual estimates of the shortfall between available and needed capital.

With the end of the Occupation, the government amended the JDB's charter (July 1, 1952) giving it authority to issue its own bonds and lifting the loan ceilings that SCAP had imposed. At the same time the Ministry of Finance modified all of the statutes covering the postal savings accounts, combining them into one large investment pool name the Fiscal Investment and Loan Plan (FILP). This 'second' or 'investment' budget was constructed annually by officials of the Ministry of Finance. From 1953 on it became "the single most important financial instrument for Japan's economic development" (Johnson, 1982: 210).

From 1953 to 1961 the direct supply of capital by the government to industry (as opposed to its indirect supply via overloans) ranged from 38 percent

to 19 percent. The JDB contributed 22 percent in 1953 and only 5 percent in 1961; although the size of its loans declined relative to the growth of city-bank funding, the bank retained its power to 'guide' capital through the indicative effect of its decisions to support or not support a new industry.

These financial institutions served government needs for channeling funds into politically favored industries especially during the 1950s and 1960s. "The [city] banks were the dominant providers of funds during 1955-75," consistently supplying over 60% of external funds acquired by the firms (Hoshi and Kashyap, 2001). Funneling money through the banking system permitted the government to not only control the direction of funds, but also their cost. Ueno summarizes the situation:

Broadly speaking, the total supply of funds in Japan was controlled by the Bank of Japan, the level and structure of interest rates were artificially regulated by the Ministry of Finance, and private funds were allocated, under the guidance of public financial institutions, by city banks which competed for market shares. In this process, the Bank of Japan followed the guidelines of the Economic Planning Agency and the MITI and determined the total amount of funds so as to satisfy the demands to growth industries. At the same time, the Ministry of Finance maintained the low interest policy inasmuch as the policy did not lead to large deficits in the balance of payments or to sharp price rises (see endnote 6).

During the period 1952 to 1973, bond and equity markets suffered from regulations discouraging their use. Bond yields were generally kept lower than a market-clearing rate, deterring investors from buying bonds. Equity markets suffered from low levels of individual wealth following WWII, post-war inflation and land reform which wiped out most wealthy business families and landlords. Lack of legal protection for stockholders played a key role, and this was primarily due to the political interests in the legislature (i.e., big firms preferred subsidized bank lending, and since they would be the only interests in favor of securities markets, their lack of political support for markets led to banking-dominated finance). Moreover, interest payments on debt financing were deductible, offering a further disincentive to equity financing. Equity and Bond issues that did occur were subject to rationing according to government determined priorities.

5. Conclusion

This paper offers an explanation for why firms in different countries depend more on bank lending or securities markets. Specifically, I argue that labor prefers bank lending because long-term employment is more feasible when capital is provided on terms that are not sensitive to fluctuations in short-term profitability. Managers prefer markets because they are more likely to lead to a diffuse ownership struc-

ture as capital providers seek to diversify their risk. Owners prefer bank lending when the firm is uncompetitive with respect to foreign firms since banks can provide the long-term lending necessary to give the firm time to become competitive. Owners prefer markets when the firm is competitive since markets have lower transaction costs.

There is strong support that increasing left-wing political power correlates with a more banking-oriented financial when firms are competitive with their foreign rivals. When firms are uncompetitive, the evidence from France and Japan suggests that owners will seek government assisted lending via banks. This argument is consistent with the predominance of banking-oriented financial systems seen across the developing world.

Explaining why firms rely more on banks or markets has important implications for technological innovation and international mergers and acquisitions. Owners/managers deciding whether to devote resources toward radical innovations (as in high-tech industries) should be mindful of the conditions under which capital is provided to the firm. Markets are better at allowing investors to make more 'risky' bets on untested firms or ideas. In countries where bank-lending predominates, managers will have a more difficult time getting the appropriate financing to undertake such a 'risky' endeavor. Likewise, owners/managers seeking to innovate in an industry which relies on incremental innovations (more traditional industries) may prefer bank lending since it permits longer-term financing arrangements and thereby allows the research to proceed on a more gradual, long-term basis without the same pressure for short-term results.

Because banks and labor generally have greater influence on firms in countries where bank lending predominates, their priorities regarding firm strategy and organization will likely differ from shareholders in countries where market financing prevails. Labor and banks seek to preserve longer-term financing arrangements and employment stability, while shareholders pursue profit maximization, usually at the expense of employment stability and long-term bank lending. This creates obvious serious obstacles to mergers between these two types of firms in terms of immediate conflicts on interest between these two groups of actors. Additionally, the kinds of innovation that resources are devoted to will likely differ, and create additional areas of incompatibility.

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Endnotes

1. There are exclusions to this general rule which usually occur when labor is employed in competitive firms that reap benefits from raising finance from securities markets. In such cases, labor's wages may increase.
2. *Programme Commun de gouvernement du Parti Communiste et du Parti Socialiste* (Paris: Editions Sociales, 1972), p. 113.
3. These include the Compagnie Générale d'Electricité (CGE), the Compagnie Générale de Constructions Téléphoniques (CGCT) and Thompson-Brandt in electronics and telecommunications, Rhone-Poulenc in textiles and chemicals, Pechiney-Ugine-Kuhlman (PUK) in aluminum and chemicals, and St Gobain-Pont-à-Mousson in glass, paper and metals.
4. See Supreme Commander for the Allied Powers, Monograph 47, "The Heavy Industries," p. 120.
5. The eight government banks existing at the end of 1953 were the Central Cooperative Bank for Agriculture and Forestry (1926), the Bank for Commerce and Industrial Cooperatives (1936), the People's Finance Corporation (1949), the Housing Loan Corporation (1950), the Export-Import Bank (1950), the Japan Development Bank (1951), the Agriculture, Forestry, and Fishery Finance Corporation (1953), and the Smaller Business Finance Corporation (1953).
6. Hiroya Ueno, "The Conception and Evolution of Japanese Industrial Policy," in Sato, *Industry and Business in Japan*.