SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR CHINA AND THE UNITED STATES
BEIJING, CHINA • JUNE 11 – 13, 2004

FRIDAY, JUNE 11

18:00-19:00 Cocktail Reception in Main Hall, Building 17

19:00 Dinner in Thousand-People Hall, Building 17

Greetings

LU MAI, Secretary-General, China Development Research Foundation (CDRF)
HAL SCOTT, Program on International Financial Systems (PIFS), Harvard Law School
ANTHONY NEOH, Barrister-at-Law

Keynote Address

INTRODUCTION: ZHANG ENZHAO, President, China Construction Bank, Chairman, China International Capital Corporation
SPEAKER: LOU JIWEI, Executive Vice Minister, Ministry of Finance

21:00 After dinner cocktails in Main Hall, Building 17

SATURDAY, JUNE 12

7:00-8:15 Breakfast
7:00-8:15 Breakfast Meeting of Facilitators and Reporters in Four-Season Hall, Villa 10

8:30-8:40 Welcome & Opening Remarks in Multifunctional Hall, Building 17
LI JIANGE, Vice President, Development Research Centre of the State Council
HAL SCOTT, PIFS, Harvard Law School

8:40-9:00 Session 1: The role of the financial systems of China and the U.S. in the development of their economies in Multifunctional Hall, Building 17
CHINA PANELIST: GAO XIQING, Vice-Chairman, National Council for the Social Security Fund, P.R.C., Former Vice Chairman, China Securities Regulatory Commission
U.S. PANELIST: HARRISON YOUNG, Chairman, Morgan Stanley Dean Witter Australia Limited

9:05-10:25 Small Group Sessions in Building 17

Group	*Room*	*Facilitators*	*Reporter*
1	Multifuntional Hall	John Langlois & Sun Jie	Hal Scott
2	Negotiation Hall	Charles Li & Sun Di	Charles Booth
3	VIP-B (1st Floor)	Stephen Harner & Ma Hong	Peter McKillop
4	Chinese Dining Hall	Dennis Zhu & Lu Mai	Jacob Weinstein
5	Western Dining Hall	Peter Bowie & Fang Xinghai	Harvey Lau
6	VIP-A (1st Floor)	Robin Radin & Wang Boming	Yi Gang

10:25-10:40 Refreshment Break

10:40-11:00 Session 2: The approach of the financial systems of China and the U.S. to fostering corporate governance and serving multiple constituencies in Multifunctional Hall, Building 17
CHINA PANELIST: YANG CHANGBO, Managing Director, China International Capital Corporation
U.S. PANELIST: EUGENE LUDWIG, Managing Director, Promontory Financial Group LLC

11:00-12:20 Small Group Sessions in Building 17

Group	*Room*	*Facilitators*	*Reporter*
1	Multifuntional Hall	Joel Epstein & Li Shantong	Hal Scott
2	Negotiation Hall	John Holden & Xie Ping	Charles Booth
3	VIP-B (1st Floor)	Gerry Schipper & Jia Kang	Peter McKillop
4	Chinese Dining Hall	Jeffery Small & Long Guoqiang	Jacob Weinstein
5	Western Dining Hall	Julia C. Bloch & Zhu Yuchen	Harvey Lau
6	VIP-A (1st Floor)	Changgen Wu & Bei Duoguang	Yi Gang

12:30-14:00 Lunch in Four-Season Hall, Villa 6
Keynote Address
INTRODUCTION: XIAO GANG, Chairman and President, Bank of China
SPEAKER: ZHOU XIAOCHUAN, President, The People's Bank of China

14:00-15:00 Session 3: How financial issues between China and the U.S. affect the flow of investment and trade in Multifunctional Hall, Building 17
CHINA PANELIST: ZHU MIN, Executive Assistant President, Bank of China
U.S. PANELIST: MATTHEW GOODMAN, Vice President, Stonebridge International LLC
U.S. PANELIST: NICHOLAS LARDY, Senior Fellow, Institute for International Economics

