THE IMPACT OF ENRON ON ASIAN BUSINESS

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INTRODUCTION

The financial crisis that swept through Asia in 1997 devastated economies throughout the region and exposed a number of business and political practices as in dire need of reform. Although much of the crisis was caused by rapid increases in the volume and pace of international financial flows—and the herd mentality of Western bankers—the crisis was also caused by "crony capitalism," networks of personal relationships that revealed the region-wide need for better corporate governance and transparency. As argued by Paul Krugman and others, poor corporate governance in Asia led to moral hazard, high debt, and poor investment and management of firms, which in turn led to the Asian financial crisis of 1997.[1] In this popular view, reform of corporate governance is one of the critical measures that must be undertaken before these economies can resume their rapid growth.

In addition, this view places most of the blame for poor corporate governance on the pattern of practices within the Asian countries themselves, and has held up western (and particularly, American) government and business practices as the ideal model to which Asian countries should aspire.[2] Despite occasional complaints about Western arrogance, most Asians accepted and realized the need for reform in markets, corporations, and their governments.

Some observers argued that one "quick" remedy for Asian countries is to open their markets more widely to foreign firms. The influx of these firms, it was argued, would raise standards in developing countries over such issues as corporate governance, transparency, and rule of law. From this perspective, competition and diffusion of best practices over corporate governance would provide both pressure and incentives for developing

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1. *See* Paul Krugman, *What Happened To Asia?* (Jan. 1998), *at* http://web.mit.edu/krugman/www/DISINTER.html.; *see also* Samuel Brittan, *Asian Model R.I.P.*, FIN. TIMES, Dec. 4, 1997, at 24 (describing the Asian financial crisis); Jill Solomon et al., *A Conceptual Framework for Corporate Governance Reform in South Korea*, 10 CORP. GOVERNANCE: AN INT'L REV. 29–46 (2002).

2. Donald K. Emmerson, *Americanization of Asia?*, FOREIGN AFF., May–June 1998, at 49–52, 54. For a counterargument, see Robert Wade, *The Asian Debt-and-Development Crisis of 1997: Causes and Consequences*, 26 WORLD DEV. 1535–53 (Aug. 1998).

countries to raise their regulatory and legal standards and improve the quality of their institutions.[3]

However, as the cases of Enron, WorldCom, Tyco, and scandals at many of the major Wall Street investment banks have shown, Western firms are just as capable of engaging in egregious violations of corporate governance standards as any Asian company, and Western firms can be just as evasive and non-transparent as firms in developing countries.[4]

What does this mean for Asian companies? How do the Enron revelations affect Asia's attempts to reform its business practices?

The direct impact of the American scandals were minimal. Economic reform in Asia is a domestic matter, and domestic issues and concerns matter more than what happens internationally. For these countries, raising corporate standards and pursuing reform and restructuring is a long and multifaceted process that requires enduring change across a multitude of domestic institutions such as bureaucracy, legal systems, business organization, and actual personnel.

In this paper I will make two points about corporate governance in Asia. First, Asian countries have enacted a number of reforms over the past five years, and although some countries have been more successful than others, all nations have improved their corporate governance structures. Second, reforming corporate governance is not only a matter of moral or legal changes, but more importantly involves a long-term process of institutionalizing the larger democratic and economic structures within which companies operate. It is ultimately these changes that will raise corporate governance standards in Asia.

I. ATTEMPTS AT REFORMS IN ASIAN CORPORATE GOVERNANCE

One central aspect to reforming corporate governance involves institutional and legal changes. In Korea, Thailand, Malaysia, Indonesia, Japan, the Philippines, and other Asian countries, there have been considerable efforts (some successful, others not so successful) to enact campaign finance limits, laws against nepotism, mandates for greater corporate transparency, and other reforms. However, many of these legal structures

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3. MITSUHIRO FUKAO, FINANCIAL INTEGRATION, CORPORATE GOVERNANCE, AND THE PERFORMANCE OF MULTINATIONAL COMPANIES 72–80 (1995); Magdi Iskander et al., *Corporate Restructuring and Governance in East Asia*, 36 FIN. & DEV., March 1999, at 42–45; Hyuk-Rae Kim, *The Viability and Vulnerability of Korean Economic Governance*, 30 J. CONTEMPORARY ASIA 199–220 (Mar. 2000); William Mako, *Corporate Restructuring in East Asia: Promoting Best Practices*, 38 FIN. & DEV. March 2001, at 2–5; Mary O'Sullivan, *Corporate Governance and Globalization*, 570 ANNALS AM. ACAD. POL.& SOC. SCI. 153–72 (July 2000).

