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CORPORATE GOVERNANCE IN CHINA

IN THE CONTEXT OF GLOBALIZATION AND TRANSITION

by

Jing Leng

A thesis submitted in conformity with the requirements

for the degree of Doctor of Juridical Science

Graduate Department of the Faculty of Law

University of Toronto

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Abstract

This study examines corporate governance reforms in China as an economy in transition from central planning to the market in the context of globalization and the country's accession to the World Trade Organization (WTO), which serves as an example to illustrate the benefits of a gradualist transition strategy emphasizing proper sequencing and pacing of reforms at different stages of development.

In terms of the analytical framework, this study proposes a dynamic theory of corporate governance to interpret China's experience of corporate governance reforms and related financial reforms during its transition. This theory crystallizes the merits of staged corporate governance reforms that emphasize the proper sequencing and pacing at different stages of development, as opposed to the radical privatization approach adopted by Russia, known as "shock therapy." At the centre of this dynamic theory of corporate

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governance is the claim that supporting or complementary legal and institutional reforms aimed at providing investors with effective protection and ensuring the proper functioning of basic market mechanisms, such as banking and stock market reforms, should proceed prior to, or alongside, privatization in an economy in transition.

According to the dynamic theory of corporate governance, the central argument of this study is that for transition economies, there is no universal path to a market economy and the radical approach of mass and rapid privatization that had been endorsed by neoclassical economists but regrettably failed in Russia compares unfavorably with the gradualist strategy adopted by China. Given the existing constraints on reforms imposed by China's limited political resources, underdeveloped legal environment and inadequate institutional, regulatory and human capital, it makes great sense for the country to adopt a gradualist strategy for corporate governance reforms. China's experience has demonstrated that an "institutional vacuum" should be avoided in the process of a country's transition from a command economy to a market economy. Meanwhile, mutually supporting and complementary structural reforms of China's enterprises, banks, and stock market should proceed hand in hand in order to achieve synergies and effective and sustained results during the transition.

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The four years of my doctoral studies at the University of Toronto Faculty of Law have been incredibly rewarding. During this intellectually enriching, emotionally engaging, and at times physically overcharging process, I have been transformed from a curious young student from China with a preliminary understanding of serious academic undertakings to a passionate, fully committed, and increasingly confident legal academic.

It is fair to say that when I look back, I realized that the path that I have followed to reach today's destination has been filled with dramatic and on the whole pleasant surprises. These surprises, with their strong effect on me both professionally and personally, not only have made my life in Toronto by far the most exciting experience in my still unfolding journey of searching for individual fulfillments, but also have permanently changed my character and my way of thinking about the world, and happily in a very positive sense.

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Chapter 1: Introduction

Chapter 1 presents a general introduction to the background and analytical framework of this study, which is spelled out in four sections. In raising the central topic of this study, Section I points out the relevance of corporate governance to China as an economy in transition from central planning to the market in an age of rapid integration of the world economy.[1] Section II then briefly examines China's motivations in joining the World Trade Organization (WTO) as well as the implications of China's hard-won accession to this multinational institution in 2001 for corporate governance reforms. In particular, Section II reviews China's commitments to financial liberalization under the WTO agreements and highlights their impact on China's enterprise and financial sectors, most importantly the banking and securities industries, both of which are closely associated with China's ongoing corporate governance reforms. Section III proceeds to propose a dynamic theory of corporate governance as the primary analytical framework of this study, which emphasizes the gradualist/incremental/sequential nature of corporate governance reforms in China, as reflected by the "sequencing" and "pacing" of reform initiatives on different fronts of institution-building at different stages of China's transition. Finally, Section IV clarifies the major subjects of investigation in this study and explains the reasons for their selection.

[1] There are competing definitions and explanations of "corporate governance," which are reviewed in Chapter 3. This study adopts a relatively broad interpretation of corporate governance when applying it to China where the state (as both the owner and regulator of firms), managers of state enterprises, state employees, banks (as the primary creditors to SOEs), private entrepreneurs, and public investors of listed companies are all relevant parties in the discourse of corporate governance reforms in China.

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Section I

The Relevance of Corporate Governance to China as an Economy in Transition

1. Corporate governance reform as part of a broader agenda for China's economic liberalization and structural reforms at a new stage of transition

Over recent years, the topic of enterprise and corporate governance reforms in China has attracted a great deal of attention from academics in contemporary research on transition economies. This is primarily because corporate governance has significant relevance to China's transition to a market economy at the new stage of development since the late-1990s, especially after China's accession to the WTO in 2001.

As China's transition from a command economy to a market economy proceeds, corporate governance has been identified as the core element of the "modern enterprise system" toward which China's lagging state sector has been striving. To the extent that China's corporate governance reform is aimed at transforming its traditional state-owned enterprises (SOEs) to modern competitive firms operating on market basics, corporate governance reform can be seen as part of a broader agenda for China's economic liberalization and structural reforms.

Since China joined the WTO in 2001, structural reforms of state enterprise and financial sectors have increasingly proved a bottleneck to the country's transition to a full market economy. While China's growth has been driven by the non-state sector in which collectively owned township and village enterprises (TVEs), foreign-invested enterprises and private enterprises dominate and outperform SOEs, the state sector, still of a considerable size, remains an inefficient component of the national economy. In the meantime, China's banking sector has accumulated huge financial risk due to years of policy lending to loss-making SOEs, embodying the dangerous consequence of an accumulation of massive non-performing loans (NPLs).

Early attempts at state enterprise reform had obtained limited results in solving the

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persistent problem of SOE inefficiency, largely because these programs had only focused on managerial incentive building and autonomy expansion without simultaneously addressing the ownership issue. Having realized the failure of previous reform programs, the Chinese government started to implement a shareholding experiment in the early 1990s as an alternative approach to SOE reform, which marked the first attempt by the government to tackle ownership reform in the SOE sector. The shareholding reform has been aimed at diversifying the ownership structure of SOEs and transforming them into shareholding companies with a set of western-style corporate governance structure spelled out in the Company Law. It was expected that good corporate governance practices would change corporate behavior and provide effective solutions to the agency problem of SOEs. Accordingly, the importance of corporate governance reform has been widely recognized by Chinese policy makers.

Scholars interested in emerging markets and transition economies often find China's corporate governance reform an interesting topic since it has been conducted in a weak legal and institutional environment. This unfavorable backdrop poses the challenge of developing necessary complementary market-supporting institutions, such as a strong securities market and an efficient banking system that would ensure the success of corporate governance reform in a transition economy. In addition, legal and judicial reforms that provide investors with strong protection are also widely considered an important condition for the establishment of a functioning corporate governance regime in a transition economy like China.

Therefore, it is extremely important to investigate corporate governance reform in China if the dynamics of China's transition to a market economy under legal and institutional constraints is to be better understood.

2. Corporate governance matters for firm performance, financial stability and macro-economic health in emerging markets

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It is surprising that on the relationship between corporate governance and firm performance, empirical findings seem to diverge. A number of studies on corporate governance in developed market economies have suggested that a positive link usually exists between good corporate governance and superior firm performance.[2] However, other less positive studies have pointed out that firm-specific corporate governance actions have little or no effect on market value in developed countries.[3] By comparison, for transition economies and emerging markets the correlation between corporate governance and firm performance seems unequivocally significant: a number of empirical studies have demonstrated that corporate governance does matter in these less developed economies, in the sense that a firm's corporate governance behavior can have a huge effect on its market value in a country where other constraints on corporate behavior are weak.[4]

Two recent empirical studies by a group of Chinese economists also confirm that in China there does exist a positive correlation between corporate governance quality and firm performance. One paper finds that better-governed companies are associated with higher profitability as measured by ROA (return on assets) and ROE (return on equity), higher stock market valuation as measured by the ratio of market value and book value of the net assets, and lower market turnover ratio. The results indicate that good corporate governance matters greatly in China's emerging stock markets.[5] The other study

---

[2] These studies are discusses in more detail in Chapter 3.
[3] See, for example, Bernard Black, "Does Corporate Governance Matter? A Crude Test Using Russian Data" (2001) 149 U. Pa. L. Rev. 2131 [Black 2001]; Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance" (2002) 27 J. Corp. L. 231 [Black 2002]; Sanjai Bhagat & Bernard Black, "Board Composition and Firm Performance: the Uneasy Case for Majority-Independent Boards" (1998) 1053 PLI/Corp 95 [Bhagat & Black]; Benjamin E. Hermalin & Michael S. Weisbach, "Boards of Directors as An Endogenously Determined Institution: A Survey of the Economic Literature" (2003) 9:1 FRBNY Economic Policy Review 20 [Hermalin & Weisbach]; Anup Agrawal & Charles R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders" (1996) 31:3 Journal of Financial and Quantitative Analysis 377 at 394 [Agrawal & Knoeber 1996]; Anup Agrawal & Charles R. Knoeber, "Do Some Outside Directors Play A Political Role?" (2001) XLIV Journal of Law and Economics 179 [Agrawal & Knoeber 2001].
[4] See, for example, Leora F. Klapper & Inessa Love, "Corporate Governance, Investor Protection, and Performance in Emerging Markets" (2002) World Bank Research Working Paper, No. WPS 2818 [Klapper & Love].
[5] Chong-En Bai *et al.*, "Corporate Governance and Protection of the Rights of Minority Shareholders in China (2002) Working Paper, Centre for China Financial Research (CCFR) at the University of Hong Kong [Bai *et al.* 2002].

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constructs a corporate governance index for Chinese listed companies and finds that the index has a statistically and economically significant effect on firms' market valuation, indicating that investors pay a considerable premium for well-governed firms in China.[6]

As international institutional investors have come to realize the growing importance of portfolio equity flows to emerging markets, including the nascent but promising Chinese market, corporate governance in these economies has attracted growing attention from the global equity investing community. For example, the Institute of International Finance, a financial organization of a group of international portfolio management firms, has recently released a Code of Corporate Governance that it hopes to promote in major emerging markets, such as China, Brazil, Mexico, Poland, Russia, South Africa and South Korea.[7] Therefore, from the perspective of attracting international investors, China needs to improve its corporate governance regime.

Despite the increasing awareness of the importance of good corporate governance among domestic companies, the current business environment in China does not look encouraging, and has raised concerns among international investors. A 2001 PricewaterhouseCoopers survey on global business opacity in 35 countries ranked China the lowest (Russia the second lowest,) pointing to corruption and lagging legal, tax, banking, property rights and accounting reforms as major problems.[8] Moreover, according to a 2001 Credit Lyonnais Securities Asia (CLSA) survey on corporate governance in emerging markets, many countries in the lower half of the rankings have seen their indexes fall 50 percent or more over the past three or five years. The

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[6] Chong-En Bai *et al.*, "Corporate Governance and Market Valuation in China" (2004) 32 Journal of Comparative Economics 599-616 [Bai *et al.* 2004].

[7] The Institute of International Finance, Inc. (IIF), "Corporate Governance in China: An Investor Perspective" (April 2004) at 1. The IIF is the world's only global association of financial institutions, and was created in 1983 in response to the international debt crisis. Its members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. The Institute now has more than 320 members headquartered in more than 60 countries. See IIF website: <http://www.iif.com/about/index.quagga>.

[8] Art Haigh, "We Look into Russia's Future with Optimism" *Kommerstant-Daily* (26 January 2001), online: <http://www.pwcglobal.com/ru/eng/ins-sol/issues/01-02-26_ah.html>. "Business opacity" is measured against such standards as levels of transparency of legal rules and regulations, corruption among state agencies and officials, red-tapes for businesses, the effectiveness of contract enforcement, and the culture of commercial credit.

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consequence is that investors are moving away from markets that are poorly governed. The two biggest transition economies, China and Russia, are both among these falling capital markets.[9]

More recently, a 2004 survey by *The Economist* magazine attributes the difficulties encountered by foreign investors doing business in China to the "eccentric nature" of the country's business environment, characterized as "a disorderly heaven" where the "rulebook, business-school texts and western management theory" have not been found in much use. It is said that the "non-rational" business practices of Chinese domestic companies have largely contributed to this disappointing investment environment, which can be summed up under three headings– "bureaucracy," "rule of man rather than rule of law," and "cultural aversion to business logic." [10] Although such an unflattering assessment may well be exaggerated as more balanced remarks by development economists suggest that China's active involvement in economic globalization has resulted in considerable improvement of its domestic investment environment, the urgent need to reform its corporate governance regime as a response to requirements of international portfolio investors interested in emerging markets should not be underestimated.[11]

Finally, for emerging markets, corporate governance is associated not only with the availability of external finance, but also with the health of a country's financial sector in general. One of the lessons from the East Asian financial crisis in the late 1990's is that weak corporate governance can lead to excessive corporate debt; and the lack of transparency and monitoring in corporate decision-making can result in more

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[9] CLSA Emerging Markets, "Saints or Sinners: Who's Got Religion?" (survey report on corporate governance in emerging markets), published April 2001, at 7 [CLSA].

[10] "A Disorderly Heaven", in "Behind the Mask: A Survey of Business in China" *The Economist* (18 March 2004) 10-13.

[11] For example, Deepak Bhattasali, chief economist of the World Bank, just said recently that globalization boosts China's economic growth and stimulates the improvement of its domestic investment environment. See "Globalization Boosts China's Economic Growth: WB Expert" *People's Daily Online* (21 March 2004), online: People's Daily Online <http://english.peopledaily.com.cn/200403/20/print20040320_138047.html>.

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expropriation by managers and a large fall in asset prices.[12] The negative effect of weak corporate governance can become acutely severe when local firms are exposed to global markets. Accordingly, it is clear that for China, the need for corporate governance reform has now become ever more urgent, especially at a time when its entry into the WTO exposes Chinese companies to increasing global competition.

3. Corporate governance and related institution-building are crucial for a successful transition to the market as demonstrated by privatization failure in Russia

Russia's mass and rapid privatization was not a success story. Despite the original enthusiasm about the gains that mass and rapid privatization was anticipated to generate, a decade later the well-intentioned, but not equally well-conceived privatization programs implemented under a "shock therapy" strategy seemed to have frustrated the expectations of many. Mass privatization through voucher and the infamous loans-for-shares (LFS) programs had caused devastating consequences in Russia. It did not succeed in bringing prosperity to the country. Instead, the reverse seemed to be true: Russia had seen severe economic decline, intensified social and economic inequalities and increased poverty through the first decade of transition. As an unintended consequence, Russia had suffered greatly: over the first decade of transition, it had experienced constant stagnation and its economy shrunk sharply. GDP in post-1989 Russia fell, year after year. The loss was even greater than Russia had suffered in World War II: in the period 1940-46 the Soviet Union industrial production fell 24 percent; in the period 1990-99, Russian industrial production fell by almost 60 percent.[13]

In searching for the reasons of Russia's privatization failure, researchers have pointed out a series of causal links to explain why performance of Russian privatized firms has generally lagged. First, it has been suggested that there was a causal link between the

[12] Simon Johnson, Peter Boone, Alasdair Breach & Eric Friedman, "Corporate Governance in the Asian Financial Crisis" (2000) 58 Journal of Financial Economics 141.
[13] Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton & Company, 2002) at 10 [Stiglitz].

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method of privatization ("insider privatization") and the prevailing feature of management control in Russia's privatized firms. Second, the insider control corporate governance structure has been found to create incentives to loot. Third, massive self-dealing and asset stripping resulting from distorted incentives of insiders have ultimately led to the "fiascoes" among Russian firms.[14] Thus not long after privatization was completed, Russia quickly earned a reputation for poor corporate governance.[15] In the absence of institutional constraints on insider opportunism, what has been induced is wealth destruction. Given the poor corporate governance of Russian privatized firms, it is not surprising that short-term activities and asset stripping have become common practices for managers.

The primary lesson from Russia's privatization is clear: in an institutional vacuum, privatization can lead and has led to stagnation and decapitalization rather than to better financial results and increased efficiency.[16] Many Russian economists have concluded that the "mass and rapid privatization approach was wrong," that it "should have been preceded (not accompanied) by institution-building," such as corporate governance reform, prudent regulation for financial markets and effective insolvency or bankruptcy regimes. All are too weak or simply lacking in Russia.[17]

Russian experience with privatization illustrates that when market-supporting institutions were weak or non-existent and privatized firms lacked good corporate governance practices to curb managerial abuses, privatization was bound to fail. This lesson should be learned by China to avoid similar mistakes in its own privatization experiment, corporate governance reforms and related institution-building, especially in association with the banking and securities industries.

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[14] Merritt B. Fox & Michael A. Heller, "Corporate Governance Lessons from Russian Enterprise Fiascoes" (2000) 75 N.Y.U. L. Rev. 1720.
[15] Galina G. Preobragenskaya, Robert W. McGee, "Corporate Governance in A Transition Economy: A Case Study of Russia" (Paper presented to the Annual Conference of Academy of International Business, Clearwater, Florida, November 13-14, 2003) [unpublished].
[16] John Nellis, "Time to Rethink Privatization in Transition Economics" (1999) IFC Discussion Paper No.38, at 17 [Nellis]. According to Nellis, the most needed legal and administrative institutions are those that create and enforce property rights, and regulate both capital markets and the network and natural monopoly elements of infrastructure firms.
[17] *Ibid.* at 9, 6-17.

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Section II

The Impact of Economic Globalization on China's Enterprise and Corporate Governance Reforms: China's Accession to the WTO (World Trade Organization)

Section II discusses the impact of globalization on China's corporate governance reform, which is primarily reflected by China's WTO commitments to the liberalization of its financial sector, including the banking industry and capital markets.

1. The debate on globalization and how China features in this debate

As a highly complex and controversial phenomenon in contemporary human history, globalization has yielded mixed outcomes. On the one hand, globalization has spread knowledge, information and technology across nations and has led to renewed attention to long-established intergovernmental institutions, such as the UN, the ILO (International Labor Organization), the WHO (World Health Organization) and the WTO.[18] On the other hand, globalization also seems to create losers in both developing and developed countries as its benefits are not evenly shared by a wider range of the world's population. This disparity has resulted in a long-standing debate on globalization that has reached a level of passionate intensity over the past few years.[19]

The critics insist that globalization is a conspiracy of money and politics in the rich West and a damaging process primarily serving the interest of "profit-thirsty," "greedy" western multinationals eager to exploit poor people in the developing countries. They allege that the impact of globalization on living conditions in poor countries too often proves negative as the environment in these countries deteriorates and the gap between the poor and the rich becomes even wider. Other sins of which globalization is accused include encouraging child labor, harming women, threatening democracy, lowering

[18] Stiglitz, *supra* note 13. Stiglitz tends to emphasize the economic aspect of globalization in this book.
[19] For an excellent review of the winners and losers during the past two "global centuries," the first of which ended with World War I and the second of which started at the end of World War II, see Jeffrey G. Williamson, "Winners and Losers Over Two Centuries of Globalization" (2002) NBER Working Paper, No. 9161.

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wages and eroding labor standards.

Faced with a slate of charges against globalization, the pro-globalization camp replies with counter-arguments. Recently there have been two influential efforts to defend globalization. One comes from Jagdish Bhagwati, the world's "number one free trader," who wrote a new book, *In Defense of Globalization*,[20] as a response to Stiglitz's *Globalization and Its Discontents*.[21] In this book, Bhagwati takes a very positive view of globalization. By taking on globalization's critics, he argues that economic globalization is an unambiguously good thing, with a few downsides that can be mitigated through proper management and regulation. He shows that, contrary to the exaggerated claim by antiglobalists that globalization has done little good for poor countries, it does have "a human face," and what the world needs to do is to make this face "more agreeable".[22] Bhagwati's favorite examples of the beneficiaries of globalization's "human face" are India and China, which have realized remarkable poverty reduction over the past two decades by opening up to foreign trade and investment. For example, India has obtained an average 5 percent growth rate in the two decades since it adopted more liberalizing trade and investment policies. By 2000, India's poverty rate had dropped to 26 percent, compared to 55 percent 30 years ago. China is an even bigger success: as a result of trade liberalization and economic reforms, poverty declined from 28 to 9 percent between 1978 and 1998.[23]

The other defense is made by Martin Wolf, the associate editor and chief economics commentator of the *Financial Times* who published a book titled *Why Globalization Works* to explain how globalization brings positive results. He claims that the biggest obstacles to global economic prosperity have been the failures not of the market, but of

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[20] Jagdish Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004) [Bhagwati].
[21] Stiglitz's *Globalization and Its Discontents* was a bestseller in 2002. According to Bhagwati, the title of Stiglitz's book does not closely correspond to its contents, which are basically about the IMF, rather than a "balanced look" at globalization. See Edward Nawotka, "Globalization 101: PW Talks with Jagdish Bhagwati" (2004) 251:4 Publishers Weekly 244.
[22] "In Defense of Globalization", Book review of *In Defense of Globalization* by Jagdish Bhagwati (2004) 251:4 Publishers Weekly 244.
[23] See Richard N. Cooper, "Bhagwati Review Essay: In Defense of Globalization" (2004) 83:1 Foreign Affairs 152.

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politics and policies and that the world's poorest countries suffer not from globalization but from the absence of it. China and other emerging markets in Southeast Asia are the good examples he praises for actively pursuing integration into the world markets and consequently having achieved remarkable growth rates.[24]

In both books, China features prominently as a "good globalizer" or one of the most commendable beneficiaries of globalization. This partly explains China's motivation in joining the WTO in 2001 as a historical step toward greater integration into the world economy in anticipation of expanded benefits and opportunities provided by globalization. There are also challenges from globalization, which are largely reflected by the huge impact that China's WTO membership is expected to bring to its structural reforms in state enterprise and financial sectors, of which corporate governance reform is a key element.

2. China's motivation to join the WTO and its "WTO-plus" commitments

Perhaps the most remarkable achievement of economic globalization in recent years has been the establishment of the WTO. Founded in 1995 as a successor to the General Agreement on Tariffs and Trade (GATT) of 1947, the WTO now has 147 member states accounting for over 97 percent of world trade.[25] As a multilateral trading system that provides the legal ground-rules for international commerce, the WTO has greatly contributed to the promotion of a more open and liberal global trade order. China became a member state of the WTO in 2001 after a 15-year long arduous negotiation process.

A. China's motivation in joining the WTO

The primary reason for China's accession to the WTO was a strategic and pragmatic

[24] Martin Wolf, *Why Globalization Works* (Yale University Press, 2004).
[25] The WTO is one of the newer international organizations. As of April 2004, the WTO has 147 members and 31 observers negotiating membership. Source: WTO website <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm>.

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consideration among the reformist leaders that the WTO membership could serve as a lever to more rapidly push forward China's structural reforms and facilitate its transition to a full market economy. In other words, China's WTO accession could be seen as an attempt by the reformers to lock economic policies into a market-oriented course and internationalization that are costly to reverse (i.e., a "credible commitment" to the market).[26]

In practice, China's WTO membership has been used by the government as an external impetus to overcome domestic obstacles to further reforms and to protect its trade interests.[27] For example, before China's WTO accession, the increased international competition faced by domestic firms had both stimulated efficiency improvement and generated social costs, such as growing unemployment. To constrain its policy options, the Chinese government needs a lever provided by the WTO membership to maintain and deepen its market-oriented reform efforts in the face of internal resistance to the adoption of more painful reform measures in the state enterprise and banking sectors.[28]

B. China's "WTO-plus" commitments

China's accession to the WTO has been widely regarded as a "landmark event" both for the country and in the history of the international trading system. There are two reasons why this is so. First, China has emerged as a major player in the global economy over the past two decades, and its accession to the WTO is unique for the world trading system. By 2002 China had become one of the four largest trading countries in the world, and it seems likely that within a decade China will surpass Japan and Germany to become the world's second largest trader.[29] Although the technological content of its exports is limited and most of the goods China sells to the world markets are labor-intensive, its

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[26] Wing Thye Woo, "Recent Claims of China's Economic Exceptionalism: Reflections Inspired by WTO Accession" (2001) 12 China Economic Review 107-136, at 133; Harry G. Broadman, "The Business(es) of the Chinese State" (2001) 24:7 World Economy 851 at 873 [Broadman].
[27] Ramesh Adhikari & Yongzheng Yang, "What Will WTO Membership Mean for China and Its Trading Partners?" (2002) 39:3 Finance & Development 22.
[28] Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington D.C.: Brookings Institute Press, 2002) at 28 [Lardy 2002].
[29] *Ibid.* at 176.

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participation in the WTO trading system will bring 1.3 billion people into the mainstream of the world economy, which is certainly a remarkable step toward greater economic globalization.[30] The effectiveness of the WTO would be essentially enhanced if China can play a constructive role in facilitating future multilateral trade negotiations and behave responsibly as a rule-abiding trading giant.

Second, China's WTO commitments are sweeping, especially with respect to market access. For example, China made the commitment to allow international investors to enter telecommunication, financial services and distributional services sectors, which is "genuinely revolutionary" in view of some trade experts.[31] Not only has China agreed to abide by the whole package of the WTO rules, in some important areas China's commitments even exceed normal WTO standards, which are usually called "WTO-plus commitments."[32] Of strong relevance to China's corporate governance reform are those commitments with regard to financial services liberalization, including banking, securities and insurance sectors.

3. The impact of China's WTO accession

A. The estimated overall impact of WTO accession on China's economy

Since China's entry into the WTO marked a historic achievement during the country's long quest for integration into the world, the Chinese government views it not only as an economic event, but as a symbolic political success as well. The very fact that the Chinese government is willing to abide by international rules is remarkable. Optimism notwithstanding, there are also reasons to be cautious about the likely impact of China's WTO accession.

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[30] Sachs D. Jeffrey, "The Historical Significance of China's Entry to the WTO" *Project Syndicate* (May 2000), online: Project Syndicate <http://project-syndicate.org>.
[31] Lardy 2002, *supra* note 28 at 176.
[32] *Ibid.* at 2.

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According to a number of welfare studies, WTO membership will exert overall positive impacts on the economic, legal and political institutions in China.[33] There will be substantial efficiency gains, which are most likely to be reflected in the emergence of more domestic non-state enterprises that are successful in competing with foreign rivals. However, the efficiency gains in the enterprise sector under the WTO are not likely to be realized unless the reform of banking sector is accelerated. If banks continue to channel funds to inefficient SOEs and restrict capital access of non-state enterprises, the resources necessary for production expansion and R&D finance will be insufficient for those genuinely competitive firms.[34]

Optimism about the overall positive impacts of China's WTO accession aside, some economists have pointed out that these impacts will likely be small and gradual. There are several reasons to remain cautious: (1) the terms of membership are introduced in steps, (2) there is inertia in existing institutions that make them difficult to change, at least in the short run, (3) the central government's concern with possible social instability will make it particularly cautious in monitoring the speed of changes to avoid social unrest, and (4) local governments and lower-level state sectors will slow down effective implementation of the WTO commitments made by the central government to protect local interests and cushion the pains of reallocation of social and economic resources.[35]

B. The impact of WTO accession on China's financial system and enterprise sector

There will be both benefits and risks to domestic financial institutions as foreign players enter China's financial market. Benefits derive from the high quality services, expertise, experience, professional skills and additional capital available to domestic listed companies that foreign financial institutions will bring into China's markets. However, since major players in China's financial industry, including those in the banking and securities sectors, are all state-owned and with little competitive advantage against their

[33] The short-term losers will be in the agricultural and service sectors, since these sectors will be the hardest hit by increased international competition.
[34] Lardy 2002, *supra* note 28 at 132-133.
[35] Gregory C. Chow, *China's Economic Transformation* (Blackwell, 2002) at 83 [Chow].

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foreign rivals, the opening up of China's financial market entails potential risks and costs. This is particularly true for the state banks given their burdens of huge amounts of non-performing loans (NPLs) and shaky capital bases. Therefore, establishing an effective corporate governance structure at state banks is essential for the ongoing banking reform, in addition to the anticipated overseas listings of the "big four."

(1) The interaction between banking reform and corporate governance reform under China's WTO accession

The banking sector is in particular likely to encounter tremendous challenges after China's WTO accession. China's "big-four" state banks are notorious for accumulating a mountain of NPLs from years of policy lending directed by the state to favored enterprises.[36] Therefore, they are fearful of facing competition from foreign banks that operate on a commercial basis and have a much healthier capital base. The challenge from competition brought by foreign banks with advanced technology, sound risk management, rich experience and expertise is certainly serious. To catch up with foreign rivals before the 5-year grace periods expire by the end of 2006, Chinese banks have an extraordinarily difficult task to accomplish.

Regardless of how difficult it might be, China's banking reform cannot be delayed any longer. If banking reform is delayed and banks continue to channel funds to loss-making SOEs on non-commercial terms, the expected efficiency gains under the WTO will be largely lost. Consequently, China's ongoing enterprise and corporate governance reforms will yield limited results because easy bank loans destroy the financial incentives of SOEs to compete and improve performance. If banking reform is delayed, the budget constraints from banks on SOEs will still remain weak and banks will remain unqualified

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[36] The "big four" state-owned commercial banks are Bank of China (BoC), the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), and the Agricultural Bank of China. They in combination control 60 percent of all banking assets in China. The average level of NPLs is officially put at around 30 percent, while some financial analysts speculate that the true level is nearer 50 percent. By conventional commercial standards, the "big four" are technically insolvent. However, new government statistics showed that the average ratio of NPLs at China's major commercial banks had dropped to 13.2 percent in 2004, as a positive result of recent reform initiatives. See "China's Banks Cut Bad-Loan Ratio to 13.2 percent in 2004" *Asian Wall Street Journal* (14 January 2005) A.3.

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candidates to participate in the corporate governance of SOEs as prudent creditors. In this sense, banking reform aimed at transforming state banks into modern commercial banks is critical to the ultimate success of enterprise and corporate governance reforms in China.

By the same token, enterprise and corporate governance reforms are also critical to any meaningful advances in banking reform because the soft-budget constraints faced by SOEs are the primary cause of NPLs at state banks. Chinese state banks are in a very bad state of solvency precisely because inefficient and loss-making SOEs seldom repay bank loans. Therefore, these structural reforms are closely intertwined and should proceed simultaneously.

The government has recently taken new moves to address banking reform through capital injection and the adoption of shareholding and corporate governance reforms at the "big four" state banks. The purpose of recapitalization and restructuring is to bolster the capital base of the "big four" and prepare them for public listings overseas. It is widely realized that among a series of reform measures recently adopted by state banks, corporate governance reform, as compared to overseas listing, is the most important part of the overall reform agenda for the banking sector.

(2) The interaction between the opening up of China's securities markets and the introduction of new standards of corporate governance

Although the opening up of China's securities markets has been gradual and slow, it is widely believed that this process will be greatly enhanced as the Chinese government has realized that allowing foreign institutions into China would be beneficial for the country's economy in a number of ways. For example, their participation in the domestic A-share market through a "qualified foreign institutional investor (QFII)" framework would increase the capital available to domestic issuers and introduce international expertise, experience, technology and portfolio management skills into the market.[37] Moreover,

[37] The A-shares refer to shares issued to domestic investors by listed companies in China's two stock exchanges in Shenzhen and Shanghai that are denominated in the Chinese currency "*yuan*" or "*renminbi*"

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international investment banks would help China's enterprises with overseas listing and expansion. Finally, allowing the subsidiaries of foreign companies to list in China's stockmarket would provide new standards of corporate governance in the market.[38]

(RMB) and restricted to domestic investors. Foreign institutional investors that are allotted a quota of investing capital by China Securities Regulatory Commission (CSRC) under the QFII scheme can trade A-shares.

[38] Stephen Green, *China's Stockmarket: A Guide to Its Progress, Players and Prospects* (London: Profile Books, 2003) [Green].

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Section III

The Analytical Framework: a Dynamic Theory of Corporate Governance as Applied to an Economy in Transition

As the analytical framework for this study, Section III proposes a dynamic theory of corporate governance that emphasizes the sequencing and pacing of reform at different stages of development in an economy in transition. At the centre of this dynamic theory of corporate governance is the importance of legal and institutional reforms aimed at providing investors with effective protection and ensuring the proper functioning of basic market mechanisms, which should proceed prior to, or alongside, privatization in an economy in transition. This theory is applied to interpret China's enterprise and corporate governance reforms.

1. Key concepts used in the dynamic theory of corporate governance

A. "Alternative approaches to the market"

In the dynamic theory of corporate governance, it is suggested that for transition economies there is no universal path to a market economy, such as rapid mass privatization adopted in Russia. Alternative approaches are possible. For example, while privatization in Russia has transformed thousands of former SOEs to private enterprises in a rapid manner, China provides an example of a gradualist strategy for privatization whereby the government has insisted on the maintenance of state ownership and control in many transformed SOEs and had not started to seriously consider relinquishing control in non-strategic industries until recently. This makes China an interesting subject in comparative corporate governance research, as has been demonstrated in the long standing debate between the shock therapists and the gradualists over the merits of alternative transition strategies.

B. "Institutional innovations"

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Institutional innovations refer to the experiments with local solutions to transitional problems that have emerged at different stages of development during the evolutionary process of reform in an economy in transition. These experiments may not be in conformity with mainstream economics or "global best practices" but can work efficiently under the legal and institutional constraints at a particular stage of transition if designed to accommodate the existing social, economic and institutional conditions and to correspond to proper sequencing and pacing of reform.

There are four examples of "institutional innovations" in China's enterprise and corporate governance reforms.

(1) The first is the "dual-track" approach to enterprise reform at an early stage of development that encouraged the growth of the non-state sector alongside the state sector and the introduction of competition by the non-state sector with the state sector.

(2) The second example is local government ownership and control in the township and village enterprises (TVEs) as a second-best solution to the agency problem at an early stage of economic reform whereby the local governments provided effective protection of enterprise property rights, facilitated financing and the use of land, imposed less predatory taxations and fees. As an innovative but transitional institution, Chinese TVEs started to experience widespread privatization since the mid-1990s as an adjustment to previous practices.

(3) The third example is the corporatization and shareholding reforms (including public listings) of partially privatized state-owned enterprises (SOEs), which are aimed at ownership diversification and the establishment of a western-type corporate governance system without full privatization, in particular with respect to large SOEs (i.e., "grasp the large" [*zhuada*]).

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(4) The fourth example is the decentralized privatization of small SOEs at local levels (i.e., "release the small" [*fangxiao*]), which can be understood as "privatization, Chinese style" partly determined by "federalism, Chinese style."

The primary feature of "federalism, Chinese style" is the fiscal contracting system, which is an arrangement between the central and local governments regarding revenue sharing under fixed terms. The fiscal contracting system offers local governments strong incentives to pursue market-oriented reform because they can benefit from the improvement of firm performance through collecting more taxes and fees. Faced with hard budget constraints, local governments have actively encouraged the development of non-state enterprises and greater reform in SOEs within their jurisdictions to generate more revenues.[39] Their fiscal incentives to reform enterprises have largely shaped the decentralized feature of privatization in China.[40] Local governments have also played a very important role in corporate governance of local enterprises. For example, in local government-controlled enterprises (usually the TVEs), managers are given partial or total residual shares by the local governments in order to induce them to pursue higher efficiency and profits.[41]

C. "Transitional institutions" or "second-best solutions"

"Transitional institutions" can be seen as "second-best solutions" to problems and challenges of market-oriented reform in an economy in transition under legal and institutional constraints at early stages of development. In other words, "transitional institutions" are best understood as an outcome of constrained optimization of institutional choice. The thrust of this concept is the qualified or constrained validity of the sub-optimal institutional choice whose efficiency is limited to early stages of development and may be lost at the next stages when the institutional environment

[39] Hehui Jin, Yingyi Qian & Barry R. Weingast, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style" (2001) Working Paper, Center for Research on Economic Development and Policy Reform at Stanford University, at 36-37 [Jin, Qian & Weingast].
[40] Michael Burawoy, "The State and Economic Involution: Russia through a China Lens" (1996) 24:6 World Development 1105 [Burawoy].
[41] Shaomin Li, Shuhe Li & Weiying Zhang, "The Road to Capitalism: Competition and Institutional Change in China" (2000) 28 Journal of Comparative Economics 269 [Li, Li & Zhang].

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evolves and the political economy of transition changes. One such example was local government control of TVEs or state-owned small and medium enterprises (SMEs) at early stages of China's reform, which served as a second-best solution to the agency problem when there did not exist a conducive environment to the prosperity of private ownership.[42] For example, to the benefits of these local government-controlled firms, the governments provided relatively effective protection of enterprise property rights by levying much less predatory taxations and fees, imposed less burdensome requirements on firms in facilitating their finance and land use, and at times provided technological support to help firms grow and expand.

To the extent that the concept of "transitional institutions" distinguishes between political economy constraints (e.g., those created by a rigid/autocratic political regime with slow constitutional reform) and technical constraints (e.g., those resulting from limited human capital, financial resources, and inadequate regulatory capacity) on reform and institution-building, in practice institutional choices need to take into account the viability and workability of specific reform strategies in a particular political environment, in order to avoid politically unrealistic solutions.

2. The central argument under the dynamic theory of corporate governance

The dynamic theory of corporate governance crystallizes the merits of staged corporate governance reform that emphasizes the proper sequencing and pacing at different stages of development as opposed to the radical privatization approach adopted by Russia. At the centre of this dynamic theory of corporate governance is the claim that supporting or complementary legal and institutional reforms aimed at providing investors with effective protection and ensuring the proper functioning of basic market mechanisms, such as

[42] Yingyi Qian, "The Institutional Foundation of China's Market Transition", in Boris Pleskovic & Joseph Stiglitz eds., *Annual World Bank Conference on Development Economics* (World Bank, 2000) at 394 [Qian]; Jiahua Che, "From the Grabbing Hand to the Helping Hand: A Rent Seeking Model of China's Township-Village Enterprises" (2002) United Nations University Discussion Paper No. 2002/13, at 1 [Che].

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banking and stock market reforms, should proceed prior to, or alongside, privatization in an economy in transition.

According to the dynamic theory of corporate governance, the central argument of this study is that for transition economies, there is no universal path to a market economy and the radical approach of mass and rapid privatization that had been endorsed by neoclassical economists but regrettably failed in Russia compares unfavorably with the gradualist strategy adopted by China. Given the existing constraints on reforms imposed by China's limited political resources, underdeveloped legal environment and inadequate institutional, regulatory and human capital, it makes great sense for the country to adopt a gradualist strategy for corporate governance reforms. Under this strategy, "institutional innovations" sensitive to the need for sequencing and pacing of reforms at different stages of development and compatible with the existing social, economic and institutional conditions at a particular stage of China's transition play a significant role in discovering a better road to the market, even though such transitional institutions do not fully comply with a full market economy, but rather serve as "stepping stones" to it. In other words, an "institutional vacuum" should be avoided in the process of a country's transition from a command economy to a market economy. Meanwhile, mutually supporting and complementary structural reforms of China's enterprises, banks, and stock market should proceed hand in hand in order to achieve synergies and effective and sustained results.

3. Three aspects of "sequencing" in China's corporate governance reforms

In terms of sequencing, the gradualist strategy for corporate governance reforms in China requires special attention be paid to the following three aspects.

The first aspect of sequencing is that ownership reform of SOEs cannot produce competitive private firms without the accompanying implementation of necessary legal and institutional reforms to ensure the proper functioning of basic market mechanisms, the protection of private property rights and the establishment of a social safety net. In

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other words, for a transition economy at the early stages of development, wide-scale privatization should not be a policy priority until necessary legal and institutional reforms, such as the banking and stock market reforms, have achieved preliminary positive results.

The second aspect of sequencing and pacing is that in searching for optimal solutions to the emerging corporate governance problems during China's transition, it is not always workable to import "global best practices" from developed market economies that do not yet have the operating foundations in China. Instead, some local solutions or the so-called "institutional innovations," many of which are transitional and perhaps imperfect but nevertheless efficient at a particular stage of transition, have played a positive role in promoting China's economic growth over the past two decades. This is not to deny, however, that these transitional solutions may become no longer efficient and should be revised or abandoned as China's transition proceeds to the next stage. In this sense, "institutional innovations" which compromise with "Chinese characteristics" but do not conform to market basics, may have higher marginal benefits at the early stages of development and should properly move toward market basics as China enters a new stage of transition.

The third aspect of sequencing and pacing concerns the adjustment of corporate governance reform strategy as China enters a new and more advanced stage of transition, in which the country is faced with not only the opportunity for development brought by globalization, but also the internal and external challenges to maintain its market-oriented reform policy. At this new stage, "institutional innovations" under the constraints of China's political regime cannot by themselves generate adequate motivation and determination of the government to deepen and speed up structural reforms in enterprise and financial sectors, which have been regarded as the bottleneck to China's transformation to a full market economy.

Accordingly, the adjustment of sequencing and pacing at this stage needs an external lever for more extensive ownership reform in the state sector and more comprehensive legal and institutional reforms to support further development of the private sector. In this

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context, China's accession to the WTO in 2001 can be viewed as a strategic and pragmatic move by the reformist elements in the Chinese leadership to obtain an external lever to constrain the policy options of the government and rapidly push forward China's market-oriented reforms. In particular, China's WTO accession has precipitated further corporate governance reform of SOEs and state banks through shareholding transformation and public listing at this new stage of development.

4. Major applications of the dynamic theory of corporate governance to China

In this study, there are three major applications of the dynamic theory of corporate governance to China as an economy in transition at the new stage of development.

The first application is corporate governance reforms of major types of Chinese enterprises, including the following schemes:

(1) The corporatization and shareholding reforms of Chinese SOEs, decentralized privatization of state-owned small and medium enterprises (SMEs) at local levels, and efforts to establish an effective state asset management system;

(2) The adoption of the township and village enterprises (TVEs) as a transitional but efficient institution at the early stages of the transition, as well as subsequent widespread privatization of these firms since the mid-1990s;

(3) The emergence and growth of Chinese private enterprises, first under a "dual track" system at the early stages of transition, whereby private enterprises were allowed to develop alongside state enterprises, and at the later stages under the "grasp the large, release the small" strategy, whereby competitive industries in the national economy have been undergoing expanded privatization since the late 1990s.

The second application is the interaction between both domestic and overseas stock markets and corporate governance of Chinese listed companies, which is an important aspect of complementary institution-building in the process of corporate governance reforms in China.

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The third application is the much delayed banking reforms as an immediate priority of structural reforms at the new stage of the transition after China's accession to the WTO, and the interaction between the banking reforms and enterprise reforms.

5. Three perspectives of the dynamic theory of corporate governance

There are three perspectives employed in this study that are partly inspired by recent advances in contemporary research on development and transition.

A. The comparative perspective

Although this is mainly a local study examining the dynamics of China's transition experience, the role of comparative study in this research is prominent. The comparative perspective is inspired by the "New Comparative Economics (NCE)" and the "Comparative Institutional Analysis (CIA)" scholarship; both emphasize the impacts of globalization and transition on national economic performance.[43] The NCE scholarship argues for the centrality of institutional reforms to national economic performance and emphasizes institutional diversity within capitalist economies while analyzing the "politics" of countries' institutional choice. The CIA scholarship endorses the merits of institutional diversity and complementarities and suggests a path-dependent and evolutionary pattern of institutional development in a particular country, while theorizing about the likely interactions between different patterns of institutional development in individual countries through regional and global economic integration.

The comparative perspective is employed in this study to analyze alternative transition paths. Specifically, Russia's mass and rapid privatization guided by the "shock therapy"

[43] The NCE is systematically articulated in Simeon Djankov, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "The New Comparative Economics" (2003) 31 Journal of Comparative Economics 595-619. The CIA scholarship has been advanced largely by Masahiko Aoki, and is well theorized in his book, *Toward a Comparative Institutional Analysis* (MIT Press, 2001).

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strategy is closely examined in comparison with China's gradualist approach toward the market. Also, China's corporate governance reform is discussed in comparison with Russia's (so far unsuccessful) experience in establishing a corporate governance regime for newly privatized firms. There are several similarities between these two countries with respect to corporate governance reform. One is that both China and Russia have turned to the OECD (Organization for Economic Co-operation and Development) Principles of Corporate Governance for guidance. In addition, both China and Russia have enacted extensive legislation and regulations on corporate governance issues. Moreover, corporate governance failures and pathologies are rampant in both countries.

Another dimension of comparison is associated with experiences of mature market economies in corporate governance reforms and is managed at a more technical level. For example, when alternative choices of corporate governance arrangements in China are discussed, the bank-based model found in Germany and Japan and the market-based model adopted in the United States and the United Kingdom are reviewed from a comparative perspective, with an emphasis on their relevance and applicability to China.

B. The institutional perspective

To a large extent, internal corporate governance practices are influenced, or motivated by the external environment, which is under the combined influence of legal infrastructure, regulatory regime, information infrastructure, market infrastructure and political infrastructure.[44] For transition economies, this is particularly true, because both the internal corporate governance structures and the external environment are under transformation. Therefore, corporate governance in transition economies is not an isolated economic institution confined only to organizational improvements and managerial adjustments at the firm level, but is situated in a broad backdrop of social and institutional transformation. An institutional perspective, which goes beyond the "organizational perspective," is necessary in this context.

[44] Standard & Poor's Governance Services, *Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions* (New York: McGraw-Hill Companies Inc. 2002) at 12.

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C. The development perspective

From China's experience in corporate governance reform, some general lessons for developing economies with respect to the sequencing and pacing of market expansion and institution-building may be drawn. Most importantly, there is a need for a re-evaluation of the "convergence temptation" commonly observed across the developing world. New thinking on "institutional innovations," in addition to, or instead of, "institutional convergence," may be more relevant to alternative choices of development strategies. The rise of Chinese TVEs in which local government ownership and control had served to alleviate the agency problem and the shareholding reform of SOEs aimed at ownership diversification of SOEs and subjecting SOEs to checks and balances under a western-type of corporate governance structure without mass privatization, are two examples of such "institutional innovations."

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Section IV
The Subjects of Investigation

Section IV clarifies the subjects of investigation in this study. The primary subjects are Chinese state-owned enterprises (SOEs), including large SOEs and small and medium enterprises (SMEs), listed companies, state-owned banks (the "big four") and the stock market. The secondary subjects are township and village enterprises (TVEs) and private enterprises that are the major components of China's non-state sector. Foreign invested enterprises in China are not covered by this study, due to their still moderate impact on China's corporate governance reforms.

1. The ownership forms of enterprises in China

Broadly speaking, there are six types of enterprises that currently operate in China:

(1) State-owned enterprises (SOEs), including small and medium enterprises (SMEs) and large SOEs;
(2) Collectively-owned enterprises, including urban collectives and rural "township and village enterprises" (TVEs);
(3) Privately-owned enterprises, defined as private firms with more than seven employees;
(4) Individually-owned enterprises, defined as private firms with no more than seven employees;
(5) Foreign invested enterprises;
(6) Other firms not included in the above five categories.

As revealed in the above categories, there is a distinction between the "non-state sector" and the "private sector" in China, which are not identical concepts in the Chinese context. In Chinese statistical terminology, "non-state" enterprises include all ownership forms *other* than SOEs, which encompass firms in **groups (2) to (6).** The "private sector" in China, on the other hand, usually encompasses firms in **groups (3) to (6),** because most

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"collectively-owned enterprises" in group (2) are also public enterprises, with ownership structures generally dominated by local government shares, mixed in with other shareholders, including labor unions, groups of individuals and SOEs.

2. Reasons for selecting the subjects of investigation: the relevance of different sectors in the Chinese economy to the county's growth and transition

A. Reason I: Although the private sector has grown rapidly in recent years, the importance of SOEs in the Chinese economy is still significant and whether their reform can succeed will have a tremendous impact on the future prospect of China's transition to a market economy and its growth potential.

Despite the decline in importance of SOEs to the growth of the entire economy, they are still a huge burden on the government and whether their reform can succeed will have a significant impact on the overall growth potential of China's economy.

Some statistical facts can illustrate the importance of SOEs to the Chinese economy. In 2002, there were about 159,000 SOEs in China, most of which have been transferred to shareholding companies through corporatization. Although the number of SOEs now accounts for only a quarter of all enterprises in China, they produce more than half of the country's industrial output (that they produce this much at higher costs than non-state enterprises would is another matter). Not only do SOEs receive half of all bank loans and a large amount of government subsidies, they also dominate strategic industries and still employ 35 percent of urban workforces. Virtually all of China's heavy industry and much of its technology are in state hands. In addition, publicly listed former SOEs also dominate China's stock exchanges. As of September 2003, there were 1264 listed companies in China, of which 840 are state-controlled or state-held. The state alone owns two-thirds of equity in all listed companies, which, for the purpose of retaining control, is non-tradable.

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Since SOEs (especially large ones) are so crucial to China's economy and social stability, corporate governance reform in China must first address the problem of their inefficiency.

B. Reason II: Current corporate governance discourse in China focuses almost exclusively on two types of firms: (1) SOEs, particularly after their transformation to shareholding companies through corporatization; and (2) listed companies.

SOEs and listed companies are the focus of current corporate governance discourse in China. They not only attract a great deal of attention from academics and business practitioners, but are also the major subjects of existing corporate governance laws, regulations, and institutions in China. Accordingly, SOEs and listed companies on both domestic and overseas stock markets are the most discussed topics in the contemporary research on corporate governance in China.

C. Reason III: Corporate governance practices of TVEs help to partly explain China's economic growth at the early stage of development.

China's non-state sector, which consists of TVEs, foreign-invested enterprises and private enterprises, has been the main driving force for China's export expansion and economic growth over the last two decades. These firms have generally outperformed SOEs and have been the major contributors to job creation and capital investment. Of the non-state enterprises, Chinese TVEs had been the most significant players in productivity growth and employment enhancement at the early stage of China's transition, particularly by the mid-1990s. Accordingly, studying corporate governance of the TVEs is helpful to understanding the dynamics of China's economic reform.

D. Reason IV: Corporate governance reforms of China's banking sector, particularly the "big four" state-owned banks, as well as the stock market reform are critical complements to China's enterprise reforms in both the state and non-state sectors.

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In China, the "big four" state banks are the primary lenders to SOEs. Plagued by both non-performing loans (NPLs) and widespread corruption, the banking sector is in an urgent need of reform to clean up its practices in the wake of much broader financial liberalization under China's WTO commitments. In the meantime, the government has to date failed to establish an efficient stock market to facilitate efficiency-enhancing capital allocation and finances in both the state and private sectors. Because corporate governance reforms in the enterprise sector cannot obtain effective and sustained results if the reforms of the banking sector and stock market continue to lag behind China's pace of economic growth and integration into the global economy, structural reforms in all sectors concerned— SOEs, banks and the stock market— should proceed in combination to achieve synergies. Therefore, the banking sector and the stock market are also important subjects of investigation in this study.

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Chapter 2

The History of China's Enterprise Reforms and Emerging Corporate Governance Issues (1978- present)

Chapter 2 reviews the history of China's SOE reform and the emergence of corporate governance issues during the country's transition from a centrally planned economy to a market economy over the past 25 years. The historical background, strategies, designs, goals and actual results of alternative reform initiatives at different stages of China's economic development are discussed. The purpose of Chapter 2 is to illustrate how sequencing and pacing have played a dominant role in the selection and adjustment of SOE reform strategies in China.

Over the course of China's SOE reform, the government's policy priority has experienced a gradual shift. At an early stage of China's transition, the government had adopted various strategies for SOE reform which did not involve ownership restructuring, such as the expansion of enterprise autonomy, the building of managerial incentives, and the introduction of competition from the non-state sector to the state sector. At a later stage of the transition, particularly in the mid-1990s, the government began to experiment with new strategies that address ownership reform of SOEs, particularly with regard to partial or full privatization. In other words, privatization had not become an attractive policy option until recently.

In particular, China's WTO membership acquired in 2001 has brought about an external lever for the government to push forward SOE reform, which is characterized by the acceleration of decentralized privatization and the emphasis of corporate governance primacy. In the meantime, financial reform in the banking and securities sectors is also gaining some momentum, as a complementary element of institution-building to ongoing corporate governance reform in China's enterprise sector.

Chapter 2's major findings can be summarized as follows:

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(1) Alternative reform strategies adopted at an early stage of China's transition, which did not involve ownership restructuring, has not worked particularly well to bring about efficiency gains to China's SOEs. Some of these strategies, such as the managerial performance contract system, had had an initial positive impact on firm performance, but did not maintain such positive results due to inherent ownership and control problems in the SOE sector that can only be effectively mitigated through ownership reform.

(2) The corporatization and shareholding experiments started to address the ownership problem of SOEs, and have yielded some preliminary results. Existing evidence indicates that the "ownership effect" on Chinese SOEs is significant and may well dominate the "competition effect" on SOE performance at later stages of the transition.

(3) Privatization in China has proceeded in a gradual and decentralized manner, whereby regional competition and arrangements under China's fiscal federalism have largely shaped the pattern of privatization of small SOEs and township and village enterprises (TVEs) at local levels. While privatization has become a favorable policy option at a later stage of the transition, the government still insists on continuing state ownership, primarily due to its concern about retaining control over strategic sectors and preserving fundamental bases for its regime.

(4) Privatization and corporate governance reform in the enterprise sector, despite preliminary positive results, have encountered serious challenges in an underdeveloped legal and institutional environment. The primary challenge is the lagging reform of the state asset management system during the process of expanded privatization at local levels. As a result, asset stripping and self dealing have become evident in many privatization transactions, and have raised concerns and criticism from both the central government and the public. The second challenge is the lagging financial reform in the banking and securities sectors, which until recently (particularly before 2004) had not proceeded as promptly as it should have to complement the enterprise reform. Accordingly, future reform strategies should take into account these two challenges, and

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emphasize the importance of both "sequencing" and "complementarity."

Chapter 2 consists of four sections. Sections I to III recount the three stages of China's SOE reform from 1978 to 2004. These three sections examine various alternative strategies and introduce important debates over the direction and methods of reform, such as the debate over whether to privatize, when and how to privatize, and whether "more growth" or "more regulation" should be a policy priority in the reform of the stock market. These debates have enriched the understanding of the Chinese public of the dynamics of economic transition, and at times also inspired the central government's new thinking on workable strategies as the country's institutional environment evolves. Finally, Section IV concludes with the implications of the history of China's gradualist enterprise reform for future reform strategies.

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Section I

The First Stage of SOE Reform: Autonomy, Incentives, and Competition (1978-1992)

1. China's "SOE problem" and its spill-over effect

China has had a well known "SOE problem" for a long time, which is manifested by the systemic inefficiency of the state sector. Chinese SOEs, after 25 years of reform, have not experienced significant improvement in financial performance.[45] The SOE problem not only imposes a major tax on the national economy, it also poses financial risks to the banking sector as the big-four state banks have accumulated a mounting pool of non-performing loans (NPLs) to SOEs. In addition, because SOEs consume large quantities of social and financial resources and use them inefficiently, other parts of the economy, in particular the vibrant private sector, are hindered by capital starvation and a non-level playing field due to preferential government treatment of SOEs. This is characterized by economists as the "spill-over" effect of the SOE problem to the banking and private sectors.[46]

SOE reform has been a priority on the government policy agenda since the beginning of China's economic reform 25 years ago, but the government only moved to address the ownership issue at a later stage. The first stage of China's SOE reform was identified with increasing the operational autonomy granted to enterprise managers, largely by allowing them greater authority over the allocation of profits. Partial profit retention replaced the previous practice of remitting all enterprise incomes to the state by SOEs.[47]

The major cause for China's "SOE problem," as the discussion in Section III also points out, is the inherently inefficient ownership structure and the resulting corporate governance structure. The separation of the cash flow rights, which belong to the

[45] Major financial indicators of China's SOE performance are profitability, incidence of loss-making, fiscal subsidies, liability-to-asset ratios (leverage), and unfunded pension liabilities. See Nicholas Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: The Brookings Institution Press, 1998) at 33-47 [Lardy 1998].
[46] Broadman, *supra* note 26 at 859-860.
[47] Lardy 1998, *supra* note 45 at 22.

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impersonalized "state", and the control rights split between managers and government officials supervising the firm's operation, has rendered efficient production very difficult.[48]

2. Changing the method of SOE financing

Since 1985, the means of SOE financing has changed from direct capital allocation by the Treasury to state bank loans. The soft-budget constraints under the old financing system, however, still remained. After the implementation of this reform, what followed were two new problems: (1) the "insolvency problem" of SOEs due to high leverage, and (2) the resulting "NPL (non-performing loans) problem" of the "big-four" state banks caused by the heavy indebtedness of SOEs and their failure to repay bank loans. Because banks are also "politicized" as SOEs and the heads of the big-four are essentially not professional bankers but bureaucrats, the SOE problem could not be mitigated by the reform of financing methods.

3. Autonomy expansion and the building of incentives for profits

Beginning in 1979, the central government started to grant operational rights and authority to SOE managers, and changed the system of profit remittance from the transfer of all profits to the government, to tax payments at fixed rates. These measures had led to wage increases for both managers and workers and at first increased their incentives to maximize value. This was known in China as the "responsibility contract system," which spelled out terms under which SOE managers were permitted to retain profits after submitting to the state a negotiated amount of remittance. The managers could then use the retained profits to either increase workers' wages or bonuses, or reward themselves with higher salaries. This system was similar to managerial performance contracts used in

[48] Maxim Boycko, Andrei Shleifer & Robert Vishny, *Privatizing Russia* (Cambridge: MIT Press, 1995) 30 [Boycko, Shleifer & Vishny].

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other counties to create incentives to perform.

However, the positive effect of the "responsibility contract system" was short-lived, since managers and workers only took the upside of profit increases and the downside was still borne by the government. Proper incentives were still hard to establish. Therefore, the "responsibility contract system" was not successful in solving China's SOE problem.

4. Dismantling barriers to competition in the state sector: the "dual-track" system and the "parallel economies"

The following discussion will provide answers to two questions: (1) how markets and the non-state sector have evolved in China; and (2) how China's economy has grown so substantially "out of the plan" that it can be characterized as "a market economy with a mixed ownership base."[49]

As a defining characteristic, China's gradualist economic reforms have adopted a "dual-track" system, in which the non-state sector has gradually developed alongside the state sector. In other words, there are two "parallel economies" in the course of China's transition. China began its reforms by permitting entry of non-state firms and state firms to sell outside the plan, while the old planning system was not immediately abolished but only vanished gradually.[50] Markets then spread and gradually revealed inadequate institutional arrangements, thus pushing forward the process of "marketization" and institutional changes.[51] The primary reasons for adopting the "dual-track" system were

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[49] Stanley Lubman, *Bird in a Cage: Legal Reform in China After Mao* (Stanford University Press, 1999) at 105 [Lubman].

[50] Under the "dual-track" system, goods produced by SOEs are sold at planned prices, while above-quota production is sold at higher prices, some set by the market and other set by the state. As a result of further decontrol of prices, by 1997 more than 95 percent of industrial output was being sold at market prices. See Lubman, *ibid.* at 103. Over the past few years, prices of China's domestic goods have been in convergence toward international levels, as the country has become increasingly integrated into the world economy. Therefore, it can be said that in today's China, prices are basically all determined by the market.

[51] Also see Dwight Perkins, "Completing China's Move to the Market," in Ross Garnaut & Yiping Huang, eds., *Growth Without Miracles: Readings on the Chinese Economy in the Era of Reform* (New York: Oxford University Press, 2001) at 38 [Garnaut & Huang].

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the lack of clear objectives or a guiding blueprint at the outset of reforms, as well as weak administrative capabilities the country then had.[52] Contrary to the early prediction of some economists that an economy with such mixed structure as China's was unviable, the "dual-track" system has worked out its own pattern of economic growth, or has "muddled through" under institutional constraints.

During the first decade of China's economic reforms, some economists had come to conclude that China's "neither this nor that" economy was an unstable condition-economically and ethically, and would eventually be dominated by a single system–either market or plan. In their words, the unstable nature of China's mixed economy was vividly described as "half-plan, half-market; neither-plan, nor market; pretend-socialism, pretend-capitalism; with ill-defined borders between legality and illegality; socialist moral codes and principles of market efficiency; neither this nor that; in short a condition of 'market socialism,' or 'socialism with Chinese characteristics'."[53]

Despite the mixed nature of the Chinese economy in early years of reform, the non-state sector emerged alongside the state sector, and has quickly started to show its stronger competitiveness than SOEs. The non-state sector in China is primarily made up of the collectively-owned township and village enterprises (TVEs), private enterprises and foreign-invested enterprises. These firms have been the driving forces for China's export expansion and economic growth. The competition they have brought to the state sector has been intense, putting pressures on SOEs to reform and improve performance. However, the competition brought by the non-state sector only addressed the SOE problem to some degree because the intensity of competition was not strong enough to achieve a level playing field. In reality the non-state sector still encountered a number of barriers and policy discrimination in favor of SOEs, such as limited access to state bank loans, technological disadvantage due to insufficient R&D input, and regulatory

[52] John McMillan & Barry Naughton, "How to Reform a Planned Economy: Lessons from China", in Garnaut & Huang, *ibid.* at 470 [McMillan & Naughton].
[53] See Geoff Raby, "The 'Neither This Nor That' Economy", in Garnaut & Huang, *ibid.* at 19.

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impediments imposed by the government.[54]

[54] According to a survey of start-up bureaucracy in 75 developing countries by Harvard University in 2000, China was ranked 51st overall for delay and 43rd for cost. See Joe Studwell, *The China Dream: The Elusive Quest for the Greatest Untapped Market on Earth* (London: Profile Books Ltd. 2002) [Studwell]. Although after entering the WTO China has been undertaking a new round of government and administrative reforms aimed at reducing regulatory barriers and enhancing business environment, it will take time for the reform initiatives to generate real effects on the economy, which would depend crucially on the actual level of enforcement and implementation capacities.

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Section II

The Second Stage of SOE Reform: Corporatization, Restructuring, and Ownership Diversification (1993-1997)

The year 1993 marked a turning point of China's SOE reform. The government introduced the shareholding experiment and corporatization program aimed at transforming traditional SOEs into a new form of enterprise- shareholding companies. There are three types of shareholding companies under the Company Law, which was promulgated in 1993: limited-liability companies, joint-stock companies and wholly state-owned companies. Western-type corporate governance mechanisms were first introduced, including boards of directors, supervisory boards, and general shareholder meetings. Moreover, two stock exchanges in Shanghai and Shenzhen were also set up for the purpose of raising funds for the now transformed but cash-strapped SOEs.

1. The "Chinese characteristic" of corporate governance reform

Corporate governance reform in China concerns primarily SOEs, especially after their transformation to shareholding companies under the corporatization program. Strictly speaking, corporatization in China does not amount to privatization. The main purpose of corporatization is not to sell off state assets to private investors, whereby the state can then withdraw from enterprises. Rather, the essence of corporatization is to adopt a new form of enterprise (the shareholding company) to replace the old form of traditional SOEs under the central planning system, whereby the state can manage its assets in a new capacity of shareholder, instead of political body.

2. From traditional SOEs to shareholding companies

First, it is necessary to describe the "traditional SOEs" in China. The traditional SOEs in China were enterprises run by government-appointed managers, who were under the

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supervision of multiple government agencies with multiple, sometimes conflicting, objectives. Managers of traditional SOEs were not entrepreneurs, but agents of government ministries responsible for managing state assets in particular industries or sectors. These managers had a mixed identity of both "party cadres" and "bureaucrats," because they usually had to be Communist Party officials themselves to run state enterprises. They were not evaluated on the basis of performance, and their most important job was to guarantee that the quota requirements set by the central plans were met. Managerial strategic decisions, such as what to make, at what prices to sell products, and how much revenue to retain, were not their concern. All such matters were taken care of by governmental bureaucracies.

Under the corporatization program, most traditional Chinese SOEs have been transformed to shareholding companies and have installed new organizational structures similar to those of Western public corporations, such as boards of directors, shareholder meetings, and supervisory boards. However, the establishment of these "modern" corporate governance organs does not change the nature of these enterprises as SOEs, because the state usually maintains a full or controlling ownership in these shareholding companies. In this sense, shareholding companies are only a new form of SOE in China, as compared to the traditional form.

3. Corporatization and privatization: two separate steps, although can be combined

Although corporatization is not privatization, the two concepts are interlinked in China's transition context. In particular, in a dynamic sense, corporate governance reform in China has been an integrated process combining both corporatization and privatization. For one thing, when the traditional SOEs were transformed to shareholding companies, except for those still maintaining full state ownership, new enterprises (at least "new" in form) had usually undergone some level of restructuring to diversify their ownership base. Such restructuring typically involves the participation of private and foreign capital, and the prominence of such non-state capital in these new shareholding companies varies

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greatly. In general, small SOEs have undergone much deeper restructuring and ownership diversification, in the sense that many of them have been genuinely divested. Large SOEs (now there are 178 largest ones) have not been open to full privatization and still remain in state control. Therefore, privatization has been an integral element in the process of corporatization, especially for small SOEs.

Accordingly, the "Chinese characteristic" of corporate governance reform can then be understood as a combination of corporatization and privatization. However, this description does not highlight a unique feature of privatization in China, which is also not fully addressed by the existing privatization literature. Most importantly, "privatization" of Chinese SOEs is quite different from privatization in Russia and other post-communist transition economies.[55] This is so *not only* because China has not adopted mass and rapid privatization strategy, which is a matter of speed and volume, *but also* because China has insisted on maintaining state ownership and control in many "privatized" SOEs, especially those in strategic sectors, which is a matter of degree and intensity. This type of privatization is not seen anywhere in other transition economies. In this sense, "privatization" in China, as has been practiced so far, is not mainly about reducing the state's control over strategic sectors, but about making that control more effective. Indeed, after private capital began to participate in the ownership restructuring of SOEs, the state has in many cases been able to retain the same level of control as in the past, but with less capital investment.[56]

[55] See William Megginson & Jeffry Netter, "From State to Market: A Survey of Empirical Studies on Privatization" (2001) 39:2 Journal of Economic Literature 321 [Megginson & Netter].
[56] "We are the Champions", in "Behind the Mask: A Survey of Business in China" *The Economist* (18 March 2004) 14.

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Section III

The Third Stage of SOE Reform: Decentralized Privatization and the Need for Complementary Reform of the Financial System (1997-present)

The third stage of SOE reform, starting from the 15th Communist Party Congress of 1997 and still in progress, is characterized by the accelerated and expanded shareholding reform and decentralized privatization (*minyinghua*) at local levels, after the government decided that it will gradually withdraw from the competitive elements of the national economy and only concentrate on the "strategic" sectors. The participation of private and foreign investors in the ownership restructuring of SOEs is encouraged by the government, and developing a "mixed economy" with a multiple ownership base is announced as the purported destination of China's shareholding reform. China's WTO accession in 2001 has provided an external lever to deepen and strengthen the structural reforms of state enterprises and the financial sectors, in the face of enhanced competition from overseas.

Significantly, in April 2003, a new government agency, the State-owned Assets Supervision and Administration Commission (SASAC), was established to push forward state asset management reform. The SASAC is in charge of overseeing state assets and is entrusted with the exercise of ownership rights in SOEs on behalf of the state. With roughly one year of regulatory experience, the SASAC is now at the centre of a latest round of the privatization debate spurred by the public outcry over widespread irregularities during the process of privatization, in particular with regard to insider privatization to managers, i.e., the Chinese-style management buyouts (MBOs). Despite the heated controversy over MBOs, which culminated in the summer of 2004, the government seems resolved to continue to pursue ownership reform of SOEs. In the meantime, the government has also voiced its concerns with asset stripping and other forms of expropriation by corporate insiders and local officials through collusion.

As complementary measures to SOE reform, shareholding and corporate governance reforms at state banks and a new trend of tightening regulation in the stock market to

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afford investors stronger protection have also been implemented very recently. Therefore, it seems that the logic of sequencing and pacing of China's enterprise and corporate governance reforms has been under dynamic adjustment and revision, in the sense that the pace of structural reforms and institution-building is accelerating and coordination and synchronization are being incorporated into the implementation of these reforms.

The following discussion focuses on some important debates over the directions and methods of privatization. Through these debates, a broader picture can be drawn of how reform strategies have evolved.

1. The privatization debate: Whether to privatize?

A. The debate on "ownership effects *vs.* competition effects"

For researchers of privatization, the debate on "ownership effects *vs.* competition effects" is a familiar topic. This debate has been centered on the respective role of ownership reform (particularly privatization) and competition in enhancing the efficiency of SOEs. While a number of studies on competitive market economies or developed countries have generally offered privatization-positive observations, evidence from transition economies is more equivocal and in some cases negative. The reasons why transition economies have presented mixed results of privatization are many, and will be discussed in Chapter 3 where Russian privatization is examined.

To obtain a balanced understanding of whether privatization works for developing countries like China, it is important to look beyond transition economies. For example, a comprehensive review paper on the empirical results of privatization in less developed countries visits the topic of "ownership effect *vs.* competition effect" again and reaches the following conclusion:

> Empirical evidence on the economic performance of SOEs generally yields negative results and suggests that SOEs are a major tax on the economics of developing countries reflected in the

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large operating subsidies required to sustain them. These inefficiencies seem in part attributable to ownership effects and partly to lack of competition effects.[57]

It is worth noting that in addition to financial subsidies, whether through fiscal allocation of funds or policy bank loans, there are other social and economic resources consumed in large quantity and generally inefficiently by SOEs, such as government technological support and cheap (or free) land use. In China, SOEs arguably receive all but one of the common forms of government preferential treatment offered to favored firms, the sole exception being tax breaks. Chinese SOEs usually pay considerably higher taxes than private and foreign enterprises do. This has been the case throughout China's transition to a market economy over the last 25 years, and is best reflected in the discriminatory income tax rate imposed on China's SOEs, which is set at 33 percent, almost double the 17 percent borne by foreign-invested firms. The tax factor may mitigate the negative results of SOE performance to some extent. However, since the state pays high costs via subsidies in exchange for the tax revenues collected from SOEs, often exceeding what it receives in return, the tax factor does not significantly affect the level of systemic inefficiency in China's public sector, as measured by a variety of financial indicators, such as profitability and return on assets.

B. Why is state ownership inefficient?

Around the world, state ownership is widely viewed, and has been repeatedly demonstrated, as inefficient.[58] Briefly put, this is because both profit motives and political motives of government officials have the potential to distort policy objectives significantly.[59] The political targets that state enterprises are charged with are not compatible with economic targets and are often in sharp conflict with profit maximization.

Moreover, there is a problem of "SOE externalities." I refer here to the high cost to the

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[57] Andrew Smith & Michael Trebilcock, "State-Owned Enterprises in Less Developed Countries: Privatization and Alternative Reform Strategies" (2001) 12 European Journal of Law and Economics 217 at 217 [Smith & Trebilcock].

[58] See, for example, Boycko, Shleifer & Vishny, *supra* note 48; Smith & Trebilcock, *ibid.*

[59] Michael Trebilcock & Edward Iacobucci, "Public Values in an Era of Privatization: Privatization and Accountability" (2003) 116 Harv. L. Rev. 1422 at 1441 [Trebilcock & Iacobucci].

