The Financial Crisis and Corporate Governance

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What caused the crisis?

- The conventional wisdom is that the basic cause of the crisis was bad incentives in the mortgage industry

But now it seems much more is going on…

- The large global impact of the crisis suggests that the problems with subprime mortgages were a **symptom** rather than the cause

- The main problem is that there was a **bubble**, first in stock prices and then in property prices, and we are now suffering the fallout from the collapse of that

What caused the bubble?

- The monetary policies of central banks particularly the US Federal Reserve were too loose – they focused too much on consumer price inflation and ignored asset price inflation

- Global imbalances – the Asian crisis of 1997 and the policies of the IMF led to a desire among Asian governments to save funds

Why are things so bad?

- People made decisions based on the wrong asset prices for more than a decade
- In particular, people in the US increased their borrowing and lowered their saving in the belief that asset prices would continue to rise
- Now that the bubble has burst it is very unclear what the correct prices of stocks, property and commodities will be going forward and how much people should save

Price volatility is extremely high and this is chilling the economy

- Stock, commodity prices and exchange rates have been exceptionally volatile

- Individuals do not know how much debt they should have and how much they should be saving now the bubble has burst and firms do not know how much to produce or what investments to make

- These problems are considerably exacerbated by the financial crisis and the feedback effects it is having

The financial crisis

- The collapse in property prices in the US has led to enormous disruption in the global financial system
- The first problem was with subprime mortgages but now the problem has become a general problem of credit risk because of the uncertainty about long term prospects
- The crisis in the financial system has created large feedback effects into the real economy

To summarize:

- The first aspect of the problem is the development and subsequent bursting of the stock and property bubble and the need for people to revise their saving decisions

- The second aspect is that this problem is considerably exacerbated by the poor functioning of the financial system in the crisis

Why has the financial system performed so poorly?

- Why didn’t regulation help?
- Banking regulation is different from other kinds of regulation in that there is no wide agreement on the market failures it is designed to correct
- It is backward looking in the sense that it was put in place to prevent the recurrence of past types of crises

Rationale for regulation

- But what are the benefits and costs of regulation?
- What exactly are the market failures?
- The Basel agreements illustrate the lack of a widely agreed theoretical framework

The market failures

The most important are:

1. Inefficient liquidity provision

2. Mispricing due to limits to arbitrage

3. Contagion

Current policies – An assessment

Central banks and governments are concerned to get banks lending again and are spending huge amounts to “solve the problem”

- Fear of lending versus liquidity hoarding?
- Anticipation of deflation and paying down of debt?
- Better to temporarily nationalize the banks than current policies such as Geithner plan

- Governments have been assuming that if only they can get the financial system to operate properly the problem will disappear

- But the issue of price uncertainty after the bursting of the bubble will remain and may take a long time to resolve (e.g. Japan’s 15 year adjustment of real estate prices)

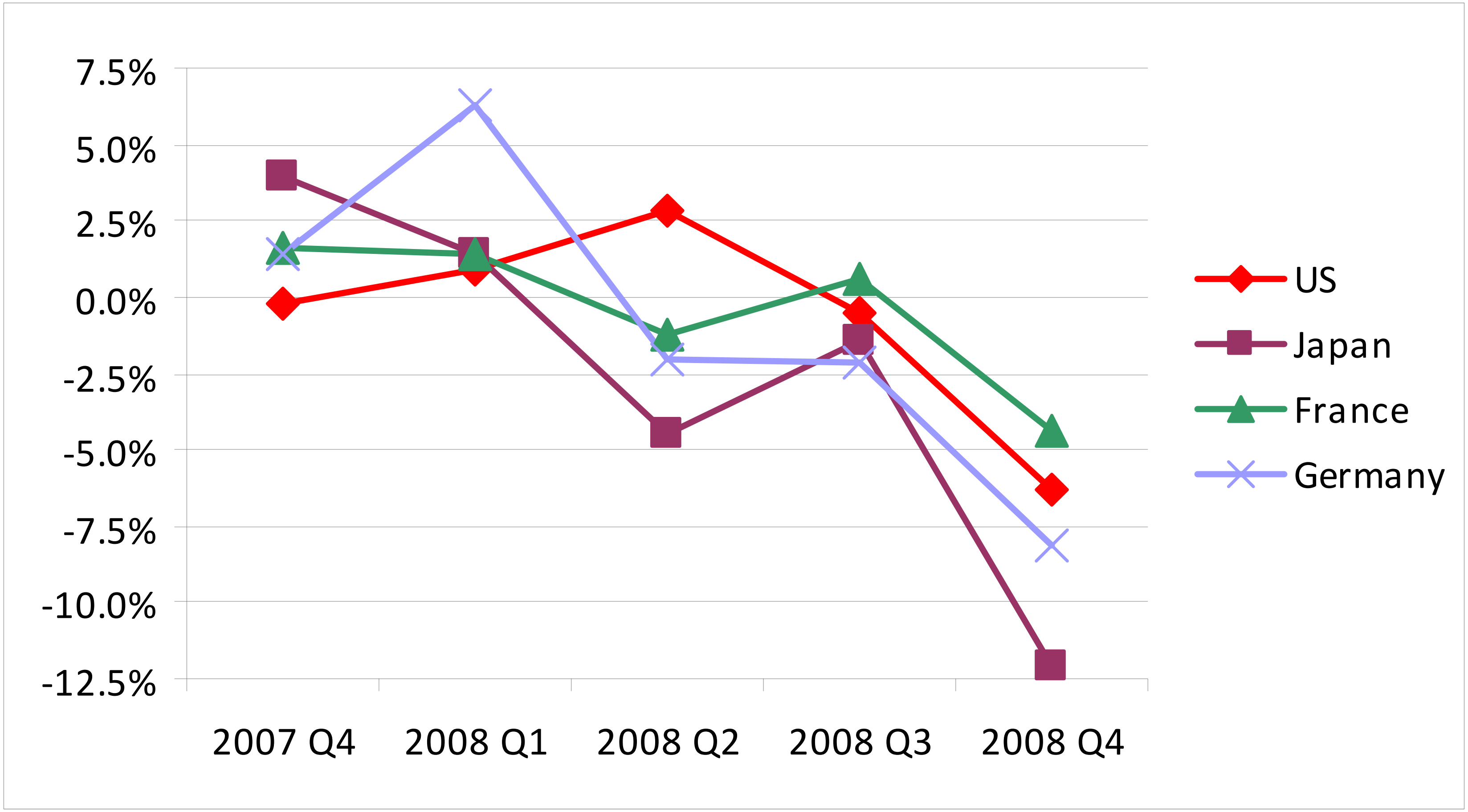
- Current government policies will have little effect on this problem and may exacerbate it