15:00-18:00 Free time

15:00-17:30 Reporters (from Small Group Sessions) Meeting in Negotiation Hall, Building 17

18:00-19:00 Cocktail Reception in Four-Season Hall, Villa 6

19:00 Dinner in Four-Season Hall, Villa 6
Keynote Address
INTRODUCTION: HAL SCOTT, PIFS, Harvard Law School
SPEAKER: PAUL SPELTZ, Emissary of the U.S. Secretary of the Treasury to the People's Republic of China

21:00 After dinner cocktails in Four-Season Hall, Villa 6

SUNDAY, JUNE 13

7:00-8:15 Breakfast
7:00-8:15 Breakfast Meeting of Discussion Chairmen and Steering Committee in Big Dining Hall, Villa 10

8:30-9:15 Presentation & Discussion in Multifunctional Hall, Building 17
The role of the financial systems of China and the U.S. in the development of their economies
CHINA CHAIRMAN: GAO JIAN, Vice Governor, China Development Bank
U.S. CHAIRMAN: RALPH PARKS, Chairman, Asia Pacific, JPMorgan

9:15-10:00 Presentation & Discussion in Multifunctional Hall, Building 17
The approach of the financial systems of China and the U.S. to fostering corporate governance and serving multiple constituencies
CHINA CHAIRMAN: SHAN JIANBAO, Executive Vice President, China Everbright Bank
U.S. CHAIRMAN: WILLIAM PARRETT, Chief Executive Officer, Deloitte Touche Tohmatsu

10:00-10:15 Refreshment Break

10:15-11:00 Presentation & Discussion in Multifunctional Hall, Building 17
How financial issues between China and the U.S. affect the flow of investment and trade
CHINA CHAIRMAN: WANG SHIHAO, Vice President, Bank of Shanghai
U.S. CHAIRMAN: JOHN WADSWORTH, Advisory Director, Morgan Stanley

11:30 Closing Lunch in Diaoyutai State Guesthouse Club

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR CHINA AND THE UNITED STATES

Beijing, China

June 11-13, 2004

The inaugural Symposium was held at the Diaoyutai State Guesthouse in Beijing, China, at a time of increasing economic growth in both China and the United States. In the months before the Symposium, the Chinese government had taken steps to limit the extension of bank credit in China in an effort to slow down China's high growth rate, and China's State-Owned Banks were in the process of disposing of their NPLs to improve their balance sheets. The first session at the Symposium focused on the development of a market-based financial system in China, and there was consensus of optimism over China's ability to avoid a financial system crisis. The second session addressed corporate governance issues, which China and the United States approach from different directions. The Symposium concluded with a session discussing the need for – and possible timing of – China's liberalization of controls on outward capital flows and the floating of its currency.

SESSION 1:
THE ROLE OF THE FINANCIAL SYSTEMS OF CHINA AND THE UNITED STATES IN THE DEVELOPMENT OF THEIR ECONOMIES

The broad-ranging discussion in this session focused on moving to a market-based financial system in China.

At the outset, participants noted that China and the United States approach a market-based financial system from quite different perspectives. With a market-based system as the norm, the United States approaches the issue from the perspective of how to improve the functioning of the markets through the enactment of additional regulations or rules; China, in contrast, approaches the issue from the perspective of how best to reform State-Owned Enterprises (SOEs) and State-Owned Banks and make the transition from an administrative-run, bank-centric system to a broader market-based system.

Developing a market-based financial system in China

Several speakers put China's current situation in a historical context: China's experience in creating a market-based financial system and modern legal system is relatively brief. In contrast to most common law jurisdictions in which legal systems and institutions have developed over a long time, in China all of these developments have occurred in only the last 25-30 years. Just ten years ago reform of the financial sector was proceeding slowly as China pursued a policy of "divided operation and divided management". One Chinese participant noted that as recently as two years ago, most decision makers did not believe in the fundamental role that could be played by the capital markets in China. Decision makers were using the capital markets for the primary purpose of allocating national resources, rather than letting them function as true markets. In spite of the progress made over the last 25-30 years, there was consensus that the current system was far from satisfactory and that the capital markets are still vastly underdeveloped.