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general economy created by the over-consumption of social resources, such as fiscal subsidies and state bank loans, as well as extractions of firm value by managers, workers and government officials. Those extractions include asset stripping by managers, shirking by workers, predatory taxes, fees and bribes levied by government officials, and non-pecuniary benefits for workers and their relatives in the form of housing and social services.[60]

Not only does the government often lack adequate means to pursue given ends, the "meta-agency" problem in government firms or programs also frequently causes the government fail to choose correct ends. In other words, government agents may not seek to maximize the welfare of their principals (i.e., the public), but more likely prefer to maximize their own welfare. This problem will have a greater impact after a particular activity has been allocated to the public sector, because such an allocation creates new interest groups.[61]

C. Can alternative strategies solve China's "SOE problem"?

According to some researchers, empirical evidence on the effect of privatization of SOEs in both developed and developing countries suggests that it is often likely to lead to major improvement in economic performance. However, where privatization is not politically feasible, SOE reform alternatives such as management contracts, performance contracts, and greater exposure to competition may, in some contexts, enhance SOE performance, although typically they are second-best policy options to privatization when both economic and political preconditions for privatization are not ready.[62] China has given credence to the above observations: it has tried alternative strategies to privatization over the course of SOE reform, but in general did not see much success in terms of achieving

[60] Gary Jefferson, "China's State Enterprises: Public Goods, Externalities, and Coase" (1998) 88:2 The American Economic Review 428-432, at 428.
[61] Trebilcock & Iacobucci, *supra* note 59, at 1443.
[62] Smith & Trebilcock, *supra* note 57, at 217.

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stable and sustainable performance improvement measured by financial indicators, such as profitability and return on assets.[63]

2. When and how to privatize?: a matter of sequencing and pacing

A. Continuing state ownership during the process of shareholding experiment and privatization

In rhetoric, a massive privatization program was announced in China as early as in 1997, under the slogan "seize the large, release the small" (*zhuada fangxiao*), which is roughly interpreted as privatizing all but the largest SOEs, numbering 178 as of January 2005.[64] In practice, however, ownership restrictions on the actual implementation of privatization, such as the requirement that publicly listed former SOEs must keep a controlling state shareholding which is non-tradable in the stock market, have resulted in a very unusual feature of privatization in China. This feature is that "privatized" SOEs have not become "private" enterprises, but enterprises with mixed ownership dominated by the state.

Therefore, corporate governance reform in China needs to deal with the issue of continuing state ownership. The impact of this characteristic of privatization in China is particularly acute if seen through the lens of the mainstream transition framework adopted in other countries, in which the Communist Party no longer functions as an economic agent. Given that China is the only transition country still ruled by the Communist Party, it is reasonably easy to see why state ownership is still protected: without state ownership, the Party would lose its most effective tool to control national economic resources, which is among the fundamental pillars of its ruling basis. This can be better understood in the context of the "party-state" bureaucratic and political styles in China.[65]

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[63] See, for example, Broadman, *supra* note 26; Lardy 1998, *supra* note 45.
[64] Megginson & Netter, *supra* note 55 at 36.
[65] It is not uncommon to find the expression of "party-state" in China-related research, which entails a vague idea that the Communist Party apparatus is absorbed by, and intertwined with, the governmental

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In this sense, state ownership in China carries other functions than organizing industrial production or realizing distributional objectives, as is commonly the case in other economies (with a couple of rare exceptions) that also have SOEs. These other functions are basically non-economic and charged with political motivations, such as the above-mentioned Party grasp of communist ruling capital. State ownership is also used to realize China's desire to produce globally competitive "national champions," so that big Chinese SOEs can have a strong international presence to show the world "the advantages of "socialism with Chinese characteristics" (*zhongguo tese de shehuizhuyi*), which, if successful, would yield more ideological than economic returns.[66]

Finally, there is another important reason why state ownership is difficult to withdraw from the Chinese economy. In China, it is SOEs, rather than the government itself, that serve as the country's social safety net.[67] The heavy policy burdens assumed by state firms, such as maintaining excessive urban employment and providing various welfare entitlements and benefits to state employees, are a direct reflection of this particular welfare function of state ownership. The welfare benefits that are traditionally provided by SOEs to their employees range from child education and medical care to housing and recreation.

In order to reconcile continuing state ownership with the market orientation of economic

establishments in China. This notion, which was appropriate in early contexts, does not tell much about the evolving nature of the Party-state relationship in today's China, where the legitimacy of communist rule has been under redefinition. For example, in addition to being a political ruling machinery of the Communist Party, the Chinese state is becoming more as a machinery for pluralist interest-mediation, which can be illustrated by the recent emphasis on rural development and the admission of private entrepreneurs to the Party. See Masahiko Aoki, "The Dual Aspects of the Institutional Transformation of the Chinese Economy" (2002) China Institute for Reform and Development (CIRD), online: <http://www.chinareform.org/cgi-bin/ResearchPaper/ResearchPaper_main.asp?Ggwk_ID=36&Ggwk_Type>

[66] Whether political or ideological objectives can *in some cases* be compatible with economic efficiency is not a settled question. With respect to transition economies that had been advised to pursue mass privatization in the 1990s, some economists comment that although the specific design of the programs were largely dictated by politics, politically feasibly programs can be made attractive from an economic standpoint in terms of maximizing value, fostering free and efficient markets, and promoting corporate governance. See, for example, Maxim Boycko, Andrei Shleifer & Robert W. Vishny, "Voucher Privatization" (1993) 35 Journal of Financial Economics 249.

[67] Megginson & Netter, *supra* note 55 at 37.

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reform at the ideological level, China has coined a new notion that "mixed ownership under the shareholding system is the primary form of realizing public ownership, especially state ownership." [68] By looking forward, maintaining the state as the controlling shareholder of partially-privatized SOEs may be only a transitional arrangement as required by the logic of sequencing. From a long-run perspective, the maintenance of state control in these firms cannot achieve the purported goal of improved performance and very likely will lead to the waste of both state and private capital inputted in these firms. As the country's institutional environment develops and both political and government reforms proceed, the further relinquishment of state control in partially privatized SOEs will be unavoidable.

B. The gradualist and decentralized nature of privatization in China

(1) The rationales for a gradualist approach to privatization in China

The gradualist approach characterized by experimentation and proper sequencing and pacing has been praised as accounting for China's success in achieving high rates of GDP growth over the last decade. Many economists in the West have endorsed this reform strategy in comparing Russia and China, including Nobel Prize winners Kenneth Arrow and Joseph Stiglitz, who have visited China and exchanged ideas on economic reform with Chinese government officials. As Stiglitz reports, both he and Arrow emphasized to the Chinese government the positive effects of experimentalism and the merits of proper sequencing and pacing:

> The contrast between China's strategy and that of Russia could not be clearer, and it began from the very first moves along the path to transition. China's reforms began in agriculture, with the movement from the commune (collective) system of production in agriculture to the "individual responsibility" system—effectively, *partial* privatization. It was not complete privatization: individuals could not buy and sell land freely; but the gains in output showed how much could be gained from even partial and limited reforms... The evidence was so compelling that the central government did not have to *force* this change; it was willingly accepted. But the Chinese leadership recognized that they could not rest on their laurels, and the reform had to extend to the entire economy.

[68] Jiang Zeming, "Report at the 15th Communist Party Congress", September 1997.

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... [H]e [Arrow] and I each stressed the importance of competition, of creating the institutional infrastructure for a market economy. **Privatization was secondary...**[69]

To the same effect he remarks elsewhere that China shows "...that an economy might achieve more effective growth by focusing first on competition, **leaving privatization until later**."[70]

Clearly, Stiglitz does not rule out the privatization option for China, but cautions against imprudent timing, speed and method of privatization in the transition process. According to him, premature and rushed privatization is a flawed policy product of political imperative and economic imprudence, and could be a major cause for substantial economic losses when the sequence of reform is ignored or wrongly devised. As discussion in Chapter 3 indicates, Russia has provided a negative example of "rushed" privatization, and China should learn from it. Indeed, while counter-factually it is difficult to speculate what would have happened if China adopted the same approach of mass and rapid privatization when markets had not expanded and critical institutions, such as an effective financial system, were weak or missing, the hard fact that it has achieved remarkable economic growth without massive privatization at the early stage of reform testifies to the merits of sequencing and pacing.

(2) The determinants of the decentralized feature of privatization in China: fiscal federalism and regional competition

There are two major determinants of China's decentralized privatization. The first is the arrangement under the so-called "fiscal federalism" between the central and local governments. It should be pointed out that although China is not a constitutionally professed federalist state, it shows some features of federalism in the fiscal arrangements between the central and local governments.

[69] Stiglitz, *supra* note 13 at 182. [italics original; emphasis added].
[70] Joseph Stiglitz, "Knowledge for Development: Economic Science, Economic Policy, and Economic Advice" (Paper presented to the *Annual World Bank Conference on Development Economics*, Washington, D.C., April 20-21, 1998, at 2 [emphasis added].

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In China, the relationship between the central and local governments resonates with the typical structure under the "market-preserving federalism" model developed by political scientists and economists in recent years.[71] Although not optimal, the Chinese style "fiscal federalism" is generally conducive to promoting market-oriented reform and economic prosperity at the local levels. The issue of incentive compatibility has been well addressed in China's fiscal contracting system as well as in its fiscal and tax reforms since 1994.

The fiscal contracting system is an arrangement between the central and local governments dealing with revenue sharing under fixed terms, which provides local governments with strong financial incentives to pursue market-oriented reform. For example, faced with hard-budget constraints, local governments have actively encouraged the development of non-state enterprises and greater reform in local SOEs, typically through partial or full privatization to generate more revenues.[72] As a result, the fiscal incentives of local governments to reform enterprises have largely shaped the decentralized feature of privatization in China.[73] In addition, local governments have also played a very important role in corporate governance of local enterprises. For example, in local government-controlled enterprises (usually the collectively-owned township and village enterprises or TVEs,) managers are given partial or total residual shares by the local governments to pursue firm efficiency.[74]

The second important factor in shaping the decentralized feature of privatization in China is enhanced inter-regional competition in product markets during the process of market expansion and economic liberalization in the areas of trade and investment.[75] In order to compete with firms from other regions with lower costs of production, a local firm as

[71] See, for example, Rui J. P. de Figueiredo, Jr. & Barry R. Weingast, "Pathologies of Federalism, Russian Style: Political Institutions and Economic Transition" (2002) under submission for Comparative Politics; Olivier Blanchard & Andrei Shleifer, "Federalism with and without Political Centralization: China versus Russia" (2001) 48 IMF Staff Papers 171; Jin, Qian & Weingast, *supra* note 39.
[72] Jin, Qian & Weingast, *ibid.* at 36-37.
[73] Burawoy, *supra* note 40.
[74] Li, Li & Zhang, *supra* note 41.
[75] Shaomin Li, Shuhe Li & Weiying Zhang, "Cross-Regional Competition and Privatization in China" (1998) 9:1 MOCT-MOST: Economic Policy in Transitional Economics 75-88 at 84.

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well as the local government overseeing it, have strong incentives to improve performance. The best way of achieving such improvement is through ownership reform, whereby private entrepreneurs receive partial or full residual rights from the government. Not only local small SOEs, but also TVEs have experienced widespread privatization since the mid-1990s in this manner. China's accession to the WTO has added more strength to inter-regional competition and accordingly provides an external lever to push forward China's decentralized privatization.

3. The latest round of the privatization debate: the culmination of the controversy over privatization (*minyinghua*) and MBOs

Over the course of China's decentralized privatization, largely due to the underdevelopment of complementary institutions, such as a strong stock market and an effective system of state asset management, there have occurred a number of incidents of rampant asset stripping. This has generated controversy over the means, and most recently the very direction, of privatization among the Chinese public. The spill-over or pull-back effect of this controversy has the potential to undermine the legitimacy of privatization as it has been so far practiced, thereby risking the reversal of SOE reform, despite having accelerated since 1997 towards decentralized privatization of small and medium-sized SOEs at local levels.

This controversy reached its culmination in the summer of 2004, when an economist at the Chinese University of Hong Kong, Larry H. P. Lang, launched a fierce attack on several well-known Chinese entrepreneurs, accusing them of stealing state assets during the process of China's SOE reform. In particular, he dismissed the legitimacy of insider privatization (Chinese style MBOs) as a method of acquiring controlling stakes in SOEs.[76] This has sparked a heated debate over privatization that has lasted to date and

[76] Larry H. P. Lang, "Questioning the Method of Ownership Reform at TCL" (17 June 2004): <http://business.sohu.com/2004/06/17/35/article220573551.shtml>; idem, "The Transformation of Haier: A Complete Analysis of A Long and Complicated Process of MBO" (2 August 2004): <http://finance.sina.com.cn/t/20040802/1417919523.shtml>; idem, "Be Aware of The Collusive

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engaged not only economists, but also the general public. I discuss this issue thoroughly in Chapter 4.

Despite the controversy and debate surrounding privatization, the government seems resolved to continue to pursue ownership reform at SOEs, while voicing in the meantime its concerns with asset stripping and other forms of expropriation by corporate insiders and local officials through collusion. The SASAC, the national watchdog of state assets, was quick to release a policy report on the principles, achievements and problems of SOE reform in China. This report largely reassured the public that the direction of ownership reform will be maintained, and that the state will not change its determination to withdraw from competitive sectors of the economy and support private firms to take over these sectors. Specifically, the SASAC expressed its opinion that MBOs are only suitable for privatizing small SOEs on a case-by-case basis, and that such transactions must be subject to a set of restrictions and be conducted in a fair, transparent, and competitive manner. This means that outside and foreign investors should be able to bid against managers for the assets on sale in an open market.[77]

This latest round of debate has a significant impact on the current understanding of privatization strategies among China's policy circles, which impact was demonstrated in a central government's review of local enforcement of privatization. This review was conducted by officials from the SASAC and the Ministry of Finance in September 2004. Such prompt response from the government to the privatization debate indicates that the government has taken notice of the irregularities in the process of decentralized privatization, and that it is poised to initiate new measures, mostly through the SASAC's rule-making, to curb asset stripping and to ensure that privatization is implemented with more scrutiny from the central government.

Expropriation of State Assets by Private and State Enterprises" (26 August 2004): <http://www.phoenixtv.com/home/finance/fortune/200408/26/317941.html>. More discussion of the privatization debate, particularly regarding the MBO controversy, is provided in Chapter 4.

[77] SASAC, "Insisting on the Direction of SOE Reform and Orderly Pushing Forward SOE Reform with Regulation" *People's Daily Online* (29 September 2004), online: <http://finance.sina.com.cn/g/20040929/09311055816.shtml>.

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4. The complementarity between corporate governance reform in the enterprise sector and reforms in the banking and securities sectors

As has been heavily documented, privatization in transition economies is only the first step to efficient ownership.[78] For China, corporate governance reform accompanied by reforms in the banking sector and securities markets is now becoming a new strategy on the government's reform agenda as the country enters the next stage of transition to a full market economy, especially in light of China's accession to the WTO.

According to some researchers of transition economies and emerging markets, corporate governance reform in these countries is closely associated with the development of capital markets, because privatization has occupied the centre of these countries' reform agenda over recent years.[79] The economic logic behind this link is that privatization is not likely to succeed unless capital markets are able to facilitate the restructuring of privatized firms, whereby efficient ownership structures can be established.[80] China is no exception to this observation. Aside from financing and investment functions, China's stock market is entrusted with an additional task to facilitate the ownership reform of SOEs by offering a place to trade property rights. However, in practice this task is by no means properly executed, or executable, given the political logic of China's stock market that works against the economic rationales described above. Chapter 5 will elaborate on this issue.

5. Major debates about China's stock market

[78] See, for example, Bernard Black, Reinier Kraakman & Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wong?" (2000) 52 Stan. L. Rev. 1780 [Black, Kraakman & Tarassova]; Boycko, Shleifer & Vishny, *supra* note 48; John J. Coffee Jr., "Privatization and Corporate Governance: the Lessons from Securities Market Failure" (1999) 25 Journal of Corporate Law 1 [Coffee 1999].
[79] See, for example, Simon Johnson, "Coase and the Reform of Securities Markets" (2000) Federal Reserve Bank of Boston Conference Series [Proceedings], 187-221[Johnson 2000]; Edward Glaeser, Simon Johnson & Andrei Shleifer, "Coase versus Coasians" (August 2001) Quarterly Journal of Economics 853-897 [Glaeser, Johnson & Shleifer 2001].
[80] Johnson 2000, *ibid*; Glaeser, Johnson & Shleifer 2001, *ibid.*

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A defining feature of China's stock market at the current stage of economic development is that the markets are corrupt and inefficient in allocating capital, where unscrupulous issuers are obsessed with a practice of "*quan qian*" (predatory fund-raising without repayment), and engaged in a race for value destruction at the expense of huge wealth losses for investors. For an overwhelming majority of companies listed on China's two stock exchanges in Shanghai and Shenzhen, numbering 1380 as of August 2004[81], the only purpose of going public is to raise money as a "free lunch" without caring about improving corporate governance quality or rewarding investors with adequate returns on investment. Major debates about China's corrupt stock market are introduced below.

A. The debate about the most fundamental problem of China's stock market

With respect to the most fundamental problem of China's stock market, or the root cause of the endemic practice of "*quan qian*", there has been a constant debate over what is more damaging to the markets: the poor quality of listed companies, or the fragmentation of the stock market manifested by the non-tradability of state shares.[82] In answering this question, China's scholars and securities market regulators share a common understanding that both these problems are equally serious and need to be addressed in tandem.

Given the problems with China's nascent stock market, what is particularly puzzling is that with both a weak legal system and largely inadequate regulation in terms of enforcement effectiveness, China's stock market still attracts many domestic investors who in general do not pay much attention to the quality of corporate governance of the companies they put their money in. This mysterious investment pattern demands explanations.

[81] Source of data: China Securities Regulation Commission (CSRC) website <http://www.csrc.gov.cn>.
[82] Wang Chenbo, "Former Head of China's Stockmarket Watchdog: Government Abidance by Promises a Precondition for Stockmarket Development" *China Newsweek* (19 October 2004) [Wang].

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In addition to the scarce alternative channels to make capital investment for the Chinese society, which means the only other place to put personal savings in is the big-four state banks which offer very low interest rates, another more important reason for investing in the stock market without considering the quality of listed companies is that Chinese investors widely hold an expectation that the government will bail out the market if it faces a collapse out of the concern for social stability.

This explanation seems to have found its resonance in the work of the 2004 Nobel Prize winners in economics, although the thrust of their theory is more vigorously tested by macro-economic booms and busts.[83] According to the two Laureates, the credibility of government to sticking to its economic policies is important to the success of these policies. If the government is perceived as not credible because it has a history of repudiations of promises, its policies will be ignored and the public will generate opposite expectations. In other words, if the government cannot fulfill its promises made *ex ante*, it will lose credibility and the public will act in opposite ways in anticipation of government compensation *ex post* if they suffer losses. This conundrum is summarized by the two economists as the "time consistency problem."[84]

The "time consistency problem" is precisely the major cause for the abnormal investment pattern in China's stock market. Investors, believing that the government will not risk social unrest by letting the market collapse, bet on an *ex post* bail-out should there be a meltdown, and accordingly recklessly engage in rampant speculative trading activities. It seems that the "time consistency problem" is fully appreciated by the government itself, as reflected in the comments on reviving investor confidence by a top regulator of China's securities markets.[85] Therefore, while investor education is by no means of secondary importance to the development of Chinese stock market, it is perhaps more critical in terms of the level of urgency that the government should commit itself to stringent regulation and fulfill its promise not to bail out the markets or rescue the market

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[83] The 2004 Nobel Prize in economics honors two economists who have reshaped macroeconomic thought and policy: Edward Prescott of Arizona State University, and a Norwegian, Finn Kydland, of Carnegie Mellon University. See "Cycles and Commitment" *The Economist* (14 October 2004) 74.
[84] *Ibid.*
[85] Wang, *supra* note 82.

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participants, be they state-controlled listed companies, state-owned financial intermediaries or individual investors, in the event of a collapse or meltdown in the markets.

B. The debate about "development *vs.* regulation": a matter of sequencing

On the issue of which of the following dimensions assumes a higher policy priority-promoting the development of the market or strengthening the regulatory regime, the Chinese government seems to favor a pragmatic stance of "discovering and solving problems over the course of market development." [86] This position has a clear "development" tilt, despite the rhetorical clarification by the government that it is unnecessary, as well as unreasonable, to regard these two dimensions as reflecting opposite or contradictory values.

There is a good example to illustrate the vigor of the philosophy of "more development, lesser regulation." Laura Cha, the former vice chairwoman of the CSRC (China's SEC) who was headhunted by the Chinese government about three and half years ago from Hong Kong for her reputation as an "iron-handed regulator," left her post in October 2004 following criticisms from the market participants (surprisingly, many being small investors) about her unbending stance on tough regulation. Some say that her departure is a verdict that that stringent regulation may not be suitable to the Chinese stock market at their early development stage. Chapter 5 will discuss in more detail the debate on "development *vs.* regulation" through case analysis.

[86] *Ibid.*

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Section IV
Conclusion

The history of China's enterprise reforms over the past two decades or so has provided some useful lessons for designing future reform strategies. The following discussion seeks to summarize these lessons and predict the directions of China's corporate governance reform and related financial reforms at a later stage of the transition.

1. Alternative reform strategies adopted at an early stage of China's transition, which did not involve ownership restructuring, did not work particularly well to bring about efficiency gains to China's SOEs.

In general, previous reform strategies all failed to effectively solve the "SOE problem." Some of these strategies, such as the managerial performance contract system, had had an initial positive impact on firm performance, but did not maintain such positive results due to inherent ownership and control problems in the SOE sector that can only be effectively mitigated through ownership reform.

2. The corporatization and shareholding experiments started to address the ownership problem of SOEs, and have yielded some preliminary results.

Existing evidence indicates that the "ownership effect" on Chinese SOEs is significant and may well dominate the "competition effect" on SOE performance at later stages of the transition. Although with some problems, such as limited participation of private and foreign capital in the ownership restructuring of large SOEs, particularly those in strategic sectors, the corporatization and shareholding experiments have proved effective with small SOEs at local levels.

3. Privatization in China has proceeded in a gradual and decentralized manner, whereby regional competition and arrangements under China's fiscal federalism have largely shaped the pattern of privatization of small SOEs and township and

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village enterprises (TVEs) at local levels.

Unlike Russia, China did not pursue a radical approach toward privatization. Instead, it has adopted a gradualist and experimental approach that emphasizes the merits of local innovative pilot schemes. Local initiatives are often useful for the discovery of a better road to the market through experiments at lower government levels at lower costs.

Moreover, the gradualist nature of China's privatization approach has also been illustrated by the fact that while privatization has become a favorable policy option at a later stage of the transition, the government still insists on continuing state ownership, primarily due to its concern about retaining control over strategic sectors and preserving fundamental bases for its regime.

4. Compared to a radical approach toward privatization, China's gradualist strategy has proved a better approach toward the market.

There has been a huge debate among students of transition economies over the questions of the optimal pace and sequence of economic reforms in transition economies.[87] Russia had implemented its privatization programs in a "big-bang" manner in anticipation of economic prosperity, but experienced significant stagnation and decline through the following decade and has only seen signs of growth over the past several years due to high oil prices in the international market. China's enterprise and corporate governance reforms, as examined in previous sections, have followed a gradualist path that takes into account proper sequencing and pacing whereby alternative strategies have been adopted at different stage of economic development.

The gradualist strategy is largely a sensible approach, for two reasons. On the one hand, a developing country cannot build well-functioning institutions overnight under economic, political, social and human resource constraints, because these institutions take a long time to develop. On the other hand, when old systems are no longer suitable and in need

[87] Lardy 1998, *supra* note 45 at 2.

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of replacement, it is important to avoid an institutional vacuum which has a potentially substantial and destructive impact on the whole society. Therefore, some transitional solutions, even if not the best in a more developed institutional environment, can still play a positive role in promoting economic growth. More importantly, today's imperfect solutions can furnish a starting basis to accumulate resources for future reforms, thus serving as "stepping stones" to the ultimate destination of a market economy. Therefore, the merits of sequencing and pacing in the dynamic of transition should be appreciated.

5. China's gradualist approach toward privatization and corporate governance reform in the enterprise sector, although with preliminary positive results, has also encountered serious challenges in an underdeveloped legal and institutional environment. Accordingly, future reform strategies need to take into account of these challenges and address both "sequencing" and "complementarity."

While generally sensible in the Chinese context, the gradualist approach toward privatization has also encountered some serious specific challenges. The primary challenge has been the lagging reform of state asset management system, particularly with regard to expanded privatization at local levels since the mid-1990s. As a result, asset stripping and self dealing have become evident in many privatization transactions, and have raised concerns and criticism from both the central government and the public. The second challenge is the lagging financial reform in the banking and securities sectors, which until recently (particularly before 2004) had not proceeded as promptly as it should have to complement the enterprise reform. Accordingly, future reform strategies should take into account these two challenges, and emphasize the importance of both "sequencing" and "complementarity."

Finally, it is important to point out that "sequencing" is not a static concept that does not allow for self-adaptation and self-adjustments when constraints on reform have been reduced or removed at later stages of economic development. For example, there are potential high costs involved in delaying the structural reforms of SOEs and the financial

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system when China is rapidly integrating into the global economy. In order to generate synergies and complementarity, the reforms of the SOE sector, banking sector and the stock market need to proceed simultaneously and in a coordinated manner.[88]

[88] Lardy 1998, *ibid.* at 3-5, 221.

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Chapter 3

Theories and Evidence of Corporate Governance and Development: Implications for China

Chapter 3 reviews contemporary theories and empirical evidence of the relationship between countries' corporate governance institutions and development outcomes, particularly in relation to transition economies.

Specifically, Chapter 3 discusses the challenge posed by China to the broad governance theory advanced by economists in the New Institutional Economics (NIE) school. The broad governance theory, while powerful in explaining the relationship between institutional quality and development outcomes in many parts of the world, seems inadequate in explaining China's growth. Chapter 3 attempts to suggest the refinement or improvement of the broad governance theory, so that it can be better applied to China.

In addition, Chapter 3 also examines alternative approaches to the understanding of corporate governance that have been advanced by academics over the last two decades. Of these alternative approaches, an historical and political model, as opposed to a purely economic model, of countries' corporate governance systems is emphasized in the Chinese context.

Moreover, in reviewing empirical evidence on privatization and securities market failures in transition economies, Chapter 3 closely analyzes the experience of Russian privatization and related capital market development, and points out both the reasons behind the discontents underlying the Russian experience and the lessons China should learn from Russia.

The main findings of Chapter 3 are presented in the following four aspects.

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1. The quality of corporate governance system in a country in transition is as important as the quality of crucial public sector institutions (such as the effectiveness of government) for sustainable economic growth, as well as for overall social development.

2. Political determinants of corporate governance and legal and institutional perspectives on corporate governance are of particular relevance to China's ongoing enterprise and corporate governance reforms. Russia proved a negative example of rushed privatization in an institutional vacuum, and this lesson should be learned by China.

In fact, China's enterprise and corporate governance reforms have followed a gradualist approach, whereby mass privatization had not become a favorable policy option until a later stage of reform. This is primarily because when the transition was at an early stage, the political, economic, and institutional environments posed huge challenges to unconstrained and rapid reform. Looking ahead, over the course of seeking practically workable initiatives under the existing political constraints, sequencing and pacing should continue to play a major role in implementing privatization and corporate governance reform at a new stage of reform. In the meantime, after China's accession to the WTO, more flexibility of transition strategies is also needed. This requires an accelerated speed of reform and complementary reform initiatives in related sectors, including the SOE, banking and securities sectors.

3. The "politics" of legal and institutional reforms in transition and developing economies has a potentially blocking effect on making reform initiatives sustained and less reversible. This is primarily because vested interests tend to make efforts to slow or hinder reforms, for fear of losing their existing benefits and entrenched advantages. Accordingly, legal and institutional reforms in these economies need to address the issue of "politics" sensibly.

4. Without establishing (if possible) complementary mechanisms, convergence of corporate governance systems in transition economies towards the U.S. model is not likely to succeed in bringing about the same effect this model has had in its home market.

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However, because it is very difficult for a reforming country to transplant from a host country systemic complementarities in corporate governance mechanisms and institutions at the same time without weakening or losing their original functions, the prospects for convergence, at least for transition economies, are still uncertain.

Chapter 3 is divided into six sections. Section I introduces new waves of global corporate governance reforms and new trends in contemporary corporate governance research. Section II then discusses the challenge posed by China to the broad governance theory advanced by economists in the NIE school. The major finding of Section II is that one possible reason why the broad governance theory seems relatively inadequate in explaining China's growth may be that it has not incorporated some important private sector institutions, such as corporate governance institutions, in constructing six aggregate governance indicators.

To present the conceptual basis of the global debate in comparative corporate governance research, Section III outlines several alternative approaches to the understanding of corporate governance that have been advanced by academics over the last two decades. Of the alternative approaches, an historical and political model, as opposed to a purely economic model, of national corporate governance systems is emphasized in the Chinese context, due to its strong relevance to China's ongoing corporate governance reform. In the meantime, the implications of the legal and institutional perspectives on corporate governance for China's corporate governance reform are also discussed.

Section IV proceeds to address the issue of corporate governance reforms and failures in transition economies, taking Russian privatization and its discontents as a major example. As Section IV shows, while there have been some positive results, the primary consequences of privatization and corporate governance reforms in Central and Eastern European transition economies are largely disappointing, as exemplified by various privatization and securities market failures across the region of the former Soviet bloc, in particular Russia and the Czech Republic.

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Section V depicts ongoing movements of international convergence of corporate governance, and also assesses the implications of the academic debate over which model should be, or already is, leading the direction of convergence for future corporate governance reforms in transition economies, especially in China. The conclusion of Section V regarding corporate governance convergence is two-fold. On the one hand, it may be necessary to reach a certain level of global convergence on widely accepted fundamental principles of corporate governance, such as the accountability of the board of directors, investor protection and equal treatment of shareholders. On the other hand, it is still far from clear whether there exists an "optimal model" of corporate governance, and there is hardly a "one-size-fits-all" solution to corporate governance reforms in transition economies.

Accordingly, Section V suggests that for an economy in transition like China, an appropriate approach toward corporate governance reform needs to avoid a tendency of "blind convergence" without first accommodating with distinctive domestic needs and conditions. Therefore, on the one hand, China should taking into account internationally-accepted standards and guidelines when undertaking corporate governance reform, in particular those spelled out in the *OECD Corporate Governance Principles*. On the other hand, local solutions that may not be in conformity with "global best practices," but nevertheless correspond to the existing economic, political and institutional environments during the transition, should be encouraged. By adopting such a gradualist strategy, China can avoid an "institutional vacuum" during transition, in which old institutions are completely destroyed or overhauled but new institutions have not yet been established.

Section VI concludes with the lessons that China should learn from the international experience in corporate governance reforms.

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Section I

New Waves of Global Corporate Governance Reforms and New Trends in Contemporary Corporate Governance Research

Section I reviews the new waves of global corporate governance reforms, particularly in the wake of a series of corporate scandals in both the United States and Europe. Section I also points out the shift of focus in contemporary corporate governance research from an organizational perspective to legal and institutional perspectives.

1. The reasons for the growing interest in international corporate governance research

In recent years, corporate governance has attracted increasing public attention in both developed and developing countries. A subject of intense interest in both business and academic circles, corporate governance has stimulated an explosion of international debate over the last two decades.[89] In particular, legal academics and economists, equipped with sophisticated analytical tools due to advances in inter-disciplinary research, have been extensively involved in corporate governance studies and produced some seminal contributions to the theory of the firm, institutional economics and financial economics. Given its prominence today as an important research frontier with profound implications for real economies, corporate governance has not been wanting for vigorous intellectual investigation.

There are several major reasons why corporate governance has become a prominent topic in the past two decades, including the following: (1) the worldwide wave of privatization

[89] The first attempt at academic inquiry into "corporate governance" issues can be traced back to the 1980s. As early as 1982, the American Law Institute started to launch its Corporate Governance Project and published a draft "Principles of Corporate Governance and Structure: Restatement and Recommendations" for comments. In 1984, Oliver Williamson, a leading scholar in the New Institutional Economics (NIE) school, published an article on corporate governance in the Yale Law Journal, proposing a law and economics perspective on corporate governance structure, and arguing for a contractual approach toward the understanding of corporate control. See Oliver Williamson, "Corporate Governance" (1984) 93 Yale L.J. 1197 [Williamson].

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of the past two decades, which has been dramatic in Western Europe, Latin America, Asia and Central and East Europe; (2) pension fund reform and the rise of active institutional investors in major industrialized countries; (3) the rapid growth in direct and indirect (through mutual funds) equity ownership by individuals, especially in North America; (4) the takeover wave in the United States in the 1980s and 1990s and in Europe in the 1990s, together with a new round of cross-border merger transactions over the past few years on both sides of the Atlantic; (5) deregulation on, and the integration of, capital markets worldwide; (6) the eruption of a series of financial crises in Russia, East Asia and Latin America in 1997-98, which have intensified the discussion of corporate governance in emerging markets; and (7) the exposure of recent corporate governance failures in both the United States and the EU.[90]

2. Corporate governance and the changing political economy of the world

The context for corporate governance discourse in the 21st century is changing. Today, the trend of economic globalization has become increasingly strong, with its consequences for the internationalization of industrial production, the integration of global capital markets, and the contagious nature of financial crises. As the domestic business environments in many countries have to various degrees undergone adjustments or transformations in response to the impact of globalization on their national economies, the challenge faced by indigenous firms to adapt to a new pattern of the world's political economy in order to compete and survive has become urgent. As a result, corporate governance is now being addressed with unprecedented intensity in public discourse not only in highly developed market economies, where, unfortunately, a series of corporate scandals on both sides of the Atlantic has been exposed over the last few years, but also in developing and transition economies that are looking for a better road to economic growth and markets.

[90] See Macro Becht, Patrick Bolton & Ailsa Roell, "Corporate Governance and Control" (2002) ECGI Working Paper, No. 02/2002, at 10-14.

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The changing political economy of the contemporary world has inspired new perspectives on the current thinking on development, which has started to incorporate the dimension of institutional diversity and innovation in searching for better development strategies. China can serve as an example to illustrate the merits of institutional innovation during its transition from a command economy to a market economy with respect to enterprise and corporate governance reforms, such as allowing local government ownership and control in the township and village enterprises (TVEs) as a second-best solution to the agency problem in local firms at an early stage of economic reform.

Accordingly, the primary task of corporate governance research in an era of globalization and post-communist transition is to provide theoretical explanations and empirical testing of the effectiveness of alternative institutional arrangements and organizational structures adopted by business enterprises in both public and private sectors across nations. At the center of this task is a straightforward question: which model of corporate governance system can better serve a firm to achieve long-term growth and competitiveness in a rapidly integrating world? Certainly, this is a critical issue of interest not only to business people who naturally have a high stake in running their firms successfully, but to national governments as well, as they compete for international investment and try to build or reinvigorate national economic strength. Broadly speaking, the global race for institutional excellence in relation to better economic performance has made corporate governance a focal issue in domestic reforms of all countries wishing to develop.

3. Recent corporate governance failures in the West and new waves of global corporate governance reforms

Good corporate governance seems to be a precious commodity today, hard to acquire but easy to break. Recent high-profile corporate governance failures in both the United States and Europe, involving firms such as Enron and Parmalat, have put degraded business

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ethics, excessive executive greed and gatekeepers' malpractice on display, thus triggering a new round of corporate governance reforms in both the United States and Europe.

A. Recent corporate governance failures in the West

The dramatic fall of Enron in December 2001 and the financial disaster which erupted in July 2003 at Italy's Parmalat, one of the world's largest dairy firms, representing two of the most spectacular corporate failures in recent years in the United States and Europe respectively. Other high-profile corporate scandals on both sides of the Atlantic include the collapse of WorldCom in June 2002, executive trials connected with financial fraud at Tyco, Credit Suisse First Boston and Credit Lyonnais in 2003, and the exposure of accounting problems in February 2003 at Royal Ahold, a Dutch company and the world's third-largest food retailer. Ahold was later labeled "Europe's Enron".[91]

In Germany, the controversy over the hostile takeover in February 2000 of Mannesmann, a German conglomerate, by Vodafone, a British mobile-phone manufacturer, has led to a criminal charge in 2003 against Josef Ackermann, the CEO of Deutsche Bank, and five other individuals for breach of trust while sitting on Mannesmann's supervisory board.[92] Recently, Royal Dutch/Shell, one of the world's largest oil companies, has been accused of "recklessly violating accounting rules and guidelines," which resulted in an "enormous and shocking overstatement of oil and gas reserves" and has been followed by a number of shareholder class-action lawsuits.[93]

The most recent corporate scandal in North America is the Hollinger scandal: Starting from July 2003, a special committee at Hollinger International, a newspaper firm whose headquarters are in Chicago, had been working for 14 months on a report about how Conrad Black, its majority shareholder, allegedly looted the company. The result was a report titled "The Hollinger Chronicles" which were released in September 2004 and "are

[91] See "The Rise and Fall of Parma's First Family" *The New York Times* (11 January 2004); "Ahold: Europe's Enron" *The Economist* (27 February 2003).
[92] See "German's Fat Cats on Trial" *The Economist* (27 September 2003) 68.
[93] See "Royal Dutch/Shell: Another Enron?" *The Economist* (11 March 2004).

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as remarkable a tale of alleged excess as any in the history of joint-stock companies." As a result, shareholders have filed lawsuits against Hollinger International's directors for failing to fulfill their fiduciary duties.[94]

B. New waves of corporate governance reforms around the world

Following public outcry over Enron, WorldCom and other corporate accounting scandals, the United States quickly– even "hastily" according to critics– enacted the Sarbanes-Oxley Act of 2002 (the "SOX") to clean up the American corporate sector, a remarkable move that was claimed to be "one of the most far-reaching reforms of American business practices since the time of FDR."[95] The SOX, however, is considered by many as an "ill conceived" piece of legislation driven largely by political imperatives rather than economic considerations and has been under sharp criticism from both academics and practitioners.[96]

Within the European Union, new initiatives in corporate governance reform aimed at providing investors with stronger protection have also been introduced by several member states, such as Germany, France, Italy and the UK. These measures are widely regarded as both an immediate reaction to recent corporate governance failures in Europe, and a coordinated effort within the EU to push forward the ongoing movement of global harmonization of corporate governance principles. Calls for closer convergence of national corporate governance practices have become increasingly strong within the EU, where its member states' divergent codes of corporate governance are considered "an obstacle to the creation of a single capital market."[97]

Moreover, in order to strengthen its business sector to meet the challenge of globalization, Japan has also experienced a "sea change decade" of corporate law reform in the past ten

[94] See "The Chronicles of Greed" *The Economist* (2 September 2004).
[95] Elisabeth Bumiller, "Bush Signs Bill Aimed at Fraud in Corporations" *The New York Times* (31 July 2002) A2.
[96] For an excellent critique of recent corporate governance reform in the United States, see Roberto Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance", ECGI (European Corporate Governance Institute), Finance Working Paper, No. 52/2004.
[97] "Special Report: Europe's Corporate Governance" *The Economist* (17 January 2004) 61.

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years. According to some observers, as a result of massive legal change in Japan, a formal institutional framework conducive to good corporate governance is now in place, which has reduced the transaction costs of basic corporate activities, such as mergers and acquisitions. However, Japanese corporate governance reform is still incomplete, as other complementary institutions outside formal corporate law are yet to be developed in the Japanese corporate sector. Of these complementary institutions, the most needed are managerial incentive structures, active institutional investors, and a flexible labor regime further divorced from the "lifetime employment" practice.[98]

More recently, there has been a program of "choice-driven" corporate governance reform in Japan since April 2003 that allows big Japanese firms to switch from "Japanese boards" identified with statutory audits to "American boards" characterized by a committee structure.[99] As my later discussion in Section V on convergence in corporate governance indicates, because this reform lacks the complementary institutions that enhance the functionality of the committee system in the United States, in particular judicial review of directorial independence that serves as a crucial complement to the committee structure, its degree of effectiveness is as yet unclear.[100]

While the world's major developed market economies have been active in reviewing their corporate governance systems and reshaping (for some, thoroughly overhauling) their corporate sectors, transition economies in the former Soviet bloc have also experienced corporate governance reforms both during and after mass privatization. However, largely because legal and institutional reforms have not received adequate attention while privatization claimed policy priority, these countries have encountered an array of serious challenges and disappointments in their corporate governance reforms. For example,

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[98] Curtis J. Milhaupt, "A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why" (2003) Chapter prepared for Magnus Blomstrom & Sumner La Croix eds., *Institutional Change in Japan: Why It Happens, Why It Doesn't* (New York: Oxford University Press, 2004) at 31-32.

[99] See Ronald J. Gilson & Curtis J. Milhaupt, "Choice as Regulatory Reform: The Case of Japanese Corporate Governance" (2005) (Paper presented at the Law and Economics Workshop at the University of Toronto Faculty of Law, No. WS 2004-2005 (1) at 14) [unpublished, archived at the University of Toronto Faculty of Law Bora Laskin Library] [Gilson & Milhaupt].

[100] *Ibid.* at 37.

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Russia's mass and rapid privatization has not resulted in a vibrant and competitive private sector, partly because corporate governance institutions that would prevent or reduce self-dealing and asset stripping in Russian privatized firms are weak or simply non-existent.[101]

Finally, China, one of the star performers among emerging markets for the last two decades, has accelerated its enterprise and corporate governance reforms through corporatization and partial privatization (or "ownership diversification" in the Chinese terminology) since the mid-1990s, with the ultimate goal of establishing a "modern enterprise system" in China. China has seen some improvements in this aspect, especially after its accession to the World Trade Organization (WTO) in 2001 that opened a wider window of competition from abroad. However, because of the insistence on maintaining state ownership by the government in the ongoing enterprise reform, China's inefficient SOE sector still remains a huge burden on the national economy. Recently, discussions about a new approach to corporate governance reform, which would emphasize large reductions of state control and ownership concentration and encourage broader participation by private and foreign investors in the restructuring of state enterprises, have become intense within China's policy-making circles.

4. The central debate in contemporary corporate governance research

The current waves of corporate governance reforms across the globe offer new opportunities for international research on corporate governance to yield new insights into the relationship between institutional quality and development outcomes.

According to some scholars, comparative corporate governance research is currently in its "second generation." The first generation of research on comparative corporate governance had mainly focused on the examination of individual governance mechanisms– particularly board composition and equity ownership– in individual

[101] Black, Kraakman & Tarassova, *supra* note 78.

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countries. In other words, corporate governance research at this stage had generally employed an "organizational perspective" at the firm level while the role of comparative studies across nations was not yet prominent.

The second generation of research, by comparison, tends to emphasize the possible impact of differing legal systems and institutional environments on the structure and effectiveness of corporate governance regimes and compare systems across countries. Accordingly, corporate governance research at this stage has made prominent the institutional and comparative perspectives. The focus of corporate governance debates has thus shifted from organizational and national studies to legal and institutional analyses and cross-country comparisons. At the center of the ongoing corporate governance debate are two issues: (1) the role of mandatory laws and regulations in protecting investors' rights and promoting capital market development; and (2) the prospects for international convergence of national corporate governance systems toward shareholder primacy. Both issues are discussed in Section III and Section V respectively.

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Section II

Corporate Governance and the Broad Governance Theory: the Challenge from China

Section II distinguishes two concepts— corporate governance and general governance measured by six aggregate indicators in the World Bank global governance data bank. Interestingly, while corporate governance research has achieved remarkable advances in recent years, it has not received adequate attention from the emerging governance theory developed by some economists from the NIE school who currently run the global governance and anti-corruption program at the World Bank.[102]

By critically reviewing its analytical framework and possible methodological flaws, Section II points out the challenge to the broad governance theory posed by China's transition experience. It is suggested that one possible reason why the broad governance theory seems relatively inadequate in explaining China's growth may be that it has not incorporated some important private sector institutions, such as corporate governance institutions, in constructing six aggregate governance indicators. Suggestions for refining the analytical framework of the broad governance theory are provided.

1. The main theses of the broad governance theory and critiques

The broad governance theory mainly concerns two issues: (1) whether there is a correlation between governance quality measured by a set of institutional indicators and economic growth measured by per capita incomes; and (2) if there is such a correlation, which way the causality between governance and growth runs.

[102] Led by Daniel Kaufmann, the World Bank global governance research team has contributed a rich volume of studies on the broad governance theory. Their working papers can be found at the World Bank website: < http://www.worldbank.org/wbi/governance/pubs.html>. Some important papers are cited in the following footnotes.

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As to the first half of the inquiry, a general conclusion reached by the broad governance theory claims a strong correlation between better governance and better development outcomes, which is summarized as the "governance matters" thesis.[103] The reverse question of whether higher incomes lead to improved governance, however, has been subject to more contentious debates. Economists in the NIE camp observe an absence of such a causal link in some emerging markets in Latin America, East Asia and post-communist transition economies and accordingly theorize about a "growth without governance" thesis. They point out that in these countries, there does not exist an automatic "virtuous cycle" where higher incomes are translated into improved governance.[104]

According to the "growth without governance" thesis, the major reason for the poor quality of governance in many emerging and transition economies is that the private sector in these countries plays an important role in shaping public institutions through pernicious "elite influence" or "state capture" for the purpose of preserving private monopoly rents and vested interests, thus causing a "governance reform gap" or "governance deficit."[105] Despite this identified problem, growth has nonetheless occurred because of sound macro-economic policies in containing inflationary pressures, attracting FDI flows, strengthening infrastructure as well as the improved quality of macroeconomic management in many emerging and transition economies in the 1990s.[106]

On the point that incomes have negative or no feedback on institutions, other economists disagree. According to the critics, the finding that higher incomes lead to worse

[103] Daniel Kaufmann, Aart Kraay & Pablo Zoido-Lobaton, "Governance Matters" (1999) World Bank Policy Research Working Paper No. 2196 [Kaufmann *et al.* 1999]. This paper can be downloaded from: http://www.worldbank.org/wbi/governance/pdf/govmatrs.pdf.

[104] Daniel Kaufmann & Aart Kraay, "Governance and Growth: Causality Which Way? – Evidence for the World, in Brief" (2003) World Bank [Kaufmann & Kraay 2003]. This paper can be downloaded from: http://www.worldbank.org/wbi/governance/pdf/growthgov_synth.pdf.

[105] Daniel Kaufmann & Aart Kraay, "Growth without Governance" (2002) Fall 2002 Economia 169-229 [Kaufmann & Kraay 2002]; Daniel Kaufmann, "Rethinking Governance: Empirical Lessons Challenge Orthodoxy" (2003) The World Bank Research Working Paper, discussion draft, March 11th, 2003 [Kaufmann 2003]; Kaufmann & Kraay 2003; Daniel Kaufmann, "Governance Redux: The Empirical Challenge", in *Global Competitiveness Report 2003-2004* (World Economic Forum, 2004), Part 2.5, 137-164 [Kaufmann 2004].

[106] Kaufmann & Kraay 2003, *supra* note 104; Daniel Kaufmann, "Governance Redux: The Empirical Challenge", in Kaufmann 2004, *ibid.*

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governance not only defies history, but also gives precedence to the math over common sense.[107] They point out that because the analytical instruments and empirical data used to support the "growth without governance" thesis have defects, the conclusion on the unusual "negative feedback" of incomes on governance cannot stand.[108] Most crucially, the central explanation for "growth without governance" in transition economies is also questioned and regarded as not compelling. Except "state capture," the critics suggest other possible channels through which the negative influence of incomes on institutions can take place, such as demographic changes, urbanization and a greater diversification of economic activities led by income increases. Following this line of reasoning, these other channels, not necessarily "state capture," may render some of the former institutions unsustainable.[109]

2. Private sector institutions: missing in the broad governance theory

There may be several reasons for the broad governance theory's difficulty in refuting these criticisms, which relate to its basic premises, analytical instruments and methods of data selection. One possible reason for these potential weaknesses may be associated with its omission of private sector institutions in constructing the aggregate indicators of governance quality. According to the definition of "governance" adopted by the broad governance theory, it is clear that it does not explicitly exclude private sector institutions as an inherent aspect of "governance" in a given country. The definition of governance in the broad governance theory refers to "the traditions and institutions by which authority in a country is exercised,"[110] which can be thought as including those governing the activities in the private sector, such as corporate governance institutions. "Authority" in this context can also refer to the power and influence exercised by the corporate sector in many countries.

[107] Lant Pritchett, comments on Daniel Kaufmann & Aart Kraay, "Growth without Governance" (2002) Fall 2002 Economia, at 225-226.
[108] Eduardo Lora, comments on Daniel Kaufmann & Aart Kraay, "Growth without Governance" (2002) Fall 2002 Economia, at 217-221.
[109] Eduardo Lora, *ibid.* at 221.
[110] See Kaufmann *et al.* 1999, *supra* note 103, at 1.

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However, despite its apparent affinity to the broad governance theory, at least rhetorically, *corporate* governance has not featured prominently in the discussion of the relationship between governance and growth by the World Bank's global governance research team led by Daniel Kaufmann, the chief contributor to the broad governance theory.[111] In constructing the aggregate governance indicators, the broad governance theory seems to focus narrowly on public sector institutions, such as voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law and control of corruption.[112] Private sector institutions, such as corporate governance and property rights regimes, have been largely ignored.

3. The challenge from China

This omission may have potentially hindered the ability of the otherwise powerful governance theory to explain an obvious deviation from its general finding that better governance leads to better development outcomes– specifically, China. China's rise as one of the world's fastest growing economies despite its low scores on almost all aggregate indicators in the World Bank's global governance surveys is an embarrassment to the broad governance theory.

China is a hugely successful story of development over the past 20 years, where real GDP per capita increased five times since 1981 and the number of extremely poor fell from over 600 million to 200 million. According to a recent report released by the IMF on the world economic outlook, China's GDP has grown at an average annual rate of over 9 percent while its share of world trade has risen from less than 1 percent to almost 6 percent. As a result, China is now the sixth-largest economy (at market exchange rates)

[111] Although the global governance program at the World Bank has not put corporate governance at the center of its research agenda except making a scant mention of "corporate ethics" and "corporate social responsibility (CSR)" at its website, the Bank has nevertheless directed a significant amount of resources to corporate governance research initiatives in both its "Finance" and "Private Sector" programs.
[112] Kaufmann *et al.* 1999, *supra* note 103.

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and the fourth-largest trader in the world.[113] In addition, China is also currently the largest recipient of foreign direct investment (FDI) among developing countries. This leading status will likely be maintained as the latest UNSTAD (United Nations Conference on Trade and Development) survey of international investment advisors confirms that China is the most attractive destination for business opportunities and FDI flows in Asia.[114] As to the sustainability of China's economic expansion, the IMF offered an optimistic prediction that as the necessary structural reforms (including in the financial and enterprise sectors, labor markets, and social safety nets) are implemented, China will continue to grow at a rapid rate of 6-9 percent a year and its impact on the rest of the world will be deep.[115]

Such remarkable economic success, however, cannot be explained by the broad governance theory, which is aimed at exploring the very dynamics of development. Judged by the World Bank's measurement of global governance, which is the empirical basis for the broad governance theory, China's vigorous economic expansion has not been associated with improved institutional quality. In a series of governance surveys conducted by the World Bank since 1996, on virtually all features of public sector institutions regarded as critical components of good governance, China has consistently scored low, to the extent that it falls considerably below the world's average level of competent governance.

For example, according to a recent report by the World Bank that measures the quality of governance in 199 countries during the periods of 1996, 1998, 2000 and 2002, China can hardly be categorized as a "well-governed" country with its below-average scores on all of the six aggregate indicators.[116] The range of countries' estimated governance scores is between -2.5 and +2.5 (the higher the scores, the better the quality of governance). Of the six aggregate governance indicators, throughout the periods of 1996, 1998, 2000 and

[113] IMF, *World Economic Outlook 2004: Advancing Structural Reforms* (IMF, 2004) 82 [IMF].
[114] UNSTAD, "Prospects for FDI Flows, Transnational Corporation Strategies and Promotion Policies: 2004-2007", April 27, 2004 [UNSTAD].
[115] IMF, *supra* note 113, at 82.
[116] Kaufmann, Aart Kraay & Massimo Mastruzzi, "Governance Matters III: Governance Indicators for 1996-2002" (2003) World Bank, Appendix. This paper can be downloaded from: http://www.worldbank.org/wbi/governance/pdf/govmatters3.pdf.

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2002 China scored below 0 on "voice and accountability," "regulatory quality," "rule of law" and "control of corruption," and below 0.3 on "political stability" and "government effectiveness." If the numbers are to be taken seriously, this is certainly perplexing if one tries to reconcile this "China anomaly" with the broad governance theory.

4. Explaining China's growth: implications for the broad governance theory

Broadly speaking, three alternative explanations may be offered to address this challenge posed by China to the broad governance theory.

A. "Growth without governance"

Still within the analytical framework of the broad governance theory, the first explanation could be that China has also fallen into the trap of "growth without governance" as widely observed with other transition economies in the former Soviet bloc. However, since the phenomena of pervasive "state capture" and "elite influence" are not to be found in China where the Communist Party has unchallenged ruling power and private businesses do not have significant political influence over the establishment and development of public institutions, it is unlikely that the private sector in China has a blocking ability to cause a "governance reform gap." Therefore, the underlying premises of the "growth without governance" thesis, which may largely apply to other transition economies, do not fit well with the Chinese context.

B. "Unsustainable growth"

The second explanation also follows the main theses of the broad governance theory but is stated in an extended version of "governance matters." It could be argued that although China has been growing fast, the quality of China's growth is low due to its poor governance quality and cannot be sustained. Once the negative impact of its "governance deficit" on growth has increasingly intensified and the driving engines of its growth, such

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as capital accumulation and low labor costs, have been exhausted, China will cease to grow. In fact, there has been a remarkable prediction of the "coming collapse of China" which has spurred widespread controversies.[117]

If it adds anything to the ongoing debate over China's growth prospects, influential international organizations that are routinely charged with the task of promoting development and are highly sophisticated in statistical assessment and evaluation (thus more objective in factual analysis), seem to speak favorably about China, especially in the light of China's growth over the last several years. For example, the IMF predicts that China's GDP will continue to grow in 2004 at the annual rate of 6-9 percent; the World Bank praises China's achievement in large poverty reduction; the UNSTAD reports that China is the most attractive destination for international investors in Asia.[118] Of the policy recommendations and country assessments provided to China by these international organizations, "unsustainable growth" has not been a frequently mentioned country risk, while China's other structural weaknesses, such as those in its enterprise and banking sectors, have been repeatedly pointed out as a bottleneck to future growth. As enterprise and banking reforms are now being implemented in China, the danger of "unsustainable growth" seems more distant.

The favorable assessment of China's growth prospects on the one hand, and cautious warnings about the structural weaknesses in its state enterprise and banking sectors on the other, indicates that sustainable growth cannot occur unless the quality of private sector institutions is improved.

C. "Other causes of growth"

Finally, the third, and perhaps most plausible explanation for the challenge posed by China to the broad governance theory is that without denying the impact of public sector

[117] See for example, Gordon G. Chang, *The Coming Collapse of China* (Random House, 2001) (predicting China's collapse in 5 years, a judgment that has recently been amended by the author to a new version of "the coming collapse of China, perhaps?" in light of China's recent strong economic performance); idem, "Collapse Perhaps?: The Stability of the Modern Chinese State", unpublished draft paper, March 27, 2004.
[118] IMF, *supra* note 113, at 82; UNSTAD, *supra* note 114.

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institutions on development outcomes, China's growth has other causes that are not noted by the broad governance theory. These other causes for growth are closely associated with the following two factors: (1) the responsiveness of economic policies to the existing economic, political and institutional constraints, and (2) the effectiveness of *some* private sector institutions in discovering sub-optimal, yet effective, solutions to institutional constraints on development, such as the transitional corporate governance mechanisms adopted at the early stage of China's transition in the TVE sector. Both of these factors are not adequately captured by the broad governance theory, which may to some extent explain its relatively inadequate explanatory power when applied to China.[119]

In addition, the key governance indicators selected by the broad governance theory do not include an important variable that is critical to China's growth– federalism arrangements. This omission is perhaps significant because political scientists and economists have discovered that different federalism arrangements can lead to opposite incentive structures at both the central and local levels of governments, resulting in different outcomes in economic performance. China's "market-preserving" federalism identified with fiscal decentralization is regarded as conducive to market reform and economic growth.[120]

Therefore, it can be argued that despite the poor quality of those public sector institutions that are selected as key indicators of governance by the broad governance theory, China's reform policies and *some* of its private sector institutions (such as corporate governance mechanisms adopted by Chinese non-state enterprises), together with *some* public sector

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[119] It is fair to say that the broad governance theory does raise the issue of the role played by macroeconomic policies in promoting growth, see Kaufmann 2004. However, the main point made about economic policies in this context is that although favorable economic performance can be achieved through sensible policy despite poor governance, the governance reform gap in developing and transition economies can impose serious political constraints on economic growth which cannot be compensated by the soundness of economic policy. Therefore, the analytical framework of the broad governance theory, though under "rethinking," is kept intact to the extent that it continues to ignore the dimensions of private sector institutions.

[120] Hehui Jin, Yingyi Qian & Barry R. Weingast, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style" (2001) Working Paper, Center for Research on Economic Development and Policy Reform at Stanford University, at 36-37.

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institutions (such as federalism arrangements) not captured by the broad governance theory, have played a largely positive role in promoting growth. These factors may have significantly compensated for the negative impact of the "governance deficit" in China's public sector.

In terms of economic policies, China's "competition first, privatization second" approach (or the "dual-track" strategy, "gradualism," "experimentalism," "partial reform") toward the transition to a market economy has been praised by many economists as sensible and attentive to the sequencing and pacing of reform. Because the "shock therapy" transition strategy has not produced fruitful economic results in Russia and some other Eastern European countries, the approach of adopting mass and rapid privatization in an institutional vacuum has been criticized as "bad" economic policy.[121] Moreover, as one of the least protected of all developing countries, China's openness to trade and investment has also helped bring remarkable economic growth.

While it may be tempting to thoroughly review the long-standing debate over the alternative transition paths adopted by China and other post-communist states in the former Soviet bloc to bring more insights into the broad governance theory, in the present context the most relevant issue is the different strategies for enterprise and corporate governance reforms selected by China and other transition economies. Ownership regimes and corporate governance systems are important private sector institutions because they have a significant impact on a country's economic performance. The channels through which the private sector institutions affect a country's development outcomes are complex, especially in post-communist transition economies where nascent market mechanisms are being newly established and institutional capital is inadequate and in an urgent need of development.

There is another critical point regarding the third explanation for China's growth. To be sure, the fact that there are other factors than the quality of public sector institutions that have been driving China's growth does **not** lead to the following two conclusions: (1) the

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[121] Stiglitz, *supra* note 13.

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quality of public sector institutions is not important for China's economic growth and therefore does not need to be improved; and (2) the quality of private sector institutions in China, such as the corporate governance system and property rights regime, is generally "good" in the sense that these institutions conform to market basics. In fact, the primary reason for accelerating enterprise and corporate governance reforms in China since the middle of the 1990s is because China's SOE sector is inefficient and imposes a large burden on the national economy. The governance structure of China's SOEs certainly has many problems that cause not only significant "agency costs," but also "political costs." As widely recognized within China, the bottleneck of China's economic reform is the structural reforms in its enterprise and banking sectors. Since both sectors are closely related, their problems must be addressed in combination. Clearly, "structural weaknesses" naturally translate into "governance deficit" in China's private sector.

In searching for a full answer as to what has contributed to China's growth, one should look to the non-state sector.[122] The most dynamic driving force behind China's growth is the non-state sector, which is mainly made up of collectively-owned enterprises (especially rural township and village enterprises, or TVEs), foreign-invested enterprises, and private enterprises. While the state sector has suffered from persistent inefficiency, which is partly caused by the poor quality of China's legal system and market institutions and partly a result of the ownership and control structure of Chinese SOEs, there exist effective alternative financing channels and governance mechanisms in the non-state sector, such as those based on reputation and relationships, to foster growth.[123] In-depth analysis of corporate governance issues relating to Chinese SOEs and TVEs is presented in Chapters 4 and 5.

[122] According to the IMF, the determinants of China's growth include savings, investment (both domestic and international), human capital, and sectoral reallocation during the periods of China's rapid integration into the world economy. The main engines of China's annual growth at 9 percent were sustained rates of capital accumulation and strong productivity growth. See IMF, *supra* note 113, at 82 and 88.
[123] Franklin Allen, Jun Qian, & Meijun Qian, "Law, Finance, and Economic Growth in China" (2004) Wharton Financial Institutions Center, Working Paper No. 02-44 [Allen, Qian & Qian 2004], at 3.

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5. Summary

The broad governance theory has made remarkable contributions to our understanding of the relationship between countries' institutional quality and development outcomes. However, it encounters difficulties in explaining China's growth. A likely reason is that while the broad governance theory is established on a strong empirical basis, its analytical framework, particularly the method of constructing key governance indicators, may have flaws in the sense that only public sector institutions are included while private sector institutions are largely ignored.

Therefore, the broad governance theory may need to be refined to incorporate dimensions of private sector institutions, such as corporate governance mechanisms when applied to the Chinese context. Although China's growth has been driven by multiple causes that combine the impact of economic policies, some private sector institutions and some public sector institutions, the role played by certain transitional (nevertheless efficient) corporate governance mechanisms at the early stage of development as second-best solutions to institutional constraints, is a significant factor. The general lesson is that the "governance matters" thesis is still valid with respect to China's transition experience, but "governance" in this context refers to the institutional quality of **both public and private sectors.** Therefore, an extension of the "governance matters" thesis is "corporate governance matters."

Moreover, with regard to the relationship between public sector institutions and private sector institutions, it is important to point out that while they each have different functions, private sector institutions cannot substitute for public sector institutions in respect of the enforcement of law and regulation by public actors, such as courts, regulators and governmental agencies. In particular, mandatory enforcement of law and regulation is necessary for protecting property rights and investors' rights where these rights are violated by private actors, as well as for enforcing contracts where private parties breach, or do not voluntarily honor, their contractual obligations. The example of corporate governance institutions can well demonstrate this point. In terms of the main

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parties that adopt corporate governance institutions, corporate governance primarily concerns private sector actors, i.e., corporations and business organizations. However, in terms of specific means and methods, corporate governance consists of both formal/legal institutions and informal/private institutions, each with distinct functions that cannot substitute for each other.[124]

Private corporate governance institutions are generally informal arrangements and mechanisms, in the sense that they are not mandated by law. Major private/informal corporate governance institutions include boards of directors, independent directors, managerial incentive compensations, markets for corporate control, markets for managerial talents, and product markets. By comparison, legal/formal corporate governance institutions are primarily aimed at effectively enforcing legal rules and regulations, such as punishment and sanctions for corporate fraud and infringements of shareholder rights by courts or securities regulators. Private/informal institutions cannot substitute for formal/legal institutions— such as an independent judiciary and competent regulators— in enforcing contractual obligations and implementing mandatory rules and regulations to protect investors and other stakeholders.

[124] World Bank, *World Development Report 2002: Building Institutions for Markets* (Oxford University Press, 2002) [World Bank 2002].

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Section III

Alternative Approaches to Corporate Governance

1. Definitions of corporate governance

Before discussing alternative approaches to corporate governance, it is necessary to introduce a definition first. There are various definitions of corporate governance. The relatively narrow definition regards corporate governance as dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.[125] Broader definitions extend the scope of corporate constituencies to include stakeholders other than capital investors, such as employees, customers, suppliers, the community within which the corporation operates, and national governments. These broader definitions are generally described as taking a "stakeholder approach" to corporate governance.

Early discussions about protecting stakeholders' interests mainly derived from emerging public concern over the relatively weak contracting position of corporate constituencies in the face of the increasingly effective control of management over large public corporations in the US/UK jurisdictions.[126] Later propositions for the stakeholder approach have been found more frequently in the Japanese and German contexts of corporate governance discourse, where employees' welfare and representative power are traditionally emphasized. However, recently there have been discussions about a possible shift of focus in the German corporate governance system toward the primacy of shareholder value as a result of globalization and international convergence of corporate governance principles. Moreover, the Corporate Social Responsibility (CSR) movement advocates the priority of advancing community welfare on corporate agendas. The CSR movement is the latest manifestation in the West of the stakeholder approach to corporate governance issues but has been subject to controversy.

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[125] Andrei Shleifer & Robert W. Vishny, "A Survey of Corporate Governance" (1997) 52:2 The Journal of Finance 737 [SV 1997].
[126] Williamson, *supra* note 89, at 1199-1200.

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The rationale of some scholars in adopting the broad "stakeholder approach" to defining corporate governance is the following argument: all actors who have an economic or financial stake in a firm, or are likely to be affected by the firm's actions should be considered relevant players in the corporate governance structure of the firm. According to these scholars, the purpose of corporate governance is to hold the balance between economic and social goals and between individual and communal goals. Other scholars disagree, arguing that the stakeholder approach is inherently flawed and should be firmly rejected because it blurs the boundary of managerial accountability, resulting in no effective accountability at all.[127]

Based on different definitions of corporate governance, scholars over the past two decades have proposed several approaches to the understanding of corporate governance structures, of which the most widely discussed are the following: (1) the economic model (agency/contracting model) of corporate governance, (2) political and historical determinants of corporate governance, (3) social and cultural factors influencing corporate governance, and (4) legal and institutional perspectives on corporate governance.

2. Alternative approaches to corporate governance

To present the conceptual basis of the global debate in comparative corporate governance research, Section III outlines several alternative approaches to the understanding of corporate governance systems that have been under contest over the last two decades. Of the alternative approaches, the historical and political model, as opposed to a purely economic model, of national corporate governance systems receives special attention due to its particular relevance in the Chinese context. In the meantime, the applicability of the legal and institutional model of corporate governance to China is also discussed.

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[127] Williamson, *ibid.*; Elaine Sternberg, "The Defects of Stakeholder Theory" (1997) 5:1 Corporate Governance 9.

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A. The economic model of corporate governance

The economic model of corporate governance, which was first developed by transaction cost economics within the law and economics disciplines, has primarily focused on advocating contractual solutions to the classical "agency problem" caused by the separation of ownership and control of modern public firms.[128]

(1) The primacy of contractual solutions to the agency problem

Despite the variety of opinions on the appropriate scope of constituencies to whom corporate managers should be accountable, the central idea under the economic model of corporate governance remains invariable: the primacy of private and contractual solutions to reducing agency costs and maximizing shareholder value. Major private and contractual arrangements suggested by scholars to address the agency problem include managerial ownership, the separation of decision and risk bearing functions among corporate organs, and the presence of a large minority shareholder.[129]

Under the economic model of corporate governance, there is no room for government intervention in private transactions between firms and their constituencies. It has been insisted by economists who follow the "Coase Theorem" that through the internal bonding and monitoring arrangements at the firm level (such as the board of directors, managerial incentive compensation and insider shareholdings) and the external control and discipline mechanisms at the market level (such as competition in product and capital markets, the managerial labor market and the market for corporate control), the agency

[128] The rise of the "agency problem" was first pointed out in Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Harcourt, Brace & World, 1968), who first noted the separation of ownership and control in public corporations. According to the authors, this separation dissolved the unity of private property, so no one "owned" the corporation anymore.
[129] See for example, Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 Journal of Financial Economics 305; Eugene F. Fama & Michael J. Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics; Randall Morck, Andrei Shleifer & Robert W. Vishny, "Management Ownership and Market Valuation: An Empirical Analysis" (1988) 20 Journal of Financial Economics 293; Andrei Shleifer & Robert W. Vishny, "Large Shareholders and Corporate Control" (1986) 94:3 The Journal of Political Economy 461.

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problem can be effectively addressed.[130] In other words, a contractual rather than a mandatory model of corporate governance is the optimal model for achieving economic efficiency. Markets, not law, should prevail in shaping the structure of corporate governance.[131]

(2) The marginal role of law

However, to insist on the primacy of contractual solutions to the agency problem does not mean that law's function should be ignored completely. Law still plays a marginal role where contracting parties fail to perceive all possible contingencies. According to the "corporation-as-contract" thesis proposed by some "Coasian" economists, while corporate governance arrangements are best left to private actors in corporate ventures to negotiate and select by contract, corporate law exists to provide a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.[132]

In response to criticisms that managers can use their informational advantage to select unfair or exploitative contractual terms detrimental to investors, the "Coasian" economists contend that contractual corporate governance devices are unlikely candidates for challenge as mistakes if they have survived in many firms for extended periods. Markets, they claim, rather than regulation, should be the ultimate judge of the merits of specific corporate governance arrangements. The message is clear:

> ...[U]nless there is a strong reason to believe that regulation has a "comparative advantage" over competition in markets in evaluating the effects of corporate contracts, there is no basis for displacing actual arrangements as "mistakes," "exploitation," and the like.[133]

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[130] Williamson, *supra* note 89, at 1202; Anup Agrawal & Charles R. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders" (1996) 31:3 Journal of Financial and Quantitative Analysis 377; Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991, 3rd Printing, 1996) [Easterbrook & Fischel].
[131] Frank H. Easterbrook, "International Corporate Differences: Markets or Law?" (1997) 9:4 Journal of Applied Corporate Finance 23.
[132] Easterbrook & Fischel, at 34.
[133] *Ibid.* at 31-32.

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Effectively, the economic model of corporate governance rejects corporate purposes other than maximizing shareholder value because the "Coasian" economists argue for an "enabling" corporate law which is designed out of economic consideration for corporate survival, not the objectives of "fairness" or paternalism.[134] Therefore, corporate law is regarded as having an "economic structure," that it increases the wealth of all corporate stakeholders by supplying the rules that investors would select if contracting were costless.[135]

(3) The challenge from transition economies

While this "Coasian" approach has attracted much criticism in the ongoing corporate governance debate, the most difficult challenge that it has encountered comes from transition economies. The problem is evident: given the symptoms of under-development in most post-communist states of legal and market institutions, such as the absence of an independent and non-corrupt judiciary, a sophisticated financial press, and effective mechanisms of contract enforcement and protection for property rights, the internal and external corporate governance mechanisms suggested by the "Coasian" economists are either weak or missing in these countries. Under such unfavorable circumstances, it is hard to reconcile the "Coasian" argument for an autonomous model of corporate governance with the gloomy reality of institutional deficits in most transition economies. Later discussion about privatization and corporate governance failures in transition economies, primarily Russia, will provide evidence of the difficulties of applying a purely economic model of corporate governance to underdeveloped institutional environments.

B. Political and historical determinants of corporate governance

Scholars critical of the purely economic model of corporate governance have suggested other determinants of corporate governance structures and corporate finance patterns.

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[134] *Ibid.* at vii.
[135] *Ibid.*

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(1) The political model of corporate governance

A particularly influential opinion is provided by Mark Roe, who argues for a political model of corporate governance. In two important books, the first published in 1994 and the second in 2003, Roe has convincingly presented his case against the "Coasian" explanation for corporate governance. He argues that economic determinants are not primary in shaping corporate governance patterns; instead, "path dependence" can largely explain particular corporate governance models in different countries. He discovered that historical and political factors are important to the evolution of corporate governance practices in major industrialized countries, such as the United States, the UK, Germany and Japan. [136] For example, the phenomenon of "strong managers, weak owners" observed in the US corporate governance structure is not a result of economic efficiency, but a consequence of the American politics during the progressive periods, which was hostile to concentrated ownership by financial institutions and confined the terrain on which the large American enterprise could evolve.[137]

Other critics of the economic model of corporate governance have expressed similar concerns. Some argue that, as to the question of whether there is a link between corporate governance and economic efficiency, a firm conclusion is difficult to draw. In order to understand how existing corporate governance mechanisms come to respond to a changing array of problems in a given economy, one needs to study the impact of history and politics in particular countries.[138]

While some authors have looked at the political model of corporate governance at a systemic level and from an international perspective, other authors have offered specific examples at the firm level found in individual industries in individual economies. For

[136] Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (Princeton University Press, 1994) [Roe 1994]; idem, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (New York: Oxford University Press, 2003).