Corporate governance and macroeconomic stability

- One factor that has not received much attention in the crisis but that is important for macroeconomic stability is corporate governance

- Japan and Germany have had much bigger falls in GDP than the U.S. but their unemployment rate has been much less affected

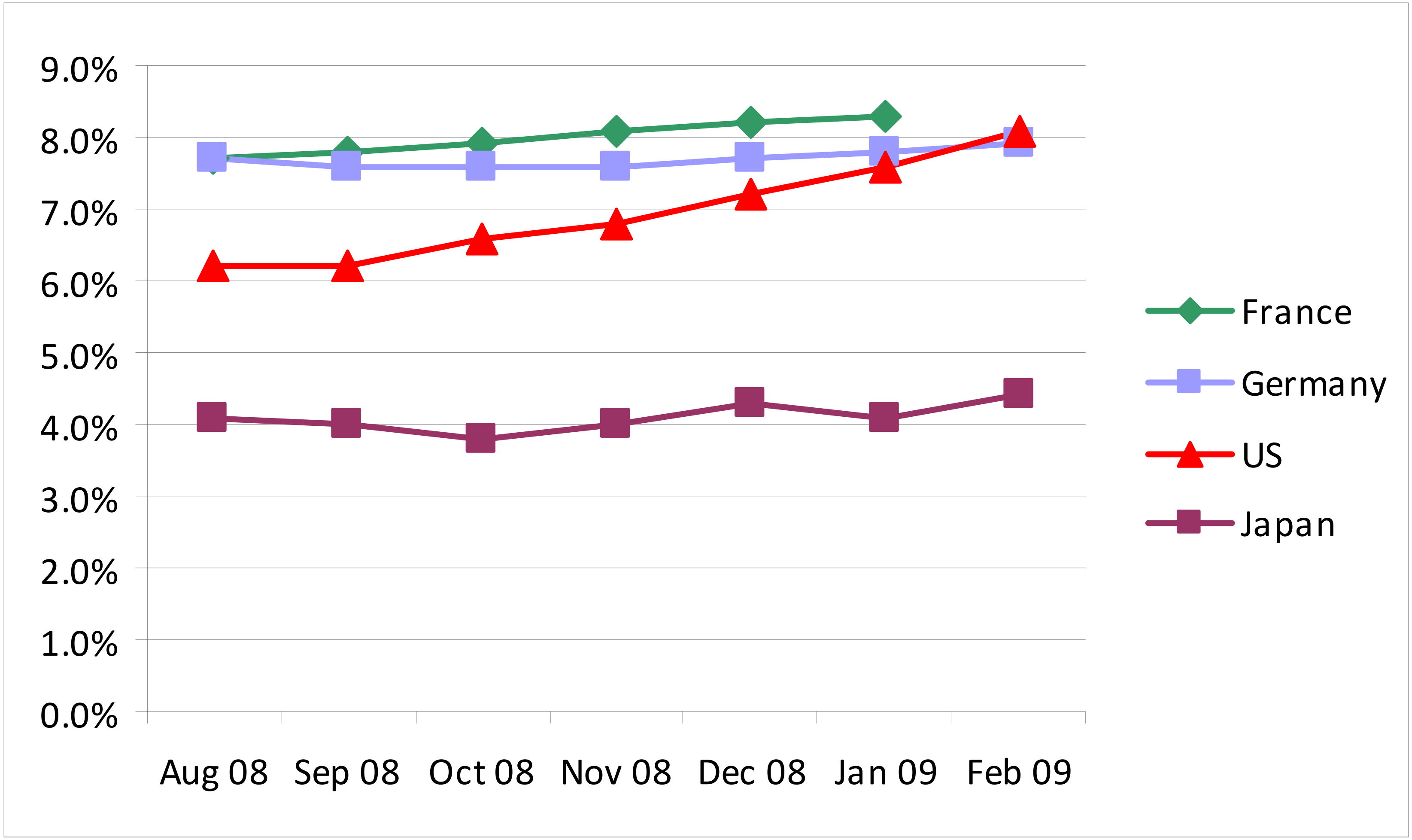
GDP growth rate evolution



Growth rate compared to previous quarter, annualized, seasonally adjusted

Source: OECD Stat Extracts

Unemployment Rates



- In the U.S. fear of unemployment for oneself and people in your immediate family is one of the main drivers of reductions in consumption
- In France, Germany and Japan fear of unemployment appears to be much less of a problem
- How can this difference in the relationship between fall in GDP and unemployment across countries be understood?
- One explanation is that corporate governance is very different in these countries

Firm priorities

Survey of managers:

Which of the following two would be the most prevalent view in your country?

