Strengthening Financial Markets and Corporate Governance

Executive Summary

The East Asian financial crisis that swept through the region over 1997-1999 has highlighted twin reform areas: namely, the financial sector strengthening and corporate governance reforms. These two reforms that have been added to the core reform area of macroeconomic risk management underscore the importance of strength and competitiveness at the microeconomic level - of enterprises, corporations, industries, and banks. East Asian economies that undertake serious microeconomic reforms with determination and political will are likely to gain enormous strategic advantage in achieving sustainable economic growth.

Taking into consideration that East Asia has increasingly become a more closely integrated economic region, it comes as no surprise that the crisis spread quickly. In order to efficiently manage the many challenges that have spun out of the crisis, reform efforts must be coordinated in sync with each other, with a region-wide network in place. Such mechanism should facilitate exchange of perspectives and notes of experience.

The following paper emphasizes that without these fundamental microeconomic reforms in financial sector strengthening and corporate governance, despite a seemingly rapid economic recovery achieved by a quick return of macroeconomic balances, there is always a high danger that a crisis would recur.

STRENGTHENING FINANCIAL MARKETS AND CORPORATE GOVERNANCE

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Introduction

Even as the debate may continue on their inexorability, the twin mega-trends of political democratization and economic liberalization have been pushing societies and economies towards becoming more open, free and inter-connected. There can be complaints aired and demonstrations staged against the ill effects of globalization. There can be non-linearities, even some temporary setbacks, in the progress towards free and open trade and investments in the Asia Pacific region and in the world economy. But the inter-related forces of democratization and liberalization appear to have momentum, and advances in technology, finance, communications and other fields are reinforcing them.

Against this background, the East Asian financial crisis of 1997-1999 has highlighted twin reform areas. These are financial sector strengthening and corporate governance reforms. These have been added to the core reform area of macro-economic risk management. Indeed, debate continues on the relative weight that can be assigned to the different factors behind the crisis. But consensus has been building around the reforms necessitated by the crisis. They include all three, from the macroeconomic reform of risk management to the microeconomic reforms in the financial sector and corporate governance.

Moreover, there is much greater recognition today that the macro-economic fundamentals that matter are broader and wider in scope than what East Asia had been traditionally focusing upon. Whereas before, the strength of macro-economic fundamentals was taken for granted when inflation rates and public sector deficit ratios were low, and when savings rates and export growth rates were high, today other factors are included in the reckoning. These include, among others, the growth of credit, the bubble in asset prices, the net reserve position of central banks, and the relative term structure of all foreign exchange liabilities. The monitoring of the macro-economy is more

systemic. It has become more inclusive of the items that used to be conveniently swept under the rug.

Important as macroeconomics is, microeconomics has regained its central place under the sun. The East Asian financial crisis of the late 1990s has shown that microeconomics also matters, and it matters decisively. Indeed, it weighs much more heavily in today's more inter-connected economic and financial systems. This is because the whole economy is a system, and its strength in time is determined by the strength of its weakest link. For the system to be strong, therefore, it has to be consistently strong, from top to bottom. Thus, strength and competitiveness at the micro-economic level (at the level of enterprises, corporations, industries and banks) are as essential as at the macro-economic level. With this perspective, those economies in East Asia that undertake serious micro-economic reforms with determination and political will are likely to gain enormous strategic advantage for the longer term.

The challenge for the East Asian economies, therefore, lies in sustaining the rapid pace of their recovery from crisis by continuously strengthening their micro-economic fundamentals. This challenge can be met by focusing on corporate governance reforms and by speeding up such reforms through financial sector strengthening programs. Indeed, the two micro-economic reform areas of financial sector strengthening and corporate governance reforms are very closely inter-connected. They are two sides of the same reform coin. They are mutually reinforcing. Thus, oftentimes the more direct and quickest way to speed up corporate governance reforms is through the further strengthening of the financial sector, and more specifically the banking sector. The reverse also holds. The stronger the corporate sector becomes, the stronger and more stable the financial sector also becomes.

