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CORPORATE GOVERNANCE AND ECONOMIC CRISIS IN DEVELOPING COUNTRIES

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A B S T R A C T

The paper analyses influence of global economic crisis on enterprises from developing countries. Analysis is conducted with the goal of determining the reason of crisis and imposing recommendations for mitigation of effects arose from crisis. Main assumption is that irresponsible behaviour of decision makers is the main cause of economic crisis. Due to this, standards and good practice of corporate governance in OECD countries and the Republic of Srpska are analyzed with goal to indicate the omissions in their implementation. Also attitudes of OECD action plan for improvement of corporate governance are presented and recommendations for improvement for state of corporate governance in the Republic of Srpska are imposed.

A R T I C L E I N F O

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Corporate Governance, Economic Crisis, OECD, Bosna and Herzegovina

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1. INTRODUCTION

Global financial crises have caused biggest and broadest fall of global economic activity in modern age. In year 2009 most of the large developed economies were in deep recession. Consequences ceased fall of global trade that is drastic fall in size and structure of foreign trade. Due to corporate weaknesses and scandals, investors lost their trust in companies (OECD, 2009).

Corporate governance is a key element for improvement of investors' confidence, increase of competitiveness and improvement of economic growth. Corporate governance is on the top of agenda for international development as stated by James Wolfensohn that "the governance of the corporation is now as important in the world economy as the government of countries (Wolfensohn, 1998). "

Good corporate governance can help to prevent corporate scandals, fraud, and potential civil and criminal liability of companies. Good corporate governance enhances image and reputation of a company and makes it more attractive to investors, suppliers, customers and other stakeholders of the company. There is evidence from many researches that good corporate governance produces direct economic benefit to the company, making it more profitable and competitive.

The paper tries to determine causes that lead to crises, especially ones that lead to current global economic crisis which has started at fourth quarter of 2008 and still lasts. It is assumed that main cause of economic crisis is irresponsible behaviour of decision makers at all levels, especially the business decision makers. Corporate social responsibility, that is efficient and effective corporate governance, might be the solution for getting out and prevention of the crisis.

2. MACROECONOMICAL EFFECTS OF ECONOMIC CRISIS

In science economic crisis is called a period of significant negative development of economy. Other than that, economic crisis is also called existence of negative development and other macroeconomic indicators (e.g. level of price, employment, capital flows). Economic crisis can strike economy of one or several countries, one sector over the world, economy of few countries or whole world economy. Economy which is strike by crisis suffers mostly from consequences of unemployment and impoverishment of population, which can lead to social disturbances. Regarding economic conjuncture, there are three undesirable types (Babić, 2003):

- Stagnation,
- Recession, and
- Depression.

Stagnation is a period in which economy do not increase, which means that output value of economy in some period stays the same. There is no unique opinion about whether a period of stagnation can be considered a crisis or not. Based on universal definition, recession is a period when output value of national economies decreases over the two sequential quarters. Depression arrives when output value decrease for a period more than two sequential quarters.

Figure 1 shows output values for economies of developing and developed countries for the period from 1961 to 2011, with crisis period shown cyclically.

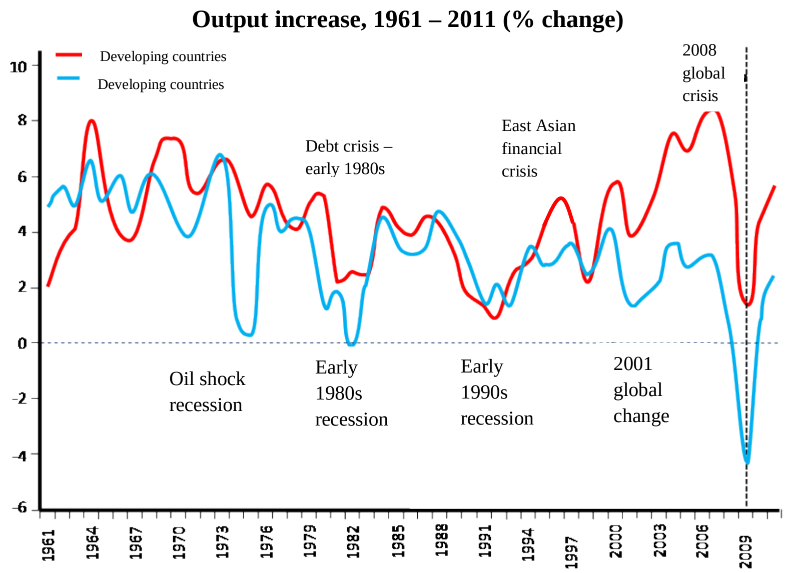

Figure 1. Output value increase for economies of developing and developed countries