(a) A company exists for the interest of all stakeholders

(b) Shareholder interest should be given the first priority

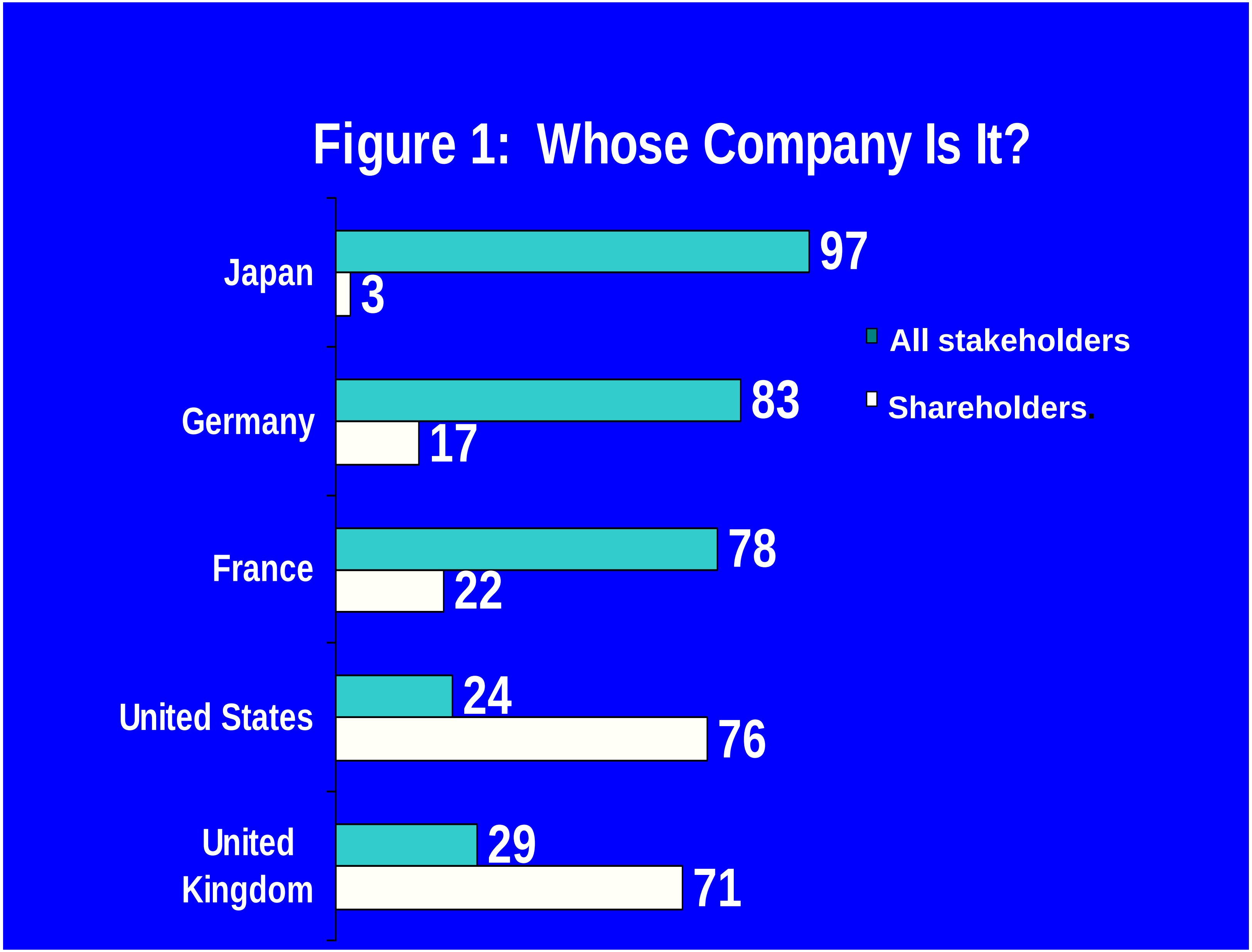


Figure 1: Whose Company Is It?
Japan
97
3
Germany
83
17
France
78
22
United States
24
76
United Kingdom
29
71
All stakeholders
Shareholders.

Firm priorities (cont.)

