Special Feature C

Corporate Governance And The Finance Sector: An Asian Perspective

by Randall Morck and Bernard Yeung[1]

Introduction

The hallmark of a modern economy is a tightly focused specialisation of both people and firms that dramatically boosts productivity. Specialisation requires efficient markets because specialised people and firms, by definition, cannot produce everything they need themselves. They need efficient markets, in which to sell what they make and buy what they need.

Efficient capital markets are especially important because revenues almost always come after investments. While a lucky few may win lotteries (including the lottery of birth) and enter the world with enough resources to set themselves up to await cash inflows to come, most need financing. An efficient capital market channels the economy's collective savings into financing for people and firms with worthwhile investment plans. Distinguishing worthwhile investment plans from crackpot schemes and scams is hard work.

Making these distinctions is what an economy's financial sector is supposed to specialise in. If the financial sector reasonably reliably allocates people's savings to value-creating investments, people would willingly entrust their savings to financial institutions and markets. Value-creating investments obviously include corporate outlays for productivity-enhancing technology upgrades, but also encompass financing for income-boosting education, financially sound home mortgages, and other ventures that boost the capital recipient's income sufficiently to repay principal plus cost of capital. The best way for the financial system to gain savers' trust is to be trustworthy by faithfully attending to this social purpose.

Savers entrust their savings to capital users through financial intermediaries and markets. Governance matters throughout this chain, from corporations which use funds to intermediaries which collect and allocate funds. Ill-governed firms can waste savings, but so can ill-governed banks, investment banks, and financial markets (by taking too big a cut themselves and by misdirecting savings into low return uses). In our view, good governance equates (or ought to equate) with fulfilling this social purpose of trustworthy allocation of funds throughout this chain; and regulators' task is (or ought to be) designing regulations so that profit maximisation throughout this chain reliably directs the economy's capital to its highest value uses.

Some two-thirds of the annual growth of developed economies comes from human capital accumulation and productivity growth, with much of the latter coming from new or rapidly growing firms debuting new technologies (Solow, 1970; King and Levine, 1993a; King and Levine, 1993b). Governments sustain economic growth by providing laws, regulations, and standards that help channel capital allocation towards such uses (Wurgler, 2000).

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This can be challenging because financing has unique information asymmetry and monitoring problems (Hertzel, 2012). Perhaps because these problems are so tenacious, reputations for trustworthiness in allocating people's savings, once established, seem extraordinarily valuable—both to the markets and institutions that develop those reputations and to the economies in which they operate (Hellmann and Murdock, 1998).

Laws, regulations and standards appear to matter in building this trust; that is, in creating ways for corporations, including those in the financial sector, to bind themselves to be trustworthy (La Porta *et al.*, 2002). Less costly and more reliable and timely information transmission appears to be an important means of engendering this trust. The low-cost, reliable and timely crucifixions of malefactors seem to be another.

Much discussion of good corporate governance (notably in Asia) stresses the idea of "stewardship": appeals to agents to serve their stakeholders faithfully and truthfully (Davis *et al.*, 1997). A sense of stewardship is obviously laudable. But we do not rely solely on evoking a sense of stewardship to prevent other forms of malfeasance. Prospective fraudsters, purveyors of shoddy goods, polluters, oppressive employers, and others who would profit by exploiting public trust surely need to know that such things are not meritorious; but we surround them with economic incentives (avoiding fines and jail time). Exhorting people not to do such things by appealing to their better natures does not always work. Top corporate and financial decision-makers likewise need concrete incentives alongside exhortations to good behaviour.

Good governance necessarily relies on laws and regulations (and their effective enforcement) to expose and weed out rascals. Sadly, the worst weeds are generally the most resistant to genteel social pressure. Governments generally lack the resources (some may also lack the will) to rake through the dirt to expose and uproot corporate and financial malefactors. Forward-thinking governments thus set up laws and regulations that provide rakes, hoes, and shovels to the investing public in the form of rights to sue malefactors in an independent and well-functioning judicial system. This empowerment of the public frees government officials from the unpleasant task of identifying and deciding whether or not to prosecute elite corporate and financial insiders.

