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CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE

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1.The Asian Economic Crisis and Corporate Governance

The scope and severity of the economic crisis that swept through the East Asian region less than two years ago are well documented. However, consensus has yet to be made about the underlying causes of the crisis, the relative importance of each cause as well as the relationship among them. At the outset, it was a seemingly sudden reversal of foreign capital flows that triggered a currency crisis, initiating in Thailand and then spreading out across the region. Shifts in external conditions, in particular increased competition from other developing countries such as China and Mexico, are said to have eroded the export competitiveness and hurt the profitability of the firms in the region. These developments may have been factors in triggering the flight of foreign capital out of the region in that they raised concerns among investors about the ability of those firms to repay their debts. Certain macroeconomic and exchange-rate policy measures undoubtedly played an important part, especially in the last months leading up to the crisis.

At a deeper level, inherent instability in the international financial market, often stemming from herd mentality and contagion effects, was identified as a key factor that triggered the currency crisis. Without a credible lender of last resort at the international level, a rational creditor is prone to the incentive to withdraw her lending out of an otherwise healthy country if she expects the other creditors to do the same thing. The resulting outcome is a massive and sudden pull-out by foreign investors, and such a flight to quality eventually exerted contagion effects on the neighboring countries and across the region. This kind of creditor panic is rational in the sense that it is a particular equilibrium, albeit bad, out of the multiple equilibria possible under the circumstances.

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More importantly, various structural defects in East Asian economies, such as prolonged moral hazard, crony capitalism, lax prudential regulation and supervision, and weak corporate governance, have been lying at the center of the crisis. In particular, underdeveloped corporate governance systems and inadequate financial supervision have already been recognized, and are perceived to have contributed to the region's vulnerability to a crisis in general and to the reversal in creditor perceptions before the onset of the current crisis. In all likelihood, any one of these factors can not be singled out as a sole cause of the crisis. Rather, they all acted together to bring about the initial currency crisis.

Another important aspect of the East Asian crisis was that the initial currency crisis quickly degenerated into a full economic crisis with massive corporate bankruptcies and soaring unemployment. In this regard, it is important to distinguish between the currency crisis and the subsequent collapse of corporate and financial sectors, although they are certainly related. It could be the case that a more astute policy response and/or better institutional arrangement in the international financial market may have averted a currency crisis which entailed an economic crisis of this magnitude. However, the structural deficiencies in the East Asian economies played the role of a magnifying lens through which the initial liquidity crisis was quickly turned into a full-blown economic crisis, not to mention their contribution to the onset of the crisis. Korea's economic crisis provides a prime example of such a magnifying linkage. Indeed, Korea's financial crisis started from a string of large corporate bankruptcies, which in turn significantly undermined the health of domestic financial institutions. The lack of transparency and information caused a free-fall of foreign investor confidence in the face of deteriorating financial soundness. In the post-crisis period, fundamental structural weaknesses in Korea's financial and corporate sectors, particularly heavy reliance of the corporate sector on debt financing and large non-performing loans held by financial institutions, caused the severe credit crunch and subsequently massive corporate bankruptcies and severe recession in the real sector.

Among various structural weaknesses in the East Asian countries, failures in the corporate governance systems have received particular attention as not

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only one of major causes of the crisis but also the magnifying channel in the post-crisis development. Although there has been little rigorous analysis that systematically relate the specific forms of corporate governance failure in the affected countries to the crisis, a useful framework to understand this issue in our context is proposed in a recent paper by Rajan and Zingales (1998).

They investigated the interaction between a large influx of foreign capital and the absence of adequate contractual infrastructures. According to their theory, in the face of ample investment opportunities in East Asian countries in which business environment was largely relationship-based and reliable institutional mechanisms that could protect their long-term investments were weak, foreign investors found it optimal to confine themselves to primarily short-term investments. As the short-term investment entailed little cost of flight, a shock could relatively easily induce an exit en masse equilibrium. They subsequently argued that a country in the process of capital market liberalization has to either accept the risk of financial fragility in the absence of necessary institutional development, or improve its financial infrastructures to transform its system for allocation of financial resources into a market-based (arm's-length) system.

