# MARKETS GOVERNING CORPORATIONS

## KEY POINTS

- Strengthening market forces play an important role in East Asian corporates' transition from a traditional, relationship based business model to a more modern, rules based system.

- Since the crisis, weakened, restructured banks are forcing many corporates to seek equity and bond financing, exposing their activities to greater market scrutiny. Eventually this trend should reduce the dominance of family owners and mitigate investment risk for new minority investors.

- More open foreign direct investment regimes are boosting foreign corporate participation, particularly in crucial financial markets, raising efficiency and corporate governance standards.

- Over the last decade, goods markets have become more competitive as most regional economies reduced trade barriers, pressuring corporates to cut costs and avoid risky investments.

- However, with vested interests seeking to shield themselves from building competitive pressures that bring better corporate governance, governments need strong political will to maintain market opening reform momentum.

In many East Asian economies, more competitive markets are starting to encourage firms to adopt practices benefiting shareholders, creditors and consumers and move from a relationship to a rules based business model. Prior to the crisis, weak market competition often facilitated poor corporate governance standards and risky corporate behaviour as much as did poor regulations and enforcement. However, corporate exposure to competition varies greatly across the region and in most East Asian economies markets need to be strengthened further before they provide optimal discipline on corporates' behaviour.

Strengthening market forces are coming from many sources. Weak banking systems, ongoing prudential reforms and corporate restructuring are pressuring corporates to shift from bank to direct capital market financing. Trade and investment liberalisation, market deregulation and privatisation are increasing goods and services market competition, providing incentives for corporates to seek out the cheapest inputs and finance and adopt more professional management approaches. To succeed in this environment, companies need a rules based business framework and stronger internal governance. This chapter maps major trends in East Asian market dynamics and their impact on the region's traditional and emerging business models.

## CAPITAL MARKETS DRIVE CHANGE

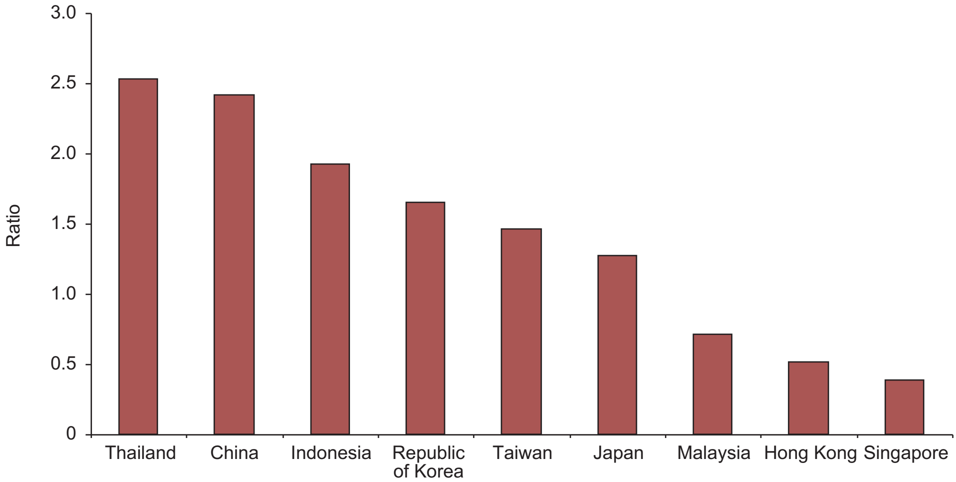
In most East Asian economies, increasing financial market competition is strengthening market pressure on corporates. Bank financing still dominates business financing in East Asian corporates, with least developed economies generally more dependent on bank finance than more advanced ones (Figure 2.1). However, several economies, like Malaysia, rely more on direct finance than much higher income economies like Japan and Taiwan, while higher income Thailand lags Indonesia. In such economies, competitive and institutional pressures are encouraging stronger regional corporates to access financial markets directly.

With bank restructuring, capital shortages, high non performing loan levels and tougher bank regulations, bank managers are less willing to offer loans, particularly on relationship basis only (Figure 2.2).

Figure 2.1

## Bank Financing Dominates

### Ratio of Bank Debt to Share Market Capitalisation, 2000



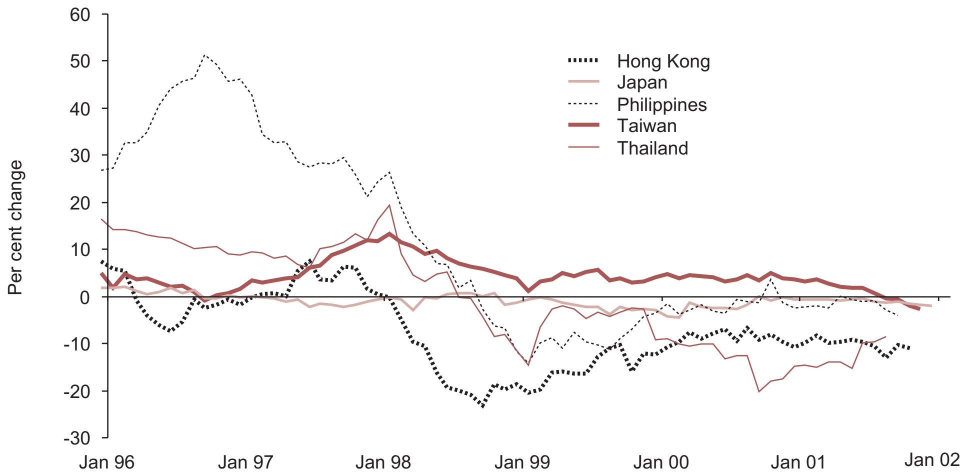

Note: The ratio of bank debt to share market capitalisation is used here as a proxy for companies' average debt to equity ratios, due to inadequate or inconsistent data for the latter in these economies. For reasons including the listing of foreign companies on share markets and the use of borrowings from non-bank domestic or foreign financial institutions, the two could deviate markedly. However, the approximate rank order of the economies concerned is not expected to differ much from the above.

Source: CEIC, 2001.

Figure 2.2

## Bank Lending Contracting

### Year-ended Per Cent Change in Volume of Bank Lending, Selected Economies, 1996-2002




Source: CEIC, 2002.

As authorities enforce new prudential regulations, corporate restructuring progresses and economies and investment pick up, many more firms will try to fund new investments from outside the banking system through direct financing from capital markets. Eventually, expanding capital markets should force banks to compete for savings and lending opportunities, reducing margins and increasing incentives for prudent lending. Corporates also will have to compete more openly for finance in share and bond markets, as cosy relationships with banks become less common. Long term access to direct finance is only possible if firms reward minority shareholders and repay bond holders.