[137] Roe 1994, *ibid.* at 283.

[138] Ronald J. Gilson, "Corporate Governance and Economic Efficiency: When Do Institutions Matter?" (1996) 74 Wash. U. L.Q. 327, at 345.

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example, empirical research on board size and composition in American firms has revealed that some outside directors play a "political role." A major finding is that "politically experienced directors" are more prevalent in firms where politics matters more, such as firms that sell to government. In many cases, lawyer-directors are more prevalent in firms where costs of environmental regulation are higher.[139] These politically appointed outside directors are not necessarily associated with value maximization of firms because they tend to increase corporate operating costs (such as those related to meeting higher environmental standards), or put political constraints on firm activities. On the contrary, some researchers have discovered either a negative effect or little effect of more outsiders on the board of directors on firm performance.[140] The political reasons for adding politicians, environmental activists, consumer representatives to the board are considered to be a major contributor to this negative feedback.[141]

(2) The relevance of political determinants of corporate governance for China

The political explanation for corporate governance is very compelling in the context of China's enterprise and corporate governance reforms because it can help explain a number of phenomena in China's transition process that might be considered as having "Chinese characteristics." For instance, maintaining a large inefficient state sector that consumes more than half of state bank loans and receives heavy government subsidies is certainly not a good way of achieving economic efficiency. For the pure economic purpose of maximizing value, there should be no state control and ownership concentration in many of China's shareholding companies.

The government's insistence on continuing state ownership in ongoing enterprise and corporate governance reforms can only be explained by political reasons, such as retaining the ability of the state to impose on firms aims other than value maximization (employment maintenance, or provision of social safety net services, for example). In addition, the Chinese government is very keen on producing state-owned "national

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[139] Agrawal & Knoeber 2001, *supra* note 3.
[140] See, for example, Black 2002, Bhagat & Black and Hermalin & Weisbach, *supra* note 3.
[141] Agrawal & Knoeber 1996, *supra* note 3 at 394.

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champions" that can have a strong international presence to show the advantages of "socialism with Chinese characteristics" (*zhongguo tese de shehuizhuyi*), which, if successful, would yield more ideological than economic premia. No doubt, the most important political reason for maintaining state ownership is to defend the Communist Party's ruling position under the current political regime. In giving up state ownership, the Party will virtually lose one of the most effective tools to control the process of resource allocation in Chinese society, which would pose serious challenges to the Chinese government whose authority and legitimacy increasingly rely on economic performance.

Another example of a political explanation for corporate governance patterns can be found in China's privatization experiment. One option for privatizing China's SOEs (including large ones) that has been studied by the Chinese government is to sell SOEs to both domestic and foreign private investors. The issue of who the preferred foreign private buyers would be is relevant to the discussion of political determinants of corporate governance. It is widely believed that wealthy ethnic Chinese in Hong Kong, Macau, Taiwan and other countries would make up a large portion of the potential "foreign" buyers. Because of these investors' Chinese origin, domestic opposition to the transfer of state assets (as compared to selling SOEs to westerners) is expected to be significantly reduced. This factor would certainly become a political (as well as cultural) facilitation for executing decentralized privatization at the next stage of China's enterprise reform because local governments usually welcome overseas ethnic Chinese businesspeople to participate in their local reform programs.

Finally, the argument for political determinants of corporate governance has one more supportive example: the bankruptcy regime in China. The logic under the economic model of corporate governance that markets automatically discipline inefficient firms does not apply to China's transition situation: inefficient firms do not exit the markets as quickly as they should because pervasive local protectionism allows many of them to stay in business long after they would have died in mature market economies. Local protectionism in China is largely a product of political considerations as local

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governments are concerned more about social unrest caused by massive unemployment than they are about economic efficiency. Hence the negligible annual rate of bankruptcy cases in China, which was no more than 0.05 percent of all enterprises in the 1990s.[142]

C. Social and cultural factors that influence corporate governance

From another perspective, a "social norms matter" thesis has been proposed to further challenge the validity of the economic model of corporate governance. Some scholars regard social norms as an important factor that influences the patterns of corporate governance practices. They argue that social norms matter for corporate governance because they can significantly affect market value and increase the stock price of listed firms. Social norms matter most when law is the weakest in a given economy.[143] Strictly speaking, this emphasis on the role of social norms in shaping corporate governance structure does not closely follow the line of reasoning under the political model of corporate governance, but it nevertheless draws upon a country's history and politics when accounting for the formation and evolution of social norms. Social norms, such as "culture," can constrain certain corporate behavior to make firms respond to the prevailing public opinion in a given society. For example, widespread outrage in the Unites States over executive pay constrains it from going even higher.[144]

Peculiar social and cultural factors that influence the shaping and maintenance of business ethics and norms in a given country can sometimes be difficult for outsiders to digest or appreciate. For example, despite corporate governance reform in the aftermath of the East Asian crisis, in today's Korean corporate sector characterized by the dominance of family-controlled *chaebols*, there still exist some controversial, even irrational corporate governance practices that are in stark conflict with generally accepted standards of corporate governance in the West, but deemed permissible by the domestic business community. This is acutely reflected in a protracted battle that has been

[142] Studwell, *supra* note 54.
[143] John C. Coffee, Jr., "Do Norms Matter? A Cross-Country Evaluation" (2001) 149 U. Pa. L. Rev. 2151 [Coffee 2001a].
[144] Mark J. Roe, "Can Culture Constrain the Economic Model of Corporate Law?" (2002) 69 U. Chi. L. Rev. 1251.

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unfolding dramatically between SK Corp., South Korea's largest oil refiner, and Sovereign Asset Management, SK's largest shareholder, over SK's returning chairman who was found guilty of taking part in a USD 1.2 billion accounting fraud at one of SK's affiliates and spent seven months in jail, before returning to his previous post at SK. Since South Korean law does not ban persons convicted of fraud from holding corporate posts, Sovereign's attempts over the course of a 20-month battle to oust this individual have not been successful and still awaits a court ruling.[145]

D. Legal and institutional perspectives on corporate governance

In recent years, a new round of corporate governance debate has been increasingly engaged in exploring the relationships between the following variables: (1) countries' legal origins, (2) the quality of institutions, (3) the effectiveness of corporate governance measured by levels of investor protection, (4) corporate finance patterns, (5) levels of financial development, and (6) economic growth. Specifically, two strands of literature on "law and finance" and "finance and growth" have developed a framework to analyze the complex nexus of correlations between these variables through cross-country empirical studies.

(1) The "law and finance" and "finance and growth" theories

(a) "Law and finance" theory

The "law and finance" theory employs legal and institutional perspectives on corporate governance. It predicts that historically determined differences in legal origin can explain cross-country differences in financial development observed today. Specifically, it is believed and supported by empirical evidence that countries with a common law tradition tend to provide stronger investor protection than countries with a French civil law tradition.

[145] See Francesco Guerrera & Song Jung-a, "Sovereign Moves to Oust SK Chairman" *Financial Times* (7 November 2004).

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With respect to the relationship between law and finance, researchers have discovered the following nexus of causal links: (1) legal origins strongly determine levels of investor protection; (2) corporate ownership structure is primarily a result of different levels of investor protection; (3) legal protection of investors, measured by both the character of legal rules and the quality of law enforcement, largely determines corporate finance patterns and levels of financial market development.[146] Consistently, scholars have found that French civil law countries have both the weakest investor protection and the least developed capital markets, especially when compared to common law countries. The primary reason suggested by scholars that civil law countries have weaker investor protection is because they have less effective courts than common law countries.[147]

While it is widely recognized that financial markets appear to improve the allocation of capital, some scholars have studied the relationship between the efficiency of capital allocation and legal protection of investors. They have found that the efficiency of capital allocation is positively correlated with the legal protection of minority investors.[148]

In addition to legal institutions, including legal rules and law enforcement mechanisms such as courts, scholars have also suggested other institutions that are considered conducive to financial market development. For example, less corrupt governments, more

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[146] Andrei Shleifer & Robert W. Vishny, "A Survey of Corporate Governance" (1997) 52:2 The Journal of Finance 737 [SV 1997]; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, "Legal Determinants of External Finance" (1997) 52:3 The Journal of Finance 1131 [LLSV 1997]; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, "Law and Finance" (1998) 106:6 The Journal of Political Economy 1113 [LLSV 1998]; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, "Agency Problems and Dividend Policies around the World" (2000) 55:1 The Journal of Finance 1-33 [LLSV 2000a]; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, "Investor Protection and Corporate Governance" (2000) 58 Journal of Financial Economics 3 [LLSV 2000b]; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, "Investor Protection and Corporate Valuation" (2002) LVII:3 The Journal of Finance 1147 [LLSV 2002]; Andrei Shleifer & Daniel Wolfenzon, "Investor Protection and Equity Markets" (2002) 66 Journal of Financial Economics 3-27; Thorsten Beck & Ross Levine, "Legal Institutions and Financial Development" (2003) NBER Working Paper, No. 10126 [Beck & Levine 2003].

[147] O. Emre Ergungor, "Market- *vs.* Bank-Based Financial Systems: Do Rights and Regulations Really Matter?" (2004) 28 Journal of Banking and Finance 2869-2887.

[148] Jeffrey Wurgler, "Financial Markets and the Allocation of Capital" (2000) 58 Journal of Financial Economics 187-214.

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efficient courts, and more informative accounting standards are regarded as important factors in promoting capital market development.[149]

Recently, there have been some attempts to modify the "law and finance" theory. For example, a recent study provided evidence for the law and finance theory that legal traditions brought by colonizers indeed differ in terms of protecting the rights of private investors vis-à-vis the state, and these differences have important implications for financial markets. However, the authors' support for the law and finance theory is qualified by controlling for endowments and other country characteristics, such as religious composition, ethnic diversity, and the fraction of years the country has been independent. Nevertheless, even after controlling for other country characteristics, a robust link is still found to exist between legal origin and stock market development. It was confirmed again that French civil law countries have significantly lower levels of stock market development than British common law countries.[150]

(b) "Finance and growth" theory

On the other hand, the "finance and growth" literature has sought to establish links between countries' financial development and economic growth. Cross-country studies have used various measures of the level of financial development to test its impact on economic growth. These measures include "financial depth" judged by the size of the formal financial intermediary sector, the relative importance of financial institutions, and financial asset distribution. Researchers have found that financial development is strongly associated with countries' economic performance as measured by several key indicators, such as per capita GDP growth, the rate of physical capital accumulation, and improvements in the efficiency of physical capital employment.[151]

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[149] LLSV 1998; LLSV 1999; Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "Courts" (2003) 118:2 Quarterly Journal of Economics 453-517.
[150] Thorsten Beck, Asli Demirgüç & Ross Levine, "Law, Endowments, and Finance" (2003) 70 Journal of Financial Economics 137-181, at 175.
[151] Robert G. King & Ross Levine, "Finance and Growth: Schumpeter Might be Right" (1993) 108:3 The Quarterly Journal of Economics 717-737; Ross Levine, "Financial Development and Economic Growth: Views and Agenda" (1997) 35:2 Journal of Economic Literature 688-726.

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In terms of the services provided by financial intermediaries for growth, it has been found that financial intermediaries exert a large, positive impact on total factor productivity (TFP) growth and therefore are conducive to overall GDP growth.[152] Comparing the different roles played by stock markets and banks in fostering growth, evidence shows that stock market liquidity and banking development both positively predict growth, capital accumulation, and productivity improvements, which is consistent with the views that financial markets provide important services for growth.[153]

(c) The nexus of causal links

To summarize the "law and finance" and "finance and growth" theories, a nexus of causal links between several variables can be presented below:

> Legal origins→ quality of law (including legal rules and enforcement) and institutions→ levels of investor protection → corporate finance patterns and levels of financial development→ outcomes of economic growth

Seen from the above illustration, corporate governance reform in countries with poorer investor protection should pay special attention to strengthening legal and institutional reforms that will afford investors stronger protection. For transition economies that have under-developed capital markets and weak legal and institutional environments, this task is not only urgent, but also difficult. As later discussion will indicate, there are many obstacles to legal reforms in developing and transition economies, with the most serious challenge posed by the "politics" of legal reforms. The "politics" of legal reforms in developing and transition economies is mainly reflected in the opposition to reforms from various interest groups who are concerned about losing their vested interests.[154]

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[152] Thorsten Beck, Ross Levine & Norman Loayza, "Finance and the Sources of Growth" (2000) 58 Journal of Financial Economics 261-300.
[153] Ross Levine & Sara Zervos, "Stock Markets, Banks, and Economic Growth" (1998) 88:3 The American Economic Review 537-558.
[154] Florencio Lopez-de-Silanes, "The Politics of Legal Reform" (2002) Spring 2002 Economia 91 [Lopez-de-Silanes 2002].

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(2) Debates over the "law matters" thesis and the role of securities market regulation

The "law and finance" and "finance and growth" literature has resulted in an extended debate on the "law matters" thesis. The central issue of the debate is whether mandatory laws and regulations are superior to more autonomous solutions with respect to the functioning of corporate governance systems and capital markets. Considerable research dissects, critiques, and debates the influence of investor protection laws, the efficiency of contract enforcement, and private property rights protection on the effectiveness of corporate governance, the efficient allocation of capital, and the overall level of financial development.[155]

There are several representative opinions emerging from this contentious debate, which differ greatly. For example, while some scholars completely dismiss law's relevance for maintaining good corporate governance and capital market development, other scholars strongly advocate imposing strict laws and regulations to protect minority investors.

(a) "Law is irrelevant or marginal" or "Alternative institutions can perform law's function"

As discussed earlier, some economists have developed a "Coasian argument" for an economic model of corporate governance. On this view, compared to private and contractual arrangements of corporate governance, law is irrelevant or marginal to efficient transactions between firms and their investors and other constituencies.[156] Moreover, some scholars have suggested that in addition to private contracting, there exist other alternative institutions to perform the function that "law matters" advocates

[155] Beck & Levine 2003, *supra* note 146.
[156] Ronald Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1-44; Bernard S. Black, "Is Corporate Law Trivial: A Political and Economic Analysis" (1990) 84 Nw. U. L. Rev. 542; Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991, 3rd Printing, 1996) [Easterbrook & Fischel]; Frank H. Easterbrook, "International Corporate Differences: Markets or Law?" (1997) 9:4 Journal of Applied Corporate Finance 23.

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say the legal system needs to play, such as rules enacted by stock exchanges or self-regulation by corporate issuers for reputational purpose.[157]

Evidence from emerging markets shows that compared with legal institutions, firm-level corporate governance provisions matter more in countries with weak legal environments and firms can partially compensate for ineffective law and enforcement by establishing good corporate governance and providing credible investor protection.[158] Some legal academics also argue that social norms may play a bigger role than legal rules in shaping and determining corporate behavior. They suggest that there are areas of internal corporate behavior and decision-making that courts should monitor less rigorously because social norms adequately govern behavior.[159]

(b) "Law matters and other institutions cannot substitute for law"

Regarding law's role in protecting investors, especially minority investors, there are also scholars who are "law optimists." They reject the "Coasian" argument for law's irrelevance and suggest that contrary to the "Coasian" argument, recent empirical research demonstrates that legal rules protecting investors matter in many ways and other institutions do not adapt sufficiently to substitute for law's function. In addition, it has been suggested that changing domestic legal rules– in particular through the reform of securities markets– can have a major impact on financial development.[160] To illustrate the point that law matters and legal reforms can have a large effect, evidence has been offered to compare the successful securities market reforms in Germany, the United States, Korea and Poland, and the negative example of the Czech Republic.[161]

(c) "Written corporate law matters, but law enforcement and the effectiveness of securities regulation are more important than corporate legal rules"

[157] Brian R. Cheffins. "Does Law Matter? The Separation of Ownership and Control in the United Kingdom" (2001) XXX The Journal of Legal Studies 459-484.
[158] Klapper & Love, *supra* note 4.
[159] Coffee 2001a, *supra* note 143.
[160] Johnson 2000, *supra* note 79 at 188.
[161] *Ibid.*

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Coffee is a "corporate law skeptic" with respect to corporate law's function in promoting corporate governance and securities market development, and has expressed doubt, in the following terms, about a "paradigm shift" in financial economics from emphasizing the role of private contracting toward asserting the centrality of protecting minority investors by corporate law:

> ...A "paradigm shift" is now underway in the manner in which financial economics views corporate governance, with the new scholarship emphasizing both the centrality of legal protections for minority shareholders and the possibility that regulation can outperform private contracting... [However,] one possibility is that substantive differences in corporate law may matter far less than differences in enforcement practice. In turn, enforcement may depend more upon the strength of the incentives to assert legal remedies than upon the availability of legal remedies themselves...Another possibility is that differences in substantive corporate law are less important than the differences in the level of regulation that different nations impose on their securities markets...[162]

In his opinion, strong securities market regulation and strict enforcement of disclosure rules may be more important than revising corporate law. He argues that corporate law, which provides protection to minority shareholders against unfair self-dealing transactions at the firm level, may play only a secondary role in fostering good corporate governance and securities market development. What is of primary importance to strong securities markets and successful privatization, he suggests, is the level of regulation that different nations impose on their securities markets. Therefore, inadequate securities regulation plays the primary role in explaining privatization failures in transition economies.[163]

Though a "corporate law skeptic," Coffee does not dismiss corporate law's role as irrelevant, especially in the context of post-communist transition and privatization. According to him, corporate law, though of secondary significance, is still vital to good corporate governance and successful privatization in transition economies. For example, evidence reveals that deficiencies in Czech corporate law contributed to the systemic

[162] Coffee, *supra* note 78 at 2-3.
[163] *Ibid.* at 3.

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looting of Czech companies by their controlling shareholders.[164] The same was true with Russian corporate law, which was not effective in preventing self-dealing and expropriation of minority shareholders.[165]

The view that law enforcement and the effectiveness of securities regulation are more important than written rules in corporate law seems to have found supportive evidence not only in transition economies, but also at a world-wide level. A recent study on international differences in firms' cost of equity capital showed that countries with extensive securities regulation and strong enforcement mechanisms exhibit lower levels of cost of capital than countries with weak legal institutions. The effects are strongest for institutions that provide information to investors and enable them to privately enforce their contracts.[166]

(d) "Law matters, but core institutions equally matter for strong securities markets"

Legal academics have studied the experience of transition economies in building functional securities markets after privatization. They have come to realize that various corporate governance failures during and after privatization have much to do with the lack of institutions that control self-dealing and asset stripping. One of these missing institutions is strong securities markets that can discipline corporate behavior and afford investors effective protection. Therefore, establishing legal and institutional preconditions for strong securities markets is regarded as critical to successful transition. Among the core institutions suggested by scholars, the most needed are those that address information asymmetries and self-dealing.[167]

The question as to which steps a developing country should take first to strengthen its securities markets– legal reform or building supporting market institutions— is a futile

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[164] *Ibid.*
[165] Black *et al.*, *supra* note 101, at 1780.
[166] Luzi Hail & Christian Leuz, "International Differences in Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" (2003) ECGI Working Paper, No. 15/2003.
[167] Bernard Black, "The Core Institutions that Support Strong Securities Markets" (2000) 55 Bus. Law. 1565 [Black 2000]; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets" (2001) 48 UCLA L. Rev. 781 [Black 2001].

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one, because a central characteristic of these institutions is that they interrelate and develop together and reinforce each other.[168] However, for transition economies, there does exist an issue of "sequencing," whereby caution is needed with respect to legal reform and transplantation: corporate governance reform in these economies should be much more basic and less "advanced." In other words, transition economies need "honest judges and regulators, good disclosure rules, and the beginnings of a culture of honesty," before it makes sense to worry about independent directors.[169] This point on sequencing is particularly relevant for the ongoing enterprise and corporate governance reforms in China, where calls for adding independent directors to corporate boards are very strong at present. Given the current under-development of legal and institutional environments and inadequate resource of managerial talents in China, the applicability of this relatively "advanced" practice may need reconsideration.

(e) "Laws and regulations matter, but their enforcement costs should not be excessive"

Some scholars hold a middle ground in the current debate on the role of mandatory legal rules and regulations in investor protection. In his study of the controversy over regulation of financial markets, Luigi Zingales maintains that a strong case can be made in favor of more mandatory disclosure while it is unclear whether the benefits of other mandatory regulation exceed its costs.[170] He also analyzes the political barriers in the legislative process, which are largely erected by incumbent firms, to the emergence of an "ideal regulation model." Based on a careful calculation of potential costs and benefits of regulation, Zingales advocates a "skeptical middle ground" for financial market regulation, as compared to two opposite approaches taken respectively by the "extreme libertarians" who disapprove any type of regulation, and the "interventionists" who support massive intervention as remedies to market failures.[171]

[168] Black 2000, *ibid.* at 1606-1607.
[169] *Ibid.* at 1607.
[170] Luigi Zingales, "The Costs and Benefits of Financial Market Regulation" (2004) ECGI Working Paper, No. 21/2004, at 53.
[171] *Ibid.* at 54.

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(f) "Law matters, but the causality between legal reforms and economic changes is backward": evidence from China

The issue of the causality between law and development outcomes has been extensively studied. Whether law is a "dependent variable" responsive to political and economic changes, or an "active agent" that endogenously promotes political and economic outcomes has been subject to controversy. The NIE school regards the causality as being from law and legal institutions to social and economic changes. This premise has been questioned by some legal academics, who expressed criticisms of North's concept of path dependency, in terms such as the following:

> Path dependency is neither absolute nor timeless and leaves open the question of whether changes in formal law and legal institutions have been, or can be, an active agent in promoting socially beneficial change, or whether they are largely a dependent variable.[172]

Other scholars concur in such criticism and further offer alternative explanations for the causality issue. For example, Coffee points out a backward sequence of legal reforms whereby legal developments have tended to follow, rather than precede, economic change. The suggested reason for the backward causality between legal reform and economic change is that without a motivated constituency that will be protected (or at least perceives that it will be protected) by the proposed reforms, legal reforms are not likely to be initiated due to the lack of interested parties.[173]

One piece of empirical evidence of this backward causality can be found in China. According to some Western legal academics, China is an example that shows the possibility of economic liberalization without significant political and judicial reforms.[174] Law, on this view, is not an active agent in promoting economic growth, but a dependent variable in the development process that is responsive to economic changes. Specifically, China is an example to demonstrate the pattern of "crash-then-law" or "growth-then-law"

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[172] Kevin E. Davis & Michael J. Trebilcock, "The Recent Intellectual History of Law and Development" (2004) forthcoming in Law & Social Inquiry, at 26.
[173] John J. Coffee Jr., "The Rise of Dispersed Ownership: the Roles of Law and the State in the Separation of Ownership and Control" (2001) 111 Yale L.J. 1, at 7 [Coffee 2001b].
[174] Amy L. Freeman, "Review of *Bird in A Cage: Legal Reform in China after Mao*" (2000) 10:7 The Law and Politics Book Review 454-456.

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of legal reforms.[175] The "crash-then-law" or "growth-then-law" thesis argues that the initial phrase of development is necessary both for a constituency to be formed and to set the stage for "crashes" or problems; legal change will then follow.[176] Legal reform is necessary in the second phase to prepare a country for further growth, or, conversely, to respond to the crash. Therefore, some scholars conclude that an efficient legal system may not be a precondition for initial market development, but a precondition for more mature, sustained development.[177]

In fact, the broad governance theory presents a similar finding on the causality issue when reviewing the puzzling negative feedback of higher incomes on governance quality, but offered a different explanation of "state capture/elite influence," as compared to the "crash-then-law" thesis. As pointed out earlier, "state capture" does not apply in the Chinese context. Therefore, the "crash-then-law" thesis, though still primitive, may have greater potential in interpreting China's transition experience with respect to legal reform.

(g) "Law matters, but the politics of legal reform matters more": evidence from China

Finally, academic interest in the "politics" of legal reform has been on the rise recently. Empirical studies have revealed that despite heavy input from the movement for "rule of law" reform in developing countries, the actual results are limited. Judicial reform in particular has yielded little fruit.[178] It is a widely shared view that the primary obstacles are not technical or financial, but political and human.[179]

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[175] Zhiwu Chen, "Capital Markets and Legal Development: The China Case" (2003) 14 China Economic Review 451-472 [Chen].
[176] Coffee 2001b, *supra* note 173, at 7.
[177] Chen, *supra* note 175 at 470.
[178] Ronald Daniels & Michael Trebilcock, "The Political Economy of Rule of Law Reform in Developing Countries" (2004) [unpublished, forthcoming in Michigan Journal of International Law].
[179] Thomas Carothers, "The Rule of Law Revival" (1998) 77:2 Foreign Affairs 95 [Carothers 1998]; idem, *Aiding Democracy Abroad: The Learning Curve* (Washington, DC: Carnegie Endowment for International Peace, 1999).

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Evidence shows that there are strong opposition forces against legal reform in developing countries. With respect to financial legal reform, the major blocking forces come from vested interest groups like incumbent managers, workers, labor unions, and incompetent judges.[180] Given the considerable constraints, feasible legal reforms need to appease local opponents and be situated in a local enforcement context. In other words, "legal transplanting" may not be a workable strategy if local circumstances are not taken into consideration. Accordingly, blindly copying a list of investor rights or importing rules is not likely to succeed.[181]

Two primary lessons have been suggested by scholars regarding circumventing the "politics" of legal reform in developing countries: (1) blindly transplanting the laws from developed countries and providing rights to investors will not necessarily work, and (2) reform needs to be in accordance with the local legal system, however "backward" it might be.

These lessons are of particular importance concerning China, where some western politicians, especially those from the United States, have begun "pinning hope on the idea that promoting the rule of law will allow the United States to support positive economic and political change without taking a confrontational approach on human rights issues."[182] Predictably, this will not be an easy task, although it is no wishful thinking either. The "politics" of legal reform in China, while sharing many similarities with that of other developing countries, has some special features and may hinder the process of reform.

In general, the politics of legal reform in China tends to be centered on forces that limit the development of legal institutions. For example, the Party-state pattern of governance and the Party dominance in national political and economic life are constraints on profound legal reform. Aside from the Party policies, other influencing forces include the state bureaucracy and the courts, the rise of the local party-state as a result of

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[180] Lopez-de-Silanes 2002, *supra* note 154.
[181] *Ibid.* at 92.
[182] Carothers 1998, *supra* note 179.

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decentralization, the Chinese legal culture (emphasizing the role of "*guanxi*" in social interactions) and overseas Chinese influence.[183] These factors are not necessarily fatal to advancing legal reform in China, but could constitute serious obstacles.

According to an American law professor who was among the persons mentioned earlier as having a strong interest in promoting rule of law in China, many of these constraints derive from basic political arrangements (such as the role of the Communist Party or the lack of a free press) or from deeply ingrained ideological and cultural beliefs (such as a belief that courts are like other administrative organs rather than distinctive kinds of institutions or a view that law is basically an instrument of governing rather than a restraint on government).[184] Because of these constraints, an incremental and long-term approach to legal reform, instead of a rapid and wholesale style, is needed in the Chinese context of promoting the rule of law.[185]

Recently, there have been heated discussions about China's integration into the global community and the expected reform of its legal system, especially after China's accession to the WTO. Although a newly shared vocabulary about the notion of the "rule of law" has been emerging in China, it conceals, however, underlying differences in meanings that stem from profound contrasts between historical and current Chinese and Western notions about law and governance.[186]

Therefore, a cautious conclusion on the prospects and directions of China's legal reform is warranted: (1) in adopting legal reform in relation to corporate governance rules, merely transplanting "law in the books" from western mature market economies without simultaneously developing the institutional foundations for these rules to function, is not likely to work; and (2) legal reform in the corporate governance area at the current stage of development should not give priority to the "advanced" mechanisms commonly found

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[183] Lubman, *supra* note 49 at 299-306.
[184] Paul Gewirtz, "The U.S.-China Rule of Law Initiative" (2003) 11 William & Mary Bill of Rights Journal 603-621, at 618. The author is a law professor at Yale Law School and was Special Representative for the Presidential Rule of Law Initiative at the United States Department of State under President Clinton.
[185] Lubman, *supra* note 49 at 299.
[186] *Ibid.* at 318.

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in developed countries (such as more independent directors), but needs to focus on strengthening some basic aspects of institutional capacity (such as an independent judiciary and competent securities market regulators).

3. The relationship between corporate governance and firm performance

According to the World Bank, institutions which affect the governance of firms are important for determining how resources are allocated, and who has rights over resources, both within countries and between countries. Therefore, they affect growth and poverty reduction.[187] Moreover, weak governance in large firms, which are few in number relative to small firms but on average account for a significant proportion of value added and employment across countries, has been associated with financial and economic crises, which can have severe consequences for poor people. However, when these large firms do well, they contribute significantly to growth and poverty reduction.[188]

A. Mixed/equivocal evidence on the link between corporate governance and performance

In terms of empirical evidence, researchers have found mixed or equivocal results regarding the link between corporate governance and firm performance. On the one hand, some researchers have found that it is difficult to establish a positive link between outside directors and better financial performance, such as firms' market valuation.[189] On the other hand, while the causality between the quality of corporate governance and the level of financial performance is difficult to prove, there seems to have emerged some strong evidence in support of a close correlation between good corporate governance and firms' long-term performance.

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[187] World Bank 2002, *supra* note 124 at 73.
[188] *Ibid.*
[189] See, for example, Agrawal & Knoeber 2001, Black 2002, Bhagat & Black, and Hermalin & Weisbach, , *supra* note 3.

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For example, with regard to existing empirical evidence for a link between corporate governance and firm performance, in a literature review published in 2005, researchers at Hermes, a well-known institutional investor in the UK that has been active in promoting corporate governance among its investee companies, have reached the following conclusion[190]:

> ...[W]e believe the active promotion of good corporate governance in investee companies increases shareholder value in the long term. In this paper we review the evidence for a link between corporate governance and performance and conclude that the research we have found supports the proposition that underlies our corporate governance work.[191]

B. Country characteristics, such as levels of economic development, have a strong impact on the link between corporate governance and performance

It is important to note that for countries at different levels of economic development, the results of empirical investigation of the relationship between corporate governance and performance vary. In developed economies, such as the United States, researchers have found that there usually exists a positive link between better corporate governance and better financial performance, measured by shareholder returns and firm value. For example, some researchers have found that among a set of 24 governance provisions followed by the Institutional Investors Research Centre (IRRC) in the US, increases in the level of an "entrenchment index" consisting of six provisions are "monotonically associated with economically significant reductions in firm valuation, as measured by Tobin's Q."[192] These six provisions are aimed at preventing a majority of shareholders from having their way, and allowing boards to adopt anti-takeover measures, such as poison pills and golden parachutes.[193]

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[190] Hermes is an institutional fund manager independent of any broader financial services group. It invests funds on behalf of over 200 clients, including pension funds, insurance companies, government entities and financial institutions, as well as charities and endowments. See Hermes, online: <http://www.hermes.co.uk/>.

[191] Hermes, "Corporate Governance and Performance: A Brief Review and Assessment of the Evidence for A Link between Corporate Governance and Performance" (2005), online: <http://www.hermes.co.uk/pdf/corporate_governance/corporate_governance_and_performance_060105.pdf>.

[192] Bebchuk, Alma Cohen & Allen Ferrell, "What Matters in Corporate Governance?" (2004) John M. Olin Centre for Law, Economics, and Business at Harvard Law School, Discussion Paper No. 491.

[193] *Ibid.*

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With regard to transition economies and emerging markets, such as Russia, China and South Korea, researchers have found that corporate governance, particularly at firm-level, does matter for firm performance in these economies, especially when the general legal and institutional environments are not well developed to afford investors strong protection.

For example, researchers at the World Bank have recently presented three empirical findings regarding the link between corporate governance and firm performance in emerging markets. First, the determinants of firm-level corporate governance in emerging markets include the extent of asymmetric information and contracting imperfections that firms face, which are influenced by the legal environments in which firms operate. Second, better corporate governance is highly correlated with better operating performance and market valuation. Third, comparing with more developed economies where legal environments are sound, firm-level corporate governance provisions matter more in countries with weak legal environments.[194]

In addition, researchers have also found that in transition economies like Russia and China, the quality of corporate governance has a significant impact on both investor confidence and securities market development, thus affecting firms' financial performance on the securities markets.[195] Moreover, recent evidence from South Korea provides some "preliminary" empirical support for the proposition that there exists a positive and causal link between corporate governance institutions, such as outside directors, and better financial performance, such as higher share prices.[196]

C. Recent studies suggest a reverse link between growth and institutions

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[194] Klapper & Love, *supra* note 4.
[195] See, for example, Black, Kraakman & Tarassova, *supra* note 78; Black 2001, *supra* note 3; CLSA, *supra* note 9; Bai *et al.* 2002, *supra* note 5; Bai *et al.* 2004, *supra* note 6.
[196] Bernard S. Black, Hasung Jang & Woochan Kim, "Does Corporate Governance Predict Firms' Market Values? Evidence from Korea" (2004) University of Texas Law School Law and Economics Working Paper, No. 26 [Black, Jang & Kim 2004].

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While some researchers have found a positive link between corporate governance on one hand and firm performance and financial market development on the other hand, by contrast, some researchers have found a reverse causal link between economic growth and better corporate governance institutions.

For example, in a recent study, some scholars point out that almost all of the variation in corporate governance ratings across firms in less developed countries is attributable to country characteristics, such as a country's financial and economic development, rather than to firm characteristics.[197] What is more, according to these researchers, financial globalization and "piggy-backing" can sharpen firms' incentives for better corporate governance, but also decrease the importance of home-country legal protection of minority shareholders.[198] In other words, law matters less in these countries where domestic firms seek overseas listings in mature and better regulated capital markets. Recently, some researchers have also found a reverse link between the level of economic growth and the quality of institutions in less developed countries.[199]

[197] Craig Doidge, G. Andrew Karolyi & René M. Stulz, "Why Do Countries Matter So Much for Corporate Governance?" (2004) ECGI (European Corporate Governance Institute) Working Paper, No. 50/2004.
[198] *Ibid.*
[199] Edward L. Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "Do Institutions Cause Growth?" (2004) NBER Working Paper, No. 10568 [Glaeser *et al.*].

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Section IV

Corporate Governance Failures in Transition Economies: Lessons from Russian Privatization and Its Discontents

Taking Russia's mass and rapid privatization and its discontents as a major example, Section IV addresses the issue of corporate governance failures in transition economies and the resulting consequences for economic development. As Section IV shows, while there are limited positive results such as those achieved in Poland, the primary lesson from privatization and corporate governance reforms in transition economies is generally negative, which is exemplified by various privatization and securities market failures across the region of the former Soviet bloc, in particular Russia, where mass and rapid privatization had failed to bring prosperity.

1. Russian privatization and its discontents

A. Mass and rapid privatization: bad medicine?

In Russia, "shock therapy" was adopted as the primary approach toward reform. It was a top-down reform package consisting of radical programs, aimed at swiftly destroying all existing economic structures at whatever cost and replacing it with a market system like that in West Europe. On the "shock therapy" list, the most difficult and complex was privatization. It was considered that the whole program of reform was contingent on the success of privatization.[200]

(1) The political reason for mass and rapid privatization

In the initial debate about how to privatize Russia's SOEs, the strategy of mass and rapid privatization finally prevailed as the primary vehicle to privatize medium size and large

[200] Peter Murrell, "What is Shock Therapy? What Did It Do in Poland and Russia?" (1993) 9:2 Post-Soviet Affairs 111 [Murrell].

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industrial enterprises. In fact, not only Russia, but most countries of the region had chosen mass and rapid privatization to privatize their medium size and large industrial enterprises, with the major exception of Hungary, which followed a slow and measured path of privatization.[201]

The gradual, firm-by-firm privatization approach was rejected for political reasons. The principal concern of radical reformers was to gain as broad support from the population as possible, in order to make privatization politically viable and to avoid a likely standstill of economic reforms that small-scale privatization may cause. As three key advisors for Russian privatization put it straightforwardly:

> The need to gain support for reform is the political argument for privatizing rapidly. If privatization is slow, the benefits to the population are by definition small, and hence the political capital they buy the reformers is small as well. Fast privatization is privatization that offers large political benefits from the start– exactly what a reformist government needs...Slowing it down further beyond what internal political forces accomplish will stop it altogether...[R]apid privatization buys enormous political benefits and thus allows reforms to deepen.[202]

(2) The immediate outcomes of privatization

(a) The rapid rise of a new private sector due to the impressive speed and scale of privatization

The shock therapists had boasted about the swift speed with which Russia's mass privatization had been conducted. For instance, one of the advisors on Russian privatization provided the following triumphant remark on its immediate outcome:

> ...[I]n a few short years, Russia managed to privatize more than 15,000 industrial firms– to turn over their ownership from the state to private investors. Together with more than a million new businesses and tens of thousands of newly privatized shops, over half the output of the Russian economy is now produced by the private sector– a higher fraction than in much of Western Europe. But privatization did a lot more than just reshuffle assets. It gave the declining

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[201] Ira W. Lieberman, Stilpon S. Nestor & Raj M. Desai, eds., *Between State and Market: Mass Privatization in Transition Economies* (Washington: The World Bank, 1997) at 1.
[202] Maxim Boycko, Andrei Shleifer & Robert W. Vishny, "Privatizing Russia" [1993] 2 Brookings Papers on Economic Activity 139 at 148 [footnote omitted].

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> state firms real owners, with real desires to assert their rights as investors, and hence gave Russian firms a hope of surviving in a market economy... As it destroyed central planning, it also destroyed the very roots of the Soviet state... Politically and economically, privatization truly transformed Russia.[203]

Although the shock therapists have expressed such elation, they have also voiced a moderate concern about the fact that a majority of privatized firms were transferred to "insiders." At the end of voucher privatization, managers and workers in combination controlled about 2/3 of the shares in the average privatized firm.[204] Also, they have conceded that corruption had been a serious problem throughout the program, especially in its second stage of implementation. The most egregious example of "illegitimate" privatization was the "loans-for-shares" (LFS) program in post-1994 privatization waves, whereby a few oligarchs became instant billionaires by taking over remaining state firms through fraudulent "auctions". The LFS program in 1995 was the most notorious scheme during the second phrase of Russian privatization. It was a quasi-privatization program designed to raise revenues for the Russian government. Unfortunately, this program was in no sense a "transparent" and "credible" process as originally intended. What actually happened was that, the Russian government put up shares of its own firms in private banks as collateral for needed funds; when the government defaulted on its loans, the private banks took over the firms in what might be viewed as a sham sale (i.e., a charade of collusive "auctions" in favor of friends of the government).[205]

Even the strongest supporters of the first phrase privatization, Ira Lieberman and Rogi Veimetra at the World Bank, regarded the LFS scheme as a "lose-lose" proposition for all of the stakeholders in Russia. They pointed out that it "...was non-transparent...involved clear conflicts of interest... created collusion... involved a nonlevel playing field, excluding foreign investors..." In their opinion, the LFS scheme substantially discredited Russia's privatization efforts, causing the program to be widely viewed as "collusive and corrupt, failing to meet any of its stated objectives." Yukos, until recently Russia's largest oil exporter, was transferred from the state to private hands exactly through the LFS

[203] Andrei Shleifer, Foreword to Joseph R. Blasi, Maya Kroumova & Douglas Kruse, *Kremlin Capitalism: the Privatization of Russian Economy* (Ithaca: Cornell University Press, 1997) at ix-x.
[204] Nellis, *supra* note 16 at 7.
[205] Stiglitz, *supra* note 13 at 159.

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insider deals. Its sale at a "ridiculously low price" –Khodorkovsky bought a majority share stake for USD 170 million in a company approximately worth USD 180 billion– was labeled "the most scandalous offering" of the second phrase privatization.[206]

Despite all these negative factors mentioned above, in terms of speed and scale, Russian privatization was indeed unprecedented in history. Therefore, it is not surprising that some economists, mainly from the advisory teams for Russian privatization, have regarded it as a huge success. However, the line of reasoning, starting from the figures on speed and scale and directly arriving at the conclusion that firms were thus "depoliticized" and the job of privatization was done (and done brilliantly) is inadequate, to say the least. The fact that in Russia most business has been in private ownership since the mid-1990s does not necessarily mean that the private sector has become competitive and has been running efficiently. In fact, competition in post-privatization Russia generally does not function well, because entry of new firms has been very sluggish due to administrative barriers to small business, and this in turn has made it easier for existing firms to apply political pressure to secure their protection.[207]

Moreover, speed and scale have only a largely quantitative, rather than qualitative, explanatory power to highlight the significance of the huge transformation of the Russian economy. The transition process has been regarded as highly complex and involving the establishment of complementary institutions that can make the speed and scale of privatization substantively meaningful. One can imagine how this difficult task could invite serious problems if proper sequencing and pacing were not given sufficient consideration.

In addition, assessments based only on speed and scale have also neglected the "relativity test." Within a comprehensive review framework, the level of success of Russian privatization should not be measured in absolute and abstract terms, but needs to be

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[206] Ira W. Lieberman & Rogi Veimetra, "The Rush for State Shares in the 'Klondyke' of Wild East Capitalism: Loans-for-Shares Transactions in Russia" (1996) 29:3 Geo. Wash. Int'l L. & Econ. at 738, 758 and 759.
[207] See Paul Hare & Alexander Muravyev, "Privatization in Russia", in David Saal & David Parker ed., *Handbook of Privatization* (Edward Elgar, 2003), Chapter 17.

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balanced against costs and drawbacks. For an optimist reviewer, when calculating the benefits and achievements of Russian privatization, an important question to ask is "successful relative to what?" For example, one frequently visited issue in reviewing Russian privatization is the trade-off between efficiency gains for privatized firms (if there are any) and the distributional impact on the general Russian population. Therefore, the conclusion that Russian privatization was an "extraordinary success," or an "amazing achievement," or a "solid foundation" for recent growth of the Russian economy is not fully warranted without the support of empirical evidence on the financial performance of privatized firms and distributional effect of privatization within Russia's general population. As later discussion will reveal, the empirical evidence is largely negative.

(b) Insider control as the defining feature of corporate governance structure of privatized firms

The Russian privatization program offered generous benefits to enterprise insiders (both the workers and managers) in exchange for their support for reform. As a consequence, enterprise managers have gained a substantial amount of equity ownership and a very high degree of control.[208] This corporate governance structure has not since changed to incorporate more inputs from outside investors. The "powerless" shareholders have become a frequently cited pathology of corporate governance in Russian privatized firms. Such an ownership and control arrangement has proved inefficient, because it has created incentives for asset stripping and self-dealing, rather than for value maximization.

B. The broken promises of Russian privatization

(1) General consequences of privatization for the Russian economy and society

Despite the original enthusiasm about the gains that mass and rapid privatization was anticipated to bring about, a decade later the well-intentioned, but arguably not equally

[208] Andrei Shleifer & Dmitry Vasiliev, "Management Ownership and Russian Privatization", in Roman Frydman, Cheryl W. Gray & Andrzej Rapaczynski ed., *Corporate Governance in Central Europe and Russia* (Budapest: Central European University Press, 1996) at 62.

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well-conceived program seemed to have frustrated the expectations of many. Mass privatization through voucher and the infamous loans-for-shares (LFS) programs had devastating consequences for Russia. It did not succeed in bringing prosperity to the country. Instead, the reverse seemed to be true: Russia saw severe economic decline, intensified social and economic inequalities and increased poverty through the first decade of transition. As a consequence, growing domestic discontent has spread across the country, thus rendering the maintenance of social and political stability no easy task. The reformers who had actively pursued privatizing Russia "at all costs" were later showered with blame for selling state assets to crooks at ridiculously low prices, which had led to the rapid rise of a group of super-rich "oligarchs".

As an unintended consequence, Russia now often serves as a negative example to students of transition economics, showing how "shock therapy" failed to deliver promised prosperity, and how flawed transition policy could lead to disastrous outcomes. Russia certainly suffered: over the first decade of transition, it had experienced constant stagnation and its economy shrunk sharply. GDP in post-1989 Russia fell, year after year. The loss was even greater than Russia had suffered in World War II: in the period 1940-46 the Soviet Union industrial production fell by 24 percent; in the period 1990-99, Russian industrial production fell by almost 60 percent.[209]

Russia's economy has been showing some strength for the past few years, largely due to the rise of oil prices in the international market, from which Russia gets much of its revenue. However, economists have warned that high oil prices make Russia's economy look much better than it really is and that the country is too dependent on commodity prices. These economists worry that when oil and metal prices fall, the country could be plunged back into darkness.[210]

It is also interesting to note that the defenders of "shock therapy" and of its positive effects in transition economies have offered rebuttals to the criticism that Russia was

[209] Stiglitz, *supra* note 13 at 143.
[210] "Lightbulbs" *The Economist* (8 February 2002) 49.

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"lost" as a result of insensitive transition strategies. In particular, some of the original advocates for radical reform package have offered their own version of interpreting the transition process, especially the controversial mass and rapid privatization in Russia, as opposed to the dark depiction presented by the critics. A recent interpretation of the Russian transition regards Russia as a "normal country" already. Its main arguments read as follows:

(a) Contrary to what the critics have suggested, by the late 1990s Russia was not "a disastrous and threatening failure," but had become a typical middle-income, capitalist democracy.

(b) Russia's being a normal country (i.e., *only* a middle-income, not a developed capital state yet) is an amazing and admirable achievement, given its starting point as a "shortage-ridden, militarized, collapsing bureaucracy" of 1990, although to those who had hoped for more it is a disappointment.

(c) "Shock therapy" had worked in Russia, by transforming it into a marketplace of mostly private firms and an electoral democracy *irreversibly*.

(d) It is arbitrary to attribute all the flaws and problems in the transition process to the reform policies, especially to mass and rapid privatization, because a large part of the Russians' genuine suffering was caused by the unavoidable (therefore, unsurprising) costs of transition. Specifically, problems with income distribution should not be attributed to the *wisdom* of privatization strategy; rather, the blame should be laid on the ill-handled, corruption-ridden *implementation* of privatization.

(e) Russia's prospects in the immediate future are neither as bleak as the critics predict (i.e., Russia will stagnate,) nor as positive as the optimists think (i.e., Russia will soon become a developed capital state). Rather, Russia will remain a normal market economy and a capitalist democracy, albeit with flawed institutions and a great deal of state

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intervention.[211]

However, some Russian economists do not seem to agree with the conclusion that Russia today is a "normal country". For example, it has been suggested that that such a positive statement is confusing, because Russia's genuine decline after privatization is an undeniable fact; and that if this could serve to prove that the country is "normal," the rhetorical device must have been faulty.[212]

(2) Firm-level economic consequences of Russian privatization

As Gustafson critically points out, there are three economic consequences of privatization for privatized firms: capital starvation, unstable ownership, and the continuation of soft-budget constraints. Also, by and large there have been no real restructuring, no substantial change of corporate culture, no effective corporate governance improvements, and no signs of effective use of scarce capital. When capital infusions have become available in some rare cases, managers have not directed it to new plant and new products, but to other purposes such as paying wage arrears, buying short-term treasury notes and other financial instruments in Russia's nascent capital markets, and repaying bank loans.[213]

Recent surveys on restructuring and corporate governance of Russian privatized firms provide no encouraging indications of significant improvements, but raise questions about the method, sequencing and pacing of privatization, as well as alternatives to privatization. For example, one recent survey paper by two leading experts in privatization finds that, although privatization is usually beneficial, and that it is often associated with general improvements in governance at all levels in a society, the positive results did not happen in Russia. The empirical evidence available so far indicates that insider privatization has been a failure throughout the former Soviet Union, especially in Russia, and that the concentrated managerial ownership structure that characterizes

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[211] Andrei Shleifer & Daniel Treisman, "A Normal Country" (2004) 83:2 Foreign Affairs 20.
[212] See, for example, Matthew Maly, "My Comment on *A Normal Country* by Andrei Shleifer and Daniel Treisman" (24 February 2004), online: <http://matthew-maly.ru/articles/eng25.shtml>.
[213] Thane Gustafson, *Capitalism, Russian Style* (Cambridge University Press, 1999) at 46 [Gustafson].

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almost all privatized firms will likely hamper these economies for many years to come.[214]

On the dimension of efficiency gains and financial performance, Russian privatization has not delivered satisfactory results. The declining financial performance of firms in the post-privatization period is alarming. The available evidence offered in some empirical studies on Russian privatization suggests that privatized firms "merely don't perform much better than state-owned companies, if at all." The efficiency gains are so small that economists are debating whether they exist at all. This raises the question about the wisdom of having spent so much political energy in a program that turned out to be not very helpful for economic revival.[215]

(3) The distributional impact of privatization

With regard to issues relating to efficiency and equality in post-communist transition and economic reform, there have been two unsettling questions. The first question is whether the goals of efficiency and equality are compatible at all. The second question is whether government actions are needed to overcome the distortion by the private actors and realize such compatibility in circumstances where it is indeed possible to make efficiency and equality compatible but private actors tend to prevent such compatibility. The Chinese experience in this aspect has not been positive, and has added more murkiness to debates over "efficiency *vs.* equality" during the transition.

Since 1992, when the longstanding debate over whether markets should be officially endorsed in the Chinese "socialist system" was decisively resolved, China's transition and economic reform has been overwhelmingly leaning toward the "efficiency" direction while sacrificing a considerable amount of "social equality," for which China has been criticized throughout the reform period. According to a new survey on income disparity in China by the Chinese Academy of Social Sciences (the CASS), in 2002 urban residents earned three times more than their rural counterparts, a record high in the

[214] Megginson & Netter, *supra* note 55.
[215] Black, Kraakman & Tarassova, *supra* note 78 at 1780.

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history of China's transition. The researchers in charge of this survey also claim that even the new figures do not paint a true picture of the disparity, which is commonly believed to be even wider. The primary causes for this astonishing income gap are the heavy tax burdens on rural population and the rampant corruption among local officials.[216] The survey also points out an alarming trend that the urban-rural income gap in China is now the widest in the world, taking into account non-monetary factors. An even more daunting prospect is that the gap will continue to grow in the coming years. The likely destabilizing impact of this increasing wealth gap on China's social and political orders cannot be underestimated. Now the Chinese government realizes that excessive distributional disparity not only creates huge challenges in maintaining social stability, but can also cost the now buoyant economy efficiency losses.[217]

However, as distinct from the Chinese story, Russian privatization was expected to bring about a positive distributional impact when the mass and rapid privatization strategy was selected. To begin with, carrying out a privatization program that was fair and equal to all participants had fundamental political economy implications when reform first started. The very reason for adopting the strategy of mass and rapid privatization was to gain popular support for reform before it could be completely blocked by opposition interests. Therefore, to "make every Russian an owner" was declared as the preliminary goal of Russian privatization. The political reason for radical reform was essentially a reflection of the need for a balanced distribution of benefits within the general population, if it was to proceed without serious political backlash. Logically, popular support could hardly be elicited unless the majority of Russian citizens could obtain a decent deal from the reshuffle of state assets. In this sense, the swift rise of a "Kleptocracy" class represented by the "oligarchs" in post-privatization Russia was certainly not a desirable outcome. In the meantime, the anticipated emergence of a new private sector run by honest business people has not materialized to date.[218]

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[216] See Louisa Lim, "China's Wealth Gap Widens to Gulf" *BBC News* (26 February 2004), online: BBC News <http://news.bbc.co.uk>.
[217] Li Shi & Yue Ximing, "A Report on Urban-Rural Income Gap in China" (2004) *Caijing* 101.
[218] Black, Kraakman & Tarassova, *supra* note 78 at 1746.

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Broadly speaking, Russian privatization had failed on the dimension of "distributional equality." Evidence of severe social inequalities in post-privatization Russia abounds, including concessions from the shock therapists that Russia today is not a "just society." For example, Russia's per capita GDP may lag behind Costa Rica's, but its headcount of billionaires is the fourth highest in the world, according to *Forbes Magazine's* annual rating of the super rich.[219] Also, according to recent empirical studies, a new welfare pattern and a deep social stratification of society are evolving in post-privatization Russia, which are identified with large income differentiation and non-transparency of distributional relationships in society.[220] All these alarming trends reinforce a concern held by many international observers: in today's Russia, a potentially destabilizing factor is that wealth differences soar while the social pie shrinks.

(4) Political consequences of privatization

It has been suggested that Russian privatization has left "a residue of popular distrust of privatization and market economy," which is exactly the opposite result to the original expectation that fast privatization would build popular support for reform.[221] In particular, the ill-handling of the "loans-for-shares" program, which was a corrupt and non-transparent transfer of state assets, precipitated widespread insider expropriation and thus contributed greatly to the political unpopularity of privatization.[222]

2. What went wrong?

In searching for reasons why the promises of Russian privatization were broken, a primary question to be asked is why performance of Russian privatized firms has lagged. Academics have extensively studied this issue, and have suggested a series of causal links.

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[219] "Russia's Unpopular Billionaires on Forbes's List" (2003) 14:7-9 Transition 14.
[220] Svetlana Glinkina, "Distributional Impact of Privatization in Russia"(Paper presented to the CGD (Centre for Global Development) Conference on Distributional Impact of Privatization, February 24-25, 2003, Washington, D.C.) at 53-54 [unpublished].
[221] Black, Kraakman & Tarassova, *supra* note 78 at 1788-1789.
[222] Megginson & Netter, *supra* note 55.

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The first suggested causal link is between the method of privatization ("insider privatization") and the prevailing feature of management control in Russia's privatized firms. Second, the insider control corporate governance structure has been found to create incentives to loot. Third, massive self-dealing and asset stripping resulting from distorted incentives of insiders ultimately led to the "fiascoes" of Russian firms.[223] The causal links can be illustrated as follows:

> Insider privatization→ concentration of ownership and control in privatized firms→ incentives for opportunism, assets stripping and self-dealing→ the fiascoes of Russian firms

In the short period of time since privatization was completed, Russia has quickly earned a reputation for poor corporate governance.[224]In the absence of institutional constraints on insider opportunism, what has been induced is wealth destruction. Given the poor corporate governance of privatized firms, it is not surprising that short-term activities and asset stripping have become common practices for managers. The most serious problem of corporate governance failure in Russian firms is that rather than maximizing value, managers have turned to making personal profits from loss-making companies through "ingenious" techniques. [225] One popular device is to spin off private "daughter companies," owned by a narrow circle of managers and their allies, through which the output of the privatized firm is siphoned off. The "mother company" takes the losses, accumulates debts, delays wages and payments, and holds back taxes– while the profits go out the back door. Theft by "kleptocrats" has been rampant in privatized firms.[226] Performance of privatized firms, as a consequence, has lagged and has not been much better as compared with remaining state-owned firms.

[223] Merritt B. Fox & Michael A. Heller, "Corporate Governance Lessons from Russian Enterprise Fiascoes" (2000) 75 N.Y.U. L. Rev. 1720.
[224] Galina G. Preobragenskaya, Robert W. McGee, "Corporate Governance in A Transition Economy: A Case Study of Russia"(Paper presented to the Annual Conference of Academy of International Business, Clearwater, Florida, November 13-14, 2003) [unpublished].
[225] See Gustafson, *supra* note 213 at 50.
[226] Black, Kraakman & Tarassova, *supra* note 78 at 1750.

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Moreover, the proclaimed accomplishment of "depoliticization" of firms and private sector activities, which was regarded by the designers of Russian privatization as the first yardstick of good reform, also appears hollow under close scrutiny. According to them, while the first yardstick of good reform is depoliticization, the second is corporate governance. The key objective of Russian privatization, however, should be the former, not the latter. This is because "controlling managers is not nearly as important as controlling politicians, since managers' interests are generally much closer to economic efficiency than those of the politicians."[227] This argument has been disputed by other scholars based on later research on corporate governance of privatized Russian firms that has led to a conclusion that "crooks are no better than politicians."[228]

Indeed, if the assertion that Russia today has achieved the goal of depoliticizing private businesses, one has to be very creative in explaining the following realities in post-privatization Russia, which are certainly not to be found in a better institutional environment conducive to real growth and prosperity: (1) the still pervasive intervention of politicians with privatized firms through various channels other than direct subsidies; (2) the still excessive administrative barriers and red tape that distort the incentives and activities of small business; and (3) the suspicious new alliance of oligarchs with politicians through controversial political finances.

To sum up, because by and large there has been no genuine restructuring taking place in Russian insider controlled firms, the proclaimed goals of privatization, including depoliticization of firms and creating a vibrant private sector, have not been achieved. As is widely understood, the very purpose of privatization goes beyond the mere dismantling of state sector dominance in the economy (a "destructive" process); its essential task is to create a new form of competitive firm that can operate efficiently and make profits (a "creative" process). Viewing Russian privatization from this perspective, one can see that the impressive speed and scale with which firms were sold off did not guarantee the emergence of "real owners" with the incentives to monitor managers and the resource to

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[227] Boycko, Shleifer & Vishny, *supra* note 48 at 121.
[228] Black, Kraakman & Tarassova, *supra* note 78 at 1789.

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enforce property rights. Given the regrettable results of too much "shock" and too little "therapy" in Russia's "big-bang" privatization, one would wonder if it turned out to have offered a modern vindication of Edmund Burke's judgment made two centuries ago: destructive revolutions often come to bad ends.[229]

3. The primary lesson from Russian privatization

The main result of Russia's mass and rapid privatization was to turn over mediocre assets to people lacking the incentives, skills and resources to manage them well, or to distribute high-quality assets to the resourceful and well-connected few who have tended not to embark on restructuring of the acquired firms that might have justified their acquisition of the assets. Privatized firms typically performed not much better than the remaining state-owned enterprises. Thus, Kenneth Arrow calls Russian privatization "a predictable economic disaster".[230]

Based on such grim results, the primary lesson from Russia's privatization is clear: in an institutional vacuum, privatization can lead and has led to stagnation and decapitalization rather than to better financial results and increased efficiency.[231] Some Russian economists have concluded that "mass and rapid privatization approach was wrong," that it "should have been preceded (not accompanied) by institution-building," such as a corporate governance regime, prudential regulation for financial and capital markets, and effective insolvency or bankruptcy regimes. All are too weak or simply lacking in Russia.[232]

As many scholars have pointed out, institution-building is an essential element in economic transformation. For example, an influential empirical study of Russian privatization concludes: "Economic revolutions that destroy existing institutions before

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229 Edmund Burke, *Reflection on the Revolution in France* (Thomas H.D. Mahoney ed., Liberal Arts Press, 1955), cited in Black, Kraakman & Tarassova, *supra* note 78 at 1803.
230 Nellis, *supra* note 16 at 9.
231 *Ibid.* at 17.
232 *Ibid.* at 9 and 16-17.

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new ones can be built are likely to founder, as those without scruples take advantage of the resulting institutional vacuum."[233] In post-privatization Russia, a self-enforcing model of corporate governance regime has not accomplished much precisely because the institutional vacuum has rendered corporate law powerless in the face of massive self-dealing.[234] Therefore, multiple legal, institutional and microeconomic reforms are badly needed in Russia to improve corporate governance, such as effective mechanisms to control corruption, a strong securities market and independent courts.[235]

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[233] Black, Kraakman & Tarassova, *supra* note 78 at 1803.

[234] Bernard S. Black & Anna S. Tarassova, "Institutional Reform in Transition: A Case Study of Russia" (2003) 10 Sup. Ct. Econ. Rev. 211 [Black & Tarassova 2003]. In this paper, the authors have amended some of the early (positive) hypotheses about corporate governance in Russia made in 1996, when Bernard Black was advising Russia to draft a self-enforcing company law for Russian privatized firms. According to his later research, the law has been ineffective due to the lack of institutional constraints on massive self-dealing. See Bernard Black & Reinier Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 Harv. L. Rev.1911.

[235] Black & Tarassova 2003, *ibid.* at 211.

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Section V

The Debate on Global Convergence in Corporate Governance: Convergence or Persistence?

Section V delineates the ongoing global debate on convergence or persistence in corporate governance around the world and assesses its implications for corporate governance reform in developing countries, especially China. At the centre of this debate is the following question: in an age of globalization and capital market integration, which model should be, or already is, leading the direction of global corporate governance on which different national systems will gradually converge? In answering this question, a general observation can be reached that while it may be necessary to reach a certain level of global convergence on some fundamental principles of corporate governance, such as the accountability of the board of directors, investor protection and equal treatment of shareholders, it is still far from clear, however, whether there exists an "optimal model" of corporate governance that will dominate alternative national systems.

1. Efforts to promote convergence in corporate governance at the international level

On the practical side, there has been a visible trend of global convergence of corporate governance codes and guidelines to produce a set of "best practices" at regional and international level. The first attempt of such sort was the OECD's *Principles of Corporate Governance* issued in April 1998, which sought to provide a set of corporate governance standards and guidelines for its member states to evaluate and improve their legal, institutional and regulatory framework for corporate governance. Another important multilateral development in this regard was the establishment of the Commonwealth Association for Corporate Governance (CACG) in April 1998 to promote excellence in corporate governance in the former British Commonwealth of Nations. Moreover, the establishment in 1999 of the Global Corporate Governance Forum via the World Bank and the OECD to create a formal program of governance assistance on a global basis marked another step toward convergence. An even broader

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project is currently organized by the World Bank and the OECD to combine their efforts to promote policy dialogue on corporate governance issues through the Regional Corporate Governance Roundtables (RCGRs) covering Asia, Russia, Latin America, South-East Europe and Eurasia.[236]

2. The representative points of view in the debate on global convergence or persistence in corporate governance

Broadly speaking, there are five representative points of view on global convergence or persistence in corporate governance, as introduced in the following discussion. It can be seen that they present very different opinions. While the strong version of convergence optimism predicts systemic convergence, the strong version of convergence skepticism predicts systemic persistence in corporate governance.

A. Systemic convergence: formal and functional

In "The End of History for Corporate Law," Henry Hansmann and Reinier Kraakman propose a strong version of convergence optimism. They boldly argue not only that corporate governance convergence on a shareholder-oriented model adopted in United States and the UK, or the so-called "shareholder primacy" model is both desirable and inevitable, but that corporate governance has already largely converged on that kind of model.[237] The authors claim:

> The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago. .. [T]he standard model earned its position as the dominant model of the large corporation the hard way, by out-competing during the post-World War II period the three alternative models of corporate governance: the managerial model, the labor-oriented model, and the state-oriented model...

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[236] See Low Chee Keong, eds., *Corporate Governance: An Asian-Pacific Critique* (Hong Kong: Sweet & Maxwell Asia, 2002) at 11-18; OECD, "White Paper on Corporate Governance in Asia" (2003) online: OECD <www.oecd.org>.

[237] Jeffrey N. Gordon & Mark J. Roe eds., *Convergence and Persistence in Corporate Governance* (Cambridge University Press, 2004) at 6-7 [Gordon & Roe].

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> We predict, therefore, that as equity markets evolve in Europe and throughout the developed world, the ideological and competitive attraction of the standard model will become indisputable, even among legal academics. And as the goal of shareholder primacy becomes second nature even to politicians, convergence in most aspects of the law and practice of corporate governance is sure to follow.[238]

The view of systemic convergence has drawn many criticisms, particularly from proponents of systemic persistence in corporate governance, as introduced later.

B. Formal convergence ("*de jure*" convergence)

In this debate, some researchers have advocated a "formal convergence" position that convergence in some important aspects of corporate governance (such as board composition) has occurred with respect to formal or written rules in countries' domestic corporate and securities law, without simultaneous convergence in the function that these rules are intended to play in their host jurisdictions.

For example, Ronald Gilson and Curtis Milhaupt take the example of Japan's recent corporate reform that allows large firms to abolish the board of statutory audit and adopt a U.S. style "committee system" for corporate governance, to illustrate the dynamics of the "formal convergence".[239] During this reform, Japan "transplanted some visible components of a U.S. style board committee structure, but without the complementary institutions that exponentially increase the functionality of the committee system in the host country," such as the judicial review of directorial independence that serves as a crucial complement to the committee structure in the United States.[240] Therefore, the authors conclude, in order to utilize the new board option, Japan will need to create governance mechanisms that function quite similarly to those of U.S. firms.[241]

C. Formal persistence and functional convergence ("*de facto*" convergence)

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[238] Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law" (2001) 89 GEOLJ 439 at 468.
[239] Gilson & Milhaupt, *supra* note 99 at 14.
[240] *Ibid.* at 37.
[241] *Ibid.* at 41.

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In "Globalizing Corporate Governance: Convergence of Form or Function," Ronald Gilson argues for the possible emergence of a worldwide corporate governance system that is relatively uniform in functional terms, despite persisting formal differences.[242]

According to Gilson, functional convergence occurs when existing governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics.[243] The means of functional convergence include contracting and the so-called "piggy-backing" on the law of other jurisdictions, such as firms' decision to list on an overseas stock market with higher standards of corporate governance requirements than that of their home countries, as has been exemplified by some European firms. However, the author also points out that not every function can converge because of the difficulty in creating institutional complements that support the function. The difficulty in adopting a U.S. style venture capital system in Europe due to the lack of a highly liquid and dispersed market there is such an example.[244] Arguing along the same line, John Coffee Jr. also supports the functional convergence position by adding examples of convergence through corporate migration (primarily via cross-listing) and stock exchange harmonization.[245]

It seems that the functional convergence position is shared by some academics on both sides of the Atlantic. In a recent paper, several European economists review the history of the share price movements over the last two decades at Royal Ahold, a Dutch company that is cross-listed in Amsterdam and New York exchanges (but now scandal-strapped as mentioned in Section I), to sketch some general observations on the trend of global convergence in corporate governance. The authors find that the co-existence of rather different regimes of corporate governance may be undercut by the reaction of institutional investors in the global financial markets to the actions of corporate

[242] Gordon & Roe, *supra* note 237 at 18.
[243] Ronald J. Gilson, "Globalizing Corporate Governance: Convergence of Form or Function" (2001) 49 AMJCL 329 at 358.
[244] *Ibid.* at 344-345.
[245] John C. Coffee Jr., "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications" (1999) 93 NWUL 641 at 653.

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management. Because poor corporate governance could lead to the destruction of firm value and the discounting in share prices by international institutional investors, cross-listing can be a strong driving force for global convergence of better corporate governance practices.[246] However, the authors also caution that convergence may have potentially disruptive effects on countries' existing corporate governance structures in the short run, as compared to a more beneficial impact on global financial markets in the long run.[247]

However, there have been counter-examples of functional convergence through "piggy-backing," i.e., firms going public in overseas capital markets with higher standards of securities regulation and corporate governance, thus voluntarily subjecting themselves to tighter market disciplines and requirements for investor protection. One example is from China, where some of its large and more competitive firms have started to accelerate overseas investment and expansion over the past couple of years through cross-listing or M&A (merger and acquisition) transactions. After the coming into force of the Sarbanes-Oxley Act (SOX), some Chinese firms that originally had plans to launch a US IPO have abandoned their plans, given the higher costs of an US IPO embodied in the increased risks of shareholder class actions and the stringent disclosure and reporting requirements by both the SEC and SOX. In searching for alternative channels, some of these firms have chosen to raise capital from US institutional investors through rule 144A private placements which grant disclosure exemptions to foreign issuers, such as the filing of financial statements with the SEC, thus circumventing the SEC and SOX altogether. Other Chinese firms, such as the big shipping company Sinotrans Ltd. and the carrier Air China, have chosen to open trading on the London Stock Exchange or launch a public listing in Hong Kong alone. [248]

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[246] Gordon L. Clark, Dariusz Wójcik & Rob Bauer, "Corporate Governance, Cross-listing, and Managerial Response to Stock Price Discounting: Royal Ahold and Market Arbitrage— Amsterdam and New York, 1973-2004" (Paper presented to the 2004 Annual Conference of Canadian Law and Economics Association, October 12, 2004, Toronto) [unpublished].
[247] *Ibid.* at 19.
[248] Laura Santini, "Chinese Firms Tap U.S. Market without IPOs" *Asian Wall Street Journal* (21 October 2004) M.1.

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Another recent example of the declining attraction of the US capital markets to foreign companies comes from some European firms listed in the United States. After the coming into force of the SOX, European firms listed at NASDAQ or NYSE have found themselves stuck in a dilemma of either remaining listed in the US markets with higher compliance costs under the SOX requirements on disclosure and auditing, or exiting the US stock markets after taking pains to prove to the SEC that the number of their US investors is less than 300 under SEC requirements, which is a time-consuming and expensive process. This difficulty in leaving the U.S. market is clearly demonstrated by the hard won victory of Last-minute.com, an UK internet operator, for its delisting from NASDAQ after winning a four-month court battle against the SEC over whether it had satisfied the conditions for exit and sending out hundreds of letters to its U.S. investors for their consent. As a consequence, some European firms have abandoned their plans to list in the United States, including big names such as the car maker Porsche and the world's biggest re-insurance company Benfield.[249]

Despite the above counter examples of functional convergence through piggy-backing, new evidence of functional convergence in other aspects of corporate governance seems to grow. According to Bernard Black, Brian Cheffins and Michael Klausner, there has been a trend of functional convergence in outcomes of corporate governance across countries in the specific aspect of out-of-pocket liability risk for outsider directors, despite large differences in law.[250] The bottom line of the authors' assessment is that outside directors of public companies in four common law countries (Australia, Canada, Britain and the United States) and three civil law countries (France, Germany, and Japan) face only a tiny risk of out-of-pocket liability, as damages and legal fees incurred in director liability suits are paid by the company, directors' and officers' (D&O) insurance, or both.[251]

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[249] Qi Hezhong, "European Firms Trapped in the U.S. Market: A Choice between Expensive Listing and Thorny Delisting" *International Finance News* (25 October 2004), online: <http://www.chinanews.com.cn/news/2004/2004-10-25/26/498422.shtml>.
[250] Bernard Black, Brian Cheffins and Michael Klausner, "Liability Risk for Outside Directors: A Cross-Border Analysis", University of Texas Law School, Law and Economics Working Paper, No. 27.
[251] *Ibid.* at 2.

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D. Systemic persistence: "path dependence"

In "The Theory of Path Dependence in Corporate Governance Ownership and Governance," Lucian Bebchuk and Mark Roe express skepticism that corporate governance and ownership structures have converged thus far and argue that structural imperatives help to explain why differences in corporate governance have persisted, despite convergence in many economic areas such as product standards.[252] The authors attribute this trend of systemic persistence to path dependence in the process of institutional development in a given country, which has a "lock-in" effect on the evolution of institutions once they are established under peculiar political, economic and social environments and constraints that may not long endure.[253]

E. Systemic complementarities

In "Path Dependence, Corporate Governance and Complementarity," Reinhard Schmidt and Gerald Spindler approach the issue of systemic persistence in corporate governance from the perspective of institutional complementarity.[254] In their view, the complementarity between the inherent components of corporate governance regime in a given country is the main reason why a rapid convergence toward a "universally best corporate governance system" is not likely to happen. However, according to the authors, there are possibilities of convergence toward a common system that is economically inferior, such as the possibility of the "inefficient convergence" of corporate governance in Europe toward the Anglo-American model, in the sense that such convergence reduces total social welfare.[255]

3. Implications for China

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[252] Lucian Bebchuk & Mark Roe, "The Theory of Path Dependence in Corporate Governance Ownership and Governance" (1999) 52 Stanford Law Review 127-170.
[253] *Ibid.*
[254] Reinhard H. Schmidt & Gerald Spindler, "Path Dependence, Corporate Governance and Complementarity" (2002) 5:3 International Finance 311-333.
[255] Gordon & Roe, *supra* note 237 at 17.

