

STRATEGIC UNCERTAINTY WITHIN A NEW GEOPOLITICAL REALITY

Is there hope for more global responsible investments?

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ABSTRACT

The current global economic crisis and financial meltdown have aggravated the global challenges of changing international power structures and unsustainable corporate (herd) behavior. Under this strategic uncertainty, corporations will need to rethink and reengineer their way of doing business. Moreover, the geopolitical framework has changed as well with the USA losing its super-power status though nobody is able to challenge yet its military might. Economically, Asian nations and corporations are in a position to start to take a more leading role. It is assumed that appropriate governance structures and practices on the one hand and visionary and engaged spirited leadership on the other hand could partially counter the current global strategic uncertainty. Moreover, it could enhance global or sustainable investments over a longer term perspective.

KEY WORDS: *global strategic uncertainty, the emerging power of Asia, global governance, financial crisis, new global geopolitics*

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This paper analyzes the new reality of economic players within the changing geopolitical framework of power and influence amidst an ongoing financial mortgage meltdown and economic crisis. The political failure by the Bush Administration to stabilize the world after 9/11 and the lack of real visionary leadership with respect to economic policies and governance on the part of the European Union and the USA under Bush has led to greater international political uncertainty. The current global economic crisis and financial meltdown have aggravated the global challenges. Moreover, the geopolitical framework has changed as well with the USA losing its super-power status though nobody is able yet to challenge its military might. Economically, Asian nations and corporations are in a position to start to take a more leading role. However, better governance structures, policies and practices will be needed to strengthen firms, organizations and institutions. Moreover, insurance and risk tools should reduce the chances of such a financial crisis to occur.

The authors - being European and American respectively, working for and with Russian, Chinese and American shareowners in the Great Union Group, a multinational energy company in Hong Kong - have lived in Southeast Asia for the last two decades each and they emphasize some possible “wishful” scenarios within a new current geopolitical situation. Obviously, the focus will shift to Asia (and particularly China) and Russia as new “super-partners”, next to the prevailing economic, political and military importance of the West, and the USA in particular. Our analysis is nothing more than an attempt to provide an idea of how to deal with a chaotic future – by definition uncertain – through enhanced cooperation and global collaboration in a multipolar world order. We are convinced that good relations of trust based on subjective emotions of hope bearing goodwill between the leaders of the multiple power centers in the world, with the USA as still the *primus inter pares*, are necessary to materialize rational objective economic and political stability. Globalization does not need to be the battle ground of increased poverty and ecological disasters but can become the fertile ground of reasonable peaceful co-existence and collaboration among firms and governments that might benefit all the participants of this functioning core of interdependent global members and a number of “super-partners”.

This paper will firstly analyze some reasons why a lack of responsibility and weak governance practices is at the root of those apparently unrelated crises and corporate ethical debacles. Greed, neglect and ignorance cannot be a valid excuse for those corporate failures. Secondly, the growing global interdependence and fast growing Asian economies and the energy might of Russia are changing the geopolitical context, likely resulting in a multipolar geopolitical order in which the functioning core of some superpowers will hopefully lead towards a more

sustainable future. Finally, a quest for converging good governance principles is part of the solution in this increasingly complex and uncertain global interdependent economy. Finally, respect for widely accepted governance practices as the “playing framework of core connectivity” might reduce uncertainty in this new geopolitical reality.

STRATEGIC UNCERTAINTY AMID A FINANCIAL CRISIS

Crises do not come unannounced. We just do not seem to respond to those tacit or explicit indications till too late. The current Sub Prime Mortgage Crisis in the U.S.A. shows that the price to be paid for lacking transparency and accountability in the securitization process of mortgage loans (Collateralized Mortgage Obligations or CMOs) has proven to be very costly in terms of loss of credibility, reputation, market share and value. The financial meltdown starts to show its negative repercussions in the real economy, resulting in an economic recession that could easily last till the first quarter of 2010 or way beyond. It is unnecessary to mention that it is not [just] the overzealous risk-taker but [most likely] the taxpayer who will pick up this expensive bill. What went wrong? Excessive credit, excessive leverage and excessive funding were at the root of the subsequent panic in September-October 2008 that led to systemic illiquidity and insolvency to be rescued by the respective governments in the world¹. *Excessive credit* was made possible through “dumb money” where investors were looking for yield in high rated securities, hind insight wrongly rated as non-risky by the international rating agencies. Since investment banks and the securities packaging companies started to sell more and more of this “toxic waste” without recognizing the potential risks, fed by cheap credit that lured sub prime borrowers to take advantage of the free lunch available, a lack of oversight made the meltdown, hind insight once more, inevitable. Competitive pressures at the top of those banks and a well-known herd-effect pushed them to purchase and keep those securitized loans on their own books instead of further mitigating the risk. Moreover, one can argue that there was a *lack of full internalization of those risks* in the banks buying and selling those CMOs. Even if risks were expressed by the respective risk departments, they became less efficient as the cycle of buying and selling those securitized loans was progressing and in fact at the height of the danger, risk management was at it weakest. There was a total breakdown of applying the appropriate governance principles because more leverage was taken on the balance sheet without providing any cautionary cushion. In addition, the short term credit was considerably cheaper than long term capital with the idea that one could keep the borrower on a short leash. No one was building reserves, one paid out the cash to their

top executives as bonuses for the short term profits generated through this apparently profitable securitization process till the presumably golden eggs broke in August 2008. It seems that the institutions were not prepared to support the increasingly complex financial securitization process and the related mortgages which were not that risk-free as wrongly presumed. Moral hazards, and the failure to anticipate quite obvious risks aggravated by “irrational exuberance” at the prospects for profits partially explains the bubble (Shiller 2008²). Finally, the *excessive funding* for mortgage loans paradoxically lead to illiquidity and insolvency as those loans unexpectedly started to mount, securitization became increasingly more complex (un)consciously hiding any risk. Pricing of these mortgages-backed securities became harder by the day. The myth that there was plenty of money available was finally unraveled in August 2008 and panic erupted when Lehman Brothers were not bailed out by the USA government. The rest of this mortgage story is history in process now.