The relationship-based system and weak corporate governance in East Asian countries went hand in hand with each other until the current crisis brought to light the combination's flaws and abuses. Since the early days of economic development when firms were largely financed by bank loans under government influence, close links among firms, their banks, and the government have developed through ownership, family ties and political deal making. Both firms and banks within this relationship-based system felt little need to develop elaborate corporate governance mechanisms, since the former were able to rely on banks to continue to finance their projects and the latter felt comfortable under the explicit or implicit government guarantee. On the other hand, outsiders had little incentive to heavily invest into a new relationship given the lack of protection provided by the underdeveloped corporate government system.

By contrast, the market-based system allocates financial resources through explicit contracts and associated prices. To the extent that contracts are inevitably incomplete, investors who supply funds to a firm are better protected if the firm is equipped with better corporate governance mechanisms with a higher level of

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transparency. Thus an economy's move from the relationship-based to well-functioning market-based system requires improvement of its corporate governance system.

Looking beyond the relationship between corporate governance system and the financial crisis, the issue of corporate governance also has important implications on economic restructuring and growth as it is an issue related to the functioning of both financial and nonfinancial firms, as well as the market as a whole.

Corporate Governance and Economic Restructuring

When the East Asian governments liberalized their capital markets, foreign investors from the market-based system rationally chose mostly to lend primarily on a short-term basis in the face of the existing relationship-based system and weak corporate governance, as explained by Rajan and Zingales (1998). Meanwhile, capital market liberalization was not accompanied by the development of requisite market and regulatory institutions, in particular prudential supervisory functions in the financial sector. Thus while the banking sector rapidly expanded its lending to the corporate sector, banks failed to play a proper monitoring role.

Under these circumstances, it is likely that some of the funds newly provided by foreign investors were misallocated, lowering overall corporate profitability and raising vulnerability. To be sure, the relationship-based system can perform the task of resource allocation relatively well through inter-temporal cross-subsidies within a firm or inter-firm cross-subsidies within a business group, especially when legal and contractual infrastructures are not well developed and price signals are not informative. But the problem of resource misallocation can be significant under the relationship-based system since it does not use price signal and lacks monitoring and discipline from the market.4 These deficiencies hurt most when abundant funds need to be allocated among new investment opportunities, which was the case in the East Asian countries after the liberalization.

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First, the rules of game have to be changed for a better economic outcome to be obtained in equilibrium. The key characteristics of the pre-crisis environment were a relationship-based system, weak corporate governance, a liberalized capital market, and inadequate financial supervision. One obvious policy direction leans toward the market-based system in order to take the best advantage of liberalized and open capital markets by strengthening corporate governance and supervisory institutions, as pointed out by Rajan and Zingales (1998). The other direction goes back to the old relationship-based system with a government-directed financial sector and underdeveloped governance and market institutions. Not only does this move have inherent inefficiencies but would entail serious growth implications as explained later. Second, a third party is needed to change the rules and to coordinate the players' move to a new, better equilibrium since no individual player has any incentive to do so unilaterally. A natural candidate is the national government, in cooperation with international

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organizations and other governments. The most important function of the third party is to provide leadership. Thus it does not have to be a single entity, and other parties from the private sector should be welcomed to join.

Corporate Governance and Economic Growth

As Radelet, Sachs, and Lee (1997) argued, the East Asian countries have achieved their phenomenal economic growth with export-oriented policies by successfully integrating national production with international production, through specific institutions such as technology licensing, original equipment manufacturing, and export processing zones. This strategy enabled the economies to begin with low-technology manufactured export activities and gradually upgrade to high-technology products.

Now these economies stand at the crossroads facing important decisions on how to sustain continued economic growth without creating, and suffering from, bubbles in the nontradable sector. Other than maintaining stable macroeconomic environments, the following three related policy issues can be identified.