4. APP-Indonesia and Daewoo are just two widely-known examples.

already existed before the Asian financial crisis—the problem is not necessarily a lack of institutions, but the enforcement of those laws.

South Korea has probably acted with the most vigor of any country in Asia to enact reform measures. In South Korea, the Monopoly Regulation and Fair Trade Act (MRFTA) was enacted during the Roh administration (1988–92)[5] and had a number of provisions regarding corporate governance.[6] Direct cross shareholdings between any two subsidiaries of each of the 30 largest conglomerates were prohibited, as were mutual debt payment guarantees among chaebol subsidiaries. Conglomerates were also required to designate three core companies and divest extraneous units. The MRFTA also introduced fiduciary responsibilities of corporate directors, making de facto directors, including controlling shareholders, accountable and liable as normal directors.[7]

Furthermore, after the crisis of 1997, the South Korean government enacted a number of other laws.[8] In 1998, listed Korean Stock Exchange firms were required to have at least one outside director on the board, and by June 2000, large firms (those with assets over $1.7 billion) were required to have over half of directors be independent.[9] Table 1 shows the compliance with those regulations.[10] Although there are still areas in South Korea that need improvement, it is generally agreed that South Korea has gone farthest with its reforms.[11]

Table 1. Outside directors for firms Listed on the KSE

	1998	1999	2000
Number of firms	736	701	704
Percent of Outside directors	1.4	24.8	32.3
Average number of outside directors	0.91	1.72	2.12

Source: Korea Stock Exchange

5. For the full history of the MRFTA, see the Korea Fair Trade Commission, *available at* http://www.ftc.go.kr/eng/overview.html (last visited Aug. 30, 2003).

6. *See* DAVID KANG, CRONY CAPITALISM: CORRUPTION AND DEVELOPMENT IN SOUTH KOREA AND THE PHILIPPINES (2002).

7. Korea Fair Trade Commission, *supra* note 5.

8. These regulations covered foreign investment in Korea, bankruptcy, and financial reform.

9. Juan Miguel Luz, Ramon V. del Rosario Sr., Managing Corporate Governance in Asia: Notes on the Legal/Regulatory Environment and Corporate Governance Practices in Three Asian Economies (2001) (presentation paper prepared for AIM Center for Corporate Responsibility, Manila), *available at* http://asiancorpgov.aim.edu.ph/issue5d.htm (last visited Aug. 30, 2003).

10. Joongi Kim, *Recent Amendments to the Korean Commercial Code and their Effects on International Competitions*, 21 U. PA. J. INT'L ECON. L. 273, 324 (2000).

11. For an analysis, see TAT YAN KONG, THE POLITICS OF ECONOMIC REFORM IN SOUTH KOREA: A FRAGILE MIRACLE (2000).

Southeast Asian countries have also attempted to craft corporate governance reform in the past five years, although with varying success.[12] In Thailand, the government responded to the 1997 crisis by giving the Bank of Thailand greater power to intervene in bank operations in cases of mismanagement and fraud, while limits on foreign ownership were removed.[13] In Malaysia, the government has tightened rules on insider trading, and enacted reform legislation regarding corporate governance.[14] The Philippines has formed the Presidential Commission on Governance, and also an Institute for Corporate Directors, both aimed at raising the standards for governance in the Philippines. However, as the World Bank noted, ". . . [in the Philippines a] comprehensive set of corporate law and capital market regulations are enforced by relatively weak institutions."[15] Indonesia has remained the most troubled nation in the region, attempting to overcome political and economic crises.[16]