(Source: Prof. dr Besim Ćulahović, World economic crisis: implications and solutions for Turkey, Bosnia and Herzegovina, and West Balkan)

On one hand, it can be disproportion between supply and demand in one national economy, and that is when demand falls below the level of supply of goods, so one part of goods stays unsold, in other words do not find the way to customers. This can be consequence of distrust of customers' in future economic development (e.g. perspectives for economic growth, safety of work, etc.). On other hand, negative effect on economy growth can have large natural disasters, threat of war or terrorist attacks, etc. Equivalently, shortage of resources (e.g. in form of oil shocks) can lead to abstain of consumers from purchasing, which can cause negative growth of economy. According to followers of John Maynard Keynes theory, country's demand for goods has large impact on total economy movements; if country decrease its expenditure or increase taxes, it can through multiplication factor lead to decrease of total demand and can cause or increase economy crisis. Growth crisis can be also caused by foreign supply: non utilization of potential capacities (so called structural crisis) can lead to earlier mentioned insecurity of customers and decrease of total demand.

3. IRRESPONSIBLE BEHAVIOUR – CAUSE OF CRISIS

World economic crisis has its roots in total collapse of financial system which happened in fourth quarter of 2008. Amazing is the speed by which crisis has spread over the world and seriousness of its impacts on sectors of economies. Consequences of financial sector mistakes also devastate other sectors of economies. In them market economy has unrealistically function, short term funds have multiplied quickly and irrational wealth was created. Crash arose after the decade of cheap money, large growth, easy acquired loans and related inflation of asset and real estate values. Participants: commercial banks, investment banks, central banks, regulators/supervisors of banks and agencies for assessment of credit ability – all of them have to accept its part of guilt. Rules that regulate markets, especially financial markets, were inadequate, unsuitable or simply were not applicable in practice. Organs of public authority seem to be not aware of this behaviour and large risk taken by financial institutions. Figure 2 shows effects of economic crisis at the end of 2008 on the decrease of industrial production of leading world economies.

Same analysts believe that crisis would not happened if from its beginnings stakeholder model was used instead of solely protecting shareholders and owners of capital. This means that irresponsible behaviour is main cause of economic crisis, which arise on malversation, doing business without coverage, non transparency as well as on consideration of interests of one small group of stakeholders.

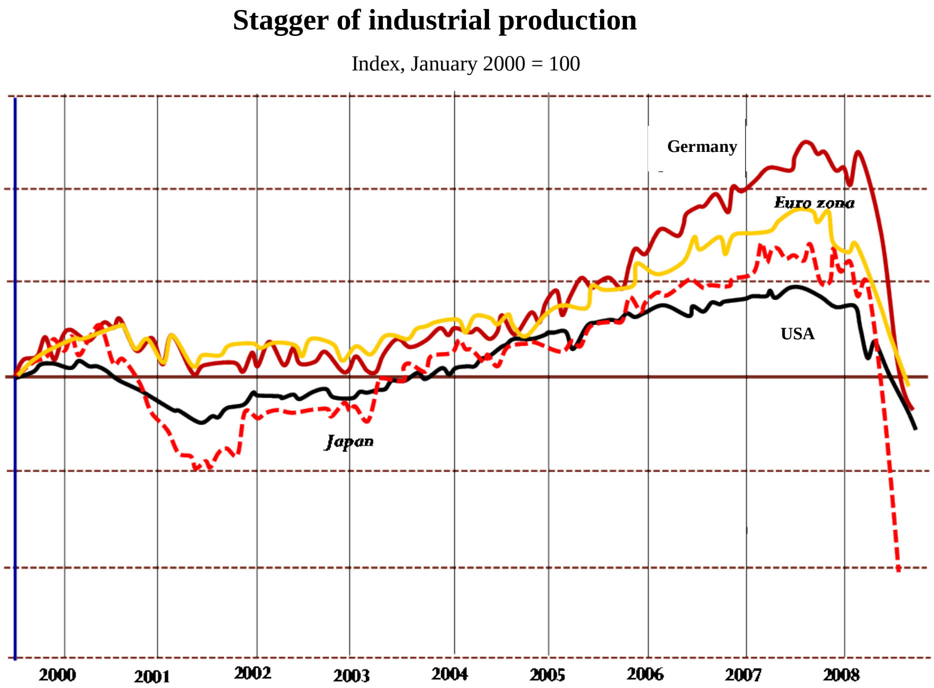

Figure 2. Stagger of industrial production of leading world economies

(Source: Prof. dr Besim Ćulahović, World economic crisis: implications and solutions for Turkey, Bosnia and Herzegovina, and West Balkan)

3.1. Irresponsible behaviour of investors

Beside mentioned, crisis has confirmed that investors are ready to reward managers of companies which generate large profits in high-risk businesses.