Finally, in high-income economies (including those in Asia), information-intense efficient resource allocation both supports economic development and is supported by economic development. In much of the world (and much of Asia), the focus is the first half of this connection: getting to economic development. This can make current regulations and policies in high-income economies questionable as models. Perhaps the economic histories of high-income economies (especially in Asia) might offer better guidance. Still, policy missteps are inevitable, and governments too are well-served by being well-informed and nimble.

Good Governance

Well-governed corporations are run by specialists in spotting economic opportunities and collecting and organising the talent and capital needed to realise those opportunities. This is a kind of division of labour: individuals, called "executives", earn their keep by being a bit better than everyone else at foreseeing what economic opportunities will arise, and preparing in advance by amassing funds and skilled people within organisations called "firms". Middle managers, workers, and investors entrust their future well-being to these executives, who are expected to live up to their grand billing. What could possibly go wrong?

Two things stand out. Untalented people could end up making financial and corporate decisions. Or, talented but self-interested people could end up making financial and corporate decisions to advance their personal interests primarily (or only). Neoclassical economics models executives as self-serving. They seek highly paid jobs whether or not they can do them or use whatever decision-making powers they acquire to advance their private interests. Economics then focuses on incentive alignment and setups so that:

- People who lack the talent to be successful executives do best for themselves by finding other work; and
- People who do end up making important financial and corporate decisions do best for themselves by fulfilling the trust others place in them.

The workhorse model economists use to think about this is called the principal-agent problem (Fama and Jensen, 1983a). This models laws, regulation and social conventions (including calls for stewardship) increasing or decreasing the alignment of executives' self-interest with the interests of those who entrust their future prospects to those executives. The parties entrusting their welfare to the executives are called *principals* and the active, free decision-makers are called *agents*.[2] The whole setup is called an *agency problem*.

Mathematically articulated economic models (e.g., Jensen and Meckling, 1976) tend to focus on top executives as agents and shareholders as principals, but the framework is actually general (e.g., Jensen and Meckling, 1979). Published models also tend to focus on laws and regulations as incentive alignment mechanisms, but social pressure, such as exhortations to stewardship, are also readily incorporated into the framework.

Corporate governance studies emerged first in American and British universities (Berle and Means, 1932; Cadbury, 1992) where most large firms have already become very widely held and their investors are small individual shareholders (Morck, Shleifer and Vishny, 1988). Large shareholders might own stakes as large as two or three percent, and top executives typically owned few or no shares in the firms they ran. The principals (investors) were thus relatively weak compared to the agents (CEOs). Understandably, the corporate governance mechanisms of interest were ways of aligning executives' self-interest with small shareholders' interests. These included increased executive stock ownership, ways of tying executive pay to growth in shareholder wealth, and hostile take-overs and shareholder rebellions (called proxy fights) as mechanisms for ousting underperforming executives.

Other mechanisms to make executives more concerned about small shareholders' wealth included fostering the growth of powerful institutional investors that could speak for shareholders, adding more independent directors to boards (and on audit, nomination and compensation committees), enhanced disclosure requirements, independent auditors, and whistle-blower protection (Shleifer and Vishny, 1997).

In subsequent years, corporate governance concerns spread to other countries. Many countries are starkly unlike America and Britain, in that most of their large firms have powerful controlling shareholders, often economically and politically powerful tycoons of business families (Morck, 2005). In some, multi-tiered holding company structures (pyramiding), cross-shareholding and super-voting shares let these powerful shareholders control huge constellations of firms by controlling a single firm that, directly or indirectly, rules all the others.

In these countries, getting down to the basics of the principal-agent model means asking instead "Who has the decision-making power to subordinate others' interests to their own?" We suggest that, in such countries, the worrisome agents are the powerful tycoons and families, and the principals needing protection are the small public float shareholders as well as creditors, providers of trade credit, employees and perhaps even professional executives (Morck, 2005; Morck, Wolfenzon and Yeung, 2005). The corporate governance mechanisms of interest are laws, regulations and social pressure that align the self-interest of the strong with the interests of the weak (Djankov *et al.*, 2008).

We therefore respectfully suggest that the following sorts of arguments might be relevant to Asia.