What can be learned from this particular crisis? Illiquidity is contagious. Although hedge funds are usually better equipped than regulators to monitor risk, one pushed the bottom of risk-taking profitability a little too far. By imposing enormous reserves for risk taking, money was pushed away by securities houses and investment banks – which are comparably less dictated by regulatory oversight than traditional banks - to off-balance sheet activities out of sight of the regulator. Excessive greed motives for example overtook the fear for too high risks within the opaque hedge-fund business. It is acknowledged that a governance problem should not be equated to a regulation problem. Having a variety of markets and instruments, institutions, government intervention and global oversight coordination can help the system to regain some form of confidence rather quickly. Financial infrastructure should be strengthened. Obviously, the private sector needs mechanisms to absorb this crisis, and not just put the tax burden on the public at large. Such improved mechanisms will imply some form of governmental regulation that underpins the support for the financial sector without stifling innovative and creative new products and services. However, the “Washington consensus” who advocated a strong belief in open, free markets, and general acceptance of faith in the efficiency of the market, presumably worldwide, seems to be in retreat in the face of the current global financial meltdown. The Obama economic team and the EU leaders have clearly indicated during the G20 Summit in Washington in November 2008 and again quite clearly at the G20 Summit in London in April 2009 and on a number of occasions afterwards that government intervention will be needed to address the global crisis and rectify the “free” market. Moral hazards linked to the market mechanism needs to be minimized by better oversight, less opacity and stricter accountability, not by more bloated regulations that could cause to aggravate the current crisis situation. It can be suggested that in

the short term the government has no choice but to bail out which unfortunately has the side effect of encouraging moral hazard as in people acting irresponsibly because they expect a bail out in case of failure (Shiller 2008). In the long term, an improved information infrastructure, and thus transparency and accountability, is needed allowing people and firms to use an improved knowledge base through transparency processes. Such improved framework will imply that the Rating Agencies will need to be more effective and made accountable for their advice as well. They grossly over-rated the CMOs; now they have changed shoulder and are about to over-react in the pessimistic sense by about to downgrade some South European countries, possibly causing unnecessary long term damage. A more moderate, less erratic and 'objective' attitude from financial institutions, including the Rating Agencies, should be expected. If not, their existence becomes redundant and dysfunctional. The role of policy-makers is not only to enforce current laws, but to promote institutions that facilitate market discipline (Low, 2005). Second, commitment to value creation through or under the constraint of moral values, social norms and a legal framework will help a responsible and accountable leadership to prepare and implement visionary strategies. It is within limit(ation)s that a system can optimally function. The USA, UK and Japan opt to "spend" their economics out of the crisis by an enormous stimulus package under the minimum regulatory constraints of systemic risk. The EU, especially Germany and France, emphasize the need for global regulation to prevent such contagious international crises again in the future. Their aim is to push for far more transparency in the financial global transactions, relying on an existing social security system on the old continent that hopefully will cushion most of the atrocious social consequences of this crisis. That leaves China and Russia to strategically exploit the division in interpreting a contextual solution. The G20 has recently agreed on the global principles to address the current economic financial crisis and prepare the framework of a new "global world order", whatever that means. The devil – as always – lies in the details.

When subjective uncertainty – unknown unknowns versus objective uncertainty or known unknowns – dominate and when the economic environment is so complex and near incomprehensible, the result is extreme prudence, if not paralysis, on the part of investors, consumers and firms which in turn feeds the crisis. What needs to be done is to remove the tail risks and the perception of tail risks as much as possible (cf Appendix, Figure 1). On the portfolio investment side, it is recommended to establish floor prices of troubled assets and on the consumption side, commitment to fiscal stimulation and "quantitative easing" may help to restore some consumption confidence. Policy-decision-makers should not overreact and should focus on prudential not excessive regulation of the financial system. Greed needs to be tempered by fear of

losses; if you bail people out, there is less fear. Prudential regulation and supervision should avoid certain excesses.

Similarly, the Asian Crisis of 1997 highlighted the inadequacy of systems of governance at the state level as well as at the corporate level. During that crisis, the five most heavily affected countries - Indonesia, South Korea, Thailand, Malaysia and the Philippines - lost more than USD 600 billion in market capitalization³ or around 60% of their combined pre-crisis gross domestic product. Total private capital flows to emerging markets are estimated to have fallen in 2002 to levels last seen in the early 1990s (Cornelius, 2003). The predominant relationship-based style of corporate governance in Asia can be seen as one of the fundamental drivers of concentration of ownership accompanied by a lack of transparency has turned out to be one of the causes of the region's economic crisis (Millar *et al*, 2005; Pye, 1997). However, the Asian Crisis has brought considerable progress in a more transparent corporate governance mechanism and more comprehensive and internationally converging accounting standards in the respective inflicted countries. In the ASEAN banking sector for example, a substantially improved transparency and decision to adopt the International Basel II standards⁴, allowed for a drastic change from close and intrusive regulation to a risk-based supervisory regime in most of those ASEAN countries (Rhandawa, 2005). Such amelioration may prepare them for a more robust and sustainable growth in the future.

However, the last couple of months, the GDP probably fell by an average of 15% in Hong Kong, Singapore, South Korea, and Taiwan, the four Asian traditional tigers. Stock prices on the respective Asian exchanges have plunged by almost as much as during the Asian financial crisis a decade ago, though they all recently regained some share, following the trend of the last couple of months from February till June 2009. The current crisis (2009) has been caused by Asia's excessive dependence on foreign capital, especially in the economy of the four above mentioned tigers. The Asian tigers' export-driven economies had benefited from America's consumer boom of the last years, so its manufacturers were bound to be hit hard by the sudden downward trend. This plunge in exports has been aggravated by the global credit crunch, which made it harder for corporations to get trade finance. China is a case in itself since China's exports account for about 36% of GDP from which half contain imported components. Thus the impact of a fall in exports is partially offset if imports fall too. Pure value-added from exports therefore can be estimated to be a more modest 18% of GDP. Consumer spending in China is just over 35% of GDP, half the American share (The Economist, Jan 31, 2009), but the savings are considerable and assuming that private households can be stimulated to spend more, private consumption could become an important growth engine for the Asian region. Every government in the Asian

region has cut interest rates and announced fiscal stimulus, and the Chinese public spending – especially to upgrade or expand their infrastructure - is impressive. Fiscal spending in the other Asian emerging countries after the 1997 crisis resulted in significantly reduced government capital spending, especially in Thailand and Indonesia in which the public infrastructure is probably worse than a decade ago. That makes it enough room to introduce some sensible public spending. The open economies of Hong Kong, Singapore, South Korea and Taiwan will likely contract in 2009 whereas the bigger less open economies of China, India and Indonesia may resist the current crisis slightly better with growth rates of 7% to 4% respectively. Taking into account the rising productivity, high savings to finance investment, low import barriers to speed up competition, one can assume that Asia might fare much better to overcome the current crisis than the debilitating crisis of 1997. Asia's room to increase local consumption could function as the engine for more growth. On the supply side, structural reforms and better governance and risk management should enable corporations to become more globally competitive and to become less dependent on the protectionist pressure in the West. And psychologically, stimulated by an enormous emotion of hope for better (Moïse, 2009), Asian (especially Chinese) growth economies and Russia, rich in oil and gas reserves, may undermine the current Western hegemony.