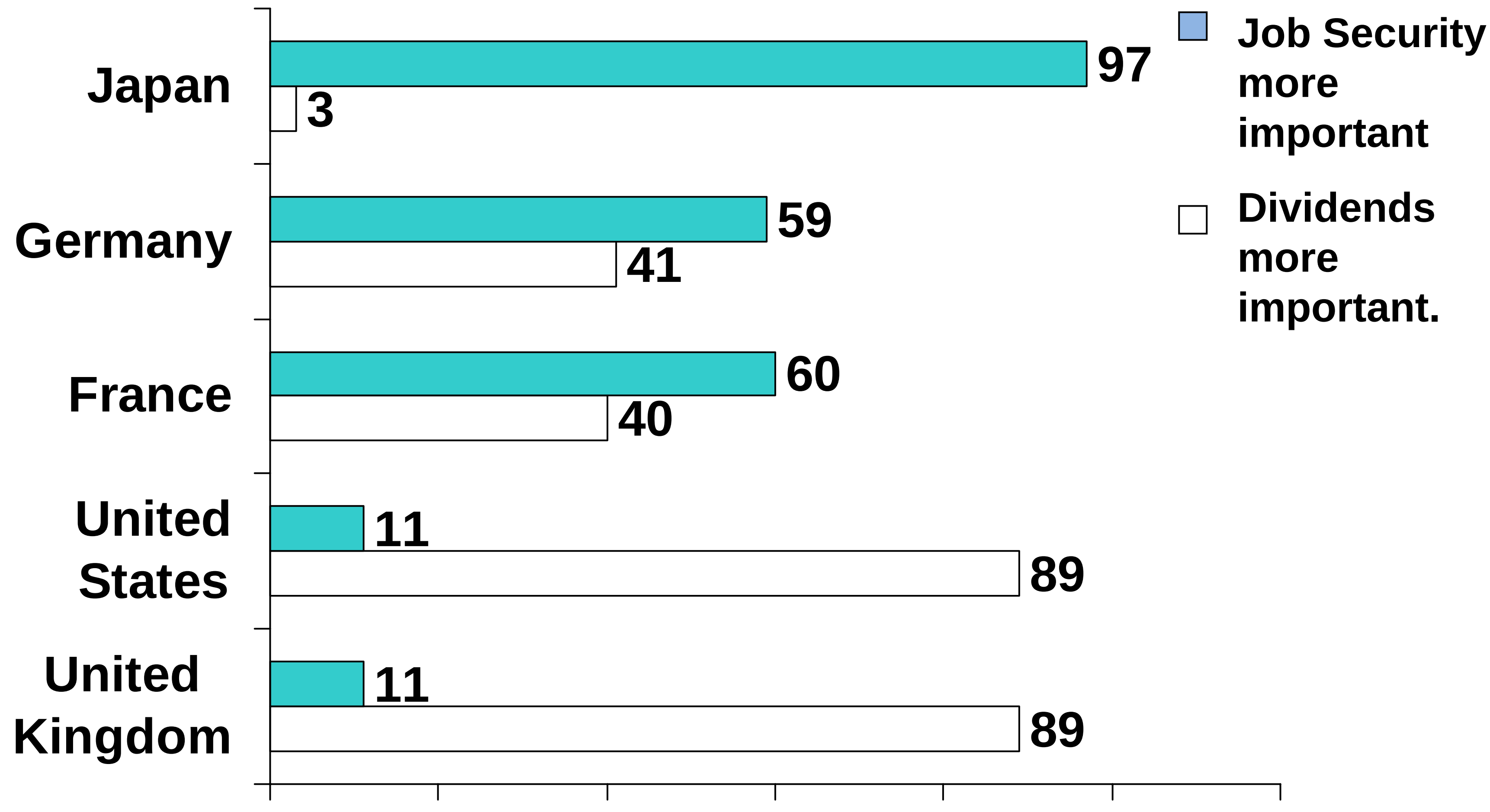
Survey of managers:

Which of the following two would be the most prevalent view in your country?

(a) Executives should maintain dividend payments, even if they must lay off a number of employees

(b) Executives should maintain stable employment, even if they must reduce dividends

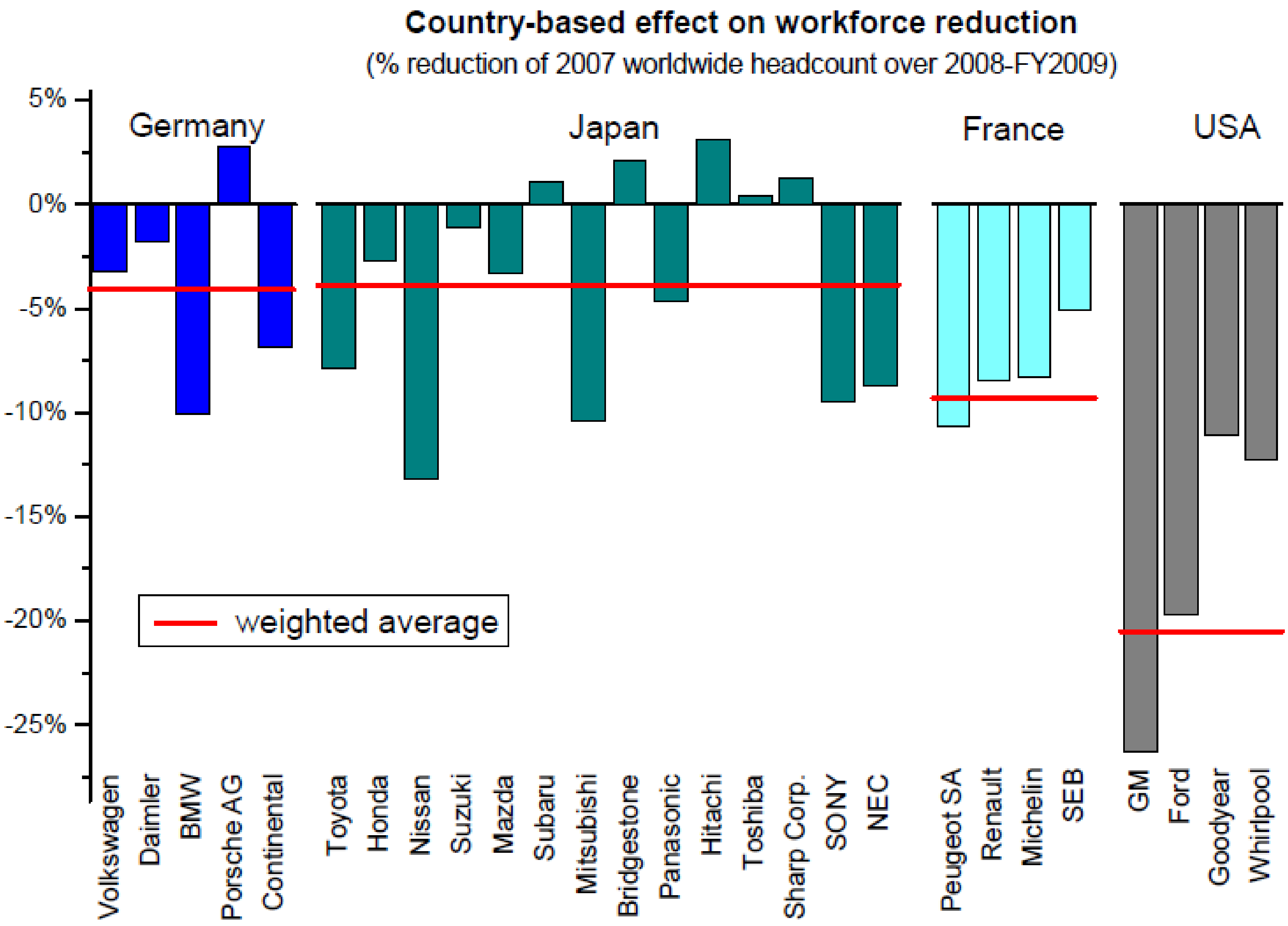
Figure 2: Job Security or Dividends?



