

COASE AND THE REFORM OF SECURITIES MARKETS: DISCUSSION

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Simon Johnson's paper, "Coase and the Reform of Securities Markets," is an extensive and useful review of the relevant literature, which has become quite voluminous in recent years. Johnson addresses various legal issues, based upon a host of cross-country comparisons. His major conclusions, that law definitely matters, that legal origin is not destiny, and that legal reform works, hardly seem controversial. Given the complexity of the real world in which we live and the prevalence there of lawyers, how could it be otherwise? One wonders why it took us so long to obtain evidence supporting these conclusions. After all, markets are not perfect. Enforcement is uneven. Cultures do differ. The behavior of investors, governments, and other private sector actors is sometimes erratic and constantly changing. So are the rules and regulations by which we are expected to play—and we do not always abide by them. The simple fact is that the strict assumptions we commonly use in our analytical constructs are not so common in the world that we are trying to analyze.

My thoughts and perspectives are not those of a theoretician but those of a practitioner, since I spent many years working at a global securities firm. And at the Milken Institute we are now engaged in a variety of research projects that touch on one or another of the issues raised in this stimulating paper. I will not comment at any length on the survey work that Johnson has done. Rather, I will focus on two quite separate and distinct items and try to stimulate interest in some further research.

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First, I want to sound a systematic caution. All international comparisons are highly complicated. It would be easy to reach inappropriate conclusions by failing to fully take into account these complications and complexities. The result would be that dangerous lessons might be drawn regarding policy, structure, and conduct of the markets and both private sector and public sector actors. I will raise a variety of points that merit further exploration, although I am not volunteering for such an assignment.

Second, I want to bring to your attention some of the work being done at the Milken Institute on what we call our “capital access index.” It is a first effort—and it is ongoing—in an attempt to collect in one place the relevant data around the world that provide the raw material for the type of analyses surveyed by Johnson. We have been working on this project over the past two years, trying to quantify some of the international differences that are important ingredients in many of the papers that Johnson cites.

GLOBAL MARKETS AND SOME COMPARISONS AND COMPLICATIONS

I confess to not having read all of the references cited in the paper. Nonetheless, I was struck by the breadth of the survey and, more to the point, by the analytical task faced by the various authors trying to make sense of the welter of data and problems associated with so many diverse countries.

Dealing with global markets and market participants over the years drives home the complexity of cross-country comparisons. People, countries, cultures differ. Ways of doing things that are acceptable, or not, differ. Accounting standards differ, as do rules, governments, and enforcement. The quality of the data for the private sector and the public sector differs. Objectives of individuals and companies and countries differ. And to make matters even more complicated, change is perhaps faster now than at any time in recent memory. This implies that caution must be the watchword.

Globalization and Inter-Country Comparisons

Globalization of economic activity and financial markets is upon us. An increasing share of economic activity occurs outside the borders of the country where a company is headquartered. A great deal of caution is therefore in order when making the various inter-country comparisons

that are the raw material of so many of the articles surveyed. The process of analysis is more complicated than in the past. Consider an example.

Finland and the Case of Nokia

Nokia is the world's number one seller of mobile phones. It is a Finnish company, headquartered in greater Helsinki, but it is, in some sense, a Finnish—and Scandinavian—company in name only. A very small percentage of its 51,000 employees worldwide reside in Finland. Sales are also global, with the vast majority occurring outside of Finland. Nokia's production facilities and other assets are deployed worldwide.

Thus, most of the business activity that determines the firm's economic health and well-being and the returns to investors occurs outside Finland. The rules, regulations, and laws that determine the environment in which Nokia operates are more global than local. This activity is not governed mainly by the laws and rules of Finland, but rather by those of all the other host countries. And to the extent that the Finnish management of the firm bring their own customs, values, and behaviors to other host countries, the economic performance of the company is not even comparable to what might be otherwise expected in those host countries.

So what does it mean to compare financial or other performance statistics in Finland that are driven by Nokia's results? Nokia (and Finland) is perhaps an extreme example, but by no means is it an isolated one. Nokia's market capitalization of about \$85 billion dominates the Finnish stock market, accounting for about 60 percent of the total market cap of roughly \$140 billion. But what does it mean to use it as a significant measure of the Finnish equity market? And should results for Nokia be realistically used as a measure, pro or con, for judgments about their equity market? Should lessons from the Finnish stock market, given what we know of Nokia's dominance, be used as a base of comparison around the world?