NEW GEOPOLITICAL REALITY AND GLOBAL INTERDEPENDENCE

The USA government has greatly over-invested in military approaches which did not prove to be convincing. As the USA's reputation has been seriously tainted under the Bush administration, it neglected too much the power of foreign assistance as a tool to promote global stability while it overrated its own invincibility losing enormous soft power in the process (Nye, 2004). The USA hard power has acted in a way as if negotiation stands for appeasement despite the overwhelming empirical evidence to the contrary.

The too optimistic perspective of Fukuyama's "End of History" has definitely not been materialized. When the Cold War ended in 1989 with the fall of the Berlin Wall and Europe looked confidently into the future, while China was chastened and traumatized by Tiananmen, few would predict that the geopolitical power structure would change so dramatically over these two or three last decades. And geopolitics is all about influence and control. However, the US has become a nation of debtors at a dangerous level. Moreover, the "rise of the rest" (Zakaria, 2009) – best symbolized by the rise of China – have undermined the superpower position of the USA. The

rise of the rest is reflected in the enormous growth of Asian economies. This transition has also political, military and cultural consequences. The new powerhouses, Brazil, Russia, India and China (BRIC) dare to stand up against the West, the USA in particular. Global power, nonetheless, is above all incarnated in the dominance over ideas, agendas, and models (Zakaria, 2009). The result of the current crisis is that market capitalism as in the USA and to a lesser extent in Europe now “competes” with state capitalism and “bamboo” capitalism in Russia and China.

State capitalism in China and Russia, and interventionism have gained prominence again in the aftermath of this severe global crisis. China and Russia are leading the way in the strategic deployment of state-owned firms and their example is followed by a number of other governments. Free markets are not the drivers of success but enablers to help to make the provision of products and services as efficient and effective as possible. At this time of enormous uncertainty, more complex forms of cooperation are required with the inclusion of private corporations and consumers but also public and non-for-profit organizations.

The Asian newly founded might, despite its temporary economic downturn, will need to be translated in sustainable policies that accommodate its new international position of reciprocal “power” and authority. The economic and political power in China and Russia, based on the emotion of hope that contrasts with the emotion of fear in the West and of resent, anger and frustration in a number of Middle Eastern countries (Moïse, 2009). The BRIC’s new international position also implies some expected responsibility and accountability towards its neighbors and the international global community. In September 2008, Robert Zoellick, the President of the World Bank, called on China to become a “responsible stakeholder” in the international system. The Chinese elite treasures political “peace, friends and time” as one of the most important contributors to create an environment in which its 1.3 billion citizens can live comfortably in peace and harmony with its neighbors. We are convinced that good relations between the leaders of the multipolar power centers in the world, with the USA as *primus inter pares*, are necessary to materialize rationally objective economic and political stability. Globalization does not need to be the battleground of increased poverty, unethical greedy corporate behavior and ecological disasters but can become the fertile ground of reasonable peaceful co-existence and collaboration that might benefit all the participants of this functioning core of interdependent global members (Barnett, 2004). Within this functioning core, firms achieve a competitive edge through soft power which is only possible when the nation has the knowledge and technological capacity to keep innovating.

Nudging globalization in the direction of best *governance practices* is the ultimate example of good global risk management and to connect people into a *functioning core* of interdependent nations and economies. *Global connectivity*⁵ benefits America and Europe economically by increasing its access to the world's goods and services while promoting its exports (Barnett, 2004). Such connectivity also significantly enhances the political collaboration and interdependency. However, those at the center of power, having the authority to make decisions, should also engage in corresponding duties, i.e. being accountable and sharing responsibility for their actions. Moreover, when Western societies are confronted with global crises, it often leads to a return of psychological and economic protective measures where specific often biased interests (of a select few) trump values. For example, the EU and US spend an average of USD 67 billion and USD 20 billion respectively on agricultural subsidies in 2005 (Mahbubani, 2008). Protectionism in trade and economic fields may endanger the open global system the West has created at the end of World War II.

Analyzing the individual economies and political constitutional regimes separately is one possible approach to understand the current and future trends of international economics and international relations. The authors emphasize the relationships and collaboration between the different economies and regimes. The global economic order is under scrutiny at the moment and the widespread confusion over what constitutes legitimate threats to international economic and political stability and order cannot be ignored, especially by those countries who feel left behind and have nothing to lose to react against a core of (mainly Western) interdependent countries. We could argue that the current global crisis may require its leaders to create new rules to guarantee such international order amidst a new geopolitical constellation. America, as the "default superpower" (Joffe quoted in Zakaria, 2009: XXVI), and its global trading and political partners will need some common action to overcome the current global crisis. The American leadership and or the European Community – or whoever will take a lead to spur the world towards a new economic and political order – will lose credibility as a competent power if those newly created rules will be dismissed by other cultures as reflecting an American or European bias, not universally applicable principles or rules. Hence, it is important that both America and Europe will be able to sell those ideas to the other upcoming powers, most notably Brazil, Russia, India and China – the BRIC countries. China's and India's population (constituting about one third of the total world population) and the growing economic wealth (however small it may be in its initial phase) guarantee the magnitude and long-term nature of the global power shift towards these two Asian giants. Acknowledging the power of energy, makes Russia the third contender to regain the status of a "super-partner". It seems that China believes in a "peaceful rise" that

reflects a carefully thought-out consensus within the Chinese political elite and even society that emphasizes harmony and peaceful relations. Of all the five “legal” nuclear powers, China keeps its nuclear weapons in the least operationally stage without any first-strike intention. Moreover, the US spends more on defense than the next twenty-three largest military spending nations combined (Mahbubani, 2008: 105). It is also true, however, that without the global presence of the US armed force, the world order would currently be less orderly.

Our challenges have become so global that old nation-state boundaries have become too small to provide public goods or global solutions. How to address those issues? Only international cooperation will be able to address the global challenges. The well-know Earth Institute Director at Colombia University, Professor Jeffrey Sachs, believes that a sense of legitimacy and global connectedness could result in some form of galvanizing that may make people appreciate the interconnectedness of our global challenges⁶. Multinational companies will need to accept the “intervention” of some sort of state capitalism for the years to come. The G20 Summit of April 2009 revealed the differences between the USA, UK and Japan on the one hand, and Europe on the other hand, with an unknown global position of China and Russia. Generic principles as expressed during the recent G20 meeting in London need to be translated into contextual practices which makes global governance under this strategic uncertainty in a new geopolitical environment so primordial. We believe that the application of governance principles and practices at an corporate and the public level accepted by the international community as expressed in the OECD rules and other conventions (Verhezen & Morse, 2009) could contribute to a more global solution.