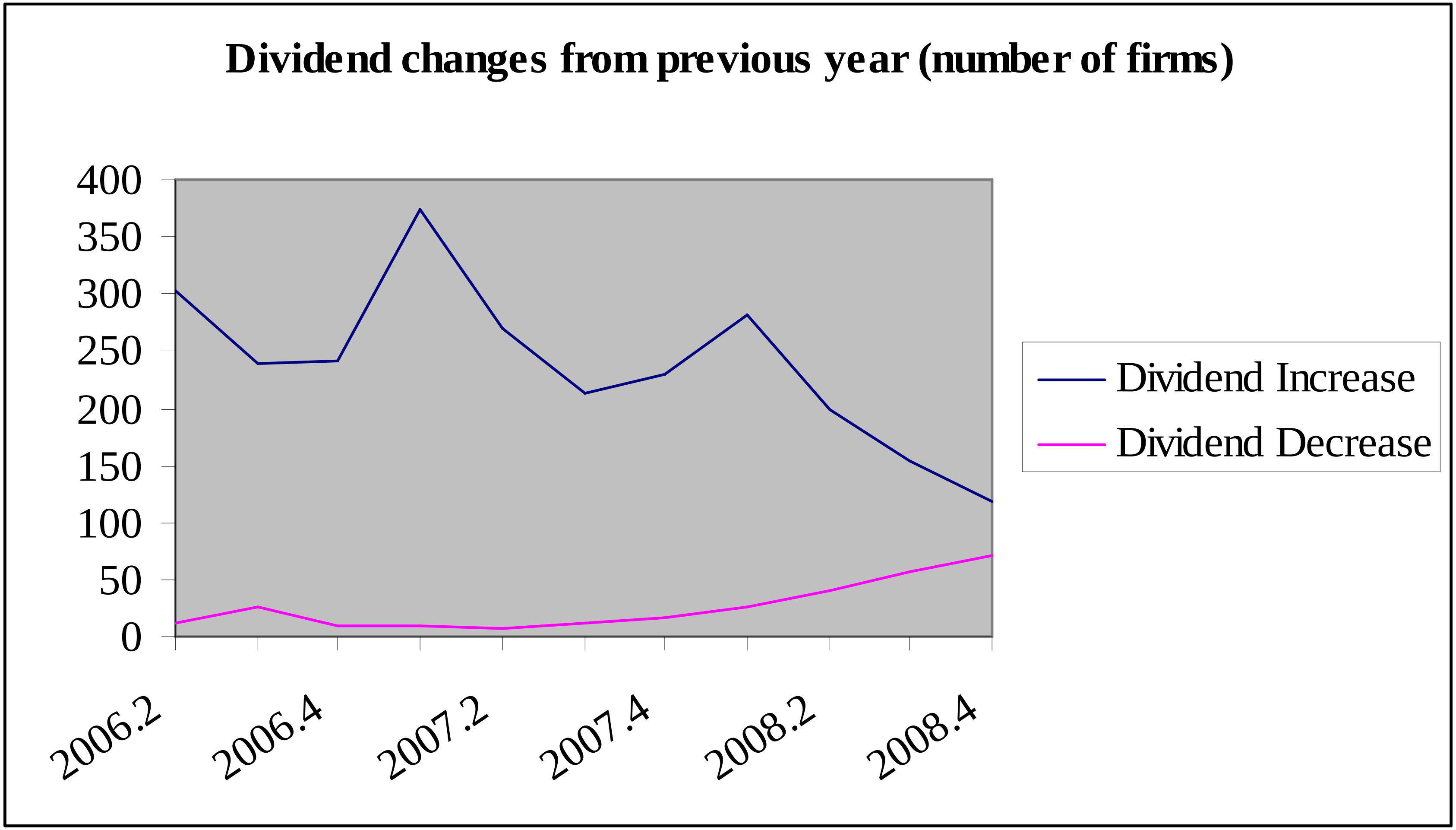
Governance and the crisis

- This last question suggests that in times of crisis there may be a significant difference in how shareholder and stakeholder firms react
- Shareholder firms may be much more willing to fire workers and this can have important effects in terms of macroeconomic stability
- We will focus on differences between the U.S. and France, Germany and Japan