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The debate on convergence or persistence in corporate governance has deep implications for China as a developing and transition economy that has been undertaking corporate governance reform. While China should take into account internationally accepted rules and guidelines— particularly those spelled out in the *OECD Corporate Governance Principles*— in its corporate governance reform at the new stage of transition, local solutions that correspond to the existing legal and institutional environments should be accepted, even though these solutions are transitional and not perfect.[256]

In fact, the *OECD Corporate Governance Principles* were the major reference when China was drafting its first *Code of Corporate Governance for Listed Companies*, which was jointly released by China Securities Regulatory Commission (the CSRC) and State Economic and Trade Commission in January 2001.[257] However, the implementation of the Code has not been satisfactory because of the inexperience in competent regulation on the part of the CSRC and the lack of supporting or complementary mechanisms allowing the principles enshrined in the Code to function. For example, while the hiring of independent directors is required under the Code for Chinese listed companies, in reality it is very difficult to find enough qualified individuals to serve as independent directors, given the underdevelopment of human capital in China and the lack of an effective screening mechanism to select qualified candidates, not to mention the virtual absence of a managerial market where business talents can be properly priced.

Therefore, proper sequencing and pacing should be the guiding principle in adopting global "best practices" in China where their institutional foundations – such as experienced and competent financial market regulators, sophisticated financial intermediaries, an independent and incorrupt judiciary, an effective financial reporting industry, and a solid base of institutional investors- are either absent or underdeveloped.

[256] The *OECD Corporate Governance Principles* were the major reference when China was drafting its first *Code of Corporate Governance for Listed Companies*, which was jointly released by China Securities Regulatory Commission (the CSRC) and State Economic and Trade Commission in January 2001.
[257] The text of the Code can found at the CSRC website:
<http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1061948026100&type=CMS.STD>.

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Section VI
Conclusion

Section VI concludes with the lessons that China should learn from the international experience in corporate governance reforms. Three points are of particular importance.

1. The quality of corporate governance system in a country in transition is as important as the quality of crucial public sector institutions for sustainable economic growth, as well as overall social development.

Although there has been limited evidence that firm-specific corporate governance actions have little or no effect on market value in developed countries, for transition economies and emerging markets, the correlation between corporate governance and firm performance seems unequivocally significant: a number of empirical studies, particularly those in the strands of "law and finance" and "finance and growth" theories, have demonstrated that corporate governance matters greatly in less developed economies.

While the powerful broad governance theory indicates a strong causal link from better governance to higher incomes, it does not incorporate private sector institutions, of which corporate governance systems are a very important aspect. Moreover, it encounters difficulty in fully explaining China's growth over the past two decades. China's transition experience will likely provide a distinctive perspective on governance and growth to the broad governance theory, making it more applicable to transition economies.

2. Political determinants of corporate governance and legal and institutional perspectives on corporate governance are of particular significance to China's ongoing enterprise and corporate governance reforms.

China's enterprise and corporate governance reforms had followed a gradualist approach whereby mass privatization had not become a favorable policy option until China's recent

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accession to the WTO. This is primarily because when the transition was at an early stage, the political, economic and institutional environments posed huge challenges to unconstrained and rapid reform. The political considerations behind the continuing state ownership and control in China's partially privatized state sector, such as retaining an ability of the state to control employment and labor policies, should not be dismissed on the sole basis of economic efficiency. Over the course of seeking practical and workable initiatives under the existing political constraints, even after China's accession to the WTO, sequencing and pacing should continue to play a major role in implementing privatization and corporate governance reform. In the meantime, after China's accession to the WTO, more flexibility of transition strategies is also needed. This requires an accelerated speed of reform and complementary reform initiatives in related sectors, including the SOE, banking and securities sectors.

For China, legal and institutional reforms aimed at establishing market mechanisms and promoting a sound environment for the private sector to grow and compete on an equal footing with state enterprises are the guarantee for successful corporate governance reform in both the SOE and banking sector. Russia provided a negative example of rushed privatization in an institutional vacuum and this lesson should be learned by China. In addition, legal and institutional reforms need to address the "politics" behind them, which has a potentially blocking effect due to the effort by vested interests to slow or hinder reforms for fear of losing their existing benefits and entrenched advantages. In many developing as well as transition economies, some incompetent or corrupt judges and state monopolies in strategic industries are the most likely opponents to legal and institutional reforms. China should take the "politics" of reform as a critical matter and address it sensitively during its legal and institutional reforms in order to establish sound foundations for the market. "Bribing/buying" the interest groups in exchange for their consent to reform through allocating more benefits of reform to them, or promoting competing forces in the national economic system that are supportive of reform, such as private entrepreneurs, are possible solutions.

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3. Without establishing (if possible) complementary mechanisms, convergence of corporate governance systems in transition economies toward the U.S. model is not likely to succeed in bringing about the same effect which this model has had in its home market. Moreover, because it is very difficult for a reforming country to transplant from a host country systemic complementarities in corporate governance mechanisms and institutions without at the same time weakening or losing their original functions, the prospects for convergence, at least for transition economies, are still uncertain.

China has encountered this difficulty of convergence in experimenting with a hybrid corporate governance model that combines main features of both the U.S. model and the OECD guidelines for corporate governance. China's *Code of Corporate Governance for Listed Companies* was intended to bring global best practices to its domestic firms. However, judged by empirical evidence of how Chinese firms have behaved so far, this attempt at legal and institutional transplantation has only yielded limited results. This experience suggests that the convergence possibility may be still out of reach in the Chinese context of corporate governance reform, given the identified legal and institutional deficits (or a "governance gap") at the present stage of development. Therefore, while China needs to take into account internationally-accepted standards and principles of corporate governance in its domestic reform, local solutions that may not be in conformity with international best practices, but which still serve as a second-best choice at a particular stage, should be accepted and adjusted later as the country's economic and institutional capital both improves.

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Chapter 4

Corporate Governance Practices of Major Types of Chinese Enterprises and the Institutional Constraints on Corporate Governance Reform during Transition

Chapter 4 examines the design and implementation of corporate governance mechanisms at Chinese enterprises and assesses their effects on both firm performance and the growth prospects of Chinese economy. Under investigation are four types of Chinese enterprises: state-owned enterprises (SOEs), listed companies, township and village enterprises (TVEs), and private enterprises. In Chapter 4, reform strategies adopted by the Chinese government for difference types of enterprises, as well as typical corporate governance problems arising from reforms and their causes, are discussed. In addition, Chapter 4 also investigates closely the current legal and institutional environments for China's corporate governance reform and the constraints they impose on corporate governance improvements.

The major findings of Chapter 4 are presented in the following four aspects.

(1) Due to legal and institutional constraints at the current stage of China's economic development, whereby market basics are not firmly established, the role of the government is still under transformation, and investor rights are not adequately protected, the quality of corporate governance of Chinese enterprises is generally not satisfactory and requires further reform or enhanced implementation of existing reform schemes.

(2) Privatization in China had not become a favored policy option until 1997, when the central government decided that the state should withdraw from competitive sectors of the economy and only concentrate on strategic sectors. In terms of implementation, privatization in China has proceeded in a decentralized and experimental manner, whereby local governments have been the driving force in seeking workable reform

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strategies for local SOEs and TVEs under existing federalist and government structures. Corporatization and shareholding reform have been the primary methods of corporate governance reform in the SOE sector aimed at transforming traditional SOEs into shareholding companies with diversified ownership structures. Currently, while privatization has been extended to a much broader scale at the local levels, large SOEs, especially state monopolies under central government's control, have not experienced much privatization, or have only been partially privatized. What is more, the reform of SOEs in China, in particular since 2000, has been primarily identified not with mass privatization, but with "gradual participation of private capital in the ownership restructuring of SOEs" (*jianjinshi minyinghua*).

(3) Although at an early stage of reform some transitional corporate governance mechanisms had played a positive role in bringing about efficiency gains, such as local government ownership and control of TVEs that served as the second-best solution to the agency problem, these transitional mechanisms are no longer efficient at later stages of reform. As China's transition proceeds, these "stepping stones" toward a full market economy need to be replaced by more market-oriented institutions. One such example is the widespread privatization of TVEs since the mid-1990s.

(4) Under a "dual track" system at the early stage of reform, which encouraged competition between the state and non-state sectors without addressing ownership reform of SOEs, China's indigenous private enterprises were permitted to grow alongside the state sector, but were also subject to various forms of policy discrimination, particularly with regard to financing and eligibility for industry entry. After two decades of development, Chinese private enterprises have become the primary contributor to the country's economic growth and employment expansion, but the policy discrimination against them has only started to be addressed seriously by the government very recently.

Moreover, although the private sector, now consisting of both "born private" firms and privatized former SOEs and TVEs, is widely expected to dominate China's economy in the future as the most competitive sector, it has also encountered serious challenges of

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corporate governance reform. These challenges are primarily associated with the overall transformation of traditional business patterns in China's private sector, such as the "lock-up" pattern of family business lines, lax internal controls, "founder's dictatorship," and the practice of "private entrepreneurs paying for a government identity card." These old patterns of doing business are unlikely to sustain global competition and need to be reformed and replaced by modern corporate governance mechanisms, particularly with respect to effective internal checks and monitoring of the owner-manager.

Based on the above observations, Chapter 4 argues that careful sequencing and pacing should be regarded as the central feature of corporate governance reform in China, which requires realistic and workable schemes that accommodate available economic and political resources and existing legal and institutional environments. Because of the huge size of China's economy and diversified local conditions and levels of development, local experiments with innovative pilot schemes should be encouraged in the process of corporate governance reform, which has been a major characteristic of China's gradualist approach toward transition. These local experiments are not only useful for the accumulation of collective knowledge of transition strategies across the country, but can also facilitate the discovery of effective reform strategies suitable for a broader scope of application through trial-and-error at lower costs.

Chapter 4 is divided into seven sections. Section I draws a broad picture of the current landscape of China's enterprise sectors by presenting relevant statistics and data on major types of Chinese firms. Based on the empirical data, Section I also assesses the respective importance of different types of enterprises to China's economy, as well as their prospects for contributing to the country's future growth and enhancement of global competitiveness.

Section II reviews corporate governance reform of China's SOEs, including large SOEs controlled by the central government ("central SOEs") and small and medium enterprises (SMEs) controlled by local governments ("local SOEs"). The focus of examination in Section II is the progress of shareholding reform and decentralized privatization over the

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past decade or so, and in particular after 1997 when the central government decided that the state should withdraw from competitive sectors of the economy and only concentrate on strategic industries. A strategy of "grasp the large, release the small" (*zhuada fangxiao*) was announced in 1997 by the central government as the guiding principle for SOE reform. After various experiments at the local levels, this strategy has been interpreted as privatizing all but the largest SOEs controlled by the central government, i.e., the "central SOEs," numbering 178 as of January 5, 2005. Accordingly, Section II closely examines the core elements, implementation and effect of the "*zhuada fangxiao*" strategy.

Specifically, the State-owned Assets Supervision and Administration Commission (SASAC), which currently oversees state assets in the SOE sector as the **sole** representative of the state owner, is a key subject of investigation in Section II, especially with regard to its intensive rule-making and monitoring activities since its establishment in April 2003. The term "sole" is particularly important, because it marks a notable difference between the newly established practice and the old practice of supervising SOEs. Under the new design of state assets management system, the SASAC is solely responsible for exercising the ownership rights in SOEs and ensuring the maintenance and increase of the value of state assets. By contrast, before the SASAC was established, multiple government agencies with different (and at times conflicting) objectives had split the state ownership rights in the SOE sector, yet none had been made ultimately responsible for firms' performance failure.

In addition, in Section II, issues that are closely associated with decentralized privatization, primarily in relation to the reform of local SMEs, are also discussed. Local experiments with innovative schemes of privatization are introduced as an example of a gradualist and experimental approach to SOE reform in China, even though some of these pilot schemes are not always workable. Controversies over management buyouts (MBOs) as a method of privatization and the local practice of "business people wearing 'red hats'" are also examined, which indicate the challenges and difficulties of SOE reform and, to a broader extent, of building market fundamentals in China under legal and institutional constraints.

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Section III offers a brief overall assessment of corporate governance of Chinese listed companies in both domestic and overseas stock markets. The domestic stock markets are the Shanghai Stock Exchange and Shenzhen Stock Exchange. The primary overseas stock markets for Chinese listings are those in Hong Kong, New York, London and Singapore. In-depth case studies of corporate governance of Chinese listed companies on both domestic and overseas stock markets are presented in Chapter 5, which deals with the important issue of the interaction between capital markets and corporate governance of Chinese listed companies.

Section IV and Section V address corporate governance issues at Chinese TVEs and private enterprises, respectively. The main subject of investigation of Section IV is the rise and possible fall of TVEs, with an emphasis on the function of local government ownership and control as a transitional corporate governance institution in addressing the agency problem.

In examining China's private enterprises, the primary finding of Section V is that although they have outperformed SOEs over the past two decades and gradually become more competitive to meet the challenge of globalization, their corporate governance structures have displayed some worrying signs of inefficiency. Examples of such corporate governance deficiencies include the "lock-up" pattern of family business and the phenomenon of "founder's dictatorship," which need to be addressed in future reforms. Section V also points out that although the removal of "red hats" from those private enterprises originally registered as pseudo-TVEs is a significant improvement on their corporate governance structures, the problem of lax internal controls has increasingly become a significant impediment to the future growth of these private firms.

In light of the empirical review of corporate governance practices in major types of Chinese firms presented in the preceding sections, Section VI then raises important questions that have emerged from China's corporate governance reform, and attempts to explain these questions under the analytical framework of a gradualist reform strategy.

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Finally, Section VII concludes by describing the positive and negative lessons of corporate governance reform in major types of Chinese enterprises.

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Section I
Introduction

By reviewing the landscape of Chinese enterprises, Section I will point out that among China's major enterprise sectors, the relative importance of SOEs to the national economy has been in decline, while the private sector has become the main contributor to China's GDP growth. It is also suggested that future competitive Chinese enterprises on both domestic and international markets will be found not in the SOE sector, but in the private sector. To learn from previous reforms and seek appropriate future reform strategies to improve corporate governance of Chinese enterprises, it is important to study both SOEs and private enterprises. While SOEs have been the primary concern of China's corporate governance reform and whether they can be transformed into competitive firms will have a huge impact on China's growth prospects, private enterprises have demonstrated tremendous potential to contribute significantly to China's transition to a market economy and international competitiveness in an age of economic globalization.

The following discussion is aimed at providing relevant statistics and data on major types of Chinese enterprises, which indicate their respective importance to China's economy.

1. State-owned enterprises (SOEs), including large SOEs controlled by the central government ("central SOEs") and SMEs controlled by local governments ("local SOEs")

In December 2003, there were about 150,000 SOEs in China, of which more than 147,000 were SMEs under local government control (i.e., "local SOEs").[258] The largest SOEs under central government control with the State-owned Assets Supervision and Administration Commission (SASAC) as their custodian (i.e., "central SOEs") numbered

[258] SASAC, "Maintaining the Direction of SOE Reform and Orderly Pushing Forward SOE Reform" *People's Daily* (29 September 2004).

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178 as of January 2005.[259] These firms have been described as "white elephants" by some western observers.[260] Under a gradualist strategy, the central SOEs and local SOEs are treated differently with regard to ownership reform. On the one hand, the central SOEs are the subject of the "grasp the large" (*zhuada*) scheme whereby the state owner retains control of these firms. On the other hand, the local SOEs are the major concern under the "release the small" (*fangxiao*) scheme aimed at introducing foreign and private capital into the ownership structures of these firms, which usually involves deeper ownership diversification or fuller privatization.

Even after two decades of reform, China still has the world's largest number of SOEs in an era marked by global waves of privatization. This is a sharp dissonance with the prevailing theme of the day. With such a huge size, China's SOE sector has continuously underperformed its non-state counterparts, especially the vibrant private enterprises which now account for nearly two thirds of China's annual GDP output. Despite the decline of their importance to the growth of the national economy, SOEs are still a huge burden on the government and the success or failure of their reform will have a significant impact on China's overall growth prospects.

2. Listed companies

As of October 2004, there were 1378 listed companies on China's two stock exchanges in Shanghai and Shenzhen.[261] The state owns two-thirds of equity in all listed companies, which, for the purpose of retaining control, is non-tradable.

Partially privatized SOEs, many of which lose money and are badly governed, dominate China's stock market. By contrast, most profitable private firms have been denied public

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259 Duan Xiaoyan, "The SASAC Admonishing SOE Bosses" *21st Century Business Herald* (15 December 2004).
260 "The Other China: Parts That The Bulldozers Have Not Yet Reached" *The Economist* (8 January 2004) 59-61.
261 Source of data: China Securities Regulatory Commission (CSRC), online: CSRC <http://www.csrc.gov.cn/cn/statinfo/index1_cn.jsp?path=ROOT>EN>Statistical % 20Information>Listed>.

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listings in China's stock market. For example, Standard & Poor's, a credit-rating agency, counted only 35 "private" listed companies in China in 2003 out of a total number of 1300 listed companies, and pointed out that a good number of these so-called "private" listed companies are in fact controlled by local governments and even the military.[262]

3. Township and village enterprises (TVEs)

Having prospered in early years of China's economic reform, Chinese TVEs have been in decline since the mid-1990s and undergone widespread privatization. However, recent statistics show that they are still relevant to employment generation and income increases for China's rural population. For example, TVEs are estimated to have employed a total number of 138 million rural workers over the periods of 1978-2004. Even though in decline, they were projected to still have employed 3 million workers in 2004 alone. TVEs are also an importance source of income increases for China's rural residents. For instance, in 2003, TVEs contributed 35 percent to the annual total income of China's rural population.[263]

4. Private enterprises

In January 2005, there were about 3.01 million private enterprises with an employment size of more than 8 people and 23.53 million private businesses with an employment size of less than 8 people. Until June 2004, these firms in combination had employed a total number of 90 million workers.[264] According to the latest statistics released by All-China Federation of Industry and Commerce (ACFIC), the Chinese private sector now accounts

[262] "Casino Capital", in "The Weakest Link: A Survey of Asian Finance" *The Economist* (6 February 2003) 10-12 ["Casino Capital"].
[263] Zhao Yongping, "TVEs Absorbed 1.4 Million Rural Workers in the First Half of 2004 and Are An Important Source of Rural Income Increases" *People's Daily* (28 September 2004) online: *People's Daily* <http://www.chinanews.com.cn/news/2004/2004-09-28/26/488937.shtml> [Zhao].
[264] Wang Zi, "The Non-State Sector in Chinese Economy Is Now Given Proper Evaluation and Treatment" *21st Century Business Herald* (24 January 2005), online: 21st Century Business Herald <http://www.nanfangdaily.com.cn/jj/20050124/zh/200501240001.asp>.

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for roughly one half of the country's annual GDP output and 70 percent of the aggregate employment.[265] If measured by employment expansion, the private enterprises stand out even more remarkably. Since 1992, they have added 5-6 million new employment posts per year. In 2004, they even provided 90 percent of all newly created employment posts in China.[266]

The above data strongly support a prediction that is widely shared by Chinese economists: in the future landscape of competition among Chinese enterprises, the dominant players with the most vigorous competitiveness are not likely to be found in the SOE sector but in the non-state sector, in particular the private enterprises. The following discussion in Section II and Section V will provide resounding support for the validity of this prediction.

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[265] *Ibid.*
[266] *Ibid.*

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Section II

Corporate Governance of SOEs in China

Corporate governance reform of China's SOEs as a policy priority has been underway since the shareholding reform was expanded nationwide in the mid-1990s. The shareholding reform, starting from local pilot programs of corporatization, has transformed traditional SOEs into a new form of firm- shareholding companies. As reported in Chapter 2, as an alternative approach to SOE reform after previous schemes had all failed, the shareholding experiment marked the first attempt by the government to tackle ownership reform in the SOE sector. The shareholding reform has been aimed at diversifying the ownership structure of SOEs and transforming them into shareholding companies with Western-style corporate governance structures.

Corporate governance reform of Chinese SOEs has generated some encouraging results as the shareholding experiment and privatization have extended to a wide application across the country. There are some reports showing that, through corporate governance reform, especially privatization, SOEs have improved their performance. For example, according to a recent empirical study of China's privatization, during 1990-97 newly privatized SOEs had shown "significant improvements in real output, real assets, and sales efficiency" in addition to "significant declines in leverage" and "significant improvements in profitability" compared to fully state-owned firms.[267] Another study reports that China's shareholding reform has had huge impacts on both firm efficiency and social equality.[268] On the one hand, for SOEs and collectively-owned enterprises such as TVEs, their conversion to joint stock companies "contributes to overall increases in both current productivity and innovation" and paves a way for the emergence of "a domestic managerial and entrepreneurial class." On the other hand, the greater concentration of shareholding reform in wealthier coastal areas is likely to contribute to

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[267] Zuobao Wei, Oscar Varela, Juliet D'Souza & M. Kabir Hassan, "The Financial and Operating Performance of China's Newly Privatized Firms" (2003) 32:2 Financial Management 107-127 at 107.
[268] Gary H. Jefferson, Su Jian, Jiang Yuan & Yu Xinhua, "The Impact of Shareholding Reform on Chinese Enterprises, 1995-2001" (2003) William Davidson Institute Working Paper No. 542.

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regional inequality in China.[269]

Although the corporate governance reform of Chinese SOEs has produced some positive results, the problems and challenges must not be underestimated. Section II reviews several important aspects of corporate governance at Chinese SOEs to demonstrate this point.

1. The "politics" of privatization: the political economy constraints on privatization in China

The "politics" of privatization is chiefly a reflection of the current political economy constraints on China's economic reform and transition to the market. Broadly speaking, privatization in China has taken, and had to take, a gradualist approach in terms of both speed/scope and method.

The speed/scope of privatization concerns issues such as when to privatize and which types of SOEs should be privatized. The method of privatization primarily centers on the following issues: 1) how to transfer state assets to private hands (e.g., through IPOs, MBOs, open market auctions, or government-coordinated mergers and acquisitions); 2) how to solve the problems of labor reallocation and debt payment to workers, such as salary arrears, unpaid welfare benefits and pensions; and 3) how to reach an agreement with bank creditors with respect to usually huge amounts of un-recovered loans to the firm.

These issues are all practical challenges and always a headache for local governments who supervise state firms during the process of privatization, primarily because the necessary legal rules and regulations governing the management and transfer of state assets have been in short supply at the central level. As a consequence, the experiments with privatization at the local levels have been subject to a variety of

[269] *Ibid.*

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diverse practices and a considerable level of uncertainty surrounding the legitimacy of already executed deals.

In China's decentralized privatization, local governments have been engaged in a "game" with the central government. To both the central and local governments, the problems and challenges arising from privatization as mentioned above raise different political as well as social and economic implications.

From the point of view of the central government, privatization should be conducted in a "stable and cautious" manner, given various legal and institutional constraints on ownership reform of SOEs. The most cited constraints include the explicit (e.g., salary arrears and unpaid welfare benefits) and implicit debts (e.g., a huge deficit in the current pension system) owed to workers, the fairness between coastal and interior areas with different levels of industrial growth, potential social instability caused by massive lay-offs, the lack of necessary laws and regulations to govern state assets transfer, weak monitoring by the central government of asset stripping at local levels, and an inadequate social security system.

The local governments, however, are generally driven by different incentives in the process of privatization. It has been repeatedly reported that local governments, especially those with larger bases of state-owned industries, have a strong "impulse" for embarking on rapid ownership reform. Two reasons are behind this "local impulse." First, local governments are eager to get rid of the huge fiscal and social burdens of running SOEs as quickly as possible and raise local economic performance, which is closely linked to the promotion prospects of local officials. Second, because the SASAC is now in charge of SOE reform and is poised to introduce vigorous regulation and monitoring over the implementation of assets transfer at local levels, some local officials are afraid of losing the last opportunity to "catch fish in turbid water" or "enjoy the last free supper" when rules and disciplines were not fully in place, which usually involves irregular transactions.[270] Some local governments, such

[270] "The SASAC in Swift Action: A Sudden Break on Local SOE Reforms" *21st Century Business Herald* (24 December 2003).

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as Nanjing municipality of Jiangsu province, even set up a timetable to speed up privatization and impose "execution targets" on local SOEs, forcing them to conduct expedient ownership transfer.[271]

Seen from the central-local power play or a dynamic "game" between different levels of Chinese government, the conclusion is that the "politics" of privatization has a lot to do with China's gradualist approach to privatization and corporate governance reform.

2. Privatization and corporate governance reform of local SMEs ("release the small" or "*fangxiao*")

For China's state-owned SMEs, which are usually controlled by local governments, corporate governance reform has been gradually taking place and achieved some meaningful results. Through ownership restructuring guided by the policy of "seize the large, release the small," the majority of China's state-owned SMEs have been privatized by insiders, including former managers and employees. As a result, insider shareholding, particularly the controlling shareholding by managers, has become the dominant ownership structure of these firms. This type of insider privatization was largely an accommodation to the strategic consideration of the government to "buy consent" from managers and employees, in order for reforms to take place.[272]

While this kind of ownership structure (i.e., managerial controlling shareholding) may have advantages over the old firms, the problems associated with insider control and lack of transparency and competition from outside bidders in transferring state assets have also caused corporate governance failures, such as poor management and asset stripping.

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[271] Lou Yi & Li Qing, "The Mystery of Hunan's Sale of State Shares on Sale" *Caijing* (20 September 2003); Wang Chenbo, Chen Xiao & Pan Songtao, "The Window-Dressing Role of Property Rights Trading Centre: Jiangsu Province Reviewing Expedient Reform of State Assets" *China Newsweek* (25 October 2004); Li Jing & Wang Shengke, "A Thorough Review of the Transfer of State Assets Worth 2 Billion: Jiangsu Province Under Central Government Scrutiny" *21st Century Business Herald* (9 October 2004).
[272] Zhang Chunlin, "The Ownership Reform of Small SOEs" *Caijing* (5 February 2002).

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Some Chinese economists have proposed a solution to these problems: introducing outside investors either through direct transfer of managerial shareholding to new owners, or by issuing new shares to outsiders to change the controlling shareholders. In either case, fairness, transparency and competition from outside bidders should be guaranteed in searching for the optimal owner.[273]

It is also important to note that in the process of privatizing local SMEs, some pilot reform schemes have been designed by local governments to experiment with workable strategies that accommodate distinct local conditions and levels of economic development. There have been some successful examples in the 1990s. The experience of three localities, including Zhucheng county of Shandong Province, Shunde county of Guangdong province, and Yibin county of Sichuan province, for example, has received positive remarks from Chinese economists.

As to the first example, Zhucheng county of Shandong province, its initially controversial but ultimately successful privatization experiment began in September 1992. The county eventually transformed 37 of the 50 SOEs controlled by the local government into non-state enterprises. Of the 37 transformed former SOEs, 32 became stock cooperatives collectively owned by their managers and employees, three larger firms were incorporated into limited liability companies under the *Company Law*, one firm was merged with a Beijing-based non-state enterprise, and one firm went bankrupt, which was rare at the time when bankruptcy was still an unfamiliar notion to China's SOEs. The remaining 13 SOEs not included in the privatization experiment were all in public utility and transportation sectors, which the county regarded as appropriate for continuing government control in order to serve its duty to provide public services to the local community. Moreover, the county also privatized 235 of its 238 urban collectives.[274]

The reported results of privatization in Zhucheng county were impressive. Before the reform, many of the local SOEs were losing money. After the reform, all transformed

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[273] *Ibid.*

[274] Yuanzheng Cao, Yingyi Qian & Barry R. Weingast, "From Federalism, Chinese Style, to Privatization, Chinese Style" (1999) 7:1 Economics of Transition 103-141, at 127-129 [Cao, Qian & Weingast].

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enterprises started making profits. The total profits made by the reformed firms, the average rate of return on capital in local enterprises, the average annual growth rate of local government revenue, and the average annual incomes of employees of local enterprises all increased significantly in the first three years after privatization.[275]

The second example, Shunde county of Guangdong province, was well known across China in the late 1980s for its successful TVE sector. As China's transition proceeded in the 1990s, TVEs started to show signs of decreased competitiveness and some localities, including, notably, Shunde county, began to privatize TVEs. In 1993, the county launched its reform of both local SOEs and TVEs by changing their ownership structures and introducing ownership diversification.[276] For example, the local government changed the ownership structures of 743 former SOEs and collectively-owned enterprises (including TVEs and urban collectives), accounting for 69 percent of the total in Shunde county.[277] Of these 743 enterprises, 249 were sold to the public, 331 were transformed into stock cooperatives owned by their managers and employees, 21 changed their controlling owners (i.e., the local county or township government) to minority shareholders, and 142 in public utility, transportation, real estate and foreign trade sectors remained solely owned or controlled by the country or township government.[278]

As privatization has expanded to a much broader application nationwide after 1997, when the central government gave its endorsement to the "grasp the large, release the small" policy, Shunde country has experience much deeper and accelerated privatization. It is currently the best performing local economy in China, with local private enterprises now contributing nearly 60 percent to the county's annual GDP output and 57.2 percent to the annual tax revenues of the local government.[279] Most recently, the projected annual GDP

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[275] *Ibid.*
[276] *Ibid.*
[277] *Ibid.*
[278] *Ibid.*
[279] "Private Sector Now Accounts for 59.7 Percent of Shunde's Aggregate GDP Output" *South Daily* (2 November 2004), online: South Daily <http://www.southcn.com/news/dishi/foshan/ttxw/200411020421.htm>.

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growth rate of Shunde county for 2005 was estimated to reach 20 percent.[280]

The third example, Yibin county of Sichuan province, started ownership reform of local SOEs and collective enterprises (including TVEs and urban collectives) in 1992 through privatization, which was a pioneering experiment at the time. By 1995, of the total 110 local SOEs and collective enterprises, 86 had been transformed into private enterprises.[281] What distinguished the Yibin model of privatization was its adoption of a method of non-cash mortgage sales, whereby buyers, usually former managers and employees of the transformed enterprises, paid 30 percent of the book value of the firm assets and paid off the balances in installments over the following three years. Before the full value of the sold assets was paid off, buyers in general had paid an annual fee to the state as rents for using state assets. The results of privatization in Yibin county were positive in the immediate three years. For example, between 1993 and 1995, the profits and taxes contributed by the reformed enterprises to the local economy had increased seven times, while workers' average incomes increased by 30 percent per year.[282]

While the examples of Zhucheng, Shunde and Yibin were generally positive, there have also been local experiments that were not always workable, at least at a particular stage of reform when the necessary political and institutional conditions were not yet receptive to such pilot schemes. For instance, in September 2003, the provincial government of Hunan pooled all the state shares in its listed companies together and put these shares on sale as a wholesale package at the annual China High-Tec Fair (CHTF) held in Shenzhen, with the expectation to sell off these shares to private investors (including foreign investors). However, this move was very controversial and raised criticism from both the public and central government as "too radical," as the central government had yet to clarify its position and policy on the non-tradable state shares in listed companies. In the end, the Hunan provincial government had to withdraw its privatization plan under

[280] Ma Zhenhua, Wang Maolang, Ma Hongsheng & Zhang Tao, "The Projected GDP Growth Rate of Shunde County for 2005 Has Been Increased to 20 Percent" *Pearl River Daily* (11 April 2005), online: <http://county.aweb.com.cn/2005/4/11/8144648.htm>.
[281] Cao, Qian & Weingast, *supra* note 274.
[282] *Ibid.*

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external pressures, particularly from the SASAC.[283]

3. The controversies over MBOs

The term "MBO" (management buyout) has different meaning in the Chinese context, compared to how it is generally understood in the capital markets of mature market economies. In China, the MBO is a new concept to the business community and only started to emerge several years ago during the process of SOE reform. In the first place, the target firms of many MBO deals were not public companies, as is usually the case in Western capital markets, but state-owned, non-listed firms. Managers of these firms usually became their new owners by acquiring controlling stakes or full ownership via off-market negotiations with local governments. Because there have been some irregularities associated with this method of privatization, such as asset stripping, extraction of state resources, self-dealing, corruption, and violation of workers' rights, public scrutiny and criticism have intensified over the past two years, which eventually amounted to a storm of attacks on MBOs.

In particular, controversies over a few high-profile Chinese enterprises which had transformed from old SOEs, through which process capable managers successfully turned loss-making SOEs into profitable private firms through explicit or implicit MBOs, have raised the issue of the legitimacy of this particular method of privatization, given the lack of necessary legal rules that govern MBO transactions. The MBO controversy reached its culmination in the summer of 2004 when an economist of the Chinese University of Hong Kong, Larry H. P. Lang, launched a fierce assault on several well-known Chinese entrepreneurs, including Zhang Ruimin, the CEO of Haier, a white goods maker, Li Dongsheng, the CEO of TCL, a TV and phone maker, and Gu Chujun, the CEO of Greencool, an electronics manufacturer. Mr. Lang accused these managers of accumulating personal wealth through stripping state assets during the process of China's

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[283] Hu Yifan & Lou Yi, "Some Puzzles Surrounding the Transfer of State Assets Still Waiting for Clear Answers" *Caijing* 96 (20 November 2003), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=4844>.

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SOE reform.[284] He dismissed the legitimacy of Chinese-style MBOs as an acceptable method of acquiring controlling stakes in SOEs, because in his view this is no much different from the much criticized Russian style of privatization, whereby some large SOEs were sold at ridiculously low prices to insiders.

Mr. Lang's open criticism of MBOs, which first appeared in a popular Chinese financial internet forum, *Sohu*, and later began to be aired in a Shanghai-based TV program, *Larry Lang Live*, has resulted in a wave of debate over privatization among Chinese public, media and academic circles. This debate is still commanding the height of public attention today. Almost every well-known Chinese economist has joined this debate, either concurring with Mr. Lang or challenging his position by criticizing him for "reaching a general conclusion based on limited case studies" or "relying on questionable data."[285] Hundreds of commentaries and newspaper reports have been pouring into the public domain, mostly on the internet. One of the entrepreneurs criticized by Mr. Lang even brought a libel lawsuit against him, which has been much publicized by the media and added in more dramatic flavor to this episode.

The lawsuit against Mr. Lang was brought by Mr. Gu Chujun, the CEO of Greencool. Greencool expanded operations through acquiring controlling stakes in ailing state firms. Mr. Gu was attacked by Mr. Lang for "stealing state assets" through a series of

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[284] Larry H.P. Lang, "Questioning the Method of Ownership Reform at TCL" (17 June 2004), online: <http://business.sohu.com/2004/06/17/35/article220573551.shtml>; idem, "The Transformation of Haier: A Complete Analysis of A Long and Complicated Process of MBO" (2 August 2004), online: <http://finance.sina.com.cn/t/20040802/1417919523.shtml>; idem, "Be Aware of The Collusive Expropriation of State Assets by Private and State Enterprises" (26 August 2004), online: <http://www.phoenixtv.com/home/finance/fortune/200408/26/317941.html>.

[285] See, for example, Liu Jipeng, "Leftism and Rightism both Harmful in Ownership Reform" (19 October 2004) online: <http://business.sohu.com/20041019/n222560185.shtml>; Qin Hui, "The Battle between Leftists and Rightists, the Danger in the Institutions, and the Fair Reform of SOEs" (11 October 2004), online: <http://business.sohu.com/20041011/n222424113.shtml>; Qiu Feng, "Seeking the Legitimacy of Ownership Reform of SOEs" *China Newsweek* (4 October 2004); Chen Zhiwu, "Preserving SOEs or Returning the Assets to the People?" *Securities Market Weekly* (25 September 2004); Zhou Qiren, "Why My Response to Lang?" *Business Watch* (11 September 2004), online: <http://busines.sohu.com/20040911/n221992495>; Zhang Weiying, "My Response to Lang: Those with Contributions to Our Society Deserve Good Treatment" *Business Watch* (30 August 2004); Yang Ruifa & Yao Jian, "Zhang Wenkui: the Direction of Ownership Reform of SOEs Cannot be Dismissed" *21st Century Business Herald* (21 August 2004).

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"illegitimate acquisitions" of rival SOEs in the electronics industry.[286] The case had not been resolved as of December 2004, and was famously known to the Chinese public as the "Lang-Gu Affair."

It is important to examine why Mr. Lang's attacks on MBOs has obtained widespread support from the Chinese public. At a time when the Chinese public has increasingly become critical of widened social inequality and of an enlarging wealth gap during the country's economic reform, Mr. Lang has become a "cult hero" by criticizing the managers of China's best-known enterprises. Recently, Mr. Lang has used his newly launched but widely popular TV show in Shanghai, *Larry Lang Live*, as a platform to continue his attacks on the managers who were able to buy state assets at cheap prices through MBOs. Widely speculated to be partly prompted by recent public debate over privatization led by Mr. Lang, in December 2004, the SASAC prohibited MBOs of large SOEs and set stringent conditions for MBOs of smaller SOEs.[287]

Interestingly, according to his interview with *Financial Times*, Mr. Lang's claims about the private wealth obtained by the managers of SOEs was based on a list of China's richest business leaders, published in January 2005 by Euromoney China, a financial and business journal. According to Euromoney China, five of 50 enterprise managers on this list acquired their shares through MBOs. For example, Mingzhe (Peter) Ma started off in 1988 with no shares as general manager of Ping'An Insurance, a formerly state-owned insurance company. However, he has gained effective control of the firm, now listed overseas with a total capitalization of USD 4.5 billion, through an "employee shareholders association (ESA)." Such ESAs have been used as an incentive mechanism through issuing shares to managers of SOEs. However, in some cases these ESAs have been deployed by the managers as a tool of implicit MBOs to dilute state holdings.[288] These firms include previously mentioned Haier and TCL, as well as Lenovo, a PC

[286] Li Ranzhou, "The Lang-Gu Case Is A Focus of Public Attention: Lang Took the Challenge with High Profile" *The Oriental Outlook Weekly* (21 October 2004).
[287] Geoff Dyer & Richard McGregor, "China's Answer to Larry King" *Financial Time* (1 February 2005) 13.
[288] *Ibid.*

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maker that announced an acquisition agreement with IBM in December 2004 to take over the latter's PC business.

Supporters of these firms' managers argue that they have earned their success and therefore deserve decent reward, including a controlling stake in their firms. These supporters pointed out that all three firms— Haier, TCL and Lenovo— have prospered at home and also started to launch ambitious overseas operations, largely at the initiative of their top managers. However, in the view of Mr. Lang, the process of MBOs in China, including those transactions involving Haier, TCL and Lenovo, is inherently flawed, because it is usually the managers themselves who decide on what price should be paid for the state assets they acquire.[289]

As already pointed out, the government quickly took notice of the MBO controversy. In December 2004, the SASAC made it clear that it is not permitted to privatize large SOEs through MBOs.[290] While acknowledging that MBOs to some extent do improve the vitality of enterprises, the SASAC expressed deep concerns over implementation irregularities, such as self dealing and insider trading in some of the MBO transactions completed so far. In its recent review of the implementation of SOE reform at local levels, the SASAC found that in most MBO transactions, asset stripping and stealing by managers through unfair or non-transparent procedures of valuation, pricing and transfer were widespread, usually in conspiracy with local officials who oversaw the privatized firms and accepted bribes to give the deals a green light. In addition, there have been some cases where managers tried to transfer risks to the buy-out targets and state banks by using state shares and assets as loan guarantees to finance their MBO deals. The SASAC also pointed out that some MBO transactions also harmed the rights of investors and employees.[291]

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[289] *Ibid.*
[290] "Reform: State CEOs Salaries Linked to Profit" *Asia Times Online* (17 December 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FL17Ad04.html>.
[291] "Monitoring State Assets: the SASAC Is Facing A Supervision Deficiency" *China Newsweek* (18 October 2004).

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In summary, an overall assessment of the policy consequences of the recent MBO controversy is two-fold. On the one hand, the Chinese government has not shifted from the general direction of ownership reform of SOEs, nor has it dismissed privatization as a favorable policy option. On the other hand, the government has also cautioned against irregular or illegal implementation of privatization at local levels which had resulted in asset stripping and self dealing and had harmed the rights of employees. Out of this caution, the government banned MBOs as a method of privatization with regard to large SOEs. While MBOs are permitted in the case of small SOEs, their implementation is now closely monitored by the central government, specifically by the SASAC.[292] Since its establishment in March 2003, the SASAC has been working diligently to draft rules to govern proper methods and procedures of state assets transfer, and the pace of its rule-making is accelerating in the wake of recent debate over the "Lang-Gu Affair."

It seems that the policy signal at the present time is generally opposed to those managers with a MBO ambition. The position of the SASAC on MBOs could however be a double-edged sword, because while its ban on MBOs of large SOEs and tightened monitoring of MBOs of small SOEs may well put irregular practices to a halt, its toughened position could also block or deter potentially efficiency-enhancing privatization transactions.

Some economists in favor of MBOs argue that MBOs are an effective way to realize the intrinsic value of entrepreneurs, and are also a much-needed cure for the pathology of "the world's cheapest entrepreneurs but most expensive entrepreneurial system" in China.[293] On the one hand, Chinese entrepreneurs in SOEs are "cheap," because their compensation packages are very shabby and cannot yield adequate incentives, which often leads to underperformance or mismanagement. On the other hand, China's entrepreneurial system is "expensive," exactly because the lack of incentives and the resulting poor performance usually cause huge losses and waste. The issue of managerial

[292] SASAC, "Maintaining the Direction of SOE Reform and Orderly Pushing Forward SOE Reform" *People's Daily* (29 September 2004).
[293] Xu Peihua, "Seeking the Road to the Realization of the Value of Chinese Entrepreneurs" *Caijing* (20 November 2002).

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compensation will be revisited shortly when new reform strategies designed by the SASAC for the largest SOEs ("central SOEs") are examined below.

4. Reforming the state assets management system and corporate governance of the "central SOEs"

In 1997, the central government finally decided that the state should withdraw from the competitive sectors of the national economy and only concentrate on strategic industries. A strategy of "grasp the large, release the small" (*zhuada fangxiao*) was announced as the guiding principle for SOE reform, which, after various experiments at local levels, has been interpreted as privatizing all but the largest SOEs controlled by the central government or the "central SOEs," numbering 178 as of January 2005. The following discussion mainly concerns the "*zhuada*" part of the policy and with a specific emphasis on the role of the State-owned Assets Supervision and Administration Commission (SASAC), which since April 2003 has been in charge of overseeing state assets as the sole representative of the state owner.

A. State assets management system in transformation: from "centralized ownership and decentralized control" to "decentralized ownership and control"

The SASAC was established in April 2003 as the sole representative of the central government to oversee state assets nationwide. It reports directly to the State Council (i.e., the cabinet) and its officials and staff are appointed by the State Council. The SASAC also has established its local branches at both municipal and provincial levels, but the progress has varied with different localities. As of April 2005, two years after of the SASAC's establishment, some provinces still have not set up their local bureaus of the SASAC's branches.

The mandate of the SASAC is to represent the state owner in China's largest SOEs under central government's control (i.e., the "central SOEs"), with a primary responsibility of

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maintaining and increasing the value of state assets in these firms. In the past, local SOEs, which are by and large small and medium enterprises (SMEs), had been controlled by local governments which did not officially have the ownership rights. By comparison, under the new state assets management system the local governments are granted ownership rights to local SOEs.

Accordingly, the central feature of the current reform of state assets management system in China can be categorized as a transformation from "centralized ownership" of all SOEs by the central government and "decentralized control" by local governments of local SOEs, to "integrated decentralized ownership and control" of local SOEs by the local governments.

Under the old system, the central government was nominally the sole owner of SOEs at all levels, including those it did not directly supervise. Local governments, although with direct control of SOEs in their jurisdictions, did not formally enjoy the status of "owner" and were obliged to obtain central government's approvals of significant transactions or ownership reform involving local SOEs. This is described as a system of "centralized ownership and decentralized control." The old system was replaced by a new system of "integrated decentralized ownership and control" in June 2003, when local governments were granted the *de facto* ownership rights to local SOEs. This means that local governments now enjoy the status of owners of the state assets under their control, and have the rights to transfer or auction off these assets as well as make personnel decisions in local SOEs, without first having to obtain central government's approvals.[294]

Moreover, this policy shift also means that the old practice of multiple government agencies splitting the ownership rights to SOEs, i.e., "five dragons fighting the flood" as vividly summarized by Chinese economists, has been replaced by a new system, whereby

[294] Shi Dong, Zhao Xiaojian & Hu Yifan, "A Close Look at the SASAC: State Assets Management System in Gradual Clarification after the 16th Party Congress" *Caijing* (24 February 2003).

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the SASAC is the sole representative of the state owner with a consolidated range of ownership rights.[295]

The phenomenon of "five dragons fighting the flood" had been the primary cause of the agency problem of Chinese SOEs. On the one hand, multiple government agencies with different, and sometimes conflicting, objectives were each responsible for assets management, personnel decisions (such as appointments and removals of managers), and routine business operations (such as investment and R&D strategies). On the other hand, none of these agencies assumed the ultimate responsibility for firms' performance failure.[296] As the SASAC now bears sole responsibility for asset management, personnel decisions and business operations of SOEs, many Chinese economists and policy makers believe that agency costs will be significantly reduced.

B. The quest for "national champions" or "globally competitive SOEs"

As of January 2005, there were 178 large SOEs owned and directly controlled by the central government with the SASAC as their custodian. These firms are commonly known to the Chinese public as the "central SOEs" and are described by some Western observers as "the state-owned white elephants."[297] These central SOEs are generally in strategic sectors and industries, such as oil, telecommunications, civil aviation, highway, steel and power. The SASAC has taken actions to implement a strategy of "grasping the large" (*zhuada*) aimed at building global competitiveness of the central SOEs and producing 30-50 "national champions" among these firms.[298] The following discussion introduces major schemes adopted by the SASAC to implement the "*zhuada*" strategy.

(1) Encouraging mergers and acquisitions (M&As) in the same or related sectors to achieve operational integration and capacity expansion

[295] "The Path Taken by the Pioneers" *Caijing* (20 November 2002). "Dragon" is a powerful symbol in ancient Chinese legends with expertise in curbing flood.
[296] Shi Dong & Zhao Xiaojian. "The Direction of 10 Trillion State Assets" *Caijing* (20 November 2002).
[297] "The Other China: Parts That The Bulldozers Have Not Yet Reached" *The Economist* (8 January 2004) 59-61.
[298] Mary Boyd. "The State Sector" (2003) Q3 China Economic Quarterly.

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Mergers and acquisitions involving Chinese SOEs include both domestic transactions between themselves and overseas transactions with foreign partners. Recently, there have been some significant overseas M&A negotiations and deals, including two notable examples. The first is the acquisition negotiations between China Minmetals and Canada's Noranda in the mining industry, which had not produced substantial results as of April 2005, despite active initiatives by China Minmetals to reach a deal. The primary reason is that the Canadian partner, also state-owned, has been under both political pressure and public criticism for negotiating an acquisition deal with a state monopoly from a regime with "poor human rights record." The second example is the transfer of IBM's personal computer unit to China's computer maker Lenovo in December 2004, which hugely surprised US capital markets.[299] However, the Lenovo-IBM deal has also been under close scrutiny by the US government on the ground of "national security." These complexities imply that the level of difficulty in overseas expansion for Chinese SOEs might well exceed their original expectation.

A big problem of using M&As as a means to integrate and restructure China's state monopolies is that some transactions are not market-driven, but orchestrated by the government through "coordinative efforts" of the SASAC, which usually involves administrative intervention in business decision-making.[300] This problem indicates that at the current stage of China's transition, the line between the role of the government and that of the market is still not clear cut. As a result, corporate governance reform of Chinese SOEs, especially the central SOEs, is subject to strong non-market influences.

(2) Introducing competition to state monopolies in strategic sectors

Recently, private enterprises have been permitted to enter previously forbidden sectors where state monopolies dominate, such as oil, automobile, steel, electricity, transportation

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[299] Jayanthi Iyengar, "China's Misstep in Canada" *Asia Times Online* (23 November 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FK23Ad07.html>; "M&A's New Giant: IBM Deals Shows How Normal China Has Become" *Financial Times* (9 December 2004).

[300] Hu Yifan & Zhu Xiaochao, "Restructuring the Central SOEs: Searching for Market-Driven Solutions" *Caijing* (20 September 2004).

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and banking industries. The purpose of relaxing entry restrictions on private enterprises is to bring competition to monopoly SOEs and improve their performance. However, where the private enterprises are involved, abrupt policy changes and the government's arbitrary repudiation of contracts have too often proved serious impediments to the enhancement of competition in monopoly sectors. As a result, private enterprises have suffered losses, in some cases significant, as demonstrated in the much publicized incident of "government seizures of private oil wells" in 2004.

As one of the most egregious examples of violating private property rights by the government, in the spring of 2003, the local government of the northwest Shanxi province ordered the seizure of about 5,500 private oil wells in over 15 counties as part of an environmental cleanup and overhaul of the industry. These oil wells had been explored by private investors since 1994, when the Shanxi government started to encourage private investment in local oil industry to both increase efficiency and enhance competition.[301] Outraged by the government's arbitrary change of policy, investors, largely private entrepreneurs from China's heartlands, started their preparations in November 2004 for bringing collective lawsuits against both the provincial, municipal and county governments involved, over the forced seizures without due process and proper compensation. These investors claimed that the closed wells were worth nearly RMB 7 billion yuan (USD 845 million).[302] This case has been marked by both lawyers and academics as "the flagship case of protecting private property rights" in China after the Constitution was amended in March 2004 to declare that "legally obtained private property is inviolable."

(3) Consolidating "core business lines" (*zhuye*) and removing unrelated operations (*fuye*)

[301] Zhu Yuchen, "The Flagship Case of Protecting Private Property Rights" *China Newsweek* 202 (1 November 2004).
[302] Antoaneta Bezlova, "China Seizes Private Oil Wells, Mirrors Russia" *Asia Times Online* (2 November 2004), online: Asia Times Online <http://www.atimes.com/China/FK02Ad03.html>.

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China's central SOEs are required by the SASAC to gradually split from their core business lines unrelated operations and social burdens, such as schools, hospitals and employees' housing services.[303] The split had been completed with 49 central SOEs and some 800 large-sized local SOEs by December 2004.[304] Although the effect of removing social burdens and unrelated operations remains to be seen, it is widely believed that such measures will have a positive impact on firm efficiency.

(4) "Going out"

Under the SASAC's guidance, the "going out" strategy for enhancing global competitiveness of China's state monopolies can be implemented through the following channels: (1) expanding industrial operations abroad, such as reaching M&A deals with foreign partners, and (2) making overseas investments in "strategic" industries, such as mining, oil and power, and (3) seeking overseas listings of large SOEs.[305]

Of the major channels of "going out," overseas listings have become a primary method to facilitate industrial restructuring and corporate governance reform of China's state monopolies. For example, several state-owned airliners, such as Air China, Hainan Airlines, Shenzhen Airlines and Xiamen Airlines, have gone public on overseas stock exchanges in Hong Kong or London to both raise funds and change ownership structures. Apart from the fact that they can collect more money on the overseas markets, an important change for these airlines is that they all become public companies.[306] The government hopes that by going public overseas, these firms can have much better incentives to perform and make profits. However, although overseas listings to a considerable extent indeed provide stricter regulatory oversight, tougher market

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[303] Xinhua News Agency, "China Axes Redundant Operations of SOEs" *China Daily* (30 April 2004), online: China Daily <http://www.chinadaily.com.cn/english/doc/2004-04/30/content_327745.htm>.
[304] Wang Shengke, "49 Central SOEs Have Consolidated Core Business Lines" *21st Century Business Herald* (1 December 20004).
[305] James Mackintosh, Richard McGregor & Francesco Guerrera, "Chinese Companies Acquire a Taste for Western Targets" *Financial Times* (19 October 2004) 20; Arthur Kroeber, "Chinese Invasion Has Yet to Happen" (2004) Q4 China Economic Quarterly.
[306] "Air China Debuts on HK and London Markets" *Asia Times Online* (18 December 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FL18Ad03.html>.

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disciplines and higher corporate governance standards, overseas-listed Chinese SOEs have nevertheless experienced dramatic corporate failures, due to lapses in internal control systems. These corporate governance failures have dampened the confidence of international investors. Chapter 5 will provide an in-depth analysis of some significant cases.

C. A new round of corporate governance reform of the central SOEs (2003-2004)

(1) Experimenting with a board system

Since June 2004, the board of directors has been introduced as a new form of supervising central SOEs by the SASAC. The purpose of this new practice is to change the old pattern of monitoring SOEs by the state owner, whereby direct intervention by the government had dictated the appointment of management. Under the new board system, members of the board of directors are appointed by the SASAC.[307]

However, there remains a major problem with the implementation of the board system: the Party still retains direct control over firms' operations through taking part in decision-making on "significant matters," such as firms' growth strategy, investment projects, fund-raising plans, as well as appointments to the management team.[308] Certainly, the board system cannot function well under this constraint. However, this problem is beyond the scope of corporate governance issues and extends to the area of political reform, which is not far advanced in China today.

(2) Hiring managers on the open market and building managerial incentives

[307] Wang Chenbo, "Central SOEs Saying Goodbye to the Board of One-Person" *China Newsweek* (28 June 2004).
[308] Li Yizhong, "Vice Director of the SASAC on the Role of the Party in the Decision Making at Central SOEs" *China News* (24 June 2004), online: China News <http://www.chinanews.com.cn/news/2004year/2004-06-24/26/451885.shtml>.

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To help SOEs improve their performance, the central government has decided to hire top managers on the open market, including the overseas market. This is virtually an abolition of the traditional system of internal appointment.[309] By November 2004, the SASAC had hired 22 mangers in central SOEs who stood out in open market competition.[310]

Meanwhile, managerial compensation systems are also under reform. Recently, the SASAC signed a performance contract with the CEOs of 30 central SOEs, linking their salaries and bonuses to the profitability of their firms.[311] According to the SASAC, other more advanced schemes of incentive compensation, such as stock options, will be under consideration when the necessary conditions, including a well-functioning stock market, are in place.

(3) Strengthening risk control and internal monitoring

Risk control and internal monitoring have been traditionally lax in many SOEs. In order to strengthen internal control and risk management systems in central SOEs, the SASAC has asked these firms to establish necessary corporate governance organs and mechanisms, such as a chief accountant and a chief legal counsel.[312] Besides, managers are now responsible for significant operational losses caused by irresponsible investment decisions and asset stripping. In serious cases where the state suffers huge losses, the responsible managers are now subject to legal liabilities.[313]

(4) Regulating state asset transfer and improving transparency of transactions

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[309] Hu Yifan, "We Want You: State-owned Companies Pay for Talented Managers" *Caijing* (5 October 2003).
[310] Jia Quanxin, "22 Newly Hired Managers at Central SOEs Meet the Press" *China News* (13 November 2004), online: China News <http://www.chinanews.com.cn/news/2004year/2004-11-13/26/505420.shtml>.
[311] Asia Pulse/XIC, "Reform: State CEOs Salaries Linked to Profit" *Asia Times Online* (17 December 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FL17Ad04.html>.
[312] Duan Xiaoyan, "The SASAC Admonishing Bosses of Central SOEs" *21st Century Business Herald* (15 December 2004).
[313] Fan Lixiang, "Guarding Central SOEs: the SASAC is Armed with Legal Tools" *21st Century Business Herald* (18 October 2004).

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On February 1, 2004, the SASAC and the Ministry of Finance jointly issued rules that require all transactions involving state asset transfer be executed in the open market, i.e., the trading centers for property rights. Currently, China has three trading centers for state assets transfer, located in Shanghai, Tianjin and Beijing. In addition, the information of state asset transfer, such as the identity of the buyer and the prices paid, must be disclosed to the public.[314]

5. Abolishing the local practice of "business people wearing 'red hats'" to avoid "crony capitalism"

A. "Business people wearing 'red hats'" (*hongding shangren*)

The term "business people wearing 'red hats'" refers to those communist party officials who hold managerial posts in local SOEs or private enterprises. Economists in China have expressed deep concern about this phenomenon. They have pointed out that such practice entails a potential danger of driving China into a trap of the so-called "crony capitalism," which is a "bad model of market economy," as has been observed in East Asia.[315] The central government seems to have received the warning from some Chinese economists that China may likely fall into this undesirable track, if administrative power is aligned with "socially advantaged or privileged classes" to jointly expropriate public resources at the expense of social equality. In the association between public power and private interests, the "socially advantaged or privileged classes" primarily refer to China's emerging private entrepreneurs, who have gotten rich ahead of the majority of the country's general population, especially their countrymen in rural areas.

B. The central government taking on "business people wearing 'red hats'"

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[314] Jean-Marc Deschandol, "Breaking New Ground in State-owned Assets Transfers" *China Law & Practice* (1 March 2004) 1; Jia Quanxin, "Sunshine Transactions Required for State Assets Transfer" *China News* (29 September 2004), online: China News <http://www.chinanews.com.cn/news/2004year/2004-09-30/26/489835.shtml>.

[315] Hu Shuli, "Embrace A 'Good Market Economy'" *Caijing* (20 October 2003).

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By nature, the widespread local practice of "business people wearing 'red hats' " is a manifestation of public power entering the market for private gains. This is a serious distortion of market principles and also a hotbed for breeding corruption. The central government has become increasingly concerned about this local irregularity and decided to act upon it. Recently, the Party's Central Committee issued a memo to address this problem. According to this memo, as of May 2004, Chinese Communist Party cadres as well as government officials were no longer permitted to work in SOEs as managers.[316]

However, the implementation of the central government's memo has largely lagged. This is because local governments have discovered some "merits" in having officials sit on the management teams of local SOEs, such as their role in helping these firms obtain loans from local branches of state banks, and communicating with different government regulatory agencies on behalf of these firms. In the view of local governments, the transaction costs of local firms could be reduced if "business people wearing 'red hats' " can effectively deal with regulatory red-tapes, thus saving firms considerable time and resources that they can put into normal business operations.

This "transaction costs" argument has found echoes in some localities where local governments are benign to business. With regard to implementing measures to abolish the practice of "business people wearing 'red hats'," these localities have become sophisticated in playing a "game": they take little action in reality, but submit positive reports on paper to the central government. This attitude of local governments has impeded the effective implementation of the 2004 memo.[317]

Therefore, the dynamics of the relationship between China's central and local governments needs to be understood in predicting the prospects of China's market-oriented reform. It is important to note that seen from some local market-distorting practices, a danger of the country falling into the trap of a "crony market economy" is for

[316] Peter Morris, "Chinese Cadres Must Give Up Corporate Posts" *Asia Times Online* (26 March 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FC26Ad05.html> [Morris].
[317] Fan Lixiang, "Public Power Flirting with the Market: the Crisis of the 'Government-Business' Model in Yixing City" *21st Century Business Herald* (18 December 2004), online: 21st Century Business Herald <http://www.nanfangdaily.com.cn/jj/20041209/zj/200412080014.asp>.

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real. If not brought under control, this emerging danger may well contribute to future problems at later stages of China's transition.

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Section III
Corporate Governance of Chinese Listed Companies on both Domestic and Overseas Stock Markets

Section III introduces a brief assessment of corporate governance of China's listed companies. In-depth analyses and case studies are presented in Chapter 5, which deals with the important issue of the interaction between capital markets, primarily stock markets, and corporate governance of Chinese listed companies.

1. State dominance in the stock market and "the dictatorship of a single largest shareholder"

With regard to Chinese listed companies, a majority of them are either state-owned or state-controlled. Corporate governance improvement of these firms is closely associated with the development of the stock market. Because the state owns two-thirds of equity in all listed companies, which, for the purpose of retaining control, is non-tradable, the state shareholder or the state-owned legal-person shareholder as the controlling shareholder faces no market discipline. As a result, expropriation of minority shareholders is widespread. This phenomenon is described by investors as "the dictatorship of the single largest shareholder" (*yigu duda*), which has its root in the non-tradability of state shares (*guoyougu*) and legal-person shares (*farengu*). The artificial split of shares into three categories— individual shares, state shares and legal-person shares— has not only resulted in the fragmentation of the stock market, but also led to corporate governance failures in listed companies.

Although the *Company Law* spells out basic governance structures for all shareholding companies, it incorporates special provisions to accommodate continuing state ownership. However, the Chinese-style shareholding system cannot reconcile the dual goals of maximizing shareholder value and maintaining state ownership. This is because wealth maximization and other social and political aims that the state imposes on firms, such as

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maintaining excess employment, are incompatible with the interests of shareholding companies. As a result, this incompatibility has caused conflicts of interest between the state shareholder and minority shareholders.[318] This is an important cause of corporate governance failures in state-owned listed companies.

2. A "vicious circle"

In terms of the implementation of corporate governance mechanisms spelled out in the *Company Law*, many listed companies did not strictly follow the letters of such legal requirements. For example, in reality, even though the legal requirements on paper have been satisfied and basic corporate governance organs have been established, such as the general meeting of shareholders, the board of directors and the supervisory board, these institutions do not function effectively. More than often, managers (the "insiders") and controlling shareholders disrespect the rights of small investors by extracting corporate funds and stealing corporate assets and resources.

Moreover, China's stock market is not well-regulated in underdeveloped legal and institutional environments. The state frequently intervenes in market activities, and securities regulators, primarily the China Securities Regulatory Commission (CSRC), frequently submit their independence to political will. As a result, fraudulent behavior and violations of investor rights have become rampant. In other words, ineffective regulation of China's stock market and the poor quality of corporate governance of listed companies are mutually reinforcing, thus constituting a "vicious circle."

[318] Donald Clarke, "Corporate Governance in China" An Overview" (2003) 14 China Economic Review 494-507; idem, "Corporatization, not Privatization" (2003) 7:3 China Economic Quarterly 27-30.

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Section IV

Corporate Governance of Township and Village Enterprises (TVEs) in China

1. The puzzle of China's growth in defiance of conventional property rights theory

For many curious western observers, there remains a major mystery in the pattern of China's economic growth, which is lucidly summarized in the following commentary:

> China's economy has grown rapidly despite the absence of any systematic attempt to clarify "property rights."...Chinese economic success defies conventional theory, which requires that "to function anywhere near its potential, an economic system must have property rights that are much better defined and enforced than is true of China's mixed economic system today."...However, not only have the ambiguities and uncertainties in clarifying property rights done "surprisingly little" harm to Chinese reform, but they may have a longevity that will surprise Western observers.[319]

Competing interpretations of such a puzzling anomaly have proliferated in recent years, but all share a common ground: in China, it is often the social and cultural forces, such as social networking (*guanxi*), personal bonds (*ganqing*), reciprocity, sense of shame (*mianzi*), as well as invocation of the state administrative apparatus, that function to allocate and enforce property rights in practice, while formal legal institutions are largely avoided.[320]

Here, "*guanxi*" is a key notion in understanding Chinese business culture. Though inconsistent with the idea of "rule of law," *guanxi* seems to work well in many circumstances involving reciprocity and long-term business ties. As a social norm, *guanxi* has penetrated into the Chinese society at almost every level. It usually does not lead to "disorderly" social behaviors, as some western commentators have speculated and criticized when disappointed with unsuccessful business ventures in China.[321] On the contrary, "*guanxi*" by and large works well within Chinese business society, including ethnic Chinese overseas, exactly because it embodies certain commonly recognized rules

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[319] Lubman, *supra* note 49 at 117.
[320] *Ibid.*
[321] "A Disorderly Heaven", in "Behind the Mask: A Survey of Business in China" *The Economist* (18 March 2004) 10-13.

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of behavior among local communities that function as "tacit knowledge" and informal agreements to guide or restrain individual actions. This interpretation of "*guanxi*" bears equal implications for Chinese TVEs as well as private enterprises in their running of businesses, as later discussions will reveal.

However, it should also be noted that the personalized pattern of transactions built upon "*guanxi*" cannot sustain the challenge from globalization at the new stage of China's transition to the market, especially after its accession to the WTO which marked China's commitment to abiding by international business principles and commercial rules of the market. As will be pointed out, in order to survive and grow in an evolving business environment that is destined for competitive markets, corporate governance reform of Chinese TVEs as well as private enterprises need to tackle the issue of their dependence on "*guanxi*," although this process may take long. Hopefully, Chinese enterprises will one day no longer have to invest heavily in "*guanxi*" with their financial and human resources, and will be able use these resources for their routine business operations.

2. The rise of TVEs

TVEs were a major driving force of China's economic growth and export expansion during the early stage of transition. They showed robust performance during the 1970s and 1980s as compared to SOEs, but started to decline since the mid-1990s and have been subject to widespread privatization.

According to many China experts, there are two primary reasons for the success of TVEs by the mid-1990s. First, reforms in the 1970s and 1980s created competition in product markets and incentives for profit of local government officials and TVE managers, because they can share economic benefits generated from running TVEs efficiently at local levels without remitting the profits to the central government, which their SOE counterparts had to remit. Second, policy discrimination against, and societal suspicion of,

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private enterprises had suppressed their growth, primarily due to ideological constraints at the early stage of reform.[322]

In particular, banks were very reluctant to lend to private businesses in support of their maintenance and expansion, and local governments were not at all helpful in providing technological assistance and facilitating the allocation of assets and factors of production, such as land use. Therefore, TVEs enjoyed a relatively comfortable playing field for better performance, as local governments, as well as local branches of state banks under their jurisdictions and hence susceptible to local government influence, were generally supportive of these firms in terms of favorable policies of credit, land use, technological assistance, and property rights protection.

3. Ownership, control, and incentive structures of TVEs

Transitional but efficient corporate governance mechanisms adopted by China's TVEs can partly explain the country's growth over the last two decades, especially by the mid-1990s. Government ownership and control identified with the corporate governance structure of Chinese TVEs was a second-best solution to the agency problem at the early stage of reform when private enterprises did not enjoy a favorable institutional environment and their growth was suppressed by various forms of discrimination.

The TVE sector had showed the most significant progress by the mid-1990s when local governments, by taking control of TVEs, had facilitated financing, provided technical assistance, helped with allocating and accumulating assets and factors of production such as land use. Government ownership also yielded more secure property rights and helped contain corruption through granting ownership rights to government officials, thus reducing the agency costs and enhancing entrepreneurial incentives. Although the relative advantage of China's TVEs in productive efficiency has been in decline as China enters a

[322] See, for example, Brett H. McDonnell, "Lessons from the Rise and (Possible) Fall of Chinese Township-Village Enterprises" (2004) 45 Wm and Mary L. Rev. 953 [McDonnell].

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new stage of reform, and some authors have started to discuss their "possible fall," the function of those transitional corporate governance mechanisms in the middle of China's transition should not be ignored or underestimated.

The major strengths of the corporate governance mechanisms of Chinese TVEs as a transitional institution (or to some an "institutional innovation") include the following:[323]

(1) The hard budget constraint and the possibility of bankruptcy faced by TVEs;
(2) The ability of local officials to find solutions to the "delegation problem," whereby local officials appointed by higher bureaucrats may have conflicting incentives to seek higher profits, as opposed to pursuing revenue and employment generation at the expense of higher profits; and
(3) The profit sharing arrangements between managers, local governments and community members that largely aligned competing interests;
(4) More secure property rights under local government protection as compared to private enterprises.

Given their robust performance by the mid-1990s as a result of relatively efficient corporate governance structures that effectively solved problems of delegation and incentive design as compared to their SOE counterparts, Chinese TVEs were regarded by many economists an alternative to early privatization during the early stage of reform.[324]

4. A "helping hand" interpretation of TVEs success

In China, the economic roles of central government and local governments in transition are different. Local governments have generally played a more active role in promoting

[323] Barry Naughton, "Chinese Institutional Innovation and Privatization from Below" (1994) 84:2 The American Economic Review 266 at 270 [Naughton]; Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy" (1995) 102:2 American Journal of Sociology 263-301; McDonnell, *ibid.*
[324] See, for example, Naughton, *ibid.* at 270; Andrew G. Walder, "Local Governments as Industrial Firms: An Organizational Analysis of China's Transitional Economy" (1995) 102:2 American Journal of Sociology 263-301.

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non-state enterprises as well as reforming SOEs. As discussed in Chapter 2, the decentralized feature of privatization in China is primarily a result of the fiscal incentives of local governments to improve firm performance. If local governments were not faced with hard-budget constraints and revenue inducements, they would not have had a strong fiscal motivation to take supportive measures. The central government is certainly the dominant force in designing and promoting reform agenda, but the implementation and enforcement of particular reform schemes are carried out by the local governments. In general, Chinese government at both central and local levels has been positive. In particular, the success of China's TVEs is a good example to show that the economic role of the Chinese government in transition has been largely a "helping hand", as opposed to a "grabbing hand."[325]

It has been suggested that the "helping hand" role assumed by local governments is the major reason for the relative success of TVEs. How this works can be explained by the corporate governance function of local governments in TVEs, which is exercised through their ownership and control in these firms. For example, government ownership is shown to serve as a second-best commitment mechanism, through which the government agency will restrain itself from rent seeking activity and even offer the manager support and favor, such as tax breaks and subsidies.[326]

Certainly, local governments are not always destined to be supportive of or benevolent to businesses. They need to be induced to do so. The motivation and incentive for preferring a role of a "helping hand" to that of a "grabbing hand" reflect local governments' fiscal interest in helping firms improve performance so that they can collect more revenues. An important consideration for the local governments in this calculation is that predatory

[325] The terms "grabbing hand" and "helping hand" as different models of government in transition were first coined in Timothy Frye & Andrei Shleifer, "The Invisible Hand and the Grabbing Hand" (1997) 87:2 The American Economic Review 354-55. According to the authors, under the "helping hand" model, bureaucrats, though subjected to limited and organized corruption, are intimately involved in promoting private economic activity, while law plays a limited role. Under the "grabbing hand" model, government is not just as interventionist, but much less organized and more corrupt, than in the "helping hand" model, while predatory regulations are usually adopted to extract rents from private businesses. Russia is regarded by the authors as a typical example of the "grabbing hand" model, while Poland is considered in conformity with the "helping hand" model.
[326] Che, *supra* note 42 at 1.

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taxation is inferior to supportive policy combined with a well designed revenue sharing scheme. Clearly, the local governments are most likely to adopt such a business-friendly position when they can be sure that the central government does not take away too big a piece of the pie. Therefore, whether the local governments are willing to serve as a "helping hand" depends on how federalism arrangements in China can reconcile the interests at both central and local levels, especially with regard to the sharing of fiscal revenues. This factor of central-local relationship has also featured significantly in China's financial reform, as Chapters 5 and 6 demonstrate.

5. The decline of TVEs

The rapid privatization of China's TVEs has been underway since the mid-1990s, while private enterprises have flourished and prospered in China. Government control in corporate governance of TVEs as a second-best solution played a positive role in addressing the agency problem at the first stage of China's enterprise reform (1978-1994) when conventional market supporting institutions, such as the rule of law, were not well established. However, at the second stage of China's enterprise reform starting from 1994, the costs of government control in corporate government have increased because of the changing institutional environment that has become more conducive to the emergence of private ownership, and therefore the "exit" of government control from corporate governance of TVEs seems a better choice.[327]

While some transitional corporate governance mechanisms in China can be efficient and generate positive development outcomes, this is not to deny that these mechanisms may become inefficient when China's transition enters into a new stage, where the demand for new institutions in conformity with market basics must be met. As a result, the once thriving Chinese TVEs have undergone rapid privatization since the mid-1990s, whereby

[327] Yingyi Qian, "Government Control in Corporate Governance as a Transitional Institution: Lessons from China" (2000) University of Maryland Department of Economics Working Paper, at 28-30.