Perhaps it would be more useful to eliminate Nokia from the Finnish calculations—or, more precisely, to eliminate the non-Finnish operations of Nokia from the calculations. Include only those companies in Finland that are solely Finnish—or just use their Finnish operations. Then, by parallel reasoning, add in the Finnish operations of other companies that are headquartered outside Finland into the calculations. This exercise would not be easy; perhaps it is not even feasible to pull out the Finnish operations from a global firm in order to make such calculations. But it would be an instructive exercise, and, despite the assumptions required, would form a basis for comparison and analysis that I believe would be just as instructive as pretending that worldwide Nokia's fortunes say something useful about Finland per se.

The Trend Toward Globalization

There is no mistaking this trend, and several aspects of it deserve mention. Cross-border merger and acquisition activity is becoming more prevalent with the harmonization of rules, regulations, and laws, and with more even and uniform enforcement. So how should DaimlerChrysler be handled? Is it an American car company? Or is it a German car company? Or neither? Where should analysts put this company, when plying their trade? Where their assets are deployed says one thing. Where their sales are says another. And what about the culture, behavior, background, and practices of the management? This may be a lot more important than the address on their annual report.

Companies become global companies faster now and in a different way than in the past. The old model for the entrepreneur was to start selling locally, then statewide, then regionally, then nationally, and finally globally. In the mainstream of the U.S. manufacturing sector, that process might have taken two decades. Now, the first thing a new firm does is open up a web site that has a global reach. The first sale may be to a customer across the world, not across the street. Many young companies now are fully as global after one or two years as others have become after one or two decades. So the problem of understanding how to interpret some of the findings of the studies cited by Johnson will become more difficult, not less.

Some Domestic Examples

Just as the comparisons across countries are difficult, at a different level a similar set of issues arises when making comparisons across states within the United States. Bank of America is now a North Carolina bank—or so the headquarters would suggest. But a relatively small share of its operations occur in that state. No one would argue that a change in the regulatory environment in North Carolina, or a local ordinance in Charlotte, would have much effect on this global operation. Or consider Fleet Bank and Rhode Island.

Wal-Mart is another domestic example that is instructive. It is an Arkansas-headquartered firm, but other than its headquarters, few of its operations are in that state. What can we learn about Arkansas by looking at Wal-Mart's performance? Arkansas state laws are relatively unimportant. And local rules and regulations in the city of Bentonville, where the headquarters are located, are even less relevant. Or what about the companies headquartered in Delaware because of the laws that they have chosen to incorporate under, even though they are not major domestic players in the state?

Citigroup, the parent of Travelers Insurance, the securities firm of Salomon Smith Barney, and the commercial banking arm Citibank, is

another case to consider. One of the premier global commercial banking names of the last half-century, Citibank has offices and employees in over 100 of the 191 United Nations countries or 182 World Bank members. Is it really a U.S. firm? Its activities are governed by rules globally, not just by those in the United States. (As an aside, on the eve of World War II, there were about 70 countries around the world.)

Laws, Regulations, Harmonization, and Enforcement

Johnson briefly discusses harmonization and convergence on the U.S. model. It strikes me that global competition is going to drive this process, and it is not clear that convergence will necessarily center on the U.S. practice (no matter how much we like the idea). It is worth remembering that the concept of return on investment is still quite foreign in many places around the world, where many enterprises are state-owned. Even in Japan, for example, a ranking of the importance of the stakeholders in a corporation would likely put the employees and management—and maybe the suppliers and customers—ahead of the owners, in their meritocracy. Other countries could be cited similarly. So it is not at all clear that this convergence will follow what our theoretical desires would suggest.

Much of the literature and analytical attention over recent years have been focused on the best laws, legal institutions, regulations, and regulatory systems and bodies to achieve whatever is at issue. This is an important and a legitimate focus of attention and decision. But it is only half the issue. Enforcement—the other half of the issue—has been long neglected. Laws and regulations on the books are of little consequence if they are not enforced evenly and uniformly. An unenforced consequence is no consequence at all!

An instructive case outside the more narrow issues of the financial markets deals with intellectual property rights. In the early 1990s, there was a growing outcry that intellectual property rights were being ignored in China. The outcry finally became so great that a team of legal experts from the United States—and to a lesser extent from Europe—was assembled. They spent perhaps a full year in China and in the United States, writing what are widely regarded as the most up-to-date and comprehensive intellectual property rights laws in the world. The problem is that they are not enforced uniformly.

One other point. That laws matter is not difficult to say, or to defend. Again, this is just a start. It is more difficult to say which ones matter. Do they all matter? Equally? Do particular ones matter more than others? How can we identify them? The new Gramm-Leach-Bliley banking law is 144 pages long. Just one law. Is this law one that matters, or one that does not? How would we know? And which of its constituent parts matter most or least?