[2] The word *agent* is Latin and means *doer*; *principal*, from the Latin *principalis*, means *first* or *original*.

What Good Governance Is Not

Good governance is often defined too superficially. We take issue with many of these definitions and so, begin by saying what good governance is not.

Good governance is not ticking off checklists of independent directors, independent audit committees, and the like. Financial and corporate decision-making that directs the economy's capital and other resources into their most valuable uses is good governance. Enron checked off every box on such good governance checklists and collapsed, in one of America's greatest governance scandals. Many countries have enacted international best practice corporate governance laws and regulations, often by cutting and pasting checklists in US regulations, but then did not enforce them. This might be because of general inefficiency in the public sector, pressure from powerful business insiders, or the genuine realisation that cloned US regulations might do more harm than good in Asian economies.

Good governance is also not equivalent to agents keeping promises to use resources in specific predefined ways. Efficient decision-making requires changing course when conditions change. If good governance regulations and laws have kept away the untalented and tamed the rapacious, small investors and other stakeholders can trust agents with decision-making powers to adapt.

Good governance is not equivalent to a no-holds-barred maximisation of shareholder value. Allocating the economy's capital and other resources to their highest value uses requires paying for talent, investing in innovation, and obeying the spirit, as well as the letter, of laws and regulations that convey the government's standards regarding the environment, human rights, and other public charges. Shareholders are due a competitive risk-adjusted return, but this in no way justifies the abuse of workers, the environment or society in general. This is an often underemphasised feature in every reasonable economic model of agency problems.

What Good Governance Is

Despite all the above arising commonly as definitions, we argue for a back to basics approach, in which good governance is fundamentally about hard-earned trust.

If share prices are low and firms have difficulty raising capital, the problem is likely to be market participants' distrust in the agents running those firms or the financial intermediaries through which they would raise capital. Financial markets are not perfectly efficient, but market sentiment usually has reasons. Investors who distrust the governance of financial institutions and firms seeking capital either demand higher returns (that is, they offer to buy only at lower securities prices, raising the cost of capital) or decline to provide funds altogether (depriving firms of access to their savings entirely). Either way, investments that would make sense in an atmosphere of greater trust do not happen and the economy is less dynamic. Jobs are not created, raw materials not demanded, and consumers not offered goods that were never made.

Corporations and investors see the benefits of establishing trust, and good firms find the means to do so. For example, well-run firms can demonstrate their trustworthiness by paying high dividends, which ill-run firms cannot afford to match (La Porta *et al.*, 2000; Morck and Yeung, 2005). In economic jargon, this is a "stable separating equilibrium", in which trustworthy capital users can make "credible commitments" to be trustworthy while untrustworthy capital users cannot.

Such separating equilibria are not always easy to get going. Channelling capital to genuinely promising start-ups and away from unpromising ones cannot rely on past dividends. In the US, the reputations of well-governed venture capital funds that back high-tech start-ups come into play instead (Gompers and Lerner, 2004). Many other countries lack comparably credible ways of separating wheat from chaff. These generally take the form of state-financed venture capital programmes, and most have very low success rates (Gompers and Lerner, 2004). Government bureaucrats in most countries generally have very poor track records for picking winners (Krueger, 1974).

The government's job is to set up corporate governance rules and regulations that ensure that trustworthy agents, that is, those both able and willing to direct resources to their highest value uses, can and do distinguish themselves from untrustworthy ones. Successful separation imposes costs that low-quality agents cannot pay, while keeping costs imposed on trustworthy agents reasonable (Spence, 1973).

How this can work clearly differs across countries. In America and Britain, where a key agency problem arises between top executives and shareholders of diffusedly-owned corporations, regulations that inform and empower shareholders—disclosure requirements, majority voting for directors, links between executive pay and shareholder valuation, and the like—make sense. In countries where different agency conflicts matter more, different solutions are needed.

In many Asian economies, major firms are controlled by wealthy business families (Claessens *et al.*, 2000). These shareholders are already well informed and powerful, and do not generally need government help in becoming better informed or more powerful. They are not powerless principals, but are free decision-makers—that is, agents. In contrast, small shareholders genuinely are relatively powerless principals.

