CRISIS DRIVES CORPORATE CHANGE?

KEY POINTS

- Increasingly, most regional governments recognise weaknesses in their corporate business environments helped cause and deepen the crisis, boosting the political will needed to upgrade corporate governance standards.

- 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, less dependent on relationships.

- Even before the crisis, many East Asian economies were outgrowing their traditional relationship based business. The most advanced regional economies and market leaders among East Asian corporates already adopt rules-based corporate governance models.

- Now, most regional governments are upgrading key corporate laws, listing rules, disclosure and accounting standards, assisting their economies to move towards a rules based business environment.

- Market forces reinforce this transition. Since the crisis, most regional economies have opened more to foreign investment and trade, and the shortage of bank lending and foreign capital forces many firms to seek finance directly from domestic finance markets.

- However, in emerging regional economies, developing effective regulatory capacity and implementing new laws and regulations is proving difficult; achieving this will take considerable time and resources.

- Also, most regional markets need time to instil new corporate cultural values so firms recognise higher corporate governance standards serve their interests, as well as society's.

To survive, East Asian corporations are changing. Falling demand, failing investments and rising insolvency are forcing many businesses to restructure and explore new ways to attract finance. New laws also are steering Asian corporations towards a business model based not just on old relationships and trust, but also transparency, accountability and rules. However, in most economies, to effect these changes, governments must confront powerful vested interests and upgrade bureaucratic capacity to implement new laws and regulations.

Dominant business relationships and models are in flux. In several East Asian economies, including Japan, the Republic of Korea and Thailand, longstanding relationships between firms and their banks are weakening while arm's length financing, including share and bond markets and institutional investors, are strengthening. In other economies, like Indonesia and China, many companies once owned exclusively by powerful families or the state are attracting new owners, including foreign investors; eventually this should change business cultures and pressure management to raise profitability. Across East Asia, increasingly open trade and investment regimes expose firms more to global competition, forcing weak firms to exit and raising competitive pressures on firms that remain.

Australia and other developed economies are also enhancing transparency and reviewing many aspects of business culture in the wake of several large corporate failures. The Australian Government is assisting emerging East Asian economies in recovering from the crisis and building institutional capacity; it has a strong interest in understanding and supporting this important transition. Australia assists regional governments through its development assistance program and partnerships between Australian and East Asian agencies, including in regulating securities markets, developing corporations law and strengthening prudential controls.

The implications for Australian business are profound. Those East Asian economies creating a level playing field for domestic and foreign firms and a rules based business environment are likely to grow faster and be more viable trade and investment partners. Second, market access reforms and weaker relationships between local corporates, suppliers and financiers should generate business opportunities for Australian exporters, financial institutions and investors. Third, Australian business service suppliers can help East Asian corporates make their businesses more open and accountable, comply with new company laws and listing rules and improve their financial reporting so they can access direct financing.

However, progress toward a rules based business model is uneven across North and South East Asia and many emerging economies will take years to achieve these major corporate governance changes. Aspects of traditional business culture are likely to remain part of future business practices. Hence, investors and business people need information about the pace and nature of corporate change in East Asia to do business successfully.

In East Asia's market-based economies, and to an increasing extent in China, corporate decisions and behaviour drive economic growth. Market economies rely on the corporate sector to invest its savings productively, boosting productivity, output and living standards. However, firms in most East Asian economies operate differently from those in most western economies. This divergence reflects historical experience and culture, but mostly institutional capacity.

RELATIONSHIPS DRIVE ASIAN BUSINESS

The importance of relationships in East Asian business is well documented. This preference is not only cultural; it probably mainly reflects relatively undeveloped legal and regulatory systems that make contract and property right enforcement difficult. Hence, doing business with people you know and can influence, is less risky than doing business with strangers (East Asia Analytical Unit, 1996).[1] Relationship driven business dealings are common place everywhere, including in Australia, but adoption of more transparent rules based systems has reduced business dependence on using personal connections.