Perspectives on Corporate Governance Reforms

Corporate governance has become a buzz-phrase, one as often used today as it is taken for granted that everyone already knows much about it. A whole literature about it is sprouting, and experts are coming out of the woodwork to discuss and discourse about it. In the process, despite the general assumption that everyone knows about it, many people actually get baffled when asked to define what it really entails.

Instead of debating for long on the technical and conceptual definition of corporate governance, we can benefit more from an exchange of perspectives about the reforms that need to be undertaken under its banner.

A first perspective about corporate governance reforms is that they are about separation of powers. In the same way as in open societies and systems, there is a separation of powers (e.g. in politics, between the executive, legislative, and judicial), in open, market-oriented enterprises, corporations and financial institutions, there is also separation between the powers and responsibilities of ownership, governance and management. Ownership belongs to shareholders. Governance is the responsibility of the Board of Directors. Management is delegated to the CEO and a team of officers.

Separation of powers and responsibilities institutes a system of checks and balances. Such a system helps guarantee fairness, accountability and transparency. These happen to be features and characteristics that market discipline imposes. Markets demand that these guarantees are firm and secure. Against this perspective, it becomes clear that corporate governance reforms are intrinsically linked with competition principles in a market regime.

A second perspective about corporate governance reforms is that they are mainly about making the Board of Directors effective.

The Board of Directors can be effective if it exercises its powers, conferred upon it by law, with due care, diligence and competence. Moreover, all other parties, particularly those with ownership and management powers and responsibilities, must respect the autonomy and independence of the Board of Directors. Without these (autonomy and independence), the Board can not live up to its mandate of maximizing long-term shareholder value, guiding corporate strategy and shaping policy as well as overseeing and supervising management. It is only when the Board is autonomous and independent that it can properly balance the competing claims of different stakeholders, which include sectors representing the broader interests of the corporation, the community, the economy and society.

Against this perspective, corporate governance reforms are seen as providing protection---by an independent Board of Directors whose loyalty is to the corporation as a whole---to minority interests and outside parties with stakes in the corporation. These can not be overlooked, disregarded, or unfairly

treated, for they have a vital role in securing the long-term strength of the corporation that thrives in a free and open market.

A third perspective about corporate governance reforms is that they are about bringing an open, participatory system into the corporate boardroom.

In an open system, responsibility is conferred together with the freedom (independence and autonomy) that is enjoyed. In a participatory system, responsibility is given to everyone to contribute as much as one can. In other words, every director is asked to contribute positively and to add value to policy decision-making. This means that decision-making is a shared responsibility. It is collegial, and it is the board alone, as a board, that can perform corporate acts. No single individual should dominate the board or is allowed to arrogate to himself or herself the collegial powers of the board, which must be exercised at all times in a collegial manner.

Against this perspective, corporate governance reforms provide a system of accountability and of performance evaluation. This system starts at the very top, at board level, where even the chairman, the CEO and individual members of the board get to have their performance assessed, recognized and rewarded. Such a system needs to be fully consistent with open market mechanisms.

In sum, no matter how corporate governance is technically and conceptually defined, these perspectives frame up reforms in this important new field as extending the reach and application of competition principles to the corporation and the manner in which it is governed. Corporate governance reforms, therefore, enable corporations to align their governance practices with the demands of market discipline in open and free regimes.

Risk Management and Corporate Governance

The connection between corporate governance and competition principles is tight and fundamental. As progress is made, inexorably although at times haltingly, towards free and open regimes, subject to market discipline, the broader and stricter observance of competition principles is as essential as the pursuit and implementation of corporate governance reforms. In this sense, these reforms are increasingly recognized as *conditio sine qua non* for continued progress of free and open economies, increasingly inter-connected by the market mechanism.