Workforce reductions by country



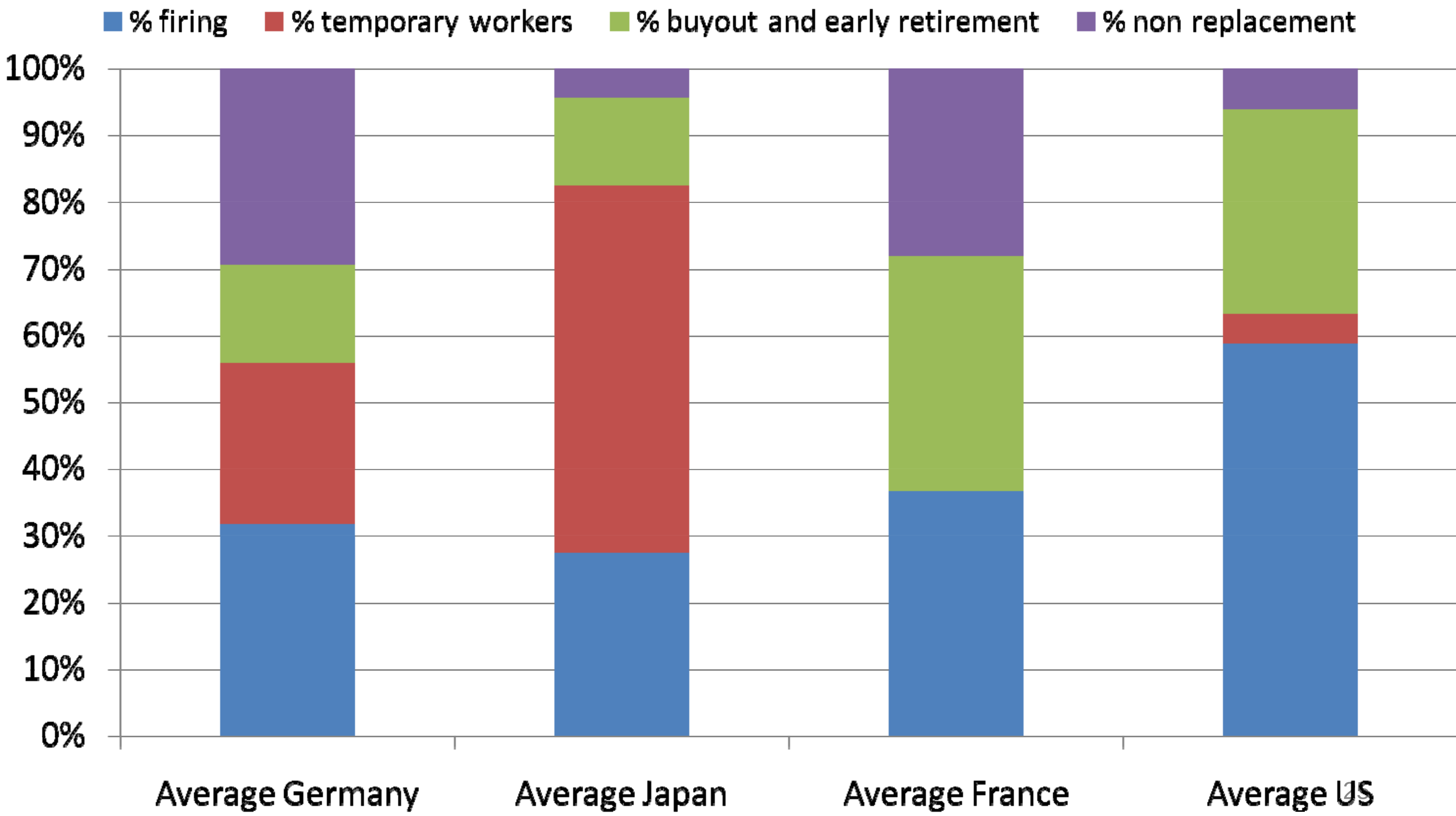
U.S. dividend changes



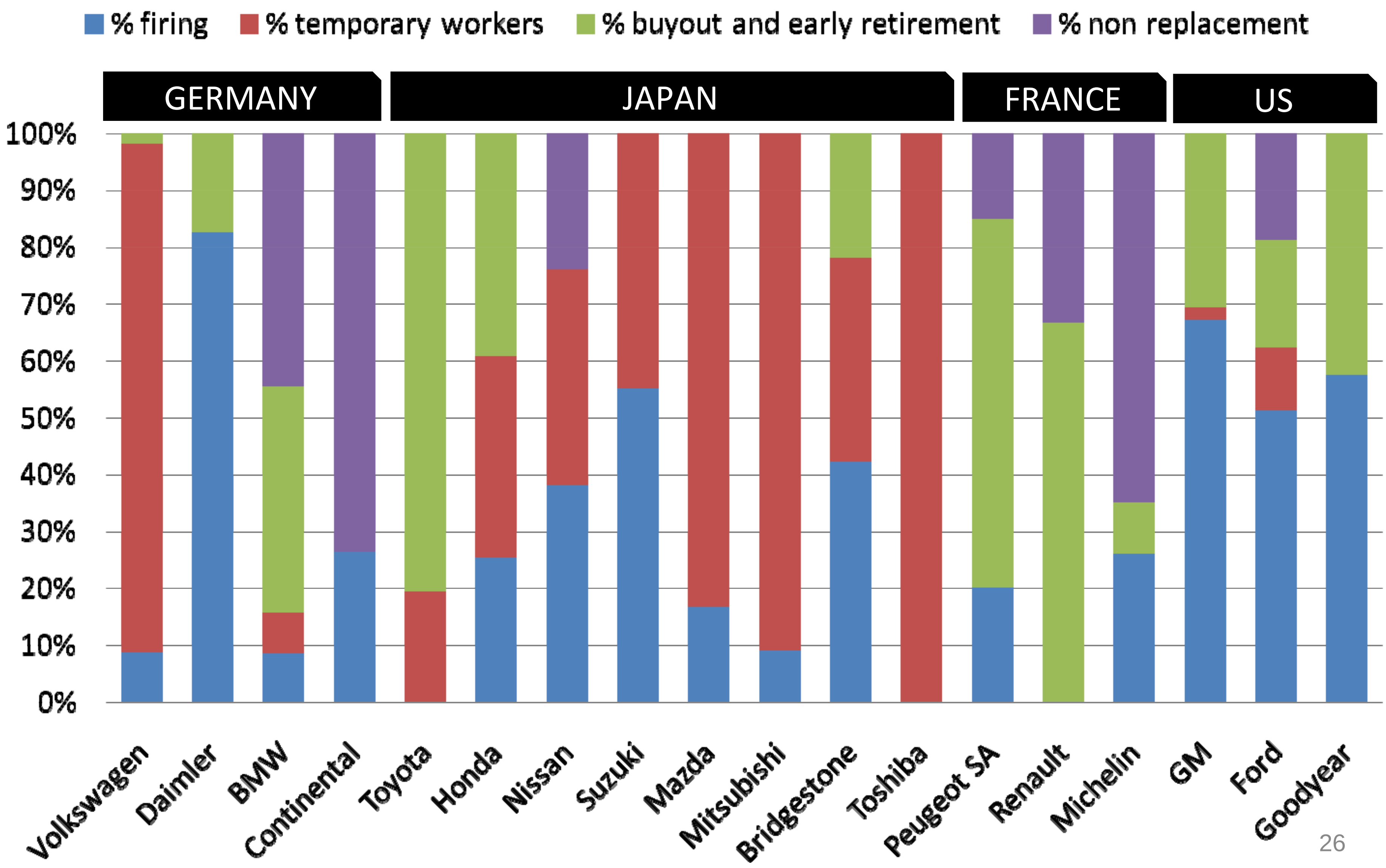
Comparison of dividend changes

Country	Year	Number of firms	% omit	% incr.	% decr.	% same
U.S	2006	1810	4	67	11	19
	2008	1719	6	53	20	21
Germany	2006	249	8	56	11	24
	2008	317	8	43	45	4
Japan	2006	2911	4	48	10	38
	2008	3118	7	34	17	41