One Chinese participant offered an overview of the steps necessary to improve China's financial regulatory system and improve the efficiency of China's financial industry:

- Improvement of financial macro-management mechanisms that would require the central bank to refine the mechanisms for conducting monetary policy.
- Improvement of the mechanisms for setting the Renminbi (RMB) exchange rate and stabilizing it within a reasonable and balanced range; and to gradually open controls on capital accounts.
- Improvement of the financial regulatory system, including taking steps to ease government control over the finance industry, to simplify administrative oversight and approval procedures, to create an environment in which

financial institutions are encouraged to innovate, and to strengthen the cooperation and coordination among the central bank, the China Banking Regulatory Commission, the China Securities Regulatory Commission, the China Insurance Regulatory Commission, and the Ministry of Finance.

- Continuation of the reform and modernization of financial institutions including commercial banks, securities companies, and insurance companies. This includes providing for adequate capital and instituting internal controls, implementing joint-stock restructuring of eligible state-owned commercial banks and accelerating the disposal of the NPLs of state-owned commercial banks, encouraging the participation of private funds in the restructuring of small- and medium-sized financial institutions, and developing financial institutions with varied forms of ownership (including private ownership).
- Intensification of efforts to develop capital markets, including establishing a multi-tiered market, improving the market structure, expanding the market's products, attracting more foreign investors, strengthening market supervision, improving information disclosure by listed companies, and prosecuting illegal market activities.
- Setting up an effective credit system, including increasing public understanding of credit, improving legislation, and improving the social credit system.

Many of these reforms are premised on the enactment of Western-style formal market and legal mechanisms. Several Chinese participants pointed out that the current Chinese system is more of an informal-based system with internal regulations and administrative discretion, and they stressed that it will take a long time for any formal system to replace this informal system.

Government governance

The topic of corporate governance is hotly debated in both China and the United States and was the focus of the Symposium's second session. However, several Chinese participants stressed that the key factor for China at this stage of development is not corporate governance – but rather government (public) governance – given that the state continues to retain ownership of state-owned banks and SOEs, as well as the majority of securities firms. Until issues involving government governance are adequately addressed, it will be difficult for effective corporate governance to take root in China. One suggestion was for China to establish a central advisory or supervisory commission for the State-Owned Banks.

Benchmarking

An issue that arises when judging the effectiveness of on-going reforms in China is which jurisdictions China should benchmark itself against. Many believe that the West offers good models, and more than one commentator over the years has suggested that the United States offers the best one. However, at the Symposium it was suggested that within China this is a minority view. The majority view is that China is best off selecting critically from various systems and choosing what is best for China; thus, it should not be surprising that over the last few years many of China's rules and procedures have been borrowed or adapted from a variety of jurisdictions including the United States, Taiwan, and Hong Kong.

Moving to a market-based financial system – Cleaning up the past

There was consensus that China is now paying the price for previous policies. For example, several Chinese participants noted that the Chinese conception of credit is inconsistent with a market-based system. In the West, loans are (or should be) made on the basis of appropriate credit analysis, which often includes cash flow analysis of ability to repay. In addition, Western banks have a variety of data about their own activities and those of their borrowers. In China, in contrast, loans are often made on the basis of trust; to enquire too aggressively into a borrower's ability to repay would show a lack of respect; and even if a lender desired to enquire, much less data would be available for analysis.

A second policy highlighted by participants is the massive level of policy loans that the government over the years required the State-Owned Banks to make to SOEs, without any concern as to the SOEs' ability to repay. It was also noted that the banks were not completely innocent; at least some of the loans resulted from bad banking decisions.

These factors have contributed to a massive level of NPLs for the State-Owned Banks. Nevertheless, most participants believed that the main concern is not the current level of bad debts on the banks' books, but rather the need to ensure that current and future lending does not lead to a new round of NPLs. Participants welcomed the government's recent disposal of large tranches of NPLs to asset management firms (many of which, in turn, were transferred onward to Western investment banks). These steps have dramaticallyimproved the banks' balance sheets.