While East Asian blue chip companies already are accessing local and international equity markets, and lifting corporate governance standards to do so, to maximise control, many family controlled firms continue to prefer bank over equity finance and remain reluctant to list or receive credit ratings. If governments let unreformed banking systems forgive corporates' loans and breach capital adequacy rules, these family owned firms, with their bank borrowing preferences, could revert rapidly to high leveraging. This will retard share and bond market development, entrenching poor governance and risky investment behaviour.

## FINANCING COMPETITION LIMITED PRE-CRISIS

Before the crisis, many East Asian firms, particularly large ones, had little need to compete for finance, reducing market pressure and scrutiny. Overwhelmingly, corporations funded their activities through close relationships and even formal ownership links with banks. In Indonesia, the Philippines and Thailand, and less commonly in Taiwan and Malaysia, many banks were part of large business conglomerates and serviced their group's non-financial firms. In the Republic of Korea, *chaebol* were not allowed to own banks but did own non-bank financial institutions, including leasing companies and merchant banks, to finance their activities. In Japan, under the *keiretsu* system, many firms enjoy close relationships and some cross shareholding with their banks. Whilst this system enabled Japanese banks to monitor their corporate clients' performance, throughout the rest of East Asia, banks mainly made loans based on connections backed, often inadequately, with collateral and rarely scrutinised closely their customers' investment intentions.

With relatively free access to finance, conglomerates expanded into many sectors, some beyond their core competencies, and invested excessively in real estate, producing property bubbles in major East Asian cities. Partly because of poor risk analysis due to connected lending, after 1997, bank non performing loans skyrocketed, bank shareholders sustained major losses and many banks collapsed (Figure 1.1) (East Asia Analytical Unit, 1999a).

Limited competition in finance markets reduced incentives for firms to assure minority investors and banks of their financial integrity and to comply with regulations governing board structure, transparency and minority shareholder rights. When funds are scarce, firms that fail to repay their investors will be cut off from future finance or pay much more for funds; East Asian companies rarely faced these sanctions before the crisis.

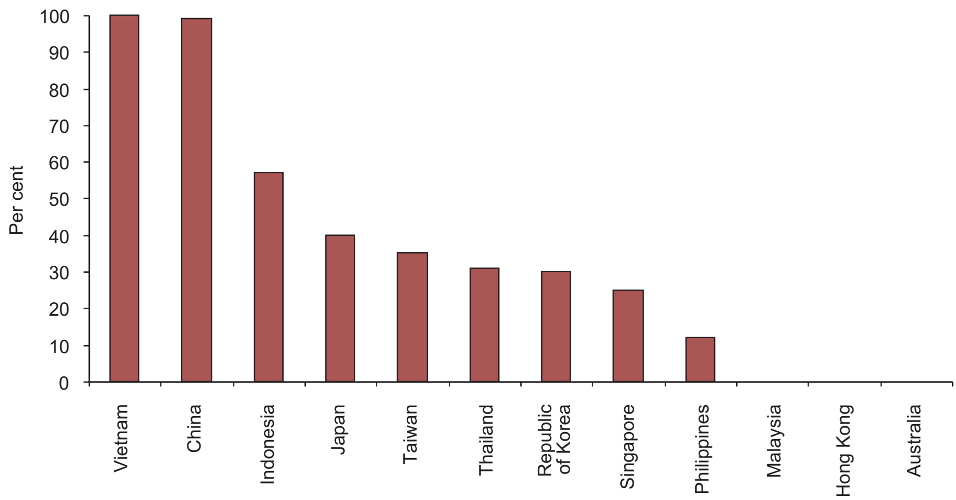
## State Owned Banks Problematic

State owned banks also provided easy finance for well connected corporates and poorly performing state enterprises, reducing corporate discipline. Before the crisis, Taiwan, Indonesia, Thailand, Japan and, before the 1980s, the Republic of Korea, had significant state bank ownership, reflecting governments' desire to promote key industrial sectors. Due to forced government bailouts and bank nationalisation, government ownership is even higher by 2001 (Figure 2.3). In China and Vietnam, state owned banks also dominate banking and hold a high proportion of non performing loans, mainly owed by state owned enterprises. Poor management and political interference resulted in these banks making many non-viable lending decisions. Even before, but especially since the crisis, Thai and Indonesian state owned banks had significantly higher non performing loan levels than private banks.[1]

Figure 2.3

**State Banks Often Important**

**Share of Bank Assets in State Hands, Selected East Asian Economies, 2000**




Note: Figure for Japan treats the Postal Savings System as a government owned bank.

Source: PricewaterhouseCoopers, 2001.

[1] After the crisis, Thai and Indonesian state bank non performing loans peaked at over 70 per cent of outstanding loans, 30 to 40 percentage points higher than private banks' non performing loans (East Asia Analytical Unit, 2000a; 2000b).

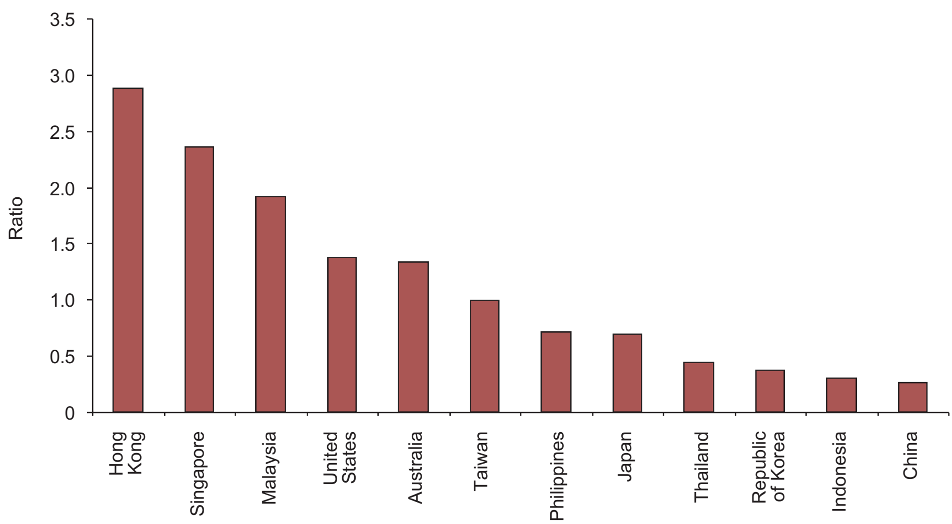
## Share Markets Often Weak

A strong preference for bank finance in most East Asian economies results in a low ratio of share market capitalisation to gross domestic product (Figure 2.4). Except in Hong Kong, Singapore and Malaysia, East Asian stock markets' role in corporate financing is more limited than in many developed economies, and hence equity market discipline on corporates generally is weaker (East Asian Analytical Unit, 1999a). Share market capitalisation in Hong Kong and Singapore is somewhat inflated because they act as regional finance hubs. Emerging economies have lower share market capitalisation because their corporate sectors constitute a relatively small share of gross domestic product, so the ratio of share market capitalisation to GDP tends to rise with an economy's level of income and institutional development.[2] However, given their relatively high per capita income and low sharemarket capitalisation, Japan and the Republic of Korea are obvious East Asian outliers. Both have particularly low share market capitalisation because their large corporates prefer high leveraging via bank borrowing. Thailand and Indonesia also have relatively low levels of share market participation compared to, for example, the Philippines with similar or lower per capita income. In the last six years, China's share market capitalisation has jumped from a very low base as more state owned enterprises and some private firms have been allowed to list.