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managers and employees become partial or full owners as many of the old TVEs have been transformed into joint stock cooperatives or sold off to private hands.

As a policy response, the central government has shown remarkable tolerance toward the conversion of TVEs into shareholding cooperatives and the removal of red hats by pseudo-TVEs.[328] In other words, privatization has become a widespread practice and a practical way out for the declining Chinese TVEs since the mid-1990s, and the government is in favor of this option, although without explicit endorsement.

6. A possible revival?

While on the subject of the prospects of Chinese TVEs, it can be safely predicted that in the immediate future, they will be less important and their advantages over private enterprises will fade. However, they are not likely to disappear from the layout of the national economy, but rather may preserve a distinctive presence in the Chinese economic landscape. Some recent numbers can illustrate the relevance of TVEs to China's economy today.

According government statistics, TVEs are estimated to have employed a total number of 138 million rural workers over the periods of 1978-2004. Even though in decline, they were projected to still have employed 3 million workers in 2004 alone. TVEs are also an importance source of income increases for Chinese rural residents. For instance, in 2003, TVEs contributed 35 percent to the annual total incomes of China's rural population.[329]

A cautious conclusion, therefore, is that under the industrial policy of "giving priority to employment expansion," China's TVEs still have a role to play in the national economy, given their contribution to income increases of China's rural population, which

[328] Jeffrey D. Sachs & Wing Thye Woo, "Understanding China's Economic Performance" (1997) NBER Working Paper 5935, at 43 [Sachs & Woo]. The issue of "red hats" is discussed in Section VI where corporate governance of Chinese private enterprises is the subject of investigation.
[329] Zhao, *supra* note 263.

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understandably has a significant impact on the much emphasized "social stability" in an age of rapid economic transformation and a resulting wealth gap between China's urban dwellers and their less fortunate rural countrymen. Seen from the current structure of the Chinese economy, a permanent "fall" of Chinese TVEs, as some western observers might have in mind, is not likely in the immediate future. However, a "revival" is only possible if Chinese TVEs can upgrade their technologies, modes of production and management style, and moving quickly from traditional "strongholds of sectoral growth," such as the manufacturing of toys, clothing and shoes, to service sectors with higher added-value.

However, since private enterprises may have considerable advantages in achieving these same goals more efficiently and more quickly, given their better designed ownership and incentive structures, Chinese TVEs may well become even more marginal in years ahead. Ironically, the decline of Chinese TVEs as a transitional institution has filled the academic community with much enthusiasm, since it offers rich opportunities and new perspectives for vigorous inquiries about the dynamics of economic transition and development. Many scholars see the gradual marginalization of TVEs in the economic landscape of Chinese economy as a positive sign that marks the country's advances in the transition path. In this sense, the fall of Chinese TVEs is not a gloomy story; it may well have a happy ending.

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Section V
Corporate Governance of Private Enterprises in China

1. At long last, full constitutional recognition of private property rights and the government's new pledge to promote the private sector

The 2004 constitutional amendment that finally declared private property "inviolable" is a vivid illustration of China's gradualist transition path with regard to property rights. It took over 15 years and four rounds of constitutional amendments to eventually establish full constitutional recognition and protection of private property in China. The Constitution was amended the first time in 1988 to affirm the legal status of the private sector, stating that it "complements the socialist economy"; the second was in 1993 when the Constitution declared China will practice a market economy instead of a planned economy; then in 1999 the Constitution was amended again to upgrade the private sector from a "complementary" status to "an important component" of the country's market economy; finally, the 2004 amendment provides full recognition and protection to private property rights.[330]

While the private sector has been elevated to a prominent status now that China's Constitution declares "lawful" private property rights inviolable and under the protection of law, in reality it still faces a number of barriers that impede its growth. As evidenced by discrimination favoring SOEs, China's private sector does not enjoy a level playing field. Capital starvation resulting from limited access to state bank loans, technological disadvantage due to insufficient R&D input, and regulatory impediments in the routine conducting of business are major constraints to the further development of China's private sector. For example, according to a survey of start-up bureaucracy in 75 developing countries by Harvard University in 2000, China was ranked 51st overall for

[330] "Constitution to be Amended a Fourth Time" *China Daily* (3 March 2004), online: China Daily <http://www.chinadaily.com.cn/english/doc/2004-03/content_311108.htm>.

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delay and 43rd for cost.[331] According to the World Bank, the situation for doing business in China has improved over the past several years in terms of regulatory environment.[332]

It is important to note that China's accession to the WTO in 2001 has stimulated domestic government and administrative reforms. To submit itself to the requirements under the WTO agreement indicates that the government is willing to reduce administrative intervention and to adapt core government functions to a market economy. According to recent announcements by the government, China will further enhance deregulation through streamlining regulations and simplifying administrative procedures. In fact, the deregulation reform has already produced some positive results. For example, some 4,000 permits and authorizations previously issued by the government had been reduced to 789 by the end of 2003.[333] Moreover, in August 2003, China enacted a new *Law on Administrative Licensing* after heated debate among scholars and policy makers. The purpose of the new law is to limit and standardize the government's power with regard to granting licenses to citizens, particularly those applying for starting a private business.[334]

Although China has been undertaking a new round of government and administrative reforms aimed at reducing regulatory barriers and enhancing the business environment, it will take time for the reform initiatives to have real effects on the economy. The effectiveness of reforms will depend crucially on the actual enforcement and implementation capacities of the government.

Finally, as a positive sign, the government has recently taken a decisive move in addressing the development of the non-state sector. It was announced in a government work report released in March 2004, that the Chinese government will "promptly eliminate or revise regulations and policies" that restrict the development of the non-state sector and "implement measures that relax market access." In addition, the non-state

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[331] See Studwell, *supra* note 54.
[332] World Bank & IFC, *Doing Business in 2004: Understanding Regulation* (co-published by the World Bank and Oxford University Press, 2004).
[333] Chi Fulin, "China's Reform Focuses on Streamlining Government" (2003) 14:1-3 Transition 10.
[334] Shi Dong, "Another Effort to Limit the Administrative Power" *Caijing* (5 September 2003), online: Caijing English Newsletter
<http://www.caijing.com.cn/english/2003/0905/0905%20Another%20Effort.htm>.

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sector is "encouraged to participate in the reform of SOEs" and assured to "receive the same treatment as other enterprises in investment, financing, taxation, land use and foreign trade."[335] How long it will take to put these promises into action and make them generate genuine effects remains to be seen, but at least the signal is encouraging.

2. Capitalists now "welcome to the Party"

In today's China, a significant number of private entrepreneurs are communist party members, and a significant number of government officials hold corporate posts in SOEs. According to a recently published survey by China Academy of Social Sciences (CASS), in 2003 30 percent of 2 million private entrepreneurs in China were communist party members; another 11 percent expressed an interest in joining the Party.[336]

The mutual penetration of the Party and businesses has not resulted in "state capture," but signals a certain level of "the mutual penetration of party-business," which the government only partly endorses. What the government does support, and even actively promotes, is a "one-way" interaction between the Party and businesses: private entrepreneurs are welcomed to join the Party, but party officials must resign from their corporate posts.[337]

To a large extent, this is a very encouraging position for the government to take. On the one hand, the withdrawal of party officials from corporate posts would help to insulate businesses from government intervention. On the other hand, the decision to admit "capitalists" carries a message that the Party is now willing to share some of its political power and responsibility with wider segments of Chinese society.[338] The decision to admit private entrepreneurs to the Party was announced by then China's president Jiang Zemin in 2001, which sparked an immediate round of controversies within China. This

[335] "Premier: China to Boost Non-Public Sector Economy" *People's Daily* (5 March 2004), online: People's Daily <http://english.peopledaily.com.cn/200403/05/print20040305_136611.html>.
[336] "Report of Private Enterprises in China" *Caijing* 78 (20 February 2003).
[337] Morris, *supra* note 316.
[338] Chow, *supra* note 35 at 82.

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change of heart by the Party has been well received, however, by some western observers who think that it signaled the Party's increasing desire to strengthen both the private sector and the party links to the burgeoning private business elite.[339] Seen from some recent improvements in the government's support for the private sector, there is much truth to this assessment.

3. Private enterprises removing "red hats"

An intriguing example of ambiguous property rights in China is the so-called "red hat" phenomenon. The "red hat" is a metaphor referring to a popular practice among Chinese private entrepreneurs in early years of reform, whereby private businesses were registered as rural collective enterprises or TVEs, with the consent of local governments (i.e., putting a "red hat" on the firm as a cover). The purpose of doing so was twofold. On the one hand, the entrepreneurs could avoid breaking the ideological taboo on overtly promoting private business and become qualified for business facilitations controlled by local governments, such as bank loans and technological support. On the other hand, by offering a "red hat," local governments could share a considerable portion of profits. A major drawback is that controversies over whether the "red hat" should amount to an "ownership investment" by the local governments have frequently arisen. But matters have improved as more and more private enterprises have removed the "red hats" over the past few years, especially after the Constitution was amended in 1999 to upgrade the non-state sector from "beneficial" and "necessary" supplement to "important component" of the economy.

4. Chinese private enterprises going public and overseas

[339] Mary E. Gallagher, "Reform and Openness: Why China's Economic Reforms Have Delayed Democracy" (2002) 54 World Poliitcs 338 at 353.

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Although with very limited success, Chinese private enterprises have started to raise capital in the country's nascent stock markets by applying for an IPO. However, since China's stock markets are corrupt and inefficient in allocating capital at the present stage of development, where unscrupulous issuers are obsessed with "*quan qian*" (predatory money-swallowing) and engaged in a race for value destruction at the expense of the huge wealth loss of investors, the "adverse selection" problem has become increasingly serious.[340] The high possibility of the mis-pricing of firm value, in addition to policy discrimination against private enterprises in share issuing under the priority of reforming the ownership structures of SOEs through capital markets, have propelled some well-performing and genuinely competitive Chinese private enterprises to seek overseas listings. Hong Kong is the favorite destination for these firms.

However, although the much higher quality of securities regulation and a much healthier market environment in overseas capital markets do serve as effective disciplines of market-abiding behavior, some inherent weaknesses in the corporate governance practices adopted by Chinese private enterprises during the overall transition of the entire private sector, such as "founder's dictatorship" and lax risk controls, have led to corporate governance failures on both domestic and overseas markets. Chapter 5 addresses this issue by providing case studies of these sorry incidents.

5. Corporate governance of Chinese private enterprises at the crossroads

A. Credit discrimination against private enterprises and its negative consequences

It is commonly known to Chinese private enterprises that credits from state banks are very difficult to obtain. The "big four" state banks heavily discriminate against private enterprises in allocating loans. As a general rule, state banks are more likely to lend to private enterprises with the lobbying of local governments hoping to give a hand to their

[340] Detailed empirical evidence to support such a negative assessment of the domestic stock market is provided in Chapter 5.

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local private sector. However, this latter case is not always a common practice among China's different localities.

As a result of the difficulty in receiving capital from the state banks, Chinese private enterprises have incurred higher operational costs by resorting to more expensive trade credits.[341] Worse still, capital starvation not only induces private enterprises to hide profits and thus embark on tax evasion in order to save enough for business expansions, it also distorts the banking system when money irregularly flows out of the banks to underground credit markets for higher returns, where private enterprises, not able to obtain money through normal channels, are willing to pay generous rates of interest. This poses a huge challenge to the stability of China's banking system because it could accumulate serious financial risks.

Therefore, credit discrimination against the private enterprises has negative impacts on both corporate governance of these firms, which are best exemplified by their tax evasion activities and distorted lending practices in the underground markets, and the stability of China's banking system.

B. The possible decline of the "Wenzhou model"? A political economy interpretation

Recently, there has been much discussion of the prospects of the "Wenzhou model" of private sector development in China, in light of some discouraging signs of its vitality at a new stage of China's transition to the market. The "Wenzhou model" was once a prize model of market-driven local growth, in which the private sector was allowed to release its productivity and competitiveness, while subject to few policy and regulatory constraints by the local government during the early years of China's reform. The local government was very supportive and served as a strong "helping hand" in aiding the growth of private enterprises in terms of allocating factors of production, removing local red-tape and facilitating the cooperation between local businesses and external as well as

[341] Loren Brandt & Hongbin Li, "Bank Discrimination in Transition Economics: Ideology, Information, or Incentives?" (2003) 31 Journal of Comparative Economics 387 at 387.

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foreign partners. In other words, the workings of the markets were relatively undistorted and the private sector was left relatively autonomous to pursue business opportunities. As a result, Wenzhou municipality had been the strongest performer in the Province of Zhejiang, an affluent coastal province in China.

However, things took a dramatic turn in 2002 when Wenzhou, the long leading performer in the province throughout the 1990s, suddenly found itself in 7th place on the list of "Rankings of Municipal GDP Growth Rates in Zhejiang Province in 2002." The case was even worse in July and August of 2003, when the proud Wenzhou municipality learned that it had to settle with the lowest rank in the monthly provincial GDP report.[342]

Does this signal a sign of "decline" or more precisely, the "crossroads" of the "Wenzhou Model," a local innovation of economic growth path that once not only gained nationwide admiration, but also attracted some level of international attention from Western observers eager to decipher the "China Exceptionalism"?

Perhaps the answer should be drawn from a perspective of political economy. There are several major reasons for the recent under-performance of Wenzhou's private enterprises, some with corporate governance implications and some resulting from the political economy constraints on the growth of China's private sector as a whole.

(1) The crisis of the "lock-up" pattern of family business in the "Wenzhou Model": a corporate governance deficiency

The "lock-up" pattern of family business in Wenzhou refers to the widely observed phenomenon in which the young generation of firm owners were continuing to follow their parents' footsteps in almost all aspects of operations. They have inherited from the first generation (i.e., the founding generation) of private entrepreneurs the same business practices, including the same industries in which the firms operate, the same client bases,

[342] Zhong Weizhi, Liu Mingjuan & Shi Chunhua, "GDP Ranking A Dramatic Fall to the 7th in Zhejiang Province: Death Bell Ringing for the Wenzhou Model?" *Economy Watch* (17 April 2004).

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the same business culture, the same "local knowledge" of business norms and rules, the same educational background, and the same sales network.

This "lock-up" pattern has restrained the ability of the younger generation of private entrepreneurs to expand to more promising markets with better growth potential, and to gain new business opportunities in other sectors or industries. Certainly, the "lock-up" pattern of family business is not consistent with the much needed creativity, flexibility and risk-taking spirit for Chinese private sector in an age of global economic integration. According to some Chinese economists, this is the primary reason behind Wenzhou's recent decline.

(2) A recent unfavorable macro-economic environment and the central government's intervention with local economic activities

The current macro-economic policy of the central government is not necessarily in line with local interests, especially for those localities in the prosperous coastal areas that have hugely benefited from the "open door" policy friendly to foreign direct investment (FDI) and export expansion. In 2004, the central government, wary of signs of an overheating economy, decided to put a hold on local engines of investment expansions and ordered by administrative fiats that local branches of the "big four" state banks stop allocating credits to a few overheating sectors, such as the steel industry. Because many private enterprises, particularly those from Wenzhou, have been heavily investing in these industries with an expectation to profit from China's gigantic need for raw materials and energy goods, this sudden withdrawal of capital provision amounted to a lethal blow.

The result was not surprising: private enterprises, including those from Wenzhou, suffered huge losses from the government intervention with local business activities in an arbitrary and dramatic manner. This example indicates that the government, still not well trained in market fundamentals, is an impediment to effective corporate governance as detrimental as are the lapses in firms' internal control system. While lax internal controls

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cannot discipline reckless investment activities of dictatorial CEOs, arbitrary government intervention in private businesses is equally bad for even the most prudent CEOs to make sound financing and investment decisions.

(3) The mutual penetration of public power and private businesses and a prevailing "personalized pattern" of business transactions

A "personalized pattern" of business transactions is based on an invisible but seamless web of "*guanxi*," which affords unequal protection of property rights in favor of local businesses but at the expense of non-local businesses. This has resulted in a reduction of external investment and a wave of capital flight from Wenzhou over the past several years. This factor of an unfavorable investment environment for outsiders has significantly contributed to Wenzhou's GDP decline and a local scarcity of capital needed for the expansion and growth of its private sector.[343]

C. "Paying for a government identity card": Chinese private enterprises stranded in a "bureaucracy-business complex"

A worrying sign in China's private sector is that there has been a "bureaucracy-business complex," whereby government officials are closely associated with private entrepreneurs in daily operations of private firms. In terms of the bureaucracy-business complex, the same can be said of Chinese government officials and party cadres keeping posts in SOEs, as discussed in detail in Section II where "business people wearing 'red hats'" are under review. What makes this link between bureaucracy and business different in the case of Chinese private enterprises is that the direction of influence is the reverse. Here, the private entrepreneurs usually enthusiastically pay higher taxes to local governments, especially those in a desperate need of fiscal expenditures to run local affairs, in exchange for a post in local government agencies.

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[343] *Ibid.*

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Typically, the government posts obtained by private entrepreneurs are not "strategically important" and also lack significant licensing power, and hence carry less rent-seeking opportunities. Rather, these posts largely function as an "identity card," which implies government connections and social resources.[344] Needless to say, although the government posts assumed by private entrepreneurs may not have much of the licensing power that is likely to invite corruption, in a number of circumstances the "identity cards" do help private business people access other implicit benefits, such as promoting their business profiles when dealing with foreign partners or businesses from outside, and facilitating negotiations with other government agencies in conducting transactions where the local governments are among the parties or have a stake.

It is clear that this bureaucracy-business complex has a negative impact on the building of market basics and a healthy commercial environment in China's localities. It does not guarantee a level playing field among private entrepreneurs and only favors those with a tight link with the bureaucracy. This practice, which has unfortunately started to spread to a wider range of China's local communities over the past few years as private enterprises have grown stronger, should be curbed effectively before it evolves into a new variety of "cronyism, Chinese style."

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[344] Sun Zhan, "The Government and Market in A County of Prosperous Private Enterprises" *China Newsweek* (1 March 2004); Tang Jianguang, "Why 'Wealthy People Assuming Public Offices'?" *China Newsweek* (1 March 2004).

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Section VI
Important Questions Arising from Corporate Governance Reform in China

Based on the examination of corporate governance practices at major types of Chinese enterprises, it can be seen that there are some important questions and problems arising from enterprise and corporate governance reforms in China under legal and institutional constraints at the current stage of transition. From different angles and to various degrees, those questions signal the rationale as well as the dynamics of a gradualist approach to corporate governance reform.

1. How to redeem the "original sin" of private entrepreneurs?

It is often described as the "original sin" of some private entrepreneurs that they had conducted irregular transactions when participating in the ownership reform of SOEs and made personal fortunes through questionable channels in China's underdeveloped legal and institutional environments. The primary causes of this "original sin" include the ambiguities of property rights, the lack of fair rules and transparent procedures to govern the transfer of state assets to private hands, personal greed to steal and extract state assets, and corruption among government officials supervising local SOEs. For example, some dishonest private entrepreneurs had bought state assets at ridiculously low prices in conspiracy with local government officials who took bribes. In other cases the buyers were themselves insiders (usually managers) of the old firms who grossly undervalued the state assets. Those practices have to a large extent mirrored the Russian experience of mass and rapid privatization in the 1990s.

Accordingly, these private entrepreneurs may well have acquired state assets illegally, and, in the view of some Chinese commentators, have to pay "redemption" to clean their property rights at a later stage when rules and procedures have been put in place and transactions have become more transparent and in more conformity with market basics. The methods of "redemption" have been under discussion primarily among China's

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academic circles, since it is understandable that private entrepreneurs have largely avoided taking part in this discourse. How to redeem the "original sin," however, is still subject to an ongoing debate in China, and some economists have proposed such methods as BOT (build-operate-transfer) and levying inheritance taxes.[345]

2. Has the performance of China's SOEs improved over the last two decades of reform, especially after the shareholding reform since the early 1990s?

To the question of whether the performance of China's SOEs has improved over the last two decades of reform, especially after the shareholding reform since the early 1990s, there are three conflicting answers.

The first answer is that if measured by profit increases, the performance of transformed SOEs, especially listed SOEs, has not improved. Where firms have shown sings of performance improvement, it might be well because managers of SOEs have strong incentives to misreport performance by overstating profits or understating costs. Typical incentives and practices with regard to misreporting include two types. The first type is the window-dressing of financial performance by listed companies to cheat investors and regulators in order to remain in the stock market where they can continue to raise cheap money. The second type is the reporting of false performance improvement of local SOEs by officials at lower levels to higher-ranking officials in order to preserve positions or receive promotions.

The second answer is that some large SOEs do make profits at comfortable rates, but the sources of their profits are the monopoly positions they hold in strategic industries or sectors under government protection, such as the electricity, telecommunications and oil industries. Because these firms do not face intensive competition from private firms, their

[345] Gu Ming, "Larry H.P. Lang in Quest for a Way Out for Those with the 'Original Sin'" *Nan Feng Chuang Magazine* (6 August 2003), online: <http://business.sohu.com/33/02/article211880233.shtml>.

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profits cannot reflect the real situation of productive efficiency, managerial effectiveness, and the quality of corporate governance.

The third answer is that although some SOEs have recorded accounting profits, these profits are usually obtained at huge costs of capital input and government subsidies that outweigh the gains of reported profits. These costs are recorded as unpaid debts in the books of these firms and non-performing loans (NPLs) in the books of state banks.

It seems that these three answers all have some validity, and in combination they speak to the fact that Chinese SOEs, despite more than two decades of reform, are still not up to the task of meeting the challenge of competing with both domestic private enterprises and overseas players.

3. How has the interaction between central and local governments affected China's corporate governance reform?

The relationship between the central government and local governments has significantly influenced the pattern of corporate governance reform in China, particularly in relation to Chinese SOEs and TVEs. The rise of TVEs was largely a result of experimental reform strategies driven by the local governments, and the decentralized feature of privatization of both SOEs and TVEs to a large extent was shaped by the arrangements under China's fiscal federalism.

Specifically, at the new stage of China's transition when mass privatization of SMEs seems a favorable policy option, the dynamics of China's central-local power play needs to be understood in predicting the prospects of China's market-oriented reform. On the one hand, the central government has been very cautious in extending the experimentation of privatization of SOEs to a wider scope. Its primary consideration is that potential social unrest may be prompted by increased unemployment rates and controversies over the distribution of rights and benefits among various social groups

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where "fairness" matters. On the other hand, local governments and managers of SOEs have been proactive in privatizing middle and small-sized local SOEs. The primary reason is that for local governments and enterprise managers, there are considerable local and private benefits generated from privatization, in many cases at the expense of the state. Specifically, when legal and institutional environments are underdeveloped, insider dealings, asset stripping and corruption are often involved in local implementation of privatization schemes.

4. On the road of transition from the state to the market, is China heading towards a "good market economy" or a "bad (crony) market economy"?

From what has been discussed regarding such market-distorting practices as "business people wearing 'red hats'," "business people paying for a government identity card," and the dubious "bureaucracy-business complex" in China's localities, it is not surprising that the question arises as to whether China is heading towards a "good market economy" where the state stays out of the business of the market, or a "bad (crony) market economy" as been observed with some East Asian countries. Seen from the identified local market-distorting practices, the danger of the country falling into the trap of a "crony market economy" is emerging. If not under control, this dander may well contribute to future problems at later stages of China's transition. Accordingly, future corporate governance reform should proceed in combination with reforms in other related areas, including, among others, government and administrative reforms.

5. What are the implications of the Party's role during China's transition for corporate governance reform?

The communist party in China is not only a political organization; it also plays a role of an economic agent in many circumstances. China's market-oriented reform over the years may have reduced the party's tight control on ideology to a large extent, but has not

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excluded the party's influence from state businesses, which is still significant in the running of SOEs. Earlier discussion demonstrates that the Party's control of personnel decisions at Chinese large SOEs is not likely to loosen even after a series of corporate governance reform schemes have been introduced to make these firms more look like modern enterprises. Chinese SOEs cannot fully capture the benefits of corporate governance reform under continuing party intervention into business. It remains to be seen how the party's role will evolve at the new stage of transition, which of course is not a pure economic matter but chiefly depends on further political liberalization in China.

6. How long will it take to accomplish necessary legal and institutional reforms?

The necessity of emphasizing sequencing and pacing of reform is determined by the reality of the general underdevelopment of legal and market-supporting institutions in transition economies at the early stage of reform, as well as by the reality that it will take a long time to establish well-functioning legal and institutional environments in an economy in transition given the constraints of government resources and human capital. For example, the establishment of rule of law, the education of qualified investors, and the emergence and development of a managerial market that prices professional corporate managers correctly are difficult tasks and will need continuing input of time and energy from all levels of society, not to mention the potentially huge amount of financial and human resources needed. Therefore, it is predicted to entail a long process of legal and institutional reform.

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Section VII

Conclusion

The experience of corporate governance reform in major types of Chinese enterprises has provided a unique perspective on the dynamics of transition under legal and institutional constraints. In general, the empirical review presented in this chapter offers strong support to ownership reform aimed at expanding private ownership in the competitive sectors of the Chinese economy. However, corporate governance reform has also encountered a number of challenges, especially those attributable to legal and institutional constraints. As a result, corporate governance reform in China has proceeded in a gradual, experimental, and at times decentralized manner. Some general conclusions can be drawn, as stated below.

1. The "politics" of economic reform and the under-development of legal and institutional environments are the major determinants of a gradualist approach to corporate governance reform in China.

2. There has been a considerable distance between "design on the paper" and "implementation on the ground" of corporate governance reform in China. On the one hand, the deficiency or ineffectiveness in local enforcement of certain centrally mandated reform policies not only reflects the interaction between the central and local governments whereby interests often diverge, but also indicates practical constraints on the country's political resources and institutional capacities needed to push forward reforms during the transition. On the other hand, local experiments with innovative pilot schemes, aimed at discovering a better road to the market that suits distinctive local conditions, have also been an important source of new understanding of institutional development at the central level.

3. Corporate governance reform, in particular ownership restructuring through privatization of local SOEs, has produced positive results in terms of efficiency improvements, but has also contributed to inequality between different social groups and

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regions. Therefore, the balance of "efficiency" and "equality" needs to be addressed to reduce social resistance and discontent that could hamper China's successful transition to the market.

4. Transitional institutions can serve as second-best solutions to build efficient corporate governance structures at the early stage of reform, but need to be adjusted to meet new challenges when reform has proceeded to the next stages and the institutional environment evolves.

5. In reforming China's business sector, it is crucial to avoid the danger of falling into a "bad (crony) market economy." Some worrying signs of the state intervening with the business of the market during the process of corporate governance reform in both SOE and private sectors, such as using public power for private gains, must be taken care of seriously if China is to build a truly competitive enterprise sector and complete a successful transition to the market.

In summary, the overall conclusion of Chapter 4 is that careful sequencing and pacing should be regarded as the central feature of corporate governance reform in China, which requires realistic and workable schemes that accommodate available economic and political resources and existing legal and institutional environments. Regarding future direction of corporate governance reform, as a major characteristic of China's gradualist approach toward transition throughout, local experiments with innovative pilot schemes should continue to be encouraged, especially with regard to privatization strategies. These local experiments are not only useful for the accumulation of collective knowledge of transition across the nation, but can also facilitate the discovery of effective reform strategies suitable for a broader scope of application through trial-and-error at lower costs.

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Chapter 5

The Interaction between Domestic and Overseas Capital Markets and Corporate Governance of Chinese Listed Companies

Introduction

After the old Shanghai Stock Exchange was closed by the PRC (People's Republic of China) government four decades ago upon taking over power from the Kuomintang (now the opposition party in Taiwan), China's stock market was re-established in the early 1990s when two stock exchanges in Shanghai and Shenzhen officially came into being. The Shanghai Stock Exchange was founded on November 26, 1990 and started to operate on December 19 of the same year. The Shenzhen Stock Exchange was established on December 1, 1990. Both are not-for-profit institutions and under the supervision of the China Securities Regulatory Commission (CSRC, i.e., China's SEC).

The stock market in China's transition economy is a nascent financial institution with a short history and operates on a totally different basis compared to mature capital markets in the West. To many western observers, China's stock market serves as a good example of the contradiction of the country's "socialist market economy," in which private enterprises and markets now play important roles in promoting growth, while political reform has barely taken place to introduce a more transparent and democratic political system.[346] The reflection of the fundamental and unresolved contradiction between China's economic and political aspirations in the capital markets is that the state, as the owner of SOEs, wants to attract foreign and private capital to shore up the financial base of these firms, but does not wish to cede control over the "commanding heights" of the economy by adopting full privatization. The "commanding heights" of Chinese economy, such as the strategic industries of telecommunications, banking, transportations and energy, are still controlled by the

[346] Green, *supra* note 38 at 3.

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government where state monopolies dominate. This ambivalence remains at the heart of the government's failure, at least so far, to create a properly functioning stock market in China.

As a result, China's stock market is largely ruled by political logic rather than by economic rationales, and it remains inefficient.[347] According to some harsh critics, China's stock market is "little more than funny-money casinos built on foundations of sand and populated by manipulators."[348] One of China's most respected economists, Wu Jinglian, even considers the corruption-ridden stock market "worse than casinos in foreign countries," because the latter still operate on the basis of rules.[349] Barely exaggerations, these critical statements indeed reveal much of the truth about China's stock market at its early stage of development.

The political logic of China's stock market is the root cause of the poor quality of listed companies, which are dominated by partially privatized SOEs with their minority stakes issued to the public and which have, over the past fifteen years, rewarded investors with abysmal returns on capital. Despite the government's insistence that listed companies with good corporate governance are the fundamental basis of a well-functioning stock market and therefore should be given paramount emphasis by both regulators and market participants, the performance of China's listed companies has been, and continues to be, the opposite of the government's wishful thinking. The interaction between China's stock market and corporate governance of listed companies seems to have formed a "vicious circle," as the poor-quality listed companies and fraud-filled stock market are mutually reinforcing.

In light of this unfavorable assessment of the interaction between China's stock market and corporate governance of listed companies, Chapter 5 argues that removing

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[347] *Ibid.* at 4.
[348] Gary LaMoshi, "China's Stock Market Binge", book review of Carl E. Walter & Fraser J.T. Howie, *Privatizing China: The Stock Markets and Their Role in Corporate Reform* (Singapore: Wiley (Asia), 2003), *Asia Times Online* (30 August, 2003), online: Asia Times Online <http://www.atimes.com/atimes/China/EH30Ad02.html> [LaMoshi].
[349] Wu Jinglian, "China's Stock Market Worse than Foreign Casinos", interview with China Central Television (CCTV) in the "Conversation" program, January 13 2001.

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the political logic from China's stock market and replacing it with market basics is the ultimate solution to building good corporate governance of listed companies and attracting foreign and private capital. Even more importantly, reforming China's stock market is a critical condition for the country to sustain rapid economic growth and complete a successful transition to a full market economy.

While urgent, the reform of China's stock market is a difficult task, given the existing political, legal and institutional constraints which suggest that it would be unrealistic to find a quick fix to the existing compounding problems. Therefore, a more workable strategy for the government is to push forward necessary structural reforms of the stock market on the basis of what is already in place, and seek improvements on the existing market structure and practices. In this context, compared to a rapid and complete overhaul of the existing market structure or "starting anew," which would involve a wide range of parties and likely entail extraordinarily high costs with uncertain prospects for success, a strategy of sequencing and pacing, which focuses on improving— instead of destroying— the existing market structure, seems to be a more practical approach.

In terms of its key proposal, this strategy of sequencing and pacing advocates a two-fold solution to stock market reform. On the one hand, necessary market regulation, such as rules on disclosure and related-party transactions, must be strengthened to become truly effective, i.e., not only "admonishing" but also "deterring" to wrongdoers. On the other hand, the stock market should be encouraged to grow and expand without excessive government intervention and over-regulation, especially in relation to regulators' efforts to import "advanced" institutions from mature capital markets that not yet have a working foundation in China, such as the mandatory requirement for listed companies to have a fixed number of independent directors. In the process of stock market reform, the most important constituencies of investor protection— the investors themselves— also need to develop a strong awareness of rational and value-based investment and to form a powerful interest group to assert their own rights.

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China's accession to the WTO in December 2001 and its commitments to the opening up of the financial industry are expected to generate external pressure and stimulus for the reform of the stock market. Among other things, the WTO factor can help propel the Chinese government to take decisive actions to clean up the stock market before competitive overseas market players, such as highly sophisticated international investment banks and fund management companies, have obtained wider access to China's financial market. A consensus among Chinese economists, financial regulators and stock market participants is that foreign competitors would force a number of much less experienced domestic financial institutions to exit the market if unreformed, of which the most vulnerable are the approximately 130 securities companies currently facing an industry-wide insolvency crisis.

Accordingly, Chapter 5 suggests that alongside the ongoing banking and SOE reforms, one priority on the government's policy agenda at the new stage of transition should be making the stock market a better regulated and safer place to invest as a beneficial component of the national economic structure. As Chapter 5 indicates, and later echoed in Chapter 6, stock market reform not only is critical to the restoration of investor confidence, which is currently at a lowest ebb, but also matters greatly for the health of the entire financial system and, in particular, for the revival of the banking sector.

Chapter 5 further points out that given the complementarity between structural reforms of SOEs, state banks and the stock market, a much improved stock market will bring about significant benefits to both China's banking system and SOE sector. At a time when China is experiencing rapid GDP growth, a properly functioning stock market could relieve the "big four" state banks of overwhelming financing burdens, currently accounting for four fifth of the sources of funds for China's annual new investment.[350]

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[350] Despite recent efforts of the Chinese government to cool the overheating economy, China still recorded a remarkable annual GDP growth rate of 9.5 percent for 2004, compared to 9.3 percent for 2003. See Murc Dickie & Andrew Yeh, "Policy Fails to Rein in 9.5 percent Rate of Growth" *Financial Times* (26 January 2005) 9.

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Similarly, the success of China's SOE reform also partly depends on the progress of stock market reform.

There are two important reasons for the complementarity between the SOE reform and stock market reform. The primary reason is that the privatization of SOEs needs a well functioning stock market as an effective channel to reshape their ownership structures, thus facilitating their transformation into modern enterprises. Another reason is that China's national social security fund, now with a huge account deficit, will need a safe place to invest and make adequate returns to fund the country's pressing pension liabilities, thereby reducing the heavy debt of the government. The government debt, mostly in unfunded current pension liabilities, is around 45 percent of China's GDP, as reckoned by some international observers. After adding in the costs of bank restructuring and unfunded future pension liabilities, the government's implicit debt exceeds 100 percent of GDP.[351]

Chapter 5 is organized into seven sections. Following this introduction, Section I reviews some basic aspects of China's stock market, including the following: (1) a snapshot of the stock market, such as its size, major players, capital and regulatory structures, fundamental problems, and relevance to the national economy, (2) the political logic beneath the inner workings of the stock market and the resulting consequences, and (3) the operational quality of the stock market under its political logic.

Section II examines relevant aspects of corporate governance of China's domestically listed companies, such as their capital structure, ownership structure, financial performance and typical forms and causes of poor corporate governance. Section III examines the role of overseas capital markets in China's transition, with an emphasis on the risks associated with investing in Chinese companies that are largely attributable to corporate governance deficiencies.

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[351] Jonathan Anderson, "How to Fix China's Banking System?" *Caijing* 95 (5 November 2003) [Anderson].

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Section IV explains the complementary feature of structural reforms of the stock market, SOEs and state banks in China's transition economy. In particular, the implications of fundamental reforms of the stock market for the strengthening and ultimate success of SOE and banking reforms are discussed in Section IV.

Section V reviews the process of important legal and regulatory reforms of China's stock market and related corporate governance reforms of listed companies since 2000, in the context of both accelerated transition to markets and greater financial liberalization under China's WTO commitments. Drawing on the assessment of the results and effects of reforms that have been implemented so far, Section V proceeds to discuss an appropriate strategy for future reforms that is centered on sequencing.

Section VI concludes by pointing out the peculiar pattern of interaction between China's stock market and corporate governance of listed companies which has formed a "vicious circle," and by reiterating the urgency of fundamental reforms of the stock market, of which solving the split share structure is a critical and challenging necessary reform. Section VI also proposes the appropriate sequencing of future reform measures in the short run, medium term and longer term that are aimed at addressing the "vicious circle" problem and providing support to the SOEs and banking reforms.

Finally, this introduction points out an important qualification of the subject of study in Chapter 5: the term "capital markets" used in this chapter primarily refers to the stock markets in China and overseas. This is primarily because equity financing is the dominant method for Chinese listed companies to raise capital, compared to the small proportion of debt financing in their capital structures, as the discussion in Section II will indicate.

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Section I
An Overview of Important Aspects of China's Stock Market

Section I reviews three important aspects of China's stock market: (1) a snapshot of its basic structure, fundamental problems and relevance to China's economy, (2) its political logic and the resulting consequences, and (3) its operational quality. This overview provides some critical facts about China's stock market during the transition and their implications for the country's economic development, thus providing the context for later discussions of solutions to the identified structural problems and future reform directions.

1. A snapshot of China's stock market

From a very low level, the development of China's stock market has been rapid. Until 1990 China had no stock market at all, and until 1993 no Chinese company was listed abroad. Today, the Shanghai Stock Exchange and its smaller counterpart in Shenzhen have more than 1,300 listings and a combined market capitalization of around USD 500 billion, second in Asia only to Japan. Officially, as of February 2005, some 70 million individuals—more than the population of Britain or France—have invested in the stock market, where 130-odd securities companies[352] and 50 investment fund companies are the major market intermediaries and components of China's nascent institutional investor base.[353] The primary regulator of the stock market is China Securities Regulatory Commission (CSRC) established in 1998.

China's stock market has been undergoing very cautious or "prudent" liberalization, compared to other vibrant sectors of the economy that have been more receptive to globalization, such as trade and foreign investment. Indeed, according to former chief negotiator for China's WTO accession, Long Yongtu, one reason behind China's acceptance of unfavorable conditions attached to its standing in anti-dumping disputes

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[352] "Securities companies" in China are also called "brokerage firms."
[353] "Casino Capital", *supra* note 262.

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with the United States, was to maintain protection in its securities industry for a longer period of time. By accepting the condition that China should be regarded as a "non-market economy" when dumping margins are calculated, China received a concession from the United States that its securities industry would not be liberalized as quickly as would the insurance and banking industries.[354]

Over the past few years, under China's WTO commitments, rules which had previously operated to prohibit foreign ownership of securities companies and investment fund companies have been relaxed. Approved foreign investors have been gradually allowed into the domestic markets under a Qualified Foreign Institutional Investor (QFII) scheme, which draws on the example of Taiwan's earlier financial liberalization. The government has hoped that the opening up of China's capital markets will mark its integration into the global financial system. Meanwhile, Hong Kong has become a more important financial centre by helping to raise foreign capital for the transformation of SOEs in mainland China, and increasingly also for the development of China's growing private sector.[355] Chinese companies now make up 35 percent of Hong Kong's stock market capitalization, compared to only 7 percent in 1995. With public listings in Hong Kong of China's monopolistic giants, such as China Mobile, China National Offshore Oil Corporation (CNOOC) and the Hong Kong branch of Bank of China (BoC), the mainland accounted for the biggest share of the world's international share offers in 2001-2002, which was a welcome signal to global investment banks facing a decline of new issues in America and Europe.[356] With more mainland listings, the year 2003 for the international capital market was marked as a "golden year" for Chinese listings.

Despite the impressiveness of the rapid development of China's stock market, it has many serious problems. The most fundamental problem that has for years lingered and raised investor concern is the fragmentation of share structure resulting from the split of tradable and non-tradable shares. In the early years of the development of China's stock

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[354] Zhang Fan, "Interview with Long Yongtu on the Early Years of China's WTO Negotiations" *Caijing* 121 (29 November 2004), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=6212>.
[355] "Casino Capital", *supra* note 262.
[356] *Ibid.*

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market, the government sold overpriced minority stakes in mostly badly run SOEs, confident that retail investors, who are mostly urban households, with few alternatives for capital investment and enamored of China's growth prospects, would buy these shares regardless. With the state able to intervene in the market as both regulator and controlling shareholder and through government owned or controlled brokerage firms, stock prices soared, multiplying earnings by 60 times in the summer of 2001.[357]

However, plagued by the deep-rooted structural problem of non-tradable shares and investors' persistent concerns about steps that the government may take to their detriment, such as abruptly pouring large chunks of state shares into the market to dilute their holdings, the market started to decline in June 2001 upon the release of a "full flotation" plan to relinquish a portion of residual state shares to the public. This plan was short-lived due to strong negative market reactions. The decline has continued to the present day in the face of the uncertainty of a new attempt by the government to sell state shares. Both the Shanghai Composite Index and Shenzhen Composite Index reached their five-year low in February 2005.

Moreover, measured by both market capitalization and the percentage of capital markets financing in aggregate investment, the size of China's stock market is not impressive. As of December 2003, the total capitalization of China's stock market was RMB 4,245.8 billion yuan (around USD 500 billion), which was equivalent to 36.38 percent of the country's 2003 GDP. However, the market capitalization of the tradable shares was only RMB 1,317.9 billion yuan and equivalent to only 11.29 percent of the 2003 GDP.[358] While in terms of gross size China's stock market dominates those of transition economies in Russia and East Europe, when measured as a proportion of GDP, China's stock market does not fare well. For example, compared with 34 percent in Hungary and 25 percent in the Czech Republic, China's stock market capitalization only accounted for

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[357] "A Marginalized Market" *The Economist* (24 February 2005).
[358] Source of data: China Securities Regulation Commission (CSRC). "An Introduction to China's Securities and Futures Markets: 2004 Edition", April 2004. This document can be accessed at the CSRC website: <http://www.csrc.gov.cn> [CSRC].

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less than 12 percent of GDP in 2003.[359] Meanwhile, China's stock market only financed less than 2 percent of total investment in China for the year 2003, which was negligible compared to the dominant role of banks in funding the country's investment projects.[360]

Finally, the composition of Chinese investors is also in notable contrast with the prevailing pattern of institution-driven equity investment in most overseas capital markets. In China, institutional investors account for only a very small fraction of the total number of the A-share investors. As of December 2003, there were 68.35 million A-share trading accounts at Chinese banks, of which 68.02 million were registered by individual investors and only 330,000 were held by institutional investors, representing 99.52 percent and 0.48 percent of the total respectively.[361] In other words, China's stock market is largely retail-oriented and lacks a meaningful base of institutional investors.

2. The political logic of China's stock market and its consequences

According to the original design of the government, China's stock market should be, and in fact has been, primarily a tool to take over part of the financing of SOEs from the state banks burdened by huge amounts of non-performing loans (NPLs). Clearly, when the government first advanced the idea of creating a stock market, concepts such as protection of investor rights, equal access to the capital markets of different types of enterprises and effective financial intermediaries which provide information authenticity and market liquidity did not feature at all in the blueprint. This should not be surprising, given the still limited understanding of markets by the entire nation at the time, and one would reasonably expect that as China's reforms advance the situation will improve.

However, the irregular start, marked by the mandated role of the stock market as a cash cow for the SOEs (bluntly embodied in a policy statement that the stock market

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[359] Green, *supra* note 38 at 34-35.
[360] "Casino Capital", *supra* note 262.
[361] Source of data: CSRC, *supra* note 358.

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should "save SOEs from financial difficulties," or *wei guoqi jiekun*), has not to date re-directed itself to a regular course. After 15 years of operation, China's stock market not only failed to reward investors with adequate rates of return on capital, which have been lower than the actual interest rates of fixed-term bank deposits over the same time periods, but also saw little achievement in improving the books of listed SOEs despite a stunning pool of money injected into them by China's 70 million-odd investors, standing at RMB 890 billion *yuan* (USD 107.36 billion) over the years of 1998-2004 when the CSRC was in charge of the stock market.[362] Much of the money raised by the listed companies has been wasted, or in many cases stolen. The root cause of the vanishing capital is poor corporate governance of most listed companies, whereby managers, commonly known as "insiders," are not subject to effective monitoring and often direct capital to inefficient use or simply steal it, and the controlling shareholders of many listed companies have gained a reputation for extracting corporate funds and expropriating minority shareholders. The root cause of the poor corporate governance of China's listed companies, in turn, is the distorted stock market, driven by its political logic.

There are a few notable examples of the political logic of China's stock market. First, the government has used editorials in the state run newspaper *People's Daily* to influence the trading of shares in the stock market, such as encouraging investors to trade when the market sentiment was low, and discouraging investors to trade when the market seemed "excessively speculative." Second, the government has plenty of room for indirect influence and direct interference in market transactions through the dominance of state ownership in almost every type of major market player, including the listed companies, securities brokerage companies, institutional investors such as securities investment funds and insurance funds, accounting firms, credit-rating and assets appraisal agencies, and lastly, the stock exchanges themselves.[363] Third, in addition to helping finance SOEs as mandated by the government, the China Securities Regulatory Commission started to

[362] Jiao Qian, "High Costs Yet Low Returns: 40 percent of Chinese Investors Want to Quit" *Beijing Yule Xinbao* (25 January 2005), online: <http://www.chinanews.com.cn/news/2005/2005-01-25/26/532685.shtml>.
[363] Green, *supra* note 38.

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assume another seemingly unsuitable responsibility since 1999: to help achieve China's GDP growth targets and stabilize the society by propping up the stock index. It was believed by some decision makers that by maintaining a high stock index, the aggregate demand would be stimulated and therefore the GDP growth would be sustained. This line of reasoning has been criticized as questionable.[364]

The political logic of China's stock market was embedded at the very outset of the stock market's establishment, and has served to implement the government's industrial policy of supporting SOEs. It is commonly understood that in transition economies, the functions of the stock markets are not only limited to providing financing to enterprises, but also include helping with the privatization of SOEs by facilitating the transfer of their ownership rights to private hands. However, China's stock market seems to completely disregard its "investing" function and pays only limited attention to its "privatizing" function, but heavily leans toward the "financing" function, which has in practice been translated into a notorious game of "*quanqian*" (predatory money-raising without repayment). The natural results of this single-dimensional function of China's stock market, as discussed below, are frequent infringements of investor rights, widespread fraud and manipulation of share prices in a dysfunctional trading place, and poor corporate governance of listed companies.

An important extension of this unfavorable assessment of China's stock market relates to its pre-communist industrial history.[365] Perhaps not accidentally, in imperial China in late 19th and early 20th century, there was a similar pattern of stock market operation which emphasized only its financing function. After China lost the Sino-Japanese war in 1895, in order to promote private industrial businesses as a means to rebuild China's national strength, some top-down reformers in the imperial government enacted a new Corporation Law in 1904, which was modeled after contemporary English and Japanese

[364] Zhang Weiying, "Some Problems in China's Stock Market" *Caijing* (April 2000). Also see "An Overview of Shang Fulin's First Year as CRSC Chief: Reshaping the Regulatory System of the Stock Market" *China News* (12 January 2004), online: China News <http://www.chinanews.com.cn/n/2004-01-12/26/390584.html>.

[365] For an interesting investigation of the reasons behind the emerging prominence of historical studies in contemporary law and economics scholarship, see Ron Harris, "The Uses of History in Law and Economics" (2003) 4:2 Theoretical Inquiries in Law 659.

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law and designed to codify modern corporate governance practices and attract investment by public shareholders. However, partly because these reformers saw capital markets only as sources of funds, but overlooked their use as mechanisms for improving corporate governance, such as disciplining errant corporate insiders, the 1904 Corporation Law was remarkably ineffective.[366] Other potential factors that likely contributed to this failure of legal transplantation included an asserted "cultural inertia" that prevented real change because China's long culture of family businesses paying for the patronage of imperial bureaucrats proved too deeply ingrained, and the lack of an independent and trustworthy judiciary in China's traditional legal system to implement the law effectively.[367]

Seen from these peculiarities of corporate legal reform in imperial China, it is reasonable to suggest that path dependence may explain to a large extent why corporate governance reforms in China's transition economy have encountered similar problems as in the pre-communist periods. For example, many private entrepreneurs in today's China are still stranded in a dubious "business-bureaucracy complex," and "businesspeople paying for a government identity card" is still a popular practice in some localities, as illustrated in Chapter 4. Moreover, the incompetence and corruption of the judiciary is still a serious barrier to effective corporate governance reforms in contemporary China, as revealed in later discussion in Section III as to why it is difficult to punish wrongdoers in China's stock market.

Given the historical lesson from the imperial China, corporate governance reforms in China's transition economy should avoid the mis-steps of the past, and extend the functions of the capital markets from the single dimension of financing cash-starving SOES to other critical aspects, such as facilitating privatization of SOEs that is efficiency-enhancing and improving corporate governance practices of listed companies. This change cannot be realized unless the political logic beneath the inner workings of China's stock market is removed. Understandably, this will require complementary reforms to take place in China's SOE sector that would extend privatization on an even

[366] See Randall K. Morck & Lloyd Steier, "The Global History of Corporate Governance: An Introduction" (2005) NBER Working Paper, No. 11062, at 6-7.
[367] *Ibid.* at 7.

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wider scale than is permitted under the current "grasping the large, releasing the small" (*zhuada fangxiao*) strategy. From a long-term perspective on China's economic transition, the government will eventually come to a point where it need to not only "release the small," but also "release the large," including state monopolies in strategic industries, which means to adopt a comprehensive privatization strategy covering the entire SOE sector. For this to happen, complementary reforms in China's political and government systems are necessary. Predictably, these are more daunting tasks than China's economic transition.

3. Main consequences of the political logic of China's stock market: deep-rooted structural problems

There are several negative consequences of the political logic of China's stock market, which have formed the basis of its deep-rooted structural problems.

A. State dominance among major stock market players

State dominance among major stock market players, including listed companies, brokerage firms, investment fund management firms, accounting firms, assets appraisal firms and the stock exchanges themselves, allows the government a number of mechanisms to indirectly influence and directly interfere in the market.

First of all, unprofitable SOEs make up the majority of China's listed companies. Under the government policy of using the stock market to "save SOEs from financial difficulties," or "*wei guoqi jiekun*," SOEs have been heavily favored by the stock market regulators in receiving the green light to launch IPOs on the Shanghai and Shenzhen stock exchanges. These firms often received IPO approvals through window-dressing financial books and "packaging" less rotten assets with the assistance of local governments. By contrast, most profitable private firms have hitherto been denied access to the stock market. For example, Standard & Poor's, a credit-rating agency, counted

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only 35 "private" listed companies in China as of 2003 out of a total number of 1300 listed companies, and pointed out that a good number of these so-called "private" listed companies are in fact controlled by local governments and even the military.[368] Because of the significant political and regulatory barriers to the listing of private companies, some well performing private companies have been seeking overseas listings.[369]

Another result of this discriminatory listing policy is that most of the investment in the dynamic, private non-SOE sector that is propelling China's industrial growth in the new century is self-financed, or dependent on foreign capital. With few of these non-state enterprises being allowed to issue shares, trade on China's domestic stock exchanges is mainly in SOEs, whose non-transparent accounting practices and perceived lack of viability deter retail investors from holding much of their savings in these firms for the purpose of long-term and value-based investment. Hence the thinness and volatility of China's domestic stock market, where even a little news from the opaque SOEs can trigger big price movements.[370] The issue of volatile stock price movements is also related to the discussion below about China's "government policy-driven" stock market that has been identified with the politicization of economic activities.

In addition to the dominance of SOEs among listed companies, state ownership or control of other major stock market players has also caused serious problems of moral hazard and insolvency, most critically for China's approximately 130 brokerage firms that are supposed to be one of the pillars to provide market liquidity in the institutional structure of the stock market. The brokerage industry in China is a loss-making and scandal-prone sector that has been plagued by malpractice for years, primarily due to its lack of incentives to operate on a market basis under state ownership and control. The most notorious and widespread types of malpractice by China's brokerage firms include misappropriation of clients' funds (i.e., clients' "margin deposits"), insider trading, guaranteeing returns to investors, which could in some cases reach double-digit rates

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[368] "Casino Capital", *supra* note 262.
[369] Green, *supra* note 38.
[370] Deepak Lal, "How Foreign Reserves Could Make China yet Stronger" *Financial Times* (29 December 2004) 11 [Lal].

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regardless of the market movements, and falsifying financial statements to cover losses and retain qualifications or licenses for business.[371]

As of January 2005, the accumulated debts in the entire brokerage sector were estimated by some financial analysts at a staggering amount of RMB 200 billion yuan (roughly USD 24 billion).[372] This threatens an imminent meltdown of China's stock market as the share prices on both stock exchanges in Shanghai and Shenzhen hit their five-year low. How to deal with the insolvency crisis of China's brokerage firms, which has been underlying the negative investor sentiments since the second half of 2004 over a deeply depressed "bear market," is a serious concern for China's securities regulators in designing proper reform strategies, and will presumably be a high priority on the government's reform agenda at the next stage.

B. Government intervention in the stock market and the resulting politicization of economic activities

As a prevailing "local distinction" in China's stock market, Chinese investors hold an enduring belief that share prices are dictated by political signals, not by the laws of supply and demand.

Because China's two stock exchanges are dominated by poorly-run SOEs, the government has developed a habit of maintaining stock prices by controlling the flow of information. The periodic release of "good news" to the public has been part of the drive to keep stock prices buoyant, although with diminished effect over past several years. The government's practice has been to talk up poor-quality SOEs while preventing information on their true financial health from making its way into the media.[373] For example, during the period of 1991-2001, the 25 highest and lowest records of the

[371] Geoff Dyer, "Brokerages Face Audit as China Starts Clean-up" *Financial Times* (22 January 2005) 4.
[372] Li Zhenhua, "Is Government Taking Over 'the Best Solution' to those 'Problem Brokerage Firms'?" *21st Century Business Herald* (4 January 2005), online: 21st Century Business Herald <http://nanfangdaily.com.cn/jj/20050103/jr/200501040026.asp>.
[373] Chen-Ee Lee, "Dish the Dirt: China's Markets Need the Info" *Asian Wall Street Journal* (17 August 2000) 6.

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Shanghai Composite Index had been all correlated with policy announcements and information releases by the government.[374]

Indeed, policies filtering out the "bad news" were partly responsible for a spectacular boom in China's two stock exchanges between January 2000 to June 2001, before the market started its decline which has endured since then, when the "bad news" that the government tried to relinquish its remaining holdings by selling off the non-tradable state shares through a "full flotation" plan was released.

The history of the emergence, strengthening, and entrenchment of the belief of Chinese investors in the role of government intervention in stock market operation has its roots in the early 1990s when China's stock market was first established. First of all, it should be pointed out that the active involvement, and indeed the driving influence, of the Chinese government's involvement in the stock market, primarily with regard to IPO (initial public offering) qualification and pricing in the primary market and share price movements in the secondary market, had its origins at the very beginning of capital markets development in the country when economic reforms initially started. The establishment of a stock market, then a completely alien notion to most Chinese citizens accustomed to years of central planning, was not an "autonomous institutional innovation by the market," but a direct result of government actions and administrative ordinances.[375]

In other words, China's stock market was originally not a product of market mechanisms, but a government creation at a time when there was virtually no visible presence of private equity investment, financial intermediaries or firms with public shareholdings. Therefore, government actions were a necessary determinant of the establishment of China's stock market. Even though from the start this was an "irregular," or "state-dominated," or "government policy-driven" market, it nevertheless was still better than

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[374] Cheng Siwei, "Walk Out of the Vicious Circle of the Government Policy-Driven Stock Market" *Caijing* 118 (10 October 2004).

[375] Zhang Weiying, *The Theory of the Firm and China's Enterprise Reform* (Beijing: Peking University Press, 1999) at 383-385.

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"no market at all," because an imperfect market may well serve as a "transitional institution" and could still improve at later stages when China's economic transition had progressed.

However, the problem is that the "transitional period" turned out to have been protracted, and necessary reforms that would have improved the imperfect market have been largely delayed. After nearly a quarter of century of operation, China's stock market is still dictated by the political logic, which has increasingly proved detrimental to the effective and efficient workings of the market. The policy-driven share prices, which reflect the immediate effect of government intervention, now usually taking the form of bail-outs (or "*jiushi*") every time the Shanghai Composite Index is headed downwards, have politicized economic activities and distorted investment culture in the stock market.

C. The fragmentation of the stock market: the problem of non-tradable shares as the biggest challenge to China's stock market reform in the immediate term

The political logic of China's stock market has also led to the fragmentation of shares, low market liquidity, and poor corporate governance of listed companies. Under closer scrutiny of the causal relationship among these three identified structural problems, the fragmentation of shares, specifically the A-shares, is in turn the major cause of the other two problems. Basically, there are three categories of shares issued by China's A-share listed companies, each with different rights, benefits and prices: state shares, legal-person shares, and public shares.[376] As of December 2003, a total of 642.8 billion shares were outstanding, of which 226.8 billion were tradable and represented 35.38 percent, or about one-third, of the total shares.[377] The non-tradable shares, accounting for almost two-thirds

[376] The A-shares are shares issued by listed companies on China's mainland stock exchanges in Shanghai and Shenzhen, which are denominated in Chinese currency *yuan* or RMB and until November 2002 had been restricted to domestic investors. Since November 2002, foreign institutional investors that have obtained the joint approval by the CSRC, the central bank and the State Administration of Foreign Exchange can also trade A-shares with an allotted quota of funds. This is called the "qualified foreign institutional investors" (QFII) scheme, which is borrowed from Taiwan's experience during the earlier years of the island's capital markets development when the conditions for full financial liberalization were not mature.
[377] Source of data: CSRC, *supra* note 358.

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of the outstanding shares, primarily consist of state shares and legal-person shares.[378] The legal-person shares are usually held by state-owned or controlled enterprises. Therefore, it can be said that the structure of China's stock market is dominated by the state. Such a split share structure has put the public investors in a worse position than the actual controllers of the listed companies in making corporate policies and disposing of the companies' profits and assets.[379]

In the summer of 2001, encouraged by a booming stock market and strong performance of share indexes on both stock exchanges in Shanghai and Shenzhen, the government tried to sell a portion of its remaining holdings. This was a deeply unpopular plan that triggered the protracted decline of the market, which reached its five-year low in February 2005. Even though the so-called "full flotation" plan (*quanliutong*) was hastily withdrawn in the face of strong negative reactions from investors, who felt that they were being exploited by the government through "unfair" pricing of the shares being sold and the dilution of their existing holdings by news shares in the market, the threat of another mass sell-off of state shares continues to frustrate investor confidence. As of today, two-thirds of the market's USD 460 billion capitalisation still remains tied up in non-tradable state shares or legal-person shares held by state-controlled entities. This structural fragmentation of the stock market continues to distort valuations of tradable shares. For example, the average A-share trades at an expensive 25 times earnings on China's domestic stock exchanges, even when precisely the same asset, if listed in Hong Kong or New York, is priced at half that price/earnings ratio.[380]

As the non-tradable shares have increasingly become a serious structural problem in the stock market, making them tradable and abolishing the current split share structure is an urgent task that could not afford extended delay. However, this task can only be achieved if a mutually acceptable "full flotation" plan can be designed to both satisfy the government, which hopes to use proceeds from selling off state shares to fund its pension

[378] Other less dominant components of the non-tradable shares are employee shares, transferred rights issues, shares placed to investment funds and strategic investors etc. See *ibid*.
[379] Asia Pulse/XIC, "Shanghai Stock Market Hits Six-year Low" *Asia Times Online* (2 February 2005), online: Asia Times Online, <http://www.atimes.com/atimes/China/GB02Ad08.html>.
[380] "A Marginalized Market" *The Economist* (24 February 2005).

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liabilities, and meet investors' demand that they be compensated for the dilution of their existing holdings. As to how to "compensate" the public investors, proposals include offering them discounts on the state shares being sold, or attaching rights warrants to the shares investors already hold that will allow them to buy state shares proportionately at lower prices to avoid the dilution of their holdings.

It is worth noting that in 2004 a breakthrough in protecting holders of tradable shares from the exploitation by holders of non-tradable shares was made through the scaling back of China Merchants Bank's convertible bond issue. In February 2004, China Merchants Bank, China's largest listed shareholding bank, was forced to scale back a RMB 10 billion convertible bond issue in the face of a rare but effective display of shareholder anger at the dilution of their own holdings. The bank reduced the bond issue, which would have been the largest in China, to RMB 6.5 billion, and made up the remaining RMB 3.5 billion by issuing subordinated debt to strengthen its capital base to satisfy the 8 percent threshold of capital adequacy under the Basel Accord.[381]

Institutional investors representing 47 funds and one brokerage firm, which collectively own 310 million shares in the bank, had threatened to sue China Merchants Bank over the convertible bond issue. These investors regarded the bond issuing plan as "illegal action" which had seriously violated the interest of holders of the bank's tradable shares. They had also called on the CSRC to take full consideration of the interest of all shareholders, and not approve of the bank's convertible bond issuing plan. The institutional investors contended that as holders of tradable shares, they would suffer disproportionately from the dilution caused by the convertible bond, compared with the state shareholders as holders of non-tradable shares, because the latter would not have to pay real cash for their gains from the bond issue at the expense of the former.[382] As a result of this investor protest, which was an unusual demonstration of "investor activism," the bank finally

[381] Richard McGregor, "Bank Forced to Cut Value of Bond Issue" *Financial Times* (19 February 2004) 27.
[382] *Ibid.*

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announced that its board "had given approval to the changes after taking into account shareholders' advice and the company's need to urgently boost its capital base."[383]

This incident was a typical example revealing a basic fact that the rights of minority shareholders are routinely ignored in China, where about two-thirds of the shares in most listed companies are still held by government entities and non-tradable. The peculiarity of this case was that the minority intuitional investors won an important battle for their shareholder rights through collective action. From a positive perspective, China Merchants Bank's unusual, if partial, compromise may reflect the growing power of institutional shareholders, which has been encouraged by the government in an attempt to put the stock market on a sounder footing through creating an institutional investor base in China guided by a value-based investment culture.[384]

D. A pathological investment environment identified with widespread fraud and speculation

The political logic of China's stock market has also resulted in a pathological investment environment characterized by widespread fraud, manipulation of share prices by large investors or the so-called *zhuangjia* (manipulators), and speculative short-term share transactions other than merit-based investments by small investors, who usually do not care about the corporate governance of the firms they invest in.[385] Such political logic is the root cause of pervasive fraud in China's stock market. The government, especially at local levels, is directly responsible for, and in some cases even has an active part in, the cheating. A typical example is that a company in the northeast province of Heilongjiang (*Daqing Lianyi*) went public on false accounts fabricated jointly by the local government and the Commerce and Industry Administration, an agency whose job it is to ensure that all business activities comply with rules and regulations.[386]

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[383] *Ibid.*
[384] *Ibid.*
[385] Green, *supra* note 38 at 154.
[386] Yong Yan Li, "China's Equity Markets: Buyer Beware" *Asia Times Online* (9 May 2003), online: Asia Times Online <http://www.atimes.com/atimes/China/EE09Ad01.html> [Yong Yan Li].

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Even if regulators have punished some of the most outrageous manipulators in the stock market, insider trading is still rampant. This is primarily because the punishment has not been severe enough to effectively deter wrongdoing. Fines, even in huge amounts, are still deemed by the unscrupulous as a price worth paying in return for much lucrative gains from share price manipulation. Simply put, the potential benefits far outweigh the possible costs (when the fraud is discovered) of committing wrongdoing, hence the weak deterrent effect of punishment. According to the estimate of China's stock exchange executives, the real number of investors is around half the official number, which was at 70 million in 2004, because many investors use multiple accounts for questionable or illegal share transactions.[387]

Before the adoption of the delisting system in February 2001 and the first actual delisting of a listed company, the Shanghai-based Narcissus Electronic Appliance (Narcissus) on April 23 2001, Chinese investors would buy the shares of companies which were threatened with delisting in the knowledge they would inevitably be bailed out by local governments. Regional authorities also used numerous deceptive tools to ensure that favored local companies did not continue to record losses, including injecting assets into the enterprise and showering them with preferential policies. However, the ending of the old listing system in 2001, which allocated quotas to provinces to take local companies public, has removed companies such as Narcissus of their value for regional governments as fund-channeling vehicles. Local investors once considered clever for pouring money into loss-making companies in anticipation of their recovery have instead been mocked in the local media for buying shares in Narcissus.[388]

E. Poor quality of corporate governance of listed companies and the "adverse selection" problem

While non-profitable and debt-ridden SOEs are given strong preference for public listings in the domestic stock market, better performing private enterprises are largely excluded

[387] "Casino Capital", *supra* note 262.
[388] Richard McGregor, "First Chinese Company to be Delisted Today" *Financial Times* (24 April 2001) 11.

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from seeking an IPO on mainland exchanges and have been increasingly propelled to overseas capital markets. In addition, with respect to companies that have been listed domestically, their share prices often do not reflect true levels of financial performance and operational efficiency in a pathological and speculative investment environment. It is not unusual that shares of some poorly-run listed companies may be hotly pursued by investors, not because they have good performance prospects, but because they are decorated by some market manipulators with such glamorous concepts, as "restructuring" and "mergers and acquisitions (M&As) prospects" that usually entail profit opportunities through capital gains. On the contrary, for some better performing companies, which are a minority group in the stock market, their shares may be traded at lower prices than should be the case, because of the large size of their capital base and their lack of "restructuring" prospects that would fuel the imagination of speculative traders for abnormal and quick gains.[389]

Indeed, the adverse selection problem is so severe in the domestic stock market that some well-performing issuers would rather go to overseas capital markets for listings, even though their shares are usually sold at a considerable discount, with an average level of 13 to 14 percent, as compared to comparable foreign counterparts listed in the same market.

F. The CSRC's conflicting roles, lack of independence, and resulting ineffective regulation

Under the political logic of the stock market, the securities market principal watchdog, the China Securities Regulatory Commission (CSRC), has been entrusted with conflicting responsibilities. First, in theory it should assume the primary responsibility to supervise and monitor the stock market through promoting good behavior and truthful disclosure and punishing wrongdoers. However, the function of "supervision and regulation" has largely been compromised by a more compelling function: to facilitate

[389] Huang Huimin, "Delisting: Another Driving Force for Stock Market Development" (2001) 4 Listed Companies.

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the raising of capital for SOEs to help mitigate their financial distress. These two functions are inherently incompatible. Because SOEs are generally unprofitable and poorly managed, the preservation of their financing opportunities translates into weak regulation and disregard for investor protection._Otherwise, these firms would have long ago been excluded from the stock market. In addition, since 1999, a curious position has been adopted by some policy makers in the central government, specifically, that maintaining high share indexes would be beneficial and stimulative to the achievement of high GDP growth targets because a booming stock market with more capital inflows would contribute to high aggregate demand in the economy. Accordingly, the CSRC started to assume a new function: to prop up the stock indexes. However, when the indexes did reach their height, any possibility that they could fall engendered investors' dismay and outcry. Thus the primacy of "social stability" always prevailed to prevent the indexes from declining, which has created a perverse pattern of interaction between the state, the market, the regulator, and the investors.

Obviously, these competing functions have deprived the CSRC of regulatory vigor and effectiveness. On the one hand, the controlling shareholders of most listed companies are usually local governments or entities controlled by them. On the other hand, as a quasi-governmental agency, the CSRC lacks independence and is ultimately subject to government will. Therefore, it is usually difficult for the CSRC to effectively rectify the misdeeds by listed companies and their government controlling shareholders. More than often, providing investors with adequate protection through vigorous regulation is an empty promise, especially when the interests of the state and that of the investors are not aligned.[390]

Partly due to this significant drawback for the independence of the CSRC, the presumed function of the stock market in facilitating privatization of SOEs in China's transition

[390] Chen Xiao, "Judicial Enforcement Intervenes into the Stock Market, but Effective Regulation Is Still a Long Way Off" *China Newsweek* 164 (12 January 2004), online: China Newsweek <http://www.chinanewsweek.com.cn/2004-01-14/1/2935.html>.

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economy, as is generally expected of its counterparts in other transition economies, has been at best very limited.[391]

4. The operational quality of China's stock markets

An overall assessment of the operational quality of China's stock market is that, except for channeling funds to poorly-run SOEs under its political logic, which has eventually led to the drying up investment resources in the society, it has largely failed all important functions that it is supposed to perform. These functions include the following: (1) allocating capital to deserving firms, (2) protecting investor rights through punishing wrongdoers, (3) promoting good corporate governance and disciplining firms with market mechanisms, (4) building market credit mechanisms and a value-based investment culture, and (5) offering adequate returns on capital to investors that reflect the risks the bear.

Since June 2001, the share prices of China's stock market have been moving in the opposite direction to the strong growth trend of the country's economy. It is telling that the world's greatest economic success story has produced Asia's, and the world's, worst share performance in 2004. The Shanghai Composite Index, which covers yuan-denominated A-shares and hard currency denominated B-shares, fell 14 percent in 2004 and experienced a free-fall to a six-year low on February 1 2005. Meanwhile, the Shenzhen Composite Index hit its lowest level since 1997.[392]

The root cause of receding investment confidence is the very low, or complete absence of, return for investors in the stock market. For more than a decade, many listed companies have regarded the stock exchanges as places for "*quan qian*" and do not care about investor rights. Instead, they rarely pay dividends and often provide false information.

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[391] Han Zhiguo. "China's Stock Market on the Verge of Demise" *Securities Market Weekly* 1092 (15 January 2005).
[392] Asia Pulse/XIC. "Shanghai Stock Market Hits Six-year Low" *Asia Times Online* (2 February 2005). online: Asia Times Online <http://www.atimes.com/atimes/China/GB02Ad08.html>.

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The market remains dysfunctional as the mechanism for protecting investors' rights has yet to be fully established.[393]

[393] Asia Pulse/XIC. "China Moves to Cage its Rampaging Bears" *Asia Times Online* (20 January 2005), online: Asia Times Online <http://atimes01.atimes.com/atimes/China/GA20Ad02.html> [Asia Pulse/XIC].

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Section II

Corporate Governance and Performance of China's Listed Companies

Section II examines important aspects of corporate governance and performance of China's domestically listed companies, including their capital and ownership structures, financial performance, and typical forms of poor corporate governance.

Before proceeding to more substantive topics, it is necessary to explain the relationship between the stock market and listed companies. On the one hand, in the words of China's principal securities regulator, the CSRC, the quality of listed companies is the fundamental building block of the stock market. Following this conviction, some economists interpret the current depressed stock market sentiment as a reflection of investors' discontent with widespread corporate governance weaknesses of China's listed companies.

On the other hand, a better regulated stock market would help encourage good corporate behavior. As the strategy for China's SOE reform has shifted from granting autonomy, building managerial incentives and promoting competition, to reforming the ownership structure of SOEs through partial or full privatization, a stock market seemed a necessary institution to promote the ownership reform of SOEs.[394] However, because there is no true market for corporate control in China due to the underdevelopment of a property rights regime, the role of the stock market in disciplining listed companies and their management and promoting good corporate governance is very limited at this stage of reform. In addition, at a time when legal and regulatory reforms for the stock market are still progressing and their results have so far been limited, advanced corporate governance mechanisms, such as an independent director system and stock option plans for management, may not work as effectively as in a better developed market.

[394] With respect to privatization, the debate over "the competition effect" vs. "the ownership effect" is discussed in Section IV.

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1. The capital structure of Chinese listed companies

Chinese listed companies prefer equity financing over debt financing. Issuing shares to raise capital has been an enduring favorable option for these firms, as compared to bank loans and corporate bonds. The key feature of the capital structure of most listed companies in China, therefore, is low leverage.