However, many East Asian family business operations still are relationship based. (See Chapter 2 – *Markets.*) Mostly, these companies appoint relatives or trusted friends to management and board positions; most raise their funds internally or from banks in the same business group. Most family owned firms avoid issuing equity because it dilutes family control and ownership of potentially valuable assets. Such firms often maintain longstanding relationships with suppliers and distributors, reducing the risk of a supply chain disruption and fraud, but also limiting scope for purely commercial decision making. Family owned corporates dominate domestically owned business in Thailand, Indonesia, the Philippines, Hong Kong, Taiwan, the Republic of Korea and privately owned Singapore companies.

Elsewhere in East Asia, relationships rather than market forces also determine many investment and commercial decisions. In Japan's more mature market economy, family ownership is less dominant and many large firms are widely owned. However, firms in *keiretsu*, the large Japanese business groups, have close, longstanding relationships with each other and their group banks; some of these relationships can compromise objective evaluations of financing risk and potential profitability. In China and Vietnam, state owned enterprises dominate large scale domestic corporate sectors and banking, preventing arm's length relationships between firms, government owned banks and regulators. In Singapore, government linked companies also are very important, accessing low cost pension fund finance, closely interacting with regulators and involving the Government as major shareholder in selecting boards and management. While modelled on public companies, their operational outcomes can be quite different.

Market reinforcing institutions reduce risks when unrelated parties do business, but these are relatively weak in most East Asian economies. Outside Hong Kong, Singapore, Australia and to some extent Malaysia, legal systems generally do not effectively enforce commercial law and contracts effectively. Also, in some emerging and middle income East Asian economies, the prudential framework and enforcement mechanisms underpinning share market transparency is relatively underdeveloped, so investors are less willing to fund firms directly, inhibiting financial market development.

In most developed economies, although contacts and networking are crucial, relationships are relatively less crucial in business dealings because a range of institutions, including strong legal systems, market regulators, independent banks, active shareholders including institutional investors, a strong financial press and well enforced rules governing financial reporting, accounting and financial system operation protect arm's length transactions (Prowse, 1998). For example, although US, UK and

Australian savers and investors usually do not know each other, they can cooperate in various finance markets with relatively little risk. Equity finance provides most funding for larger firms. Family businesses play a relatively small role in the corporate sector; most large companies have widely dispersed ownership, so managers and owners usually are separate. While many developed economy firms maintain longstanding relationships with banks, these must be commercially justified and most prudential authorities prevent conglomerates, single families or individuals owning banks.

EAST ASIAN BUSINESS MODEL UNDER PRESSURE

Relationship based business models produced rapid growth in East Asia from the late 1970s to 1996 and provided stakeholders with several benefits. Close relationships between banks and their client firms ensured rapidly growing companies accessed finance as needed and received flexible treatment when financial difficulties arose. In return, banks secured guaranteed loan repayments and inside information on clients' activities and performance. With family members in management and board positions, corporate owners could monitor investments and make rapid decisions, exploiting emerging commercial opportunities. In Japan and the Republic of Korea, close relationships between firms and suppliers increased certainty in production decisions and cooperation when business cycles deteriorated; this lowered operating costs.

In many East Asian economies, close relationships also included government. Governments operated banks which offered easy finance to favoured projects and issued exclusive business licences to selected insiders. Governments also sought to promote industrialisation by selectively implementing prudential and business regulations, and operating restrictive foreign direct investment and trade regimes favouring local businesses.

However, the relationship based model also has several disadvantages. Most importantly, banks with close relationships with corporate customers often 'name lend' on collateral rather than cash flow, without thoroughly scrutinising loan applications; this resulted in lending for low return and risky projects. Directed lending from state owned or controlled banks to selected projects and entrepreneurs produced even lower quality lending and higher non performing loan rates in Thailand, Indonesia, Malaysia, the Philippines and the Republic of Korea. In the early and mid 1990s, many East Asian banks willingly funded major conglomerate expansions into new sectors, despite weak business plans and the inexperience of managers in these sectors. In many East Asian economies, including Japan and China, high non performing loan levels indicate the serious failure of relationship based business models (Figure 1.1). This poor use of loans and shareholders' funds has shaken confidence in many East Asian economies; for growth to return, new approaches are vital.[2]