Figure 2.4

**Share Market Capitalisation Low in Japan and Korea**

**Ratio of Share Market Capitalisation to GDP, Selected Economies, 2001**




Source: CEIC, 2002.

2 This is because agriculture, small and medium sized enterprises and the informal sector constitute a relatively large share of gross domestic product in low income economies and such enterprises do not list.

## BANK RELATIONSHIPS NOW THREATENED

Several factors are weakening links between East Asian banks and their corporate clients. Some governments acquired significant stakes in their banking sectors after the crisis; many are selling these to new, independent owners. For example, in 1998 and 1999, the Thai and Korean governments each sold two nationalised banks to foreign banking interests. The Japanese Government sold a major bank to foreign interests and the Indonesian Government is attempting to sell several major nationalised banks, although this process has been delayed. By 2001, the Taiwanese Government had sold over half its state owned banks through a long term bank privatisation program (East Asia Analytical Unit, 1999a; 2000a; 2000b). Huge capital losses also forced several private banks to find foreign partners. For example, since the crisis, four private Thai and Korean banks have formed joint ventures with foreign banks.

Eventually, with conglomerate restructuring, many more banks should become independent entities. Thai and Indonesian family owned conglomerates shed many subsidiaries, including banks, as they rationalised operations, and the governments recapitalised and nationalised their banks. Now, only two Thai banks and a few Indonesian banks remain part of family owned conglomerates.

Complying with newly enforced Basel Committee capital adequacy ratios forces many banks to limit lending, including to firms with which they have long standing relationships. Now, many Korean, Indonesian, Thai and Malaysian banks prefer holding low risk government bonds to lending to corporates. In Japan, tougher capital adequacy standards also force banks to sell shares in insolvent firms, weakening links with group firms. Tougher prudential standards also should force banks to comply with limits on connected lending.

## DIRECT FINANCING MORE IMPORTANT

Shares provide a relatively small source of funds for corporates in most East Asian economies (Figure 2.1). However, since the crisis, banks have curtailed new lending to local corporates and bond and share markets have financed a rising share of new investment. As economies mature, most large corporates move from bank to equity financing. As this occurs in East Asia, corporate governance should improve.

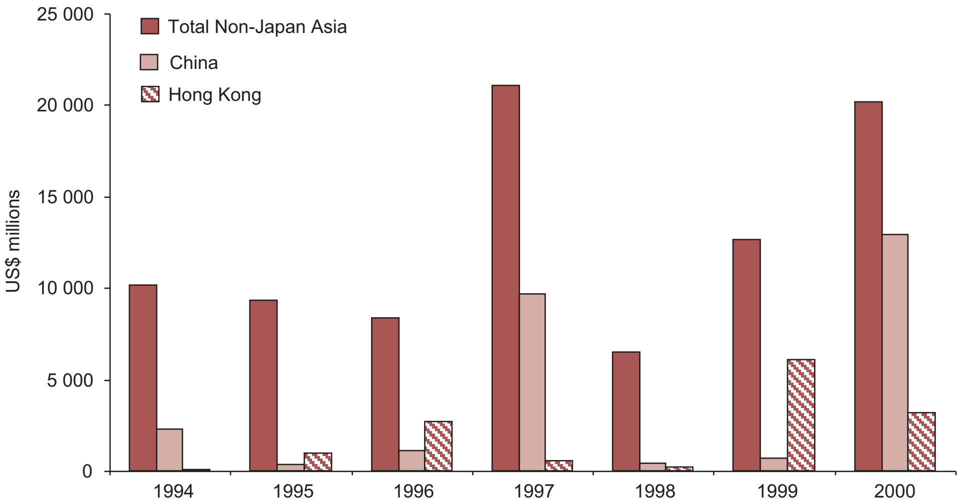
### Initial Public Offers Increasing

Across East Asia, more frequent and better value initial public offers confirm the gradual trend towards equity financing (Figure 2.5). China now accounts for most initial public offers, although Hong Kong, Singapore, Thailand, the Philippines, Taiwan and the Republic of Korea returned to modest activity in 2000 after the financial crisis lows of 1998.

Figure 2.5

**Initial Public Offers Increasing across East Asia**

**Value of Initial Public Offers in East Asia, US$ million**




Note: Only includes deals greater than US$500 million.

Source: Hale, 2001; CEIC, 2002.

Several trends drive the increasing use of direct financing.

- As regional economies resume growth, more firms will seek funds to expand. With debt-to-equity ratios already high, and banks less willing to lend under tough new regulatory regimes, better managed corporates will to resort to equity finance. Already, Hong Kong and Chinese firms in rapidly growing sectors, including technology, are seeking equity funding.
- In many crisis-affected economies, governments, distressed corporates and creditors participated in large debt-for-equity swaps to restructure debt; when creditors and governments sell these shares to the public, share markets will deepen.[3]
- East Asian share markets are inefficient; prices often fail to react rationally to relevant events and excessive returns can accrue to initial public offerings (Naughton, 2001). However, as share and bond markets mature and institutional investors play a larger role, these problems should diminish.
- If well enforced, new regulations to outlaw price manipulation and insider trading, strengthen share market governance and tighten listing requirements eventually should reduce risks to investors and firms, increasing the attractiveness of equity financing and holding.

[3] However, in some cases, existing owners will be able to repurchase these reducing this benefit.

- Corporate restructuring and competition for funds in financial markets should force more conglomerates to shed equity in non-core or non-profitable businesses, increasing share market size and liquidity.
- Indonesia, Thailand, Malaysia and China have established second tier development or technology bourses, with less stringent listing requirements, so smaller, younger companies can access capital markets.
- Most regional economies have relaxed restrictions on foreign purchases of local stocks, increasing the demand for stocks and liquidity and reducing the cost of equity finance to local firms.[4]

Firms listing most of their shares and obtaining most of their financing from equity and bond markets have more incentive to comply with listing rules protecting outside investors. Since a firm's equity finance costs decline as profitability rises, listed firm managers have an incentive to maximise profits in line with shareholder interests.[5] Also, firms adopting good corporate governance practices have lower equity funding costs (Institutional Analysis, 2001).[6] For example, institutional investors pay an average 26 per cent premium for Thai companies that abide by good governance guidelines (*Far Eastern Economic Review*, 21 June 2001); premiums are even higher in Indonesia. In this way, greater market exposure should increase compliance with new regulations, hopefully creating a virtuous corporate governance circle.