Nonetheless, experience has proven that the Western notion of the rule of law, in which all human beings are to be treated equally under the law and all citizens subject to the same impartial laws, as envisaged by Hobbes’s Leviathan and Rousseau’s General Will, goes against the grain in Asian minds. The question remains whether the engrained *guanxi* relationships based on personal connections will veer towards a system of meritocracy and legal impartiality or rule of law, or whether a more hybrid form of relationship-based & rules-based governance will prevail (Verhezen, 2008). The famous symbol of a blindfolded figure holding the scales of justice captures this deep aspiration to create a just society in which the law applies equally to all acknowledging the dignity of each individual. The pursuit of such form of justice should be regarded as a very high ethical aspiration, though the devil sometimes lies in the content of the law or in the implementation of the law in which the tension between the predominance of loyalty of community members over individual rights is sometimes misinterpreted or misunderstood in the West.

More concretely, evidence suggests that Western approbation or sanctions are often based on Western interests and not merely on their well-thought Western values. Despite the obvious economic and political interests any political elite tries to preserve, the West often sees the world in black and white terms, distinguishing itself from either the evil empire or the “axis of evil”, whereas Asian societies are able to see the ambiguous world in many different colors. The West – with 12% of the total population attempting to control the world - needs to understand that the world will almost by necessity become more complex and that the Asian countries will play a more important role. It is obvious that China is emerging slowly but carefully as a global geopolitical player by making careful inroads into Latin America and Africa. Chinese low profile gradually positions itself to emerge as a great power. China’s decision to help ASEAN countries was based not merely on altruism but on *real politik*.

The governor of China’s Central Bank recently suggested to consider the possibility of a new world reserve currency to replace the US dollar, with the understanding to “reset the obsolescent unipolar world economic order”. The question whether or not the IMF could create a global currency by expanding the use of its already-existing Special Drawing Rights (SDRs), a synthetic currency linked to the underlying currencies of IMF states, remains to be seen. One of the solutions to provide enough “global” insurance is to pool foreign-exchange reserves at the IMF. However, this synthetic currency needs to be exchanged into local currencies at local central banks to buy real assets and facilitate trade. It should not be forgotten either that the IMF’s economic prescriptions have sent numerous (particularly Asian) nations into tailspins during the 1997 crisis. Moreover, China’s central bank is eager to have more legal power at the institution. With Chinese government heavily investing in US Treasury Bonds as an important component of China’s foreign currency reserve investments, China is understandably concerned about the US trade and economic policies, affecting the value of those T-bonds. Although there is no obvious immediate successor to the US dollar, Russia and China and other nations are seriously concerned about and sometimes resent the US dollar as international currency. The euro might become an alternative but the political cohesion and international economic cloud of the Europeans need to be proven once more before more trust can be placed into this alternative. The global imbalances between international borrowers (especially the Americans) and savers (Chinese among others) could boost protectionism and sentiments of isolationism.

No country today welcomes foreign invaders or even direct or indirect un-welcome pressure or influence from foreign participants. Hence why the 5.6 billion people who live outside Western borders will no longer accept decisions made on their behalf in G-7, IMF or the World Bank in Western capitals. The G-7 is meant to represent the most powerful countries of the world

and it has become progressively less relevant to the rest of the world. Despite the iconization of democracy became a tool of a new crusade against the “axis of evil” as if democracy developed in the West could be un-adapted exported to any society everywhere in the world, regardless the specific context of such a nation that may be quite different from a Western one. The authors do not dispute the virtue of democracy. Underwriting Churchill’s now infamous statement that democracy is the least worst among the political systems known, indicates that a blind implementation of the rule of majority in feudal environments sets up unintended scenarios as the hatred of a majority versus a minority has shown us in the Gaza, in Indonesia, in Myanmar, in Thailand, and so on. The democratization process of a Western liberal democratic society did not prove to be universally applicable, unless the local socio-political context is acknowledged and taken into account.

The reluctance by leading Western politicians to acknowledge the un-sustainability of long term Western global domination presents a great danger to the world (Mahbubani, 2008). It should also be noted that fear in the West and resent in the Middle Eastern countries may be no match to the enormous emotional power of hope in most Asian countries (Moïse, 2009). Moreover, dangers and crises can result in either some regret for wrong decisions and fear for the unknown and deep uncertainty or they can lead to new created opportunities (Cf Appendix, Figure 1 & 2). At the moment, international monetary reform reducing systemic risk and currency fluctuations, and enhancing price stability and world trade remain the main priorities of the global superpowers or “super-partners”.

Personal chemistry will also continue to play an important role in the *realpolitik* of international global politics and trade. However, Asians may feel a certain European disdain or American condescension that does not help to solve the current global challenges. Maybe we should get back to the old Greek, Roman, Ottoman or old Chinese tradition who embraced other cultures and became centers of learning and knowledge.

In establishing relationships with other nations and companies, one should be lead by the virtues of common sense and pragmatism (in its most philosophical meaning). Engagement rather than containment will lead to global solutions. Previously, America has been down to earth and sensible to common values to solve problems. We may like to return to such an attitude. If one get rid oneself of ideological assumptions and presumptions, one can most likely find pragmatic solutions with an open mind to communicate with others, addressing those global challenges. As Deng Xiaoping famously stated it: “it does not matter whether a cat is black or white; if it catches mice, it is a good cat”. This is exactly what the current chairman’s intention of the Great Union

Group aims for by forming and establishing a stabilizing partnership that could address and stabilize the world energy issues together with the other energy giants.

BETTER GOVERNANCE COUNTERS UNCERTAINTY AND ENHANCES RESPONSIBLE INVESTMENTS

The capitalist market has failed us or rather our well paid business leaders have not fulfilled their duties. It can be assumed that a more stable and peaceful world is underpinned by some rules-based order on a domestic, regional and global level. Stability and a feeling of security are the assumed critical factors that provide stimulus to the economy. Moreover, one could assume that – despite the increased dangers of systemic risk – interconnectivity will increase productivity and thus ultimately the welfare of its connected citizens (Cf Appendix, Figure 3). The business objectives of the newly formed Great Union Group, an emerging new energy company for example, entail the preservation of providing gas and oil to its main customers within the functioning core of an interdependent world order while still fulfilling the fiduciary duties to create wealth for its shareowners.