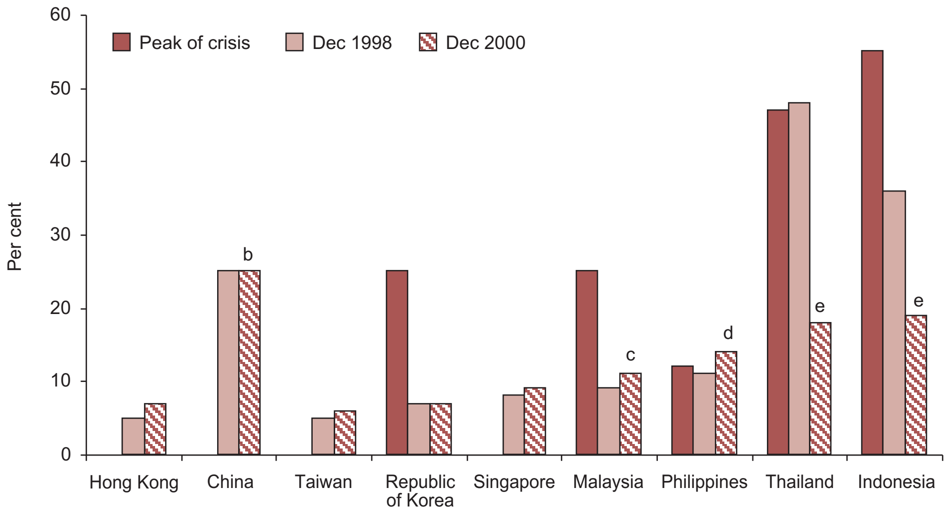
1 In some economies, business and government interactions based on relationships and patronage also reflect traditional, pre-capitalist social systems, which require individuals to fulfil obligations to social superiors and inferiors.

2 Importantly, high levels of non performing loans are not confined to East Asian economies most affected by the financial crisis. Despite recent progress in some economies, usually due to sales of non performing loans to asset management companies, the level of non performing loans in East Asia remains stubbornly high. Non performing loan rates are well above levels experienced at the peak of the Scandinavian and US banking crisis in the early 1990s.

Figure 1.1

Lending Practices Under Scrutiny

Share of Non Performing Loans in Total Loans in East Asian Banking Systems[a]



Notes: a Sharp drops in non performing loan levels reflect asset management companies (usually government funded) buying out non performing loans.

b Estimates of non performing loans are as high as 50 per cent.

c December 2001.

d September 2000.

e November 2001.

Source: Hawkins and Turner, 1998; CEIC Database, 2002.

Relationship banking also may deny bank funding to new firms lacking a close bank relationship; this reduces opportunities for new firms to promote growth. New firms can bring new competition, management expertise, products and technologies; without these, living standards will be lower. For example, small and medium sized enterprises in Indonesia, the Republic of Korea and Taiwan and private enterprises in China and Vietnam have little access to bank finance.

Furthermore, over time, a small, closed business elite often finds investment opportunities dwindle, then 'captive' banks are forced to make increasingly risky loans, and economic growth contracts. Declining returns on East Asian investments in the lead up to the crisis suggest the supply of new high return investments diminished rapidly (Table 1.1) (Krugman, 1999).

Table 1.1

Investment Decreasingly Productive Before Crisis; Now Recovering

Ratio of Private Investment to Change in National Output[a], Selected Economies, 1994-2000