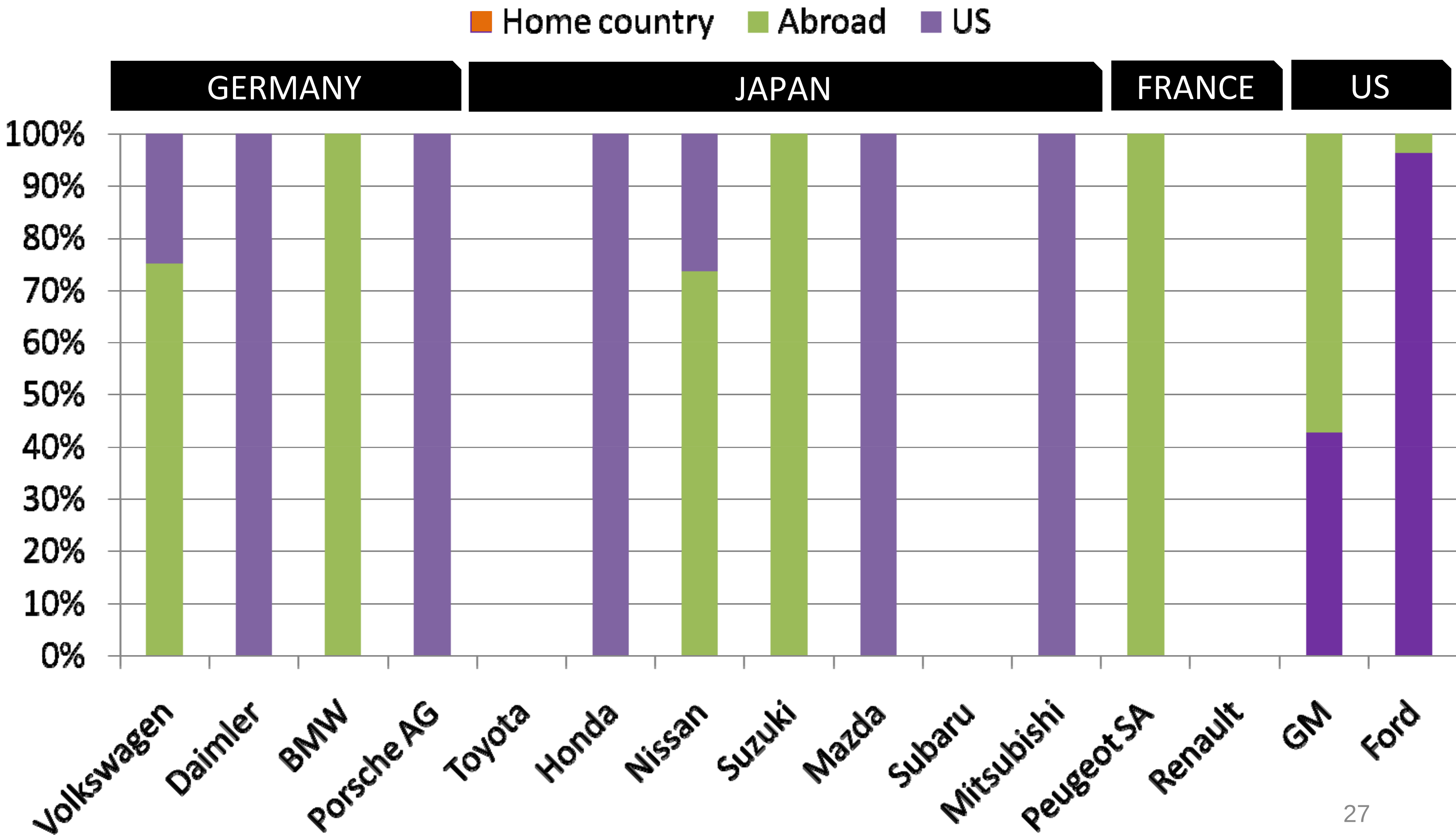
Workforce reduction methods



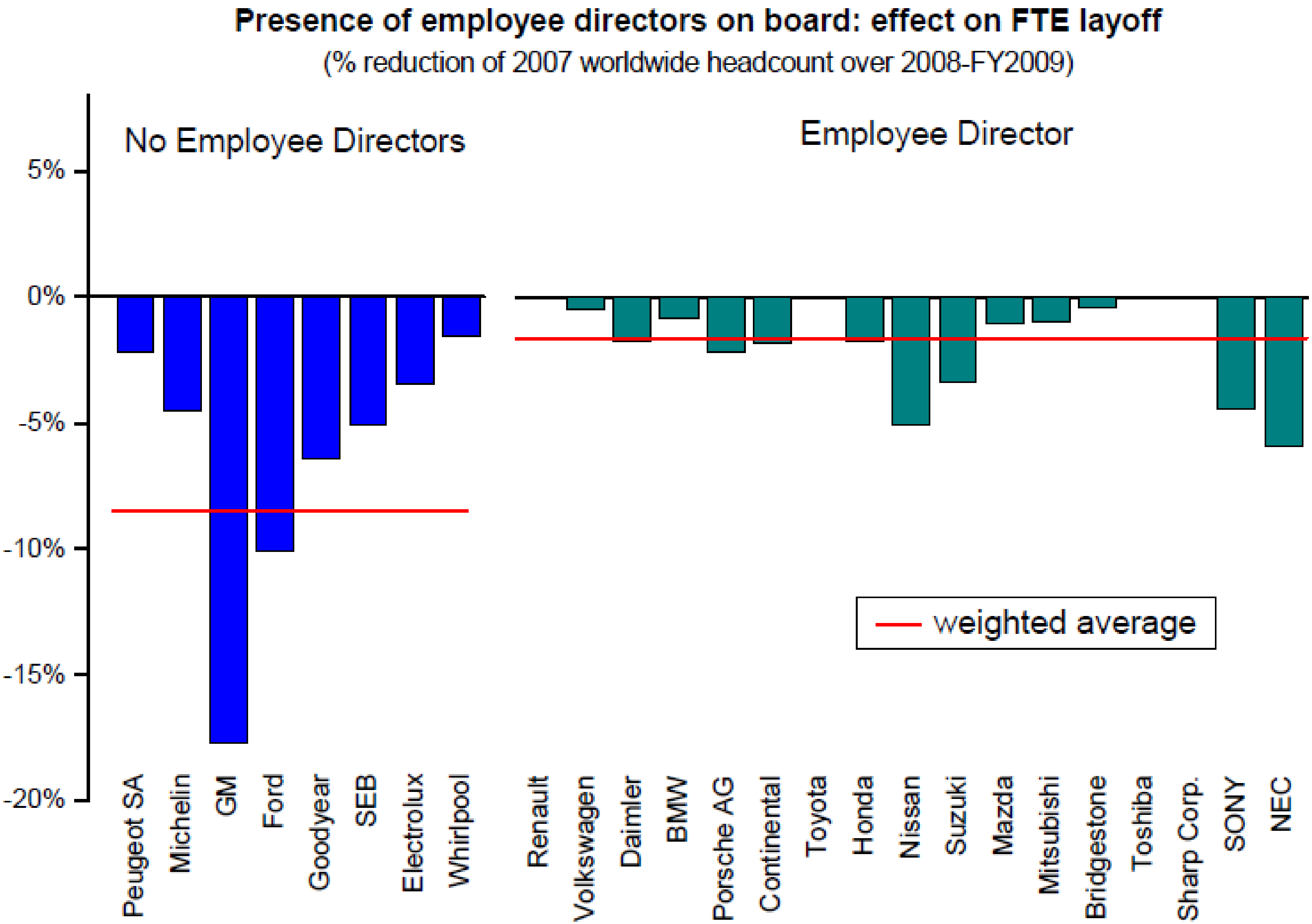
Workforce reduction methods



Firing of Full-time workers by Region



Employee Directors



Concluding remarks

- Anglo-Saxon system works well in booms but has undesirable macroeconomic spillovers in times of crisis

- Globalization has led to the U.S. becoming a dumping ground for some firms' unemployment

- Stakeholder system works well in downturns and avoids spillovers

- A full evaluation of stakeholder governance is needed