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Corporate Governance, Evolution of Corporate Laws and Asian Economic Development into the 21st Century[1]

by

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1. Introduction

Professors Wellon and Piston's report entitled "The Role of Law and Legal Institutions in Asian Economic Development 1960-1995" provides very valuable information on the evolution of corporate laws in six Asian countries. It shows how these laws were transplanted from the UK, the US, Germany and France to the various countries and how they have progressed in response to changing economic circumstances. Wellon and Piston's general conclusion with respect to this area of law for the sample countries is that "legal change responded to economic change rather than leading it and refutes the proposition that law is a determinant for patterns of external finance" (p. 160). The authors provide persuasive evidence and analysis in support of this view.

The purpose of this paper is to build on the Wellon - Piston analysis and to make two specific proposals for the further evolution of corporate law in Asian countries. The first of these proposals is designed to deal with important aspects of the current

economic and financial crisis in South East and East Asia. It addresses the problem of corporate restructuring in these countries in the wake of the economic crisis and considers specifically the case of South Korea. The second proposal is concerned with the more general issue of corporate governance in semi-industrial countries and refers particularly to the Indian situation. The two proposals are not, however, entirely independent. The first proposal could potentially have significant implications for corporate governance while the second proposal is also likely to be helpful in the restructuring of the Asian economies as they begin to recover from the crisis.

The next two sections set out in turn the two proposals and outline their respective contexts and the reasons for making them.

II. Corporate and Financial Sector Restructuring in Asia

An important analyses of the 1997-1998 financial crisis, which suddenly, and simultaneously, devastated the hitherto highly successful economies of East Asia, has ascribed its fundamental causes to the underlying model of 'state directed capitalism' which most of these countries followed. This causal linking of the acute economic crisis to the 'Asian model of capitalism' has not just been confined to distinguished financial journalists and

[1] This short paper draws on my previous papers, Singh (1997, 1998a, 1998b, 1998c, 1999) and Singh and

popular commentators, but is a view endorsed by the highest circles in government, and international institutions in Washington.[2] Indeed, following this type of analysis, the IMF policy programme for the crisis-affected countries required them to institute fundamental structural reforms to their economic systems. They were asked to change, among many other things, their systems of corporate governance, labour laws, and competition policies so as to rid these economies of "crony capitalism", "non-transparency" and myriad market rigidities (e.g. life-time employment in the largest South Korean firms).

Singh (1998, 1999) and Singh and Weisse (1999) have systematically examined this thesis and have found that it is seriously flawed. They conclude that this analysis is not only incorrect, but that the policy recommendations based on it are likely to prolong the crisis rather than alleviate it whilst also undermining the prospects for long-term growth. These papers suggest that the "deeper" reasons for the crisis do not lie in the

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Weisse (1998), to which the reader is referred for data and evidence and for citations to the relevant literature.

[2] Thus, Mr. Greenspan, the cautious chairman of the US Federal Reserve, in his testimony before the Senate Foreign Relations Committee suggested that, in the last decade or so, the world has observed "a consensus towards, for want of a better term, the Western form of free-market capitalism as the model which should govern how each individual country should run its economy…We saw the breakdown of the Berlin wall in 1989 and the massive shift away from central planning towards free market capitalist types of structures. Concurrent to that was the really quite dramatic, very strong growth in what appeared to be a competing capitalist-type system in Asia. And as a consequence of that, you had developments of types of structures which I believe at the end of the day were faulty, but you could not demonstrate

dirigiste model of the Asian capitalism, but rather in too little government control over corporate and financial sector activity following the financial liberalisation process implemented in the period immediately preceding the financial crisis.

However, regardless of the causes of the crisis, since it has occurred there is general agreement among analysts that the corporate sector in affected countries needs restructuring. The problem is particularly serious in relation to the *chaebol*, the joint conglomerate firm, in South Korea.

Although the Korean economy staged a spectacular recovery in 1999, the crisis of corporate restructuring is far from being over. The recovery is fragile. Daewoo, the fifth largest *chaebol*, is on the verge of bankruptcy. Samsung, the largest conglomerate, has seen its share price fall by 50% in the recent period, which has depressed the whole Korean market. Another leading conglomerate, Hyundai, is also facing serious difficulties. The *Financial Times* (November 6, 2000) reports on the problems the Korean conglomerates and government face in relation to corporate restructuring:

> Worries about labour unrest increased over the weekend after a violent protest at Samsung's truck plant in Taegu. Workers burnt vehicles and

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that so long as growth was going at 10 percent a year." See further statements by Larry Summers and the former Director General of the IMF Michael Camdessus in Singh 1999.

barricaded production facilities when it was announced that Samsung Commercial Vehicles would be liquidated under a programme by banks to close 29 troubled companies. Analysts believe the government may not want to place Daewoo Motor under court receivership when it must also deal with the possible collapse of Hyundai Engineering & Construction, the nation's biggest builder. The head of the Financial Supervisory Commission, Korea's restructuring agency, yesterday said the government might allow creditors to place Hyundai Construction under a restructuring programme after a debt-for-equity swap. Lee Keun-young, the FSC chairman, said this was preferable to court receivership for Hyundai Construction, which would have "a big impact on the national economy".