	1994	1995	1996	1997	1998[b]	1999	2000
East Asia ex Japan	4.1	4.5	5.0	5.7	Na	4.9	4.3
China	3.7	4.3	4.5	4.7	5.2	5.6	4.9
Hong Kong	5.7	8.3	7.7	7.5	Na	9.5	2.9
Indonesia	3.8	3.7	4.1	6.9	Na	Na	4.7
Japan	28.5	18.0	8.5	16.1	Na	36.1	17.8
Republic of Korea	4.7	4.5	5.8	7.2	Na	2.8	3.4
Malaysia	4.6	4.9	4.7	6.4	Na	4.2	3.6
Philippines	5.6	5.3	4.5	5.4	Na	6.8	5.6
Singapore	3.2	4.6	5.0	5.6	Na	6.1	3.5
Taiwan	3.8	4.2	4.3	4.1	6.0	4.9	4.7
Thailand	4.9	4.8	7.4	Na	Na	4.6	4.5

Notes: a A higher ratio means investment is less efficient, as one dollar of investment is associated with less output in the same year, possibly suggesting investment is less productive. This is referred to as the incremental capital output ratio.

b Years where recessions occur, or when output declines due to other factors, such as in 2001, distort the ratio as it rises to very high levels. These have been omitted.

Source: Economic Analytical Unit estimates using CEIC data, 2002.

Over time, businesses choosing suppliers and distributors based on relationships rather than price usually face higher costs and have higher selling prices, as lack of competition permits inefficient, rent seeking behaviour. While export-oriented firms usually need to source from the cheapest supplier, firms supplying protected local markets do not. For example, longstanding relationships between Japanese firms, suppliers and distributors result in significantly higher prices for local consumers despite strong pressure from cheaper imports (East Asia Analytical Unit, 1997).

RULES BASED BUSINESS BETTER FOR GROWTH

How business works affects the health of the economy; a business model based on rules and market signals has major advantages for economic efficiency, equity and growth. Rules and institutions allow many risks to be socialised; they protect people dealing with new parties against fraud, poor disclosure or exploitation. Laws enforce contracts and even if an investment fails, company and bankruptcy laws and courts ensure investors' losses are minimised. This allows financial and goods markets to thrive, bringing together anonymous parties whose prime concern is maximising commercial returns within a socially responsible framework. Direct financing markets, mainly sharemarkets, allow firms access to savings from a large pool of investors who are willing to bear commercial risk, freeing firms from the risks in borrowing from a bank at fixed interest.

Rules and institutions protecting contracts and property rights encourage firms to deal with new or foreign firms to provide inputs they need and buy their outputs. This increases competition, enabling firms to obtain supplies at lower cost, benefiting consumers, and sell at the best prices, benefiting producers.

Developed market economies took centuries to move towards a rules based business model, and there relationships still can lead to poor investments, as seen in the recent collapses of Australia's One.Tel and, to a lesser extent, HIH Insurance. Nevertheless, as rules and institutions develop sufficiently to allow deep and transparent markets, self interest increasingly produces better corporate behaviour. The attractiveness of rules based business environments also is increasing in East Asia, as business and government grapple with the fall out of failed investments and bad debts.

CRISIS FORCES CHANGE

Since the financial crisis, growing non performing loans and declining investment returns have triggered market responses and state intervention, weakening many traditional business relationships. In the Republic of Korea, Indonesia and Thailand, governments have nationalised and sold several banks to new owners, often severing relationships with former favoured clients. Closures, sales and mergers of Japanese banks and the liquidation of bank and corporate cross-shareholdings weaken relationships between banks and *keiretsu* affiliated firms. (See Chapter 6 – *Japan.*) The Chinese Government is corporatising and selling shares in large state owned enterprises to boost corporate management standards and loan repayment performance.

Many East Asian firms must look beyond the weak banking sectors for finance, even to previously underdeveloped equity and bond markets. (See Chapter 2 – *Markets.*) This trend is increasing liquidity and depth in several regional share markets. However, during the financial crisis, local and foreign minority shareholders and bondholders fared badly and many will not re-enter equity or bond markets until regulation and transparency improves. Consequently, East Asian governments have introduced new initiatives to strengthen company laws, stock exchange listing rules, corporate disclosure and accounting standards. While implementation will take time, eventually regulatory strengthening should increase individual, institutional and foreign investor willingness to finance Asian corporates. Companies seeking equity and bond finance are subject to much greater scrutiny than unlisted companies which borrow only from banks and eventually must raise corporate governance standards to keep accessing direct finance.