## Growing Importance of Institutional Investors

As domestic and foreign institutional investors are increasingly active in regional economies, firms' direct financing options will expand. Pension funds, investment banks and bank and insurance company treasury operations are critical to share and bond market development. Deregulation of many East Asian government run pension systems will result in domestic and foreign institutional investors placing these funds in share and bond markets, adding liquidity to markets and increasing the scrutiny of listed companies. Many institutional investors operate on a large scale, so they can research prospective and current investments in corporate equity and bonds and pool risk, overcoming many limitations minority investors face in East Asia.

4 China also has given local residents access to its foreign currency denominated B share market, significantly increasing its liquidity.

5 In the case of bond markets, high profits reduce the risk of firm failure, lowering the risk premium and cost of finance to managers.

6 If shareholders perceive their interests are under threat, they can increase the firms' funding costs by selling down its stock. In extreme cases, sustained low profitability may drive the share price so low it encourages a hostile takeover, challenging the firm's ownership and management. Active share and bond markets also force banks to compete for community savings by offering the highest rate of return, increasing banks' incentive to closely scrutinise their lending quality. Finally, the availability of investment options increases the incentive for shareholders to scrutinise the returns on their investments and exercise their minority shareholder rights.

### US INVESTMENT FUNDS ALSO STARTED SMALL

Institutional investment rose in the United States in the early 1970s, helping to disperse corporate ownership. The 1974 Employment Retirement Act promoted the shift of investment funds from retail accounts to pension funds and other institutional investors. The Act also required public pension funds to uphold fiduciary responsibility to their members, so pension funds had to scrutinise corporate governance in the firms in which they invest. By the 1990s, institutions such as the California Public Employees' Retirement System, CalPERS, expressed this shareholder activism abroad, voting their proxies in foreign holdings.

Source: Finance East Asia, 2001.

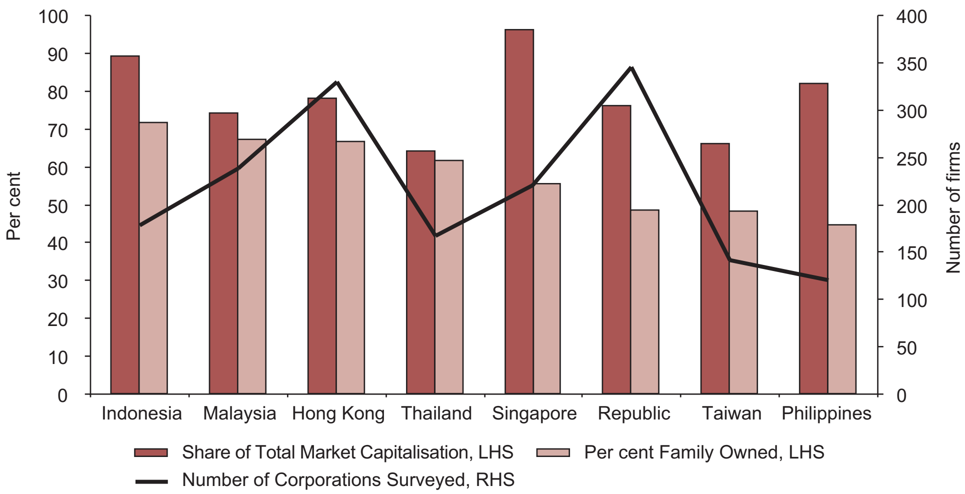
## FAMILY FIRMS ATTRACT NEW OWNERS

East Asian corporate ownership is highly concentrated; a few large firms account for most listed corporate assets (Figure 2.6). In the most extreme cases, the five largest Philippine and Indonesian families control about 40 per cent of these economies' share market capitalisation (Finance East Asia, 2001). In 1998, the wealthiest Filipino family controlled 17.1 per cent of Philippine capitalisation and the top Indonesian family controlled 16.6 per cent of total Indonesian market capitalisation (Claessens et al., 1999). In Singapore and Japan widely held listed corporates hold the biggest share of market capitalisation, but most regional markets are more concentrated than western economies. However, corporate restructuring and weak banks force firm owners to seek new investors, potentially reducing firms' ownership concentration.

Figure 2.6

**Small Number of Corporates and Families Control Share Markets**

**Ownership Concentration and Family Domination of East Asian Public Companies, 1996**




Source: Finance East Asia, 2001.

## MAJOR FAMILIES STILL CONTROL CORPORATES

Most of the region's largest corporates are private, family owned and managed firms. Most are unlisted, so owners bypass listing rules. For example, fewer than 100 of the Philippines' top 1 000 firms are listed (Backman, 1999). Furthermore, listing firms often offer only a minority of their shares to the public, ensuring owners retain control.

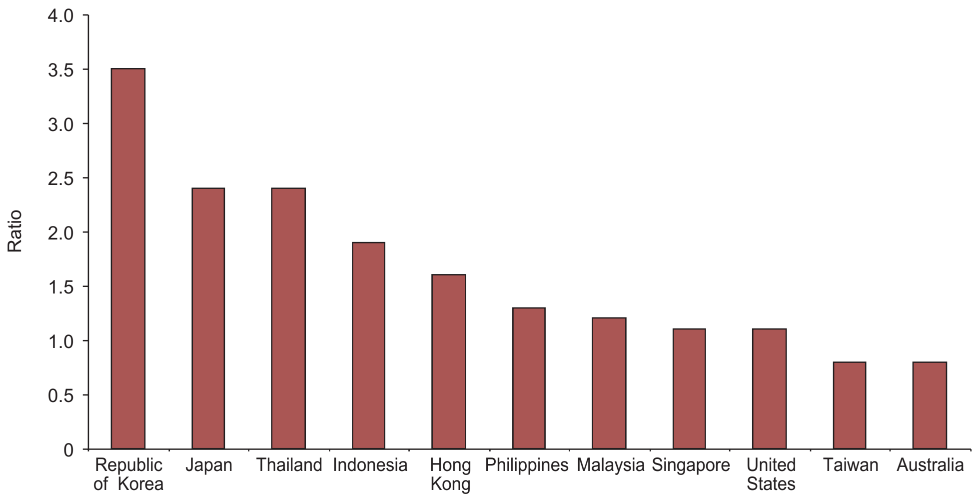
Family ownership dominance adversely affects East Asian creditors, minority shareholders and share market development. First, family owners usually appoint family members rather than qualified professionals to senior management positions; this increases the risk boards will ignore outside investor interests.[7] Second, dominant owners can use pyramid holding structures, allocate special dividends to majority shareholders and deviate from one share-one vote rules so family voting rights exceed formal equity holdings, maximising dominant shareholder returns at the expense of smaller external investors (Claessens et al., 1999a).[8]

Third, pre-crisis, corporate owners' desire to retain control and finance expansion through debt rather than equity pushed East Asian debt-to-equity ratios to high levels (Figure 2.7); this increased shareholder exposure to losses and contributed to the financial crisis. However, since the crisis, most corporates have reduced leveraging, substituting some debt for equity and selling non-core assets.