Indeed, one could argue that the principles of good governance – democracy, rule of law & meritocracy, and social justice - and its contextualized “best practices” based on those principles can be seen as the cornerstone for a new geopolitical structure. A global leader will need to take responsibility and being accountable for its actions. Such leaders will steer firms to become “migrators” if not “pioneers” and create wealth through innovative strategies (Kim & Mauborgne, 2005; cf Appendix, Figure 3).

It seems that a number of international public and private organizations are out of sync with the present dramatically changed geological and economic situations of global interdependence. Many public and private organizations are still driven by national or strictly limited corporate interests that have a tendency to avoid to address transnational global challenges because there is no supra-institutions unlike a dysfunctional one that forcefully could embrace challenges beyond national or corporate rooms. China is still focusing on developing its own economy providing its citizens the welfare securing peace and harmony, while not necessarily willing to take a global leadership role yet. India may be more cosmopolitan than Chinese leadership, but its economic size is small compared to China and the Western powers – merely USD 800 billion compared to USD 12.5 billion for the USA, USD 13.3 billion for EU,

and USD 2.3 billion for China according to World Bank figures in 2005 (before the recent financial meltdown).

The authors argue that corporate governance principles both for public listed, private and state owned corporations are the best chance to harmonize the “rules of the international game”⁷ to preserve international collaboration and responsible corporate behavior while acknowledging the global connectivity and interdependence (cf Appendix, Figure 3).

It is worth asking what those more generic governance principles and “best” practices are. Corporate Governance can be re-defined as the interactions between coalitions of internal and external actors and the board members in directing and *steering* a corporation for value creation (Huse, 2007; Brown & Caylor, 2006). Good corporate governance refers to the exercise of power and responsibility for corporate entities (Mallin, 2002) to become distinctive and differentiating “pioneers” and examples for others. Corporate Governance can be defined as structures of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective of profitability (Solomon & Solomon, 2004). Moreover, good corporate governance’s concern for capital providers or investors is related to assessing risk in investments in a firm’s resources, to evaluating capital allocations to provide reasonable returns and to monitoring how capital is managed over time (Puffer *et al*, 2003; Banks, 2004; Clarke, 2007; Huse, 2007). One of the main objectives of corporate governance is to provide reliable information about the firm through transparency and disclosure to all shareholders. Indeed, we can safely assume that good corporate governance principles refer to and are concretely translated into an obligation of *care* and formal *fiduciary duty*⁸ of officers and directors that accommodate the shareholder value. The former refers to an *attitude of responsibility* towards all shareholders and stakeholders embedded in informal *social capital* structures affecting the company; the latter to a legal fiduciary contract. In other words, dramatic changes in cultures of information require access about and from centers of power and their accountability leading to the “right to know” and expanding “duty for disclose”.

The reasons for improved good corporate governance could be either to improve efficiency or to legitimize institutional investment (Zattoni *et al*, 2008). The traditional agency theory emphasizes the formal corporate governance mechanisms that focus on controlling and monitoring of management by the Board (Fama & Jensen, 1983; Jensen & Meckling, 1976; Jensen, 1986 & 2002). However, such a formal approach should not ignore the more informal corporate governance mechanisms that underpin resource-oriented and relationship-based governance (Peng, 2003 & 2005; Pfeffer *et al*, 1978; Hu & Verhezen, 2009). Corporate

governance principles are justifiably considered as a needed check and balance system of the top management who runs the firm on behalf of the owners. However, in the UK, both the Cadbury (1992) and Hempel (1998) Report respectively warned against the dangers of over-emphasizing the control role of non-executive directors at the expense of their strategic role (Roberts, 2005). Our personal experience in Asia confirms this view: the importance of personal *guanxi* and reputation of leadership can only be ignored at one's own peril. Nonetheless, in most ASEAN countries and other emerging economies, poor enforcement of disclosure laws and accounting standards stifle regulatory authorities unable to monitor banks and public companies for example (Randhawa, 2005). In emerging markets, majority and family ownership are quite common, disclosure levels are low, shareholders' rights are sometimes ignored, and judicial recourse is sometimes very uncertain. Asian corporations deploy opaque accounting principles, keeping the data 'in the family' and practice 'gift giving' on a scale that could be interpreted as bribery in an Anglo-American context. In Asian Cultures the lack of trust beyond extended family, collectivism and cultures of power distance based on hierarchical status elevate the importance of certain socially acceptable behaviors such as loyalty and close personal relationships in business. These specific cultural and organizational characteristics, important to sustain *social capital*, may turn into cronyism which selects and favors some "in-group members" based on relationships and loyalties, or can overemphasize relationships and loyalties that can result in corruptive behavior (Khatri *et al*, 2003; Verhezen, 2008b & 2009). Such cultural complexities may hinder and even undermine the development and implementation of the good corporate governance required for sustainable 'modernization' in a global interdependent world.

In contrast to the agency model of the board as a control mechanism, it is suggested that boards have a broader, more inclusive role, with non-executive directors involved in giving advice and embracing strategic discussions (Roberts *et al*, 2005). Actual board effectiveness depends upon the behavioral dynamics of the board, not on the formal procedures. It largely is dependent on how the web of interpersonal and group relationships between executives and non-executives is developed in a particular company context. It seems logic that organizations will respond to changes in their environments by initiating strategic change to adapt to changed situations. Empirical research indicates that changes in the environment usually motivate changes in the structure and composition of the board of directors as an environmental link (Pfeffer, 1972 & 1978; Hillman *et al*, 2000). Relationship-based governance and a resource-oriented mechanism should be acknowledged in improving the effectiveness of the board and the need for more transparent responsibility under the constraints of formal disclosure requirements and informal moral integrity (Verhezen & Morse, 2009). Without appropriate information based on more

transparency, it is impossible for non-executive board members to develop a confidence that top management is focused on the most appropriate indicators of business conduct and performance.

