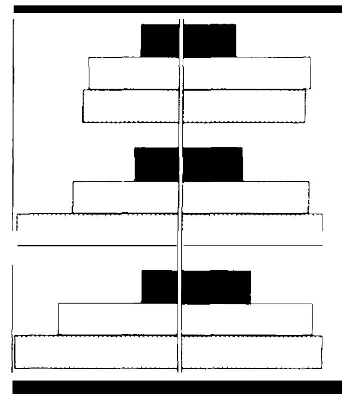
Corporate Governance and National Technology Systems 7

Policymakers and academic analysts have paid increasing attention to the ways in which different systems of internal corporate governance affect the long-term planning and investment decisions of corporations. [1] The issue is of direct relevance to this assessment, for these decisions constitute the fundamental building blocks for national technology systems. Since a strong technology base is crucial to national prosperity, such decisions have consequences that go far beyond the immediate interests of individual corporations.

The term "corporate governance" refers broadly to the rules and norms that guide the internal relationships among the various stakeholders in a business enterprise. These stakeholders typically include owners, directors, managers, creditors, suppliers. employees, and customers. The emphasis here is on the central relationships between the managers of a corporation and the owners of voting shares, whose interests are intermediated by boards of directors. Those relationships center on rights and obligations that are either specified in law or legitimated by long-standing custom and practice.

Since MNEs span a number of legal jurisdictions, their governance is more complicated than that of local firms. The core governance structures of almost all MNEs nevertheless are associated with prevailing norms in the jurisdiction within which their head



[1] For analytical perspectives, see (). Williamson, "Corporate Finance and Corporate Governance," *The Journal of* Finance 43(3):567-591, July 1988; and M.J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States," with responses by J.M. Ramseyer and R. Romano, *Yale Law Journal 102(8) 1927-2037,* June 1993. Also see "Corporate Governance Watching the Boss," *The Economist* 330(7848)" SS3-SS5, Jan, 29, 1994.

offices are incorporated.[2] Competition among MNEs therefore embodies the frictions that occur when distinctive national systems of corporate governance become ever more interlinked.[3] The following sections examine basic differences among the systems of corporate governance prevailing in the United States, Japan, and Germany.

CORPORATE GOVERNANCE IN THE UNITED STATES

In the United States, corporate governance, corporate investment, and the national technology base are intimately connected. Corporate governance for American-based MNEs, and publicly owned American firms in general, centers on legal relationships among shareholders, directors, and managers. Under the rubric of federalism, the foundations for those relationships are set primarily in state law, although various national laws, and American culture more broadly, influence that law.[4] It was once conventional to refer to the system as "shareholder capitalism."

In reality, the voice of individual shareholders in the United States has declined over time. With the rise of institutional investors and the increasing turnover of shareholders during recent decades, the links of accountability between owners and managers have weakened. A spectacular series of hostile corporate takeovers during the 1980s served not to redress the situation but to exacerbate it. The takeover movement, for example, soon set state legislatures and corporate managers to work building ever higher legal hurdles to stymie potential raiders. In such a context, the system seems more accurately labeled "competitive managerial capitalism."[5]

In the traditional terms of American liberalism, corporations exist mainly to create wealth for their owners. Owners delegate their right to oversee the corporation to a board of directors, and directors empower managers to run the corporation. In theory, owners have a stake in the long-term success of the corporation. Moreover, they may replace directors, and through them managers, if they perceive the actions of those managers to be compromising that success. In practice today, however, the owners of most American MNEs tend to be institutions that trade their shares frequently. In recent years, the fastest growing institutions have been mutual funds (see figure 7-1).

Indeed, for the 1,000 largest corporations in the United States, estimates of the percentage of voting shares held by mutual funds, pension funds, and other investment vehicles run as high as two-thirds.[6] In addition, except in atypical cases, neither the directors nor the managers of American MNEs are actually chosen by shareholders. Most directors on MNE boards are outsiders chosen by, and often beholden to, chief executive officers.

In the wake of subnational efforts to make 1980s-style hostile takeovers more difficult, the managers of many U. S-based MNEs have, in theory, gained a degree of operational autonomy. Whether this is a positive or negative develop-

[2] For relevant debate, see R.B. Reich, "Who Is Us'?' '*Harvard Business Review* 68(*I*):53-64, January-February 1990; and L.D. Tyson, "They Are Not Us: Why American Ownership Still Matters," *The American Prospect* (4):37-49, Winter 1991.

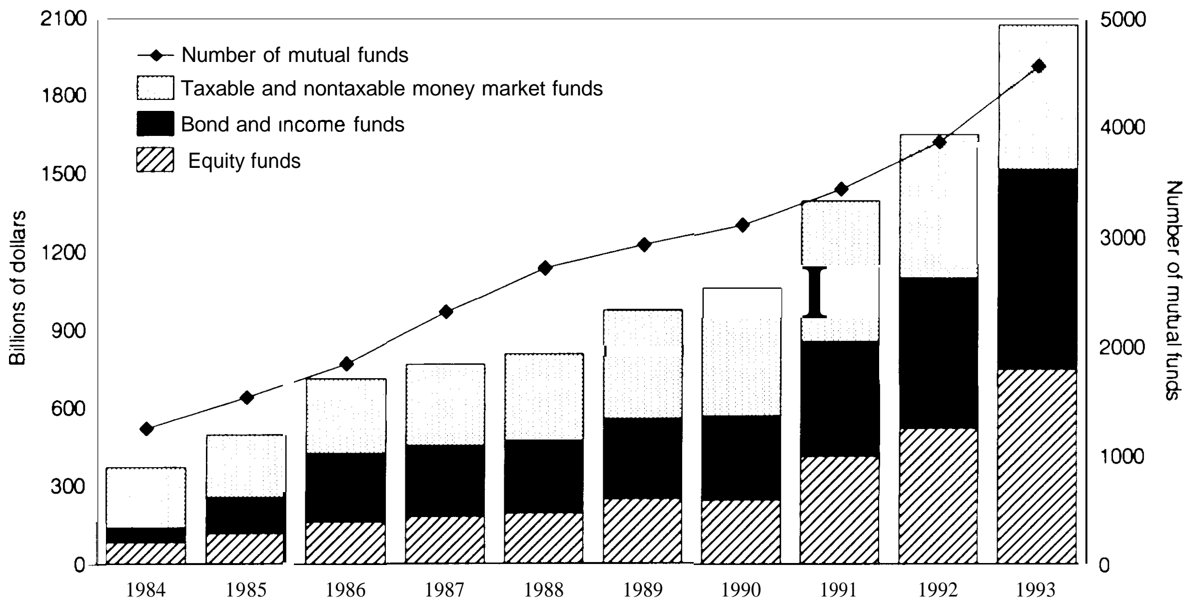
[3] on the notion of "system friction," see S. Ostry, *Governments and Corporations in a Shrinking World: Trade and Innovation Policies in (he United States, Europe and Japan (New* York: Council on Foreign Relations Press, 1990). Also see J.H. Dunning, "The Global Economy, Domestic Governance, Strategies and Transnational Corporations: Interactions and Policy Implications," *Transnational Corpora/ions I (3).7-45, 1992.*

[4] See M. J. Roe, "A Political Theory of American Corporate Finance," *Columbia Law Journal 91(1): 10-67,* January 1991.

[5] A. Chandler, Sea/e *and Scope* (Cambridge, MA: Harvard University Press, 1990), pp. *62* I -627.