In fact, through modern risk management systems, corporate governance reforms are basic to continued financial sector strengthening. For it is through such (risk management) systems that from the perspective of banks, credit risks are constantly monitored and assessed, risk-weighted capital is allocated, and differential treatment is given to credit accounts on the basis of the risks they carry. Market mechanisms have shown that risks are inversely related to the quality of corporate governance practices. In short and in very broad terms, risks are smaller the higher the quality of corporate governance. Conversely, risks are greater the lower the quality of corporate governance. Thus, banks show greater comfort, charge lower fees, allocate less capital for credit extended to corporate accounts, which have high quality corporate governance practices. Through such market-dictated differential treatment between corporate accounts, under modern risk management systems that banks are putting up, banks and other financial institutions can give strong signals favoring corporate governance reforms. In the process, they take out more guarantees against credit risks, and for their greater strength and stability.

Corporate governance reforms are also related, albeit more distantly, to prudent macro-economic risk management. Under modern risk management systems, the Board of Directors needs to evaluate market risks, which are influenced by macro-economic trends and shocks. Indeed, the systemic influence of the broader macro-economic market environment upon micro-economic corporate performance and prospects has become much clearer and stronger in a more tightly inter-connected world. Few, if any corporations, can escape the influence of interest rates and exchange rates, of inflation rates and wage rates, of stock market and product market trends, among others, upon their present and future financial position. Thus, it is vital to any corporation, particularly one that adheres to corporate governance best practices, to be closely tuned in to the monitoring and surveillance mechanism for several macro-economies that are closely connected with each other. A modern corporation with open governance practices can put to good use the signals and readings such a mechanism sends out.

Through modern risk management, therefore, the connection between corporate governance reforms with both financial sector strengthening and macro-economic monitoring and surveillance is more firmly established. Such a connection underscores the foundational importance of corporate

governance reforms, which touch upon the micro-economic base of any financial and economic system. In this regard, the imperative for corporate governance reforms is also highlighted. Without these reforms, despite a seemingly rapid economic recovery through a quick return of macro-economic balances, there is always a high danger that a crisis would recur. Also without them, any financial sector strengthening program would be left hanging, with an important leg on which it can continue to stand untended and unpropped. It has become clear since the 1997-1999 East Asian financial crisis that corporate governance reforms are at the very heart of the reform agenda in the region. It is also becoming increasingly obvious that no economic recovery in East Asia can be secured unless it is sustained by appropriate governance reforms, pursued with a high degree of commitment and urgency.

East Asia has increasingly become a more closely integrated economic region. Just as the contagion during the crisis spread quickly, so must reform efforts be more closely coordinated and undertaken in sync with each other. It is with this in mind that corporate governance reforms in East Asia are more effectively pursued, if promoted by a region-wide network. This network should facilitate exchange of perspectives and notes of experience. It should also provide an opportunity for cooperation in undertaking research, exploring policy options, and propagating "best practices". It should also be an effective spur for reforms and for speeding up their implementation.

Furthermore, since corporate governance reforms require that a continuing education program for directors serving in corporate boards be made available, a regional network enables institutes of corporate directors to provide mutual support to each other. Materials can be shared, responsibilities for the development of common courses given in different economies can be distributed, and teaching expertise can be tapped in a coordinated and more cost-effective basis. Moreover, the involvement and support of international financial institutions and of key market players and "reputational agents" can thereby be more probably secured. Finally, there is no reason why East Asia should reinvent the wheel for progress in corporate governance reforms. By remaining open to lessons and best practices from outside the immediate region, particularly from other economies in the Asia Pacific region, East Asia can fast-track the implementation, perhaps even on a coordinated basis, of these reforms.

Networking, tripartite involvement and open regionalism are hallmarks of PECC. The opportunity for PECC to continue to contribute positively to the promotion of reforms demanded by free and open regimes in the Asia Pacific region is as good in corporate governance reforms, financial sector strengthening, and macro-economic risk management as it has been in other fields. These three reform areas happen to be among the most important in the wake of the 1997-1999 East Asian financial crisis. And of the three, corporate governance reforms are at the very base and core of the reform agenda.

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