In such economies, binding limitations on controlling shareholders' freedom of action can make sense as ways of guaranteeing their trustworthy behaviour—or of discouraging those who are not trustworthy from seeking public equity capital. Such limitations include rules against self-dealing, mandatory coat-tail provisions in corporate takeovers, mandatory majority-of-the-public float votes for related transactions, director fiduciary duties to non-controlling shareholders only, and the like (Djankov *et al.*, 2008).

In these economies, where controlling shareholders are powerful, stronger labour rights may well be helpful in achieving the needed separating equilibrium. Well-run firms might be able to reward talented employees in ways that ill-run firms cannot match. Well-enforced high environmental standards might likewise create a separating equilibrium by driving out ill-run businesses that can only survive by using obsolete high-pollution technologies.

Obviously, laws and regulations cannot reduce agents to marionettes, whose strings are pulled by lawyers and regulatory compliance officers. In an efficient economy, agents—whether top executives in widely held Anglo-American firms or controlling shareholders in Asian firms—are in charge because they are talented and trustworthy. They are, at a minimum, marginally better than others in fulfilling Keynes' charge to "defeat the dark forces of time and ignorance that envelope our future". To fulfil that charge, they need to be able to get on with running the firm. Micromanagement by government, lawyers, board, and the like, is unnecessary.

But the countervailing downside agents must accept in return for this freedom of action: when they fail to perform, they have to accept ouster, economic losses, and social and legal sanction for overtly negligent or felonious actions. The fear of these downsides should activate both self-selection (untalented agents will not apply for positions entailing responsibility for other people's money) and market selection (firms run by untrusted agents, deprived of cheap capital, shrink and die).

Stakeholders And Shareholders

Still governance practices seem to be small shareholders focused. The logic?

A corporation is a legal person with duties to multiple constituents: public shareholders, controlling shareholders, top executives, current and retired workers, banks, bond-holders, and suppliers granting trade credit, municipalities and national governments (taxes and employment). All of these assorted interested parties, along with environmentalists and future generations, qualify as stakeholders, in that their interests are, to varying extents, affected by the decisions the firm's agents make.

Some stakeholders are better positioned to pay attention to agents' decision-making, and to its impact on their welfare. Banks, bondholders and other creditors can watch companies to ascertain that their loans will be repaid (Morck and Nakamura, 1999; Morck, Shivdasani and Nakamura, 2000). Organised labour can likewise monitor agents' decisions, and press for the protection of workers' jobs and wages and for retirees' pensions. Newspapers and other media boost their own revenues by exposing frauds and incompetence; such coverage contributes to corporate monitoring (Dyck, Moss and Zingales, 2013).[3]

But the failure of such stakeholders to coalesce into unified classes limits their influence. Different creditors' interests can correlate negatively with other creditors' interests. Different labour subgroups can be at odds. Retirees want well-funded pensions, senior employees want high wages, junior employees want no lay-offs, and job market entrants want jobs. Tax ministries want clear reckonings of profits (Desai, Dyck and Zingales, 2007) but other branches want jobs. Shareholders' interests differ fundamentally from those of other stakeholders in a way highlighted by Fama and Jensen (1983a, 1983b, 1985). Other stakeholders' claims on the firm are, for the most part, fixed. Creditors are owed fixed prearranged repayments of interest and loan principal. Workers and employees are due fixed predetermined wages and benefits. Local governments are owed fixed pre-assessed property taxes, and short-term oriented national governments' income tax revenue depends on current earnings, not future earnings. Such claims are called *contractual* claims: legal contracts which the firm must honour or invite lawsuits or bankruptcy proceedings.

Shareholders' claims, in contrast, are residual claims and they are most sensitive to flagging firm performance. Shareholders get whatever is left over after all contractual claimants have been paid in full. Firms with cash-flow shortfalls cut or skip dividends first. Only if circumstances deteriorate far more do firms seek to reorganise their obligations to their creditors, workers, suppliers, and customers, often under bankruptcy (or the immediate threat of bankruptcy).