[6] J.W. Lorsch and E. MacIver, "Corporate Governance and Investment Time Horizons," background paper prepared for M. Porter et al., *Capital Choices,* A Report to the Council on Competitiveness and co-sponsored by the Harvard Business School, June 1992. Note that of the 50 largest publicly held American companies, only seven have a shareholder with more than a 10 percent stake. Note also that the scale and rapidity of the turnover of shareholders has increased tremendously in recent decades. In the mid- 1960s, for example, large block trades represented around 3 percent of the annual volume of trading on the New York Stock Exchange. By the late 1980s, they exceeded 50 percent.

FIGURE 7-1: Growth in American Mutual Funds—Value of Assets and Number of Funds



SOURCE: Investment Company Institute, 1994 *Mutual Fund Fact Book,* 34th ed. (Washington, DC Investment Company Institute, 1994), pp. 98-99

ment is the subject of much debate. It should be noted, however, that the excesses of the 1980s have had more subtle effects. Many corporate boards, for example, have become more assertive in meeting their oversight responsibilities. This has been especially obvious in cases where corporations have come under severe financial pressure, and it has culminated in the recent ouster of the chief executive officers of several leading American MNEs, including IBM, Westinghouse, and Kodak, Behind this new assertiveness often lay the discontent of large institutional shareholders. This may be a cyclical phenomenon, or it could signal a revival of shareholder activism. In the course of OTA interviews for this assessment, several directors of American MNEs praised the heightened interest in monitoring corporate performance that has come from large institutional shareholders like the California public-employees' pension fund (Calpers) and various mutual funds. They noted, however, that it remained an open question as to whether a basic change in American corporate governance was afoot.

The American system still stresses indicators of short-term financial performance. Securities analysts evaluate firms largely on the basis of quarterly earnings reports, and their assessments exert far more influence over managerial decisions than do shareholders. Indeed, most American shareholders have little voice in day-to-day management, although they do have the option of exit. And they continue to exercise that option with much more vigor and regularity than do their counterparts abroad. For all the talk in business circles about the wisdom of the kind of long-term strategy associated with such investment firms as Berkshire Hathaway, the prospect of exiting quickly retains its attractiveness for most investors. This is especially true for mutual fund managers whose own performance (as agents for individual investors, not as direct owners) is measured on a rigorous comparative basis that emphasizes the short term.

Because of their reliance on open and active stock markets to raise new capital directly, as well as to provide indirect signals to lenders and other stakeholders, managers of American MNEs oper-

ate from abase that encourages them to emphasize short-term returns. With individual and institutional owners frequently changing, they actually have little direct influence on corporate decisions. The constant churning of the shares of large corporations does, however, get one message across: keep earnings rising on a steady track. The message is often strongly reinforced by the tying of personal compensation packages for senior executives to stock market performance. Two astute observers summarize the consequences:

> U.S. CEOs understand this message. When they issue their companies' quarterly earnings report and meet with security analysts, they believe they are being judged on a 90-day basis. If the verdict is not positive, many sell orders will be forthcoming with a commensurate decline in share prices. In an era when many CEOs have been seriously concerned about unfriendly takeovers, such a decline was an especially unpleasant prospect. But even in more halcyon times, CEOs feel the pressure to keep earnings up.[7]

As many business and academic observers point out, this obsession with the short run can seriously hamper the development of optimal corporate strategies, especially in sectors characterized by short product life cycles. The pressure to keep current earnings high and dividend payments stable can force firms to postpone the long-term investments and restructuring measures needed to stay competitive.[8] Delays or cuts in expensive investments in technology, or in the new plants from which new process technologies develop, can have a positive effect on current financial statements. In the long run, however, imprudent delays or cuts will have a negative impact on performance. Theoretically, this impact should be discounted in current stock prices. In practice, information flows imperfectly, and rarely are the motives for managerial decisions obvious. The perception that short-term thinking by corporate managers weakens the technology base of the country therefore has become more widespread.

Compounding the tendency to emphasize the short term in managerial decisionmaking are the vagaries of the U.S. corporate proxy voting system, which can make it difficult for shareholders to cooperate in disciplining entrenched managers. Working in the same direction are disclosure requirements and antitrust rules that preclude significant cross-shareholding by unrelated corporations. For example, under rules first specified in the 1934 Securities and Exchange Act, when an individual or related group seeks more than 5 percent of the shares of a corporation, public disclosure of plans, financing sources, and other information is required.[9] Securities and Exchange Commission (SEC) proxy rules can also come into play when a group seeking a controlling position is formed. Together with various impediments that have been put in place by state laws in the wake of the "takeover wars" of the 1980s, such rules have made both costly and risky the assemblage of large blocks of stock or significant cross-shareholdings.

Senior executives of several leading U. S.-based MNEs told OTA that their investment planning was frequently constrained by the need to satisfy the expectations of temporary shareholders as expressed in current stock prices. They admitted that their R&D budgets, in particular, suffered as a result. Several executives expressed concern that many of their foreign-based competitors faced a much less binding constraint and were therefore better able, for example, to maintain R&D expenditure levels over an entire economic cycle. More specifically, they suspected that differences in corporate governance helped to explain the maintenance, or at most the marginal

[7] Ibid.

[8] See M.T. Jacobs, *Short-Term America: The Causes and Cures of Our Business Myopia,* (Boston, MA: Harvard Business School Press, 1991), chs. 2, 3.

[9] F.R. Edwards and R.A. Eisenbeis, "Financial Institutions and Corporate Investment Horizons: An International Perspective," background paper prepared for M. Porter et al., *Capital Choices,* op. cit., footnote 6.

trimming, of R&D spending by many Japanese MNEs even as their earnings came under severe pressure in the early 1990s.

CORPORATE GOVERNANCE IN JAPAN

The effort to understand how Japanese corporate governance differs from the American system has in itself become something of a growth industry. The once common view that Japanese MNEs represent the visible face of Japan Inc., with the implication that government really calls the shots, is now widely dismissed as simplistic. So too is the more recent characterization of those firms as run by and for a managerial elite, accountable to no one, including government or traditionally passive shareholders. Impressions garnered in OTA interviews in Japan with senior corporate executives, government officials, and others support a more complex view

The managers of Japanese MNEs do play the key role in a system of corporate governance that has evolved over time.[10] And, indeed, the system does free them from some of the pressures for short-term returns that their American counterparts face. Extensive institutional cross-shareholding arrangements, for example, can explain why real earnings might be allowed to fluctuate widely in order to keep R&D budgets stable. However, executives of Japanese MNEs, most of which are embedded in keiretsu networks, are accountable for their performance to a wide array of constituencies. Some of those constituencies may be represented on the board of directors, but most directors are in fact insiders.

The constituencies to which Japanese directors and managers must and do attend include employees, the MNE's lead bank, its other long-term creditors, corporations with which it is affiliated in keiretsu or other intercorporate groupings, suppliers, and important customers. These constituencies share certain basic interests in the firm beyond simple survival. Unlike the case of their American counterparts, however, it is impossible to agglomerate those interests under a single financial indicator, such as return on investment. Nevertheless, one interest has long been broadly shared by many constituencies: the need both to compensate for past technological weakness and to ensure technological parity or leadership in the future. Indeed, this theme was a common refrain throughout a series of OTA interviews with senior executives in Japan. The structure of corporate governance in contemporary Japan has evolved in light of that overriding interest.

In contrast to the legalistic, arm's-length, and often antagonistic relationships at the core of American corporate governance structures, the Japanese equivalent is a system of "networks" built upon relationships of trust, the reciprocal exchange of information, technology, and other benefits, and expectations of long-term endurance. Within a corporate network, managers often compete energetically, but they also cooperate to the extent required to maintain both the network and their place within it. During periods of crisis, this can entail direct support of one another's internal organizational affairs.

