



China: A New Model of Corporate Governance?

by

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Outline

- Introduction: The IPD Corporate Governance taskforce
- Transition and Governance
- Minority Shareholder Protection and Corporate Governance for Emerging Market Countries
- The quota system for public listings

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Outline, continued

- Speculative Markets and Corporate Governance
- Governance of non-listed firms
- Bank monitoring and the non-performing loans (NPL) problem
- Conclusion

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The IPD Corporate Governance Taskforce

- Focus on CG in developing and transition countries
- Taskforce builds on a network of economists, political scientists, legal scholars with diverse backgrounds and views
- *Members:* Sergei Guriev (Co-Chair, Russia); Chong-En Bai (China); Suddipto Bhattacharya (India); Erik Berglof (Sweden); Luigi Zingales (Italy); Ailsa Roell (Netherlands); Alexander Van Dyck (US); Antoinette Schoar (Germany); David Skeel (US); Wei Xiong (China); Katharina Pistor (Germany); Hansung Yang (Korea); Marco Pagano (Italy)

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Transition and Corporate Governance

Policy Agenda on CG in China:

Driven by the transition process from state ownership and central planning towards...

a market economy based on some form of private ownership!

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Transition and Corporate Governance (2)

- Chinese model of transition process:
 - Led and managed by the Chinese Communist Party
 - Development of market infrastructure together with reform of Government
 - Gradualism
 - Experimentation
 - Partial reform and pragmatism

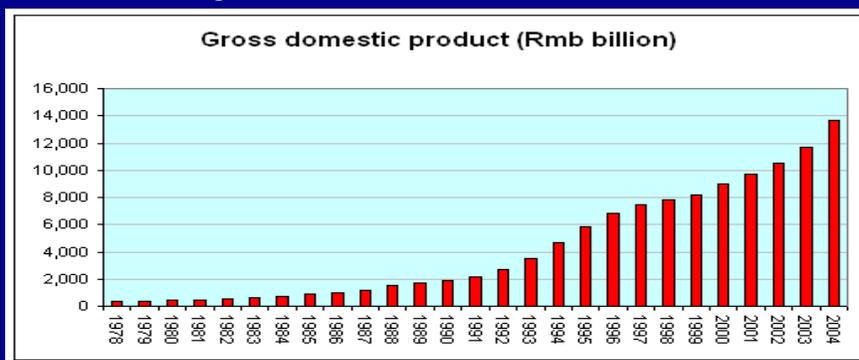
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Transition and Corporate Governance (3)

- Stunning achievements:
 - GDP growth:



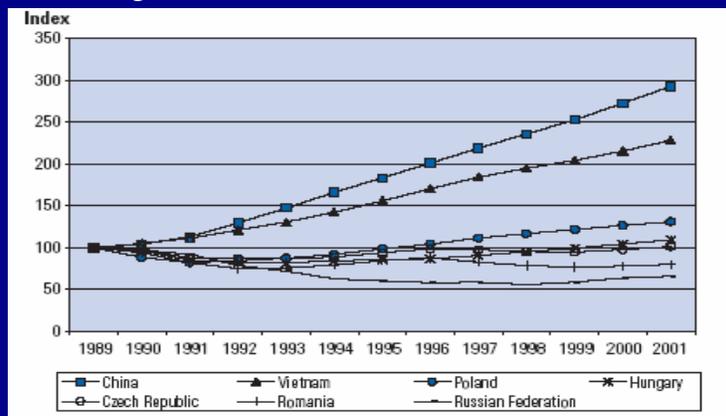
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Transition and Corporate Governance (4)