Shareholders' sensitivity to poor performance justifies shareholder-focused corporate governance. Thus, shareholder-focused corporate governance "uses" shareholders as an alarm system to protect all other stakeholders, an important aspect of governance that should not be overlooked. Shareholders are like canaries in mines. That a canary falling silent causes huge concern doesn't mean we run mines in the interests of canaries, or think canaries are more important that miners. We are merely using both canaries' silence and shareholders' squeals of outrage as early warning alarms. This logic is correct given its assumptions, but may go too far for several reasons.

[3] Encouraging a free and independent business press helps create the separating equilibrium discussed above, while a controlled press or a press captured by special interests makes it difficult for investors to separate trustworthy from untrustworthy governance, and leads to a pooling equilibrium in which investors trust no one very much. It might be argued that a controlled press better encourages trust, and therefore capital formation, by curtailing coverage of scandals that would undermine public trust in the system. Empirical results support the former logic and undermine the latter. Dyck, Volchkova and Zingales (2008) link Russia's controlled press to its financial underdevelopment, suggesting that a separating equilibrium is less likely to emerge in such economies.

First, the claims of creditors, labour, and government are not perfect contractual claims. Firms can reduce the value of their outstanding debt securities by taking on excessive risk. The option value associated with higher risk can lift share prices and depress debt prices. In this scenario, creditors are residual claimants, at least to an extent. If firms cut wages or retirement benefits, or cut jobs, in order to boost the share price, labour is effectively made the residual claimant.

Second, shareholders valuations can rise and fall with market bubbles and crashes (Kindleberger, 1978; Aliber and Kindleberger, 2015). These phenomena may well reflect changing levels of trust, but might also reflect waves of buying and then waves of selling by uninformed noise traders. Recent work in behavioural finance highlights all manner of deviations from rationality in share valuations. Shares exhibit momentum—in the short term, shares can react oddly gradually to things like news in earnings announcements. Shares also exhibit mean reversion—high share prices predict low returns over the next decades and low share prices predict high returns over the same horizon. These and other well-documented forms of investor behavioural biases and irrationality distort share prices (Shleifer, 2000), providing grounds for questioning the reliability of public shareholders as alarm systems.[4]

Third, the "watchers" that we rely on to raise the alarm may themselves have governance problems. We rely on institutional investors, auditors, analysts, and sophisticated private investors to raise the alarm and demand change when the price drops because of bad decisions, rather than bad luck. All of these "watchers" are run by mortal people, who may be as talentless or self-interested as the worst agents running firms. The 2008 financial panic is attributed to governance problems in financial sector corporations and to inadequate financial sector regulators.

Shareholder-focused corporate governance would use shareholders' cries as an early warning alarm. But these considerations suggest that the alarm might go off when it should not and fail to go off when it should. Moreover, the first line responders can be asleep on the job or react incorrectly to the alarm. However, unplugging an alarm system that occasionally misfires may be worse. An imperfectly functioning alarm system may be better than nothing.

Imperfect Government

The laws and regulations, regulators, and governments cannot be perfect. They need only be good enough to let well-run firms credibly distinguish themselves from ill-run firms to establish the separating equilibrium the financial sector and savers need. That separating equilibrium then allows the economy's resources, including its savings, to be allocated efficiently.

The imperfections of government need attention everywhere. Government bureaucracies are run by officials who act as agents for citizens. Political parties are run by politicians who act as agents for voters. Even some unopposed ruling parties, such as the Communist party of China, worry about their legitimacy in the eyes of the public. In both government and politics, agency problems abound because officials and politicians can (if rarely) be imperfect, untalented, and worse, corrupt. This makes overreliance on monitoring and intervention by officials and political leaders a problematic approach to resolving governance problems in the private sector in many countries. Indeed, even well-intentioned, competent and honest officials may have difficulty challenging a powerful tycoon, a well-connected business family, or a national champion firm.