For example, in 2001, the average leverage rate for Chinese listed companies in 2001 was 44.8 percent, compared to 62.4 percent for the national average, 52.1 percent for the group of shareholding companies (listed companies included), and 65.8 percent for the group of collectively-owned enterprises.[395]

The fundamental reason for the low leverage rate of China's listed companies is the underdevelopment of the capital markets where investors have very few alternatives for capital investment. Specifically, the corporate bond market has long been depressed under the government policy to control credit flows, because state banks are not yet commercial lenders and interest rates are not the primary monetary tool to adjust currency flows. With inadequate liberalization of the financial system, in particular the banking sector, an active corporate bond market has not developed in China.

In addition, because China's stock market is inefficient and diverges from standard rules of capital costs, firms do not have to worry about either the costs or the risks of issuing equity capital. One example is that the price/earnings ratio in the primary market is set artificially high (as high as 60 times) as a result of administration-driven share issuing and pricing systems that do not reflect the true market value of assets. This means firms can raise equity capital at a very low cost, and that they provide investors with virtually no meaningful returns on assets. Given the fact that most of China's listed companies do

[395] Gu Weiping, "Why Do Chinese Listed Companies Prefer Equity Financing to Debt Financing?" (2001) 8 Listed Companies.

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not pay dividends at all, the costs of raising equity capital for these companies are even lower than the average level.[396]

From the perspective of investors, why in the first place would they want to buy these shares if returns are so low? The answer is that most investors view stock buying as a speculation tool for gains from short-term share trades in the secondary market, not as a long-term, value-based investment vehicle. Therefore, they buy into these shares regardless of their long-term return prospects.[397]

In further examining why investors would buy these shares and why there could be short-term gains for (at least some) investors, there are two factors that explain a lot the irrational investment pattern. First, in the early years of stock market development, some economists, who were then seen by investors as the government's "think tanks" or policy advisors, had assured investors that "60-80 times price/earnings are absolutely normal" and "the government will definitely not allow the market to decline," which had misled small investors into buying shares at high prices, in the hope of making lucrative returns at a later time.[398] The second factor is that although on average public investors as a whole will lose in buying inflated shares issued by poorly-run listed companies, there had existed a well known "fool's game" in the Chinese stock market. Many investors believed that as long as there was a "fool" willing to buy shares from the previous holders, everybody can make gains in share trades until the last "fool" could not find anyone else to buy the shares from him/her, thus bearing all losses as the unlucky end chain of the "fool's game."

However, as the problems of the stock market have become increasingly evident, many investors could not realize their hope of exiting the market by selling shares at high prices to a "fool," because more and more investors are becoming aware of this long practiced game. Instead, they have remained "locked" into a in the market desperate to find a buyer

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[396] *Ibid.*
[397] *Ibid.*
[398] "Forcing China's Stock Market Down to the Bottom: Tails of Robbing Wealth in China's Stock Market" *Business Watch* 24 (12 December 2003).

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of the shares they hold. As a result, investing in the stock market has become one of the most risky businesses in China, and there have been reported cases where retail investors, many of them pensioners, committed suicide upon losing all their savings in the stock market.

2. The ownership structure of Chinese listed companies

The prevailing ownership structure of China's listed companies is the so-called "sole controlling shareholder dictatorship," whereby the state, or a state-controlled entity, is the sole largest shareholder with a controlling stake. Of Chinese shareholding companies, many have been transformed from old SOEs. These firms have to various degrees experienced the diversification of ownership bases by introducing private or foreign capital. However, in most cases such ownership restructuring process primarily involved inviting customers, suppliers, and other related enterprises to participate in the diversification, thus creating an ownership structure with *de facto* control by the sole largest shareholder.[399] For example, in 2001 there were 890 listed companies, or 79.2 percent of the total, that had a single shareholder holding at least 50 percent of their outstanding shares. The state, or a state-controlled legal person, is usually the largest shareholder of Chinese listed companies.[400]

This peculiar ownership structure has caused a widely observed problem of insider control among Chinese listed companies, as the state shareholder usually lacks effective mechanisms to exercise its ownership rights. This is also the most fundamental source of various corporate governance failures or misbehavior, of which the most typical forms are: (1) the extraction of corporate funds and resources and expropriation of minority shareholders by controlling shareholders, (2) expropriation and stealing by managers of corporate funds and resources, (3) the preference of listed companies for issuing new

[399] Liu Zhaohui, "The Stock Market Needs a Double Adjustment of both Corporate Governance and Industrial Structure of Listed Companies" (2003) 7 Listed Companies [Liu].
[400] Wen Zhao, "Is 'Sole Controlling Shareholder' the Culprit for Corporate Governance Failures?: Part V of a Report on Corporate Governance Structure" *China Business Times* (27 August 2001).

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shares that dilutes the interests of minority shareholders, (4) manipulating shareholder meetings by the controlling shareholders to pass new issuing plans against the will of minority shareholders.[401]

3. The financial performance of China's listed companies

A. Poor financial performance of listed companies

An abnormal phenomenon in China's stock market is that the performance of many listed companies is even worse than before listing. In a recent paper by two Taiwanese economists on the empirical results of the relationship between an IPO and the operational performance of Chinese listed companies, the author found that in measuring firms' growth, profitability and stability after IPO, the only industries in which China's listed companies displayed signs of strong performance were public utilities, transportation and finance, which are all in the "sunrise sectors" during China's transition where SOEs still hold a monopoly status. As to the changes in the financial indicators of listed companies following the IPO, the evidence shows that with the exception of earnings related indicators, such as EPS (Earnings per Share) and ROE (Returns on Equity), there are no significant changes. Moreover, the financial indicators tend to fall rapidly on a year-on-year basis. These findings indicate that the IPO is of little help to companies' operational performance, and in some cases may actually worsen it.[402]

Measured against the performance of those overseas-listed Chinese companies, the A-share companies as a group display a much lower level of financial performance. For example, for the year 2003, the average P/E (price/earnings) ratio for the A-share companies was 29.5 percent, against 14 percent for overseas-listed Chinese companies; the average ROE ratio for the A-share companies was 7.3 percent, compared to 13.5 percent for their overseas counterparts. In particular, almost a half of the A-share

[401] Liu, *supra* note 399.
[402] Chen Chien-Hsun & Shih Hui-Tzu, "Initial Public Offering and Corporate Governance in China's Transitional Economy" (2003) NBER Working Paper, No. 9574 [Chen & Shih].

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companies recorded a ROE ratio lower than 5 percent, despite the fact that 2003 was a fast growing year for China's economy, which means that many of these poor-performing firms should have been excluded from the stock market.[403]

B. Why financial performance of China's listed companies has been poor

For many listed companies in China, going public did not improve their corporate governance and financial performance, and for some their performance and financial condition became even worse after listing.[404] There are three major reasons suggested for the disappointing results of financial performance of Chinese listed companies.

The first reason for the declining performance of China's listed companies is that in order to be qualified for an IPO and secure an equity listing, Chinese companies tend to submit inflated figures in their financial statements that they are required to provide as part of the prospectus.[405] In other words, firms cooked their books to pass the review of IPO applications and their subsequent performance decline is only an inevitable reflection of the previously disguised fact. After these firms have entered the market and raised money from the public, they suddenly become truthful and disclose a stunning loss. As critically reported in a recent commentary on China's stock market:

> ...[T]here is no telling the extent to which the listed companies resort to cheating (in order to get listed). But the dozens of cases that have been made public are alarming in their sheer contempt for laws. From financial reports to accounting books, and from bank statements to related transaction contracts, everything can be falsified. From management to auditors, and from law firms to securities brokers, everybody can be a paid co-conspirator. Non-existent sales are recorded, imaginary profits are announced, while in reality the companies are insolvent even before they get listed.[406]

The second reason is incomplete privatization. According to some empirical estimates, exposure to capital markets through public equity offerings has been scarcely more

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[403] Chen Changhua, "Before the Bad Companies Go, the Good Companies will not Come" *Caijing* 121 (29 November 2004).
[404] Erika Leung, Lily Liu, Lu Shen, Kevin Taback & Leo Wang (with advice from Stewart C. Myers), "Financial Reform and Corporate Governance in China" (2002) MIT Sloan School of Management, 50th Anniversary Proceedings [Leung *et al.*].
[405] Chen & Shih, *supra* note 402.
[406] Yong Yan Li, *supra* note 386.

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effective in imposing disciplines on managers that under the old management system of SOEs. Many so-called privatizations so far have simply parceled out dominant shareholdings to different arms of government, leaving only minority stakes for private investors. Although ministries' direct interference in day-to-day management has been curbed, companies still face pressure to fulfill sometimes conflicting social and industrial policy priorities, which helps explain why studies have repeatedly found that many Chinese companies perform worse after privatization than before.[407]

The third reason is the commonly observed poor corporate governance of Chinese listed companies that usually leads to performance failure. Specifically, the endemic phenomenon of pervasive corporate litigation usually leads to huge financial losses and heavy debt burdens of China's listed companies. Such litigation often results from disputes over the extraction of corporate funds by the controlling shareholders and irregular guarantees by the listed companies for bank loans to related-party companies.

In most cases, the defendant is a listed company that experienced financial losses in failed business transactions or because of theft by managers and controlling shareholders. The plaintiff usually includes the following categories: (1) the defendant's creditors, such as banks that made unrecovered loans to a related-party of the defendant with the defendant as the loan guarantor, (2) minority shareholders of the defendant who demanded that the corporate funds stolen by the controlling shareholders be returned or compensated by the defendant, and (3) public investors who entrusted funds with the financial services arm of the defendant for guaranteed returns that were promised, yet not realized, by the defendant, many of whom were not only defaulted on the promised returns, but also lost their original funds. The average loss arising from the costs of such litigation for the A-share companies reached more than RMB 15 million yuan (around

[407] Guy de Jonquieres, "Investors are Drawn to China in Spite of the Risks" *Financial Times* (1 February 2005) 19.

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USD 1.81 million) in 2003. The litigation burden has eroded the profit margins and increased the debt burdens of many listed companies.[408]

4. The quality of corporate governance of China's listed companies

As pointed out above, poor corporate governance is an important contributor to the performance failure of listed companies in China. Even some of the better-regarded listed companies indulge in various forms of market abuses, such as lending money raised on the stock market to the parent company rather than investing it, or speculating in the stock market on their own account. Almost all companies that were allowed to list are the beneficiaries of government favoritism. Their profitability is usually abysmal, their levels of disclosure poor, and—with the state holding roughly two-thirds of the shares of companies listed in Shanghai and Shenzhen—their treatment of minority shareholders appalling.[409] Meanwhile, it should be pointed out, that state-controlled companies and private companies both bear their own share of the blame, and both contribute to the problem of corporate governance pathology in China's stock market, as the cases reported below reveal. Therefore, listing more private companies would not be sufficient to improve the general quality of corporate governance. Moreover, as the later discussion of corporate governance failures of China's private companies listed overseas suggests, these firms face similar problems of insider control, in the form of "the founder's dictatorship."

Typical forms of corporate governance pathology include the following five categories: (1) related-party transactions, (2) insider control and the resulting expropriation of corporate funds and resources by managers, (3) fraudulent listing applications and disclosure, (4) the extraction of corporate funds and expropriation of minority

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[408] Li Zhongdong & Li Hongwei, "The Fatal Litigation Trouble for Chinese Listed Companies" *Securities Market Weekly* (25 October 2004), online: Securities Market Weekly <http://news.hexun.com/detail.aspx?id=879820>.
[409] "Casino Capital", *supra* note 262.

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shareholders by controlling shareholders (usually the state and legal-person shareholders), and (5) weak internal controls and risk management.

From the following cases of corporate governance failures that have raised serious concerns to investors, it can be seen that the listed companies in China need an effective cleanup across the board, as both private and state-controlled companies, including some previously regarded as "better governed" firms, have recorded egregious misbehavior. It should also be noted that some of China's "new rich"— an emerging class of wealthy private entrepreneurs— turned out to be big corporate thieves and, in some cases, criminals. This phenomenon has been described as China's new epidemic of "question tycoons" or "tycoons with the original sin."

A. The Xi'an Diamond fraudulent listing and embezzlement case

One such "question tycoon" as described above was the former chairman of Xi'an Diamond, a listed private company that fabricated financial papers to obtain a fraudulent listing. In January 2005, the People's Congress of Xi'an city approved "compelling measures" against the fugitive chairman of Xi'an Diamond, Xu Zonglin. Xu is accused of taking nearly RMB 500 million yuan in public funds between 1996 and 2004, before absconding with the stolen money overseas. Prosecutors approved his arrest in December 2004, but Xu still remains at large.[410]

B. The Xinjiang Hops embezzlement case

Another recent embezzlement case involved Aikelamu Aishayoufu, the chairman of Xinjiang Hops, a Shanghai- listed company, who has been missing since November 2003. In a recent Asiamoney list, Mr. Aishayoufu, an ethnic Uighur from western China, was listed as one of China's richest businessmen, ranked 22nd in the country according to the value of his shares in Xinjiang Hops. Asiamoney calculated that Mr. Aishayoufu's

[410] "Measures to Track Down Fugitive Xian Diamond Chief" *South China Morning Post* (29 January 2005) 6.

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personal wealth was USD 351 million, based on his shareholding declared in Xinjiang Hops' annual report, but according to the board he has not left his company in good financial condition. In a statement to the Shanghai Stock Exchange following his disappearance, the board also disclosed new loan liabilities of RMB 987 million (USD 119 million), double the company' net assets, and receivables of RMB 265 million. Xinjiang Hops, which produces hops for the beer industry, had a further RMB 140 million in overdue loans and RMB 800 million in already disclosed loans guarantees. After the disappearance of Mr. Aishayoufu, the board announced that it only became aware that the former chairman had absconded when it received a request to contact him on October 30, 2003 from the Shanghai Stock Exchange.[411]

C. The Hongguang fraudulent listing and false reporting case

As to false reporting and fraudulent IPOs, the first reported fraud case in the stock market involved a cathode-ray-tube maker in Sichuan province, Hongguang Company. In the year before it went public, the company accumulated an aggregate loss of RMB 53 million yuan, making it ineligible for an IPO under China's Company Law and listing regulations. The listing rules require that an applicant firm must have achieved a certain level of profit growth for three consecutive years immediately before its listing. However, to circumvent this requirement, the company, with help from auditors and lawyers, forged a financial statement indicating a RMB 54 million yuan profit in 1996, while in reality it was losing money. The regulatory authorities may well have been kept in the dark in approving its IPO, but the market was skeptical of the firm's real financial condition. Within ten months after going public, Hongguang stunned the market with recorded losses worth RMB 200 million yuan. All the shareholders' equity was lost. There was no money left in the firm even to pay the million-yuan fines levied by a deeply embarrassed CSRC, which did not exercise prudent review when the firm applied for an IPO.[412]

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411 Richard McGregor, "Head of Xinjiang Hops Goes Missing" *Financial Times* (5 November 2003) 16.
412 Yong Yan Li, *supra* note 386.

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D. The Changhong-Apex dispute over unpaid bills

While the cases reported above largely involved fraud and embezzlement, which are commonly seen in China's stock market, the recent Changhong-Apex dispute reflects a new, but potentially critical, source of corporate governance failure: the disregard for risks in overseas expansion at a time when China's enterprises are seeking to increase their participation in the global economy.

In December 2004, China's biggest television maker and exporter, Shanghai-listed Sichuan Changhong Electric Appliances, admitted that it was in serious financial difficulty, largely because of its reliance on Apex Digital, its US distributor. It was likely to recover only USD 150 million of the USD 467.5 million in debts that were allegedly owed by Apex. As a result, Changhong, hitherto a much praised "favorite son" to Chinese leadership for its remarkable success in transforming itself from a small local SOE to the country's biggest TV maker, was facing significant losses in 2005 and it later declared to its shareholders that it was making provision to incur losses of USD 310 million, implying that the shareholders will not receive any dividends for at least ten years to come. Apex's co-founder, David Ji, a US citizen, has been detained by Chinese authorities over suspicions of financial wrongdoing.[413]

Analysts believe the sour relationship between Changhong and Apex reflects a strategic decision by Changhong to focus on sales growth in the US while neglecting its profit margins in recent years. In other words, Changhong sacrificed profit for market share. According to expert estimates, Apex was selling Changhong products at such low prices that after taking into account various costs, Changhong's profit margins on its exports to the US have been close to zero, compared with an industry export profit margin of 2 to 5 percent.[414] This pattern of overseas expansion not only entails great risk of profit losses, but has also forced Changhong's domestic competitors into a vicious circle of price competition, which is hurting the overall competitiveness of China's TV industry. The

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[413] Chris Buckley, "Leading Chinese TV Exporter Has Huge Loss" *New York Times* (28 December 2004).
[414] Justine Lau & Andrew Yeh, "Picture Suddenly Goes Fuzzy for One of China's Favorite Sons" *Financial Times* (4 January 2005) 15.

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two companies' unusual business relationship, whereby Apex acted as an agent but not the owner of Changhong's goods and took a 10 percent commission from sales, encouraged Changhong to continue sending orders despite slow demand in the US market.[415]

This case reminds Chinese enterprises with an ambition to expand overseas that business prudence and risk control are crucially needed when tapping global markets, and the typical problem of insider control whereby top managers make important business decisions without broad consultation, could lead to spectacular losses. As a local - government controlled company— the government of Mianyang city where Changhong's headquarters are located holds a 53 percent stake in its listing entity— Changhong demonstrates precisely this danger: its former CEO, Ni Runfeng, who stepped down before the Apex affair was exposed to the greater public, made decisions to continue to co-operate with Apex, despite warnings from other managers when criticism of Apex's credibility was being spread among the industry and media circles by some firms with unhappy experience with the US distributor in the past. Indeed, the reckless business adventure of Changhong with its US distributor was so bereft of reasonable care that the contract detailing the rights and responsibilities of each party was only one-page long, and Changhong even did not set up a representative office in the US, a remarkable oversight for such a large exporter with a significant market share for imported TV sets in the US.

E. The D'Long debacle: the collapse of one of China's flagship private enterprises

Since July 2004, Tang Wanxin, the former president of D'Long, a flagship Chinese private enterprise with a wide range of operations, which also had an international presence by acquiring Western brands, has been under investigation by Chinese authorities for alleged financial crimes involving the firm's spectacular collapse in the summer of 2004. The government has been preparing the biggest debt-restructuring plan

[415] Chris Buckley, "For Entrepreneur, Business Trip Ends in a Chinese Jail" *New York Times* (18 January 2005) C.6.

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in China's financial system since the collapse of Guangdong International Trust & Investment Corporation in 1998.[416]

Tang Wanxin, together with his three brothers, started business in photo-processing industry in 1986 in Xinjiang, which had grown into a financial conglomerate in less than twenty years. In 1992, D'Long entered into China's stock market, first as a "*zhuangjia*" (an account player or manipulator of share prices), which had built the well known "D'Long Faction" consisting of five to six listed companies, including Shenzhen-listed Hunan Torch and Alloy Investment and Shanghai-listed Xinjiang Tunhe.[417] One industry estimate reckoned that D'Long controlled equity capital worth USD 2.6 billion in five listed companies as of October 2003.[418] Moreover, with minority holdings in several more listed companies, as well as investments in hundreds of unlisted private enterprises, D'Long accounted for 35 percent of the capitalization of China's stock market.[419]

However, the share prices of the "D'Long Fraction" plunged in April 2004 in the wake of spreading news that the government had ordered D'Long's bank loans cut off, which eventually led to the collapse of the firm's entire business empire. What followed were a trail of lawsuits and fraud allegations against D'Long. For example, the Industrial & Commercial Bank of China (ICBC), one of the "big four" state banks, has sued the firm for the return of loans.[420]

It is indicative to examine the reasons for the D'Long debacle, which reveal some serious challenges faced by China's private enterprises, many of which are experiencing a transformation of business strategies from local operations and usually a narrow scope of business lines to vigorous expansion. Before its collapse, D'Long had pursued its business on two fronts. On the one hand, D'Long invested heavily to acquire hundreds of companies in a range of industries, including tomato jam, cement, auto parts, electric tools, heavy trucks, seeds and mining. On the other hand, D'Long took control of dozens

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[416] Mark O'Neil, "D'Long Officials under House Arrest" *South China Morning Post* (24 August 2004) 2.
[417] Ling Huawei, "D'Long Bubble Bursts" Caijing (22 April 2004), online: Caijing English Newsletter <http://www.caijing.com.cn/english/2004/040420/delong.htm>.
[418] Richard McGregor, "D'Long Group Pledges Shares" *Financial Times* (13 May 2004) 26.
[419] "D'Long Caught Short" *The Economist* (22 April 2004).
[420] Richard McGregor, "D'Long's Woes Spark Lawsuits" *Financial Times* (11 June 2004) 26.

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of financial service firms, including brokerage firms, trust companies and financial leasing companies. These two fronts were closely interrelated. Because of its pursuit of an aggressive expansion strategy that was capital-intensive, D'Long had to invest large amounts of capital into the restructuring of the companies it had acquired or merged with. The primary solution to D'Long's continuing expansion was to borrow money, and the need for funds eventually prompted D'Long to take direct control of financial institutions. In 2002, after it obtained control of several trust and securities companies, D'Long started to extend its business scope to the banking industry.[421]

The result was remarkable: over a short period of time, D'Long had acquired shares, including controlling stakes, of six or seven city commercial banks and had made appointments to the boards or management teams of these banks. According to an investigation report by China's banking regulators in their probe into the firm's irregular financial transactions, D'Long had borrowed from these banks a total of RMB 20-30 billion yuan (USD 2.4-3.6 billion). Many of these loans were guaranteed by connected companies or pledged with stocks. Adding in other funds obtained by D'Long from other financial institutions, D'Long was estimated to have ultimately controlled RMB 40-50 billion yuan (USD 4.8-6 billion) of funds in China's financial system.[422]

A report by one of the "big four" state banks revealed that although D'Long ostensibly had "reasonable projects" for all its bank loans, it actually had used many of its loans to buy shares in acquisition transactions to pursue its expansion strategy. Most of the loans were not lent on adequate collateral, and many of them were guaranteed by third-parties— usually the most risky type of loans for banks. When banking regulators were alerted by D'Long's aggressive moves in the financial industry that potentially involved high risks, the firm started to founder. After the China Banking Regulatory Commission sent risk alerts to local banking regulators, pointing out that D'Long and several other companies (mostly private enterprises) had excessively high leverage ratios, which increased the possibility of generating huge amounts of bad loans in the banking sector,

[421] Ling Huawei, "D'Long Bubble Bursts" Caijing (22 April 2004), online: Caijing English Newsletter <http://www.caijing.com.cn/english/2004/040420/dlong.htm>.
[422] *Ibid.*

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D'Long was doomed. Its fragile financing chains could not sustain an overall tightening of credit in the banking industry.[423]

The result was the chain collapse of the share prices of the "D'Long Fraction." On April 15 2004, the Shenzhen Stock Exchange suspended the trading of shares of Hunan Torch and Alloy Investment. At the same time, the stock price of Xinjiang Tunhe on the Shanghai Stock Exchange also went down to a miserable level. Shares of Hunan Torch and Alloy Investment later resumed trading but experienced further falls that were irreversible. The "D'Long Fraction" thus collapsed, which quickly caused the spectacular failure of the financial conglomerate.[424]

5. The limited effect of advanced corporate governance mechanisms from overseas

From the cases reported above, it can be seen that both China's private enterprises and partially privatized SOEs listed on domestic stock exchanges have widespread corporate governance problems. Would, then, introducing advanced mechanisms of checks and monitoring to combat these corporate governance deficiencies work— such as the installation of an independent director system? While it is necessary to seriously consider such measures, in the short run the effect of such effort is not always positive, because the advanced corporate governance mechanisms lack necessary operational conditions in an institutional environment where many basic market mechanisms are either still at their early stage of development or simply absent. Recent incidents surrounding several "dismissed independent directors," as discussed below, offer a typical example of where the distance between the intended goals and actual consequences of corporate governance reform can be much larger than one might expect.

In the summer of 2004, independent directors of at least three listed companies in China were forced off their boards after challenging management decisions, including

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[423] *Ibid.*
[424] *Ibid.*

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requesting an audit of one company's accounts. The board of a listed company, Leshan Power Electric, held a special meeting in August 2004 to sanction the resignation of a director who had hired an auditor from outside the province to investigate charges the company had not disclosed loan guarantees to other enterprises. Two other companies—Xinjiang Tunhe Investment, part of a private financial conglomerate, the failed D'Long group, and Inner Mongolia Yili Industrial, a dairy company — also both lost their independent directors around the same time in controversial circumstances.[425] Although many analysts commented that it was wrong for companies to remove independent directors because they were trying to disclose possible misbehavior, in the business reality of many Chinese listed companies, independent directors are largely considered "guests" or "vases" only for decorating purposes, which makes it doubtful whether they can play any material part in the operation of the company.[426] In particular, as a large proportion of the independent directors in China, now more than 1400 in total, consists of people from academic circles, including universities and research institutions, their expertise in commercial matters and the time and energy they are willing to spend on corporate affairs are also doubtful.

It is worth noting that compared to China, recent empirical studies have provided preliminary evidence indicating a better record of independent directors in listed public companies in South Korea. It has been found that Korean firms with 50 percent outside directors have 0.13 higher Tobin's q (roughly 40 percent higher share price), after controlling for other components of an overall corporate governance index. Moreover, this effect is found to be likely causal, which suggests the first evidence consistent with the proposition that greater board independence causally predicts higher share prices in emerging markets.[427] The difference in the effect of independent directors on share performance between China and Korea may be partly attributable to the better regulated capital market in Korea, as well as the different composition and incentive structure of

[425] Richard. McGregor. "Director Loses Seat for Hiring Auditor" *Financial Times* (18 August 2004) 26.
[426] *Ibid.*
[427] Bernard S. Black, Hasung Jang & Woochan Kim, "Does Corporate Governance Predict Firms' Market Values? Evidence from Korea" (2004) University of Texas Law School Law and Economics Working Paper, No. 26.

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independent directors in Korean listed companies. This issue requires future empirical research that will be addressed in my next research project.

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Section III

Overseas Listings and Corporate Governance of Chinese Companies

Since the listing in 1993 on the Hong Kong Exchange of the first mainland company, Tsingtao Brewery, Chinese companies have begun going overseas to raise capital. Major overseas capital markets for Chinese listings are the Hong Kong Exchange (including both main board and GEM board), the New York Stock Exchange, NASDAQ, the London Stock Exchange, and the Singapore Stock Exchange.[428] The major components of China's overseas listed companies are large SOEs with better performance, usually in such strategic sectors as energy, telecommunications, transportation, civil aviation, and finance. Meanwhile, since the 2001 IPO in Hong Kong of the first private Chinese company, Zhejiang Glass, private firms have also increased their interest in seeking overseas listings, partly because of the restrictions on domestic listings of private firms.

The reasons for China's companies to list in overseas capital markets are numerous and, happily, related in large part to positive considerations, including the following: (1) reaching a much wider base of international investors guided by value-based investment ideas, (2) accessing deeper and more liquid capital markets where not only more funds are available but the regulatory quality is much higher, (3) improving information disclosure and accounting practices, (4) facilitating the ownership reform of large SOEs, (5) promoting enterprise image and reputation internationally, and (6) expanding their participation in the global economy.

While headway has been made in terms of improved corporate governance under stricter regulation and market discipline, Chinese companies listed overseas have shown some critical weaknesses in internal controls and other forms of corporate governance deficiencies closely associated with the country's incomplete transition to a market economy, thus creating potential investment risks for investors.

[428] Lu Wenying, "A Study of the Relationship between Cross-Border Listing and Corporate Governance", in Zhu Congjiu, eds., *Shanghai Stock Exchange Research: the 1st Issue of 2004* (Shanghai: Fudan University Press, 2004).

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1. The likely fading attraction of the New York Stock Exchange (NYSE) to Chinese firms in the wake of SOX (Sarbanes-Oxley Act)

Before the coming into force of the Sarbanes-Oxley Act (SOX) in 2002, the New York Stock Exchange (NYSE) had been an attractive destination for many potential Chinese issuers. After all, a listing on the world's most dynamic and liquid capital market would naturally carry a significant reputational premium for firms ambitious to acquire global recognition and expansion.

However, tightened regulation under SOX has given some of China's big companies second thoughts about seeking a NYSE listing. Passed in the wake of the Enron and WorldCom scandals, this law calls for auditors to approve a company's procedures for preventing fraud and ensuring that its accounts are correct. It also requires managers to certify the effectiveness and adequacy of internal controls in year-end filings. For foreign companies registered with the Securities and Exchange Commission (SEC), compliance with the internal-controls rule is due to start with the financial year ending on or after July 15th 2005.[429] Given the increased costs of compliance, two of China's "big four" state banks, the Bank of China (BoC) and China Construction Bank (CCB), which are planning billion-dollar international flotations in 2005, have expressed reservations about listing on the NYSE. This issue is revisited in Chapter 6 where China's banking reform is examined.

As a result of the negative impact of the SOX on the listing plans of potential Chinese issuers, the London Stock Exchange recently replaced the NYSE as one of the listing destinations for Air China, the country's largest civil aviation carrier, which launched a dual-listing in December 2004 in London and Hong Kong.[430]

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[429] "Foreign listings in New York: Big Apple Blues" *The Economist* (27 January 2005) 73.
[430] *Ibid.*

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Although according to the chairman of the NYSE, William Donaldson, non-American firms may be granted more time to comply with the internal-controls clause under the SOX and the rules on delisting from American exchange may also be relaxed, Chinese companies would still find these concessions inadequate, given their generally higher difficulty in improving corporate governance as compared to European counterparts.[431] Faced with the serious threat of class action for corporate governance failures in American stock markets, Chinese issuers on the NYSE have already found life uneasy. For example, China Life, China's largest life insurer, has been under a formal investigation by the SEC since December 2004 and has a class-action suit pending, having failed to disclose accounting irregularities of RMB 5.4 billion (USD 652 million) at its state-owned parent company, which were uncovered by China's national audit office after China Life's dual-listing on the NYSE and the Hong Kong Exchange in December 2003.

2. Hong Kong's stock market as the primary channel of raising foreign capital for mainland Chinese companies

Many of China's biggest companies are listed in Hong Kong and are generally well received by overseas investors. At the height of the investment fever over China's growth story, overseas investors raced to buy every new issue, leading to exponential over-subscription of IPO shares.

In terms of the attractiveness for Chinese companies, Hong Kong has three important comparative advantages: (1) a language advantage, as Hong Kong is the only overseas capital market that uses both English and Chinese as working languages; (2) a transportation advantage due to Hong Kong's location adjacent to the mainland; and (3) a human capital advantage, as most securities analysts with an expertise in the mainland companies are located in Hong Kong.

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[431] *Ibid.*

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There are two types of Chinese companies listed in Hong Kong: H-share companies and the red-chip companies.[432] H-share Chinese companies are usually state-controlled entities, and many of them are state monopolies in strategic industries such as oil, telecommunications, steel, aviation, highway transportation, banking and insurance, even though competition is eroding their franchise.[433] By contrast, the red-chip companies are largely controlled by private companies which registered parts of their businesses overseas (e.g., in the Virgin Islands) as listing vehicles to circumvent domestic regulatory approval requirements for overseas public listings, which apply to all H-share companies.

Since the first mainland listing of Tsingtao Brewery in 1993, over 300 Chinese companies have gone to Hong Kong for listings, making up 28 percent of all listed companies there. Over the past decade, the 10 biggest IPOs on the Hong Kong Exchange have all been mainland listings. Newly listed mainland companies helped boost Hong Kong's market capitalization to a record HKD 6.696 trillion in 2004.[434] Therefore, measured by both the number of listed companies and market capitalization, the presence of Chinese companies in Hong Kong's capital markets is truly impressive.

3. Dual listings of China's mainland companies and the P/E (price/earnings) difference between domestic and overseas shares representing the same assets

Hong Kong-traded H-shares are generally priced 50 to 90 percent lower than their Shanghai or Shenzhen A-share counterparts, even though each of these different shares

[432] H-share companies refer to companies incorporated in the PRC and approved by the CSRC for a listing in Hong Kong. The par value of the shares of these enterprises is denominated in RMB, and the shares are subscribed for and traded in HKD or other currencies. Red-chip companies refer to companies which (a) have at least 30 percent shareholding held in aggregate by Mainland China entities, and/or indirectly through companies controlled by them, with the Mainland China entities being the single largest shareholders in aggregate terms, or (b) if the shareholding of the company held in aggregate directly and/or indirectly by Mainland China entities is below 30 percent but is 20 percent or above and there is a strong influential presence, on a judgmental basis, of Mainland China-linked individuals on the company's board of directors. See Hong Kong Exchange, online: <http://www.sfc.hk/sfc/doc/TC/research/stat/b01.doc>.
[433] "Capital Markets Are Good for You, But In Asia They will Take Time to Build", in "The Weakest Link: A Survey of Asian Finance" *The Economist* (6 February 2003) 14-16.
[434] Rita Raagas de Ramos, "Hong Kong Exchange Targets Dual Listings" *Asian Wall Street Journal* (10 January 2005) M.3.

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represents the same assets in the same company.[435] This has been described by both some financial analysts as a system of "one country, two valuations." Ever since the first overseas listing of Chinese companies in 1993 when Tsingtao Beer Brewery launched its IPO on Hong Kong Exchange, shares of mainland companies have traded at a sharp discount on international markets compared with the home market.

Currently, the valuation gap, which has shrunk from 90 percent in 2001 to about 40 percent in 2005, is poised to fall further with the advent of simultaneous listings of mainland companies on both domestic and Hong Kong's stock markets.[436] For example, China Construction Bank (CCB), Bank of Communications (BoCom) and coal miner Shenhua Group are among those planning simultaneous offerings on the mainland and Hong Kong exchanges in 2005. The CSRC, burdened with an ailing but still overvalued domestic A-share market, is widely expected to push for pricing parity on these simultaneous listings.[437] Although the different valuations of the A-shares and H-shares may move closer in the future if the reform of China's stock market achieves meaningful results and greater liberalization brings stricter market discipline to domestic market players, for the USD 3.5 billion of foreign funds currently qualified to invest in China's A-share market under the QFII scheme, A-shares remain unattractive.[438]

4. Risks associated with investing in mainland Chinese companies and the resulting corporate governance controversies

International private equity investment entities, such as large funds and investment banks, have made comfortable returns in Hong Kong-listed Chinese companies over the past couple of years. However, this does not negate the fact that there are also risks, which

[435] LaMoshi, *supra* note 348.
[436] "Another Country, The" *Financial Times* (12 January 2005) 14.
[437] *Ibid.*
[438] *Ibid.*

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could potentially be significant, associated with investing in overseas-listed mainland companies, including both state-controlled companies and private enterprises.[439]

A. Risks associated with investing in China's state-controlled companies

Although China's growth has been remarkable, investing in this boom economy remains a risky proposition. For instance, some international investors who had hoped to make money by buying stock in overseas listed mainland companies have instead suffered large losses as a consequence of corporate governance failures.[440] There are three major types of risk associated with investing in China's overseas-listed companies.

(1) The first type of risk: state intervention in firms' daily operation

The first type of risk comes from the still firm habit of the government to view SOEs, especially large ones, as quasi-government agencies rather than independent profit-making commercial entities. Accordingly, top members of SOE management are often treated as government officials in their promotion or transfer, as suggested in the recent incidents of sending the CEO of a listed oil company to a government post in Hainan Province and more controversially, rotating top managers of the listed telecommunications companies among one another.

The changes of senior management in the telecom industry included moving China United's chairman and chief executive, Wang Jianzhou, into the top spot at the country's largest wireless operator, China Mobile Communications Corp. The government also shifted China Mobile's chairman, Wang Xiaochu, into the equivalent position at fixed-line operator China Telecommunications Corp., while China United was assigned a new chairman, Chang Xiaobing, currently a vice president of China Telecom. All three companies have publicly listed units that trade in Hong Kong and New York. In fact, the Chinese telecom industry had undergone personnel rotations before this reshuffling, and

[439] "Capital Markets Are Good for You, But In Asia They will Take Time to Build", in "The Weakest Link: A Survey of Asian Finance" *The Economist* (6 February 2003) 14-16.
[440] "The Quest for Fair and Open Markets" *South China Morning Post* (24 July 2003) 10.

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according to the telecom regulators, these shifts reportedly "have not directly resulted in noticeable, significant operational strategy or policy changes." Indeed, telecom regulators at the Ministry of Information Industry and executives of phone companies sometimes have even swapped jobs.[441]

This reshuffling of senior managers of China's telecom companies was the latest move by the government to restructure the industry, which restructuring did not go through any board approval procedures at all. Such pattern of personnel decisions at large and strategic Chinese SOEs partly revealed that administrative orders often trump commercial calculations in the running of China's state monopolies. Indeed, if managers believe that their next positions will be at the head of their direct competitors, why bother trying to build a competitive company in the first place?[442] Moreover, by simply moving telecom executives into different positions at competitors, the government might have missed an opportunity to bring in professional managers from the outside. In the view of some overseas investors, the management shifts showed that a company's leaders are "ultimately accountable not to investors, but the Party." That might not be a positive message for foreign investors trying to judge the companies based on their growth prospects and profitability.[443] Needless to say, this enduring mindset of government intervention has made good corporate governance difficult to maintain, or to be established in the first place.

(2) The second type of risk: related-party transactions at large SOEs

The second type of risk is the high likelihood of related-party transactions created by the peculiar pattern of restructuring China's large SOEs before their domestic as well as overseas listings. Over the past decade, China has been restructuring its massive SOEs and selling pieces of them to international investors, raising billions of dollars. The most common method, which has so far been applied to telecommunications companies, power

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[441] Rebecca Buckman, "China Plans Job Shifts for Telecom Executives: Changes to Come Ahead of Mobile-License Awards and China Netcom's IPO" *Asian Wall Street Journal* (2 November 2004) A.1 [Buckman].
[442] Murc Dickie & Richard McGregor, "Chinese Business at Risk from Monopoly Mindset" *Financial Times* (7 December 2004) 34 [Dickie & McGregor].
[443] Buckman, *supra* note 441.

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producers and oil companies, is to hive off the best businesses of an inefficient state giant and then package them into a new company with stronger management to set up a listing entity, and finally sell shares of the new firm to the public. This pattern of restructuring has unavoidably led to a number of incidents of related-party transactions that could result in unsecured business dealings and thus risks for investors. The recent deposit controversy surrounding Hong Kong-listed China Oilfield, is just the latest example of how conflicts can arise over how the listed companies conduct business with their parent companies and related parties.

To better understand the pervasiveness of related-party transactions among Chinese companies, it is useful to review the recent deposit controversy surrounding China Oilfield. In 2004, a fight over a request from China Oilfield, a Hong Kong-listed Chinese oil services company, to deposit up to 40 percent of its 2003 revenue, about USD 148 million, with a finance company owned by its parent illustrated how China's approach to accessing global capital markets can generate corporate governance concerns among investors. Corporate governance advocates and some investors have asserted that it is poor corporate governance to put so much of the firm's cash into a company controlled by its main shareholder. Because its deposits would not be secured, China Oilfield would have no recourse if the finance company were to make bad investments.

The request from China Oilfield was viewed by the firm— and indeed many other large Chinese companies listed overseas— as "business as usual," which indicated the widespread nature of this practice among Chinese companies. For instance, in 2001, Hong Kong regulators uncovered that Guangdong Kelon Electrical Holdings, a Chinese refrigerator and air-conditioner maker, had failed to disclose a RMB 1.26 billion yuan (USD 52.2 million) loan to its parent. The company later received a warning from its auditors. Another example is that when China Oilfield went public in 2002, Hong Kong regulators permitted it to deposit up to 10 percent of its previous year's revenue at CNOOC Finance Ltd, which is controlled by its parent company. Again, in April 2004, a sister company of China Oilfield, Hong Kong-listed CNOOC Ltd., won shareholder

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approval to deposit as much as RMB 6.8 billion yuan, which was equal to 17 percent of its 2003 revenues, at the group's finance company.[444]

Although similar deposit or loan plans had gained shareholder approvals, investors of China Oilfield regarded this type of practice as a veiled way for the parent company to effectively borrow from its listed subsidiary on an unsecured basis. According to an angered shareholder rights activist in Hong Kong, David Webb, it was simply "bad behavior" to finance the parent company with the listed company's funds.[445] Eventually, the deposit proposal was voted down by shareholders of China Oilfield.

(3) The third type of risk: moral hazard of international investors

Finally, the third type of risk is the dangerous belief held by investors in government bail-outs of troubled state firms, which is very likely to cause moral hazard and distort rational judgments about firms' financial health and operational efficiency. It has become increasingly clear that with a favored position within China's economy which has only started to diminish recently and the hope of investors that the government would support them in times of need, China's large SOEs, usually state monopolies in strategic sectors, have been considered compelling and relatively low- risk investments by many investors. These investors often justify putting money into state-controlled entities with questionable records or governance by pointing to the likelihood that the state would bail them out. However, this belief, or indeed moral hazard on the part of investors, started to founder in 1998, when the local government controlled Guangdong International Trust & Investment Corp. defaulted on USD 4.7 billion in debt and investors were left with huge losses.[446]

Thus, it is clear that investing in China's state-controlled companies entails potentially significant risks. Global investors are supposed to be aware of the risks, because Chinese companies are allocated risk-weightings by brokerages and fund managers to reflect their

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[444] Kate Linebaugh, "China Oilfield Fight Highlights Questions about Governance" *Asian Wall Street Journal* (2 November 2004) M.1.
[445] *Ibid.*
[446] *Ibid.*

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relative regulatory and political risks. The weighting builds in a discount from the returns that might be expected from a stock in a similar industry in a developed country. For China, the discount is about 13-14 percent. However, even aware of the risks, many investors buy shares of these companies regardless.[447] Perhaps there is a pressing need to educate investors in international capital markets about the old principle of "buyer beware" when investing in China's companies.

B. The enormity of the 2004 CAO scandal: "China's Barings"

In December 2004, in a shock that was soon to reveal the biggest corporate scandal in Singapore's financial markets, China Aviation Oil (Singapore), a locally-listed subsidiary of the monopoly oil giant, China Aviation Oil Holding Corp. (CAOHC), stunned investors by disclosing massive trading losses, worth USD 500 million, in oil future transactions. CAO has filed for bankruptcy protection with a local court in Singapore. Its biggest creditors, including Japan's Sumitomo Mitsui Banking, the SK Energy of South Korea, South Africa's Standard Bank, Australia's Macquarie Bank, SG Asia, Barclays Capital, and Goldman Sachs and Fortis, have all been negotiating with CAO for a restructuring plan. Some of them have sued the firm for unrecovered loans.[448] Moreover, a group of local investors has launched a class action against CAO and its parent, CAOHC, for failing to disclose the losses when CAOHC sold a 15 percent stake in CAO to the public in late October 2004, allegedly to fund a bail-out of its troubled subsidiary, which was widely considered a violation of rules banning insider trading. This spectacular collapse has been infamously billed as "China's Barings."[449]

In this case, three things have become clear: (1) due to insider control, CAO had inadequate internal controls over its derivatives trading, since deals were supposed to be suspended if any of the company's 10 traders assumed a loss of more than USD 500,000; (2) the company, as well as its parent, failed in their obligation to make timely disclosure

[447] Dickie & McGregor, *supra* note 442.
[448] John Burton, "CAO Seeks $500m Debt Write-offs" *Financial Times* (5 January 2005).
[449] In 1995, Nick Leeson, a British "rogue trader," triggered the collapse of Barings Bank, a respected British bank with a history of more than 100 years, as a result of massive losses of USD 1.2 billion from failed speculation on foreign exchange transactions in Singapore's financial markets.

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when beset by financial disaster, and (3) domestic regulators, including the CSRC and SASAC, failed to monitor the company's risky financial transactions overseas.[450]

(1) The "monopoly mindset" as a major contributor to the CAO debacle

Trading scandals are not unique to China: Britain's Barings and Japan's Sumitomo have demonstrated the potential dangers of derivatives trading to corporations from any country.[451] However, few analysts doubt that CAO's woes are an important reminder of the particular problems that plague many Chinese companies listed abroad, and an indication that these problem stem in part from structural issues as much as individual failures of corporate governance. While Chinese companies that have gone overseas for listings are generally considered the best performers of the state sector, their performance often depends on the lack of liberalization and competition in the industries they operate, rather than entrepreneurial spirit or managerial skill. For the SOEs that are highly profitable, an important source of their profits is the near "risk-free" monopoly rents in home markets.[452]

While the monopoly mindset has led the Chinese government to treat state-controlled companies as quasi-government agencies, as pointed out earlier, the debacle at CAO shows that for companies with a monopoly mindset, the pressure to generate profits embodies great dangers. In this particular case, because CAO had a monopoly in market distribution of jet oil for China's domestic civil carriers, the thirst for profits, combined with the fact that the firm had been seeking growth in aggressive overseas investments and oil and derivatives trading, paved the road to perdition.

According to many domestic commentators, this thirst for profits was likely driven, at least partly, by the profit-linked compensation package of its CEO, Chen Jiulin, who bore the primary responsibility for the firm's reckless gambling in the oil futures market. While some may think that in most cases profit-linked managerial compensation will deter foolish speculative investments, the CAO was an exception. As a "layman" in

[450] "China's Champions: Markets Have Been Too Eager for 'Red-Chip' Companies" *Financial Times* (3 December 2004) 22.
[451] Dickie & McGregor, *supra* note 442.
[452] *Ibid.*

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future market transactions, without consulting either the board or his supervisors at the parent company, Chen turned out to have made all critical trade decisions by himself alone that eventually led the firm to collapse. It is hard to imagine that a big Western company listed on a mature capital market would hire a non-professional CEO to run its daily business. In a sense, Chen's ignorance of financial basics and the high risks associated with speculative trades in oil futures market was unparalleled: even after CAO filed for bankruptcy protection, Chen, himself also under an investigation by the local financial regulators, still claimed that if he could have another USD 500 million, he can "make a turnaround and recover all the losses incurred." This has been bitterly swallowed by commentators in the domestic financial industry as "beyond madness."[453] What has inspired particular cynicism is that before its dramatic fall, CAO was once praised as "the best governed company" and "the most transparent listed company" in Singapore, and Chen Jiulin was ranked among the "new economic leaders in Asia" by the World Economic Forum in 2003.[454]

(2) CAO is not an isolated exception, but a typical example of the Chinese pattern of restructuring the state sector during the country's transition

Some financial analysts are less discouraged by the potential risks in investing in China's companies demonstrated in the CAO scandal. In their opinion, CAO's collapse was purely the result of a breakdown in internal controls caused by pressure to increase profits, and is therefore similar to western corporate scandals such as Enron and WorldCom in the US and Parmalat in Italy, in which executive greed and disregard for shareholder rights led powerful managers to pursue a reckless course that sent their firms into spectacular collapses. More skeptical observers, however, believe that the transformation of China's partially privatized giants is plagued by structural problems, typical of a country in transition from a command economy to a market economy.[455] In the wake of the CAO scandal, one should carefully evaluate the impact it may have on international investors' perceptions of Chinese firms in general. The question for investors impressed

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[453] Gao Yu, "Why There Was No One to Stop CAO from Going Crazy?" *Business Watch* 24 (2004).
[454] John Burton, Murc Dickie, Francesco Guerrera & Joe Leahy, "A Collapse that Waves a 'Big Red Flag' about Business with Beijing" *Financial Times* (21 January 2005) 15.
[455] *Ibid.*

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by China's growth story is whether CAO was an aberration caused by one or more "rogue traders," or the first of many disasters waiting to happen as the country proceeds further on its transition to a market economy and hidden structural problems caused by incomplete privatization and industrial liberalization start to emerge and ultimately explode.[456]

The likely answer does not seem encouraging. In fact, in many respects CAO is not an isolated exception, but a typical example of a Chinese state company to which the government had granted a monopolistic market status: CAOHC, its state-owned parent, has a near-total monopoly in supply of aviation fuel, and had made CAO its sole supplier of imports. That monopoly prompted investors to buy into CAO's 2001 IPO, which was Singapore's biggest that year. Supported by the parent, which retained a 75 percent controlling stake, CAO's mission was clear: use foreign capital to increase profits and expand operations, while keeping a strategic industry under state control.[457]

This is a familiar model of industrial restructuring of China's "strategic sectors," which has enabled the Chinese government to restructure and inject market discipline into sectors that used to be huge economic burdens, such as oil, telecommunications and power, without ceding ultimate control. The resulting mix of entrepreneurial energy and state ownership has made the listed entities of China's state giants attractive for foreign investors as they hold a belief in government bail-outs in times of difficulty.

(3) Regulating overseas businesses of Chinese SOEs is a particular challenge

Finally, from the perspective of Chinese regulators, the dramatic losses at CAO in 2004 made clear the importance of regulating state enterprises' overseas businesses. For example, according to the State-owned Assets Supervision and Administration Commission (SASAC), which until January 2005 had been slow and weak in responding to the debacle, it would step up efforts to establish an effective supervision system to avoid another CAO scandal. While this pledge to improve offshore regulation marked SASAC's most substantive public response to the CAO scandal, it gave no details of the

[456] *Ibid.*
[457] *Ibid.*

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regulatory system it plans to develop. Therefore, domestic critics who see the SASAC's reaction to the scandal as representative of its failure to improve corporate governance of state companies significantly, are unlikely to be convinced by this pledge alone.[458] Indeed, with weak governance and corruption endemic among state ventures and government offices even at home, regulating managers stationed overseas present a particular challenge.[459]

C. China's private companies listed overseas are not immune from corporate governance controversies

While state-controlled companies may carry potentially significant investment risks, their private counterparts are not innocent either and have recorded a series of corporate governance controversies between 2002 and 2005, which has dealt a blow to the confidence of international investors who had been previously chasing with enthusiasm the so-called "p-chips" on the Hong Kong Exchange.

(1) Recent corporate governance controversies surrounding China's private companies listed overseas

In December 2004, Skyworth, the Hong Kong-listed private company and China's fourth-largest TV manufacturer by volume, insisted that business was continuing as usual even as authorities in the territory, most notably the Independent Commission against Corruption (ICAC), formally charged the company's chairman, Wong Wang-sang, and Wong Pui-sing, an executive director, for allegedly misappropriating HKD 48 million (USD 6 million) in company funds. The two Mr. Wongs, who were among 15 people arrested in relation to the case, were jointly charged with conspiracy to steal.[460] The arrests are a humiliating fall from grace for a group favored by foreign fund managers and have once again highlighted the risks facing investors in Hong Kong-listed mainland

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[458] Mure Dickie, "Beijing Promises Better Offshore Rules" *Financial Times* (27 January 2005) 9.
[459] *Ibid.*
[460] Alexandra Harney & Justine Lau, "Skyworth Officials Charged with Theft of Funds" *Financial Times* (2 December 2004) 26.

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Chinese companies, of which the difficulty of the regulators to reach the management based in the mainland is a serious one.

In the Skyworth case, Mr. Wong Wang-sang founded the company about 15 years ago and is its largest shareholder with a 40 percent stake. The "founder's dictatorship" and disregard for investor rights have been the major reasons for corporate governance failures at China's private companies, and this case was merely exemplary. Another of those arrested in the Skyworth case was understood to be a former accountant who allegedly took bribes and falsified Skyworth's accounts for its Hong Kong listing in 2000.[461]

The investigation surrounding Skyworth was not the first incident involving potential criminal manipulation of the listing process by mainland private companies. Back in July 2003, the Independent Commission against Corruption charged five people, including an accountant, with alleged conspiracy to defraud connected to the listing of Gold Wo International.[462] In addition, among Chinese companies listed in Hong Kong, companies ranging from the Hong Kong branch of Bank of China (BoC), where three senior managers have been charged with embezzlement of corporate funds, to Shanghai Land, a developer controlled by a local tycoon, Zhou Zhengyi, who has been in jail in the mainland for corporate crimes, have all been at the centre of similar probes over alleged corporate governance failures over the past two years. The BoC Hong Kong branch case is discussed in more detail in Chapter 6.

In April-May 2003, the consecutive walk-out of two auditors in five weeks highlighted the accounting controversy at China Rare Earth Holdings. KPMG had quit as its auditor, 36 days after the resignation of Ernst & Young due to disagreement on proper accounting measures with the firm. Unfortunately, China Rare Earth's quarrels with its auditors are not a rare phenomenon in mainland China and highlight just how difficult the relationship can be between auditors and Chinese firms steeped in a tradition of non-transparency.[463]

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[461] *Ibid.*
[462] *Ibid.*
[463] Eric Ng, "Auditors Walk China Tightrope" *South China Morning Post* (6 May 2003) 18.

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Another notable case of corporate governance controversy involved Euro-Asia Agricultural Holdings, an orchid-grower listed on the Hong Kong Exchange. In December 2002, Hong Kong police launched an investigation into the company, after documents were seized from its offices by the Commercial Crime Bureau in Hong Kong.[464] Euro-Asia had been probed by mainland regulators for allegedly overstating its revenues by 20 times in the previous four years, and was under investigation by both mainland and Hong Kong securities regulators.[465] The founder of Euro-Asia, Yang Bin, was reputedly China's second-richest man in 2002 and has since July 2003 been serving an 18 year jail sentence for illegal real estate deals at his Holland Village development in Shenyang city of Liaoning province. After the company's mainland assets were stripped by the Chinese government, the regulators and investors in Hong Kong were left with little or no recourse to the firm's business interests in the face of uncertainty.[466]

Moreover, another private Chinese company listed in Hong Kong, Chaoda Modern Agriculture (Holdings), tried to convince the local market of its good practice by announcing in October 2002 that it was ready to report quarterly to improve transparency and restore confidence in private mainland firms, after its auditors refused to sign off on its financial results. Chaoda's move was an attempt to distance itself from the scandal-ridden Euro-Asia. The difficulty for Chaoda was that it looked very similar to Euro- Asia: privately owned, in the agriculture business and with abnormally high profit margins and startling growth rates in revenues and profits. The suspected inflation of profit margins and growth rates by Chaoda had raised deep investors' concern over its accounting practices.[467]

As new and continuing scandals have begun to affect a wider scale of Hong Kong-listed mainland private companies, the need for better corporate governance extends across the board, rather than involving just a few isolated cases. The investigations into financial

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[464] Clifford Lo & Raymond Ma. "Police launch probe into Euro-Asia" *South China Morning Post* (30 October 2002) 2.
[465] *Ibid.*
[466] "The Quest for Fair and Open Markets" *South China Morning Post* (24 July 2003) 10.
[467] Clifford Lo & Raymond Ma. "Police launch probe into Euro-Asia" *South China Morning Post* (30 October 2002) 2.

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dealings of Shanghai Land and Shanghai Merchants, and the doubt auditors had cast over the accounts of Guangdong Kelon and China Rare Earth were prominent examples in 2003 alone.[468] In particular, the practices that flourished at Shanghai Land and Euro-Asia, which followed a pattern of making real estate investment funded by bank loans and then diverting funds or funneling proceeds into even more leveraged businesses, could only have persisted as long as they were implemented in a corporate environment where oversight was lax and checks and balances were poor, as has been generally the case for corporate governance of most mainland companies.[469]

(2) Reasons for the wide scale of corporate governance controversies

Three main reasons explain why incidents of corporate governance controversies have increased among China's private companies listed overseas over the past several years.

The first reason is that China's private entrepreneurs have built their businesses in China's transition economy where a well defined property rights system has not been established, which has resulted in uncertainty surrounding the legitimacy of the personal wealth and business interests of some private entrepreneurs. In cases where the government decided that a private business was illegitimate and its profits were illicit, the risk of government deprivation of personal and corporate property, which usually triggers a business collapse, could be very serious. The jail terms for both Yang Bin of Euro-Asia and Zhou Zhengyi of Shanghai Land, are two notable examples.

The second reason is that China's private entrepreneurs are faced with a challenge of transforming the pattern of their business practices from a "primitive" stage of wealth accumulation, whereby hard work and prudent savings had been the primary source of success and expansion, to a new stage of more advanced market practices whereby knowledge of modern business operation, commercial ethics and risk management are critical to sustained corporate growth. Given that most of the first generation of China's private entrepreneurs only had limited education and business training and their

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[468] "The Quest for Fair and Open Markets" *South China Morning Post* (24 July 2003) 10.
[469] *Ibid.*

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understanding of modern accounting and reporting rules in mature capital markets is inadequate, the likelihood of violation and misbehavior in corporate governance practices is significant after they enter international capital markets.

The third reason is that the pattern of "founder's dictatorship" has been common in corporate governance structures of many Chinese private companies, which makes effective internal controls impossible. This is the primary cause for the massive stealing of corporate funds by Wong Wang-sang of Skyworth. While in China's domestic capital markets this pattern of running private businesses is more tolerable when transition is still in progress, in more advanced overseas capital markets it may be subject to stricter scrutiny and if not mitigated may well become an important source of corporate governance failures.

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Section IV

The Complementary Role of Fundamental Stock Market Reform in Facilitating SOE and Banking Reforms in China

Looking forward, the deepening and ultimate success of China's SOE and banking reforms will significantly depend on the progress made with the stock market reform. First, a well functioning stock market can serve as an efficient channel to implement fuller privatization of SOEs as they restructure and diversify their ownership bases. Second, to be able to fund the country's massive pension liabilities and reduce the heavy debt of the government, China's social security fund, currently operating with a huge deficit, also requires a safe market to invest that can offer adequate returns. The lack of safe investment tools has been a serious constraint on promoting deeper SOE reform. Third, a better regulated and improved stock market will relieve the overwhelming financing burdens of China's banks, currently accounting for four-fifths of annual new investment, thus making their reform, including likely domestic listings, easier to proceed with.

1. Privatization of SOEs, especially large state monopolies, requires a properly functioning capital market

In reviewing the academic debate over "the ownership effect *vs.* the competition effect" on the performance of SOEs, particularly state monopolies, it can be argued that while counting on better state regulation is unlikely to be a workable solution to the inefficiency of SOEs in China's current legal and institutional environments, privatization, which in theory could ultimately be a superior solution to competition, is also unlikely to have adequate institutional support at an operational level if the capital market is poorly regulated and operates inefficiently.

With regard to natural monopoly, some scholars— mostly notably the British economists John Vickers and George Yarrow— have argued that where there is little competition and

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the industry is strictly regulated, there is little difference between the efficiency of private and public enterprises.[470] Therefore, privatization is not a necessary condition for bringing about efficiency to natural monopoly industries under those identified circumstances.

This hypothesis about "the irrelevance of the ownership effect under the condition of strict regulation" is not fully consistent with the operational situation of China's state monopolies, which is identified with two peculiar characteristics.

First, there is indeed "little competition" in China's natural monopoly industries or the so-called "strategic" sectors, such as energy, transportation and telecommunications, but the reason for this lack of competition is somewhat unique. Specifically, while the inherent nature of these firms' businesses, which puts an overwhelming emphasis on economies of scale and concentrated market shares, may to a large extent explain their dominant market status, state favoritism that creates an additional advantage of "administrative monopoly" is also a significant contributor to the lack of competition in China's state monopoly industries.

As China has accelerated its integration in the global economy, these firms have begun to compete globally, especially after the "going out" strategy has been implemented to encourage China's "national champions" to expand overseas. However, at home they still operate in monopoly sectors that have not been liberalized. It is not surprising, therefore, that the valuation of some of China's state monopolies in overseas capital markets is higher than that of many more fully privatized firms, as the valuation differential may be associated with monopoly rents which are still present at home, but removed overseas. Moreover, the government still provides special benefits to these firms that lead to higher valuation, such as subsidized loans, protection of market share, favorable regulatory treatment, and guaranteed business from the state, which is part of the reason why the additional market status of "administrative monopoly" is added to China's natural

[470] John Vickers & George Yarrow, Privatization: An Economic Analysis (Cambridge: MIT Press, 1991), cited in Smith & Trebilcock, *supra* note 57 at 225.

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monopoly firms.[471] This artificially created market advantage has deterred competition from private firms to China's state monopolies to an even more severe extent.

Second, "strict regulation" is not a well practiced, or even well defined, concept in relation to China's natural monopoly industries, where the quality of economic regulation is poor primarily due to the conflicting roles of the state as both owner and regulator. Aside from the notoriously known overcharges of consumers and the provision of poor-quality services by China's state-owned telecommunications companies, a notable recent example of the difficulty in regulating natural monopoly effectively is the surprising lifting of a short-lived ban on construction projects undertaken by China's 30 power companies.

Out of environmental concerns, China's State Environmental Protection Administration (SEPA) fined 30 errant power companies for not taking environmental costs into account and lacking necessary approvals when pursing construction projects. The suspension of these projects was announced in January 2005 by SEPA. Only a month later, the green light was given to resume construction work on most of these power projects previously halted. This resumption, seen as a demonstration of the SEPA's lenient policy towards environmental violations by China's natural monopoly companies, has come as a big surprise to many environmental experts in China. Indeed, if all the projects are permitted under China's *Environmental Impact Assessment Law*, why is the law needed in the first place? Some experts considered that SEPA's decision was likely to have been influenced by concerns over economic losses caused by the suspension of the projects. According to these experts, SEPA, which has been under enormous pressure from local authorities and other government departments, cannot cancel those projects, especially given the national power shortage. It is not surprising that many power companies, including the China Guodian Corp, which had two big power projects blacklisted by SEPA, had expected the ban on construction work to be short-lived.[472] Therefore, the "Vickers and Yarrow

[471] Bernardo Bortolotti & Mara Faccio, "Reluctant Privatization" (2004) ECGI (European Corporate Governance Institute) working paper No. 40/2004 at 25.
[472] Shi Jiangtao, "Watchdog Clears the Way for Power Plant Construction to Restart" *South China Morning Post* (17 February 2005) 4.

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hypothesis" does not apply to China at the current stage of transition, and its conclusion respecting the irrelevance of the ownership effect cannot be fully validated in China's transition economy.

The question that follows, then, would be whether privatization is a superior solution, as compared to competition and regulation, to the performance problems of large state monopolies, as has been advocated by Andrew Smith and Michael Trebilcock, who are critical of the Vickers and Yarrow hypothesis and instead stress the dominance of the ownership effect over competition effect for SOE reforms in less developed countries.[473] While in theory this position is sound and persuasive, the case of China's privatization raises distinct issues and goes beyond the analytical structure of existing privatization debates. What is particularly relevant to the China extension of contemporary privatization debates is that in addition to the government insistence on preserving continuing state ownership for political reasons, the biggest challenge to China's privatization of large SOEs is that there are virtually no effective channels to implement privatization schemes for large SOEs in the open markets, especially in the case of state monopolies in oil, telecommunications, civil aviation, steel and finance industries.

Because MBOs are not a desirable option for implementing privatization— especially for China's large SOEs— for reasons indicated in Chapter 4, where the recent controversy over MBOs is discussed, IPOs would be one desirable method, which necessarily requires properly functioning capital markets to provide an operational platform. However, in China's transition economy, the stock market is still developing its structural framework and operational strengths. In this market, investors are not well protected and their rights frequently infringed. Moreover, IPO and trading prices are misplaced. Financial intermediaries are struggling with their own ownership problem and corporate governance deficiencies. The principal regulator of the stock market, the CSRC, is not fully independent and is entrusted with conflicting responsibilities. The courts are not yet an independent and competent guardian of investor protection. Even the investors themselves are not guided by market-oriented investing fundamentals based on firm

[473] Smith & Trebilcock, *supra* note 57 at 225.

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value, rather than on speculation about government policies or politically motivated announcements of "good news."

In other words, how to implement privatization in open capital markets is subject to various operational difficulties. The methods of privatization are still being studied, and some theoretically sound methods that would be applicable to other political and institutional environments generally lack the institutional support in China's transition context. The economic, political, and institutional prerequisites are not all in place at the current stage of transition. As stated earlier, while MBOs are not a desirable method of privatization, IPOs also lack the necessary supportive institutions and market mechanisms to be properly implemented and transform SOEs into competitive modern enterprises. The various implementation barriers to successful IPOs make an ultimately efficiency-enhancing privatization scheme difficult to achieve.

By comparison, introducing competition to those industries formerly dominated by state monopolies, at least in the short run when the transition to markets is still incomplete, seems to be a relatively easier solution with lower implementation costs. In fact, recently China has already started to move toward greater liberalization of hitherto highly monopolized "strategic sectors." In February 2005, the central government released what the official media praised as the first official document aimed solely at promoting development of the private sector after China launched its economic reform.[474] Highlights of the document, known as the *36-Point Policy Statement for Promoting Private Economy*, include clauses allowing private capital to enter sectors not specifically banned by law and granting private businesses equal access to bank loans and fair treatment in taxation, and the approval of projects and land-use rights. For the first time, an official document clearly states that private firms can invest in sectors such as electricity, civil aviation, telecommunications, banking, railways, petroleum and national defense, which are now effectively monopolized by state enterprises.[475] Although the effect of this positive policy will critically depend on implementation, which is reasonably expected to

[474] "Businessmen Right to be Cynical about Promise of Equal Treatment" *South China Morning Post* (28 February 2005) 5.
[475] *Ibid.*

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be of less assuring quality given the enduring discrimination against private enterprises in China, the prospects are still promising as the government has gradually become determined to rectify previous mistreatment of private enterprises.

On the other hand, promoting greater liberalization and competition in the strategic sectors does not mean that full privatization should be further delayed to an uncertain future date. As argued in Chapter 5, the structural reform of any single sector among China's SOEs, banks and capital markets would require complementary support from one another because synchronization and coordination are necessary. Therefore, the progress of the reform of China's stock market, and in this connection the banking system as well, will significantly impact the pace and effect of the privatization of large SOEs. This will be a gradual process and needs careful sequencing.

2. Reforming the stock market is a necessary condition for reducing the overwhelming financing burdens of China's banks and making the banking reform easier to implement

The inadequate input of China's government into the stock market reform contrasts starkly with its extensive emphasis on bank restructuring. China has private savings of at least 12 trillion yuan (USD 1.4 trillion) deposits held by the banks. The country also has thousands of entrepreneurial private firms facing a serious problem of "capital starvation." If the stock market were able to attract portions of public savings from the banks by offering better returns, and bring together these funds and the private enterprises desperate for capital, it could, through better allocation of capital, both raise the efficiency of the economy and help maintain its growth rate. More importantly, developing China's capital markets would reduce the primacy of the banks in the financial system, making their reform easier to proceed.[476]

[476] "A Marginalized Market" *The Economist* (24 February 2005) ["A Marginalized Market"].

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Corporate governance reform in China should be viewed in the broader context of the economic liberalization agenda that the government has gradually advanced since the early 1990s and that has made significant strides since China's accession to the WTO in December 2001.[477] The slow pace of liberalizing the banking sector, at least before 2004, had seriously constrained the economy-wide corporate governance environment. Efforts are now undertaken by the China Banking Regulatory Commission (CBRC) to accelerate banking reform. The CBRC was established in April 2003 to take over the supervision of China's commercial banks and other financial institutions from the central bank, and to facilitate corporate governance reform of the banking sector. The new round of China's banking reform, beginning with capital injections into two of the "big four" state-owned commercial banks, Bank of China (BoC) and China Construction Bank (CCB) to bolster their capital bases, has now proceeded to make preparations for the banks' overseas listings. The latest banking reform initiatives are a stepping stone toward, and also a critical component of, broader-based corporate governance reforms in China's economic structure. The topic of China's banking reform is discussed in Chapter 6.

[477] The Institute of International Finance, Inc. (IIF), "Corporate Governance in China: An Investor Perspective" (2004) at 4.

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Section V

Legal and Regulatory Reforms to Improve China's Stock Market and Corporate Governance of Listed Companies (2000-2005)

Section V reviews important legal and regulatory reforms over recent years to improve China's stock market and corporate governance of listed companies. In this process, the CSRC has played a central role in designing and implementing reform initiatives, usually combining regulatory efforts of other financial regulators, such as the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC), the Ministry of Finance and the State Administration of Foreign Exchange.

The CSRC was established in 1998. However, significant moves to improve the effectiveness of stock market regulation and capacity-building at the CSRC to enhance regulatory oversight did not happen until 2000. Since being placed in charge of the centralized supervision of China's stock market, the CSRC has taken a number of measures to improve corporate governance of listed companies and crack down on bad behavior and fraud in the stock market.[478]

Meanwhile, until recently the role of the courts in punishing securities fraud and protecting investor rights had been largely absent in the institutional structure of China's stock market regulation. Until January 2002, the courts did not accept lawsuits brought by investors for damages suffered from securities fraud and market manipulation. This situation began to change after the Supreme People's Court (SPC) issued its first judicial interpretation in this regard to assert court jurisdiction over cases involving false disclosure. One year later, the SPC again released its second interpretation on private securities litigation, detailing the rules on damage calculation and the scope of compensation, which was an improvement on the first interpretation. After the release of these two important judicial documents, investors have increasingly brought private securities litigation to the courts. A landmark case was adjudicated in August 2004, whereby the Harbin Intermediate People's Court rendered judgment in favor of

[478] Leung *et al.*, *supra* note 404 at 18-19.

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shareholders against a listed company, Daqing Lianyi, and its underwriter, Shenyin Wanguo Securities Company, for damages resulting from a false statement. This was the first private securities litigation judgment after full trial. In this case, 109 plaintiffs sued the firm and its underwriter for damages worth RMB 3.04 million, with 98 of them being awarded a total of RMB 1.87 million.[479]

Moreover, the central government had not paid adequate attention to stock market reform until very recently, compared with its emphasis on the urgency of China's banking reform and its tremendous input of resources into the restructuring of the "big four" state-owned commercial banks. This imbalance of government input only started to be mitigated after the release of a nine-point policy guideline by the State Council on February 1st 2004 to address the urgency of the development and opening up of the capital markets. This policy statement was entitled "*The Nine-Point Guideline on Promoting Reform, Opening up and Steady Development of China's Capital Markets,*" or the so-called "*guojiutiao,*" and has since become a roadmap document at a new stage of China's capital markets reform in the wake of the upcoming broader financial liberalization in 2006 under China's WTO commitments.

1. Important measures of legal and regulatory reforms (2000 to 2005)

Broadly, there are six specific areas of legal and regulatory reforms that are aimed at improving the quality of both stock market operation and corporate governance of listed companies.

A. Improving information disclosure and accounting standards

The CSRC has gradually tightened information disclosure requirements in an effort to make listed companies more transparent and protect minority shareholder rights. In 1998,

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[479] "The Court Renders Judgment in the Daqing Lianyi Case: Investors Won the Fist Case of Collective Securities Litigation" *Xinhua News* (25 August 2004), online: Xinhua News <http://news.xinhuanet.com/stock/2004-08/25/content_1878929.htm.>.

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new disclosure rules and accounting standards were introduced by the CSRC to the stock market to improve the transparency and financial reporting of listed companies. In addition, since 2001, listed companies have also been required to provide quarterly audited financial statements.