- Stunning achievements:
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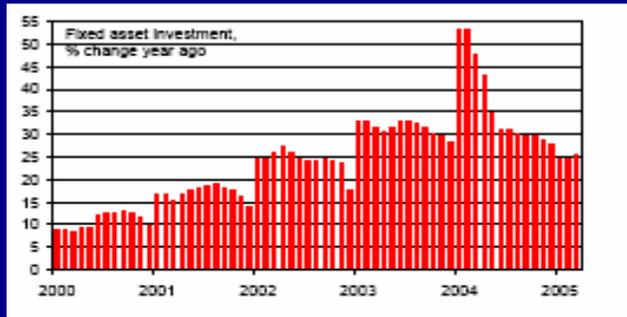
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Transition and Corporate Governance (5)

- Stunning achievements:
 - investment:



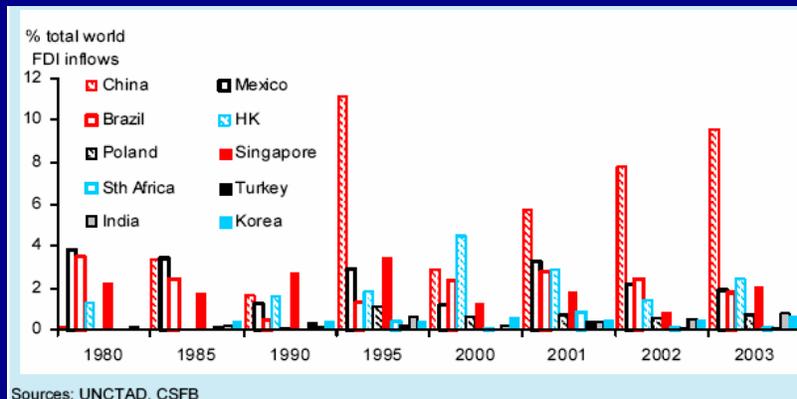
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Transition and Corporate Governance (6)

- Stunning achievements:
 - Foreign direct investment:



Sources: UNCTAD, CSFB

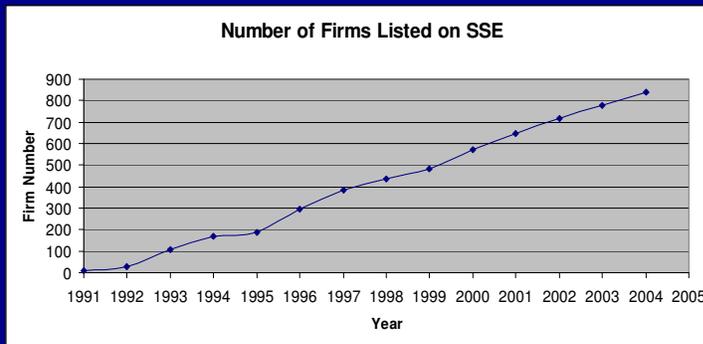
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Transition and Corporate Governance (7)

- Stunning achievements:
 - Growth of stock markets:



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Transition and Corporate Governance (8)

- Stunning achievements:
 - Growth of stock market capitalization?



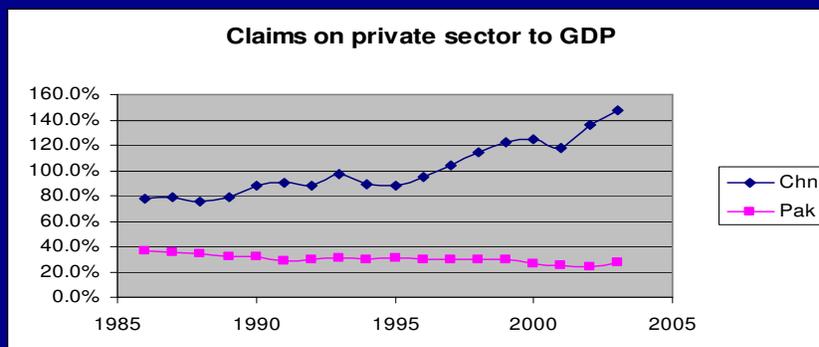
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Transition and Corporate Governance (9)

- Stunning achievements:
 - Growth of lending:



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Transition and Corporate Governance (10)

- A word on the Macroeconomic Environment....