First, market liberalization will continue to be important. As long as exports remain a key to future economic growth and development, the domestic markets and production processes need to be ever more deeply integrated with the global economy. Second, provision of low-cost long-term financing to the corporate sector is going to be crucial. As the impetus of growth for an economy increasingly comes from the high-tech sector, production and development processes become more capital intensive, and the corporate sector needs to adjust their financing accordingly to stay competitive in the international markets. In this regard, healthy growth of the securities market along with a prudent banking sector will be instrumental.

Third, better investment decisions and a mechanism to induce such decisions will be needed more than ever. As the economy places more emphasis on technological advancement and integrates itself more deeply into the global economy, production and investment decisions become more complex under the diverse market environments. For an efficient investment decision to be made, not only should all the relevant information be efficiently aggregated, but also

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the incentives of any given decision-maker need to be aligned as close to the social efficiency as possible. This observation points to the importance of the signaling function of market price, and to the effectiveness and transparency of corporate governance systems.

2. Key Aspects in Corporate Governance System

As with any other economic institution, a successful corporate governance system must accomplish the tasks of coordination and motivation. The decisions and actions of the interested parties, i.e. shareholders, management, and creditors and potential investors in the financial market, need to be coordinated to protect the shareholders' interests and efficiently advance other corporate goals. At the same time, the relevant parties must be motivated to carry out their parts in the coordinated system through rewards for taking appropriate actions, and punishments for failing to do so.

Three main requirements for effective corporate governance are usually identified. Transparency is a must for generation and use of information needed for efficient coordination and motivation. Equity is about protecting legal and contractual rights of the interested parties, and helps to set the boundary and parameters of the corporate goals that management is mandated to pursue. Accountability is a key to providing adequate incentives and discipline for the management so that it is properly motivated.

An efficient corporate governance system would ensure that a firm is managed to increase its value to the shareholders, subject to legal and contractual constraints, and help achieve the socially efficient resource allocation given that financial and product markets relevant to the firm are properly functioning as well. Failures in corporate governance on the other hand could result in a sub-optimal allocation of resources, overly risky investments, abuses and downright theft by management, expropriation of "outside" shareholders and creditors by controlling shareholders, financial distress, or even bankruptcy.

With those tasks and requirements in mind, we will take a broader view of corporate governance and review the corporate governance systems in the Asian countries by examining the following five aspects, or subsystems, of corporate governance in the following sections.

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1. “Internal” corporate governance concerns the relationship between management and shareholders, or between corporate insiders (management and controlling shareholders) and outside shareholders. Important institutions and legal and contractual arrangements of the internal corporate governance system include the rights of shareholders, and the means to their protection and ex-post remedy; the role and responsibility of the board of directors and its composition; as well as disclosure and listing rules.
2. The internal and external corporate governance system of financial institutions ensures that they are managed as profit-seeking entities with due consideration on soundness, rather than functioning as simple conduits of funds into the corporate sector. Proper risk management and credit evaluation by financial institutions constitutes the core of internal governance, while prudential regulation and supervision are institutional devices for external governance to ensure the soundness of both individual institutions and the financial system. Without effective corporate governance of financial institutions, the discipline from the financial market would be significantly weakened.
3. “External” corporate governance by the financial market concerns the relationship between the firm and other suppliers of funds such as creditors. The regulatory and legal environments, and institutions of the financial market constitute this external governance system. It reinforces internal corporate governance by monitoring the efficiency of a firm’s investments, and requires adequate internal governance of financial institutions for its effectiveness.
4. “External” corporate governance by the market for corporate control concerns the relationship between the firm and potential investors/entrepreneurs in the stock market. Among the important elements in this external governance system are stock market regulations regarding merger and acquisition (M&A), corporate charters and bylaws with respect to hostile take-overs, and disclosure and listing rules. It complements internal governance by disciplining inefficient management with a take-over threat while rewarding efficient ones with rising stock prices.