Figure 2.7

**East Asian Corporates Highly Leveraged**

**Ratio of Debt to Equity of Corporate Sectors, Average from 1992-96**




Source: Claessens et al., 2000.

7 A survey in nine East Asian economies found that in 66 per cent of corporates, firm management was directly related to the controlling shareholder (Claessens et al., 1999b).

8 For example, although Korean *chaebol* founding families now are minority shareholders, their complicated shareholding arrangements still allow them to control and manage the top 70 or so conglomerates dominating the economy. Some partially listed conglomerates engage in complex, illegal related transactions with unlisted firms in the same business group, reducing minority shareholder access to dividends (Backman, 1999).

Fourth, a World Bank study found family dominance of corporates and poorly functioning legal systems were connected closely, suggesting powerful families influence governments and judiciaries to protect their interests (Claessens et al., 1999a). Weak, non transparent legal systems limit creditors' and minority shareholders' ability to exercise their rights. Finally, families' tight share holdings reduce market liquidity, increasing price volatility and investment risk, deterring direct investors and limiting share market development.

## CORPORATE OWNERSHIP LIKELY TO DIVERSIFY

Markets and corporate restructuring should reduce the dominance of East Asian family owned corporates, threatening complex pyramid schemes and reducing risks to outside investors. Regional governments and banks are converting bad debts firms owe into equity; eventually these may be sold to new owners. Authorities in Indonesia and Thailand favour debt-to-equity conversions when resolving bankruptcy cases. More relaxed foreign investment regimes also attract new interest in domestic corporates from abroad.

### US CORPORATIONS ONCE RESEMBLED EAST ASIA'S

In the nineteenth and early twentieth centuries, the US and other western economies featured highly diversified, family owned conglomerates with significant cross-holdings. However, economic downturns, political will and growing capital needs combined to cause the decline of family owned conglomerates.  By the 1940s, diverse investors owned and professionals managed nearly all blue chip companies.

The Rockerfeller family were typical conglomerate owners. Their flagship company, Standard Oil, made its wealth during rapid US industrialisation in the late nineteenth and early twentieth centuries, accumulating vast wealth and acquiring stakes in 41 major companies across all sectors of the economy. However, the holding company refused to increase its transparency and accountability to minority shareholders or broader society, raising public and government resentment. Theodore Roosevelt's tough anti-trust legislation dismantled Standard Oil in 1911, creating several new companies that had to compete against each other. In other cases, family businesses seeking rapid growth accessed outside equity funding, weakening family control.

Between 1890 and the 1930s, the optimal scale of industrial operations grew rapidly; many families no longer could finance or competently manage their growing firms. Financiers gradually took control, installing new managers chosen for their expertise rather than family connections. Some tycoons, including Henry Ford and George Westinghouse, tried retaining control of their enterprises, but these attempts ended in insolvency and salvage by outside investors and bankers.

Pierre DuPont, founder of DuPont and General Motors, recognised the importance of promoting the company's interests over those of the family. As his company's technical and capital needs grew, he invested in external managers and eventually sought outside investment from JP Morgan.

Source: Finance East Asia, 2001.

History shows family dominance gives way to more dispersed corporate ownership as economies develop. For example, developed regional economies, including Japan and Australia, have less concentrated family firm ownership than emerging regional economies. Some advanced East Asian blue chips already appoint professional managers as original owners retire, as second and third generation family members seldom have the same skills and drive. As these firms grow, external finance and management expertise help them remain competitive. The emerging class of outside shareholders and institutional investors will not indulge families in retaining poor managers or assets despite their importance to the family. Despite these trends, some East Asian governments resile from enforcing bankruptcy on local tycoons and selling nationalised assets to new foreign or local players; this could ensure powerful families retain their dominance (East Asia Analytical Unit, 2000a, 2000b).

Greater product market competition also spurs greater dispersion of ownership, forcing owners to seek new ways of maintaining profits, including employing skilled rather than family related managers and shedding non core businesses to new owners.

## PRODUCT MARKETS' COMPETITION INCREASING

Before the crisis, many East Asian firms operated in highly protected product markets. Falling but still significant trade barriers, foreign direct investment restrictions, government sanctioned private monopoly trading rights, state owned enterprise reservations and market dominance due to size or collusive arrangements all limited market effectiveness. Well connected local firms made profits well above normal rates of return, irrespective of management quality; this reduced discipline on internal management. Foreign direct investors could not operate in many sectors or could hold only minority shareholdings, limiting their contribution to competition and governance standards. Service sectors, particularly financial services, professional services, infrastructure, telecommunications, media and real estate were most restricted. Furthermore, most governments prevented hostile takeovers of local companies, especially by foreigners.

However, in many regional economies, the crisis prompted governments to review policies restraining competition. In future, on-going investment liberalisation, privatisation, deregulation and competition policies should encourage more local and foreign firms to enter East Asian markets, and trade liberalisation is adding to competition in product markets. Increasing competition in markets for goods and services imposes more discipline on managers and may pressure firms to lift governance standards. Rising bankruptcy levels suggest poorly performing firms are exiting markets, increasing discipline on corporate managers, lowering expectations of government bailouts and reducing moral hazard.

### Impact on Corporate Governance

From a corporate governance perspective, intense competition may reduce short term profits, but it increases discipline on managers to maximise long term returns to shareholders and creditors. High levels of competition increase the risk of firms running at a loss, becoming insolvent or exiting the market through bankruptcy. Firm managers in competitive markets therefore are motivated to improve their product and reduce costs through investments in marketing, technology development and uptake and training. These boost financial returns to shareholders and increase the probability creditors are repaid. Competition also encourages firms to seek economies of scale or scope. This expansion requires sustainable financing, mixing debt and equity and increasing the firm's exposure to the share market and the discipline listing brings.[9]