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Minority Shareholder Protection (MSP) in Emerging Market Countries

The Law & Finance view:

- Main problem of development is how to transfer capital from rich to poor countries
- Main obstacles to development are:
 1. Lack of protection of capital income (property rights protection – rule of law)
 2. Trade barriers

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MSP in Emerging Market Countries (2)

Based on evidence: **China's problem is not that it attracts too little capital for investment!**

Formal MSP and financial development (LLSV and others): on both

- *quality of law on the books*
- *law enforcement*

indicators

China has below average performance relative to other transition countries (Pistor & Xu, 2005)

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MSP in Emerging Market Countries (3)

China is not just an *outlier*.....

...its GDP is larger than the sum of GDPs of all Eastern European countries, the former SU, and all African countries....

...Poland is smaller than Guangdong province, and Hungary smaller than Shanghai (Pistor & Xu, 2005)

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The quota system for public listings and MSP

The quota system in place from 1993 to 2000:

- each year PBoC sets target aggregate number of new share issues,
- negotiation between CSRC and regional governments on size of quota for each region
- individual approval process for selected companies

=> Quota system a competitive selection device

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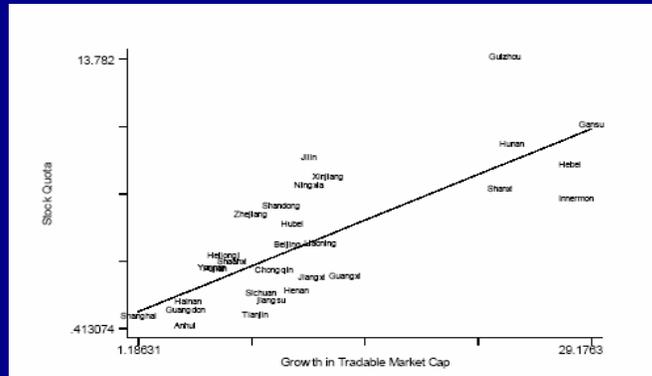
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The quota system for public listings and MSP (2)

Quota system an incentive scheme?

Good performance => higher future quotas?



Source: Julian Du and Chenggang Xu, 2005
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The quota system for public listings and MSP (3)

Crowding out of more efficient private firms

How effective can quota system be post listing?

How good is disclosure and financial accounting post listing?

What are the closure rules for poorly performing listed SOEs?

How much authority can the CSRC have over regional governments?

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Corporate Governance and Speculative Markets

China's current CG problem has more to do with speculative investment mentality

Comparison with US:

1990s technology bubble in the US: few concerns about CG at ENRON and the like...

- focus on accounting manipulation, conflicts of interest, overinvestment, excessive CEO pay **only after the crash**.....
- CG reform (Sarbanes-Oxley) a hasty reaction to the crash...

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Corporate Governance and Speculative Markets (2)

Other lesson of US experience with CG and speculative markets:

- **deregulation has encouraged speculative behavior by managers**
- **complex financial engineering a smoke-screen for managerial malfeasance**

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Corporate Governance and Speculative Markets (3)

Comparison with South Korea:

- no CG concerns before the Asia crisis hit...
- oligarchic dominance of owner-blockholders in chaebols
- directed lending by government-controlled banks (50s, 60s and 70s)
- democratization & influx of foreign investments in 80s and 90s despite limited MSP
- growth of chaebol-controlled NBFIs

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Corporate Governance and Speculative Markets (4)

When South Korea was hit by the Asia crisis....