Few years before crisis, France bank BNP Paribas has implemented its own highly conservative system of risk and liquidity control (stricter than regulatory requirement of Basel II). Due to this highly conservative conduct, profits of BNP Paribas have for few quarters lag behind its European competition, Deutsche Bank and Societe Generale. BNP Paribas has endured critics of financial public due to decrease of its profitability and stagnation of share price, which can be interpreted as a shareholders' pressure to change management politics.

Shares of two largest competitors have recorded higher value due to larger profitability. But only few quarters later financial crisis had larger impact on Deutsche Bank and Societe Generale than on BNP Paribas.

During crisis it became obvious that conservative conduct gave bank much better position regarding its competition. But only few quarter earlier investors have rewarded managers of Deutsche Bank and Societe Generale for generated profits, irrespective of that those profits were generated from highly risky businesses, while management of BNP Paribas were punished with stagnation of share value.

Second example is case of AIG (American International Group), which managers were rewarded for many years with increase of share price based on high profits they generate from highly risky businesses, which in the end caused a beginning of financial crisis.

3.2. Consequences caused by crisis

If we now compare it to Max's writings about crisis, especially cotton industry crisis from 1861, as well as data of P. T. Ellsworth regarding the crisis from 1929 it is easy to note two key characteristic from both periods:

- In both cases it is case of phenomenon of excessive production, excessive investments, that is overproduction just before the crisis occurred;
- In both cases there is a problem of placement of goods just before the crisis and during the crisis.

However, if main cause of crisis is not shortage, but past excessive consumption of all subjects in society: public sector, nonfinancial sector, financial sector, households, by writing of J. Taylor (2009), J. Stigltz (2007), J. Crotty (2008), International Herald Tribune (2009), The Economist (2009) lays a question: were they behaving responsible?

Customers act on irresponsible behaviour so placement of goods is difficult. Figure 3 shows level of customers' trust of seven largest OECD economies in period from 1978 to 2009.

Level of customers' trust of 7 largest OECD economies

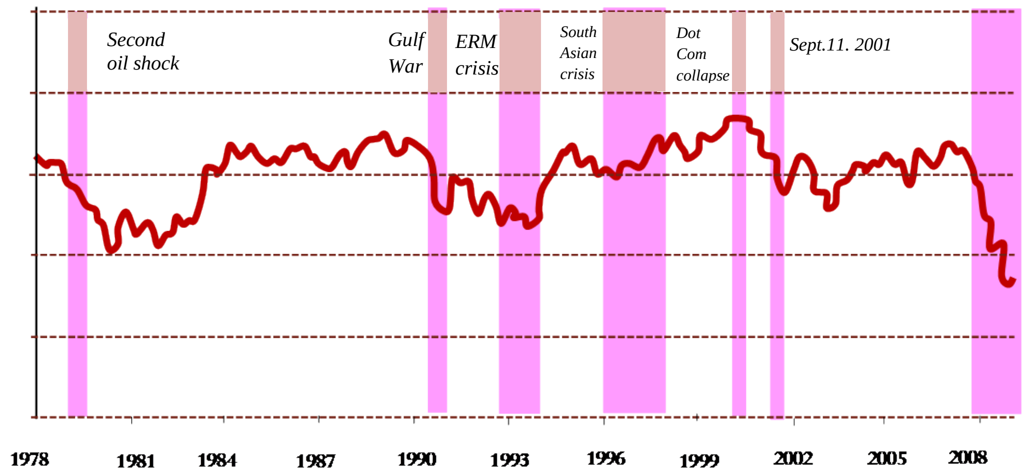

Figure 3. Customers' trust in economies
Source: OECD Report for year 2009

Every crisis is followed by: large discharge of employees, large financial losses, large economy losses on national and global level and large crisis in inventors' trust.

Common lines of every crisis are: fraud, absence of supervision and enforcement of laws, greediness, etc.

4. ROLE OF CORPORATE GOVERNANCE IN CRISIS

Although most of weaknesses of corporate governance primary affect companies from financial sector, it also affects all corporations which are listed on the Stock Exchanges. Due to this, overcoming weaknesses of corporate governance is key element of efficient response to crises and one of the main goals of international initiatives.

Considering the role of standards of corporate governance, the OECD has indicated several weaknesses. Many corporate governance tools proved to be ineffective faced to unexpected pressures and strong conflict of interests. The most important corporate governance failures are mostly due to implementation gap of existing rules and standards. While certain rules and regulations can be improved, regulatory agencies must increase control over the companies. The OECD action plan on Corporate Governance has included consultations with a broad range of representatives from non- OECD countries, the private sector, other stakeholders and civil society. Main areas for improvement should be concerned with:

1. The governance of remuneration:
   - Decision making,
   - Incentive system designing, and
   - Transparency.
2. Implementation of effective risk-management:
   - Board responsibility,
   - Relevance and Independence of risk managers, and
   - Disclosure of risk policy.
3. The quality of board practices:
   - Competence,
   - Independence, and
   - Transparency.
4. The exercise of shareholders rights:
   - The role of shareholders,
   - Institutional investors activism, and
   - Enforcement of shareholder rights.