For most Japanese MNEs, internal network structures are linked to, and reinforced by, external linkages to financial institutions and other firms.[11] These tend to be stable and are often sealed by mutual cross-shareholdings. Individual

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[10] See U. Schaede, "understanding Corporate Governance in Japan: Do Classical Concepts Apply'?" *Industrial and Corporate Change 3(2):* forthcoming, 1994.

[11] See *M.* Orru, G.G. Hamilton, *and* M. Suzuki, *patterns of Inter-Firm Control in Japanese Business,* Papers in East Asian Business and Development, No. 7, Institute of Governmental Affairs, University of California, Davis, 1989.

TABLE 7-1: Major Members and Affiliates of the Mitsui Group

Financial Institutions	Percentage of firm's stock held by other group members or affiliated companies
Sakura Bank	15,98
Mitsui Trust & Banking	24.42
Mitsui Kaijo Kasai	28.90
Trading, Manufacturing, and Other	
Mitsui Bussan	20,11
Mitsui Mining	37.48
Mitsui Construction	41,96
Sanki Engineering	20.65
Nippon Flour Mills	26.32
Toray Industries	16,45
Oji Paper	1211
Mitsui Toatsu Chemicals	18,65
Denki Kagaku Kogyo	17.56
Mitsui Petrochemical Industries	38.39
Onoda Cement	19,94
Japan Steel Works	19.56
Mitsui Mining & Smelting	12.70
Mitsui Engineering & Shipbuilding	1816
Mitsukoshi	14.39
Mitsui Real Estate Development	17,64
Mitsui O.S.K. Lines	21,60
Mitsui Warehouse	29,95
Toshiba	11.41
Ishikawajima Harima	10,72
Toyota Motor	10,30

NOTE: Data is for fiscal year 1992, ended March 31, 1993, and is drawn from a survey conducted by Toyo Keizai of 2,131 firms listed on Japanese stock exchanges

SOURCE: Kigyo Keiretsu *Soran* (Tokyo: Toyo Keizai Shinposha, 1994), pp. 44-45

shareholdings may be small, but their size is often not as significant as their existence, for they signi - fy valued and often enduring business relationships.[12] Reciprocal equity ownership comprises a critical element in a web-like system of corporate interdependence, especially obvious in the major bank-centered keiretsu (see tables 7-1 to 7-4). On al aggregate basis it can effectively close the market for corporate control, not only for new foreign entrants but also for potential domestic rivals.

[12] For smaller Japanese companies that are not part of keiretsu networks, large shareholdings are more common and they can provide the key mechanism for exerting influence over management. See S. D. Prowse, "The Structure of Corporate Ownership in Japan," *The Journal of Finance 47(3): 1121-1140,* July 1992.

TABLE 7-2: Major Members and Affiliates of the Mitsubishi Group

Financial Institutions	Percentage of firm's stock held by other group members or affiliated companies
Mitsubishi Bank	2562
Mitsubishi Trust & Banking	17.35
Nihon Shintaku Ginko	13,59
Tokyo Marine & Fire Insurance	22.61
Trading, Manufacturing, and Other	
Mitsubishi Shoji	33.22
Kirin Brewery	1920
Mitsubishi Rayon	2285
Mitsubishi Paper Mills	3187
Mitsubishi Kasei	22.12
Mitsubishi Gas Chemical	2468
Mitsubishi Petrochemical	32.99
Mitsubishi Jushi	57.32
Mitsubishi 011	4460
Mitsubishi Steel Manufacturing	3718
Mitsubishi Materials	2490
Mitsubishi Shindo	53.27
Mitsubishi Cable Industries	4975
Mitsubishi Kakoki	3668
Mitsubishi Electric	1647
Mitsubishi Heavy Industries	19.93
Mitsubishi Motors	56.44
Mitsubishi Estate	2646
Nippon Yusen	26.07
Mitsubishi Warehouse	42.57
Asahi Glass	28.09
Nikon	27.88

NOTE: Data is for flscal year 1992, ended March 31, 1993, and is drawn from a survey conducted by Toyo Keizai of 2,1 31 firms listed on Japanese stock exchanges

SOURCE: Kigyo *Keiretsu Soran*(Tokyo: Toyo Keizai Shinposha, 1994), pp. 46-47

In the early 1990s, more than half of the outstanding shares of publicly listed Japanese corporations were held by Japanese financial institutions and other corporations. [13] The historically low dividend rates of most Japanese corpora(ions surely have something to do with this fact. With little fear that key shareholders will sell, managers can be conservative in their payouts. They can also compensate their main shareholders in other ways; for example, they can give their lead banks a right of first refusal when they have

[13] W.C Kester, "Governance, contracting, and Investment Time Horizons," Working Paper 92-003, Harvard Business School, Division of Research, 1991. See also U. Schaede, op. cit., footnote 10, table 2.

TABLE 7-3: Major Members and Affiliates of the Sumitomo Group

Financial Institutions	Percentage of firm's stock held by other group members or affiliated companies
Sumitomo Bank	1932
Sumitomo Trust & Banking	26.64
Sumitomo Marine & Fire Insurance	26.62
Trading, Manufacturing, and Other	
Sumitomo Shoji	**33.08**
Sumitomo Coal Mining	**38.59**
Sumitomo Construction	30.44
Sumitomo Forestry	29.92
Sumitomo Chemical	23.11
Sumitomo Bakelite	47.40
Sumitomo Cement	32.34
Sumitomo Metal Industries	19,50
Sumitomo Metal Mining	29.87
Sumitomo Light Metal Industries	48.48
Sumitomo Electric Industries	20.84
Sumitomo Heavy Industries	28.38
Sumitomo Realty & Development	17,38
Sumitomo Warehouse	37.49
Nippon Sheet Glass	2534
NEC	27.10

NOTE: Data Is for fiscal year 1992, ended March 31,1993, and Is drawn from a survey conducted by Toyo Keizai of 2,131 firms listed on Japanese stock exchanges

SOURCE: Kigyo Keiretsu *Soran* (Tokyo: Toyo Keizai Shinposha, 1994), pp. 44-45.

external financing requirements, and they can direct other types of business to related companies.

Sectoral studies indicate a much wider set of reasons for reciprocal corporate shareholding. These include the desire to solidify a relationship with a leading supplier of vital technology. It is well known, for example, that Japanese automobile companies frequently push key engineering and design functions to their supplier companies. Cross-shareholding can seal the relationship of technological cooperation and mutual dependence that thereby results. [14]

Corporate interlocks can represent the legacy of divisions that were spun off as independent companies once they became strong enough. Cross-shareholding can represent the purchase of "insurance policies" from financial institutions. Both types of linkage yield a degree of protection in the event of a crisis, albeit at the possible price of having to allow the financial institutions to intervene directly in management. In addition, cross-shareholdings can create a kind of leverage that helps assure performance under other types of contractual or noncontractual business arrange-

14 For a defense of the system, see Y. Futasugi, "What Share Cross-Holdings Mean for Corporate Management," *Economic Eye* 11(1): 17-19, spring 1990.