THE NEW RULES OF DOING BUSINESS

As doing business with strangers is risky in a weak legal environment where relationships are breaking down, East Asian governments are introducing new laws governing commercial relationships and better implementing existing laws. Over time, these initiatives will underpin a new 'rules' based business environment. (See Chapter 3 – *Regulations.*)

Firstly, governments recognise firms must disclose information on profit performance, activities and financial transactions, particularly related party transactions, to gain prospective investors' trust. Hence, most East Asian authorities now require listed and in some cases unlisted companies to report punctually and accurately, based on international reporting standards. Furthermore, while still weak, legal enforcement of these requirements is improving.

Second, to protect minority investors against exploitation by majority, often founding family owners, many East Asian governments now accept minority shareholders should appoint directors in proportion to their cumulative shares and minority shareholders should contribute to major decisions. Third, in many regional economies, shareholders now can sue directors for providing misleading information or failing to run the company properly. This further protects small investors.

Finally, most East Asian governments now have enacted modern bankruptcy laws protecting creditors when borrowers become insolvent; however, often enforcement is weak. China and Vietnam still do not have modern bankruptcy laws because they are concerned bankrupting many insolvent state owned enterprises would cause social instability.

Although East Asian economies are far from adopting a single model of doing business, their approaches to reforming corporate governance are strikingly consistent (Allen, 2000). Most are gradually adopting a new legal, regulatory and market framework, encouraging better corporate governance. Nearly all economies have a voluntary best practice code for listed companies, although few of these yet have legal backing. Many governments now recognise rating companies and institutional investors are important; some are changing laws to encourage deeper sharemarkets and institutional investor participation.

MARKET FORCES AND REGULATIONS WORK TOGETHER

Increasingly, market forces are working with new regulations to encourage East Asian businesses to adopt a more rules based corporate governance model. Weak banks will force firms to access share finance, increasing the relevance of new listing rules. If minority shareholders use new laws to improve their rights and disclosure rules force more transparency, the share market should attract more savings, reducing bottlenecks in the currently weak banking system. Particularly in Japan, tough new bank lending quality and balance sheet standards and bank competition is reinforcing bank independence as banks sell stakes in traditional corporate borrowers. In South East Asia, restructuring conglomerates, nationalising banks and re-privatising firms is similarly effective. More liberal foreign investment regulations allow corporate takeovers, including banks, increasing the influence of rules based corporate cultures.

Some top regional bluechips, like Sony, Thai Farmers Bank and Indonesia's Astra are market leaders in recognising good corporate governance is in their interest. While this perception is not yet widespread, analyses indicate listed companies disclosing all relevant corporate information and providing small investors adequate board representation can access equity funds 25 per cent more cheaply than average firms. Nevertheless, with more firms listing, this perception should spread gradually (Naughton, 2001). At present, most firms are concerned compliance costs could put them at a disadvantage relative to their competitors and some family dominated firms still see gains from non-compliance.

ENFORCEMENT MUST IMPROVE

Hence, East Asian governments have an important role in encouraging the transition to a rules based business model. To regain the trust of investors, governments know they must not merely pass laws and introduce new codes of conduct; they must implement them. Authorities must fine or delist firms that fail to comply with accounting and audit standards, prosecute directors who defraud small shareholders or creditors and bankrupt recalcitrant debtors. This will demonstrate to shareholders and creditors that regulators and courts will protect them when firms fail to represent their interests or repay them. Several regional governments have not yet taken these vital steps, inhibiting a rapid transition to the new Asian business model and recovery from the crisis.

To enforce new laws and make them credible, building capacity in institutions implementing new regulations, including the courts, is critical. In several regional economies, vested commercial interests are attempting to block regulatory upgrading and further corporate restructuring; if they succeed they will limit competition and transparency and frustrate economic recovery. Overcoming these interests requires considerable political will.