In November 2004, China's two stock exchanges published rules aimed at improving corporate disclosure, including a tight definition of related-party transactions and a requirement aimed at giving investors more information about company officers.[480] In December 2004, the CSRC again tightened reporting rules for listed companies, requiring among other things more information on relationships between major shareholders. The revised rules on information disclosure for annual reports will be applied from the full-year 2004 annual reports. The revised rules also seek to make shareholder ties clearer. For example, companies must disclose the party that is actually in control of the firm, which may not always be the same as the largest shareholder. In addition to previous requirements to publish the top 10 shareholders and the top 10 shareholders of tradable shares, the revised rules require companies to detail relationships that might exist among these shareholders. The revised rules also strengthen requirements on disclosure for related-party transactions, loan guarantees extended by the company and major accounting changes.[481]

B. Reforming share issuing mechanisms

Until 2001, the share issuing process had been governed by a quota system, which was first introduced when China's stock market was established in the early 1990s, to limit the number of companies to be listed and the amount of shares to be issued. Under the quota system, local governments were responsible for the primary review of the qualifications of local firms for IPOs before they submitted their decisions to the CSRC for final approval. The central feature of the quota system was that it was driven by administrative direction. For example, the number of listings that a province could have

[480] Kate Linebaugh, "Holders Reject Revenue Plan by China Oilfield" *Asian Wall Street Journal* (1 December 2004) M.1.
[481] "Chinese Regulator Tightens Reporting Rules for Listed Firms" *Asian Wall Street Journal* (21 December 2004) M.2.

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each year was determined by the central government, while the IPO prices were jointly decided by regulators and brokerage firms.[482] In 1999, the Public Offering Review Committee (PORC) under the CSRC was established as the responsible agency for the final approval of IPOs.[483]

In 2001, a registration system replaced the quota system governing the share issuing process. The registration system was aimed at liberalizing the processes of IPO pricing and the review of listing qualifications previously controlled by regulators and administrative agencies, by introducing a more market-oriented screening system whereby the role of the CSRC was expected to be less substantive in judging firm's listing qualifications. However, in practice the reviewing body, the PORC, has still played a substantial part in the IPO review process, making the purported goal of reducing administrative intervention largely unrealized.

Since February 2004, a sponsorship system has been put in place to introduce more market forces into the share issuing process, whereby a "sponsor," usually a brokerage firm, is to be responsible for supervising an IPO applicant for one year before making a listing recommendation to the CSRC. The sponsor must undertake certain responsibilities after it submits recommendation documents to the CSRC. Despite the intended goal of introducing more market forces into the listing review process, administrative intervention has not been removed, especially after new rules were released to limit the number of IPO applicants that each sponsor can supervise each year to 8, thus artificially controlling the size and capital flows of each year's new listings.

One of the main questions now is how the PORC and the sponsor system can co-exist. On the future direction of reform, some brokerage firms have suggested that the PORC must be reformed together with the sponsor system, to ensure that the sponsorship system would succeed in its intended task of making the IPO review more transparent and market-driven. A more radical suggestion is that since the sponsors eventually bear some

[482] Duan Haihong, "Ten Years of the Reform and Development of Stock Issuing System in China" (2001) 5 Listed Companies.
[483] Yu Ning, "Reform of Stock Issuing Mechanism" *Caijing* (3 December 2003), online: Caijing English Newsletter <http://www.caijing.com.cn/english/2003/1120/1120ReformStock.htm>.

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responsibilities for issuers recommended by them, the right to approve IPO applications should also be decentralized and ultimately left to the exchanges.[484]

The latest move to reform the share issuing system was the introduction of a new IPO pricing method in 2005. The CSRC had temporarily suspended IPOs since August 30, 2004 to draft new rules on IPOs, which took effect on January 1, 2005, and which were expected to increase transparency and ensure fairness in the pricing of initial public offerings. Under the old IPO system, IPO prices were approved by the CSRC and already set by the time a prospectus was issued. Prices were often set artificially low in order to ensure a large jump on the opening day of trading, which would then be followed by a gradual fall to below the listing level. The result was that many retail investors applied for shares in the IPO and quickly sold the holdings in order to make short- term profits, thus fueling the market with more speculative sentiment.[485] To change this situation, the new rules were aimed at bringing market- driven pricing to IPOs.

Under the new rules, a two-step pricing process will be implemented after an issuance plan receives regulatory approval. The first step will be to seek initial pricing levels from at least 20 approved institutional investors, depending on the size of the IPO.[486] The second and final pricing of the IPO will take place via bids during the IPO's subscription period. In an effort to keep pricing reasonable and prevent any price manipulation, depending on the size of the IPO, approved institutional investors participating in an IPO price discovery and subscription will be limited to between 20 percent to 50 percent of the placement. The rules also set a minimum three-month lock-up period for approved institutional investors receiving placement of shares from an IPO.[487]

C. The delisting system

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[484] *Ibid.*
[485] Geoff Dyer, "Huadian Debut a Blow to China Listings Reform" *Financial Times* (4 February 2005) 17.
[486] Six types of institutional investors are allowed to participate in price discovery for IPOs: approved fund-management companies, brokerage firms, investment trusts, finance companies, insurance institutions and Qualified Foreign Institutional Investors (QFII).
[487] J.R. Wu, "China to Change Rules For the Pricing of IPOs" *Asian Wall Street Journal* (13 December 2004) M.2.

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On February 22, 2001, the CSRC issued a circular to clarify rules on suspending and terminating the listing status of a loss-making company. Under these rules, a company which has recorded three years of consecutive losses can apply to the stock exchange for a "grace period" to restructure its business.[488] Following these rules, a Shanghai electronics company, Narcissus Electric Appliances, was delisted on April 24, 2001, in a landmark event for China's stock exchanges, which had never lost an enterprise in their 11-year trading history as of that date.[489]

However, in practice it is still difficult to delist companies because both local governments and investors are unwilling to see this happen. While for the local governments, delisting a local firm would mean losing a low-cost fund-raising tool, for the investors it could result in huge losses if the companies in which they invest were to be excluded from the market.

D. Reforming corporate governance mechanisms centered on the protection of shareholder rights

In January 2001, drawing on the OECD Corporate Governance Principles, a *Code of Corporate Governance for Listed Companies* was jointly released by the CSRC and the State Economic and Trade Commission to ensure better corporate governance practices of listed companies. In December 2001, the CSRC released the *Guideline for the Establishment of an Independent Director System*, aimed at the reform of the board of directors of listed companies through the adoption of an independent directors system. Under this guideline, all listed companies were required to have at least two independent directors by June 30 2002. This number must be increased to one-third of all board seats by June 30, 2003.

Since late 2004, a new round of rule releases has been underway at the CSRC to emphasize the protection of shareholder rights in the stock market. Most importantly, the CSRC announced sweeping regulations on December 7, 2004 that gave minority

[488] Richard McGregor, "First Chinese Company to be Delisted Today" *Financial Times* (24 April 2001) 11.
[489] *Ibid.*

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investors their strongest voice to date in corporate affairs, essentially subordinating the role of big government owners to proposing major transactions, not approving them. Under these new regulations, decisions on whether to proceed with large corporate investment projects and new fund-raising plans will depend on the majority vote of public shareholders attending annual meetings. The regulations were aimed at constraining the voting power of the government, the biggest shareholder of listed companies in China and affording small shareholders more protection against expropriation by controlling shareholders.[490] In addition, under these new rules, if profitable companies do not pay dividends, they will have to explain such actions in detail and explain how the profits will be used instead. Where a listed company fails to pay dividends for three consecutive years, it will not be eligible for issuing new shares or convertible bonds. These requirements will have a huge impact on the previous practice of many listed companies that for years have paid meager or no dividends to investors.

Apart from the proactive role of the CSRC in enacting rules to strengthen investor rights, allowing the courts to play a role in regulation and protection of investors is also an important aspect of enhancing shareholder protection. In China, courts had for years refused to hear securities-related lawsuits, denying investors legal remedies for damages suffered from fraudulent securities dealings. As discussed earlier, this situation began to change in January 2002, when the Supreme People's Court issued a notice allowing such suits to be filed. This long delay in providing judicial protection to investors should not be viewed as a surprise, however, given the fact that a Securities Law was not promulgated until 1998, eight years after the stock market was established.[491]

Meanwhile, by revising the Company Law and Securities Law, the government has begun to allow the courts to rule on private suits brought by investors compared to the previous practice where only the CSRC had been empowered to punish fraudulent behavior. The

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[490] James T. Areddy, "China's Smaller Investors Get Bigger Voice in Company Affairs" *Asian Wall Street Journal* (9 December 2004) M.1.
[491] Yong Yan Li, *supra* note 386.

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CSRC is likely to increasingly resort to the courts to prosecute wrongdoers instead of its previous practice of only invoking its own administrative sanctions.[492]

In 2005, progress has been made in terms of legal reform in strengthening shareholder protection. Revisions to the Company Law were approved in March 2005 by the People's Congress, China's highest legislative body, although the actual effect of legal reform remains to be seen, as implementation is much more difficult than writing nice rules into law. The 2005 revisions to the Company Law were the first since it came into force in 1994, another indication of the remarkably slow pace of corporate legal reform. The revised law includes new rules on shareholder protection and securities litigation. First, while the old law only vaguely spelled out the principle of shareholder rights protection without elaborating on enforceable procedural rules and clarifying punishment of violations, the new law, aside from reiterating the primacy of shareholder rights, increases the mandatory number of independent directors in listed companies to one third of the board seats and introduces the mechanisms of cumulative voting and derivative actions. In the meantime, the mandatory quorum for provisional shareholder meetings has been reduced from 25 percent to 10 percent of outstanding shareholding. The drawback is that the new law does not yet introduce a class action system, to the disappointment of some enthusiastic advocates of shareholder rights. This omission was probably deliberate, given lagging judicial reform in relation to corporate litigation, as judges are not yet ready for a likely influx of lawsuits brought to them that could be spurred by the introduction of class actions.[493]

E. Developing an institutional investor base

China's major financial regulators, including the CSRC, CBRC (China Banking Regulatory Commission), and CIRC (China Insurance Regulatory Commission), have been very proactive in promoting the establishment of an institutional investor base in China, and a series of supportive measures have been adopted over the past year.

[492] Green, *supra* note 38.
[493] "Revising the Company Law: Re-allocating Rights Is Only A Starting Point" *Southern Daily* (2 March 2005), online: Southern Daily <http://www.nanfangdaily.com.cn/southnews/spqy/200503020483.asp>.

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To help China's insolvent brokerage firms, in November 2004 major financial regulators jointly announced that they would allow brokerages to use securities as collateral to obtain bank loans as a means to fund the ailing industry. In addition, fund managers also received a reduction of the stamp duty from 0.2 percent to 0.1 percent in January 2005. The government has also agreed to permit some commercial banks to set up fund management companies, a move designed to introduce more institutional investment to the equity market. Moreover, securities companies are now allowed to issue bonds, investment funds have their mutual fund products approved much faster and easier than previously, and insurance and pension funds have obtained wider access to stock investment, providing a fresh source of funds.

Since 2005, another round of supportive initiatives has been taken by the regulators to promote the performance of the stock market. On February 21st, 2005, the CSRC and the Ministry of Finance announced an investor protection fund, which is estimated to be worth up to USD 6 billion, to compensate investors for the bankruptcy or incompetence of local brokerage firms. In addition, regulators launched a pilot program allowing commercial banks to set up mutual fund arms. Selected insurers have also received the green light to invest up to USD 7 billion in shares.[494]

While the government has been very supportive of the development of an institutional investor base in China, many of its newly introduced stimuli will not bring about a sustained recovery of the stock market, now in a deep slump, without adopting fundamental solutions to the insolvency crisis of the brokerage industry. One fundamental solution to the insolvency crisis of China's brokerage industry is to introduce ownership reform and market-based sectoral integration, which would not only reduce state dominance and the resulting moral hazard and poor management, but would also optimize the capacity of the brokerage industry and increase its competitiveness. In this process, participation of international investment banks through establishing joint ventures with domestic brokerages would be a beneficial factor.

[494] "A Marginalized Market", *supra* note 476.

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While the financial regulators have increased their policy support for domestic institutional investors, the continued exclusion of foreign investors has limited the amount of capital that flows into the Chinese share market. While foreign investors can invest in Chinese companies listed overseas, generally without restrictions, on the Chinese domestic exchanges there are two kinds of stocks available for foreign investors: (1) hard currency-denominated B-shares that are sold to foreigners— and since February 2001 also to domestic investors— but are mostly worthless,[495] and (2) yuan-denominated A-shares that are only open to domestic investors and a group of foreign investors who fall under the Qualified Foreign Institutional Investor (QFII) scheme.[496] Under the QFII scheme, large institutional investors like UBS, Citigroup and Bill Gates' charity foundation are allotted a quota by the government to invest in the A-shares and bonds. As of December 2004, 27 overseas institutions had been granted quotas worth a total of about USD 3 billion, and another 10 were pending approvals.[497]

In a move to further liberalize China's financial system, recently the government gave its approval to the "qualified domestic institutional investors" (QDIIs) to invest in overseas capital markets. The QDII scheme is expected to provide China's major institutional investors, including insurance funds, securities investment funds and the national social security fund with an opportunity to gain investment experience in more advanced international capital markets, thus helping to cultivate a rational investment culture and strengthen the base of China's capital markets.

F. Reforming the split share structure to generate higher market liquidity

The government has for the past several years made attempts to reform the split structure of the stock market, identified with a large portion of non-tradable shares, but to little

[495] For some investors in the B-share market, a main reason for buying the "worthless shares" at all is their speculation that the now separate A-share and B-share markets will eventually converge, and when this finally happens they will make huge gains by selling these shares at much higher prices.
[496] Jamil Anderlini, "The Stock Market a Casino for Communists" *Asia Times Online* (9 October 2004), online: Asia Times Online <http://www.atimes.com/atimes/China/FJ09Ad05.html> [Anderlini].
[497] *Ibid.*

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avail, because the interests of the government and public investors are so divergent on this issue that they could not reach consensus and agree on a mutually acceptable plan. The key obstacle to implementing a "full flotation" scheme is the controversy over pricing — while the government wants to sell these shares at the market value at which the tradable shares now trade, the investors, concerned about the prospect that their current holdings will be diluted when flows of state shares pour into the market, expect huge discounts.

It is also necessary to point out that before the establishment of the State-owned Assets Supervision and Administration Commission (SASAC) in 2004 and the subsequent reform of state assets management system it has been undertaking, which has granted local governments ownership rights to local SOEs, oppositions to the idea of "full flotation" had also come from local governments. The reason is simple: during China's SOE reform in the pre-SASAC periods, the central government had only granted local governments the right to manage daily operations of local SOEs, with the ownership rights still held by the central government, which means under such circumstances the local governments would not receive any money/gains from selling state shares. For some localities, both the financing of their fiscal expenditures and tax revenues largely come from local SOEs. Therefore, adopting the "full flotation" scheme in pre-SASAC periods meant virtually taking away an important source of funds from the local governments.

Since the summer of 2001, the government has attempted to make the non-tradable shares tradable. For the state shares, the favored option is to sell a portion of them to investors in the secondary market and use the proceeds to balance the account of China's social security fund, which has been in poor financial condition because of a huge deficit in unfunded pension liabilities. For the legal-person shares, the favored option is to put them up at auctions in an already existing, though informal, "C-share" market where negotiated transfers of legal-person shares have been underway for some time. In fact, although the non-tradable shares have not been openly sold to investors in the secondary market at discount, over-the-counter (OTC) transfers to private and foreign buyers have flourished

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over recent years, usually with rather opaque procedures whereby both the transfer prices and the identifies of buyers are not disclosed to the public, thus leading to irregular MBO transactions which grossly benefit management. In June 2001, a plan called "reducing the state shareholding in the listed companies" was implemented to sell a portion of outstanding state shares to investors, but was aborted a year later due to strong negative market reactions as investors' discontent with "state exploitation" mounted.

The latest move in reforming the split share structure was a pilot "full flotation" scheme that is to be adopted with a limited number of listed companies which have a smaller size of state shareholding. In February 2005, shares in Shanghai Automotive, a carmaker, Handan, Wudan and Angang (all steelmakers), and Yangzi and Qilu (in petrochemicals) have risen on the expectation that they will be first to be fully privatised. However, for this pilot scheme to go ahead, the prerequisite conditions are favorable market conditions and restored investor confidence. These, understandably, entail some difficult tasks in the short run.

To address the problem of unfavorable market condition, the government has recently made some moves. For example, in order to revive the currently declining market which discourages good quality issuers from listing on the domestic exchanges, the government has been persuading some well performing firms to "stay home" and thus gradually dilute the market share of poorly governed companies. In March 2005, the Bank of Communications (BoCom), China's fifth-largest lender, was reportedly planning to split its IPO between Hong Kong and Shanghai after the government approached it with the suggestion of "staying home." This change of BoCom's listing plan would be positive news for the domestic market, given the fact that China's better performing firms have so far opted out of domestic listings in favor of overseas listings.[498]

2. Assessments of the effect of reform efforts

[498] "A Marginalized Market", *supra* note 476.

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A. The limited results of reforms

If the quality of legal and regulatory reforms was measured by published regulations, China would be a good role model. Especially over the past two years, its financial regulators have released rules and regulations to promote market disciplines and good corporate governance almost weekly. In term of enforcement and implementation, however, there is still a large gap between intended goals and actual consequences. Despite the vigor and intensity of rule making, meaningful results of reform measures have been limited, as spectacular corporate governance failures in both domestic and overseas capital markets have been reported with serious negative repercussions for shaken investor confidence.

Although China's regulators recognize that systematic corporate misconduct undermines economic development and could deter the foreign capital on which it depends, to effectively address such a fundamental problem takes much more regulatory input and political determination. In this respect, the government has been remarkably cautious, as solutions to the problem of split share structure have yet to be developed and market forces have not been introduced into the share issuing system as adequately as they should be.

Progress in reforming China's stock market and corporate governance of listed companies has undoubtedly been made, albeit from a very low level. The outlines of a clearer regulatory and legal framework are emerging, corporate boards are being established and some companies have begun to take corporate governance seriously in the face of a delisting threat. Therefore, some corporate governance experts argue that judged by the opaque cronyism and weak corporate accountability prevalent in much of Asia, China does not look quite so bad. Yet even optimists expect that just the curbing of rampant abuses will take a decade or more, and that the path ahead is paved with obstacles, such as the still very limited role of the courts in protecting shareholder rights

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and the efforts of some entrenched interests in the stock market to delay urgently needed reforms.[499]

Indeed, there is much more challenging work to be done, primarily with regard to making the non-tradable shares tradable and replacing the political logic of the stock market with an economic agenda. One worrying sign is that under current weak market condition, even presumably stimulating measures would not bring about expected benefits. For example, all of the reforms in 2004 to implement the *Nine-Point Guideline* (*guojiutiao*) were supposed to be positive news that should have made the stock market turn around. However, apart from short-lived rebounds, the market gave a cold reaction to the stimuli and relentlessly headed downwards. As of February 2005, the market still had not recovered from its five-year low share price performance.[500]

B. Why results have been limited

There are three main reasons for the limited results of reform. The first reason is the lack of determination on the part of the government to address some fundamental problems of the stock market in a timely fashion. Although the government has been making efforts to strengthen stock market reforms under both internal and external pressures, especially after China's accession to the WTO which requires much greater liberalization of China's domestic financial markets from 2006, it has missed some opportunities to tackle the fundamental structural problem of the split share structure in a timely fashion.

In the meantime, one important reason why corporate governance reform of listed companies has had limited effects is that the government has insisted on retaining state ownership and control of partially privatized SOEs. This has made modern corporate governance mechanisms difficult to work, because, among others, the conflict of interests between the state controlling shareholder and minority shareholders is hard to mitigate. Besides, even though advanced corporate governance mechanisms, such as the

[499] Guy de Jonquieres, "Investors are Drawn to China in Spite of the Risks" *Financial Times* (1 February 2005) 19.
[500] Asia Pulse/XIC, *supra* note 393.

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independent director system, are written into legal and regulatory documents, implementation and enforcement are usually ineffective.

The second reason is related to the pursuit of divergent interests by different government agencies in the process of reform, which has prevented some reform measures, which require collaboration between different government agencies, from being implemented effectively. For example, in the process of designing the QDII scheme, while the State Administration of Foreign Exchange has been an active supporter, out of concerns about pressure on yuan reevaluation, the QDII scheme has been continuously delayed because of fears by the CSRC that allowing Chinese institutions to invest in overseas stocks will remove even more liquidity from the home market and further depress share prices. Another example is found in the differing opinions among the central bank, the Treasury, and the CSRC about a workable solution to the insolvency crisis of the brokerage firms, because this issue raises a controversy over which government agency should be paying for the bail-out.[501]

The third reason is the problematic sequencing of certain reform initiatives. For example, although some decision makers believed that introducing the new IPO pricing method was an essential step to establishing a market-driven share issuing system, its immediate effect was contrary to their expectation. One reason was that some institutional investors conspired to deliberately offer low prices in the price-bidding process, thus causing a perverse impact on price movements in the secondary market. As a result, the old pattern of share price volatility has not been mitigated after the new IPO pricing method was introduced.

According to many financial analysts, until the current administrative control over share issuing process is dismantled, merely introducing a new pricing method may not only be

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[501] Mo Fei, "The Stock Market Slumped to 1200 Points at the Anniversary of the 'Nine-Point Guideline'" *21st Century Business Herald* (31 January 2005), online: 21st Century Business Herald <http://www.nanfangdaily.com.cn/jj/20050131/cj/2005013110035.asp>.

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ineffective, but could even worsen the current situation.[502] When some important decisions relating to IPOs are still determined by the government, such as how many firms should launch IPOs each year, at what time they should launch IPOs, and how much money these firms should raise from the stock market, it is impossible that market-driven mechanisms and institutions could work properly in China. Accordingly, in terms of proper sequencing of reform, removing administrative control of the share issuing system and reducing excessive government intervention in the daily workings of the stock market should be more fundamental and urgent tasks than providing piecemeal stimuli.

C. Regulatory corruption at the CSRC as the consequence of excessive administrative intervention in the market

In the context of developing a strategy for future reform, it is necessary to review the important issue of regulatory corruption at the CSRC, which is primarily a result of its excessive intervention in the market— such as its role in the IPO review process— and the ongoing delay in reducing it. This has cost the CSRC investor the confidence it has actively sought, and diminished the credibility of regulatory oversight. According to an index of financial corruption in China (FCI) compiled by two Chinese economists, the securities industry was assigned a staggering figure of 7.26 on a 1-10 scale (the higher the number, the more severe the corruption) and was described as "the most severe" among China's financial sectors.[503] The recent "Wang Xiaoshi case" is only the latest manifestation of regulatory corruption at the CSRC.

Wang Xiaoshi, a deputy division director in the CSRC's Department of Public Offering, has been arrested on corruption charges, including taking bribes from a businessman to

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[502] Guo Ba & Wang Chenbo, "Why the Newly Adopted IPO Pricing Method Not Only Unable to Bail Out the Market, But Also Making the Market Down Further?" *China Newsweek* 216 (7 February 2005), online: China Newsweek <http://www.chinanewsweek.com.cn/2005-02-23/1/5238.html>.
[503] Xie Ping & Lu Lei, "A Study on Financial Corruption" *Caijing* 124 (10 January 2005), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=6451> [Xie & Lu].

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facilitate the IPO application review of a favored company. This case could lead to a more comprehensive probe into stock market listing approvals.[504]

Financial analysts pointed out that the arrest of Wang showed that there were still problems with the approval procedures for public offerings and new share issues, despite the CSRC's efforts to promote regulatory transparency and accountability. In 2003, the CSRC changed its procedures by posting on its website the names of listing applicants and the names of the members appointed to the listing committee (i.e., the Public Offering Review Committee, or PORC), who are responsible for reviewing and approving the IPO applications. Until then, the names of the applicants and PORC members had remained secret, which led to allegations that many listing candidates paid huge bribes to find out whether they were short-listed or to get the names of PORC members appointed to review a particular case. Despite the 2003 reform, financial analysts believed that it was still an open secret that listing candidates and investment banks gave massive payments to public relations firms to lobby the PORC members.[505]

Based on the above assessments, proper sequencing is a more critical determinant of the progress and effect of China's stock market reform than writing good rules that are in practice not well implemented. Specifically, removing the political logic and the resulting excessive intervention by the regulators in the workings of the market, as well as timely resolution to the problem of non-tradable shares, should be priority tasks on the reform agenda at the next stage.

3. The prospects of future reforms: strategic thinking on reforming China's stock market at the next stage

At the next stage, the reform of China's stock market must put more emphasis on a strategy and approach centered on proper sequencing. Specifically, it is necessary to draw

[504] "Securities Official Held for Allegedly Taking Bribes" *South China Morning Post* (17 November 2004) 6.
[505] *Ibid.*

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on the experience of securities market building in other transition and developing economies under legal and institutional constraints. The following discussion attempts to introduce some important lessons from international experience as to what institutions are needed for a strong securities market and how to build these institutions.

A. The core institutions for a strong securities market: "necessary" *vs.* "nice to have"

Legal academics have studied the experience of transition economies in building functional securities markets after privatization. They have come to realize that various corporate governance failures during and after privatization have much to do with the lack of institutions that control self-dealing and asset stripping. One of these missing institutions is strong securities markets that can discipline corporate behavior and afford investors effective protection. Therefore, establishing the legal and institutional preconditions for strong securities markets is regarded as critical to achieving a successful transition. Among the core institutions suggested by scholars, the most needed are those that address information asymmetry and self-dealing.[506]

For example, Bernard Black has suggested the following core institutions that control information asymmetry and self-dealing: (1) effective regulators, prosecutors and courts, (2) financial disclosure and procedural protection for investors, (3) reputational intermediaries, such as sophisticated accounting firms, investment banks, securities lawyers and stock exchanges, (4) company and insider liability, including criminal liability, (5) legal and regulatory rules that control insider trading, (6) rules ensuring market transparency and banning manipulation of trading prices, and (7) cultural and informational institutions that can uncover and criticize misleading disclosure or fraudulent transactions, such as an active financial press and securities analysis profession.[507]

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[506] Bernard Black, "The Core Institutions that Support Strong Securities Markets" (2000) 55 Bus. Law. 1565 [Black 2000]; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets" (2001) 48 UCLA L. Rev. 781 [Black 2001].
[507] Black 2001, *ibid.* at 789-814.

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Black also distinguishes between core institutions that are "necessary" and those that are "merely nice to have," particularly for countries at their early stage of capital markets development with limited institutional resources, such as transition economies.[508] While choosing not to offer a definitive and universal calcification because of the complex interrelationships among institutions (i.e., complements in some respects and substitutes in others), he suggests that a practical approach would be to evaluate the importance of each institution, both on its own and as part of an overall economic system. For instance, while a ban on insider trading is considered a core institution, it is not absolutely critical. By comparison, because legal and regulatory enforcement is critical, honest courts and regulators, without which a strong securities market cannot exist, are critical.[509]

B. Convergence vs. self-adaptation and self-correction under the "incomplete law" constraint

As to the approach of legal and regulatory reforms of the capital markets in China's transition economy, some authors strongly support a gradualist strategy that does not follow the convergence path centering on legal transplantation from mature market economies without in the first place building complementary enforcement institutions. For example, under an "incomplete law" theory, Katharina Pistor and Chenggang Xu do not favor the "convergence" approach to legal reform in building securities markets in China and Russia; instead, a gradualism strategy that emphasizes self- adaptation and self-correction in developing financial markets institutions is a better choice for these countries.[510]

First, the authors argue that for a country to develop governance structures for financial markets when law is highly incomplete, which can be the case even for developed countries, allocating law enforcement power to proactive law enforcers, such as

[508] *Ibid.* at 803.
[509] *Ibid.*
[510] Katharina Pistor & Chenggang Xu, "Beyond Law Enforcement: Governing Financial Markets in China and Russia", in János Kornai & Susan Rose-Ackerman, eds., *Building a Trustworthy State in Post-Socialist Transition* (Palgrave Macmillan, 2004) [Pistor & Xu].

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regulators, may be superior to leaving it with courts that enforce the law only reactively. For this proposition to be valid, however, one must assume that regulators have access to reliable information about companies, which requires that accounting information is meaningful and can be verified by market watchdog institutions (such as accounting and audit firms) as well as law enforcement agents.[511]

The authors then assert the invalidity of the above assumption for transition economies, where not only law is even more incomplete, as both law making and law enforcement agencies lack the experience to apply and interpret law to a variety of newly emerging cases. Market watchdog institutions are also lacking and reliable information is scarce. Under these unfavorable conditions, according to the authors, simply shifting law enforcement power from courts to regulators is not sufficient, and a more practical approach is to "move beyond law enforcement" and allow state actors greater involvement in selecting companies and setting conditions for companies to access the market. Because state actors may misuse their power, this selection process needs to be accompanied by governance mechanisms that minimize such misuse and create incentives for state agents to make decisions that maximize social welfare, not their personal interests.[512]

To explain how such state agent-driven mechanism could work, the authors use China's quota system of selecting firms for public listings as a positive example. In their view, because the likely repercussions that state agents faced for making bad decisions (such as the possible responsibility if the companies they selected failed), this created incentives to invest in the selection process, thus making the quota system relatively successful. The major drawback of the quota system is its reliance on continuing state ownership, because otherwise the state agents could not access reliable information about companies. Therefore, whether China can move from dominant state ownership to dominant private

[511] *Ibid.*
[512] *Ibid.*

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ownership without major disruptions in the stock market will determine the ultimate success or failure of the Chinese gradualist strategy for developing financial markets.[513]

Seen from recent stock market reform initiatives, such as the abolition of the quota system, the development of disclosure requirements and accounting rules and the introduction of the QFII scheme, China's stock market is already reforming itself, which reflects the dimension of "self adaptation" and "self correction" embodied in China's gradualism reform strategy.

C. The sequencing of building core institutions for China's stock market and improving corporate governance of listed companies

As to which steps a developing country should take first– reforming the legal system or building supporting market institutions— to strengthen its securities markets, a practical answer is that this is a futile question because a central characteristic of these institutions is that they interrelate and develop together and reinforce each other. [514] However, for transition economies, there does exist an issue of "sequence," whereby caution is needed with respect to legal reform and transplantation: corporate governance reform in these economies should be much more basic and less "advanced." In other words, transition economies need "honest judges and regulators, good disclosure rules, and the beginnings of a culture of honesty," before it makes sense to worry about independent directors.[515] This emphasis on sequencing is particularly relevant for the ongoing corporate governance reforms in China, where calls for adding independent directors to corporate boards are very strong at present. Given the current under-development of both institutional and human capital in China, the applicability of this relatively "advanced" practice may need reconsideration.

Based on the current progress of legal and regulatory reforms, a primary assessment of the prospects of China's stock market is that deeper and more fundamental reforms must

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[513] *Ibid.*
[514] Black 2000, *supra* note 506 at 1606-1607.
[515] *Ibid.* at 1607.

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accelerate as China's economic transition enters a critical new stage, whereby not only is the SOE reform expanded to a far broader scale of privatization, but much greater financial liberalization under China's WTO commitments is also imminent. In terms of the sequencing of stock market reform, an urgent task in the immediate term is to mitigate and eventually solve the deep-rooted structural problem of share fragmentation that has severely dampened investor confidence and brought the risks of a market meltdown. If this particular task is further delayed, the "marginalization" of China's stock market in the country's economic structure could very likely become a reality.[516] In the meantime, significantly reducing the state ownership and control of Chinese listed companies through further or full privatization to change the ownership structure of listed companies is a key determinant of real improvements of corporate governance.

According to Stephen Green, the author of a recent book on China's stock market[517], the best scenario for solving the problem of non-tradable shares would probably be if the government could just carry on privatizing these companies in a slow and steady way. After ten years, when these companies are private and better run, selling the non-tradable shares in the open market would be much easier.[518] However, although ideally this forward looking and less radical approach would avoid a shock that would follow a sudden introduction of all non-tradable shares to the stock market, the immediate situation is that China needs a healthy capital market right now in the wake of accelerated SOE and financial reforms. One critical reason for this urgency is the government's plan to clean up the NPL-laden banking sector which centers on listing two of the "big four" state-owned commercial banks, Bank of China (BoC) and China Construction Bank (CCB), on domestic and overseas stock exchanges by approximately 2005. Therefore, the problem of the non-tradable state and legal-person shares must be dealt with as an urgent priority if there is to be enough capital available in the future when investor confidence has been restored to fund such large and important listings.[519]

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[516] "A Marginalized Market", *supra* note 476.
[517] Green, *supra* note 38.
[518] Anderlini, *supra* note 496.
[519] *Ibid.*

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Section VI
Conclusion

Chapter 5 undertakes a comprehensive overview of the interaction between capital markets, both domestic and overseas, and corporate governance of China's listed companies during transition. Many issues discussed in Chapter 5 are interrelated and if understood in isolation would generate misperception of mutually dependent or highly associated reforms. The principal finding of Chapter 5 is that while there exists a dynamic interaction between the reform of the institutional structure of China's stock market and the reform of corporate governance practices of the listed companies, legal and institutional reforms aimed at improving both have so far only produced limited results, which partly explains the failure of the stock market to serve as an efficient resource allocator in China's economic structure and the poor quality of corporate governance of most listed companies plaguing the stock market.

Over the past fifteen years, China's biggest achievement in developing a stock market is that under a gradualism strategy, the stock market has gradually obtained a legitimate status as a necessary economic institution for the country to build a market economy, having been subject to controversies during the early years of reform when the ideological debate over "socialism *vs.* capitalism" was not solved and private ownership was a marginal factor in the economic landscape. However, this legitimacy has come at a high price— the fragmentation of the market, which has brought a huge negative impact on its operational quality. The artificial creation of a split share structure, marked by the division of tradable and non-tradable shares, was a compromise with the initial institutional environment where safeguarding state ownership was a major imperative. In order to come into being under such condition, the stock market had to install the split share structure to show that it indeed had the function of "preserving state ownership and preventing the eroding of state assets," and was thus compatible with a "socialist economy." The split share structure has been the fundamental cause of major problems in the stock market, including corporate governance failures of listed companies caused by the "sole controlling shareholder dictatorship."

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Looking forward, initiating deeper and more fundamental reform to solve this structural problem is both necessary and urgent, as China's transition to a market economy enters a new stage. At this stage, China faces both increased internal and external pressures to accelerate structural reforms of its SOEs and financial sectors. These reforms are interrelated and need to proceed hand in hand to generate synergies. The following discussion attempts to provide some thoughts about the strategy and prospects of future reforms.

1. Overseas listing ("piggy-backing") is not a full substitute for good legal, financial and corporate governance institutions: "borrow" *vs.* "build" good institutions

Since the early 1990s, China's companies have increasingly gone overseas to raise capital. Of the overseas capital markets, Hong Kong has played a critical role in providing a channel of fund-raising to finance Chinese enterprises, including large state-controlled entities and local firms transformed from formerly government or collectively-owned enterprises, thus facilitating their ownership restructuring. Especially for those private companies hoping to remove their "red hats," Hong Kong's capital markets provide them with a platform to implement full privatization schemes. According to some economists, this institutional function of Hong Kong in helping with China's transition stems partly from the British colonial legacy of the rule of law and the territory's rich human and regulatory resources in managing financial transactions. Another important reason for the preference of China's companies for Hong Kong's capital markets is the slowness of legal and institutional reforms in China to protect and finance private businesses, which has propelled these firms to access both capital and good institutions in Hong Kong.[520] From a positive perspective, the government has been supportive of this "going out" trend, which enabled some entrepreneurs to escape an unfavorable system and insufficient capital in the home market.

[520] Yasheng Huang, "China's Big Hope Is Not Hong Kong" *Financial Times* (14 January 2005) 13.

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Therefore, borrowing good legal and financial institutions in overseas capital markets through firms' "piggy-backing" has been an important factor in explaining China's economic success over the past decade. However, while during the early stage of reform this strategy worked reasonably well, it cannot become a full substitute for building good legal, financial, and corporate governance institutions at home when China's transition has gradually moved to a more advanced stage and its participation in the world economy has become increasingly active. As China has gradually become an important contributor to the growth of the world economy over recent years and the presence of Chinese companies in the world market has expanded, the underdevelopment of its domestic institutions may generate a negative "spill-over" effect across borders. For example, while "exporting democracy" seems to have become a Western obsession these days, China is likely to be seen as entering into an infamous business of "exporting corruption" through serious corporate governance failures of its firms listed overseas. The CAO debacle is just another warning.

Accordingly, instead of continuing reliance on borrowing good institutions, it is now time for China to build good legal, financial and corporate governance institutions at home. This will not only help China's own transition, but will also reduce the possibility of negative impacts of poorly governed Chinese companies on overseas markets.

2. The necessity and urgency of fundamental structural reform of the stock market in the wake of accelerated reforms of SOEs and the banking sector

At the new stage of reform, China's SOE sector is experiencing a process of expanded privatization under the "grasping the large, releasing the small" strategy. In the meantime, the banking sector has also started sweeping structural reforms to transform the "big four" state banks into modern commercial lenders. In order to facilitate these reforms, or make them much easier, the stock market needs to accelerate its own structural reform,

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both to provide a functional platform for the implementation of ownership restructuring of SOEs, and to relieve the banks of heavy financing burdens. Moreover, since domestic listings are likely to be part of the banking reform strategy, a well functioning stock market is necessary.

3. Proper sequencing is required for the reforms of the stock market and corporate governance of listed companies at the next stage

How to design proper sequencing is a critical concern in the process of reforming China's stock market and corporate governance of listed companies. Generally speaking, there are competing priorities on the reform agenda of the government, all of which seem necessary. These priorities include the following:

(1) Solving the insolvency crisis of the brokerage industry and optimizing its operational capacity through sectoral restructuring;
(2) Increasing regulatory oversight to discover and punish fraud and violations committed by corporate insiders, controlling shareholders and managers of financial intermediaries;
(3) Reforming the share issuing system to introduce more market forces, fairness, and transparency;
(4) Combatting regulatory corruption at major securities regulators, especially at the CSRC;
(5) Developing an institutional investor base with a rational and value-based investment culture;
(6) Providing investors with stronger protection both by giving shareholders a stronger voice in corporate decision-making process and by instituting a securities litigation system;
(7) Abolishing the split share structure to generate higher market liquidity and mitigate corporate governance failures caused by the "sole controlling shareholder dictatorship"; and

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(8) Further liberalizing the capital markets and allowing greater participation of international players.

This long list of priorities indicates not only that there are indeed many important issues to be addressed in the process of financial development for a country that has only experienced a stock market for fifteen years from a very low starting point, but it also implies that future reforms will be extremely challenging and much more difficult than at the early stage, primarily because accumulated problems and institutional inefficiencies have all emerged at the new stage and may reinforce each other. Although these identified tasks all need to be addressed at some point, as both the economic and political resources of the government are limited, selecting the most urgent tasks with which to proceed first is necessary.

There are two basic assessments of what should be done first. First, at the current stage of transition, building basic-level institutions should precede introducing more advanced institutions, as indicated in the discussion of the role of independent directors in the corporate governance of listed companies. In that case, delisting and punishing errant corporate insiders, including the imposition of criminal liability, may be more effective than counting on independent directors to deter wrongdoing. Second, because the political logic of the stock market is the source of its various deviations from expected functions, most importantly allocating capital efficiently and disciplining firms through good corporate governance practices, replacing the political logic with an economic agenda should be the guiding principle in designing the sequencing of reform.

4. The proposed sequencing of future reforms

Based on the above assessments, a reasonable order of reform measures at the next stage can be designed.

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The essential first step is to remove the split share structure and make non-tradable shares tradable. The difficulty is to design a selling plan that could be accepted by both the government and the public investors. Some Chinese economists have suggested that the government should compensate investors for their losses, because minority shareholders bought their shares at artificially inflated prices under government-driven share issuing and pricing systems which implicitly mandated a fixed high P/E ratio. While this proposition is not without reason, the government should be cautious in "compensating" investors as it could generate moral hazard. If the government chooses to compensate public investors, it should point out that the compensation is the "last supper," and the government will not assume any future compensation responsibilities if investors incur losses again.

In the meantime, another urgent task is reducing government intervention in the day-to-day workings of the stock market and making the CSRC independent of the government and free from conflicting responsibilities. This will essentially strengthen the regulatory capacity of the CSRC and make it easier for the CSRC to punish violations, thereby creating a favorable external environment for corporate governance reform of listed companies.

The second step is to solve the debt crisis of the brokerage industry and to restructure it on a market-basis through ownership reform and sectoral integration, which would avoid a systemic crisis of the stock market as the brokerage firms are the most important financial intermediaries and also a component of the institutional investor base in China's stock market.

The next step is to deepen legal and regulatory reforms aimed at improving information disclosure and corporate transparency. Meanwhile, implementing newly enacted rules on the protection of shareholder rights, such as those spelled out in the recently revised Company Law with regard to shareholder voting rights and derivative actions, is also critical to improve corporate governance at the next stage. Accordingly, the role of courts in hearing securities-related cases should be enhanced.

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The fourth step is to expand privatization to a wider scale to change the overwhelming shareholding structure of the listed companies, identified with the "sole controlling shareholder dictatorship." More efficient ownership structure with less concentrated shareholdings will redress the problems of "insider control" and expropriation of corporate funds and resources by both managers and controlling shareholders.

After the preceding reform measures have achieved meaningful results, further liberalization of the stock market should follow. Although opening up the stock market to international players is important and necessary, it must proceed with great caution and prudence. On the one hand, greater financial liberalization in the stock market will introduce higher standards of corporate governance and market ethics, and the experience and expertise of international fund managers and investment bankers will be beneficial for the knowledge and skill upgrading of domestic financial institutions. On the other hand, because structural reforms in the SOE, banking, and securities sectors are complementary, at a time when the general level of liberalization and marketization in the entire financial system is still low, rushed liberalization of the stock market could cause a systemic crisis. Specifically, because both interest rate and currency rate systems in China have been lagging in market-oriented reform, a sudden flux of capital flow into the stock market could be disruptive as it is possible that international capital with an appetite for betting on the re-evaluation of yuan will always have the incentive to make speculative transactions, as the 1997-98 Asian financial crisis revealed. As the deadline for fully liberalizing China's capital markets and banking sector under its WTO commitments draws near, preparing domestic financial institutions for greater competition from overseas and accelerating financial reforms to bring more market forces into the banking and securities sectors must be pushed forward as an urgent priority for the government without protracted delay.

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Chapter 6

Corporate Governance Reforms of China's Banking System

Introduction

Chapter 6 examines corporate governance reforms of China's state-owned banks, paying close attention to the important issues of NPL (non-performing loan) disposal and the preparations of the "big four" for overseas listings.

As a special type of SOE (i.e., state-owned financial enterprise), the reform of the "big four" is by nature aimed at solving the same problem as the SOE reform has so far targeted: government ownership and its costs. There exists strong complementarity between China's SOE and banking reforms, not least of all because the "big four" are the principal lenders to SOEs and their primary fund providers for meeting social burdens, such as state-subsidized housing, medical care and other welfare entitlements of state employees. Accordingly, the success or failure of the "big four" in the wake of a new round of reforms in the banking sector, including foreign exchange reserve injections and shareholding restructuring, will ultimately affect the results of China's SOE reform, and in no small part also the development of private enterprises that currently have no equal access to bank credit as their state counterparts.

Specifically, if China's banks cannot eventually operate on a commercial basis and become independent of government intervention in their lending decisions, even a successfully implemented privatization scheme will not bring global competitiveness to China's transformed SOEs. Examples of politically-directed loans to private firms as beneficiaries of government favouritism abound when one looks to Japan, South Korea, and Latin America where bank crises resulting from government intervention have not been an uncommon phenomenon. In this regard, ownership reform alone is not a sufficient condition for China's SOEs in order to transform them to modern enterprises that can perform and compete in the global economy. Replacing the soft budget

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constraints on SOEs with hard budget constraints is also a necessary component of China's enterprise reform, and this cannot be achieved without a successful transformation of the banks from credit allocators controlled by the state to modern commercial lenders.

Given these broad implications, Chapter 6 argues that China's banking reform must proceed swiftly, with the most difficult and politically challenging steps being taken decisively, such as considerably reducing government ownership stakes and introducing foreign and private capital in the state-dominated banking sector. As China's SOEs are currently implementing an accelerated privatization scheme on a much wider scale under the "grasping the large, releasing the small" (*zhuada fangxiao*) policy, and the stock market has also come to a critical point of reform, corporate governance reforms of the banking system carry great importance for the health and stability of China's economic structure. As the potentially most effective reform strategies, shareholding restructuring and overseas listings would provide China's state banks with improved governance mechanisms and incentive structures, together with international management skills and much stricter commercial discipline.

Although only a start and despite considerable challenges ahead, the reform measures that are currently being implemented in China's banking sector, as Chapter 6 reviews, are positive signs of a revolutionary turning point for fixing the country's fragile financial system. This encouraging trend must be sustained. Furthermore, it has become clear that any progress in China's banking reform will have profound repercussions for the privatization of SOEs as well as the stabilization and development of the stock market, where an alarming pool of funds irregularly diverted from the banks for lucrative returns on share speculation poses a systemic risk for the entire financial sector. Therefore, the structural reforms of the banks, SOEs and the capital markets should proceed hand in hand to gain synergies and complementary support from one another. Failing that, it will be impossible for China to successfully complete its transition to a market economy.

The remainder of Chapter 6 is organized into the following seven sections.

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Section I reviews the NPL problem and the urgency it brings to China's banking reform. Section II then analyzes the government's solutions to the NPL problem that have been tried in recent years, including write-offs of bad assets, transfer of NPLs at the "big four" to specially created asset management companies (AMCs), and the subsequent NPL disposal measures taken by the AMCs. The effects and remaining problems of these schemes are also discussed. Section III examines the effect of recapitalizing the "big four" through government bail-outs to improve their capital adequacy and help reduce their NPL ratio. The moral hazard entailed in repeated government bail-outs is explored. Section IV then turns to the issue of ultimately solving the moral hazard problem at the state banks through ownership restructuring and corporate governance reforms. The shareholding reform and the establishment of new governance mechanisms at two of the "big four," Bank of China (BoC) and China Construction Bank (CCB), are the focus of case studies in Section IV. Section V provides an account of the present level of governance quality at the "big four" by narrating some highly publicized bank failures and pointing out both their causes and repercussions. Section VI evaluates the potential far-reaching impact of the latest move in China's banking reform: the preparations of the "big four" for overseas listings. Section VII concludes on a cautiously optimistic note about the prospects of China's banking reform, and emphasizes the importance of "sequencing" for the success of banking reform.

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Section I

The NPL Problem and the Urgency of China's Banking Reform

China's "big four" state banks that dominate the country's credit allocation process are Industrial & Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC) and Agricultural Bank of China. Having been under control by the state to channel funds to SOEs for years, they are unable to price loans and allocate capital properly. As a result, they are stranded in a minefield of bad loans. Given the government's plan to sell off minority stakes in the "big four" to international investors through their overseas listings, the task of fixing the NPL problem is formidable: according to an estimate by UBS, to bring these banks into a "saleable" condition, the minimum amount of government NPL carve-out is RMB 2.4 trillion, or 21 percent of GDP.[521]

1. The severity of the NPL problem

Compared to the small capitalization of China's stock market, the banking system collects an overwhelming portion of China's domestic savings, which is equivalent to nearly 40 percent of GDP. At present, nearly 90 percent of household savings are held in deposits with state-owned banks, partly because of the lack of alternatives.[522] Unfortunately, the banks misallocate these funds on an even grander scale than China's stock market, whose dysfunction and inefficiency in disciplining listed companies and rewarding good corporate governance are widely recognized by both domestic and international investors.

The "big four" in combination account for the lion's share of the NPLs in the entire banking sector, which go as high as USD 400 billion. The poor operational quality of the "big four" and their discrimination against private enterprises are widely known. For

[521] Anderson, *supra* note 351.
[522] Lal, *supra* note 370.

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example, the "big four" direct 80 percent of their lending to generally unprofitable SOEs. The purpose is to prevent unemployment and the loss of welfare benefits to former and current SOE employees. By comparison, the vibrant private sector, which has been the main driving force of China's economy and created around 40 million new jobs during the period of 1998-2003 alone, is largely left to seek self-financing. In order to achieve growth and expansion, most of China's private enterprises rely on retained earnings, foreign capital, or informal sources of expensive credit. According to some concerned observers, until recently there has been a substantial disconnect between those earning money (often private enterprise), and those borrowing money (largely loss-making SOEs) in China's banking sector.[523]

2. The causes of NPLs

According to empirical studies by Chinese economists and working reports of China's central bank, the causes of NPL creation are multiple and not all of them are attributable to the state's intervention. In general, both "the ownership effect" and "the size effect" have an impact on NPL generation at the "big four." The "ownership effect" usually leads to state intervention in banks' lending decisions and for that matter the accumulation of policy loans. The "size effect," on the other hand, implies that the "big four" are indeed too big[524] to manage their business efficiently when the command chains are multiple under their five-layer organizational structure, whereby it is difficult for orders from the headquarters to reach the ground level of local branches and be implemented precisely. Understandably, the agency problem caused by information asymmetry between the government and bank managers is particularly severe at the "big four," which makes measuring performance difficult.[525]

[523] "Casino Capital", *supra* note 262 at 12.
[524] Take the example of the ICBC, China's largest lender: in 2003, it reported around 100 million depositors and 24,000 branches, plus USD 638 billion in assets, or 19 percent of the Chinese banking system total. See "China's Biggest Lender Is Ripe For December Recapitalization" *Asian Wall Street Journal* (23 December 2004) M.1.
[525] Ye Weiqiang, "Professor Yi Gang on the Breakthrough in the Thoughts about China's Banking Reform Strategy" *Caijing* 72 (20 November 2002).

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The governor of the central bank, Zhou Xiaochuan, provided the latest statistics on the causes of China's NPLs. According to his work report released in May 2004, the causes of NPLs can be roughly divided into the following five categories:[526]

(1) Direct administrative orders and intervention at various levels of Chinese government, primarily the local governments, are responsible for 30 percent of NPLs;

(2) Another 30 percent is caused by banks' routine lending practice of supporting SOEs;

(3) Local legal and administrative environments explain a portion of 10 percent;

(4) Another 10 percent is a result of the adjustment of China's industrial structure organized by the central government during the country's transition, and

(5) The remaining 20 percent can be attributed to banks' own mismanagement and business losses.

Interestingly, in a separate study a senior Chinese banking regulator reveals that "poor local credit environments" are the primary variable of NPLs, which account for almost 70 percent of NPL creation, while government ownership and mismanagement of bank officials can only explain the remaining 30 percent.[527] This in turn raises the question of what has caused the poor local credit environments, and the answer relates to the role of local governments in promoting regional economies under existing performance evaluation system for government officials. The chief problem lies in the central government's over-emphasis on "GDP growth" indicators with regard to measuring, and subsequently rewarding, the performance of local government officials. This sheer preference for the single dimension of GDP growth occurs at the expense of sacrificing other important yardsticks, such as protecting the property rights of local enterprises and establishing a healthy local credit environment. It is telling that the fastest growing local economy in China, the Guangdong province, is also the most affected "disaster area" for financial failures. Almost all of the recent high profile bank scandals happened in

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[526] Zhou Yang, "The 'Cult' of Banks' Shareholding Reform" *The Economics Monthly* 70 (October 2004), online: The Economics Monthly <http://www.jingji.com.cn/show.aspx?id=681>.
[527] Yi Gang, "The NPL Ratio and the Measurements of Local Government Performance" *Caijing* 68 (20 September 2002).

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Guangdong and the province's average NPL ratio is one of the highest among China's localities.[528]

Other frequently cited causes of NPLs include the personnel and compensation mechanisms at China's state banks, which usually link the qualifications for senior management positions to political considerations and link lending decisions to the size, not the quality, of loans. For all these characteristics, the "big four" act more like *government agencies, not commercial institutions.*[529]

It is worth noting that examining the actual causes of NPLs has important implications for a better understanding of the "transition costs" in China's financial system. This issue is introduced in Section III where the debate over "who should bear the transition costs" in today's Chinese society receives close attention.

3. The urgency of banking reform

Because banks are the weakest link in China's fast growing economy, success or failure of reforms of the banking sector could have broad international repercussions, given the fact that China has now become an important driver of global growth. Chinese state banks have traditionally measured success by the size of their loan portfolios, and the central task of banking reform is to change that to an operational culture based on profit.[530] In a widely shared opinion of many domestic and foreign experts, delayed banking reform could eventually threaten a collapse of China's entire financial system and severely undermine the growth trend of China's economy.[531]

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[528] *Ibid.*
[529] Ye Weiqiang, "Professor Yi Gang on the Breakthrough in the Thoughts about China's Banking Reform Strategy" *Caijing* 72 (20 November 2002).
[530] Andrew Browne, "Maverick Plays Key Role in New Bank Post" *Asian Wall Street Journal* (4 January 2005) M.1.
[531] "China's Banks: Beyond a Bail-out" *The Economist* (8 January 2004) 13 ["Beyond a Bail-out"].

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In this connection, it is worth reviewing the relationship between financial crises and economic growth. Recently, a new strand of the "finance and growth" theory has emerged to suggest a "re-evaluation" of financial crises and growth. According to this new study, cross-country empirical evidence indicates a robust link between occasional financial crises and faster GDP growth. The proponents of this "re-evaluation" of financial crises and growth argue that occasional crises can be welfare-improving when the benefits of higher growth outweigh the welfare costs of crises under some circumstances.[532] In theory, in an economy with severe credit market imperfections, the adoption of credit risk is a means to overcome the obstacles to growth by easing financing constraints. However, as a side effect finance fragility arises and thus crises occur from time to time. Therefore, there exists a trade-off between financial fragility and economic growth, i.e., "no fragility, no growth."[533]

However, this positive link between financial fragility and growth does not fit in well with China's situation. The potential systemic crisis of the entire financial system that a spectacular bank failure could engender is too devastating a scenario to imagine. It could severely impair the stability of China's economic structure and cause chain-reaction collapses in all sectors involved. Therefore, China's "big four" are in an urgent need of reform, before a systemic crisis erupts and dampens the growth prospects of China's economy in the future.

Moreover, China agreed as part of its WTO commitments to remove geographical and product restrictions on foreign banks and allow the full opening of its banking sector in December 2006. This pressure of imminent financial liberalization adds even more urgency to the long delayed banking reform. And there is the looming challenge of a fast-forming "grey/aging population," to arrive in just 15 or 20 year's time.[534] The aging population problem would make China's future pension liabilities a formidable financial burden, and the banks' health is a crucial factor in meeting that challenge.

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[532] Romain Ranciere, Aaron Tornell & Frank Westermann, "Crises and Growth: A Re-evaluation" (2003) NBER Working Paper, No. 10073.

[533] *Ibid.*

[534] Francis Markus, "China's Greying Population" *BBC News* (18 January 2005), online: BBC News <http://news.bbc.co.uk/2/hi/asia-pacific/4184839.stm>.

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Section II
AMCs and NPL Disposal

1. The establishment of AMCs and the transfers of NPLs (1998-2004)

A. The first transfer of NPLs from the "big four" to AMCs (1999)

During 1998, four asset management companies (AMCs) were established by the Chinese government to help dispose of the estimated USD 500 billion in NPLs that have plagued China's banking system. The four AMCs are China Huarong Asset Management Corp. (Huarong), China Great Wall Asset Management Corp. (Great Wall), China Orient Asset Management Corp. (Orient) and China Cinda Asset Management Corp (Cinda). Each AMC is responsible for dealing with NPLs of one of the "big four."

Over the following couple of years the government transferred, at face value, roughly USD 170 billion of bad loans from the "big four" to their respective AMCs, equivalent to more than one fifth of the banks' loan books. The loans were almost all made before 1996, and most of them were policy loans without collateral.[535] The Chinese government then warned the banks that the transfer of NPLs was their "last supper," which was later proven to be wishful thinking as the "big four" were to get more free meals in the ensuing several years, as Section III reports.

B. The second transfer of NPLs from the BoC and CCB to Cinda as a supportive measure for their shareholding restructuring and planned overseas listings (2004)

In June 2004, to help both CCB and BoC accelerate preparations for their overseas listings, the central bank and the Treasury organized another transfer of NPLs at the two banks, valued at RMB 278.7 billion yuan (USD 33.62 billion), to Cinda. The price paid by Cinda was a 50 percent discount of the book value. The purpose of this move was to make the books of both CCB and BoC look much healthier before they could invite

[535] "Casino Capital", *supra* note 262.

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external auditors to review their major financial indicators in order for the shareholding restructuring to take place, which was a necessary prior step to their overseas IPOs. As a result, both banks reportedly achieved a reduced NPL ratio of below 5 percent.[536]

2. The implementation and effect of NPL disposal

A. The implementation of NPL disposal

Until recently, the disposal of NPLs had generally been a cumbersome process. First, the "big four" transferred the NPLs at face value to the AMCs because the banks themselves were prohibited by China Banking Regulatory Commission (CBRC) to directly sell NPLs at below face value. The AMCs then recovered those bad loans or sold them to foreign bidders through auctions. In such auctions, the major buyers are international investment banks. In order to participate in the NPL disposal process, it is usually necessary for these foreign banks to form asset management joint ventures with China's AMCs.

There have been several auctions of NPL portfolios to foreign banks. In 2001, a consortium of Wall Street firms led by three U.S. investment banks, of which Morgan Stanley was the largest shareholder, bought a portfolio of NPLs with a face value of USD1.3 billion from Huarong in China's first international NPL auction.[537] In February 2003, Goldman Sachs also sealed a joint venture purchase with Huarong for a package of NPLs valued at 1.9 billion yuan (USD 229 million).[538] In March 2003, after having established a similar asset management joint venture with Huarong, a Morgan Stanley-led consortium received final regulatory approval to buy 10.8 billion yuan (USD 1.3 billion) of Huarong's NPLs, which marked the largest such portfolio sale of NPLs in China's history.[539] Most recently, as of January 2005 Great Wall was in the process of auctioning

[536] Ling Huawei "Before and After the Successful Bid of Cinda for NPLs at BoC and CCB" *Caijing* 111 (5 July 2004), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=5634>.
[537] Karen. Richardson. "China Company Sues U.S. Firms" *Asian Wall Street Journal* (5 February 2004) M.1.
[538] Dow Jones Newswires. "China Approves Its Largest Sale of Bad Loans" *Asian Wall Street Journal* (14 March 2003) A.4.
[539] *Ibid.*

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its remaining unrecovered NPLs, valued around RMB 150 billion yuan (USD 18 billion).[540]

To break the monopoly of AMCs in NPL disposal, the banks themselves have tried to enter this business by devising new methods that would circumvent the CBRC's prohibition on their selling NPLs at below face value. For example, in February 2004 CCB planned to pioneer a new type of distressed asset auction as it raced to become the first of the "big four" to launch an overseas listing. Instead of selling NPLs, CCB hoped to first separate the loan from its collateral and auction the collateral, in this case worth RMB 5 billion (USD 600 million). Meanwhile, the BoC also planned an auction that would circumvent the AMCs and offer NPLs with a face value of about RMB 6 billion (USD 724 million) to foreign and domestic bidders directly. If permitted by the CBRC, these new approaches of the "big four" to splitting the market share of NPL disposal business would bring competitive pressure on the AMCs.[541]

B. The effect of NPL disposal

In general, the effect of NPL disposal has not been encouraging, at least seen from the quick accumulation of new NPLs at the "big four" after the 1999 bail-out.

Officially, according to the China Banking Regulatory Commission, which oversees China's commercial banks and major financial institutions, the bad loans at the "big four" stood at a reduced total of 1.575 trillion yuan (USD 205 billion) and the banks' average NPL ratio dropped to 15.6 percent at the end of 2004.[542] The CBRC regarded this as a good sign and praised the banks for a "double reduction" in major NPL indicators.

However, while China's financial regulators may have stepped up their efforts to clean up the existing stock of NPLs, the country's banking system has yet to deal with another

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[540] Owen Brown, "China Audit Identifies Firms' Illegal Practices" *Asian Wall Street Journal* (7 January 2005) M.2 [Brown].
[541] James Kynge, "CCB Pioneers Auction in Race to List Overseas" *Financial Times* (6 February 2004).
[542] "China's Banks Cut Bad-Loan Ratio To 13.2 percent in 2004" *Asian Wall Street Journal* (14 January 2005) A.3.

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source of instability - new bad debt.[543] Moreover, the official figures are not credible and the true level of NPLs is certainly much higher for reasons discussed below. Independent studies have found far more worrying results as compared to the government's statistics. For example, according to the estimate of UBS, even after the write-off of bad loans by the central bank and the transfer of bad assets or bad loans to AMCs, the average NPL ratio at the "big four" still stood at a stunning 40 percent at the end of 2003.[544] Besides, the AMCs have also been criticized for their seemingly low recovery rates and for selling state assets at bargain prices, in particular to foreign buyers, as will be discussed shortly. The 2004 official figures showed the recovery rate of NPLs in cash terms was only 20.29 percent, meaning that the loss rate of uncovered loans was nearly 80 percent.[545]

3. The problems involved in the process of NPL disposal

Some serious problems have emerged in the NPL disposal process that expose the loopholes in the current institutional design and also signal the urgent need for further vigorous reform of China's banking sector.

A. The moral hazard of the "big four" and fraudulent transfers of NPLs

In the process of transferring their NPLs to the AMCs, the moral hazard of the "big four," as typically observed with every government bail-out measure, has led them to mis-categorize their problem loans and increase the bulk of NPLs transferred to the AMCs. In some cases, in order to disguise their business losses caused by irregular transactions or

[543] Matthias Bekier, "Drowned in A Sea of Debt" *Financial Times* (26 January 2005) 9 [Bekier].
[544] Anderson, *supra* note 351.
[545] Xie Fenghua, "Have NPLs Really Realized a 'Double Reduction'?" *China Business Post* 599 (30 January 2005), online: China Business Post <http://www.caijingshibao.com/Mag/preview.aspx?ArtID=10910>.

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even financial crimes, some bank managers forged documents to make fraudulent NPL transfers.[546]

B. The lack of proper valuation and standardized procedural mechanisms in the process of NPL disposal

In the course of NPL disposal, there have been accusations by some domestic critics that in their disposal of NPLs, the AMCs have made "fire sales" to foreign investment banks at the expense of potential domestic buyers and China's "national economic security."[547] Such accusations intensified after an international auction held in 2003 by Huarong that resulted in more than 10 billion yuan (USD 1.3 billion) of assets being acquired by six foreign investment banks, the largest NPL portfolio auction in China's history.[548] Public criticisms have put Huarong and other AMCs under pressure to proceed swiftly with future NPL auctions to foreign buyers.

The real question to be asked is whether the prices paid by foreign buyers in previous NPL auctions were really "too cheap" and if so what had caused the under-pricing. The answer is that the difficulty in pricing China's NPLs properly is associated with the underdevelopment of market mechanisms for NPL disposal in China's transition economy. After all, China's AMCs only started the business of NPL disposal several years ago and there was no existing domestic experience from which to draw. Although NPL disposal in other countries, in particular some East Asian countries after the 1998-1999 financial crisis, has provided some valuable lessons to China, its institutional environment and still-developing market mechanisms are not mature enough for efficiently implementing NPL disposal schemes. The first problem is that there were few domestic buyers interested in entering this market when the new business of NPL

[546] Wu Chuanzhen & Su Yuan, "The Inside Story about the 2 Trillion yuan NPL Disposal in China" *Southern Weekend* (27 January 2005), online: Southern Weekend <http://www.nanfangdaily.com.cn/southnews/zmzg/200501270977.asp> [Wu & Su].
[547] Wang Du, "China's NPL Disposal Needs to Be Vigilant of the Huge Trap Set Up by Foreign Banks" *The Economics Monthly* 72 (December 2004), online: The Economics Monthly <http://www.jingji.com.cn/show.aspx?id=745>.
[548] The deals involved Switzerland-based UBS AG and Wall Street banks Citigroup Inc., Lehman Brothers Holdings Inc., J.P. Morgan Chase & Co. and Morgan Stanley. See Brown, *supra* note 540.

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disposal first launched in China. At the beginning, few domestic institutions could imagine that NPL disposal would one day become an attractive business with potentially lucrative returns to the buyers of NPLs and simply shunned this market. Foreign banks, hoping to make inroads in China's financial industry as the country opens up to the world, were the first active participants in NPL auctions at a time when the AMCs started to experiment with market-oriented schemes to dispose of the NPLs they had acquired from the "big four." Therefore, the initiating market players in China's NPL disposal, on the demand side, were international investment banks.[549]

The second problem is that while it is likely that the prices paid by foreign buyers were indeed "too cheap," the primary reason for the under-pricing is the lack of proper valuation system and standardized auction procedures for NPL disposal in China, such as information disclosure, property documents authentification and risk assessment. Besides, there are regulatory hurdles regarding government approval, which usually result in uncertainty and delay and this factor certainly has a negative impact on NPL pricing.

Aware of these institutional inadequacies, the CBRC has been stressing the need to both improve the capacity of China's AMCs in handling NPL auctions more effectively and to develop necessary market mechanisms to facilitate NPL auctions. As to the participation of foreign buyers, the CBRC is positive about the overall beneficial impact brought by their expertise and experience, and encourages the AMCs to continue to cooperate with foreign players.[550]

C. Irregular dealings and corruption at AMCs

Adding to the already depressing problems of continuing generation of new NPLs at the "big four" and the low recovery rates at the AMCs, recently it has also been discovered

[549] Wu & Su, *supra* note 546.
[550] Li Zhenhua, "Are AMCs Selling State Assets for Cheap? Foreign Investment Banks Elaborate the Chain of Profit Sharing in China's NPL Disposal" *21st Century Business Herald* (10 January 2005), online: 21st Century Business Herald <http://www.nanfangdaily.com.cn/jj/20050110/zh/200501100006.asp>.

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that in the process of NPL disposal, irregular dealings have occurred on a wide scale, some involving corruption and embezzlement by the personnel at both the AMCs and the "big four."[551] Specifically, in a 2005 work report of China's National Audit Office, 38 cases of illegal practices at the four AMCs, valued at 6.7 billion yuan (nearly USD 846 million) were identified.[552]

4. Summary

From the discussion of NPL disposal so far, it can be seen that the operational effect of AMCs is subject to both public criticism and government scrutiny, which will add more difficulties to redressing the alarming reality of newly-created bad loans. Therefore, to effectively solve the existing NPL problem and slow the growth in new bad loans, further banking reform measures are needed, which must go beyond continuing write-offs of bad debt and capital injections. The key component of these measures is the creation of a modern banking industry based on a strong credit scoring and risk management culture, and at the heart of this effort is the need for better corporate governance.[553] This leads to the issue of shareholding reform and the preparations of the "big four" for overseas listings, which is dealt with in Section VI.

[551] Shen Jianli, "The National Audit Office Uncovered 67 RMB 6.7 Billion of Irregular Dealings at Four AMCs" *Southern Daily* (21 January 2005), online: Southern Daily <http://www.nanfangdaily.com.cn/southnews/djjz/200501210283.asp>.
[552] Brown, *supra* note 540.
[553] Bekier, *supra* note 543.

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Section III

Recapitalizing the "Big Four" through Government Bail-outs

The government has over the past several years spent huge amounts of money to bolster the capital base of the "big four," totalling USD 250 billion. The so-called "free supper" has been offered time and again despite the government's repeated warnings that every bail-out was the "last chance." While the latest effort of using China's abundant foreign exchange reserves to recapitalize the BoC and CCB in December 2003 (and eventually also ICBC and ABC in 2005) may be an innovative method with relatively lower costs compared to other bail-out options, it also entails potential risk and indeed has increased the moral hazard of the "big four."

1. Capital injection by issuing special treasury bonds (1998)

In 1998, the government injected 270 billion yuan (USD 32.6 billion) into the "big four" by issuing special treasury bonds, and at the same time spun off 1,400 billion yuan (USD169 billion) worth of their NPLs. As a direct result of this infusion, the capital adequacy ratio of each of the "big four" immediately reached 8 percent, the threshold required under the Basel accord. However, the four banks have again accumulated 2,100 billion yuan (USD 254 billion) worth of new NPLs as of February 2004.[554] It seemed that the money injected failed to bring about expected performance improvement because the banks did not change their management systems and lending patterns after the recapitalization.

2. Capital injection by using foreign exchange reserves: an innovative bail-out method (2003-2005)

[554] Ye Weiqiang & Lu Lei, "Pros and Cons of US$45 Billion Re-capitalization" *Caijing English Newsletter* (10 February 2004), online: Caijing <http://www.caijing.com.cn/english> [Ye & Lu].

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China has a large build-up of foreign exchange reserves. In October 2004, these stood at more than USD 600 billion, about 60 percent of GDP, and are largely held in US Treasury bills.[555] Making use of China's rich pool of foreign exchange reserves, the central bank in December 2003 provided the BoC and CCB, the country's second and third largest lenders respectively, each with USD 22.5 billion. This move was aimed at increasing the capital adequacy of the two banks to pave the way for their subsequent shareholding restructuring and overseas listings.

According to some approving Chinese financial analysts, the government's decision to recapitalize the BoC and CCB with foreign exchange reserves struck "a delicate balance between financial stability and monetary stability" because in this scheme the government provided the banks with capital without worsening its budget deficit.[556] At the same time, the money was injected through a newly created holding company, Central Huijin Investment (Huijin), which is wholly owned by the state, to allow the government to remove itself from direct ownership of the banks.[557] Huijin's role in the following shareholding restructuring of both the BoC and CCB is discussed below in Section IV.

After the capital injections into the BoC and CCB in 2003, China's largest lender, ICBC, is expecting a similar bail-out in 2005.[558] The expected capital injection would pave the way for an overseas listing worth up to USD 10 billion. According to industry estimates, the amount of ICBC's capital injection could reach USD 45 billion.[559] Because of its size, ICBC suffered more than any other state bank from years of policy lending. As of September 2004, its NPL ratio stood at 19.46 percent, which is described as "a scary

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[555] Lal, *supra* note 370.
[556] "China's Biggest Lender Is Ripe For December Recapitalization" *Asian Wall Street Journal* (23 December 2004) M.1 ["China's Biggest Lender"].
[557] Hu Shuli, "A Double-edged Sword: On Recapitalizing Banks with Foreign Exchange Reserves" *Caijing* 100 (20 January 2004) [Hu].
[558] "China's Biggest Lender", *supra* note 556.
[559] Bekier, *supra* note 543.

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figure for overseas investors" by Chinese bankers and is higher than China's official average NPL ratio of 13 percent.[560]

As to the ABC, the weakest and smallest of the "big four," it submitted its shareholding restructuring plan to the government for review in early 2005, in anticipation of a similar capital injection. Because of the heavy burden it has long assumed to provide rural policy loans, the ABC is widely regarded as making the slowest progress in bank shareholding reform.[561] The method of capital injection, however, is still uncertain with regard to the ABC, because the Treasury, as the owner of the "big four," has recently expressed discontent about being overshadowed by other government agencies, primarily the central bank, in China's latest banking reform moves and wants to regain a leading profile by orchestrating the next round of capital injections and providing the money itself. Regardless of the method of capital injection, however, it is the government— with taxpayers' money— which ultimately bears the cost.

3. Write-off of bad assets (the forgiveness of owner's equity claims of the Treasury): 2004

After receiving the capital injection of foreign exchange reserves, the BoC and CCB again were offered another free meal. In January 2004, the Treasury announced that it would use its owner's equity claims in the two banks, worth RMB 300 billion (USD 36.2 billion), to write off their bad assets.[562] This was viewed within Chinese financial industry as the government paying for the historical losses of the state banks out of its own coffers, for which Chinese taxpayers ultimately paid.

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[560] Wang Fang & Francesco Guerrera, "China Close to Approving Dollars 30bn Injection for ICBC" *Financial Times* (4 January 2005) 17.