TABLE 7-4: Major Members and Affiliates of the Fuyo Group

Financial Institutions	Percentage of firm's stock held by other group members or affiliated companies
Fuji Bank	26.28
Yasuda Trust & Banking	26.38
Yasuda Fire & Marine Insurance	18.16
Trading, Manufacturing, and Other	
Marubeni	19.05
Taisei	902
Nissin Flour Milling	941
Sapporo Breweries	2265
Nichirei	10.87
Nisshinbo Industries	1458
Toho Rayon	4330
Showa Denko	1957
Kureha Chemical Industry	2132
Nippon Oil & Fats	24.46
Tonen	1024
Nihon Cement	1995
NKK	1348
Kubota	1058
Nihon Seiko	227
Oki Electric Industry	2187
Yokogawa Electric	1098
Tokyo Tatemono	2748
Tobu Railway	638
Keihin Electric Express Railway	950
Showa Line	3552
Hitachi	507
Nissan Motor	1464
Canon	10.20

NOTE: Data is for fiscal year 1992 ended March 31 1993 ands drawn from a survey conducted by Toyo Keizai of 2,131 firms listed on Japanese stock exchanges

SOURCE: *Kigyo Keiretsu Soran* (Tokyo: Toyo Keizai Shinposha, 1994), pp. 48-49

ments. Therefore, it is not surprising that Japanese corporate managers "tend to view their proximate task as being the preservation and enhancement of these complex relationships rather than the immediate, direct pursuit of any one stakeholder's interests, such as that of exclusive equity owners."] [5]

Under the aegis of this system of corporate governance, Japan successfully built up its economy throughout the past few decades. Despite the effectiveness of this system, some observers have recently argued that it is now breaking down, as the inevitable consequence of both corporate ma-

[15] Kester, op. cit., footnote 12.

TABLE 7-5: Cross-Shareholdings Within Bank-Centered Japanese Keiretsu

	Mitsui	Mitsubishi	Sumitomo	Fuyo	Sanwa	DKB
1980	17.62	29,26	26.74	16,26	16,78	14.12
1985	17,87	25,18	25.01	15,79	16.84	13.33
1988	17.09	26.87	24.42	15,29	16,38	12.24
1991	16.58	26.37	24.67	15,62	16.67	12.16
1992	16,58	26.33	24.65	15.62	16,72	12.19

NOTE: Cross-shareholdings are the average of the ratios of stocks in one member company owned by other companies withln the group

SOURCE: Adapted from *Kigyo Keiretsu Soran* (Tokyo: Toyo Keizai Shinposha, 1987, 1990, and 1993)

turity and global financial integration. Despite some evidence of marginal changes in the system, OTA interviews and analysis indicate caution in the interpretation and projection of those changes.

To some extent, the weakening of equity ties between financial intermediaries and Japanese MNEs during the late 1980s and early 1990s reflected the unusual circumstances of Japan's financial bubble. Although the bubble weakened some cross-equity linkages, it actually reinforced others—particularly those of the older, core keiretsu. The bursting of the bubble encouraged a number of firms to repair their financial relationships, despite the fact that major banks were having severe difficulties. In this regard, the publicized instances of firms selling off their holdings in banks appear to be exceptions to the rule, especially in keiretsu networks.

Senior Japanese executives quite openly explained to OTA that selling member holdings risked retaliation. This is not to say that the system is inflexible. Many companies have rationalized their cross-shareholdings and reduced their volume. However, since the number of shares held is often unrelated to the degree of inter-corporate influence, neither development necessarily implies the unraveling of the cross-shareholding system.[16] Certainly within the major keiretsu, changes in the cross-shareholding system over the past decade show almost no decrease. Table 7-5 illustrates this pattern within six major keiretsu.

Within Japan's corporate networks, managers are frequently disciplined by their bankers or related companies for poor performance, although the system may also effectively allow them to defer painful decisions. Obviously weak firms, however, tend to be quickly and quietly liquidated or merged. Nissan, for example, effectively took over the management of Fuji Heavy Industries (manufacturers of the Subaru marque) in 1990. At the time, Nissan owned only 4 percent of Fuji's shares, but the two companies collaborated intensively and shared managerial staff. The de facto "takeover" occurred without any debt being restructured or any transfers of stock between Fuji major shareholders. The role of financial institutions is critical in such cases, and analysts have gone so far as to depict the direct discipline such institutions can exercise as the functional equivalent of a U.S.-style market for corporate takeovers.[7]

At certain points in Japanese history, government played the key role in nurturing this form of

16 One analysis of the issue, for example, found no evidence that the influence of financial institutions diminished during the booming 1980s. See F.R. Lichtenberg and G.M. Pushner, "Ownership Structure and Corporate Performance in Japan," Working Paper No. #4092, National Bureau of Economic Research, June 1992. On the lack of a direct relationship between ownership per se and effective influence, see Schaede, op. cit., footnote IO.

17 Ibid., and Kester, 0p. cit., footnote 12. This theme will be taken up again in ch. 8.

corporate governance. In addition to encouraging cross-shareholdings and carefully shaping the institutions that would manage corporate finance, it accepted cautious disclosure standards, and sometimes sanctioned cartel-like arrangements (especially in troubled industries) and other business practices that had the effect of restricting market access.[18] Certainly during the past two decades, the direct impact of government has been more subtle, but its residual influence is still important. As corporate officials repeatedly told OTA, even during a period of political instability, officials within the relevant ministries remain capable of dispensing "administrative guidance."[19]

In short, the Japanese system of corporate governance renders the managers of Japanese MNEs accountable to others, including a wide range of stakeholders as well as governmental authorities. But that same system has freed them from the need to focus their strategies rigidly on achieving high, direct, and near-term returns to shareholders.[20] This has enabled most Japanese MNEs to pursue the kinds of longer-term strategies required to develop and commercialize new technologies. The system has also provided those MNEs with implicit safety nets in the event of serious managerial mistakes or unanticipated market shocks. Among other things, the existence of such safety nets can explain why outright corporate bankruptcy in Japan appears to be less frequent among large firms and less costly than in the United States. It also accounts in part for the oft-noted ability of Japanese MNEs to downplay short-term calculations of return on investment for long periods of time while market shares abroad are established or defended. Finally, whether deliberately or not, the system has worked to discourage new entrants—both foreign and domestic—to Japanese markets, especially but not exclusively when entry has been sought by way of acquisition.

The relationships that underpin particular Japanese MNEs may shift overtime, but periods of turbulence often bring to light not the fragility but the durability of traditional patterns. In contrast to the American system, the Japanese system of corporate governance well deserves the label "alliance capital ism."[21] The system has commanded respect from outsiders, not in the least because of its apparent effects on long-term managerial thinking and investment in key technologies. While the system may be under unusual strain today, it is more difficult to imagine its demise than its adaptation to new circumstances.

CORPORATE GOVERNANCE IN GERMANY

Despite the economic troubles it encountered in the years following unification, German y remains the industrial leader of Europe.[22] The European technology base continues to be influenced more by German industry than by that of any other European country. To be sure, French, Dutch, U. K., and Swiss MNEs dominate particular industrial

18 See J.A. Hart, *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (Ithaca, NY: Cornell University Press, 1992), ch. 2; D.J. Encarnation, *Rivals Beyond Trade: American versus Japan in Global Competition* (Ithaca, NY Cornell University Press, I 992).

19 See also U. Schaede, "Change and Continuity in Japanese Regulation," Working Paper 66, Berkeley Roundtable on the International Economy, University of California, March 1994.

20 Compared to U.S. managers, the relative freedom of Japanese managers from immediate shareholder interests is Illustrated by the failed efforts of U.S. pension funds to influence the management decisions of several Japanese corporations at their 1993 annual meetings. See J. Sterngold, "Japanese Companies Rebuff Mighty U.S. Pension Funds," *The New York Times,* p. D], June 30, 1993.

21 M. Gerlach, *A//lance Capitalism: The Social Organization of Japanese Business* (Berkeley: University of California Press, 1992). See also Lichtenberg and Pushner, op. cit., footnote 15.