Perhaps because of long histories of such disasters, developed economies increasingly rely

[4] Oddly, perhaps the most common allegation (by CEOs), shareholders' purported fixation on short-term profitability, is the only form of shareholder irrationality lacking clear empirical support. Rather, the data indicate that shareholders highly value long-term investments by firms in the US (McConnell and Muscarella, 1985; Chan, Martin and Kensinger, 1990; Chan, Lakonishok and Sougiannis, 2001; Hall, Jaffe and Trajtenberg, 2005 and others) and by European firms without controlling shareholders (Hall and Oriani, 2006). Foreign institutional investors acted more like long-term investors than either Korean institutional investors or Korean individual investors in 1997 (Choe, Kho and Stulz, 1999).

on private litigants, the media, and (more recently) legally protected whistle-blowers. By committing in advance to protect these private actors, and to let an independent judiciary protect entrenched constitutional freedoms, officials and politicians can stand aside. Having no power to intervene, they cannot be blamed. Once exposed to sunlight, the problem can mend, rather than be left hidden to fester. Concerned officials and politicians might express regret about damage to powerful interests, but this is something over which they have no influence.

Stewardship

Many qualifications must surround the residual versus contractual claimant delineation and concerns about the reliability of shareholders, as early warning alarms are valid. This leads thoughtful policy advisors to contemplate a stewardship or stakeholder model of corporate governance.

Germany is one paradigmatic model of stewardship capitalism. Japan is another. Both economies prospered through the second half of the 20th century, so the development of their institutions deserves study.

To defeat the threat of democracy, Chancellor Otto von Bismarck laid the foundations of worker involvement in corporate governance in 19th century Germany. If workers could vote for some of their firms' directors, perhaps they would stop agitating for the right to vote for government leaders. In the mid-1930s, the German chancellor greatly extended the stakeholder model, stripping small shareholders of their voting rights and assigning director duties to all stakeholders, notably the Reich and its Führer (Fohlin, 2005). After World War II, the stakeholder system continued. Several other European countries have enacted legislation letting workers vote for a few directors, though only Austria has a system approaching Germany's, in scope and depth.

Japan is sometimes advanced as another stakeholder paradigm. Its assignment of director duties is (perhaps intentionally) vague, leaving managers largely free to run the firm as they will, though firms dependent on continual bank credit need to acknowledge creditors' interests from time to time (Morck and Nakamura, 1999). The end result may be something approximating a stewardship model, though this is far from clear.

Despite its provenance, the German model attracts substantial support from interest groups with progressive agendas. This is understandable. Given their privileges, perhaps tycoons, wealthy families, and corporate executives, and managers ought to be charged with acting for the long-term benefit of society—creditors, employees, retired employees, consumers, suppliers, the environment, the state, and so on. Perhaps government officials, state-owned enterprises' (SOE) managers, and others entrusted with major economic decisions should also have such broad legal duties. A legal duty of all key decision-makers to all stakeholders seems an entirely valid and progressive reform.

The problem with this argument is revealed by the logical device of *reductio ad absurdum*. If an agent (decision-maker) has a legal duty to all stakeholders, what is she to do if two stakeholders have opposing interests? If she acts for one, she acts against the other, who can sue her in court (if stakeholder rights are enshrined in law). Fear of litigation would surely paralyse decision-making. Interwar Germany resolved this by making directors' duty to the Führer paramount (the so-called Führerprinzip). Post-war Germany makes advancing the interests of one stakeholder a legal defence against challenges by other stakeholders. This is criticised as leeway to run the firm in the interests of its managers, in that any decision beneficial to management can be justified as beneficial to one stakeholder or another. Responsibility to all becomes responsibility to none.

As a practical matter, conflicts of interest between stakeholders abound, and every decision-maker cannot be responsible for the interests of everyone else in the economy. Rather, political and economic power is generally organised through what we call "*separation of assignment*". Specific government bodies are assigned to produce specific public goods and services, protect specific civil rights, or effect

specific government policies. In Anglo-American corporate governance, top executives (with many qualifications) are tasked with maximising shareholder wealth. This lets people specialise in advancing specific social goals, for the efficient allocation of resources by corporations is surely one of many social goals. To the extent that the system actually works, corporate executives advance their private interests by improving economic efficiency, while labour lawyers, threatening litigation under the country's labour laws, advance their private interests by protecting employees, and environmental lawyers, using other laws as weapons, protect the environment. Of course, this requires yet other well-developed institutions—notably the rule of law and an efficient judicial system.