## PRODUCT MARKETS LACKED COMPETITION PRE CRISIS

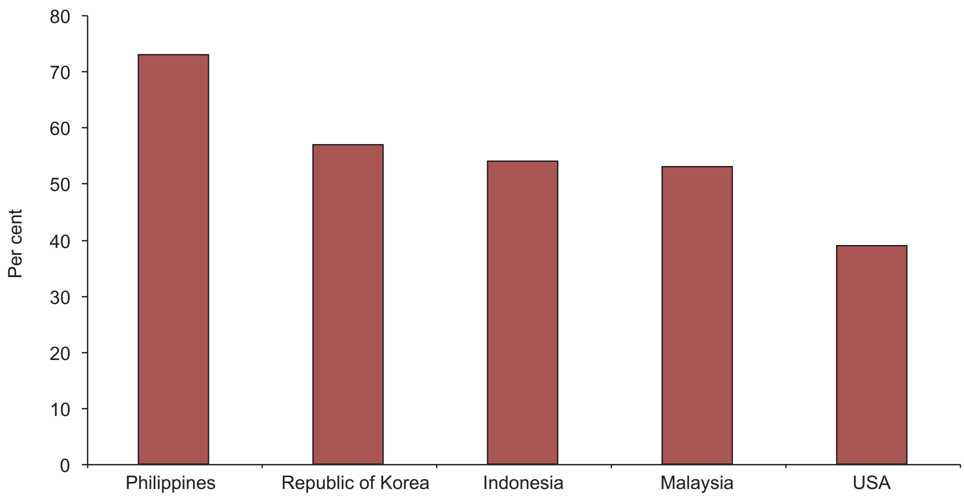
Concentration limits competition in many key markets (Figure 2.8). For example, Korean industries are among the most highly concentrated in the world; a few large *chaebol* dominate output in most sectors, but Filipino markets are even more concentrated.

Uncompetitive markets often result in excessive profit levels, evident in several East Asian economies pre-crisis (Figure 2.9).

Figure 2.8

**A Few Firms Dominate Asian Product Markets**

**Average Share of Manufacturing Markets Supplied by Top Four Corporations, Selected Economies**



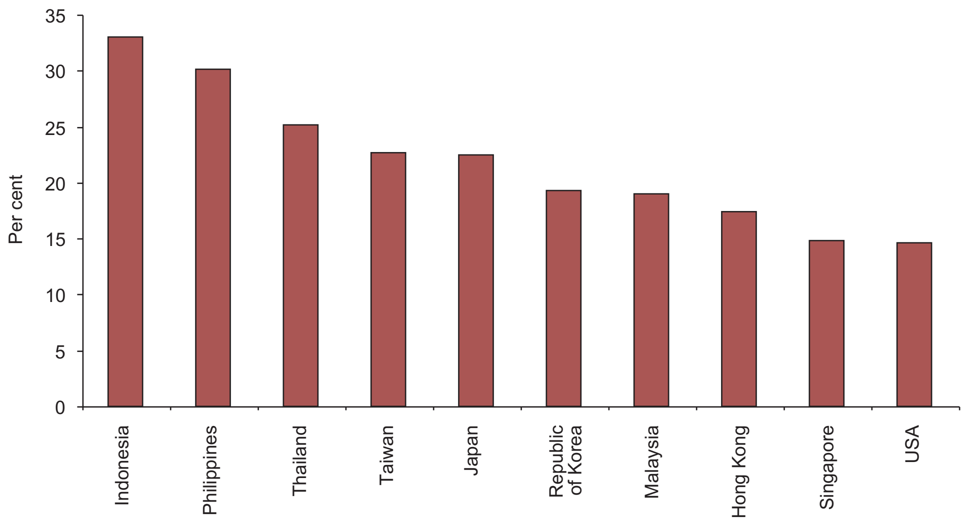

Source: Abenoja et al., 1991; Bird, 1997.

[9] On the other hand, firms operating in protected markets are more likely to pay managers excessive salaries and bonuses, and majority owner profits. Protected markets also may encourage firms and their financiers to take excessive risks on highly leveraged investments, exposing them to external shocks such as occurred during the financial crisis.

Figure 2.9

**Profits High in Markets Lacking Competition**

**Operating Margins for East Asia and Selected Economies, Percentage of Revenue, 1990-96**




Notes: Based on the average operating margin for 1990-96.

Source: Claessens et al., 1999a.

## TRADE LIBERALISING

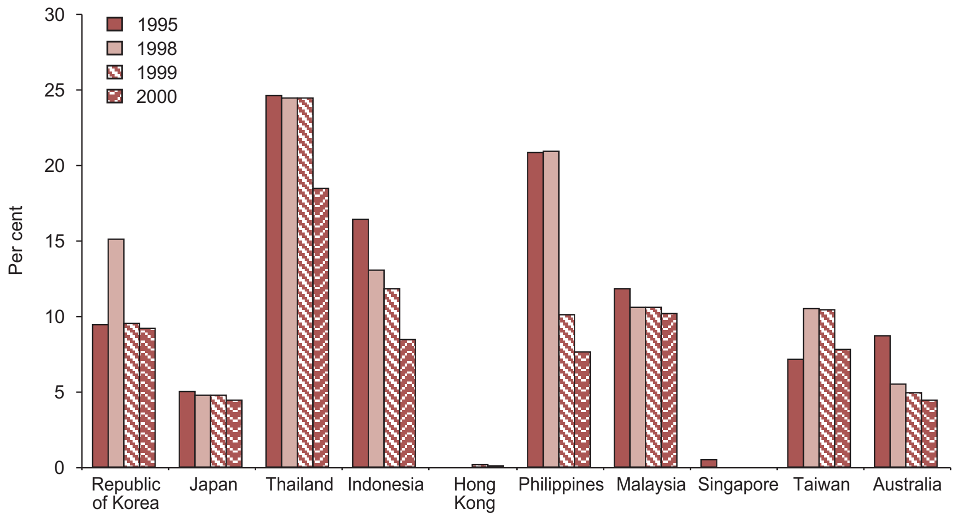
In the decade before the crisis, average East Asian tariff levels fell steadily due to WTO, APEC and other multilateral trade reform commitments and several unilateral programs. Since the crisis, unilateral initiatives have lowered barriers further (Figure 2.10).

As trade barriers fall, imports increasingly penetrate regional markets, boosting competition, forcing firm managers to increase efficiency and cut costs (Figure 2.11). Export orientation also disciplines the activities of many East Asian manufacturing companies.