22 This leadership was underlined when profits began a sharp rebound in early *1994* in a number of core German industries. See K.L. Miller and D. Wise, "Slash and Earn on the Continent," *Business Week (3369). 45-46,* May 2, 1994.

sectors. But German MNEs continue to hold the key to the evolving integration and development of European industry in general.

Like American and Japanese MNEs, German MNEs are embedded in a distinctive system of corporate governance with deep roots. The system is distinguishable from that of France, and it differs quite markedly from that of the United Kingdom; in some ways, it is similar to that of Japan. Although currently under some stress, the German system comprised a critical component of the country's initial industrialization and of its recovery and growth after World War 11.[23]

Germany's corporate governance, together with the country's approach to regulating the broad framework within which government, corporations, and labor unions continually negotiate their respective adjustments to market conditions, produces an advantage in a number of industrial technologies.[24] Germany has been a leader, for example, in high-performance transportation systems, automotive components, inorganic chemicals, metals processing, and machine tools. While not known for the creation of startling new innovations in other sectors, Germany has been a world leader in effective technological diffusion.[25] It has excelled at refining new production and process technologies and spreading their effects across a broad industrial base.

By the early 1990s, German industry had confronted the challenge of adapting its traditional corporate governance system and technology base to a much more competitive global and regional environment.[26] Productivity levels had not kept up with world standards, and unit labor costs had swollen in relative terms. Successful adaptation was recognized as crucial to regaining the country's position across the industrial sectors in which it had long excelled. The challenge of broadening and diversifying its technology base appeared even more formidable, since fundamental changes might be needed to achieve such goals. Indeed, given the social and political difficulties associated with such changes, pessimism concerning the technological future of German industry has been in vogue. OTA analysis, however, supports a more balanced view. German industry is adjusting within the constraints posed by its traditional system of corporate governance. That system may be reshaped, but it will not likely be abandoned. Negotiated and incremental reform is probable.

Managers of American MNEs often remark on the ability of their German counterparts to operate with a high degree of apparent independence from shareholder pressures for immediate returns. The common view is that this independence has been crucial to the maintenance of stable levels of investment in the technologies at the center of leading German industries. There is an element of truth in this, but the ability of German industrial managers to plan with other than short-term profit-maximization goals in mind derives from the fact that German managers have been able to convince shareholders to take a long-term view. Moreover, German corporations typically rely on their bank relationships for long-term lending, and obtain a relatively small portion of the firm's finances through the stock market. In such a context, German managers have really not been more autonomous than American managers. They have

23 See A. Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Belknap, 1962).

24 For background, see P.J. Katzenstein, *Politics and Policy in the Federal Republic of Germany: The Semi-Sovereign State* (Philadelphia, PA: Temple University Press, 1987); A.S. Markovitz, *The Politics of the West German Trade Unions* (Cambridge, UK: Cambridge University Press, 1986); and K. Thelen, *Union of Parts: Labor Politics in Postwar Germany* (Ithaca, NY: Cornell (University Press, 1991).

25 K. Wever and C.S. Allen, "The Financial System and Corporate Governance in Germany: institutions and the Diffusion Of Innovations," *Journal of Public Policy 13(2): 183-202,* April-June 1993.

26 See H. Giersch, K. paque, and H. Schieding, *The Fading Miracle: Four Decades of Market Economy in Germany* (Cambridge, UK: Cambridge University Press, 1992).

TABLE 7-6: Composition of the Supervisory Boards of the 100 Largest German Enterprises (in percent)

Individuals from	comprise
Private banks	7
Other banks	2 2
Insurance companies	1 6
Trade unions	12,4
Other employee representation	36.3
Industry representation	25,8
Other shareholder representation	10,2
Government (political parties and civil servants)	4 5

SOURCE: Federal Association of German Banks, cited in E.R. Schneider-Lenne (Deutsche Bank) The Role of German Capital Markets, the Universal Banks Supervisory Boards and Interlocking Directorships, " paper prepared for National Economic Development Off Ice Policy Seminar London, Nov. 21-22, 1991

simply been subject to different pressures, some of which can be quite severe.

German law distinguishes between two types of companies with limited liability: joint stock companies, which are publicly owned and listed (Aktiengesellschaft (AG)); and privately held, unlisted companies (Gesellschaft mit beschraenkten Haftung (GmbH)). German MNEs come in either form. Daimler-Benz, for example, falls in the former category, while Robert Bosch falls in the latter. Since most large German firms are joint stock companies, however, the emphasis in this assessment is on AG firms.

Under the terms of the 1976 Co-Determination Act, in a company with more than 2,000 employees, half of the supervisory board must comprise directors chosen by the shareholders and half by employees; one of the labor representatives must come from middle management or higher. Table 7-6 breaks down the composition of the boards in the 100 largest German enterprises. The chairman is elected by the shareholders' representatives, all of whom are outsiders, and has the ability to vote twice—and consequently break tie votes. The supervisory board appoints a management board, usually of 10 persons; by law, those managers are provided with a formal contract extending from one to five years.[27]

Although they have formal responsibilities for reviewing management contracts and providing general oversight, German supervisory boards have often been depicted as passive organs. In fact, the chairman in particular is usually involved in the most important strategic and financial decisions of a company. The boards also play a critical disciplinary role when the company gets into trouble. Their direct intervention in management, in such an event, serves a function akin to hostile takeovers in the American system. To participants and close observers, the German method of encouraging corporate restructuring when required has the notable advantage of precluding the asset-stripping, short-term planning, and social disruption characteristic of the American and British corporate takeover battles of the 1980s.[28]

Beyond the prominent role given to employee representatives, the most distinguishing characteristic of the German system is the critical role played by banks. The leading industrial banks, especially Deutsche Bank, Dresdner Bank, and Commerzbank, are "universal" banks. This means they are permitted to engage in a wide range of commercial and investment banking activities under one roof. Throughout modern German history, such powers have made them the key providers and organizers of capital for the establishment and growth of German corporations.

27 For a description of the board structure of German joint stock companies, see U. Schaede, "The Creation of a New System of Corporate Governance for the EC: An Integrative Model of the Anglo-American and Germanic Systems," Graduate School of International Relations and Pacific Studies, University of California, San Diego, June 1994, pp. *9-12.*

28 *See,* for example, E.R. Schneider-Lenné (Deutsche Bank), "The Role of German Capital Markets, the Universal Banks' Supervisory Boards, and interlocking Directorships," paper prepared for National Economic Development Office Policy Seminar, London, Nov. 21-22, 1991.

Without them, Germany's industrial and technology base would look quite different than it does today.