THE MILKEN CAPITAL ACCESS INDEX

Under the direction of Glenn Yago, our Director of Capital Studies, the Milken Institute has been investigating a variety of questions that are directly related to the concerns of Johnson's paper. A brief summary of this work follows. I encourage any of you who are interested in this effort, and those of you who might wish to become involved, to contact us.

Overview

The Milken Institute Capital Access Index (CAI) identifies quantitative and qualitative measures of the ability of an entrepreneur (broadly construed to include an innovator, manager, owner, or other economic agent) to gain access to capital. These funds might be used to start a new enterprise, expand a promising line of business, or restructure a large multi-industry firm. A fundamental assumption underlying the CAI is that easy access to capital will tend to enliven and infuse a country's economy with the ground-floor competition necessary for innovation, profitability, and long-run growth. This in turn will open wealth acquisition to all individuals—not just a select, ensconced elite. Countries that promote access to capital will possess more competitive markets and will, in the long run, be rewarded with superior economic performance. For this reason, it is not a coincidence that many of the measures used in the CAI are also good indicators of long-run securities market performance (returns) as well as economic growth.

General and Specific Measures of Capital Access

Vast quantities of data on international economic conditions and activity exist, much with direct or indirect bearing on "capital access" as broadly construed. In order to determine the measures to be included in the CAI, we asked: *What sources of capital empower an entrepreneur to start a new company or reform an existing one? How can financing ideas create new realities?*

We have constructed several general measures of capital access, which in turn are composed of several specific variables (either quantitative or qualitative in nature). This allows us to include the maximum number of countries in the Milken Institute Capital Access Index, while at the same time using as many different measures as possible. Table 1, Categories and Measures of Capital Access, shows the general measures of capital access, as well as the precise variables we considered.

The general economic environment includes vital preconditions for entrepreneurial activity. Macroeconomic measures reflect important variables relating to inflation, interest rates, and fiscal policy. Institutional measures reflect the fact that capital access will be constrained if legal

Table 1
Categories and Measures of Capital Access

Categories	Specific Measures
<u>General Environment (E)</u>	
Macroeconomic Environment (EM)	Inflation rate, short-term interest rate, interest rate volatility, government spending over GDP, corporate income tax level, capital gains tax
Institutional Environment (EI)	Property rights and contract enforcement (including risk of expropriation, risk of contract violation, and rule of law principles), corruption perception index, state interference in business, role of state-controlled enterprises, government regulation, creditor rights, accounting transparency
<u>Banking Sector (B)</u>	
Banking Sector–Depth (BD)	Claims of nonfinancial private sector to GDP, bank assets over GDP, domestic assets over GDP, claims to private sector over total domestic assets, ratio of claims to assets
Banking Sector–Governance (BG)	Moody’s Bank Strength rating, bank concentration ratio, state ownership of banks, entry to banking industry, interest margins
Banking Sector–Repression (BR)	Share of domestic credit to private sector, reserve requirements, real interest rates, interest rate controls
<u>Capital Markets (K)</u>	
Capital Markets–Equity (KE)	Equity market capitalization over GDP, equity market liquidity, IPO formation rate, equity market volatility, firm concentration ratio, number of listed firms over population
Capital Markets–Bonds (KB)	Private sector domestic debt securities over GDP, public sector domestic securities over GDP, market-adjusted debt ratio (MAD), private over public sector debt
Capital Markets–Advanced (KA)	Venture capital funds, bond market development, VC over GDP, availability of venture capital, private placements over GDP
<u>International Capital Access (I)</u>	
Internat’l K Access–General (IG)	Total reserves over GDP, foreign investment ceiling, foreign access to capital markets, corporate control by foreign investors, relative currency volatility, international bonds and equities issued by private corporations over total international bonds and equities issued, foreign investment protection
Internat’l K Access–FDI (IF)	Foreign direct investment (FDI) over GDP
Internat’l K Access–Portfolio (IP)	Portfolio flows (stocks, bonds, and total) over GDP
<u>Sovereign Bond Ratings (S)</u>	Moody’s, Standard & Poor’s

contracts are not enforced, or if private or government agents can expropriate assets or earnings with no recourse.

Given the basic condition of a sound macroeconomic and institutional setting, the next important aspect of capital access concerns the ease of securing bank lending. In what countries are banks free to lend to projects of their choice that will be likely to yield high returns? Which countries have competitive markets? Where are banks dominated by repressive policies or outright state ownership? Is the banking sector stunted or robust?