As Nobel Laureate Jan Tinbergen (1952) showed, the number of policy instruments must match the number of policy objectives. If promoting each discernible stakeholder is a legitimate public policy goal, then the government needs one policy instrument for each stakeholder class. These might include policies to encourage honest profit-making alongside policies to protect workers, consumers, the environment, and so on.

This leaves unset the weights assigned to each policy goal. Democracies let median voters set and reset the weights on policy goals, subject to constraints enshrined in constitutions. Other countries entrust this to elites. The separation of assignments is seldom perfectly clean, and even the most benevolent governments make mistakes. Appealing to the goodness of people's hearts may well mitigate such problems, but this too can fail. Some hearts are larger than others.

Developing Good Governance In Developing Asia

The Panic of 2008 has heightened doubts on governance in the West and its brands of capitalism. Manias and panics have been recurring phenomena in stock markets since shortly after the Western world's first modern stock market self-organised in early 17th century Amsterdam. Despite these episodes, and some even argue because of them, the free market economies of America, Europe and developed Asia sustain the highest living standards in the world. The Panic of 2008 provides clear evidence of their system's imperfections, but developing Asia still has no alternative. Communism and interwar dictatorial systems failed, and no third way (including Market Socialism with Chinese Characteristics) has yet lifted a major country to high-income status. Capitalism remains the worst economic system, except all the others.

Despite episodic scandals and crises, corporate governance and capital allocation in the US, UK, and other high-income economies have been "good enough" to sustain their high-income status. What works in the West (or in developed Asia) may not work in developing Asia. Copying high-income countries' current institutions may well be inappropriate because all had very different institutions when they first became high-income countries. Copying their historical institutions might also be inappropriate because their starting points were quite different—though basics like investing in education, public health and basic infrastructure early on may be a universal experience. The rule of law, corruption-free government, and various financial rules and regulations came in different sequence, more or less gradually, and more or less completely in today's high-income economies. Formulating a standardised path from low to high-income status is one of the greatest challenges in economics, and one the field has yet to solve.

There are commonalities to the end point. High income economies' sustained growth relies on the passably accurate allocation of capital, labour, and other resources to value-creating investments—typically innovations.

There are also commonalities to the starting point. Low-income economies generally have opaque and illiquid markets for products, labour and capital. Capital markets may consist of little more than providing financing for one's relatives or neighbours. Banks might take in deposits, but

lend only to the government and members of a tiny elite. Rule of law, if it exists at all, primarily protects an elite.

Many economies start developing, growing rapidly for a decade or two, and then stall in the so-called "Middle-Income Trap". This situation is thought to characterise much of Latin America and the Middle East. These countries have poorly functioning capital, labour, and product markets and big business sectors largely controlled by elitist politically powerful families—the only agents meaningfully protected by the rule of law. Wealth, government services, and market access are limited to these elites, and largely unavailable to most of the population. Middle-Income Trap economies are always developing, but never develop. To join the high-income world, Asian developing economies must rise from low-income status and get past this Middle-Income Trap.

High-income economies contain all sorts of institutions that keep markets deep and transparent enough to let investors separate sound from unsound investments sufficiently accurately and enough of the time to channel resources tolerably accurately to their best uses. The list of institutions that matter is too long to write out. It includes abeyances, accelerated depreciation, acceptance markets, accounting standards, actuarial standards, analyst reputations, annual reports, and many more starting with an "A". Comparably lengthy lists begin with the other letters.

These complex dynamic self-organising systems were not the work of central planners. Rather, they arose endogenously. Problems arose, and different solutions were tried. Some solutions faded away and others became institutions. The systems in use in today's high-income countries are clearly imperfect, but work "well enough". What will work best for developing Asian economies remains to be seen.

Government nonetheless has an important enabling role. Public schools and universities give people the skills they need to devise, implement, and improve possible solutions. Education generates accountants, analysts, annual report readers, arbitrageurs who adjust prices after announcements of material inside information, and so on. Laws and regulations matter only if lawyers, regulators, and regulated decision-makers are educated and socialised to implement and obey.