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5. Governance by insolvency mechanisms concerns firms which have fallen into deep financial trouble or gone bankrupt due to failures in their internal and external corporate governance or simply as a result of bad luck, or a combination of both. Formal insolvency procedures through the courts, informal workouts, and even the M&A market to some extent affect the corporate governance of those firms through changes in ownership structure and often management in the process of redistributing the financial claims among the shareholders and other investors. These ex post changes in corporate governance structure by insolvency mechanisms can have ex ante effects on the incentives of the current management, controlling shareholders, and other investors. Consequently, the structure and actual workings of the insolvency mechanisms will play a significant role in determining the structure and performance of the other internal and external governance systems of the firm.

It goes without saying that each of the five governance subsystems does not function in isolation. Rather, they are closely interrelated and complementary in constituting a single integrated system of corporate governance which is adapted over time to the given economic and legal environments of the firm. In this respect, it is important to look at not just the form but the substance of corporate governance in an economy, and in particular, to examine additional elements in the analysis of the Asian countries given their particular paths of economic development and growth.

First, we need to look beyond corporate governance at the individual firm level. It is well known that a small number of families dominated the corporate landscape in most East Asian countries. Given this, the relationship among the firms within a business group controlled by a single family is necessary in order to gain insights into corporate governance in the real sector. A tight linkage among the firms under unified control could lead to better firm performance by pooling resources and information as well as by reducing transaction costs. However, there is also a clear danger that such singular control of several firms may facilitate the expropriation of non-controlling (outside) shareholders by the controlling shareholders.

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In some countries, the controlling shareholders have frequently utilized inter-firm transactions as a means to divert resources from one firm to another and to increase their welfare at the expense of the outside shareholders. In such countries, one of the most crucial issues with respect to corporate governance is how to identify whether the inter-firm transactions within a group are value-enhancing for both firms or not. Equally important are the issues related to how to provide the adversely affected parties with the means to prevent the detrimental transactions beforehand and to seek redress for the damage afterwards.

Second, we also need to investigate the role that the government played in the development of corporate governance of some East Asian countries. Let us take the case of the inadequate governance structures and lax prudential regulation of banking institutions that lie at the heart of most Asian countries' failure in corporate governance. A large part of the failure in the governance of the financial sectors in the affected countries is undoubtedly attributed to the simple fact that these countries are still developing economies with only a short history of market capitalism. Consequently, relevant market institutions and other legal infrastructures are still underdeveloped.

Nevertheless, in some East Asian countries, there is a possibility that the institutional arrangements have been kept from evolving into ones that correspond to the economic conditions due to the influence of the elite in political and business spheres, as suggested by the endogeneity theory of law. Reports on some East Asian countries that relate corruption to the economic crisis also refer to this possibility

A more important source of the failure in the financial sector governance can be found in governments' interventionist industrial policies. Governments' direct control on the allocation of financial resources has distorted the incentives of financial institutions creating a severe moral hazard, and impeded the development of necessary corporate governance mechanisms. It also has adversely affected governance in the corporate sector. As governments provided subsidized credit to firms in the targeted industrial sector, and implicitly shared their investment risk, those firms, and more importantly the dominant

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shareholders of those firms, were excessively protected from market competition and discipline.

In the next section, we will document the major patterns and realities of corporate governance in the East Asian countries and analyze the important characteristics of governance structure within the framework described above.

3. Corporate Governance of the East Asian Countries

Overview

The corporate governance structures of the East Asian economies have generally been associated with a high concentration of ownership and control by a few families, low level of property right protection and weak enforcement, high leverage of corporations, loose monitoring and screening by lending institutions, and ineffective banking regulation8 . This assessment by and large conveys an image that closely resembles the true picture of the corporate governance landscape in East Asian economies. For instance, high concentration of ownership and control of corporations by families is a characteristic shared by all countries in the region. However, country reports for the East Asian countries, as well as the existing literature, indicate that there exist significant differences across countries in several key aspects.

