

IMPLICATIONS

KEY POINTS

- Increasingly, most regional governments recognise weaknesses in their corporate business environments helped cause and deepen the crisis; this has generated political will to upgrade corporate governance regulations and enforcement. A smaller number of governments also realise the need to strengthen market forces disciplining corporates.
- In crisis affected economies, the traditional relationship based business model is under threat, as major banks and corporates restructure or are nationalised and markets become more open. This breakdown increases the urgency of introducing a more rules based business environment, to replace increasingly unreliable relationships. A few regional economies are struggling with this transition and risk being left in limbo without a viable relationship or rules based business framework.
- In particular, the slow post crisis recovery in East Asian investment makes essential stronger market forces and regulations to increase corporate transparency and enforce better treatment of outside investors and creditors; these are crucial to restart lending and portfolio inflows and allow a return to robust growth.
- Australian businesses will be well advised to focus on those regional economies that are making the fastest progress in moving to a rules based business model; these economies are likely to return first to robust growth and to offer the fairest and most efficient business environment for foreign traders and investors. They will also offer the best opportunities for Australian professional and business service providers, as local firms need help to comply with new accounting and transparency regulations and indebted corporates need effective restructuring.
- To help avoid another financial crisis, Australian Government development assistance can contribute both to encouraging market forces and strengthening relevant regulations; promoting corporate governance is best done by promoting long term institutional linkages and technical assistance programs between counter-part public regulatory and private professional institutions in Australia and developing regional economies.

East Asia's relationship based business model contributed to the crisis; in turn, the crisis undermined many traditional bank and corporate relationships and their ability to deliver growth. Most regional governments now give high priority to upgrading their corporate regulatory framework and many are making good progress. Eventually a more reliable, rules based business environment should replace East Asia's traditional business model which overly depends on relationships.

Several emerging regional economies are still attempting to enforce a credible corporate regulatory framework that discloses company information, represents and protects shareholders and provides credible recourse to the legal system to enforce contracts and commercial laws. However, slow implementation and poor enforcement means these economies risk being left in limbo, where neither relationship nor rules based systems function efficiently. Hence, the future growth prospects of these East Asian economies are at risk and depend on ongoing reforms and successful enforcement.

If encouraged and reinforced, changes underway in East Asia's corporate sectors should deliver a more predictable rules based business environment; this will help deliver a return to more robust growth. Such systems would let all business people including existing players, new domestic entrants and foreign businesses access the lowest cost and most efficient inputs, finance and investments without relationships reinforcing contracts. In future, the typical corporate should have diverse owners and access a variety of finance sources. Banks would be independent of borrowing firms and firms would satisfy commercial criteria to obtain credit. Firms would enter and exit markets freely, ensuring only those generating a profit survive. Conglomerates would be rare, with firms forming alliances only when synergies exist. Large institutional investors would lead active shareholders. A mature regulatory and legal framework would underwrite this system, with well resourced and transparent regulatory authorities implementing it, backed by a strong history of successfully prosecuting non-compliers.

However, if some developing regional economies cannot overcome political and vested interests and their legal and regulatory system weaknesses persist, business will be forced back to its old relationship based approach. This still may function for some businesses in some economies, but increasingly, banks in such economies will be unable to deliver the credit needed for growth, as non performing loans will continue to rise. Share markets will be unable to replace banks, as local and foreign investors will not trust their funds to non-transparent corporates who do not represent minority shareholder interests. Arm's length suppliers of cheaper inputs will not supply their goods and services in case buyers refuse to pay. Eventually imported goods may out compete local products, or exchange rates may slide further. Such a scenario is highly undesirable.

IMPLICATIONS FOR BUSINESS

Major developments underway in corporate Asia have significant implications for Australian business. First, and most importantly, Australian companies need to be informed where the transition to a rules based business environment is occurring most effectively and where it is incomplete or stalled. Easily enforceable contracts would reduce trading and investing risks and new forms of contracting, including transparent tendering, would offer new entrants inroads to markets where once incumbents were strongly favoured. These developments should encourage Australian business to reconsider entering those East Asian markets where progress to a rules based system is most advanced.

Second, most middle income and emerging East Asian governments and corporates need professional assistance to upgrade their corporate regulatory environments and comply with new regulations, providing opportunities for Australian professional services firms. To implement newly introduced regulations, East Asian firms need to invest significantly in compliance capital. Australian accounting, auditing, legal, business consulting and training firms can offer valuable skills and services to implement this 'regulation revolution' in East Asia. Many Australian professionals already supply these services throughout the region, but demand should continue to grow if governments maintain momentum in moving towards a rules based system. Demand in China and Indonesia should grow particularly rapidly. Third, more intense competition and bankruptcy law enforcement should spur more corporate rationalisation, creating opportunities for consulting firms, underwriters, insolvency firms and information technology consultants. Opportunities for mergers and acquisitions also should increase in most regional economies.

Fourth, new and more effectively implemented securities market regulations gradually should protect minority investors better, reducing portfolio investors' risks. Eventually, improved stock and bond market regulations should justify more participation by Australian investment houses, pension funds, banks and other financial institutions. However, this process is more advanced in developed regional economies like Hong Kong, Singapore and now Japan; the Republic of Korea, Malaysia and Taiwan also are making progress in upgrading standards. While other economies are attempting regulatory strengthening, and some blue chips are upgrading corporate governance standards, the dominance of family owned corporates, issues of political will and regulatory capacity will require institutional investors to maintain a watching brief on most corporates in other emerging regional economies.