Figure 2.10

## Average Tariffs Falling

### Average Nominal Tariff Rates in East Asia, Per Cent

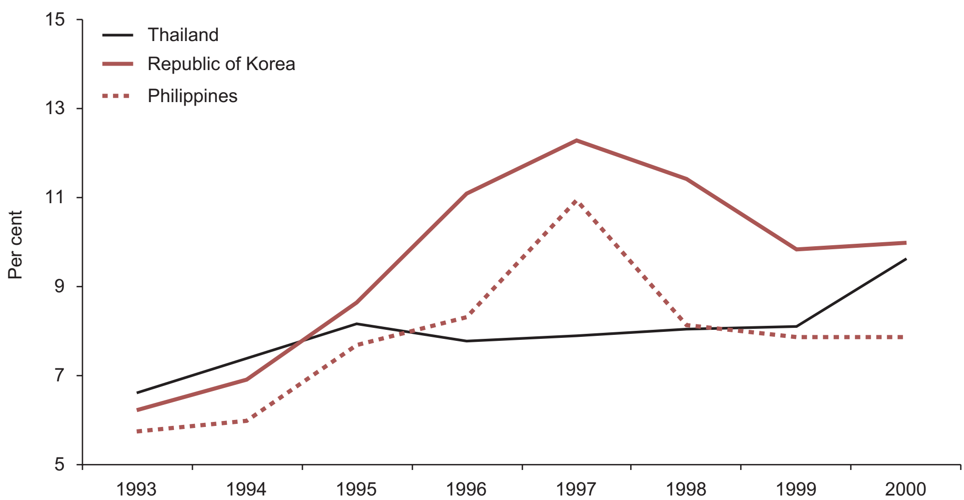



Source: Australia-Japan Research Centre, 2001.

Figure 2.11

## Imports Increase Competition

### Share of Consumer Imports in Personal Consumption Expenditure, 1993-2000, Per Cent



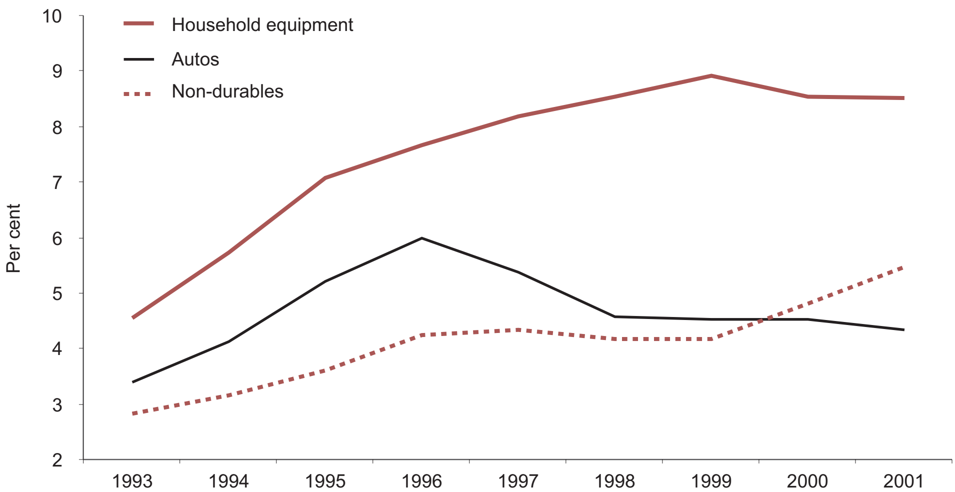

Source: CEIC, 2002.

In Japan, where formal trade barriers on manufactures are very low and informal barriers are declining, import penetration is increasingly rapidly, especially for household equipment (Figure 2.12).

Figure 2.12

**Japanese ex Auto Imports Surging**

**Share of Consumer Imports in Personal Consumption Expenditure, 1993-2000, Per Cent**




Source: CEIC, 2002.

## DEREGULATION AND COMPETITION POLICIES

Since the crisis, fewer entry barriers to new firms in some key sectors boost discipline on several previous monopolies and preferentially treated firms. Competition laws increasingly complement direct market opening measures by providing safeguards against collusive behaviour. Major sectors benefiting from increased competition include utilities, bank and non bank financing, distribution and transport.

Many regional governments have strengthened anti-monopoly legislation and competition watchdog agencies responsible for enforcing these laws.[10] Governments increasingly recognise highly protected markets and monopolistic practices allowed companies to make non-productive investments and contributed to the crisis. In the past, strong political connections and inadequate resources reduced the effectiveness of authorities enforcing competition laws. However, recently the Japanese and Korean Governments strengthened their fair trade commissions and competition policies. The

10 Some legislation covers all sectors; other regulations and agencies are specific to particular sectors.

Indonesian and Thai Governments passed broad based competition policy laws and are setting up agencies to implement them; the Philippine Government prohibits monopolies and price manipulation and is committed to broad ranging anti-trust laws. In 1993, China developed competition laws, including the *Law for Countering Unfair Competition*, although it exempts government agencies. The Australian Consumer and Competition Commission vigorously enforces competition and has assisted several regional economies, including China and the Philippines, to develop their competition policies.

Singapore and Hong Kong markets are highly exposed to international competition in goods markets so do not feel the need to legislate competition policy; however, some sectors are regulated, particularly those affected by large scale privatisation. Similarly, Malaysia argues it does not need competition laws because its trade and investment regime is liberal. However, the WTO rejects free trade as a substitute for competition law, as this does not generate service sector competition.

### Other Barriers to Entry

Trade and investment liberalisation and deregulation cannot remove all barriers to firms entering monopolised industries. The market power of existing players can be a block. The large scale of Japanese and Korean business groups deters new entrants; collusion among such firms can increase barriers. The Japanese Fair Trade Commission identifies several *keiretsu* practices preventing outsiders from entering the market and reducing competition (World Trade Organization, 2001). (See Chapter 6 – *Japan.*) For example, firms in the same group often provide cross-guarantees and subsidies to each another, disadvantaging potential new entrants. Since the crisis, the Korean Government has outlawed such practices among Korean *chaebol* (East Asia Analytical Unit, 1999b). In Japan, imports and foreign direct investment were lower in markets *keiretsu*-affiliated firms dominated, suggesting collusion prevented entry by new foreign products and firms.

## FOREIGN INVESTMENT LIBERALISING

In the past decade, and particularly since the crisis, along with liberalising trade, regional governments have liberalised significantly foreign direct investment, FDI, regimes. As a result, East Asia's FDI stock is increasing rapidly (Figure 2.13). Foreign investment is important in increasing service sector competition as often this sector cannot participate in international trade. Foreign firms employing best practice management, technology, marketing, research and development and distribution boost domestic competition. Even the threat of foreign firms entering the market can discipline domestic firms.