Moving to a market-based financial system – What is the role of government?

The government plays an active role in the Chinese banking system. Control over the top four State-Owned Banks is well known, but one participant noted that this influence also extends to the second, and even the third, tier banks.

The government also plays a major role in the stock market. One participant made the point that the price-earnings (PE) ratios in China are very high relative to values of companies elsewhere, perhaps by a factor of two to four times. Another participant stressed that this high valuation is really driven by one investor – the Chinese government. The government has an enormous burden from social security and pension funds and wants to price its assets to cover as much of those liabilities as possible. Under this view, it would be clear that the government would be unable to meet its obligations if the capital markets were opened up and PE ratios retreated. On the other hand, as noted by another participant, opening up the capital markets would likely lead to an expansion of the economy, trigger an explosive growth of smaller companies, and lead to increased income and higher tax revenue that would allow the government to more than recover its losses on assets. This issue was put forward as an idea of further research to be discussed at a later symposium.

It emerged from the comments of many Chinese participants that the Chinese plan to "privatize" the banks will be along the lines of "corporatization" and moving from a position of sole owner to shared ownership with the private sector where the government will be the majority shareholder – and will likely remain so for some time. This has been the same approach that the government has recently pursued with respect to securities firms and several U.S. participants noted that this process has not worked too well. They also noted that allowing minority stakes to be held has not resulted in good corporate governance and has led to fights among factions.

The consensus among the U.S. participants was that it would be better for the Chinese government to completely privatize and to accelerate the on-going process. This would more explicitly subject the Chinese banks to the discipline of the markets. In addition, there was concern among the U.S. participants as to how good an "owner" the government would be under the new system, whether the government would be able to foster responsible corporate governance, and whether the government would be able to avoid conflicts of interest. Some participants suggested that the government create a separate regulatory body. But other participants were skeptical as to whether the government could build an effective Chinese wall and be an owner and a regulator at the same time.

Moving to a market-based financial system – Developing market discipline

At the heart of reforms, including privatization and the creation of capital markets, is the need to create market discipline. At present, Chinese banks have no way to price financial instruments. Prices are currently set by bureaucratic rules and not by market mechanisms; this leads to the result that most instruments are mispriced. Such a system in which depositors receive interest rates fixed from above does not create market discipline for the banks.

Many participants suggested that improvements could be made through banks issuing more bonds whose prices were set by the market. In addition, several participants proposed the increased use of subordinated bonds and noted that such instruments would provide useful signals of risk and subject the banks to market discipline, as well as satisfy Tier II Basel capital requirements and improve the banks' image.

From the comments of the participants, it was clear that both borrowers and lenders suffer from the mispricing under the current system. The non-state-owned sector has a harder time getting capital than the state-owned sector and has few choices if interest rates are set too high. The flipside is that the lending banks are burdened with many loans from borrowers that cannot be repaid – which accumulate and contribute to the banks' NPL woes.

There was a strong consensus that over the next decade there will be a dramatic increase in the size of China's equity markets, but no consensus as to how much equity the Chinese markets can absorb. At present, banks in China offer a broad range of products, but they are not allowed to underwrite securities. There was a strong consensus at the Symposium that China should relax its Glass-Steagall-like legislation and allow the banks to enter the securities market – but it was acknowledged that this probably will not happen in the near future.

There was a consensus among the U.S. participants that China would benefit from more competition from foreign banks, and the sooner the better. However, the Chinese participants were of the view that it was premature for foreign banks to enter the market in a significant way – that the financial restructuring of China's banks would first have to be completed to prepare the Chinese banks for the entry of large foreign competitors into the Chinese market.

Of course, to move to a market-based financial system and develop market discipline requires better infrastructure: an effective legal system, effective accounting and auditing standards, and appropriate disclosure requirements. This topic led to a discussion of the current situation in China. There was a consensus that the level of professionalism and skill of lawyers and accountants in China has been increasing, but a number of participants noted that Chinese lawyers and accountants need to be more pro-active. One stated that since most lawyers and accountants do most of their work for state-owned companies, they generally try to appease their government supervisors.