Finally, weak regional banks and stronger prudential regulations create opportunities for Australian banks with superior compliance systems to sell services to upgrade risk management and credit analysis capacity. More open foreign direct investment regulations makes participation by Australian bank and non-bank financial institutions more feasible, while entry by foreign financial institutions is helping raise corporate governance standards.

IMPLICATIONS FOR GOVERNMENT

This report has many important implications for East Asian and Australian governments. First, regional economies would benefit significantly from governments strengthening the market forces shaping more dynamic corporate sectors. Necessary support includes removing restrictions on international trade and investment flows, deregulating markets, privatising state enterprises and selling state held assets. To prevent moral hazard and a re-emergence of risky investment behaviour that contributed to the crisis, distressed assets should be sold to new, not previous, owners. Debtor companies should not receive preferential deals as these weaken incentives to improve financial management. Similarly bank shareholders and managers should not be bailed out, but should be forced to bear the consequences of their poor lending policies.

Second, most governments recognise they should continue to prioritise upgrading legal and regulatory frameworks governing corporate behaviour and match these with stronger enforcement. They need to continue supporting investors' efforts to tap new sources of investment finance with regulations supporting outside owners. Institutions enforcing new standards need adequate statutory backing and the necessary human and financial resources. Courts applying new laws must be autonomous and their personnel capable of adjudicating often complex cases. Strong official support for prosecuting cases involving powerful interests is crucial to demonstrate government resolve to enforce change.

IMPLICATIONS FOR DEVELOPMENT ASSISTANCE

Australia's development assistance program already is active in helping regional governments upgrade and enforce corporate governance regulations and laws. While regional governments already have done much to upgrade laws, some corporate, bankruptcy, accounting and security market laws and regulations still fall behind best practice, especially in emerging regional economies. Australia has a strong corporate regulatory framework and capacity to further assist regional governments achieve best practice corporate governance levels.

Building better corporate governance comprises two parts. The first requires drafting and implementing better corporate governance regulations. Most emerging regional economies lack capacity to implement and enforce corporate regulations and laws; many institutions vested with oversight responsibilities lack the experienced personnel and systems to do this effectively. The second broad assistance strand comprises measures to help develop market forces that can strengthen corporations' incentives to comply with new regulations. These include supporting financial market development by helping governments equitise SOEs, reprivatise banks and provide financial market infrastructure; and assisting governments open up goods and services markets, by lowering tariffs, reducing FDI restrictions and enforcing antitrust measures.

Already some Australian non-government organisations support regional counterparts in training company directors in their fiduciary duties and enforcing new accounting, auditing and legal codes. Australia's strong non-government organisations, including the Australian Institute of Company Directors, accounting and auditing professional bodies and legal professional fraternities, form a vital part of corporate governance enforcement in Australia. Supporting long term capacity building relationships between Australian non-governmental organisations and their regional counterparts is a very useful method of raising corporate governance standards. In strengthening market forces, the Australian Competition and Consumer Commission and Australia's Productivity Commission provide technical assistance to regional counterpart organisations to help them investigate market structure and conduct and recommend policy measures; building long term institutional relationships also would be beneficial to this work.

Opportunities exist for new Australian assistance projects. Many regional institutions would benefit from accessing advice from well respected Australian institutions enforcing corporate governance and prudential standards and commercial law, including the Australian Securities and Investments

Commission, Australian Prudential Regulation Authority, Australian Stock Exchange and the Australian Attorney General's Department. Already, many regional governments have sought assistance from these organisations under Australia's development assistance program.

Assistance in implementing new bankruptcy laws in many economies could include specialised training programs in commercial law for the local judiciary, developed by Australian experts and support facilities for informal workouts to deal with the backlog of insolvency cases. Helping to develop better methods of registering and tracking collateral pledged as security is also worthwhile.

Long term institutional partnerships between such key Australian institutions and their regional counterparts are an effective way to build capacity. Participating Australian agencies may require long term resources so they can focus on regional capacity building, without compromising other core programs. Scholarships for promising junior staff to specialised courses at Australian universities and short courses and secondments for senior personnel from and to counterpart regulatory agencies are proven methods AusAID has developed to build such long term relationships.

Finally, supporting an active non-government sector to press for better corporate behaviour remains a priority across developing Asia. The aid program could investigate ways of supporting a free and open financial press to undertake important corporate due diligence work. The aid program can also continue to help boost corporate transparency and ethics by assisting minority shareholder groups and other non-government organisations that scrutinise firm behaviour to lift corporate governance standards.

FUTURE PROSPECTS

East Asia's corporate sector changes have significant implications for the region's future growth prospects. It is no exaggeration that regional economies' success in implementing rules based business environments will determine whether they return to robust growth or languish. Hong Kong and Singapore already benefit from more transparent, rules based business environments; Japan is lifting transparency and regulatory standards, as are Taiwan, the Republic of Korea and Malaysia. For the emerging regional economies of Indonesia, Thailand, the Philippines and Vietnam, the challenge is clear.