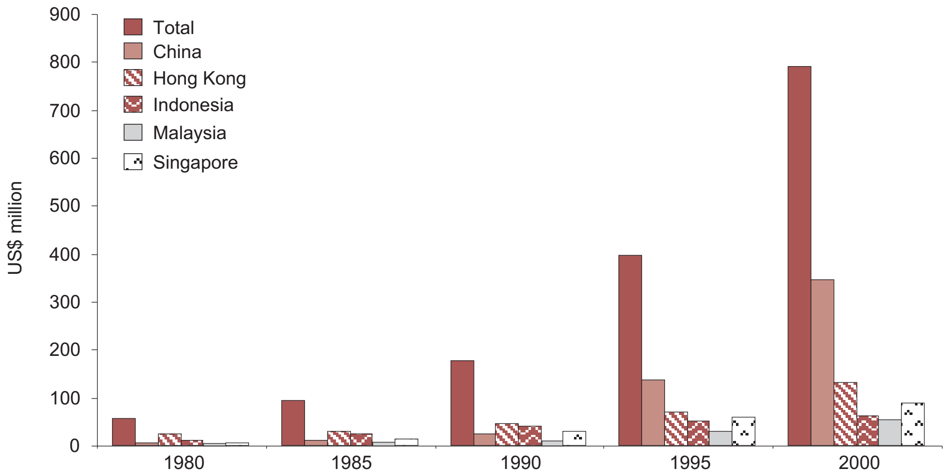
The crisis prompted FDI liberalisation in Indonesia, Thailand and the Republic of Korea to attract foreign capital to fund corporate restructuring, purchase distressed assets and increase competition. After a decade of reforms, Japan has opened foreign investor access to virtually all sectors.

Since the mid 1980s, China's liberal manufacturing and hotel FDI regime has allowed 100 per cent foreign ownership of firms. In its lead up to WTO entry, China also gradually loosened investment restrictions in key service sectors like financial services, telecommunications and distribution. WTO entry should continue to expand this access.

Figure 2.13

**East Asian FDI Growing Rapidly**

**Stock of Non-Japan East Asian Foreign Direct Investment in Selected Economies, 1980-2000, US$ Millions**




Source: UNCTAD, 2001.

Except in a few service sectors, Hong Kong's and Singapore's FDI regimes are extremely liberal, contributing significantly to their rapid and relatively robust economic growth, even during the financial crisis.

## MERGERS AND ACQUISITIONS RISING

After the crisis, merger and acquisition activity throughout East Asia increased significantly due to more liberal FDI regimes, crisis induced corporate distress and worldwide corporate consolidation (Figure 2.14). Markets for corporate management are increasingly competitive, pressuring East Asian managers to perform in owners' interests.

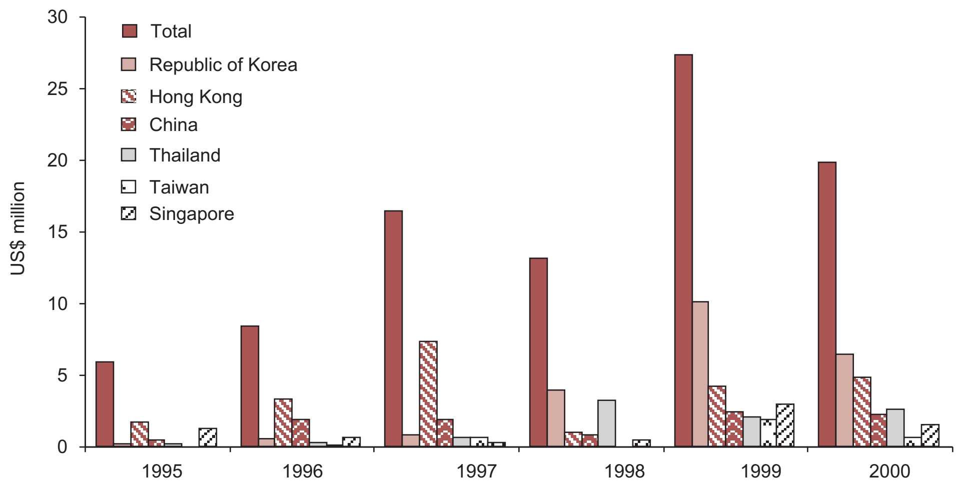
## BANKRUPTCIES INCREASING

Since the mid 1990s, increasing competition, unsustainable leveraging and the weak macroeconomic environment forced non performing East Asian corporates to exit their industries (Figure 2.15). Growing financial and prudential pressure on banks and fiscal pressures on governments weaken their ability to bail out weak firms. As the risk of firm failure rises, firms and their managers could be expected to strive harder to lift performance, improving returns to shareholders and allowing more intense creditor and shareholder scrutiny of their investments.

Figure 2.14

## Cross-border Mergers and Acquisitions Rising

**Cross-border Merger and Acquisition Activity for Non-Japan East Asia, Total and Selected Economies, 1995-00, US$ Millions**

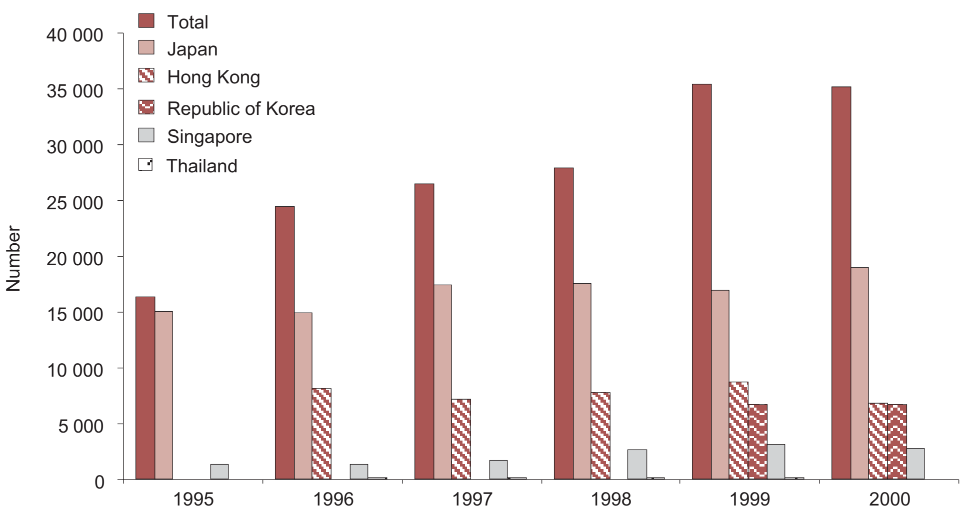



Source: UNCTAD, 2001.

Figure 2.15

## Bankruptcies Increasing Across East Asia

**Number of Bankruptcies in Selected East Asian Economies, 1995-2000**




Note: 1 Japan figures are fiscal years.
2 Data for Republic of Korea not available before 1999.

Source: CEIC, 2001.

## IMPLICATIONS

Prior to the crisis, highly concentrated market ownership, high leveraging and sustained high profits indicated low competition in many regional financial and goods markets. Since the crisis, strengthening market forces, through freer trade and foreign direct investment regimes, deregulation of markets and stronger competition policies, have increased competitive pressure on many East Asian corporates. Many indicators support evidence of stronger market forces, including increasing import penetration, growing FDI levels, falling bank lending levels and growing initial public offers. Eventually, stronger market forces in East Asia should increase discipline on regional corporates to lift efficiency, making corporate governance regulations more effective and relevant, and boost incentives to improve governance standards and pursue shareholder value.

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