[561] Sun Ming, "Agricultural Bank of China Re-submits Its Shareholding Reform Plan and the Method of Capital Injection is to be Determined" *21st Century Business Herald* (31 January 2005), online: 21st Century Business Herald <http://www.nanfangdaily.com.cn/jj/20050131/jr/200501310036.asp>.

[562] Zhang Xiaocai, "The BoC and CCB Are Allowed to Write Off Bad Loans by Using RMB 300 Billion yuan of Owner's Equity of the Treasury" *China Business Post* (12 January 2004).

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4. The problems associated with repeated bail-outs

A. The moral hazard of the "big four" and other financial institutions in anticipation of "free suppers"

For all its innovation, the approach of using foreign exchange reserves for bank capital injections has been criticized by some economists. The first problem is obvious: it could cause moral hazard not only at the "big four," but also other financial institutions currently operating with dismal capital bases, especially when government bail-outs of troubled financial institutions seem to have become a repeated exercise.

In the latest round of bail-outs, it appeared to some that injecting foreign exchange reserves into state banks is a low-cost method in comparison with other options. As a result, not only the "big four," but also other troubled financial institutions have come to believe that the government has found a new mechanism to save them. An appalling fact emerging from the lower levels of China's financial industry is that an army of 112 city commercial banks and 35,544 rural credit cooperatives is lining up for a "blood infusion" by the government, with their capital adequacy and NPL ratio even worse than that of the "big four." However, China's foreign exchange reserves, ample as they currently are, are not unlimited. With an illusion about a deep treasury box, the "big four" will not cherish the capital they have received as much as they should, and will expect more "free gifts" from the government as they proceed with further reforms.[563]

Indeed, in analyzing the actual effect of repeated bail-outs, the unavoidable conclusion is that money spent on recapitalizing China's banks over recent years did not result in evident performance improvement. Since 1998, China has spent roughly USD 200 billion in recapitalizing its banks and writing off bad loans, to little avail. Politically directed lending to favored enterprises, especially those in the "strategic sectors," has continued as before, and the previous write-off of bad assets was soon replaced by new ones. According to China's official statistics, at the end of 2004 NPLs stood at USD 205

[563] Hu, *supra* note 557.

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billion, or 13 percent of total banking assets. Some independent estimates put the level of NPLs at around USD 420 billion, or nearly 40 percent of GDP.[564]

B. The potential risks to the stability of the financial system

The second problem is the potential risks of using foreign exchange reserves to recapitalize the "big four" to the stability of China's financial system. Having sufficient foreign exchange reserves is usually an important indicator of a country's financial safety, and it is commonly understood that these funds should not be used on illiquid projects, such as strengthening the "core capital" base of state-owned commercial banks. Besides, some Chinese economists also believe that the capital injection of foreign exchange reserves will eventually harm the central bank's independence and regulatory credibility.[565]

In this regard, it is interesting to note that a veteran development economist and long time China observer, Deepak Lal, has sketched an ingenious scheme for better using China's vast foreign exchange reserves to help with the reform of both the country's banks and SOEs:

> ... There is a better way for China to use its reserves. At most, only a small proportion - say Dollars 100bn - is needed to fend off any speculative attack in order to maintain the dollar peg. The rest - some Dollars 500bn, as well as any future accruals - could be put into a social reconstruction fund under the central bank. This would function like any other big pension fund, such as that for the World Bank, whose annual return, averaged over 10 years, has been about 8 percent. If the proposed fund for China could match this, it would yield an annual income of Dollars 40bn, or 4 percent of GDP, which could be used gradually to cover the SOE's social burdens [now largely funded by the state banks]. The SOEs could then be treated as normal enterprises, to be privatised if viable and closed down if not... In time, as the SOE problem receded, the income from the fund could become the basis for a fully funded pensions system for China's ageing population...[566]

This suggestion seems reasonable and is tailored to the current situation of China's currency regime, financial development, pension liabilities and SOE reform. Therefore,

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[564] "Beyond a Bail-out", *supra* note 531.
[565] Ye & Lu, *supra* note 554.
[566] Lal, *supra* note 370.

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this new idea warrants consideration in the next stage of China's banking and SOE reforms.

5. The debate over "transition costs" and "paying for a modern banking system"

A. "Transition costs": who should pay for them?

It is worth noting that in the process of China's banking reform, an intense debate has taken place among the banks, the government, and the general public about the so-called "transition costs." Some Chinese bankers have suggested that it is the responsibility of the government to compensate the banks for accumulated losses caused by policy lending as well as lost profits due to policy restrictions on the scope of permitted banking business during China's economic transition.[567] In other words, in the view of the banks, the government should pay for the "transition costs."

However, recent public opinion, and indeed the position of China's banking regulators, has suggested that the banks' argument is unsettling because it sought to make the central bank the virtual ultimate guarantor of all troubled financial institutions. If the "big four" suffered their losses primarily from policy restrictions and state intervention, other domestic financial institutions, such as the 112 city commercial banks and numerous rural credit cooperatives, will apply the same argument to ask for government bail-outs. This would be a catastrophic scenario as the moral hazard could spread across-the-board within China's financial system.

Moreover, as to what constitutes real "transition costs," it is not up to the banks to properly define it since they tend to distort the cause-and-effect account and disguise the losses from stealing, embezzlement, expropriation and failed speculation in the stock market under the cover of "transition costs." In fact, from what has been revealed in previous discussion of the causes of NPLs in Section I, what constitutes the real

[567] Hu, *supra* note 557.

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"transition costs" seems to have some clear indications— the government, especially the local governments, which intervene in bank businesses, as well as bank staff who make blunders or cause losses in daily transactions due to incompetence, waste, and corruption, both have their shares in contributing to the NPL problem, thus both playing a role in the accumulation of the "transition costs."

B. "Paying for a modern banking system"

The situation now is that the government is in a relatively weak bargaining position in negotiating reform measures with the banks while the general public, understandably, have little say in this interaction except expressing criticism in the media. The banks now hold all cards to exploit the government's concern about the danger of a systemic financial crisis caused by bank failures. In a sense, the moral hazard has led the banks to make a hostage of, or "hijack," the government's dilemma in fixing the financial system: it certainly cannot afford to let the banks collapse, but it also worries about the effect of money used. The result of this interaction, as judged from the current progress of banking reform, is that the government has been forced to take a position of "paying for a modern banking system," as professed by some policy makers.

However, the problem here is that this philosophy of banking reform is a misnomer, and would be more accurately understood as 'paying heftily for a uncertain prospect of a modern banking system," which implies a high risk of ultimate failure if it is not accompanied by a strategy of vigorous reform to turn around the corporate governance structure of the "big four." Failing that, regardless of how much has been paid, and certainly will be paid again, a healthy banking sector in China is only an illusion.

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Section IV
Shareholding Restructuring and Corporate Governance Reforms

After a series of measures to bolster the capital base of the state banks through both recapitalization and NPL transfer, the "big four" are now ready for shareholding restructuring, a necessary prior step toward launching overseas listings.

1. The old ownership and management system for the "big four" and the new changes

Formerly, the ownership and management system of the "big four" had suffered the same problem as China's SOEs had before the State-owned Assets Supervision and Administration Commission (SASAC) was established: the split of ownership and control rights between separate government departments. In the case of the "big four," until recently the Treasury had been the responsible agency to represent the state owner and oversee the banks' incomes and expenses, while the CBRC had been in charge of personnel decisions as well as discipline and sanctions. To address the agency problem that this ownership and control structure has created, some Chinese economists have suggested establishing a "financial SASAC" to solely represent the state's ownership rights in the "big four." The reason why the SASAC itself is not suitable to play this role is that it would be a bad idea to have the same agency assume the ownership rights in both SOEs and their principal creditors, as it would certainly lead to conflicts of interest.[568]

Therefore, the shareholding restructuring that is underway at the BoC and CCB, the two banks that have been making most of the progress in the latest round of banking reform, would provide valuable lessons with regard to the reform of ownership and management systems in China's banking sector. In this new effort of the government to experiment

[568] Ling Huawei & Shi Chuan, "Huijin Corporation Taps Financial Assets Management" *Caijing* 117 (4 October 2004), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=5995>.

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with ownership reform at the "big four," the role of the Central Huijin Investment (Huijin), a newly created state holding investment company for the specific purpose of facilitating China's financial reform, is important. Under joint supervision of the Ministry of Finance, the central bank and the State Administration of Foreign Exchange, Huijin was set up after the foreign exchange reserve injection into BoC and CCB in December 2003 to represent the state shareholder in these two banks. Huijin is wholly owned by the state and has a clear mandate to represent the state owner in exercising its rights and responsibilities in the "big four" and other major financial institutions.

Although Huijin itself is still a 100 percent state-owned company, its new role in the shareholding restructuring at BoC and CCB as their founding shareholder at least allows the state to remove itself from direct ownership of the banks. In the meantime, new board structures were also created at the two banks, including seats for both domestic and foreign independent directors. When the banks' plan to introduce international strategic investors finally materializes, which will further diversify their ownership structures before overseas listings, there could be more meaningful results in banking reform. The latest development suggests that both BoC and CCB are in the process of soliciting large international financial institutions for their interest in buying minority stakes in the banks.

As complementary measures to their shareholding restructuring, the "big four" have also reduced the size of their staff and reshaped their employment, compensation and welfare systems to allow market forces to play a bigger role in their daily operation.

2. Shareholding restructuring and corporate governance reforms at BoC and CCB

A. BoC's shareholding restructuring

On August 26 2004, the BoC announced that it had completed its shareholding restructuring. Huijin is currently the sole shareholder in the restructured BoC. The new BoC inherited all of its predecessor's assets, liabilities and 188,700 staff. A board

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consisting of 11 directors, among them six from Huijin, was established and three supervisors were also appointed. In addition, Hong Kong's former Securities and Futures Commission (SFC) chairman, Anthony Neoh, has been appointed the first independent director of the restructured BoC. According to the BoC, another foreign professional will also be invited to join the board some time later.[569] The bank also announced that as it proceeds further to invite new strategic investors, more directors will be appointed. In July 2004, a list of potential strategic investors was submitted to the State Council and Huijin for their review.[570]

B. CCB's shareholding restructuring

On September 15 2004, CCB announced its completion of shareholding restructuring. The former state-owned bank was split into a holding group and a shareholding company. The shareholding company serves as a listing vehicle for its planned overseas IPO. The holding group, named China Construction Bank Group Co. Ltd (CCB Group), took over the bank's non-banking businesses, valued at around 1 percent of its total assets. As part of its restructuring plan, CCB has set up China Jianyin Investment Ltd. (Jianyin) to hold its stake in the new shareholding company, along with four founding stakeholders, including Huijin and another three SOEs as domestic strategic investors.[571]

In the shareholding structure of the new CCB, Huijin holds 85 percent of the shares of the shareholding company. In addition, Huijin controls up to an additional 10 percent of shares through the holding group, which it owns exclusively. Therefore, Huijin in effect controls 95.88 percent of the shares in the new CCB. Previous proposals from economists for Huijin to put together a professional management committee did not interest government's policy makers. Instead, Huijin's management team will be staffed by officials from the government regulatory agencies, including the central bank, the State

[569] *Ibid.*
[570] Bei Hu, "Neoh on Board at Bank of China" *South China Morning Post* (25 August 2004) 1.
[571] The remaining three major strategic investors in the new shareholding structure of CCB are all state-owned enterprises, including China Yangtze Power Co., Shanghai Baosteel Group, and State Power Grid Corp.

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Administration of Foreign Exchange, and the Ministry of Finance.[572] It has appointed six directors to the board of the new CCB shareholding company.

Despite the setback at Huijin of not establishing a professional management team, the corporate governance structure of the new CCB does seem to be an improvement in some respects. On September 21 2004, CCB appointed Masamoto Yashiro, chief executive of Japan's Shinsei Bank, as one of its two independent directors in a landmark step toward improved corporate governance.[573] This move made CCB the first of the "big four" to recruit a foreigner as an independent director as it prepares for an overseas IPO. The appointment of Mr. Yashiro and another independent director, who is a professor at Tsinghua University, is a breakthrough in China's banking sector, where appointments have generally been determined by Party and government affiliations. Some financial analysts believe that this move will help improve CCB's profile and will be beneficial to the bank's overseas IPO.[574]

Meanwhile, CCB has also started selecting potential strategic investors. The US equity fund Newbridge Capital, which will soon take control of Shenzhen Development Bank, a well-performing Chinese shareholding bank, after clearance of government approval, and New York-based Ripplewood Holdings LLC, are among the candidates being considered.[575]

3. Establishing internal controls and risk management systems

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[572] Yu Ning, "China Construction Bank Nears IPO" *Caijing* (20 June 2004), online: Caijing <http://www.caijing.com.cn/english/2004/040620/040620ccb.htm> [Yu].
[573] Zou Hua, "Masamoto Yashiro, the Independent Director of CCB, Hopes to Help the Bank with His Reform Experience" *China News* (24 September 2004), online: China News <http://www.chinanews.com.cn/news/2004/2004-09-24/26/487656.shtml>.
[574] Owen Brown & Phelim Kyne, "Chinese Lender Blazes a Trail; Construction Bank Names CEO of Japan's Shinsei As an Independent Director" *Asian Wall Street Journal* (23 September 2004) A.3.
[575] Yu, *supra* note 572.

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Since early 2004, the China Banking Regulatory Commission (CBRC), the principal regulator of China's commercial banks, has been pushing measures to strengthen banks' internal risk control and has devised an "interim method," which was to take effect on February 1, 2005.[576] As a follow-up, in January 2005 the CBRC again issued a set of *Guidelines for Commercial Bank Market Risk Management* as well as the *Provisional Regulation on Assessment of Internal Controls of Commercial Banks*. In these documents, the CBRC urged China's commercial banks to improve their risk control and internal monitoring as China's financial market opens to foreign competitors. The CBRC has indicated that it will tighten supervision over commercial banks where serious financial crimes have repeatedly occurred and pledged more inspections and punishment for wrongdoers. Meanwhile, because China's banking industry is poorly prepared to handle the new types of risk that are expected to multiply as the financial system is liberalized, the CBRC also urged domestic banks to introduce risk control systems that would limit their exposure to financial market volatility.[577]

The promulgation of these regulations was largely spurred by the alarming fact that serious financial crimes happen too often in the banking industry because of lax internal controls. Corruption and embezzlement of funds at the "big four," sometimes involving stunning amounts, have been reported extensively by both domestic and international financial media over the past few years. The most egregious bank scandals and corporate governance failures that have been recorded with the "big four" are discussed below in Section V. The most critical fact revealed by these cases is that China's banking reform not only faces the daunting task of reducing NPLs, but also the challenge of curbing corruption through tightened internal controls and improved corporate governance. However, because the legal and institutional environments during China's transition are still developing, these double tasks are not easy to achieve. This issue is revisited in the concluding Section VII, where the prospects for and necessary future steps in China's banking reform are reviewed.

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[576] Duan Hongqing & Kang Weiping, "Financial Fraud Exposes Governance Weaknesses at the Bank of China" *Caijing* 126 (24 January 2005), online: Caijing <http://www.caijing.com.cn/english/2005/05-1-24/05-1-24-4.htm> [Duan & Kang].

[577] James T. Areddy, "China to Get Tougher On Crimes at Banks" *Asian Wall Street Journal* (10 January 2005) M.2.

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Section V

Egregious Corporate Governance Failures at the "Big Four" and Their Repercussions

Drawing on international experience in measuring corruption and governance quality, such as the Corruption Perceptions Index (CPI) tracked by Transparency International, two Chinese economists have compiled an index of financial corruption in China (FCI). According to their estimates, for the year 2003 China's overall FCI stood at 5.42 on a scale of 0-10, with 0 as the best and 10 as the worst level of corruption. The banking sector recorded a medium score of 4.17, compared to the staggering figure of 7.26 for the securities industry.[578] These numbers are alarming, indicating the severity of financial corruption in both China's banking and securities industries. The cases reported below regarding China's banking sector are the most egregious ones and highly revealing of lax internal controls and other serious weaknesses in corporate governance of the "big four."

1. The BoC Heilongjiang sub-branch missing deposits case (2005)

A recent embezzlement case at a BoC sub-branch in China's northeast Heilongjiang province was revealed to the public in January 2005. This case involved missing deposits of more than RMB 1 billion (USD 121 million). The missing funds were suspected to be stolen by the former manager of the sub-branch, Gao Shan, who fled overseas just days before the case was brought to light. Investigators from the police and the BoC's headquarters have launched a probe into the case, which has uncovered serious internal control problems at the bank.[579] This was the latest in a series of scandals at the BoC in the past few years and is especially damaging when the bank is preparing for an overseas IPO. As a blow to investor confidence, Standard & Poor's noted that "the incident underlines weaknesses in the bank's relatively new internal control procedures."[580] This

[578] Xie & Lu, *supra* note 503.
[579] Duan & Kang, *supra* note 576.
[580] "Foreign Listings in New York: Big Apple Blues" *The Economist* (27 January 2005) 73 ["Big Apple Blues"].

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could delay the bank's much-anticipated domestic and overseas listings, because investment bankers have commented that unless the BoC can show its risk control systems are capable of detecting problems in its sprawling branch network, investors will demand a discount on the offering price.[581]

2. The ICBC Nanhai branch loan frauds case (2004)

In June 2004, China's Auditor General released some shocking findings in its work report to the National People's Congress, indicating that a local private entrepreneur in Nanhai city, Guangdong Province, Feng Mingchang, forged financial papers and conspired with bank executives to obtain fraudulent loans up to 7.4 billion yuan (USD 893.7 million) from the ICBC Nanhai branch. According to the audit report, a large portion of the loans was illegally transferred overseas. When the case was first revealed, it was reported that as much as 2 billion yuan (USD 233 million) had not been returned.[582]

In this episode, the delinquency on the part of the bank was outrageous: after being warned by risk-assessment officials from the upper branch that there were potential huge risks in lending to Feng, the Guangdong branch of the ICBC continued to lend billions to his company and its subsidiaries. Some bank officials have since been arrested on corruption charges. The scope of wrongdoing was stunning: when the case was finally brought to trial in January 2005, some 80 government officials and bankers involved had been either detained by the police or reprimanded by the Communist Party.[583]

According to the in-depth probe by China's financial media, the real mastermind of this loan fraud was not Feng, but local officials in Nanhai city. They used Feng's company as

[581] James T. Areddy & Vivian Tse, "Millions Missing at Bank of China" *Asian Wall Street Journal* (1 February 2005) A2.
[582] Zhang Xiang, Chen Huiying & Pan Xiaohong, "Audit Report Lifts Veil on Corruption in Guangdong" *Caijing* (15 July 2004), online: Caijing <http://www.caijing.com.cn/english/2004/040705/040705cover.htm>.
[583] Li Keyong & Zhang Xudong, "The General Audit Office Reveals the Truth about RMB 7.4 Billion Loan Fraud in the Feng Mingchang Case" *Xinhua News* (6 July 2004), online: Sohu <http://news.sohu.com/2004/07/06/32/news220873232.shtml>.

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a front to divert most of the loans overseas, in order to offset gigantic losses the local government incurred in capital and real estate speculations in Hong Kong years ago. Many facts point toward local government officials' manipulations behind the scenes.[584] For example, bank records showed that Feng's company and its affiliates obtained most of the loans by taking out mortgages on properties which they did not own or were grossly over-valued and the local land resource authorities provided Feng's company with a string of fake certificates for these properties.[585]

Therefore, compared with the outright corruption commonly exposed by Chinese media, the Nanhai loan fraud scandal poses much greater risks. It reveals deep-rooted problems in China's current political and economic systems during transition, calling for future reform measures to both combat corruption and clean up the banking sector.[586]

3. The BoC Shanghai and Hong Kong branches case (2004)

On February 20 2004, the BoC announced that it had removed Liu Jinbao as the bank's vice chairman. Liu had been under investigation for suspected involvement in economic crimes since early 2002. In July 2004, government officials from the Ministry of Supervision confirmed that Liu was suspected of embezzlement, bribery, and illegally approving loans.[587]

The alleged primary wrongdoing was Liu's role as the head of BoC's Hong Kong branch in its problem loans totaling HKD 2.1billion (USD 270 million) to a Shanghai-based private entrepreneur, Zhou Zhengyi, in early 2002.[588] However, the key factor in Liu's downfall was widely believed to be not the Zhou Zhengyi case, but another series of

[584] Hu Shuli, "Who's Behind Feng Mingchang?" *Caijing* 125 (24 January 2005), online: Caijing <http://www.caijing.com.cn/english/2005/05-1-24/05-1-24-1.htm>
[585] *Ibid.*
[586] *Ibid.*
[587] Ling Huawei & Kang Weiping, "Embezzlement Woes Haunt BOC Hong Kong" *Caijing* (20 August 2004), online: Caijing <http://www.caijing.com.cn/english/2004/040820/040820hk.htm>.
[588] Justin Lau, "Liu Sacked by Bank of China" *Financial Times* (21 February 2004) 9.

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problem loans extended by BoC's Shanghai branch, when Liu was its general manager, to a local private enterprise group, Wantai.[589] The Wantai case was exposed in December 2003, when financial inspectors from the Communist Party's Central Committee discovered astonishing results in their probe into Liu's wrongdoing: Wantai had taken 28 loans, worth 1.48 billion yuan (USD 178 million), from BoC's Shanghai branch over four years. The total value of the loans plus interest was nearly RMB 1.6 billion yuan (USD 193 million). At the end of 2000, except for two loans that were not yet mature, 95 percent of these loans had become NPLs. What is more outrageous is that less than 25 percent of these NPLs were originally lent on collateral.[590]

As the probe into the Liu Jinbao case went deeper, more scandals erupted at the BoC's Hong Kong branch. In August 2004, the branch's vice chairman, Ding Yansheng, was taken in custody by mainland police for his involvement in alleged misappropriation of funds. Ding was suspected of embezzling funds owned by controlling shareholders of former BoC member banks before the Hong Kong branch's restructuring in 2001. Zhu Chi, another vice chairman of the branch, was later also under investigation for the same allegations. Specifically, Liu Jinbao was alleged of embezzling from the BoC's Hong Kong branch HKD 4 million (USD 513,000), while Ding and Zhu each took HKD 1.5 million (USD 192,000). After misappropriating the money, they destroyed original bank records. The sequential departure of these three people left only one senior executive remaining on the board since the branch's IPO on the Hong Kong Exchange in 2002. This scandal has spurred growing investor concern over the bank's corporate governance and internal controls. [591]

4. The former BoC president corruption case (2003)

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[589] Ling Huawei. "The Dangerous Triangle" *Caijing* 103 (5 March 2004). online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=5264>.
[590] Ling Huawei. "Top Bankers Brought Down by NPLs" *Caijing* 124 (5 March 2004). online: Caijing <http://www.caijing.com.cn/english/2004/040305index.HTM>.
[591] Francesco Guerrera & Justin Lau. "Bosses Quit Bank over Scandal" *Financial Times* (17 August 2004) 26.

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In December 2003, Wang Xuebing, the former BoC president was sentenced to 12 years in prison for taking bribes worth RMB 1.15 million (USD 138,000) and numerous improper gifts.[592] Moreover, Wang was alleged to have overruled subordinates at the BoC to make risky loans to favored clients and extend their credit terms during his tenure at the bank between 1991 and 1996.[593] His case came to light just months after a loan scandal erupted at BoC's New York branch. That scandal resulted in fines against the bank of USD 20 million by both U.S. and Chinese banking regulators.[594] The details of this case are provided below.

5. The BoC New York branch fines case (2003)

In January 2003, an investigation by the US Office of Currency Comptroller (OCC) found BoC's New York branch guilty of misconduct, for which it was fined USD 10 million.[595] This incident was received by the Chinese government as a "welcome move" because the OCC's action would encourage reform in China's banking industry. Apart from the fines imposed by the US regulator, as the parent company of its New York branch, the BoC was also fined USD 10 million by China's central bank for failing to maintain proper supervision and internal controls.[596]

According to the investigators from the US Treasury, the offences of the BoC New York branch took place in 1991-1999, including improper loans to people who had personal relationships with bank officials and fraudulent loan and letter-of-credit schemes.[597] These wrongdoings had resulted in a total loss of USD 34 million at this branch between

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[592] "A List of Senior Bank Officials Implicated in Financial Crime Cases over Recent Years" *Caijing* (10 January 2005), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=6452>.
[593] Richard McGregor, "Top Chinese Banker Jailed" *Financial Times* (11 December 2003) 33.
[594] Andrew Browne, "Bank of China Unit Faces Fresh Scandal" *Asian Wall Street Journal* (4 August 2004) A1 [Browne].
[595] "Bank of China Theft Sets New Standards in Skullduggery" *South China Morning Post* (14 May 2002) 3 ["Bank of China Theft"].
[596] Hu Shuli & Gu Wei, "What Happened at the New York Branch of BoC?" *Caijing* 54 (20 February 2003), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=2338> [Hu & Gu].
[597] Associated Press, "Beijing Says Bank Fine Serves As a Warning to the Industry" *Asian Wall Street Journal* (23 January 2002) 4.

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1992 and 2000.[598] In fact, such abuses are believed to be widespread in China's state banking industry, where influential borrowers receive special treatment and loans that are never repaid.

6. The BoC Kaiping branch embezzlement case (2001)

Up to now, the largest case of spectacular embezzlement resulting from lax supervision and internal controls was the so-called "Kaiping Case" of 2001, which involved bank funds worth at least USD 483 million being stolen between 1992 and 2001 by three managers at a BoC local branch in Kaiping city, Guangdong province. The three managers in question, Xu Chaofan, Yu Zhendong and Xu Guojun, had absconded overseas with embezzled money days before an investigation by BoC's headquarters discovered this theft in October 2001.[599] Yu Zhendong fled to the U.S. but was returned by the FBI to Chinese authorities in April 2004, while the other two still remain at large.[600]

This theft was described as the biggest banking scandal in China since the establishment of the communist government in 1949. Its scale was astonishing: the money stolen, USD 483 million, was more than the aggregate income of the city of Kaiping for the previous 10 years up to 2001, and the city had attracted just over USD 100 million in foreign investment by then.[601]

This case exposed how weak the internal controls were at the bank. The three former managers at BoC's Kaiping branch were able to steal money from the bank for 8 years, and what is particularly appalling is that not only did the three go undetected but they were promoted during the time when the gross theft was taking place.[602] More

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[598] Hu & Gu, *supra* note 596.
[599] Pan Xiaobing & Wang Feng, "The Kaiping Case Returns to the Spotlight" *Caijing* (5 May 2004), online: Caijing <http://www.caijing.com.cn/english/2004/040505/040505kaipin.htm> [Pan & Wang]
[600] Browne, *supra* note 594.
[601] "Bank of China Theft", *supra* note 595.
[602] *Ibid.*

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importantly, theft on a grand scale like this could not possibly have been committed by only the three people that have so far been identified as the chief culprits in the Kaiping case. Indeed, after Yu Zhendong was repatriated to the Chinese authorities by the US government, new evidence emerged as the investigation continued, suggesting possible involvements of others at the bank. The complete version of the real story has yet to be revealed as the case proceeds further.[603]

7. The repercussions of bank failures and their solutions

The enormity of these most egregious banking scandals in China is costing the country much-needed investor confidence at a time when the state banks are preparing for overseas listings. The negative impact of these bank failures is particularly acute when China's transition has come to a critical point where the danger of an emerging "crony market economy" is looming large. In this context, banking reform, although primarily concerned with improving their corporate governance, especially with regard to the lax internal supervision and control, requires complementary measures to be adopted in related areas, most importantly anti-corruption and the transformation of the role of the government.

This need for complementary reform is clearly demonstrated in those reported cases, whereby senior bank officials taking bribes and colluding with private businesspeople to approve problem loans is a common situation. The power to control and allocate economic resources has been frequently abused for rent-seeking purposes. This cannot be cured only through corporate governance reforms at the banks without also changing the institutional and legal environments that incubate or indulge these abuses.

Moreover, from what has been revealed, local governments have often played a large part in some of the most serious bank failures, and not accidentally the province of Guangdong, China's fastest growing regional economy, has contributed largely to the

[603] Pan & Wang, *supra* note 599.

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spectacular bank scandals of recent years. There are two main reasons for this peculiarity. First, because the role of the government, especially at local levels, is not yet properly defined to accommodate the needs of a market economy, government officials often interfere with banks' lending decisions on behalf of their favored borrowers, which increases the likelihood of incurring NPLs. Second, because of the emphasis on one-dimensional "GDP growth" indicators to evaluate government officials' performance, as has been maintained over the past decade by the central government, local officials tend to disregard the need for nurturing a healthy credit culture and establishing effective property rights protection mechanisms in their jurisdictions, which is certainly not helpful in averting loan defaults or financial fraud.

Another problem associated with these bank scandals is that China's speculative stock market seems to have provided rent-seeking bankers with a strong incentive to illegally divert bank funds into the stock market for lucrative positive abnormal returns. This has had a negative impact on both the stock market and the banking sector, thus entailing the danger of threatening a systemic risk.[604]

Therefore, to effectively deal with bank failures and bring vigorous discipline and monitoring to the financial system, the following steps need to be taken at the next stage of China's financial reform:

(1) Strengthening internal controls and corporate governance in the banking sector, and establishing personal accountability, including criminal liability, of bank officials who fail to perform their duty diligently or conduct corruptive activities that cause questionable loans or NPLs.

(2) Furthering liberalizing the financial sector and introducing competition to the state monopoly in credit provision and also share issuance, and bringing more market discipline into the financial system.

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[604] Hu Shuli, "What Crime Has Liu Jinbao Been Implicated?" *Caijing* (5 March 2004), online: Caijing <http://www.caijing.com.cn/mag/preview.aspx?ArtID=5268>.

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(3) Combating corruption in both the banking sector and the government to vigorously punish rent-seeking activities as well as outright fraud and theft.

(4) Implementing complementary measures to prevent the vicious interaction between illegally diverted bank funds and stock market speculation.

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Section VI
The "Big Four" Preparing for Overseas Listings

After all necessary preliminary steps have been taken (their actual effect is another matter and will only be judged fairly after several years), the government is now preparing to sell minority stakes in the "big four" to international investors through their overseas listings. In this effort, BoC and CCB are making faster progress than ICBC and ABC and their planned IPOs are expected to take place as early as in the second half of 2005.

1. The reasons for overseas listings

As widely recognized, the most important reason for overseas listings is that forcing China's state banks to subject themselves to a much higher level of scrutiny by international market regulators, even at the cost of embarrassing exposures of scandals, may be an effective inducement to bring about systemic changes in the whole banking sector. The requirements of transparency, managerial performance and investor returns in overseas capital markets would be beneficial disciplines on China's banks and would compel them to meet the challenge from international competitors as China further liberalizes its financial sector.

According to expert opinions, the government's main goal in banks' overseas listings is not to raise cash. Compared to how much money the government has so far used to bail out the indebted "big four," which has reached a total of USD 250 billion in recent years, proceeds of overseas listings, not exceeding USD 10 billion for each bank, would be modest.[605] Therefore, instead of more funds, the government hopes to introduce vigorous discipline and monitoring of banks' lending practices that must accompany China's transition to a market economy. For example, fixing lax lending standards that comes with inspection by international auditors and management consultants is critical if the

[605] CCB expects to raise USD 5 billion -10 billion in its IPO, while the BoC is hoping for USD 3 billion - 4 billion from its own flotation.

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"big four" are to compete effectively against foreign competitors when China's banking sector opens fully in December 2006.[606]

2. The shadow surrounding the listing plans of BoC and CCB

The most relevant issue is the choice of listing location where the "big four" will launch their IPOs. The coming into force of the Sarbanes-Oxley Act (SOX) has given China's banks second thoughts. Tightening securities market rules and ongoing investor litigation against listed companies, such as the class action brought by American investors against the insurer China Life, are deterring BoC and CCB from listing in the US.[607]

Recently, the BoC, which is expecting an overseas listing as early as in the second half of 2005, announced that although it has not yet decided where its shares will be listed, SOX will be a strong influencing factor in its final decision. It is widely believed that the stock exchanges in Hong Kong and London are very likely to be the final listing places for a dual IPO of the BoC. As to CCB, uncertainty still surrounds its final listing plan. It has been indicated by the bank that the stock exchanges in Hong Kong or Singapore will be the primary market of choice, supplemented by a 144A private placement in the US, which does not require filing financial statements with the SEC, and POWL (public offers without listings) in Japan.[608] CCB is also studying possibilities of listing in China's A-share market.[609]

Some western commentators have frowned on the uncertainty in the banks' listing plans, arguing that if the BoC and CCB do opt out the NYSE because of its stricter regulation standards, this might send a bad signal to potential investors, which is not desirable at a

[606] "Casino Capital", *supra* note 262.
[607] Bei Hu & Bloomberg, "Theft May Postpone BOC's Planned Flotation" *South China Morning Post* (25 January 2005) 1.
[608] Rule 144A is a safe harbor exemption from the registration requirements of Section 5 of the 1933 Securities Act in the US for sales of certain restricted securities to qualified institutional buyers, which are commonly referred to as QIBs. A POWL is a share issuance structure that enables firms to offer stock to retail investors without listing on the local exchange.
[609] Yu, *supra* note 572.

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time when the two banks are already struggling to persuade foreign banks to take minority stakes.[610]

There are other difficult issues as well. For example, because some potential investors in CCB and BoC are worried about the health of their balance sheets and question whether the banks' lending practices have improved enough to avoid a sharp rise in NPLs after their IPOs, they are pressuring the Chinese government to pledge help to the two banks as a condition for their overseas listings. International investors believe that a promise of financial support by the Chinese government is essential to mitigate fund managers' concerns about the first international IPO from China's banking system. They demand that the Chinese government make an open pledge to international investors because the market will not trust what the banks state in their prospectuses.[611]

However, this demand for a government pledge from the international investors is not likely to be accepted by the Chinese government. As just explained, the very reason of listing the state banks overseas is to introduce vigorous discipline and monitoring by both regulators and investors in mature capital markets, thus establishing effective corporate governance mechanisms to avoid further accumulation of NPLs. Therefore, an open pledge by the Chinese government that it will bail out the banks in times of financial debacles would actually work against the government's expectation of the banks' overseas listing— the removal of moral hazard from the "big four" and the instalment of market discipline into their daily operation. Otherwise, the NPL problem will not diminish even after the banks go public on the overseas capital markets.

Despite these negative reactions to the listings of Chinese state banks from the international capital markets, what will really happen to the IPOs of CCB and BoC, and eventually the other two of the "big four," ICBC and Agricultural Bank of China, still remains to be seen. After all, as the banks are preparing for their overseas listings, the fact that China's banking reform has proceeded this far is already a significant step

[610] "Big Apple Blues", *supra* note 580.
[611] Francesco Guerrera, "Call for Beijing to Pledge CCB Aid" *Financial Times* (17 September 2004) 28.

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toward ultimately establishing a modern banking sector in China. Although this process will certainly take time, it is encouraging that the Chinese government started to make significant policy changes in the banking reform strategy addressing both ownership restructuring and corporate governance improvement.

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Section VII
Conclusion

According to recent progress reports of major international rating agencies such as Moody's and S&P, China's banking system is "in the midst of revolutionary change" and the outlook on China's banking system is "positive".[612] Even with these optimistic estimates, China's banking reform is by no means an easy task and is expected to be a gradual and highly challenging process in order to establish a modern banking sector operating on the basis of commercial lending and prudent credit scoring. Predictably, more resources and political determination are needed to push further the banking reform. This is an overall assessment of the prospects of China's banking reform.

With respect to necessary future steps of reform, the following remarks are intended to provide some indications of reform direction and policy recommendations.

1. There are two key issues in China's banking reform, both of which are closely associated with reforming the legal and institutional environments.

There are two key issues involved in China's banking reform: addressing the NPL problem, and reforming the ownership structure of state banks and the poor corporate governance it produces. As earlier discussion suggests, the NPL problem is only partly attributable to state intervention, and a large portion of NPL creation has its causes in other aspects of China's transition economy that have been lagging behind market-oriented reforms. These other aspects are primarily related to legal and institutional underdevelopment during China's transition, such as the lack of effective bankruptcy rules to recover lenders' claims, the weaknesses in local credit culture to honour loan repayments, and the single-dimensional role of local governments in promoting regional growth that has led to imprudent loan allocation. Therefore, in addition to reducing state

[612] Andrew Browne & Jane Lanhee Lee, "S&P 'Positive' on 2 China Banks" *Asian Wall Street Journal* (1 December 2004) M.3.

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intervention, the ultimate solution to the NPL problem would also require further progress being made in reforming China's legal and institutional environments.

Similarly, reforming the ownership structure of the state banks, while necessary, if without advances in transforming the role of the government to suit a market economy, a state owner with a controlling stake in shareholding banks would not essentially change its pattern of behaviour, leaving the removal of government intervention in banks' lending decisions an impossible task.

2. Devising mechanisms to contain rent-seeking activities is both a critical complement to banks' corporate governance reforms aimed at strengthening internal controls, and a necessary condition for market mechanisms to develop in a benign environment.

During China's transition, market-oriented reforms have come to a critical point where signs of administrative power entering into the market for rent-seeking opportunities are emerging. In this sense, the danger of China moving toward a "bad market economy" is not an imaginary threat. In China's current institutional environment, where market mechanisms are being developed under a largely illiberal political regime, those with control over resource allocation, such as bank officials in charge of allocating scarce capital, have a natural tendency to enter the rent-seeking process. This is among the primary causes for corporate governance failures at the state banks. Accordingly, devising mechanisms to contain rent-seeking activities, which in turn would lead to legal reform and government transformation, is a crucial complement to banks' corporate governance reforms aimed at strengthening internal controls. In the meantime, the development of market mechanisms also needs to be free from the distortion brought by rent-seekers. In this connection, China's banking reform must proceed with the assistance of anti-corruption campaigns in the financial sector.[613]

[613] For example, in March 2005, the former chairman of CCB, Zhang Enzhao, abruptly resigned from the bank for "personal reasons," and has been under investigation by the anti-corruption department of the

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3. Fuller privatization of the "big four" is not a practical option for reform at current stage.

China's banking reform, while closely associated with the SOE reform, is distinct from the latter in terms of viable ownership reform options. The shareholding restructuring and planned overseas listings of the "big four" are positive and necessary steps toward establishing a modern banking system in China, but further privatization would be extremely difficult for both economic and political reasons.

Under any potential privatization scheme for the "big four," who would be eligible for taking a controlling stake is a highly sensitive issue in a political sense, given the critical role of the banking system in China's economic structure. Economically, since the "big four" are all of gigantic size and in combination control 60 percent of China's total bank assets, to obtain a controlling stake would require capital investment worth up to 50 percent of China's GDP. This is in practice extremely difficult for any private or foreign equity investors to finance. Besides, foreign controlling stakes at the "big four" would result in billions of dollars pouring into China, thus putting the country's domestic monetary stability at tremendous risk and engendering an inflation crisis. [614]

Therefore, unlike China's SOEs, the "big four" are not suitable for privatization, at least at the current stage of banking reform. By comparison, a more viable option is to invite

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Communist Party. The real reason behind his departure from the bank, as widely speculated in China's financial industry, is not likely to be "personal" but possibly relates to a lawsuit filed in the United States, alleging that Zhang took a bribe of USD 1 million from an American firm for helping it to secure a lucrative information-technology contract with the bank. The plaintiff in this case is a former business partner of CCB, Beijing-based Grace & Digital Information Technology, which claimed that it was deprived of business benefits under its previous contract with CCB. The principal defendant is Fidelity Information Services, an American financial services company, which was accused of bribing Zhang to sign a new contract that excluded the plaintiff. Accordingly, Fidelity Information Services is faced with the allegation that it violated America's Foreign Corrupt Practices Act, which prohibits American firms to bribe government officials in foreign countries in exchange for business opportunities. See "Personal Banking" *The Economist* (23 March 2005). This latest bank scandal has spurred a new round of intense debates among both domestic and overseas commentators, over whether Chinese state banks are yet "ready" to go public overseas before "cleaning house" at home first.

[614] Zhong Jiayong, "The Implication of the Lowest Competitiveness of State-owned Banks in Beijing's Banking Circles" *Business Watch* (2 December 2004), online: Business Watch <http://www.businesswatch.com.cn/ArticleShow.asp?ArticleID=636>.

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domestic and international strategic investors to hold minority stakes, which would be both politically realistic and commercially viable. Besides, overseas listings and even moderate reform of the ownership structure of the "big four" is likely to generate considerable corporate governance improvement, because disciplines in global equity markets can mitigate the agency problem much more effectively than could the domestic stock market, which is speculative and retail-oriented.

4. While shareholding restructuring and overseas listings would improve corporate governance of the "big four," to create further incentives to perform, the liberalization of China's financial sector also needs to be accelerated.

Further opening up China's financial system under its WTO commitments will in general have a positive effect on its banking reform. As foreign and private competitors challenge the monopoly status of the state banks in providing financial services to the Chinese public, heavier pressure from the market could be imposed on the "big four" to perform and increase their operational efficiency and quality of service.

5. The complementary nature of structural reforms is a central theme of China's transition.

The strong complementarity between structural reforms of China's banking system, SOEs, and stock market is not only implicated in the long existing lender-debtor relationship between the banks and SOEs, which has not been based on commercial terms for years, but is also evidenced by the risky pattern of bank funds illegally entering the stock market for lucrative returns on share speculation, which creates more bubbles and increases the possibility of a systemic financial crisis. Therefore, China's banking reform cannot afford to be delayed further and must proceed decisively as an urgent priority. Failing that, the prospects of the privatization of SOEs and stock market reform could be severely compromised.

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6. The proper sequencing of banking reform is that "cleaning house" and overseas listings should proceed simultaneously to create synergies of complementary reform initiatives.

The specific issue of sequencing involved in the process of China's banking reform is highlighted in the ongoing debate in China's policy and academic circles over the appropriate approach toward reforming the "big four" state-owned commercial banks plagued by both NPLs and rampant corruption.

On the one hand, some Chinese economists and foreign commentators argue that China's banking reform should adopt an approach of "cleaning house first, going public overseas second," which prioritizes corporate governance reform to strengthen internal controls and curb financial corruption over overseas listings. On the other hand, other economists advocate an alternative strategy, which sees overseas listings as an external lever to propel corporate governance reform and greater competition in the banking sector. The latter position on the sequencing of banking reform presents a rationale for accelerated financial reforms at later stages of China's transition, which is similar to China's primary motivation in joining the WTO in 2001, i.e., to obtain an external lever to precipitate deeper and broader structural reforms when domestic conditions, especially the political will, have not been fully receptive to such advances.

In light of this controversy over the sequencing of China's banking reform, the basic judgment of this study is more in line with the latter position, i.e., pursuing overseas listings as a strategy for achieving external stimuli for otherwise reluctant or difficult reforms under existing political and institutional constraints. While it is uncertain how long and how much resources it will take to achieve meaningful results in domestic corporate governance reform and anti-corruption initiatives in China's banking sector (i.e., "cleaning house"), the urgency of preparing China's banks for greater competition from overseas financial institutions under the country's WTO commitments is clear. More critically, the complementary role of banking reform in helping achieve positive

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results in China's enterprise and stock market reforms provides an even stronger rationale for seeking overseas listings even if the banks are not yet independent commercial lenders and efficient resource allocators. It is widely held by many Chinese economists that external pressures from international investors and regulators could propel or force fundamental banking reforms at home, which might otherwise be off the government's reform agenda because these reforms will be painful and unavoidably bring about large dislocations in the national economy.

Meanwhile, although overseas listings are *necessary* for creating incentives to perform and compete in China's banking sector, they are not *sufficient* to bring about good corporate governance, effective internal controls, and significant reduction of corruption. Rather, domestic reform initiatives to build good legal, financial and corporate governance institutions should go hand in hand with overseas listings to best utilize and capitalize on the benefits of good institutions and of the much tighter discipline provided by overseas markets.

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Chapter 7: Conclusion

Chapter 7 concludes by reiterating the central argument of this study and the major findings in preceding chapters that support it. Chapter 7 also indicates the broad implications of China's experience for developing and transition economies in their pursuit of economic growth, before ending with a proposal for a future research agenda informed by but not comprehensively covered in this study.

1. Reiterating the central argument and further clarifying "gradualism," the key concept in this study on which the central argument is based

A. The central argument

This study proposes a dynamic theory of corporate governance which relates to transition economies— particularly China— committed to a process of gradualism in legal and institutional reforms, as opposed to "big bang"-type reforms favoured by other commentators which have had mixed-to-poor results in Central and Eastern Europe. The proposed dynamic theory of corporate governance emphasizes the merits of sequencing, pacing, and complementarity of structural reforms in the SOE, banking, and securities sectors in an economy in transition from central planning to the market.

Specifically, the proposed dynamic theory of corporate governance sheds light on the merits, as well as limits, of "transitional" or "second-best" institutions adopted by China during its transition under a gradualist strategy. This gradualist strategy is in contrast to the "shock therapy" strategy for mass and rapid privatization undertaken in Russia, whereby necessary legal and institutional reforms that should have preceded or complemented privatization were missing, and the subsequent delinquencies in corporate governance of privatized firms and capital market regulation has resulted in widespread insider dealing, asset stripping and managerial abuses of shareholder rights.

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These "transitional institutions" are imperfect and not fully consistent with market basics, yet nevertheless efficiency-enhancing at the early stages of China's economic reform as stepping-stones toward the market under legal and institutional constraints. At later stages of the transition, these transitional institutions should be subject to adjustment or abandonment, such as government ownership and control of township and village enterprises (TVEs), which have been widely replaced by private ownership since the mid-1990s.

B. The meaning and implications of "gradualism" with respect to corporate governance reforms and related financial reforms in an economy in transition from central planning to the market

There are three dimensions of the meaning and implications of "gradualism," the key concept used in this study:

(1) Sequencing and pacing of reform initiatives under existing legal and institutional constraints in an economy in transition;

(2) Complementarity and synergies between mutually supporting and contingent legal and institutional reforms; and

(3) Self-adaptability and self-adjustability in the process of corporate governance reforms and financial market development, which stresses the functions of "transitional" or "second-best" institutions designed to accommodate a country's existing legal and institutional environments in its early stages of transition, as opposed to a "convergence" approach which favors importing overseas experience or "international best practices" from mature market economies.

Measured against the three dimensions of "gradualism," one important clarification of the gradualist strategy adopted by China is that necessary structural reforms in China's enterprise, banking and securities sectors need not be "slow" or always subject to protracted delay regardless of changes in China's institutional environment as its transition proceeds. Rather, the sequencing and pacing of reforms can be self-adaptive by adopting an accelerating pace of reform at later stages of the country's transition,

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especially after China's accession to the WTO, which has made the need for deeper and broader structural reforms more urgent.

Another necessary clarification of "gradualism" used in this study is that in terms of appropriate approaches toward initiating and implementing reform schemes, developing and transition economies need to take into account the limits of legal and institutional transplantation. On the one hand, it might be tempting for these economies to import legal rules and institutional arrangements from advanced market economies in the process of their corporate governance reforms and financial market development. On the other hand, a critical constraint on such "convergence" approach is that without establishing necessary complementary institutions that support the proper functioning of the imported institutions in their home countries, any attempt at transplanting advanced experience from overseas is likely to produce limited results at best, and complete failure at worst, or even unintended consequences that may be the opposite of what was intended.

What is more, this constraint on convergence not only applies to developing economies trying to import "global best practices" from mature market economies, but can also be the case in some developed economies as well. As illustrated in the controversy over Japan's recent effort to amend its corporate law to establish the Anglo-American type of rules on M&As (mergers and acquisitions), particularly on hostile takeovers, mature market economies cannot effectively transplant from each other otherwise workable corporate governance institutions without also establishing necessary complementary conditions. For example, Japan's latest attempt at importing the "poison pill" mechanism from the US and UK capital markets without also importing necessary supporting institutions, such as judicial review of business judgments, the fiduciary duty of the boards of directors toward shareholders and shareholder litigation mechanisms, is harshly criticized by some economists as "imitating much of what is wrong with Anglo-American corporate governance."[615]

[615] "Shaking Up Corporate Japan" *The Economist* (23 March 2005).

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As to "necessary legal and institutional reforms" that should precede or complement privatization, they primarily relate to a country's reform efforts aimed at providing investors with strong protection and ensuring the proper functioning of basic market mechanisms, such as reforms in the banking sector and securities markets to introduce higher efficiency in resource allocation, to control financial fraud and corruption, and to curb insider dealings, asset stripping and managerial abuses.

Moreover, the "changing institutional environment" in an economy in transition refers primarily to situations where both market mechanisms and private ownership, which were underdeveloped or weak at early stages of reform, have evolved to the extent that continuing adoption of transitional or "second-best" institutions is no longer efficient, and more market-oriented institutions and an effective legal system based on an independent and competent judiciary are needed to replace the "stepping stones" toward a full market economy.

2. A summary of major findings in this study

A. Empirical findings: Russia

The spread of privatization programs around the world has been propelled by the inefficiency of state-owned firms and the resulting search for significant improvements in performance. However, there have been disappointments, particularly in the transition economies in Central and Eastern Europe. For example, "squandering and diversion of resources by political actors have often been replaced by squandering and diversion of resources by private actors," as Russia's experience with mass and rapid privatization demonstrated, whereby insider dealings, asset stripping and managerial abuses became rampant in an institutional vacuum due to the lack of legal and institutional arrangements to protect shareholders.[616] Disappointments in these countries have raised a new question:

[616] World Bank 2002, *supra* note 124 at 59.

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how to ensure that privatization produces benefits.[617] As suggested by this study, pursuing necessary legal and institutional reforms that should precede or complement privatization under a gradualist strategy is a better approach to the market, at least for some economies.

Most importantly, this study reviews existing evidence in academic research of the clear gap between the intended merits of a "big bang"-type transition as a "less reversible" approach to the market, and the mixed-to-poor results of mass and rapid privatization in Central and Eastern Europe, and in particular Russia's failure in implementing successful privatization under the "shock therapy" strategy.

On the one hand, the asserted benefits of "less reversible" reforms lack convincing empirical evidence, as unsuccessful privatization may have actually generated added costs of redressing the missteps in previously implemented mass and rapid privatization schemes by "reversing" reform outcomes, such as the re-nationalization of previously privatized firms and state prosecution of private entrepreneurs on corruption and economic fraud grounds. The recent Yukos case is a dramatic example of how an ill-executed privatization scheme can cost both investors and the firm greatly if the government later pursues a "redress" policy. Yukos, the privatized oil company and formerly Russia's biggest oil exporter, was virtually re-nationalized in 2004 by the Russian government, and its former CEO and biggest shareholder, Mikhail Khodorkovsky, has been facing criminal charges of theft of state assets, tax evasion and misappropriation.

On the other hand, "big bang"-type approaches are not the only alternative to achieve the goal of making market-oriented reforms less reversible. As China's experience in actively pursuing its membership in the WTO demonstrates, voluntarily opening up to greater liberalization of international trade in goods and services and actively participating in the world economy can produce similar incentives and stimuli for a transition economy to make commitments to "less reversible" market-oriented reforms.

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[617] *Ibid.*

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B. Empirical findings: China

China's schemes of corporate governance reform and related financial reforms have been implemented in three important sectors. Accordingly, this study presents these three major applications of the dynamic theory of corporate governance to China: (1) corporate governance reforms of China's state-owned enterprises (SOEs), township and village enterprises (TVEs) and private enterprises; (2) reforms of the stock market and corporate governance of listed companies (including partially privatized SOEs and private enterprises); and (3) banking reform. The following summary is intended to highlight their respective effects and lessons that should inform future reforms.

(1) Corporate governance reforms of major types of China's enterprises, including SOEs, TVEs, and private enterprises

Corporate governance reforms of major types of Chinese enterprises, including state-owned enterprises (SOEs), township-and-village enterprises (TVEs) and private enterprises, have presented a unique perspective on the dynamics of transition under legal and institutional constraints. In general, the empirical review presented in this study offers a support for ownership reform aimed at expanding private ownership in the competitive sectors of the national economy. However, corporate governance reform has also encountered a number of challenges, especially those attributable to legal and institutional constraints. This pattern of reform signals the need for a gradualist strategy. Some general conclusions can be drawn:

(a) The "politics" of economic reform and the under-development of legal and institutional environments are the major determinants of a gradualist approach to corporate governance reform in China.

(b) There has been a considerable distance between "design on paper" and "implementation on the ground" of corporate governance reform in China. On the one

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hand, the deficiency or ineffectiveness in local enforcement of certain centrally mandated reform policies is both a reflection of the "central-local game" where interests at different levels of government diverge during the transition. On the other hand, local innovations and experiments with pilot programs are also an important source of new understanding of institutional development at the central level.

(c) Corporate governance reform, in particular ownership transformation through privatization of SOEs, has produced positive results in terms of efficiency improvements, but also contributed to inequality between different social groups and regions. Therefore, the balance of "efficiency" and "equality" needs to be addressed to reduce social resistance and discontent that could hamper China's successful transition to the market.

(d) Transitional institutions can serve as "second-best" solutions to the building of efficient corporate governance structures at the early stages of reform. However, these transition institutions need to be promptly adjusted to meet new challenges when transition has proceeded to the next stages and the institutional environment has evolved.

(e) In reforming China's business sector, it is crucial to avoid the danger of falling into a "bad (crony) market economy." Some worrying signs of the state intervening in the business of the market during the process of corporate governance reform in both SOE and private sectors, such as using public power for private gains, must be taken seriously if China is to build a truly competitive enterprise sector and complete a successful transition to the market.

(2) Stock market reform and corporate governance reform of listed companies

As to the reforms of China's stock market and corporate governance of Chinese companies listed on both domestic and overseas capital markets, the subjects of examination include partially privatized SOEs, including state monopolies, as well as private enterprises.

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The sequencing of China's stock market reform and corporate governance reform of listed companies primarily concerns a policy shift from "borrowing" legal, financial, and corporate governance institutions from overseas (i.e., "piggy-backing" through overseas listings of Chinese firms), to "building" such institutions at home. While "borrowing" good institutions from overseas generated significant benefits at early stages of China's transition, this strategy is no longer sustainable. At later stages of the transition, accelerated structural reforms are necessary for both China's own sake in building a full market economy, and for avoiding the "spill over" effect of China's poor domestic institutions across borders. The "spill over" effect is increasingly likely to be brought about by spectacular corporate governance failures of Chinese companies listed overseas, given the country's rapid integration into the world economy.

Another critical issue concerning sequencing in the reforms of China's stock market and corporate governance of Chinese listed companies is the challenge of searching for an effective solution to the problem of a split share structure identified with the division of tradable and non-tradable shares, which is widely recognized among China's policy and academic circles as the most significant cause of the deficiencies in the institutional structure of China's stock market. The basic conclusion of this study on the solution to the split share structure is that making non-tradable shares tradable and therefore dismantling the inefficient share structure in the stock market, which usually results in poor corporate governance practices of listed companies, should be a top priority on the reform agenda of the government at the new stage of China's transition. The success of this critical task is a necessary precondition for other reform initiatives aimed at improving the operational quality of the stock market to generate efficient results.

By contrast, compared to the urgency of abolishing the split share structure, immediate removal of restrictions on foreign entry into China's stock market is not likely a priority in the sequencing of future reforms. While expanded entry of both foreign capital and financial institutions is necessary for enhancing competition in China's stock market, which should improve its operational quality, this assumed or asserted benefit of greater financial liberalization is subject to a critical limitation in the Chinese context — the

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slowness in the progress of reform of China's currency/exchange rates and interest rates regimes. Specifically, the lagging progress in reforming or modernizing China's currency and interest rates regimes leaves much room for speculative foreign capital to bet on the re-evaluation of the yuan if free from entry restrictions, and therefore makes the full opening up of China's capital markets a much less urgent issue on the government's reform agenda. The primary concern of the government is that a systemic financial crisis could be engendered by abrupt capital inflows or outflows, when China's foreign exchange and interest rate regimes have yet to introduce higher levels of market-oriented reforms and liberalization.

(3) Banking reform

The specific issue of sequencing involved in the process of China's banking reform is highlighted in the ongoing debate in China's policy and academic circles over the appropriate approach toward reforming the "big four" state-owned commercial banks plagued by both non-performing loans and rampant corruption.

On the one hand, some Chinese economists and foreign commentators argue that China's banking reform should adopt an approach of "cleaning house first, going public overseas second," which prioritizes corporate governance reform to strengthen internal controls and curb financial corruption over overseas listings. On the other hand, other economists advocate an alternative strategy, which sees overseas listings as an external lever to propel corporate governance reform and greater competition in the banking sector. The latter position on the sequencing of banking reform presents a rationale for accelerated financial reforms at later stages of China's transition, which is similar to China's primary motivation in joining the WTO in 2001, i.e., to obtain an external lever to precipitate deeper and broader structural reforms when domestic conditions, especially the political will, have not been fully receptive to such advances.

In light of this controversy over the sequencing of China's banking reform, the basic judgment of this study is more in line with the latter position, i.e., pursuing overseas

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listings as a strategy for achieving external stimuli for otherwise reluctant or difficult reforms under existing political and institutional constraints. While it is uncertain how long and how much resource it will take to achieve meaningful results in domestic corporate governance reform and anti-corruption initiatives in China's banking sector (i.e., "cleaning house"), the urgency of preparing China's banks for greater competition from overseas financial institutions under the country's WTO commitments is clear. More critically, the complementary role of banking reform in helping achieve positive results in China's enterprise and stock market reforms provides an even stronger rationale for seeking overseas listings even if the banks are not yet independent commercial lenders and efficient resource allocators. It is widely held by many Chinese economists that external pressures from international investors and regulators could propel or force fundamental banking reforms at home, which may otherwise be off the government's reform agenda because these reforms will be painful and unavoidably bring about large dislocations in the national economy.

Meanwhile, although overseas listings are *necessary* for creating incentives to perform and compete in China's banking sector, they are not *sufficient* to bring about good corporate governance, effective internal controls, and significant reduction of corruption. Rather, domestic reform initiatives to build good legal, financial and corporate governance institutions should go hand in hand with overseas listings to best utilize and capitalize on the benefits of good institutions and much tighter discipline provided by overseas markets, as indicated by the lessons of Chinese companies listed overseas.

3. Concluding remarks on the broad implications of China's gradualist strategy for corporate governance reforms and related financial reforms for developing and transition economies

There are broader implications of China's experience in corporate governance reforms and related financial reforms for development, especially for developing and transition economies seeking to achieve economic growth under existing legal and institutional

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constraints. It is also important to note that there are both positive and negative lessons from China. These broader implications are as follows:

A. Building market-supporting institutions is important for transition economies.

During the transition from centrally planned economies to market economies, new market-supporting institutions must be created, which is a highly complex and unpredictable process.[618] In particular, if privatization precedes legal and institutional reforms, self-dealing and wealth destruction through assets stripping and stealing could lead to serious economic consequences in an institutional vacuum. This requires a sensible allocation of limited political energy in transition economies, which raises the challenge of proper priority setting under information and political constraints.

B. Successful institutional development needs appropriate sequencing.

During the process of transition, an institutional vacuum should be avoided. China's "dual-track" reforms have demonstrated the necessity of allowing the old or existing institutions continue to function, before new institutions can finally develop out of the transforming social, economic, and political settings.[619] The lack or mishandling of sequencing, as was the case in Russian privatization, could lead to disastrous social and economic consequences.

C. "Sensible, but imperfect" transitional institutions can promote economic growth.

China's transition experience provides economists with a valuable resource for new thinking on institutional changes that is different from neo-classical economics. One such example is the role of "sensible, but imperfect" transitional institutions in promoting economic growth.

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[618] McMillan & Naughton, *supra* note 52 at 459–460.
[619] Qian, *supra* note 42 at 395.

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As China's transition experience has shown, some transitional institutions can be more effective than best-practice institutions *for a period of time*. The need to adopt these institutions is determined by the fact that market-supporting institutions need adequate human capital that can enforce them, which will take years to develop in transition economies, at least at the early stage of their reforms.[620] The role of transitional institutions, therefore, is best understood as the "stepping stones" toward a full market economy. When growth has been sustained and stabilized, it will generate sufficient economic and social resources to support more difficult reform programs, and also help strengthen the political will to pursue a more challenging and accelerated reform agenda. At this stage, it is both desirable and necessary for a transition economy to move forward by adopting best-practice institutions, such as the rule of law and a well-defined property rights system, as the previously efficient transitional institutions become undesirable and eventually wither away or vanish.

D. China's gradualist approach to transition may not work, or work as well as with China, in other transition economies under different institutional conditions, especially the "initial conditions." In other words, there is no "one-size-fits-all" solution to successful transition and institutional development.

China's transition approach is characterized as "crossing the river by feeling for the stones" and inherently rejects the "big bang" strategy that neo-classical economists regard as the only way to avoid the "partial reform trap" and render reforms "less reversible." The "partial reform trap" is a term used frequently by shock therapists, who have warned that if reform is not conducted in a swift and comprehensive manner, there will likely be a reversal of transition by the remnants of the old planning system.[621] Contrary to this prediction, China has not fallen into the "partial reform trap," and has also managed to make its reforms "less reversible" by actively participating in the global economy.

[620] *Ibid.* at 394.
[621] See McMillan & Naughton, *supra* note 52 at 459; Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions" (1998) 50 World Politics 205.

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As a relevant matter, one crucial paradox of the "big bang"-type reforms has not received adequate attention: the impediments to planning a comprehensive reform strategy are similar to the impediments to planning the economy. The problem confronting designers of the "big-bang"-type reforms is the same information barrier faced by planners. Logically, designers of "big-bang"-type reforms need to know a great deal of information to decide on many specific schemes and initiatives, which is a very difficult task. Arguably, it is easier to make such decisions on a piecemeal basis than to address them all at once.[622] Therefore, the case for gradualism seems to have another rationale from the perspective of informational constraints on reform designers.

However, that gradualism has worked in China has largely depended upon the evolutionary and path-dependent nature of its institutional development, which means that other transition economies may not find the Chinese pattern of "piecemeal social engineering" suitable for their own institutional environments.[623] In this sense, the most important contribution of comparative research on transition economies may not be to inspire countries to *copy successful schemes*, but to *avoid mistakes* already made.

The major implication here is that the path toward a market economy is not a universal, "one-size-fits-all" set of prescriptions. Diverse approaches are possible. Therefore, policymakers must accommodate country-specific conditions, especially "initial conditions," in designing their countries' transition strategies.[624] In examining the role of the "initial conditions" in transition, the debate between the "convergence school" and the "experimentalist school" among scholars pursuing research on transition economies is of particular relevance. Specifically, the "convergence school" is opposed to the "experimentalist school" among different academic opinions on what has worked for China's transition. Scholars in the "convergence school" argue that China has obtained favorable outcomes of reforms not *because of* gradualism, but *despite* gradualism.

[622] McMillan & Naughton, *ibid.* at 469.
[623] The notion of "piecemeal social engineering" comes from Karl Popper, which means that social evolution allows the designing of many *ad hoc* solutions for specific problems, and human ends can be achieved through small adjustments which can be continually improved upon. Karl Raimund Popper, *The Poverty of Historicism* (Routledge, 1957) at 61.
[624] Qian, *supra* note 42 at 394.

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According to them, an important explanation for China's rapid growth, as well as the fact that gradualism has not become an impediment to growth, is China's economic structure at the start of reforms. While the "convergence school" believes that China's successes result from the convergence of its institutions with those of non-socialist market economies, the "experimentalist school" insists that China's rapid growth is primarily attributable to the evolutionary, experimental, and incremental nature of its reforms.[625]

In particular, the debate between "convergence school" and "experimentalist school" over the actual causes of China's growth has led to discussions about whether different "initial conditions" at the beginning of reforms in different countries played a central role in their taking different approaches to transition. In the view of the "convergence school," China's initial conditions were characterized as "a largely agrarian economy with a socialist welfare system that covered only the urban population," which was uniquely favorable to inducing economic growth, especially at early stages of reform. Therefore, these economists conclude, China's growth was due not to gradualism, but to a systematic abandonment of collective farming.[626] For example, a representative interpretation of China's "favorable initial conditions" is that the country's growth was a manifestation of "advantages of backwardness"— though a major indication of China's "backwardness," millions of ill-educated, over-regulated, and underemployed Chinese peasants indeed were a huge "inducement" to its economic growth when equipped with new incentives and economic autonomy to pursue higher productivity.[627]

By contrast, many Central and Eastern European countries had very different "initial conditions," whereby farmers had never been subject to mandatory collective farming under the state order, and citizens had already enjoyed a high level of state-sponsored welfare benefits and entitlements on the eve of the transition, such as state-subsidized health care, pension, and full-pay vocation systems covering both urban and rural population in Poland. Such initial conditions were not favorable to inducing economic

[625] Sachs & Woo, *supra* note 328 at 1.
[626] Andrew G. Walder, "China's Transitional Economy: Interpreting Its Significance" (1995) 144 China Quarterly 964.
[627] Jeffery Sachs & Wing Thye Woo, "China's Transition Experience, Reexamined" (1996) 7: 3-4 Transition 3.

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growth during the transition periods, at least at the early stages, because the costs of abandoning previous entitlements and welfare benefits were significant and social resistance to such changes was strong, thus making reforms difficult and painful.

The case of Polish transition is largely a success story, as compared to Russia. Although some commentators have categorized the Polish transition as a strategy of the "shock therapy"-type, this assessment has been disputed by others. For example, it has been suggested by some economists that what had actually happened in Poland in the 1990s turned out to have diverged from the radical path under the original design. These economists argue that "shock therapy" was not the primary force behind Poland's significant gains in the 1990s; quite the contrary, Poland's success was partly due to the fact that the program of "shock therapy" was blocked by Polish society and politics.[628]

Although Poland certainly differs from China in its approach to the market, it nonetheless has achieved remarkable results of structural reforms. Poland has been experiencing strong economic growth in recent years. After it joined the EU in May 2004 together with seven other former Soviet-bloc countries in Central Europe and two Mediterranean countries,[629] it has continued to show a strong growth trend, having achieved a GDP growth rate of 6 percent in 2004, which was its best performance since 1997. However, for the Polish government, there are still structural problems that need fixing, most critically a huge fiscal deficit, standing at 6-7 percent of GDP in 2004, and a high unemployment rate, which was nearly 20 percent of the working-age population even after Poland joined the EU.[630]

In summary, there are alternative paths to the market and transition, not necessarily all consistent with or similar to China's approach, which certainly has delayed some important reforms and policy changes, as reflected most notably in the slowness of China's political and government reforms. As this study suggests, the inherent

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[628] Murrell, *supra* note 200.
[629] The ten countries that joined the EU on May 1, 2004 are Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.
[630] "A Rising Tide" *The Economist* (15 July 2004).

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contradiction between China's market-oriented economic reform and its still autocratic regime has contributed to some serious problems in its stock market and banking sector, such as the political logic of the stock market and the accumulation of non-performing loans at the "big four" state banks. This disparity in the progress of China's economic and political reforms has also heightened the risk of its falling into a track of a "bad (crony) market economy," if the state intervention in the economy does not withdraw or contract in the future and public interests continue to enter the market for rent-seeking opportunities and private profits.

4. A proposal for a future research agenda: four research questions in relation to competition regime and privatization debate in China during transition, as well as the relationship between institutions and growth

This study provides a basis for a future research agenda covering four important questions about China's transition and to a broader extent, the relationship between institutions and growth in less developed countries. In this study, these questions are discussed or implicated to different extents but not comprehensively addressed.

A. First question: further exploring "the competition effect *vs.* the ownership effect" in the ongoing privatization debate in China, particularly in relation to the reform of state monopolies

The first question would focus on the issue of "the competition effect *vs.* the ownership effect" in the ongoing privatization debate in respect of reforming China's state monopolies in strategic sectors, such as energy, transportation and telecommunications. This issue is of particular significance at later stages of China's transition, whereby decentralized privatization that has been implemented at local levels has generated intense controversies among China's public over alleged asset stripping and corruption.

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In addition, this research question is also important in the wake of recent suggestions by some policy makers in the government as well as economists that both state ownership and restrictions on competition be maintained in strategic sectors. These suggestions have been elucidated in the drafting process of China's privatization regulations and anti-monopoly law, despite the latest policy announcement by the Chinese government of removing entry barriers for private enterprises in previously forbidden industries. Therefore, it would be worth studying the future direction of China's competition regime and privatization policy, particularly in relation to the reform of state monopolies.

B. Second question: analyzing the role of ownership and competition in enhancing the efficiency and effectiveness of China's financial system

The second question is associated with the ongoing academic debate over "the competition effect *vs.* the ownership effect" on the efficiency and effectiveness of a country's financial system. Specifically, the role of ownership and competition in China's financial reforms, particularly regarding the banking sector, should be closely examined in the wake of the imminent full liberalization of China's banking sector and greater opening up of its capital markets according to the country's WTO commitments, which will bring about increased competition from overseas and likely raise the issue of broader participation by foreign and private capital in the ownership structures of domestic financial institutions. Therefore, it will be important to explore the future direction of China's financial reforms in terms of the possible role played by ownership and competition, respectively.

C. Third question: examining the future direction of China's financial reforms under the analytical framework of "bank-based *vs.* market-based" financial systems

The third question that should be addressed is whether the stock market will eventually gain prominence in China's financial system and whether a kind of "shareholder capitalism" will emerge in the country, given the *status quo* of the bank-based financial system in China and the limited results of legal and institutional reforms in developing

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the stock market to date. The issue of sequencing, centered on searching for an optimal solution to the historically rooted but long unaddressed problem of a split share structure in the stock market, should be further explored in this research project.

D. Fourth question: a further inquiry into the relationship between institutions, including political (such as federalist arrangements), economic, and legal institutions, and economic growth

Recently, with respect to the relationship between institutions and growth, some economists have suggested some new ideas. Their major propositions are following:
(1) Human capital is a more basic source of growth than are the institutions;
(2) There exists a reverse causal link between institutions and growth, i.e., good institutions are established as a result of growth, especially in poor countries where growth and poverty reduction are caused by good policies, which are often pursued by dictators, rather than by good institutions;
(3) The proper sequencing of reform in less developed countries should put economic growth ahead of the improvement of political institutions.[631]

It seems that China's example is largely consistent with these propositions. Perhaps not coincidently, the editor-in-chief of *Foreign Policy*, Moisés Naim, has also voiced the opinion that although conventionally regarded as an important aspect of improving institutional quality in developing countries, the "war on corruption" turned out to be "bad medicine," which is "undermining democracy, helping the wrong leaders get elected, and distracting societies from facing urgent problems."[632] China (as well as India), in his view, is quite a success story of economic development despite widespread corruption and therefore warrants special attention from the international community. While admitting that it would be vastly superior for all corrupt countries to have such good institutions as "an honest and independent judiciary, respect for the rule of law, and a sound educational system," he maintains that these are "outcomes," rather than

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[631] Glaeser *et al.*, *supra* note 199.
[632] Moisés Naim, "Bad Medicine" (2005) 147 Foreign Policy 96.

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“prescriptions,” of development strategy. In other words, the issues of both “sequencing” and “causality” must be closely examined in the wake of the ongoing international campaign against corruption.

Given these comments, it would be very interesting to further study the relationship between institutions and growth in the context of China’s transition in light of these new assessments of lessons for development. The scope of institutions under review would include political (such as federalist arrangements), economic, and legal institutions.

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