- government was forced to *bail out* insolvent NBFIs, Banks and Chaebols (role of unhedged FX liabilities)
- IMF-forced CG reforms: 50% independent directors, IAS accounting standards, easier shareholder lawsuits

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Corporate Governance and Speculative Markets (5)

Comparison with Japan:

- 1960s and 1970s: successful *bank-based, long-term oriented* CG system
- mid 1980s: stock market and real estate bubble: short-term speculation and breakdown of bank-based CG
- 1990s: NPL problem, disfunctional banking system and deflation
- 2000s: very limited CG reform and strengthening of MSP

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Corporate Governance and Speculative Markets (6)

Main CG concern in Chinese publicly traded companies:

- **pressure to bail out minority shareholders**
- speculative bubble that peaked in July 01
 - heavy share turnover (500% per year)
 - A-share priced on average 420% higher than corresponding B shares (*Mei, Scheinkman and Xiong, 2004*)
- Bear Market of the past 3 and a half years an inevitable consequence of earlier excess speculation...but

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Corporate Governance and Speculative Markets (7)

- Insider trading and poor disclosure were also factors, and
- Concern over future sales of new shares
 - 64% of shares are non-tradable & controlled by government entities

=>

Government could be held responsible for shareholder losses

Market could be further distorted by expectations of bailouts

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Corporate Governance and Speculative Markets (8)

What to do about the **non-tradable shares overhang**?

- current plan is to eventually have them all fully tradable
- objective: align interests of shareholders +
- get companies to focus on share value
- 4 companies in pilot program
 - approval of 2/3 shareholders required
 - may give rise to some stock repurchases in short-run

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Corporate Governance and Speculative Markets (9)

Issues:

- Is it desirable to have all shares tradable?
 - Model of the French EPIC? (SOE with publicly traded shares; explicit state guarantee; clearly defined mission)
 - What should the timetable be?
- Is it desirable to have a greater focus on share price?
- Early “exit” option of controlling shareholders could fuel speculation and encourage short-term behaviour

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Corporate Governance and Speculative Markets (10)

Policy options:

- More disclosure and the role of the CSRC?
- Strengthen independence and credibility of “reputational intermediaries”?
- encourage listings of private companies?
- Who monitors the monitor?
- Allow for competition between regulators?
- US example: Spitzer vs. SEC

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Corporate Governance and Speculative Markets (12)

Policy options:

- Board of Directors & Supervisors
 - Appointment of directors
 - Independent directors
 - Committee structure
- Dividend payments
- Shareholder suits and litigation
- IPOs & the future of the Quota System

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Corporate Governance of Privately held firms

- Reputation and relationship investing
- The efficiency of family-controlled firms and TVEs
- Good investor protection for foreign investors
- Privatization of privately held firms...

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NPLs in March 2005

NPLs as Share in Total Loans

Major commercial banks	12.7%
SOCBs:	15.0%
JSCBs:	4.9%
City commercial banks	11.5%
Rural commercial banks	6.1%
Foreign banks	1.2%

Source CBRC

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NPLs in September 2001

NPLs as Share in Total Loans

Bank of China:	27.5%
China Construction Bank:	19.4%
Industrial and Commercial Bank of China:	29.8%
Agricultural Bank of China:	36%

Source Dow Jones

\$22.5bn of FX reserves injected into Bank of China and
\$22.5bn into China Construction Bank in 2003

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Bank monitoring and the non-performing loans (NPL) problem

- Two separate issues about NPLs
 - improve debt recovery and value of existing NPLs
 - recapitalize banks and change incentives to hide NPLs
- Bank monitoring effective only if
 - no interference in lending decisions
 - threat of terminating NPLs is credible
- Greater SO bank independence?

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Conclusion: future model of Chinese CG?

- Good scenario:
 - effective bank monitoring for non-listed firms
 - effective disclosure & reputational intermediaries for listed firms
 - effective block-holder monitoring and constraints on self-dealing
 - no government guarantee for equity investments

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Conclusion: future model of Chinese CG?

- Bad scenario:
 - poor disclosure
 - no clear closure rules for listed firms
 - no credible reputational intermediaries
 - captured and ineffective monitors
- ⇒ Stock prices poor indicators of performance & risk of major financial scandals

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