The role of the banks, which is discussed further in chapter 8, is reflected in Germany's corporate governance system. Bankers hold nearly 10 percent of all nonemployee seats on the supervisory boards of the 100 largest nonfinancial companies in Germany. Moreover, in the largest companies, the lead bank (Hausbank) often provides the chairman of the supervisory board. Given the fact that there are relatively few banks involved at the highest level of corporate finance in Germany, this means that many supervisory boards in Germany are interlocked.[29]

Underpinning such linkages, as in the case of Japan, are significant cross-shareholdings. It is not uncommon for a corporation's leading creditor to hold between 10 and 20 percent of its voting shares.[30] Combined with cross-shareholdings involving suppliers, major customers, and other firms, intercorporate shareholding frequently meets or exceeds half of the voting shares in many German firms. Even when that is not the case, however, the practicalities of Germany's depository voting system often enable the lead bank of a joint stock company to control well over 50 percent of its shares. Unlike in the U.S. system, shares are issued in bearer form, and the depository institution-most often a bank—has the right to vote on them without specific authority from the actual shareholders.[31]

The connection between owners, managers, and creditors is even more intimate in Germany's privately held companies, many of which now have operations on a global scale. The autoparts and equipment maker, Robert Bosch GmbH, provides an example. When the company's founder died 30 years ago, most of his shares were transferred to a foundation that bears his name. Among other things, the foundation now provides the bulk of the financial resources for a hospital located in the town where the company is headquartered. For dividends to flow to the hospital tax-free, however, voting rights connected with the shares were transferred to a supervisory board comprised first of seven and now nine members. Board members choose their own successors, typically including the retired chairmen of the company itself, its lead bank, other large corporations, and associated labor unions .32

In practice, the role of the supervisory board at Bosch is limited, and the company's managers enjoy a high degree of operational autonomy as long as the overall performance of the firm is satisfactory.[33] In practice, its managers have more than met that standard. As the company has grown, the shareholding structure, in particular, has enabled it to maintain stable and relatively low dividend payouts to the Bosch Foundation, while simultaneously building up substantial internal reserves. Those reserves, in turn, have allowed the company to invest continuously in the technological foundations upon which its high reputation and market advantages rest.

Beyond the legal features of Germany's shareholding system, commentators frequently note

[29] For detailed analysis, see R. Ziegler, D. Bender, and H. B iehler, "Industry and Banking in the German Corporate Network," *Networks of Corporate Power*, F.N. Stokeman et al. (eds.) (Cambridge, UK: Polity, 1985).

[30] Under the terms of new legislation, public companies arc required to disclose the identities of shareholders owning stakes of more than 5 percent. "German Corporate Goverance Stirring Things Up," The *Economist* 329(7842)72-73, Dec. 18, 1993.

[31] Formerly automatic and of indefinite duration, legal reforms now require the right of proxy voting to be reviewed by the true shareholders on a regular basis, and the banks must now solic it voting instructions. In practice, the banks retain a high degree of control. For additional discussion of Germany's depository voting system, see ch. 8.

[32] For U.S. tax purposes, the IRS considers the nine board members to be [he ultimate holding company. OTA interview, Germany, Nov. II, 1993.

[33] The superv i sow boards of privately held firms function very differently than those of joint stock companies. Board members of GmbH firms can sell their shares (rely in round lots, and must receive permission from the owner or the board to do so.

that the center of gravity in its corporate governance structure is in the reciprocal and enduring relationships that exist between the few individuals representing the various groups most involved in the life of a corporation. These relationships rest on a deep sense of mutual trust, which is reinforced by continual interaction. That trust tends to be backed up, however, by the certainty of severe, if informal, sanctions in the event of breaches. Although similar in nature to the ties that bind keiretsu and other intercorporate alliances in Japan, the relationships in Germany appear to be more broadly based, overlapping, and inclusive.

With the banker frequently playing a crucial coordinating role in the most prominent German MNEs, the system balances the interests of corporate stakeholders. To be sure, there are critics, some quite vocal, who would like to shift the balance toward noncorporate shareholders, as in the American system. Few objective observers, however, are predicting their imminent success. OTA interviews with the managers of important German MNEs support such a conclusion.

Although it is now conventional to depict Germany's recession and painful economic restructuring in the early 1990s as exposing cracks in its system of corporate governance, the causal arrows in such an argument probably should be reversed. The apparent efforts of some German companies (most notably Daimler Benz) to diversify their over-concentrated shareholder bases by issuing shares in the United States should not be misunderstood. Such tactical moves do not necessarily presage the dismantling of board interlocks or extensive corporate cross-shareholdings. As one senior executive from a leading German MNE told OTA, "The core of the German company remains in its financial structure and the associated mentality of its most senior managers. " The priority is to finance new acquisitions and diversification plans out of retained earnings and hidden reserves, thus avoiding the dilution of control that can occur when significant amounts of capital need to be raised externally. Having to raise external capital is widely seen as a sign of weakness. This view may be wrong, but it will likely take considerable time before it is revised.

German executives interviewed by OTA, in fact, suggested that Germany's current economic difficulties are reinforcing the traditional system of corporate governance rather than breaking it apart. Senior officials from one of Germany's leading universal banks, for example, were forthright in explaining that a number of clients, which had sought to loosen their ties with the bank during the booming 1980s, had abruptly reversed course in the 1990s. Accordingly, they expected the system to be deepened by the difficult restructuring process most German corporations must go through in the years ahead. Significantly, no corporate managers interviewed by OTA demurred from that opinion. At most, they expected a few large German MNEs to diversify their capital bases by bringing in new minority shareholders. Most saw Daimler Benz's recent foray into American capital markets in this light. Indeed, the consensus among the leaders of German banks and MN Es, if expressed frankly, would be that the loss of control to the capital markets, typically associated with American and British MN Es. was to be avoided at all costs.

Such a goal, of course, complicates the task of reshaping and reinvigorating Germany's industrial and technology base. In particular, the risk is that it will stunt the development of broad domestic capital markets and thus prevent small and medium-sized German companies from raising the financing that might support new technological innovation. On the other hand, assuming that large German companies regain their competitive edge (by, for example, scaling back their real wage costs and markedly increasing productivity), preserving the core of the traditional system of corporate governance could once again provide German MNEs with stabilizing financial advantages in the global marketplace. Assisting in this regard will be other aspects of the German industrial system. including its accounting rules (see box 7-1).

CONCLUSIONS

American, German, and Japanese MNEs differ in the relative priorities they assign to the maximization of shareholder value, the satisfaction of cus-

BOX 7-1: Corporate Governance and National Accounting Standards

Germany's Daimler-Benz began arranging in 1993 to list its shares on the New York Stock Exchange. A 3.2 percent stake in the corporation was to be offered for sale from shares held by Deutsche Bank. Daimler officials told OTA that the move comprised part of a larger effort to raise the firm's profile in the United States at a time when it was putting up a new plant in Tuscaloosa, Alabama, and otherwise trying to maintain and build its business in this country. Press reports indicated that another motivation came from Deutsche Bank, which wanted to reduce its 28.1 percent equity stake in Daimler. In order to conform to S.E.C. requirements, the firm agreed to translate its financial statements in accordance with generally accepted accounting principles in the United States. In December 1993, after a disastrous downturn in its core businesses, the company reported in Germany that it had lost DM181 million (or $105.4 million) during the previous nine months. Under American accounting rules, however, it had to report that loss as DM2.05 billion (or $1.19 billion).[1]

Differences in national accounting rules have long made life difficult for international bankers, stock market analysts, and investment fund managers. But do those differences affect basic business strategies and skew the terms of global competition? An expanding body of research suggests that the answer to that question is in the affirmative. As two leading commentators put it, "Accounting consequences [of business decisions] are especially relevant in matters of global competitiveness. Global businesses are helped or hindered, as the case may be, by national accounting rules."[2]

The case of Daimler's New York listing reminded market observers of the impact of one key rule difference, namely the existence of hidden reserves in German corporations, which are used in part to stabilize the historic path of reported earnings. Such reserves, the legacy of periods in German history when capital for industrial development or reconstruction was scarce and had to be raised quickly, can today be created in a number of ways. German firms, for example, frequently make large provisions out of current earnings for future contingencies. Governmental rules encourage such conservatism by allowing provisions to be added to corporate pension funds and other accounts before taxes are calculated. A relatively high marginal tax rate on reported profits, on the other hand, discourages firms from not making such provisions. Hidden reserves also can be created by the practice of carrying long-term investments on the balance sheet at historic book value, a practice common in both Germany and Japan.[3]

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[1] F. Protzman, "Daimler Benz Reports Sizable Loss," *The New York Times*, p. D5, Dec. 16, 1993; C. Parkes and D. Waller, "Daimler Plans Roadshow for U.S. Stock Offering: Innovations at Germany's Largest Industrial Group," *Financial Times*, p. 21, Dec. 16, 1993. For background, see W. Cooper, "Discovering the Foreign Investor," *Institutional Investor* 27(7):81-84, July 1993, pp. 81-84; also see G. C. Biddle and S.M. Saudagran, "Foreign Stock Listings: Benefits, Costs, and the Accounting Policy Dilemma," *Accounting Horizons* 5(3):69-80, September 1991.