A main issue here is what kind of corporate restructuring is desirable and how it should be carried out? Is the Anglo-Saxon corporate and financial system, based on the stock market and a freely functioning market for corporate control ("free market capitalism" as Alan Greenspan calls it) the only viable alternative to the existing system? It will be argued that it is not; the paragraphs below outline a different system of corporate restructuring which is likely to be both more feasible and more beneficial to the crisis economies than the IMF recommended free-market system.

The Korean *chaebol* had exceptionally high debt/equity ratios prior to the crisis and many of them became technically bankrupt as the crisis hit the economy. The crisis has also led to the financial sector being burdened with enormous bad debts. To reduce the indebtedness of the *chaebol* and to restore financial viability to the corporate system and hence to the banking industry - both of which are necessary for sustaining successful recovery of

the real economy - a huge public bailout has been required at the expense of the tax payers.. The government has been obliged to effectively re-nationalise the banking industry.

However, reform of the *chaebol*, as suggested by the *Financial Times* report, is meeting increasing resistance from workers as well as the general public who feel that the burden of adjustment process is not being fairly distributed. In addition, there is public disquiet about the foreign take-overs of the *chaebol* assets envisaged in the IMF-inspired market-based government restructuring policy. Even if the government lets Daewoo go into liquidation, and allows some of its assets to be sold to foreigners and thereby pay a heavy political price, it is unlikely to either have the ability or the desire to repeat this process with another big conglomerate such as Hyundai. In order to carry out successful restructuring of the *chaebol*, without harming their economic efficiency and sacrificing their proven record of huge contributions to the wealth and prosperity of the Korean economy, the Government needs to fundamentally rethink its basic approach and policy perspective.

The essential proposal of this paper is that instead of abandoning the Asian model of social co-operation and of close business-government relationship, the present Korean government or its

successor should renew and extend it to workers, trade unions, and civil society organisations as part of a national programme to resolve the economic situation.

One way of achieving this objective would be for the government to swap its loans in the *chaebol* for equity and offer some of these to workers and trade unions in order to secure their co-operation. In other words, the current sacrifice of the workers in terms of lower wages or lay-offs could be compensated for by giving them a tangible stake in the success of the restructuring process. The government should also create a social fund with the remaining equity in order to provide either social security for the future, or a straight forward social dividend when the economy has recovered for workers in the non-*chaebol* smaller enterprises. This would help to compensate the latter for having suffered greater unemployment and wage cuts relative those who work in the *chaebol*.[3] These are measures designed to ensure some equality of sacrifice in the restructuring process.

However, it will be both socially desirable and economically efficient to go further. Workers and civil society organisations may be given a direct role in corporate governance. The *chaebol* are so huge that their strategic commercial decisions (where to

[3] See You 1998.

invest, how much to invest) have a major impact not only on those directly concerned with the enterprise (e.g. workers, suppliers) but also on the local community and the region at large. There is little social justification for these large corporations to be run in the sole interests of the shareholders. Social justice requires that other stakeholders' interests are also properly taken into account.

In terms of corporate law, this inevitably means a dilution of the property rights of the shareholders which some would regard as leading to inefficient economic outcomes. However, particularly in the present crisis in South Korea, such dilution is not only socially and politically desirable but depending on the form it takes, there are good reasons to think that it would also be economically efficient. One approach would be for Korea to adopt some version of the German system of co-determination and two-tier boards. The top tier which sets the strategic direction of the corporation could have not just workers and management representatives, as is the case in Germany, but also representation from the government and the local community.