There was a consensus that auditing standards are generally good. However, one participant pointed out that it is not generally known that publicly-owned companies are audited both by private CPAs and by the State Audit Commission, under two different standards. No problems occur where both the CPAs and the State Audit Commission have approved the accounts, but conflicts arise where the private CPAs have approved the accounts but the State Audit Commission has not. There was consensus that the current dual auditing policy should be reviewed.

Managing failure

A significant component of developing an effective financial system is creating mechanisms for managing market failure. A combination of incentives (e.g., corporate profits and bonuses for managers) and penalties (e.g., bankruptcy) usually lead market participants not to provide resources to enterprises that do not deserve them (i.e., that cannot repay them). However, corporate and bank failures do occur; at times the problems mushroom into systemic insolvency of an entire sector – for example, the banking sector in China, or the savings and loans (S&L) sector in the United States. One U.S. participant offered a lengthy analysis of the S&L crisis as an example of the importance of adequately managing failure. He began by noting that the S&L crisis was an example both of market failure (in allowing a problem to grow from one that would have cost U.S. taxpayers US$5 billion to a crisis that ultimately cost around US$100 billion) and later of success in managing failure (in the creation of the Resolution Trust Company (RTC) which, under the leadership of an excellent chairman, took bold actions to resolve the crisis, including disposing of a large amount of NPLs and selling a large chunk of assets quickly). He identified four lessons from the S&L crisis for China with regard to the disposal of NPLs:

- Sell faster, keep it simple and do not worry about the prices in the first few deals; the market, not officials will discover what is "fair".
- Embrace structures and strategies that enhance transparency and liquidity, which increase asset values and make decision-making easier at every level.
- Put individuals in charge of the process who have the status and character to be independent (in China, these individuals should report directly to the State Council).
- Recognize – and welcome – the fact that an accelerated work-out process will help China's legal system evolve toward more certain outcomes.

He also identified seven lessons for China's financial system as a whole, which were echoed by many other participants and which need to be tailored to China's current stage of development:

- A financial system should be designed not to prevent failures – whether of companies or banks – but to allow them to occur when necessary.
- Neither market failures nor administrative fiat alone is as effective as a pragmatic mixture of the two.
- It is easier to manage the failure of a bank when there are lots of them, easier to have lots of banks if you have explicit deposit insurance, and easier to close a bank when the money is there (e.g., in an actual fund rather than a government guaranty).
- As long as the public believes that the government will not let depositors suffer a loss, market forces will not close a bank. This puts the burden on supervisors to require the changes in policies and management that fear of failure would bring about, and suggests that they can move aggressively without precipitating an actual collapse.
- As a corollary, a steady increase in transparency – and the realism and flexibility that brings – entails lower risk than is sometimes assumed.
- A liquid public market provides information that accelerates necessary action; this is true whether the market is in bank shares or packages of loans or empty buildings.
- Having banks go public increases systemic stability.

Markets are not a panacea: Experience from the United States

Although there was a strong consensus that the creation of strong capital markets is necessary, several participants pointed out that capital markets in and of themselves are not a panacea. The record over the last decade in the United States shows that from the internet bubble to overinvestment in the telecom sector to the recent recession, the capital markets destroyed over a trillion dollars worth of wealth. Such boom and bust cycles are not unusual in market-based systems, and at present the United States is considering whether additional regulation might prevent some of the extreme vacillations of the market.

However, several participants also pointed out that the combination of capital markets and effective bankruptcy laws demonstrate that the U.S. system works – allowing companies to fail is important, and the current U.S. bankruptcy procedures (of which Chapter 11 is the best known) enable failed companies to be liquidated or restructured efficiently. It was stressed that a plus for the U.S. system is that the U.S. government has not stepped in to bail out failed companies. Several participants also stated that it was noteworthy that the few high profile corporate collapses of the last few years (e.g., Enron and WorldCom) did not destroy the system. The system is stronger over the long run if the losers are not bailed out.