[2] F.D.S. Choi and G.G. Mueller, *International Accounting* (Englewood Cliffs, NJ: Prentice-Hall, 1993), p. 81. Also see F.D.S. Choi and R.M. Levich, "Behavioral Effects of International Accounting Diversity," *Accounting Horizons* 5(2):1-13, June 1991; and by the same authors, *The Capital Market Effects of International Accounting Diversity* (New York: Dow Jones-Irwin, 1993).

[3] H.D. Lowe, "Shortcomings of Japanese Consolidated Financial Statements," *Accounting Horizons* 4(3):1-9, September 1990. On this and related dimensions, it is clear that accounting rules and tax policies need to be analyzed together. The international consequences of basic differences in approach are becoming much more important. For a comprehensive and policy-focused analysis, see G.C. Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (Washington, DC: Institute for International Economics, 1992). Also see D.W. Jorgenson and R. Landau (eds.), *Tax Reform and the Cost of Capital* (Washington, DC: Brookings, 1993); Arthur Young & Company, *The Competitive Burden: Tax Treatment of U.S. Multinationals*, A Tax Foundation Special Report, Washington, DC, n.d.; A. Razin and J. Slimrod (eds.), *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990); D.J.S. Brean, "Policy Perspectives on International Taxation," *Key Issues in Tax Reform*, C. Sandford (ed.), (Bath, UK: Fiscal Publications, 1993); and R.M. Bird, "Shaping a New International Tax Order," *Bulletin-for-International-Fiscal-Documentation* 42(7):292-391, July 1988.

BOX 7-1 continued: Corporate Governance and National Accounting Standards

The lack of transparency with regard to hidden reserves is surely intentional. Such methods can help corporations cope with various sources of uncertainty in their markets. In addition, by smoothing out earnings, they can assist in maintaining the confidence of creditors and investors. Although the building of hidden reserves occurs in full conformity with tax rules, and indeed, to some extent is driven by those rules, it also provides corporations with strength when it comes to fundamental strategic and investment planning. Even the illusion of strength can translate into competitive advantage. For example, partners or competitors might draw comfort or discomfort, as the case may be, from the assumption that a firm has plentiful resources to be called upon to support the successful implementation of strategic plans. But a lack of transparency can have costs, especially when a firm under pressure needs to find new sources of financing.[4]

Accounting rule diversity reflects the fact that countries and companies have made different tradeoffs between debt and equity financing in their pursuit of industrial development. A culture of managerial conservatism, tax policies, preferences for indigenous control, and deeper historical and social factors influence such tradeoffs. It does not take a bold leap of imagination, for example, to make the connection between accounting rules that foster the husbanding of resources within a German corporation and the traditional German concept of a community (Gemeinschaft), which must look after its own needs in the context of a hostile external environment.

Beyond the issue of hidden reserves, major areas of differences in basic accounting principles across the industrial world arise on such items as research and development, fixed assets, inventory, leases, income taxes, foreign currency translation, mergers and acquisitions, and consolidation.[5] Japan, France, Switzerland, and a handful of other countries, for example, often allow R&D expenses to be capitalized rather than deducted from current earnings. Under such a rule, only the current year's depreciation reduces those earnings. This provides an incentive to raise R&D expenditure levels or to maintain them over the full course of an economic cycle. Such a rule can facilitate long-term planning and consistent strategic implementation. It also suggests new policy dilemmas as divergent systems come into more direct contact with one another through the aegis of expanding multinational competition.

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[4] See G.A. Ndubizu, "Accounting Disclosure Methods and Economic Development," *The International Journal of Accounting* 27:151-214, 1992.

[5] See P.R. Peller and F.J. Schwitter, "A Summary of Accounting Principle Differences Around the World," *Handbook of International Accounting*, F.D.S. Choi (ed.) (John Wiley & Sons, 1991), ch. 4. Also see R. Bloom and M.A. Naciri, "Accounting Standard Setting and Culture: A Comparative Analysis of the United States, Canada, England, West Germany, Australia, New Zealand, Sweden, Japan, and Switzerland," *The International Journal of Accounting* 24:70-97, 1989.

tomer needs, and the stabilization of employer-employee relations. Unique patterns of corporate ownership and control, and associated differences in relations between owners and managers, appear crucial (see table 7-7).

The dispersion and mobility of shareholders in the United States seem to fixate the managers of American corporations on short-term financial performance. This is not necessarily a bad thing, unless those corporations are engaged in global competition with rivals capable of longer-term thinking.[34] German and Japanese MNEs have demonstrated just such a capability in the past.

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[34] For legal analysis and debate, see J.C. Coffee, "Liquidity Versus Control: The Institutional investor as Corporate Monitor," *Columbia Law Journal* 91 (6) 1276-1368, 1991.

TABLE 7-7: Ownership Structure of Publicly Listed Corporations (in percent)

	United States	Japan	Germany
Banks	0.3	25,2	8.9
Insurance companies	5.2	17.3	10.6
Pension funds	24.8	0.9	—
Investment companies	9.5	3.6	—
Nonfinancial businesses	—	25.1	39.2
Households	53.5	23.1	16.8
Government	—	0.6	6.8
Foreign	6.7	4.2	17,7

SOURCE Central banks and stock exchange data, 1991, adapted from WC. Kester, "Industrial Groups as Systems of Corporate Governance, " *Oxford Review of* Economic *Policy,* 8(3) 33, table 4, autumn 1993

The concentration of corporate ownership in Germany and Japan helps explain their longer-term, customer- or employee-focused strategies. As two analysts recently put it:

> In contrast to the United States' primary focus on shareholder value, these other countries' corporations are seen as durable national assets that serve a broad base of constituents. Quality products, market share, and employment are just as legitimate as goals as return on shareholder investment. While some U.S. top managers and directors prefer this perspective themselves, they are swimming against the dominant national tide.[35]

Such differences are reflected not only in the investment decisions of particular firms, but also in the nature of the national technology bases those firms have created and exploited on global markets.

Throughout the post-war period and in various high-technology sectors such as electronics, transportation systems, and others using advanced manufacturing techniques, Japanese MNEs became noted for pursuing aggressive strategies keyed on market share, not return on investment. Corporate governance structures, accounting conventions, and public policies at home contributed to their ability to design and implement such strategies. Those structures fostered balanced relationships and an enduring sense of trust, especially among employees, managers, and institutional owners. They facilitated the sharing of information across allied firms. Most importantly, they rendered the providers of base capital patient, while simultaneously attempting to limit the scope for managerial abuse. Periodic scandals indicate that the latter attempt can fail. Japanese consumers, moreover, continue to bear significant opportunity costs associated with this patient capital system. Meanwhile, Japan's massive trade surplus and international investment imbalance indicate the external consequences of such a system.