Middle-Income Traps seem to trip economies whose governments fail in these sorts of enabling roles. Governments, too, have agency problems. The agents are those who pull the levers of power and the principals are the general population. If the agents act for themselves (or their powerful families), rather than for the general citizenry, growth can slow or stall, even as firms run by the elite flourish (Pritchett and Summers, 2014). Exhortations to maintain the purity of their purpose, or to strictly obey rules and regulations are likely to be inadequate. Agents working in government are possessed of the same human nature as others, and helping family and friends is a deep part of human nature. Sure and effective penalties for such entirely human behaviour seem necessary. That is, the key building block seems to be government that itself obeys the rule of law.

Institutions can become self-reinforcing. This can aid development: stronger self-selection and selection pressure strengthens corporate governance, which in turn strengthens selection and self-selection forces. This positive feedback loop seems to have arisen in today's high-income countries around the times each experienced its economic take-off—that is, its era of sustained rapid development. But it can equally easily lock a country into a Middle-Income Trap: weaker self-selection and selection pressure let poor corporate governance persist, which further weakens selection and self-selection forces. Rajan and Zingales (2003), Morck, Wolfenzon and Yeung (2005) and others worry that these sorts of destructive feedback loops can become profoundly self-stabilising and can be very hard to break out of once in place.

Conclusion

A vibrant and dynamic economy relies on an efficient financial sector to channel the economy's collective savings into value-increasing investments by firms and people. Efficiency turns on the financial sector's ability to distinguish worthwhile investment plans from the rest. This distinction is possible if fund users with good investments can credibly signal their honesty and competence. Credibility arises if others cannot afford to send like signals. Thus, the essence of corporate governance is not regulations that enforce uniformity in incentive alignment practices or disclosure requirements, but regulations that force players to admit to their differences. Government policies can encourage this by imposing regulations that separate high- from low-quality capital users. For example, well-designed mandatory disclosure rules with large penalties for falsification impose costs on everyone, but an unacceptably high cost on low-quality firms posing as high-quality ones.

Precise details vary across countries. Regulations in the US and the UK emphasise forcing powerful executives to make enforceable commitments to their firms' numerous but individually relatively powerless shareholders. Regulations in economies whose large firms have powerful controlling shareholders force those people to make commitments to minority shareholders and others. The commonality is that the powerful decision-makers, or agents, are constrained to let less powerful people participate. The "right" rules, regulations, and governance practices are thus fundamentally similar, but the details depend on the country's other institutions.

The ultimate public objective is thus uniform: shaping rules and regulations so the financial sector fulfils its social purpose of reasonably reliably allocating people's savings to value-creating investments, so that people willingly entrust their savings to financial institutions, corporations, and markets. This accomplished, the economy can continually create and deploy innovations that continually raise productivity and living standards.

In most developing Asian economies, corporate control is often in the hands of powerful tycoons, rich business families, or generically corporate elites. Given their great power, calls for them to accept a duty of stewardship, of using their power to advance the general good, are natural and even laudable. However, there are reasons to be sceptical. Different stakeholders within an economy have different, and often diametrically opposed, interests. Stewardship models give scant guidance about which stakeholder to steward when multiple stakeholders' interests collide. Alternating across different stakeholders is no solution because every decision will have one stakeholder whose interests parallel those in control. By selecting the appropriate stakeholder to steward, the controlling tycoon, family or corporate elite can *de facto* always act in their own interests.

Given multiple objective functions (each representing the interests of a distinct class of stakeholders), Nobel Laureate Jan Tinbergen (1952) argues for a separation of assignment: the number of government policy instruments must match the number of policy objectives. This is most naturally accomplished by establishing a distinct policy instrument to advance the interest of each stakeholder class. Banking regulations and bankruptcy laws are a policy instrument that empowers banks and creditors to defend their interests. Labour laws empower unions and individual workers to defend their interests. Environmental regulations empower environmentalists. Maximising firm value is then relegated to managers or tycoons. Courts provide forums where conflicting stakeholder interests vie against each other, so the rule of law and a high degree of judicial efficiency are also important. Governments, weighing popular support for each stakeholder class, assign *de facto* weights to the various policy interests by limiting or expanding the strength of each policy instrument.

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