Such an institutional change would benefit the economy in a number of ways. Very briefly, firstly it would help to change the bitter relations between trade unions and the *chaebol* owners as the whole emphasis of the proposal would be on social co-

operation as opposed to adversarial conflict. Secondly, it would re-focus the terms of the current dispute between the unions, the *chaebol* and the government. Since the crisis, the main issue between these three parties has been the question of labour market flexibility and employment protection.[4] The proposed institutional reforms would put on the agenda important issues of participation and democratic involvement in the management of the *chaebol* and the economy as a whole.[5] Thirdly, the presence of the government, civil society and union representatives on supervisory boards would help to improve corporate governance, reduce the agency problems, promote accountability and transparency of the *chaebol* well into the twenty first century.[6] Fourthly, it would preserve the economic benefits of the *chaebol* as an organisational form. Other scholars have pointed out large conglomerate organisations such as the *chaebol* are ubiquitous in the third world and there are good economic reasons for this. Further, evidence suggests that, contrary to the experience of the

[4] See further You (1998) and Kim (1998).
[5] These were promised by President Kim Dae Jung at the beginning of his term of office, but subsequently questions of participation have simply been forgotten in the stalemate which has developed on the question of labour market flexibility. See further You (1998).
[6] Stiglitz (1985) has observed that even in large Anglo-Saxon enterprises where there is separation of ownership and control, workers are one group who have both the incentive and the ability to monitor the activities of managers. He argues that this task is not performed at all well by the market for corporate control or by the banking system (see further Section 3).

conglomerate firms in advanced countries, developing countries conglomerate, tend to be more efficient than other firms.[7]

III. Corporate governance and emerging markets. Guiding future market evolution.

The second proposal concerns the general question of corporate governance in semi-industrial countries. The background to this proposal may be summarised as follows.

Developing countries witnessed a historically unprecedented growth of stock markets in the 1980s and 90s. Between 1983 and 1993 the total combined capitalization of companies quoted on the 38 emerging markets included in the Economist's list rose from less than a hundred billion to nearly a trillion US dollars. Over this period, a number of leading individual emerging markets (e.g. Mexico, Korea and Thailand) recorded a more than twenty-fold increase in total market capitalization. By the early 1990s the size of these stock markets was comparable to those of medium-sized advanced country markets in Europe.

[7] There is an analytical reason for this phenomenon: developing countries suffer to a much greater degree from missing or incomplete markets than advanced economies. In these circumstances, the conglomerate organisation may be optimal. See further Khanna (2000) and Khanna and Palepu (1997).

The speed of development of third world stock markets in this period may be judged from the fact that it probably took 85 years (1810-1895) for the US capitalization ratio (market capitalisation as a proportion of GDP) to rise from 7% to 71%. In contrast, the corresponding Taiwanese ratio jumped from 11% to 74% in just 10 years between 1981 and 1991. Similarly, between 1983 and 1993 the Chilean ratio rose from 13.2% to 78%; the Korean from 5.39% to 36.2% and the Thai from 3.8% to 55.8%.[8]

The breadth and depth of the stock market development in industrialising countries in the 1980s and 90s may be illustrated by considering the specific case of India. Compared with many other semi-industrial countries, India has been rather conservative in initiating financial liberalisation. The Indian stock market cannot literally be regarded as an emerging market since the first stock market was established in the country as long ago as 1875. However, up to 1980 stock market development had ebbed and flowed but in general had been quite slow. In 1980-81 total market capitalization in the Indian stock market as a proportion of GDP was only 5%. As a result of the liberalisation measures initiated in the 1980s, by 1990 the

[8] See further Mullins (1993), Singh and Weisse (1998).

ratio had risen to 13%. With the major change in government policy and the acceleration of the pace of liberalisation in 1991, stock market growth became explosive. By the end of 1993, total market capitalization had reached 60% of GDP. The number of shareholders and investors in mutual funds rose from 2 million in 1981 to 40 million in 1993,a figure second only to the US(51 million). In terms of listed companies the Indian stock market(over 8ooo companies in 1997) is today the largest in the world, larger even than the US. The average daily trading volume on the Bombay stock market in the early 1990s was about the same as that in London - about 45,000 trades a day. At the peak of stock market activity trading occurred at double that rate.

There are however three points which may be noted with respect to the stock market growth in India and other leading emerging markets during the 1980s and 90s.

a) Stock market development was not a wholly spontaneous response to market forces but was often heavily assisted by government measures.
b) Although there has been rapid expansion of emerging markets during the last two decades, it should be emphasized that even the most advanced ones among them are far from

being fully mature. In many dimensions (for example the thickness of the market) developing countries' stock markets have still got a long way to go. Most emerging markets also suffer from a wide range of informational and other regulatory deficiencies (e.g. with respect to transparency of transactions; high incidence of insider trading.

c) The data indicating the very fast growth of emerging markets refers to the 1980s up to about the mid-1990s. Currently most developing country stock markets are at a low ebb and therefore the present values of indicators for stock market development are likely to be much below what they were earlier in the decade.

Notwithstanding the current declines in share prices, the financial community in India and elsewhere is eager for a further development of the stock market. They would like the Government to permit or facilitate the establishment of a market for corporate control. Such a market, it is argued, is required in order to maximise the benefits from stock market development. In the crisis-affected countries the IMF is encouraging such markets, often as a part of its conditionality.