First, there exists a significant difference between two groups of countries in the overall quality of corporate governance systems and their legal infrastructures for property right protection. Hong Kong, Singapore, and possibly Malaysia appear to maintain significantly higher standards in corporate governance and at the same time have developed more sophisticated and adequate legal systems to protect property rights than the rest of the countries. A low level of property right protection and weak enforcement, loose operation of lending institutions and ineffective regulation of the financial sector are characteristics shared by Indonesia, Korea, Thailand, and the Philippines, but not by Hong Kong, Singapore and Malaysia.

The degree of leverage in the corporate sector, which was believed by many to have been closely linked to both the boom and the bust of the East Asian economies, varies widely across countries. Further, the profitability of firms and their ability to service their debt also significantly. The dominance of

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conglomerates and the impact they have on the performance of corporations and lending institutions also differ significantly throughout the region. While concentration of ownership and control of corporations (and banks in some countries) by families is a universal phenomenon in all seven countries, it is especially severe in Indonesia, the Philippines, and Thailand, where the largest ten families control half of the corporate sector in terms of market capitalization, according to Claessens et al (1998b). Hong Kong and Korea are behind these countries in rank, but not by much as the largest ten families control about a third of the corporate sector according to the same study.

It is interesting to note that Hong Kong does not seem to suffer from the chaebol problem that is widely believed to be responsible for the failure of the Korean economy, even though the concentration of control by large families is roughly the same. It is also puzzling that widespread self-dealing, high leverage, and failed investments of large size occurred in Korea, but not in Hong Kong. Furthermore low interest coverage ratios and high probability of bankruptcy that characterize the shortcomings of the chaebols in Korea do not seem to be prevailing features of Indonesia, the Philippines, and Singapore.

The relationship between banks and corporations as well as factors behind the relationship differ across countries as well. While the banks and other lenders in Hong Kong and Singapore appear to function properly in their risk management, lending institutions in the other countries displayed lack of expertise in operation and conflicts of interests among managers or dominant shareholders that led to expropriation of small shareholders and depositors. The scores on the adequacy of prudential regulation are similar.

In the remainder of this section, we document and compare key aspects of the corporate governance systems of the seven countries that led to the above assessments.

4. Challenges and Future Policy Options for Corporate Governance in Asia

Except for Hong Kong and Singapore whose corporate governance systems have been sound, most Asian countries have made visible and indeed impressive progress in their reform of corporate governance systems over the past year or so. This is particularly so if we take into account the depth and severity of the

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problems in corporate governance shared by these countries as well as the short period of time available for change.

Specifically, the substantial portion of non-performing loans has been written off while corporate bankruptcies and mergers of financial and non-financial firms have occurred. These developments were practically unthinkable in the past in those crisis-hit countries. In tandem with these developments, the Asian countries have also strengthened their regulations and standards with respect to transparency and information disclosure. In addition, a number of institutional reforms have been implemented for the purpose of strengthening the rights of the minority shareholders, while prudential supervision on financial institutions has and will be upgraded on an on-going basis. Given the presumption that the improved regulations, standards and financial supervision are properly enforced to ensure the compliance of both financial and non-financial corporations, those developments will have a desirable effect not only on corporate governance and tax administration but also on the entire economy as well.

However, Asian countries have yet to make satisfactory progress in the area of market for takeover and bankruptcy proceedings. Although non-financial firms and banks were sold to foreign investors in the course of corporate and financial sector restructuring, such a development seems to be more the result of fire sale in the midst of crisis than the emergence of an active market for corporate control. It will take more time for the market for corporate control to emerge, particularly because of the concentrated ownership structure and the lack of well-developed capital market. Reforms in bankruptcy proceedings have also been only modest and, hence, most East Asian countries do not have an efficient institutional framework to reallocate the resources of insolvent firms.

In a nutshell, with all the significant improvements made since the onset of the crisis in the region, many fundamental reform agenda are still left unaddressed and unanswered, awaiting additional structural reform. The major remaining obstacles are found in the following areas: 1) the fragility of the legal and institutional framework and the lack of credible enforcement with regard to

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corporate governance systems, 2) an inappropriate modality of corporate and financial sector restructuring, 3) the lack of a well-developed capital market, and 4) the risk of distortionary impact on corporate governance of interventionist industrial policy.