Finally, Japan has probably lagged the farthest behind in terms of genuine reforms.[17] In Japan, there have been numerous failed efforts to force the banking sector to increase its transparency and deal with the bad loan problem.[18] For a decade, although the government introduced various reform measures for banking and corporate governance, few have been enacted, much less enforced.[19]

Although there has been varying degrees of success across Asia, all of the countries of Asia have begun to enact formal legislation for greater corporate governance. However, formal legal and political institutions are only one aspect of enacting true corporate governance reform. More important is the larger political environment within which these corporate

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12. Mark Beeson, *Globalization, Governance, and the Political-Economy of Public Policy Reform in East Asia*, 14 GOVERNANCE 481, 489–96 (2001); Jonathan Rigg, *Globalization and the Asian Economic Crisis: Indigenous Responses, Coping Strategies, and Governance Reform in Southeast Asia*, 75 PAC. AFFAIRS 482–84 (2002).

13. Scott B. MacDonald, *Transparency in Thailand's 1997 Economic Crisis: The Significance of Disclosure*, 38 ASIAN SURVEY 688–702 (Jul. 1998).

14. Greg Felker, *Malaysia in 1999: Mahatir's Pyrrhic Deliverance*, 40 ASIAN SURVEY 49–60 (Jan./Feb. 2000).

15. World Bank, *Corporate Governance Country Assessment: Republic of the Philippines*, 14 (Sept. 2001).

16. *See* Michael Ross, *Indonesia's Puzzling Crisis* (2002) (describing the Indonesian financial crisis that occurred at the end of the Suharto regime), *available at* http://www.polisci.ucla.edu/faculty/cross/indcrisis.pdf.

17. RICHARD KATZ, THE SYSTEM THAT SOURED (1998).

18. *See, e.g.*, Aurelia George Mulgan, *Japan's 'Un-Westminster' System: Impediments to Reform in a Crisis Economy*, 38 GOV'T & OPPOSITION 73–93 (2003).

19. *See* Frances Rosenbluth and Michael Thies, The Electoral Foundations of Japan's Banking Regulation (June 16, 1999), *available at* http://www.yale.edu/leitn ner/pdf/1999-02.pdf; Peng Xu, Corporate Governance in Japan: Upturn vs. Downturn of the Economy (2002), *available at* http://www.zaim.jp/papers/6-4.pdf.

governance reforms are embedded.[20] From this perspective, the prospects for reform in Asia are less positive.

II. ECONOMIC REFORM REQUIRES POLITICAL REFORM

Reform of corporate governance involves more than changes to formal institutions. This is because politics and corporate governance are deeply intertwined, and thus reforming corporate governance involves changing a country's entire government-business relationship. Much of corporate governance reform is actually an attempt to reduce the personalistic nature of business transactions. Good corporate governance involves eliminating nepotism, appointing independent directors to the board and independent auditors for the financials, and forcing management to respond to rules, laws, and regulations. Indeed, another way of describing corporate governance reform is to discuss the elimination of cronyism and personal relationships.[21]

However, in countries with weak legal, political, and economic institutions—the case in most developing countries—information about market conditions and government policy is both scarce and difficult to obtain, and investments and property rights may be insecure. In general this leads to an increased difficulty in making long-term commitments of any sort, because the political and economic conditions and actors can change rapidly. Capital markets do not function as effectively in developing countries, and in general, political or economic decision-making is subject to greater uncertainty than in developed and democratic systems. For businessmen and politicians in this environment, the transaction costs of making and keeping agreements and securing property rights can be prohibitively high. Absent some enforcement mechanism, parties may be reluctant to enter into long-term relationships.

Under these conditions, relying on personal relationships can actually reduce these barriers. This can occur if actors have deep and enduring contact with and knowledge of each other, and are able to make nuanced judgments about actors' credibility and capability. If the laws offer no recourse, personal information about the character of important actors is important. Personal contacts will reveal whether one side is likely to uphold an agreement or whether they are cheating; personal contacts will reveal information about the likely direction a government bureau is likely to take, and personal contacts with long-term, close, and overlapping

20. On the institutional environment of an economy, see generally DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE (1990).