Where boundaries as result of globalization and internationalization seem to be fuzzier than ever the need for some multi-fiduciary responsibilities within and for a corporation may become recommendable. Adapting to a multiple-principal-agent theory, quite often referred to as the stakeholder theorem (Jensen, 1983, 1986, 2002; Freeman, 1984; Donaldson, 1995 & 1996), instead of a naïve belief in the single principal-agent theory and its exuberant laissez-faire model based on individual self-interest only will have more chance to embrace necessary changes to address the global challenges. In other words, when we imply that corporate governance should also be applicable to medium-sized and smaller firms – i.e. the majority of companies are small or medium-sized in the world at present – a corporation can be seen as a bundle of resources and relationships that produce an output in the form of wanted or needed goods and services. Hence, the authors will opt for a broader definition of good corporate governance, which takes into account the relationships between shareholders, their board members and top management on the one hand and the different stakeholders who could significantly affect the value of the corporation on the other hand. The fiduciary duty of acting with due care by the boards of directors to the shareholders and by corporate managers to the corporation is here broadened and embraces prudential considerations of how the relationship with other stakeholders could be affected by corporate decision-making. It seems that quite a number of Asian companies are implicitly concerned with community development though hardly in any formal or procedural manner since they underwrite and acknowledge the good relationships with external stakeholders and community members as a necessity to survive. The authors are compelled to underwrite the argument that the interests of stakeholders other than just shareholders could and should be taken into account provided that, as the Delaware high court phrased it rather delicately in a well-known case that there is “some reasonable relationship to general shareholder interests” (Dimma, 2002: 166) which nowadays is seen as mainstream corporate governance practices. The enhancement of stakeholder interests from a board perspective is defensible and necessary, especially if such an argument protects the best interests of the firm, even though such interests may appear incongruent with non-financial goals⁹. The fact that nowadays boards take into account stakeholders’ concerns that can affect the reputation of organizations, with sometimes dire financial consequences, seems to have become mainstream governance practice. The subsequent debate is now raging as to what extent corporations should be indeed aspired to be fully fledged corporate citizens in a global village (Mirvis *et al*, 2006; Emerson, 2003).

Value is not merely profitability for shareholders in the form of dividends or stock price increases, but value is created throughout the whole value chain. Remaining deeply engaged with all critical stakeholders and developing an emotionally resonant shared purpose for their employees and other stakeholders seem to be one of the corporate features for successful corporations (Eisenstat *et al*, 2008). Most CEOs and directors in the West are rightfully concerned with the changing expectations and increasingly critical demands of stakeholders and the associated risk that are affecting their corporate reputation. They are also aware that they, and not just the regulators, need to lead the way forward to address the increasingly complex global challenges.

The objective of corporations in today's world should be to underwrite broader principles, finding a way of going beyond the contextual content of a particular community and reaching some universal validity beyond cultures or ethno-centric perspectives. It seems that a certain convergence concerning governance principles and corporate citizenship can be established beyond cultural borders. Traditionally corporate governance mechanisms imply the importance of reasonably independent boards to nominate top management, determine their remuneration packages, guarantee corporate continuity through succession planning and make sure that information is properly disclosed through internal and external auditing processes. The most active institutional investors' expectations regarding corporate governance¹⁰ can be summarized in the following well respected "best" practices: the quest for an increasing number of non-executive and independent directors, the splitting of Chairman and CEO roles, the creation of board committees (nomination, remuneration and the audit committee) made up by non-executive independent directors, and the development of an evaluation procedure for the board are all formal practices considered to increase board and firm performance (Banks, 2004; Clarke, 2007; Markarian, 2007). However, there are *no* "best" or optimal systems of governance, but there are only *better* practices¹¹. Indeed, it is acknowledged that a 'one size fits all' approach is unrealistic and often perceived as alien because experience has demonstrated that the Anglo-American capitalistic structures cannot be automatically transplanted or imposed globally. Nonetheless, investors can only be attracted to buy foreign shares if *basic standards of corporate governance* at an international level are being adhered to. When the fund manager Mark Mobius, from Templeton Asset Management, joined the board of Lukoil the market reacted by positively reevaluating Lukoil as they were convinced that Templeton being involved would bring more transparency and accountability to the Russian company, enhancing the overall value of Lukoil in the process.

No matter how powerful and technologically sophisticated the train, it is only as good as the track on which it runs and as the conductor who steers the train. The mortgage crisis has revealed that the regulatory and insurance institutions are like old tracks not suitable for the new challenges. Moral hazard can only decrease when institutional reform provides a stronger framework within which the real estate and financial markets can effectively operate (Shiller 2008). Such institutional reform does not equal more regulations; more likely it will require streamlining, adopting, and fine tuning the existing regulations. Moreover, the lack of corporate governance principles and too much greedy focus on quarterly bonuses has definitely aggravated the financial meltdown. Whether corporate governance - certainly reducing overall risks - would have been able to prevent the crises altogether is more difficult to assess.

CONCLUSION

The current international strategic uncertainty is partially caused and to an extent aggravated by the financial crisis that has been caused by a lack of governance and prudent risk management, by corporate unsustainable and unethical herd behavior. The strategic uncertainty that brought the Western and the global capitalist system almost to its knees will reshuffle the geopolitical power centers, both on a *national* as well as on a *corporate* level.

Unless the new geopolitical *national* “super-partners” will find ways to expand and enhance governance principles and implement internationally agreed rules (of the game), the world will face a very uncertain and likely violent Hobbesian future. The great challenge for international leaders is to create a new geopolitical environment based on global collaboration in mutual interest that stimulates effective global cooperation. It also will need to enhance global responsible investments that address the urgent needs of this planet (around economic, energy, climate change, criminality among others) while acknowledging the human driver to increase (economic) wealth and (socio-political) wellbeing. Political and economic cooperation among the five “super-partners” (USA, Europe, India, Russia and China) can reduce possible eruptive conflicting interests and enhance the functioning core of global interdependent participants.

The recent financial crises seem to be caused by the antipode of transparency. Global attention has increasingly turned towards the question of good *corporate* governance in both developed and emerging markets. A common factor determining the success of a corporate governance structure is the extent to which it is transparent to market or regulatory forces. The focus will increasingly be on corporations which have amassed enormous power by their mere

global reach and size, and heavily supported by governments in the aftermath of this crisis. Global corporations play an increasingly important role in the economic and also socio-psychological life of citizens. By applying those governance principles, one estimate that the strategic uncertainty could be significantly reduced and that responsible investments could be pursued.