EAST ASIAN ECONOMIES MOVING AT DIFFERENT SPEEDS

Hong Kong, Singapore and Australia already operate an essentially rules based business environment, although heavy reliance on family owned and government linked companies add a local dimension in the former economies. Japan gradually is moving to a new system based less exclusively on long-standing personal relationships and more on market institutions. Since the crisis, the Republic of Korea has upgraded institutions and laws to deal with the major anti-competitive challenge of the *chaebol* and strengthen shareholder and creditor rights. China and Malaysia are also upgrading corporate governance standards. However, in most emerging regional economies, weaker legal and regulatory institutions and less competitive markets slow the shift to a rules based business system, reducing their medium term growth prospects.

Market pressure and new regulations alone will not instantly dissolve longstanding relationships between firms, their owners, banks and governments. East Asian governments can expedite this transition by reducing powerful families' dominance by forcing the restructuring of insolvent conglomerates and privatising state held banks and enterprises. Regulations requiring higher minimum public floats and majority thresholds at shareholder meetings also would help dilute concentrated family ownership.

IMPLICATIONS FOR AUSTRALIA

Changes underway in East Asia's corporate sector are significant for Australian business and government. First, rules based corporate governance should level the East Asian business environment playing field, so Australian traders, investors and service suppliers can compete in the region on their merits. Second, when fully implemented, new rules protecting shareholders and creditors should reduce the risk and cost of minority investments and bank lending to East Asian companies. Third, Australian business and financial service firms are well placed to help regional companies upgrade their accounting and auditing standards and adopt more transparent and accountable management systems to meet new standards and access capital markets. Fourth, ongoing corporate and banking rationalisation should spur the sale of non-core business assets, particularly as the world economy continues to grow slowly in 2002. Finally, if East Asia successfully makes the transition to a rules based business environment, it will take a major step towards regaining past robust growth rates, which will have significant benefits for the region and Australia

A Different Culture

The importance of relationships often disadvantaged Australian firms doing business in East Asia, even when their products were better and cheaper. This aspect of doing business in East Asia is likely to weaken relatively over time, as firms are less likely to maintain traditional suppliers or banks if they can obtain equivalent or better services at lower cost. While establishing personal contact and rapport will continue to be an important part of the 'new Asian' business culture, this should be less central and opportunities for new providers should increase.

Regulations to Reduce Risk to Investors

In future, new rules and laws protecting creditors and minority investors should reduce risks for Australian bankers and portfolio investors. In theory, most regional economies now grant small investors many similar rights to investors in developed economies. However, as legal enforcement is weak in most emerging regional economies, lenders and investors must monitor carefully enforcement progress in these economies.

Investing in Compliance

Because many East Asian corporates must now meet new governance standards, their demand for foreign, including Australian accounting, legal and business consulting services is significant. Many Australian firms and professionals already are assisting East Asian corporates upgrade their standards and compliance, but current trends indicate these requirements should grow significantly in future. Opportunities also exist for training and supplying information technology services and software.

Corporate and Government Asset Sales

Crisis induced fiscal pressures and a desire to improve competition and corporate governance standards is encouraging government businesses to rationalise non-core assets. In Japan, the Republic of Korea and elsewhere, large diverse business groups are selling assets to strengthen their financial positions. Foreign equity limits are now more liberal, supporting divestiture. These developments provide opportunities for Australian direct investment. In 1999 and 2000, vested interests slowed government and private asset sales, but the world economic slowdown should increase fiscal and commercial pressures to reinvigorate privatisation and restructuring programs in 2002.

LOOKING FORWARD

East Asia’s business model is in transition. The financial crisis showed East Asia has outgrown its old relationship based business model; it is constraining future growth. Most regional governments now recognise they need the legal framework, institutions and enforcement capacity to provide a more rules based business environment, protecting creditors and investors and encouraging sound business decision making. This process requires strong political will and time to complete, but if successful will allow East Asia to regain its strong growth momentum. Australians doing business in East Asia need to understand the nature, pace and direction of the fundamental change occurring in East Asian corporates. The Australian Government also has a strong interest in understanding and supporting this important transition.

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