21. David Kang, *Transaction Costs and Crony Capitalism in East Asia*, 35 COMP. POL. (2003).

personal ties can share information more easily. It is not the case that if contracts are hazardous that economic activity will disappear: rather people on the ground attempt to find alternatives that will add some predictability and stability to the future, and this often means relying on personal relations.[22] Thus, personal relationships—and the lax corporate governance with which it is associated—can actually lead to better information, monitoring and sanctioning, strengthen property rights, and provide better business prospects for a firm.[23]

The point is that if the laws and other political institutions are unreliable, businessmen and politicians will find other ways to conduct their business. This will involve relying on personal relationships and intimate, almost gossipy, knowledge and information. In this context, practical corporate governance requires information about who is reliable, who is trustworthy, and who is effective. This information will be more important than information about the laws or the actual business merit. In fact, even when making loans or long-term business decisions, what may matter more is who the person is and who the person knows.

However, this is not to argue that lax corporate governance and a reliance on personal relationships is always better. There is widespread agreement across Asia that better corporate governance is ultimately more stable, more efficient, and more fair. The point is that the people and their networks came first, not the laws. As political institutions evolve, and with preexisting networks of personal relations, business and government actors in Asia have relied upon who they knew. Later, as the governments attempted to pass new legislation, the problem was that the business community was unsure whether the formal stated laws would really matter, or whether inside access remained the key. As one Philippine businessman put it, "status is still measured by the extent to which you are an exception to the laws."[24] Thus the question becomes: How can we modify corporate governance from a reliance on personal relations to more transparent and meritocratic bases? Although an obvious answer is to move countries from authoritarianism to democracy, in reality these transitions increase the role of uncertainty and hence personal relations, and only over time will democracies end up providing a better business environment.

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22. *See* Kang, *supra* note 21. For similar arguments about patron-client relations and cronyism, see Mushtaq Khan, *Rent-Seeking as Process*, *in* RENTS, RENT-SEEKING, AND ECONOMIC DEVELOPMENT 114–17 (Khan and Jomo eds. 2000). This study builds upon Khan's work by explicitly discussing transaction costs and information as part of politics.

23. *See, e.g.*, Ray Fisman, *Estimating the Value of Political Connections in Indonesia*, AM. ECON. REV. (forthcoming).

24. Personal interview with a Philippine businessman who wished to remain anonymous.

Why, with increasingly democratic and modern countries, does weak corporate governance survive? The simplest explanation for deeply-rooted cronyism is that it reveals the moral failings of the politicians and businessmen who engage in corruption. If elites only had better moral character, the argument goes, we'd get better corporate governance. Unfortunately, widespread use of personal relationships in place of good corporate governance is so widespread reveals a failing not of individual people, but of a system itself that rewards and encourages the practice.

One reason corporate governance is so difficult to improve is that as long as politicians have an important effect on the market, there will be an incentive for businessmen to attempt to influence the political process for their own ends. Indeed, the more influence the government has over economic life, the more incentive business has to try and influence the government. While in the abstract we can differentiate between smoky back-room deals and arms-length policymaking, the reality can be much more difficult to differentiate. The issue is how to limit the extra-legal influence of the wealthy and well-connected and yet avoid subverting the democratic process by disallowing any contact between constituents and politicians.

The authoritarian governments of East Asia intervened heavily during the era of high-growth. So extensive was their interference in the market that an entire generation of scholars and policymakers debated whether and to what extent government intervention helped development. This style of developmental policy came to be known as the "developmental state," most aptly characterized by the governments of Japan, Korea, and Taiwan.[25] With coherent governments implementing coherent policies, Asia experienced rapid—indeed unprecedented—economic development during the last four decades of the 20th century. Under these authoritarian and interventionist conditions, it is no surprise that people did not rely on laws, but rather pursued personal relations as the path to political or economic success.