Appendix

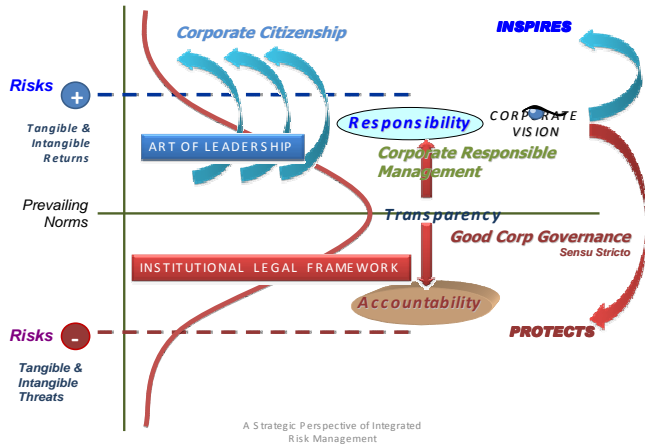


Figure 1: Risk Management & Corporate Governance

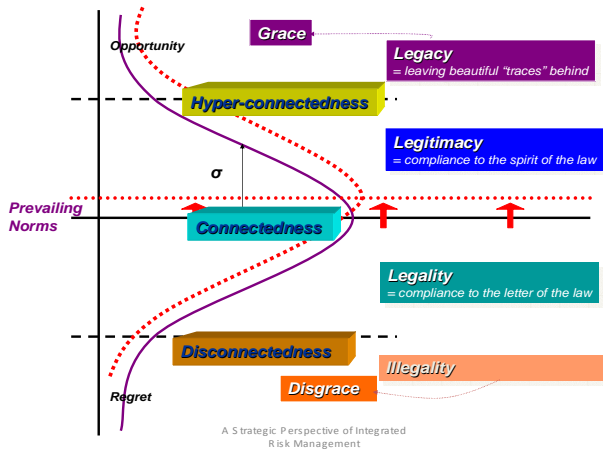


Figure 2: corporate and political governance

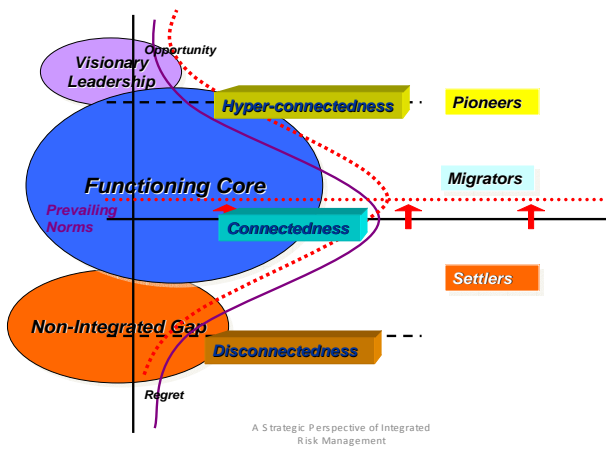


Figure 3: Globalization: Functioning Core versus Disconnected Gap

Notes:

¹ This brief analysis of the Global Mortgage crisis is based on a Lecture “Causes and Consequences of the Current Financial Turbulence” by Professor Raghuram Rajan, Professor Finance at the Graduate School of Business of Chicago, at the University of Melbourne on 5 November 2008, and a Lecture “Could Good Governance have prevented the current global Mortgage Meltdown?” by Dr. Peter Verhezen at the University of Fudan on 17 October 2008. The analysis is meant to be indicative rather than exhaustive.

² See Shiller (2008): 46. “Speculative price increases encourage genuine economic optimism. Hence more spending, hence greater economic growth, hence yet more optimism, hence further bidding up of prices. Most persons may be forgiven for not seeing that the sense of economic prosperity that usually attends a major speculative bubble is actually caused by the bubble itself and not by economic fundamentals.”

³ Although the current financial crisis has resulted in a staggering USD 6 to 9 billion meltdown of capitalized funds, the percentage lost in terms of GDP is relatively much less compared to the Asian countries during the 1997-2002 crisis.

⁴ See Randhawa (2005): 64-67. The Basel Accord on capital adequacy seeks to establish uniform risk measurement guidelines for international banks. Adherence to the accord aims to reduce the increasing level of systemic risk and the associated threat of contagion effects. Hence, most major economies, including the ASEAN countries, have all committed to adhere to the guidelines prescribed by the agreement, albeit with varying deadlines. The accord rests on three pillars: minimum capital requirements, supervisory oversight, and market discipline based on risk-based disclosure. The most serious challenge Asian banks face is in the implementation of Pillar Three of the Accord. The disclosure regime prevailing in the developing economies of Southeast Asia is grossly inadequate for this purpose. Improvements in transparency will be necessary to mobilize funds from the public. In the absence of well functioning capital markets, prospects to effectively use these risk instruments as monitoring devices will remain limited.

⁵ See Barnett (2004). Global connectivity refers to the system or community of states, individual nation-states (both good and bad) and individuals operating both within societies and across them. Such a connectivity is expressed in nations joining a core, which expects their societies to play by the rules of the game (such as transparency and accountability). Nations, firms and individuals function within globalization whereby this functioning is based on the harmonization of internal rules with rule of democracy, rule of law and free markets.

⁶ See Sachs (2008): 7. “The paradox of a unified global economy and divided global society poses the single greatest threat to the planet because it makes impossible the cooperation needed to address the remaining challenges. A clash of civilizations [...] would undo all that humanity has built and would cast a shadow for generations to come”. Since 1914 (WW I) and 1945 (WW II), we have never been so close to another disaster, this time “natural” in its nature. A natural disaster as result of ecological imbalances, caused by human behavior, may lead to global instability. The real benefits of introducing free market economics within specific constraints is the impact it has on reducing poverty. However, ecology and ethics should not become the collateral damage of such free initiative and should be contained by reasonable regulations to internalize those unwanted externalities as much as possible and make organizations and individuals fully accountable.

⁷ We like to note that the international institutions will also need to adapt to the new situation. The common thread is not market returns but rather commitment to a common goal that somehow implies that businesses promote broad social objectives that are consistent with core business principles, values and practices. Sustainable business goals and strategies attempt to align profitability and economic earnings to socio-ethical and ecological objectives that underwrite those common goals. The global interdependence in financial and security terms have become obvious after 9/11 and reconfirmed during the current economic crisis. The world has shrunk in a sense that the ecological challenges have shown us that nobody can escape their responsibility to pursue real sustainability and to avoid an increasingly dangerous lurking ecological disaster. However, if global governance – not a global government or a super-regulator – may incorporate the possible answer to the current global challenges, it will to develop both institutions and rules to manage those challenges. Democracy implies one citizen, one vote, or one nation, one vote. In some instances, one rightfully could weight those democratic measuring in order to take into account mere demography (Luxembourg may not carry the same economic weight as China for instance). Paradoxically, “direct global democracy” – where majority overrules minorities may not be the best solution. However, democracies carry a greater moral legitimacy than non-democratic societies. Currently, the UNSC may take legal