5. ROLE OF CORPORATE GOVERNANCE IN CRISIS

Results of implementation and compliance of principles of corporate governance for companies from the Republic of Srpska for year 2010, shown in Figure 4, are determined using Scorecard analysis. The Scorecard for the Standards of governance of Joint Stock Companies was developed by the Banja Luka Stock Exchange with the assistance of the International Finance Corporation (IFC) based on the model of the Scorecard for German corporate governance for evaluation of the implementation of (good) practices and principles of corporate governance (The Banja Luka Stock Exchange, 2009).

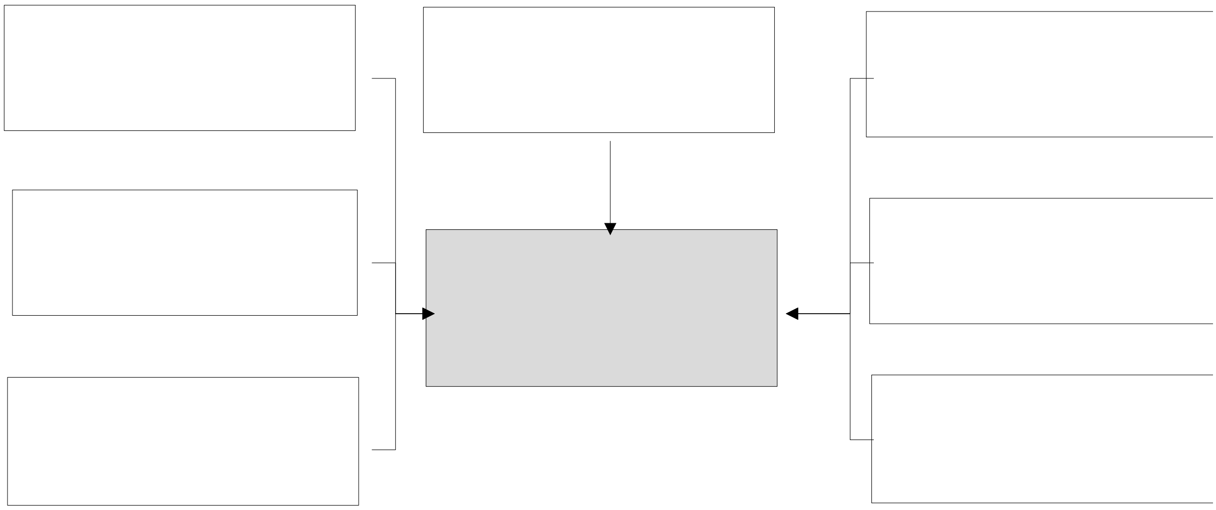

Figure 4. Results of Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska

Total score of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska is 53.46% which shows that implementation of principles of corporate governance in these companies are not on satisfactory level, taking into account that companies that apply basic principles of corporate governance should have the score between 65% - 75%. Particularly low level is showed in commitment to the corporate governance standards, role and responsibility of boards, disclosure and transparency of information and rights and treatment of shareholders.

These results indicate that state of corporate governance in companies from the Republic of Srpska is not on satisfactory level, and that implementation and compliance with principles of corporate governance is in primary phase. Low level of implementation and compliance with principles of corporate governance increases business risks, lowers company's completeness, and also increases investment risks for potential investors.

There are also many segments which companies should improve in order to bring the state of corporate governance on satisfactory level, to lover business risks and to attract new investors and raise capital at lower price.

6. CONCLUSION

Not even leading economic experts agree why crisis happened, what are its roots and what are possible consequences. Same analysts believe that crisis would not happened if from its beginnings stakeholder model was used instead of solely protecting shareholders and owners of capital. This means that irresponsible behaviour is main cause of economic crisis. Destructive effects of crisis will demand drastic measures and large changes in behaviour and business activities in the world market.

OECD has, in its action plan for improvement of corporate governance, stressed importance that world economy must move towards corporate social responsibility with a goal of protection from future crisis. Corporate social responsibility is simply making strategic decisions, decisions that consider the broadest impacts and consequences, transparency, concern for brother social interests and everything else that will ensure safe future economy in years to come.

By analysis of state of corporate governance in companies from the Republic of Srpska it was determined that these companies have low level of corporate governance, which as a result has poor rating of companies and low level of investors' confidence.

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