Several participants suggested that there is another lesson here in addition to the virtues of market discipline. They asked why collapses like Enron can occur in the United States, which has versatile capital markets, strong corporate governance institutions, a well-developed legal system, and strong incentives for executives in place. Their answer was that bad people who are determined can always find a way around the system, even the best system – there are limits to what the markets and legal systems can prevent.

Balancing fairness and markets: The Chinese dilemma

The discussion of capital markets led several participants to highlight a unique aspect of the Chinese economy – the need to balance social contract norms with the efficiency of markets. They noted that capital scarcity is not the problem in China; rather the problem is that capital is often not utilized efficiently. Their conclusion was that there is too much fairness at the expense of efficiency. The issue then arises how best to handle this policy role of funding projects that do not make clear economic sense. Three alternatives were proposed:

- Using specialized development banks
- Allowing commercial banks to fulfill social obligations
- Having the government fund social welfare programs

The second option offers a possible solution for injecting some "fairness" into the existing market framework, but there was a consensus among participants that it would be best for the commercial banks not to make these policy loans. However, some participants queried whether this is likely given that the government will remain as the primary shareholder of the banks. Overall, the first option – the use of specialized development banks – had the most support among participants, although the experience in the rest of the world with such institutions is not very good. Many participants thought welfare issues should be handled through welfare programs and not the financial system.

The risk of a financial system crisis?

Given the problems that were noted at the Symposium about the Chinese financial system – some historical and others currently being encountered in making the transition to a market-based economy – it was noteworthy that there was a consensus of optimism over China's ability to avoid a financial system crisis. Participants observed that the Chinese were realistic about the problems of the financial system and were addressing them.

Some participants, however, were less sanguine about China's ability to side-step a financial crisis. Some observed that a potential crisis is not related to the existing stock of debt (NPLs), which is currently being addressed, but rather could be precipitated by the flow of future credit. This concern was based on the lack of an effective credit system and with difficulties in checking for fraud. Another view was that problems would quite likely arise when foreign banks are allowed to operate in China. One participant stressed that time is running out for the Chinese banks to complete their restructuring to enable them to compete successfully with the foreign banks.

Another participant suggested a crisis could be triggered by the securities firms. At present, there are roughly 120 securities firms that act as market intermediaries. Unlike the banks that have tremendous deposits and can delay financial problems, the securities firms have thin margins and are on the edge of insolvency; many are misusing client funds so they can survive. The participant asserted that the regulatory commission knows about the firms' conversion of clients' accounts but is moving slowly because it is in a bind – it fears that 30-40 securities firms could collapse , but the compensation fund is insufficient to compensate for the failure of even just one small company. There was consensus among the participants that the current state of the securities firms needs to be stabilized.

SESSION 2:
THE APPROACH OF THE FINANCIAL SYSTEMS OF CHINA AND THE UNITED STATES TO FOSTERING GOOD CORPORATE GOVERNANCE

There can be no effective corporate governance without majority private ownership and public market discipline – There is no middle way

There was strong consensus that private ownership and public market discipline were necessary for effective corporate governance; however, having these two conditions in place does not guarantee effective corporate governance. Recent cases in point – Enron and WorldCom – were highlighted by a number of participants. Additional requirements are necessary to foster effective corporate governance. A lengthy discussion followed in which participants put forward a list of additional requirements; they are listed separately although there is some overlap:

- Managers' compensation
- Transparency around financial reporting/disclosure
- Independent directors
- Accountability of directors and well-defined legal consequences for failure of directors to discharge their duties
- Incentives for directors to behave appropriately
- Culture of the board
- Upstream information flow
- Activism by minority shareholders
- Empowered rating agencies and an independent financial press

Managers' compensation

The compensation of managers is a difficult issue, but overall their pay should be tied to performance. Stock options are an excellent way to create a financial incentive to perform well. However, the taxation of options must also be considered, as well as the fact that most companies give managers upside benefits but do not cut back on compensation if performance is weak.