A third set of variables is meant to capture an additional avenue of capital access: equity and bond market development. Equity and debt are vital sources of start-up and continuing external finance, and can even facilitate the restructuring of entire industries. More sophisticated instruments, such as securitization, are included in our measure of advanced capital market development. In many countries, such instruments and markets are underdeveloped and do not serve the interests of the demanders of capital. Access to international capital provides an additional source of funds for entrepreneurs and active capital market participants. Poor national credit ratings can be a significant barrier to capital access. We consider these ratings on the premise that the various rating agencies bring additional expertise and knowledge of these markets to bear in assessing country ratings. We use sovereign credit ratings produced by Moody's and Standard & Poor's (and, where available, Institutional Investor, ICRG, and Euromoney). Our rankings for the various countries are shown in Table 2.

Previous Capital Access Index Rankings

The Milken Institute Capital Access Index has been published in a variety of iterations covering various regions since 1998. We have used similar measures in the past, and the current version is largely compatible with previous versions. We have also calculated CAI historical values and rankings for many groups of countries that go back decades. CAI values and comparative rankings are available upon request for non-profit, research purposes; please contact the Milken Institute Capital Studies Group for more information.

We are involved in a variety of spin-off projects from our core work on capital access. We often talk of transparency and its importance in economic and financial transactions. We have been working on developing an "opacity" index—to measure the degree of transparency (or its converse, opacity) across economies around the world. We have taken the first steps toward measuring the cost of opacity, working with the firm of PriceWaterhouse Coopers and their offices around the world. This is a work in progress.

We have also devoted considerable attention to the rules, regula-

Table 2
Capital Access Index 2000 Rankings

Rank	Country	Score	Rank	Country	Score
1	United States	5.415	42	El Salvador	4.121
2	Hong Kong	5.373	43	Poland	4.100
3	Switzerland	5.360	44	Costa Rica	4.074
4	Luxembourg	5.343	45	Lithuania	4.071
5	United Kingdom	5.333	46	Nigeria	4.059
6	Singapore	5.220	47	Slovak Republic	4.044
7	Netherlands	5.128	48	China	4.041
8	Estonia	5.080	49	Peru	4.021
9	New Zealand	4.958	50	Greece	4.020
10	Australia	4.943	51	Jordan	4.000
11	Canada	4.923	52	Czech Republic	3.981
12	Germany	4.808	53	Bolivia	3.973
13	Taiwan	4.775	54	Indonesia	3.957
14	Malaysia	4.714	55	India	3.907
15	Finland	4.692	56	Morocco	3.897
16	Spain	4.647	57	Botswana	3.833
17	Ireland	4.640	58	Mexico	3.774
18	Sweden	4.627	59	Guatemala	3.769
19	France	4.600	60	Brazil	3.706
20	Japan	4.566	61	Ghana	3.688
21	Thailand	4.560	62	Colombia	3.649
22	Israel	4.521	63	Paraguay	3.625
23	Denmark	4.520	64	Pakistan	3.571
24	South Korea	4.519	65	Ecuador	3.564
25	Croatia	4.500	66	Turkey	3.556
26	Hungary	4.488	67	Zimbabwe	3.531
27	Italy	4.481	68	Romania	3.500
27	Portugal	4.481	68	Honduras	3.500
29	Belgium	4.467	70	Jamaica	3.414
30	Norway	4.453	71	Venezuela	3.408
31	Chile	4.451	72	Kenya	3.345
32	South Africa	4.423	73	Bulgaria	3.306
33	Iceland	4.410	74	Vietnam	3.167
34	Slovenia	4.409	75	Uruguay	3.097
35	Austria	4.289	76	Ivory Coast	2.950
36	Mauritius	4.231	77	Ukraine	2.900
37	Tunisia	4.214	78	Kyrgystan	2.867
38	Egypt	4.208	79	Malawi	2.833
39	Latvia	4.194	80	Russia	2.763
40	Argentina	4.154	81	Belarus	2.733
41	Philippines	4.137			

tions, structure, and ownership of banking systems here and around the world. That work, led by James Barth, a Senior Fellow at the Institute, has also addressed issues raised by Johnson, and it is integral to our broader so-called capital access work.

CONCLUSIONS

The Johnson paper addresses interesting and important issues that need further study. But the entire process of attempting to conduct analysis across countries and reach prescriptive conclusions about the appropriateness of rules, regulations, laws, processes, practices, and the like is even more difficult and problematic than it might first appear. When companies and investors are global in structure and scope, the old methods of analysis just may not work. It is important that we take care in not overstating conclusions that ignore the realities around us.

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