The Japanese system of corporate governance spreads large volumes of minority equity claims among lenders, customers, suppliers, and affiliates. Despite some recent flux, OTA interviews indicate that rather than changing in a fundamental way, the current corporate restructuring is an attempt to come to grips with unforeseen consequences: the creation of surplus capacity in sectors where growth has turned down dramatically, ill--advised diversification (especially into U.S. and

35 Lorsch and MacIver, 0p. cit., footnote 6.

Japanese commercial real estate), poor management of cash reserves built up during the 1980s, and associated financial scandals.

The managers of Japanese MNEs are aware that charting their way through the current difficulties and recapturing technological advantages may well depend upon maintaining the essential structure of their equity bases, the confidence of their lead banks, and the loyalty of long-term employees, suppliers, and affiliated companies. The possibility of retaliation for breaches in network solidarity is not abstract. Bankers and MNE managers both maintained in interviews that all firms in industrial groups understood well the fact that companies contemplating appreciable sales of shares in related banks or companies would elicit immediate retaliation. Although marginal adjustment in some corporate ownership structures is occurring, it typically reflects mutual negotiation between the firms involved. The sense of responsibility for collectively managing the process of national economic restructuring within tight traditional constraints remains palpable.

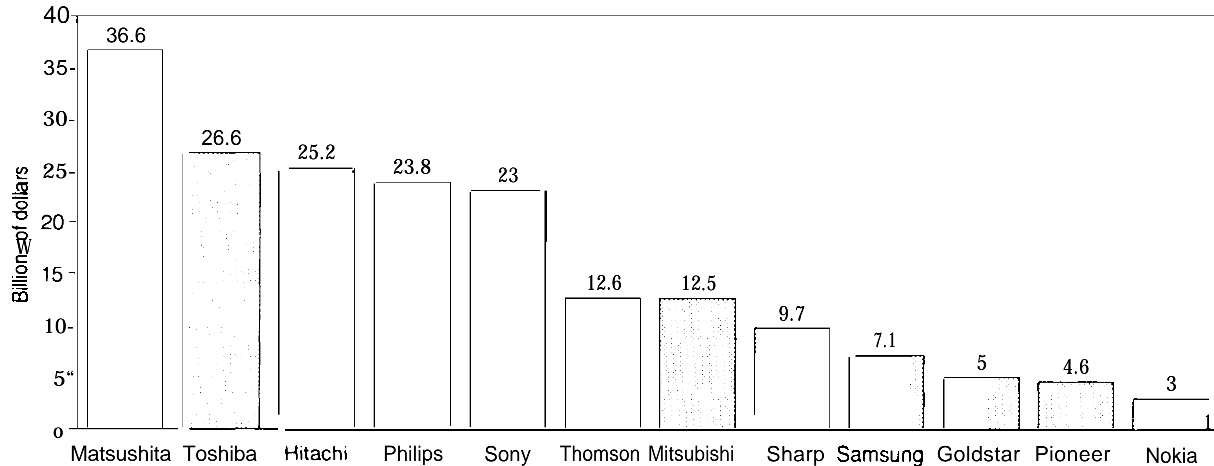
Parallels exist in Germany. The overarching system of corporate governance has in the past provided German MNEs with the financial stability necessary to build and exploit technological advantages in key industrial sectors. Together with a unique accounting system, it reinforced long-term relationships between stakeholders and enabled substantial reserves to be built up. Those reserves, and the knowledge that owners and creditors will not abandon firms at the first sign of trouble, encouraged managers to pursue long-term strategies. Cross-shareholding is a critical part of the traditional German system, but it is less extensive than its analog in Japan. Long-term bank relationships, combined with the depository voting system, provide an alternate source of stability. In addition, interlocking supervisory boards in Germany play a much more important role both in disciplining managers and encouraging long-term thinking.

The consequences of the German system can be seen in a number of sectors, but perhaps most obviously in the chemical and automotive sectors. Hoechst's purchase of Celanese, the steady expansion of BASF in the United States, the simultaneous building of major new plants by BMW in Bavaria and South Carolina and by Mercedes Benz in Alabama and Baden-Wuerttemberg--all require a highly developed ability to endure short-run perturbations in tough markets. Traditional corporate governance structures and accounting rules have helped foster just such an ability in the past. There is little reason to assume that they will not do so again in the future. Similar structures underpin high-profile MNEs based in Germany's EU partners, and nowhere is this clearer than in the U.S. consumer electronics market. The story of the abandonment of that market by once-dominant domestic firms is a long and involved one. Respected analysts, however, have emphasized strategic mistakes made by American corporate managers and the extremely high costs that would now have to be absorbed to regain their original positions.[36] But underlying governance structures enabled two non-Japanese firms based outside the United States to calculate their strategic options in a different light, and therefore to stay in a market whose top tier is now dominated by a few Japanese firms (as shown in figure 7-2).

There is a connection between the survival of Thomson Consumer Electronics and Philips Electronics in the U.S. consumer electronics market and the nature of their respective shareholder bases. Although privatization plans for its parent company have been looming for several years, Thomson is in reality owned by the government of France. Common shares in Philips are more widely held; the company relies on no one lead bank

36 See A Chandler, "Chemicals and Electronics: Winning and Losing in Post-War American Industry," pre-publication manuscript, Harvard Business School, November 1993. The author notes that the domestic market for consumer electronics grew at a compound rate of 15.2 percent between 1976 and 1986, but the share produced domestically plummeted from nearly 100 percent in 1950 to about 5 percent in the late 1980s. After 1986, the consumer electronics operations of all but one major U.S. firm, Zenith, had been acquired by foreign MINEs.

FIGURE 7-2: World's Leading Consumer Electronics Firms, by 1991 Electronics Sales



NOTE: Electronics sales are revenues earned by each company from sales of electronic products and services

SOURCE "The Electronics Business International 100, *"Electronic Business 18(12) 84-85,* December 1992

and its shareholders include foreign investors. However, a controlling block of voting rights, connected to special preference shares, remains vested in a foundation (Stichting Preference Aandelen Philips). That foundation, in turn, is controlled by a small board comprised of members of Philips' supervisory board and descendants of the founding family.[37] Combined with advantages generated by strong cash-flow from other operations, Philips did not face the takeover threats that helped shape the thinking of American rivals in the 1980s. To be sure, neither company is assured of future success. Especially in the United States, the market remains difficult, basic research has come under severe pressure, and long-run profitability is far from certain. The point, however, is that the dominant surviving players in a key technology sector are all embedded in corporate governance systems that differ markedly from the system characterizing most publicly owned corporations in the United States.

The three systems of corporate governance compared in this chapter each have their own strengths and weaknesses. It is important to emphasize, however, that they are all deeply rooted in distinctive national histories. The scope for drawing useful lessons from one system and applying them directly to another is therefore severely limited. Moreover, despite the expanding cross-jurisdictional operations of MNEs and the resulting insertion of particular forms of corporate governance into alien environments, convergence appears to be a long-run prospect at best. The challenge is to find new ways to balance across the Triad the benefits that result from the activities of MNEs without allowing their intensifying competition to compromise core values reflected in traditions of corporate governance. Frictions created by the deepening interaction of diverse systems of corporate governance must be managed. They cannot be assumed away.

[37] The 1993 Annual Report of Philips Electronics N.V. makes clear (on pages 62 and 63) that one of the purposes Of the foundation is to prevent unwanted overtures from other corporations. In this regard, the report states: "Should a situation arise in which the acquisition of a controlling influence in Philips Electronics N.V. by a third party appears imminent, the Foundation may resolve to exercise [the right to acquire] as many preference shares as there are common shares in Philips Electronics N. V."