decisions to rule the world, but they face a crisis of (moral) legitimacy. It is well documented how the USA for example uses its overwhelming hard (both economic and military) power to reach bilateral deals with other permanent or temporary UNSC members at the expense of global interests. Moreover, American power often trumps international law if it does not provide them enough leeway to preserve US interests. Parallel to corporate governance, we suggest that the board (i.e. UN Security Council) representing the shareholders and stakeholders (i.e. UN General Assembly), selects a top executive management (UN Executive Committee) that is accountable to the Board. Like in corporate governance, board members are chosen based on merit or “knowledge” and power, but their time should be limited or to be extended under strict conditions. In other words, it would end the perpetual rule of the five permanent members, which is quite unlikely at this point in time. Especially the European three member states (England, France and Russia) might object such a change. However, new Asian powers like Japan and India, and Germany for example should be given veto rights to reflect their economic weight in the international system. Adapting the corporate governance principles of meritocracy, one should select heads of relevant global institutions according to their merit in a clear and transparent manner, not based on nationality as it stands now. At this point in time, none of the permanent UNSC members are really accountable for their actions and thus undermined its own legitimacy. Similarly, the IMF and the World Bank are losing their legitimate basis under the current crisis, unless more power will be given to China and the other countries-regions that support to bail out the USA and to a lesser degree Europe.

⁸ See Mobius (2003). The Delaware Supreme Court (Delaware Corporate Litigation Reporter, 2002) stated that loyalty “as a public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of corporate officers and directors, peremptorily or inexorably, the most scrupulous observance of his duty”. In fact, one can assume that there shall no conflict between duty and self-interest according to this ruling.

⁹ See Dimma (2002): 166. Even though the Delaware jurisdiction – which rules over a great number of Fortune 500 Multinational Corporations - has historically speaking always strongly favoured shareholder rights in its strict legal interpretation, the state Supreme Court has also recognized two important principles in the classic Time-Warner case: “(a) the fiduciary duty to manage a corporate enterprise includes the selection of a time-frame for meeting corporate goals; (b) Directors must chart a course for a corporation which is in its best interests without regard to a fixed investment horizon.” In other words, these two principles now considered as the contemporary mainstream view in the Anglo-American governance framework, it may be appropriate to deviate from short-term shareholder interests in favour of longer-term corporate interests if the interest is fully compatible with longer-term shareholder interests.

¹⁰ See Markarian (2007): 298. The main issues regarding good corporate governance concern that (1) a majority of non-executive board members have to be independent and perceived as professional while the board itself should be characterized by diversity; (2) several committees should be established within the board (i.e. remuneration, auditing, nomination); (3) remuneration for executives should be decided only by non-executive directors; (4) the majority of the audit committee has to be independent and non-executive; (5) there is a preference of a separation of chairman and CEO function; (6) it has been suggested that there is a maximum duration for non-executive directors who should be evaluated on a regular basis, (7) attention should be given to social and environmental issues.

¹¹ We here refer to the very useful and well-organized criteria used by CalPERS who manages more than USD 160 billion to invest in a variety of international firms.

The first main factor investing in a firm is related to the **country risk** in which that firm is operational: 1. *Political Stability* (a. Civil liberties; b. Independent judiciary and legal protection; c. Political risk); 2. *Transparency* (a. Freedom of press; b. Accounting standards; c. Monetary and fiscal transparency; d. Stock exchange listing requirements); 3. *Productive Labor Practices* (a. ILO ratification; b. The quality of enabling legislation to explicitly protect or prohibit the rights described in the ILO Convention; c. The institutional capacity of governmental administrative bodies to enforce labor law at the national, regional and local level; d. Effectiveness of monitoring and enforcement of laws in the ILO Convention areas).

A second criteria to establish an investment will require an in-debt analysis of the **market risk**: 1. *Market Liquidity and Volatility* (a. Market capitalization, the overall size of the country’s stock market; b. Change in market capitalization, the growth of the country’s stock market over the last five years; c. Average monthly trading volume relative to the size of the market; d. Growth in listed companies over the last five years; e. Market volatility as measured by standard deviation over the last five years attributable to both currency volatility and local market volatility; d. Return/risk ratio in each market); 2. *Market Regulation /*

Legal system / Investor Protection (a. Adequacy of financial regulation; b. Bankruptcy and creditors' rights; c. Shareholders' rights); 3. *Capital Market Openness* (a. Trade policy, measuring the degree to which there is oppressive government interference to free trade; b. Foreign investment, measuring governmental barriers to the free flow of capital from foreign sources including unequal treatment of foreigners and locals under the law; c. Banking and finance, measuring government control of banks and financial institutions and allocation of credit and the degree of freedom that financial institutions have to offer all types of financial services, securities, and insurance policies; d. Stock market foreign ownership restrictions; e. Settlement Proficiency = the country's trading and settlement practices to determine the degree of automation and the success of the market settling transactions in a timely, efficient manner; f. Transaction Costs = the costs associated with trading in a particular market and includes stamp taxes and duties, amount of dividend and income taxed, and capital gains taxes).

Finally, one will need to analyze the **specific risk factors of a firm** which are often related to their specific organizational corporate governance principles or lack of them and the quality of the top management who is supposedly developing strategies and economic fundamentals which are sensible for the creation of long-term value of the firm.

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Paul Morse has been a successful international businessman and influential political scientist for almost four decades. He started his entrepreneurial and corporate career as founder and president of Earth Resources, Inc. in the USA from 1973 till 1983 (in close collaboration with Kerr Mc Gee Oil Company). Subsequently, he became the founder, co-owner and president of Metamil Ltda from 1984 till 1990 (a Brazilian Gold & Precious Metals Refining Company) and Mineracao Rodeodor Mining, Ltda., Mineracao Transamazonia, Ltda., Mineracao De Rei San Jorge Ltda Mining Companies in Brazil. In addition, he served as the USA Commercial Ambassador in Brazil (1983-86). He has been active in a number of business ventures in the USA, across South America, Europe and for the last 20 years very much in Asia. Currently, he serves as director of a number of corporations in Asia among which are Integrated Technology Solutions (Thailand) Limited and Agri-Asia Development Group Ltd (Thailand – Hong Kong), PanPacific Ventures Limited and Great King World Wide Enterprises Ltd (Hong Kong). Since 2007 he is the Chairman and a Founding Partner of the Great Union Group Limited and Great Union Oil Investments Limited (Hong Kong, SAR), which is a crude oil and natural gas trading company, with substantial investment interests in China and Russia. Paul, a US citizen, received his BA Political Science (major in International Relations) from Stanford University USA, his BS Civil Engineering from Stanford University (USA). Furthermore he obtained a Postgrad Degree in Finance from the University of Rio de Janeiro (Brazil), and an MBA and PhD International Relations from Middleham University (UK).

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