We will elaborate each issue and discuss available policy options.

First, as to the fragility of the legal and institutional framework regarding corporate governance, minority shareholders' rights are neither clearly defined in an ex-ante sense nor well protected in the ex-post sense. In particular, minority shareholders' right to participate in corporate decision making and have easy access to business information does not seem to be clearly defined within the legal framework. Furthermore, the ex-post remedy and punishment for the expropriation of minority shareholders by the major shareholders seems to be weak and inadequate. For example, illegal practices of breach of trust, expropriations bordering on embezzlement, and simple theft seem to be continuing in many East Asian countries, but the punishment on such abuses largely remains weak at best.

Of course, many East Asian countries do have institutional devices, such as class action suits, designed to protect minority shareholders' right from such illegal practices. But their practical effectiveness seems to be doubtful. For instance, theoretically, class action suits can help minority shareholders to protect their rights by filing civil claims against managers or major shareholders for their illegal practices and resultant costs impinged upon minority shareholders. In reality, however, in many East Asian countries, there exist many technical obstacles and legal impediments. Lawyers often have little incentive to undertake a civil suit due to ceilings on their legal service fees which are rigidly set at unrealistically low levels.

Furthermore, in many East Asian countries, the controlling shareholder(s) is not necessarily registered as a member of the board of directors, although most expropriations and violations are done under his approval. In this case, effective legal enforcement is not practically possible. In Korea, legal change has recently been made in such a way as to count the controlling shareholder(s) as a de facto director, but its legal status is not clearly defined. Therefore, it is quite difficult to effectively enforce the legal requirement for shareholder approval on

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connected transactions, unless the controlling shareholder is registered as a regular member of the board of directors.

Legal punishment for violations with respect to newly improved accounting standards and codes of practices must also be strictly enforced in order to secure reform credibility. However, legal enforcement in this regard has also been discretionary and short-lived at best in many East Asian countries. Under these circumstances, it is hard to expect accounting firms to fully comply with new accounting standards and rules.

There is no instantaneous fix for these problems. Rather, the government must continue to improve their legal and institutional framework for corporate governance, and strengthen their enforcement by “biting the bullet”. To this end, the government should scrutinize the regulatory framework and legal institutions, carefully analyze the incentive structure embodied in the framework, and eliminate any unclear provisions in laws and regulations. At the same time, an appropriate incentive structure needs to be established for regulators in order to ensure credible enforcement. After all, no laws or regulations can make difference, no matter how well they are designed, unless they are properly enforced.

Second, the modality of financial and corporate sector restructuring must be consistent with clear market principles. At the outset, the financial and corporate sector restructuring, which are currently underway in many East Asian countries will have profound impacts on corporate governance in the region. The reorientation of the role of financial institutions and the normalization of prudential regulation, which are the most essential elements of economic restructuring, will be critically affected by the privatization of the recapitalized banks and the post-privatization governance structure. Therefore, the success of corporate governance reform will be seriously jeopardized if the privatization process is delayed or ill-managed, or a small number of families continues to exercise dominant control in both corporate and financial sectors, or if the state control in the financial sector does not phase out quickly. On the contrary, the emergence of sound financial institutions equipped with good governance structure and strong commercial orientation will exert a positive spill-over effect into the corporate governance systems of non-financial firms.

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As corporate sector restructuring inevitably involves changes in ownership structure and corporate control, it has far-reaching implications not only for the business interests of financial institutions but also the governance structure of both financial and non-financial firms. There is little question that it is socially optimal to prevent financially troubled but economically viable firms from being liquidated. The essential question is how to share the losses or benefits among involved parties, including creditors and shareholders. Currently, the most desirable option for loss/benefit sharing seems to be debt-for-equity swaps, and setting the right price for the exchange lies at the core of this option. If, under the right exchange price, shareholders are supposed to lose their interests completely or partially, they must be strictly enforced to do so.