With the wave of democratic transitions in East Asia in the late 1980s, there was widespread belief that business and politics in Asia would increasingly mirror that of the United States. However, the reality was far different. Democracy increased the possibility of corruption and weakened the government's ability to balance or contain the naturally avaricious demands of business. This is because the choice of political system does not automatically affect the pressure and deeply institutionalized patterns of

25. On the developmental state, see generally STEPHAN HAGGARD, PATHWAYS FROM THE PERIPHERY (1991); CHALMERS JOHNSON, MITI AND THE JAPANESE MIRACLE (1982); KANG, *supra* note 6.

government-business interactions.[26] Although during the era of high-growth a relatively coherent state had acted to balance and restrain the demands of the business sector, democracy weakened the state and allowed business to run amok. The wave of Asian democratization in the 1980s did not change the generally high demand by the business sector for access to the government, but it did affect the supply. With more politicians competing on the supply side, fewer limits were placed on the behavior of the business sector. The transition to democratic rule, although fitful, radically altered the relationship between state and business. This led to increased demands for political payoffs, as politicians began to genuinely compete for electoral support, and decreased ability by the state to resist or contain the demands of the business sector.[27]

The reforms mentioned above are a good step to limiting corruption, but they are not the only, nor even the most effective means by which to do so. As long as politicians have the power to affect the economy, there will be incentives for individuals to try and subvert the democratic process and receive more selective benefits than others.[28] In particular, because voter coalitions, interests, and issues in consolidating democracies may not be well-defined, politicians may not have the incentive to respond to voters as closely. In this way, electoral accountability is potentially the best path to actual economic reform, because if the politician acts too often against the interests of the majority of the voters, they will vote the politician out of office, creating an incentive for the politician to give voters what they want. Thus, although the legal system may define what proper corporate governance is, actual reform will probably be in proportion to the government's influence over the business life.

CONCLUSION

Attempts to reform corporate governance in Asia offer a number of lessons about globalization, corporate governance, and reform in general. Most significantly, Western firms do not necessarily offer improved standards that scholars and western businessmen have often assumed it to be. While the conventional wisdom that emerged following 1997 saw as inevitable the reform of Asia's crony system of business–government

26. James Petras, *The Americanization of Asia: The Rise and Fall of a Civilization*, 28 J. CONTEMP. ASIA 149–59 (1998).

27. KANG, *supra* note 6, ch. 6.

28. This follows Susan Rose-Ackerman's argument that electoral systems that require winners to appeal to broad cross-sections of the population are more likely to supply broad-based public goods. SUSAN ROSE-ACKERMAN, CORRUPTION AND GOVERNMENT: CAUSES, CONSEQUENCES, AND REFORM (1999).

relations, reliance on shady financial instruments, and notoriously ambiguous legal system, the reality is that merely exhorting Asia to follow U.S. corporate governance standards has done little to change the underlying manner in which business operates in Asia.

This is because reform and restructuring are long-term processes that involve a multitude of different institutions and actors. Domestic institutions and vested interested that make up national characteristics are tightly interwoven. Genuine and enduring corporate governance reform requires that all institutions and actors adjust. Passing new laws regarding outside directors is of little value if there are not truly "independent" directors to be found, and if the laws are not enforced. Forcing bureaucrats to pursue restructuring will be slow going if those bureaucrats themselves are knee-deep in cozy relations with businessmen. And most significantly, foreign firms that enter Asian markets will have little effect if they only seek to take advantage of the lower corporate governance and transparency standards present there, rather than to implement better standards. Indeed, globalization and foreign capital has done little to improve the situation as of yet.

In the long run (generally left unspecified), one could argue that Asian companies will have to adjust their corporate governance standards to meet internationally accepted best practices. But the long run is far away, and the short run is much more pressing. Given the enduring personal relationships existent in every country in the world, bureaucrats' susceptibility to political pressure, a company's ability to pack the board with members of its own choosing, and the unsettled state of the international financial sector, one must conclude that Asian corporate governance standards will remain less than ideal for the foreseeable future.