Although there are embryonic markets for corporate control in a few developing countries (e.g. Brazil, India), most do not yet

have hostile take-overs and fully-fledged markets for control. The main burden of the second proposal in this paper is for the governments of the emerging markets to resist the establishment of a take-overs market. They should certainly take no steps to facilitate it - indeed, in my view, they should go further and actively discourage it. The reasons for this proposal have been set out at length in Singh (1998b), these are summarised below. .

In text-book theory, take-overs provide an important additional mechanism through which the stock market can promote a more efficient allocation and utilization of a society's capital resources. However, more recent economic analyses suggest a number of reasons why the virtues of such a market may not actually materialise in the real world. The more important of these factors are:

a) inherent imperfections in the actual stock markets even in advanced economies whereby it is far easier for a large firm to take over a small one rather than the other way around;

b) the lack of necessary information required by the relevant economic agents for the takeover disciplinary system to work adequately;

c) huge transaction costs, particularly in contested take-overs;

d) the so-called free-rider problem noted by Grossman and Hart in a seminal paper in 1980.

Further, empirical evidence from advanced countries such as the USA and UK, where these markets have long been in existence, indicate several drawbacks particularly from the perspective of economic development.

a) Take-overs greatly intensify the normal stock market pressures towards speculation and short term returns.

b) There is no evidence that the market works in such a way as to always punish the inefficient and unprofitable companies and reward the efficient ones. Empirically, selection in the market for corporate control occurs much more on the dimension of size than that of profitability or the firm's stock market valuation.

c) An active market for corporate control is likely to seriously distort the incentive system facing corporate managers. In Japan and Germany, which do not have markets for corporate control, managers are induced to seek the organic growth of the corporation. In contrast, incentives in the Anglo Saxon system emphasize financial engineering and growth by merger.

d) In view of the existence of large domestic conglomerate enterprises in India as in many other developing countries, a

freely functioning market for corporate control runs serious dangers of increasing concentration of industry as well as stifling the development of small and medium-sized efficient firms.

e) It is particularly relevant for developing countries to bear in mind not only the enormous transaction costs involved in take-over activity but also the very large unfavourable re-distributions of wealth it often leads to.

In India there are admittedly serious problems with the present system of corporate governance: conflicts of interest and lack of cohesion among many controlling families, the adverse effects of large interlocking, inter-group investments on small shareholders in the group companies; the total exclusion of ordinary shareholders from decisions with respect to corporate re-structuring, mergers, divestments etc. Corporate governance systems in large private corporations in other emerging markets no doubt have their own similar difficulties. It may therefore appear attractive to deal with the whole gamut of such governance problems through the invisible hand of the market - by the institution of the take-over mechanism. However the evidence from advanced countries suggests that the end result of this whole process may not necessarily be better and could be considerably worse than the current situation. Developing

country governments are better advised to follow the example of Japan, Germany and other countries in Europe and attempt to find different ways of solving these governance problems. Emerging markets simply cannot afford the burden of an extremely expensive and a hit and miss system of management change which take-overs present.

If developing country governments were to accept the proposal outlined here and discourage the emergence of a take-overs market, complementary actions would be required in two important areas. First, the governments would need to encourage alternative systems of monitoring and disciplining inefficient corporate managements. These may well, for example, take the form of worker, community and government representation on the top tier boards of large corporations, as outlined above in the first proposal. However, these arrangements may also take other forms depending on a country's labour history and other circumstances. The second group of complementary policies, in the absence of a market for corporate control, would involve promoting greater competition in the product markets. In the normal calculus of a capitalist economy, such competition is the main constraint on inefficient managements. However, many developing countries such as India are deficient in this area. Parenthetically, recent research however, indicates that contrary

to popular pre-conceptions, the intensity of competition in the product markets in manufacturing in semi-industrial countries is often no less than that observed for advanced economies. (See further Glen et al, 2000; Tybout, 2000). Nevertheless, in the current context of the privatisation of former public monopolies, as well as the huge international merger wave which is creating ever bigger firms with increasing market power, many emerging markets need to institute competition policies of the appropriate kind (which is not necessarily the US type of anti-trust policy).[9] These countries need to reduce barriers to entry, whether private or public, and stimulate greater domestic product market competition.

IV Conclusion

This paper has outlined two proposals which bear on the increasingly important question of corporate governance in emerging markets. These proposals challenge the conventional wisdom on the subject. The nature and extent of their application to a particular country will depend upon its specific circumstances. The legal changes in corporate and other laws required to give effect to either of these proposals are unlikely to cause any difficulties.

[9] For a fuller analysis of these questions, specifically the issue of appropriate competition policy in developing countries, see further Singh and Dhumale (1999).

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