Unless the corporate workout programs currently under way in many Asian countries adhere to such clear market principles, they will further aggravate the problems rather than solve them. The deviation from market principles will translate into not only unfair and increased burden on taxpayers but also harmful distortion in corporate governance. Controlling shareholders of troubled firms will face distorted incentives if they are exempted from due responsibility for mismanagement or penalties associated with expropriations and illegal practices. Furthermore, such distortion in corporate governance is likely to spill over into other distortions in the fabric of both financial and product markets.

Third, underdeveloped financial markets in most Asian countries could impede successful corporate governance reform, given that profit-oriented and well-managed banks and other major lending institutions can play an essential role in corporate governance reform. In most Asian countries, however, there are few financial institutions that are not connected to the dominant business families. In addition, many lending institutions whose ownership structures are well diversified do not have adequate internal governance structures. In fact, many of them are in captive positions due to their large exposure to firms under the family control resulting from reckless lending practices. As a result, the dominant family shareholders of large corporations and conglomerates in Asian countries tend to monopolize financial resources. There are few, if any, individuals or families other than the dominant families who can mobilize the

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financial resources necessary to obtain control of major financial institutions. Allowing the families who control corporations in the real sector to take or maintain control of financial institutions raises the risk of expropriation of minority shareholders as well as depositors of the financial institutions. Barring the families from taking control of financial institutions requires an alternative corporate governance structure for them. Government control of financial institutions proved to be a failure as the Korean experience revealed. For most East Asian countries, a third model for the corporate governance for financial institutions that will work reasonably well has to appear.

Fourth, interventionist industrial policies, which had constituted grounds for governance failures in the corporate and financial sectors, as well as in insolvency proceedings, may continue to stand in the way of corporate governance reform. Industrial policies of some Asian countries have been focusing on the economies of scale in strategic industries and implicit risk sharing with the private sector. Such policy orientation inevitably led to heavy government intervention in the financial sector, and hampered the emergence of proper internal governance structures of financial institutions. It also created wrong incentives for the controlling shareholders of the targeted firms in terms of excessive risk taking.

At the current stage of economic development, Asian countries seem to be faced with a dilemma in regard to the continuation of industrial policy. In order to foster the establishment of a sound and efficient governance structure in both the financial and non-financial sectors, interventionist industrial policy needs to be phased out quickly. For such transition to occur, however, these countries need well-developed capital markets, particularly market-based longterm financing facilities, in order to promote financing of large scale investment in capitalintensive industries, which had formerly been supported by directed credit programs within the context of the industrial policy. Given this dilemma, the possibility of continued industrial policy cannot be easily ruled out in Asian countries.

Lastly, a few words are in order on public enterprises and competition policy. Given their sheer size in terms of GDP share in some East Asian countries, the importance of corporate governance in the incumbent public

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enterprises and their post-privatization governance structures cannot be overemphasized. Most public enterprises in their present form are more instruments of the government's industrial policies than business entities. Corporate governance reform in those public enterprises with stronger commercial orientation, including public monopolies in network industries, should start with a clear identification of and distinction between public interests and commercial profit incentives. Another important policy issue in regard to the privatization of public enterprises in the Asian countries is whether to allow those dominant business families to acquire controlling shares in those privatized enterprises on the block. Of course, answering that question requires considerations to a broad spectrum of socio-economic concerns. Nonetheless, as a bottom line, it can be argued that the acquisition of controlling shares by dominant business families must be financed by their own money, not borrowed funds. In this context, prudential regulation and internal governance of financial institutions are critical.

In line with the privatization of public enterprises, market competition should be promoted to maximize the efficiency gains from privatization. Further, competition policy needs to be strengthened across all sectors of the economy. It should be stressed that competition policy is complementary to good corporate governance, rather than a substitute for it. Indeed, there is a feedback linkage between the promotion of market competition and improving corporate governance. If we broaden the concept of corporate governance, market competition can be seen as an important external governance device for both financial and nonfinancial firms. And, market competition can only thrive in an environment that guarantees transparency, accountability and free flows of information at the individual firm level.

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