Transparency around financial reporting/disclosure

Transparency in the dissemination of financial information and the general disclosure of corporate information are key components affecting information flow. Several participants noted that the United States does a better job with disclosure than with transparency. For example, one participant noted that the typical U.S. annual report discloses lots of information (and much more than the reports issued in other countries), but often in an unhelpful way. For example, the typical report often starts with the glossy section with lots of pictures, which is more of an advertisement; only later in the report comes the financial information, which is printed on cheaper paper and which is often impossible for most readers to parse. The result is that the information is being disclosed but not in a form that is especially helpful or meaningful for investors. However, this participant noted that a striking exception is the annual report of Berkshire Hathaway, which is a paradigm of how an annual report should be written: with a clear explanation of the company's performance – highlighting both strengths and weaknesses – and a simplified summary of the corporate financials that is set out in an easily understandable format.

Independent directors

A key component of corporate governance is including independent outsiders on the board of directors and important board committees. These individuals must exercise their independent judgment to protect the interests of shareholders. However, the independent director system is built upon an inherent tension: management nominates the independent directors and sets their compensation, but the directors are supposed to supervise management.

Accountability of directors and well-defined legal consequences for failure of directors to properly discharge their duties

Directors must be accountable for their actions and there must be well-defined legal consequences for directors who do not properly exercise their responsibilities. However, as has recently been demonstrated in the United States, even the prospect of criminal liability is often not enough to deter wrongdoing.

Incentives for directors

Both sticks and carrots are important in creating proper incentives for directors.

Corporate managers are highly compensated for effectively running their companies on a full-time basis. In contrast, independent directors work only part time, attending perhaps one meeting per month and some additional hours preparing for their meetings and reviewing corporate documents. If they fail to exercise their responsibilities they may be subject to sanctions and even criminal prosecution. Yet, they are often paid very little and have very little upside gain if things go well. A common policy is to offer directors protection against financial liability, but more attention should be paid to offering directors larger compensation packages. Warren Buffet has also spoken in favor of appointing directors with substantial shareholdings in the company that provide directors with an additional incentive for their company to perform well.

Culture of the board

In the United States, on paper, most companies have good corporate governance structures and, in practice, most corporate boards are composed of directors with honesty and integrity. However, many directors nevertheless are not pro-active and many boards are asleep. Often, the boards of companies that get into trouble often did not understand the risks that were being taken by their companies.

This is why the culture of the board is so important: Do the directors wish to adopt corporate governance in form or substance? to go through the motion of checking boxes? or to really get to the bottom of issues?

Warren Buffet has noted that one of the factors that distinguishes good boards from weaker boards is that at better run companies the independent directors speak up, debate issues, and do not hesitate to disagree with items tabled by management.

Upstream information flow

In addition to disclosing information downstream or outside the company, good companies ensure that there are mechanisms for ensuring that bad news moves up the chain to the board of directors. In companies with weaker corporate governance, bad news often remains buried deep within the institution – the result is that the directors do not receive the information that they need to make informed decisions.

Activism by minority shareholders

Pension funds and mutual funds that own substantial stakes in companies can also play an important role in improving corporate governance and management. The recent actions by minority shareholders preceding the annual Disney board meeting are a case in point. Other examples are beginning to occur in China. Several participants who represented investment banks or private investor groups that had purchased minority interests in Chinese companies stressed the need to be active at the board of directors' level.

Empowered rating agencies and independent financial press

One cannot overestimate the importance of outside institutions in improving corporate governance. This extends from empowering rating agencies to rate companies on a variety of factors to creating an aggressive financial press.

The United States and China approach corporate governance from different directions

There was a consensus among participants at the Symposium that China and the United States approach corporate governance from different directions. The impetus for corporate governance within the United States is from within corporate entities themselves: at the heart of the U.S. approach is the evolution of the private, closely-held firm, whose organic growth leads to a desire to list on a stock exchange and thereby for the need to protect minority investors. China, in contrast, approaches the issue from above – from outside the corporate entity. The primary issue is how to make sure the government effectively controls the running of SOEs and State-Owned Banks. As indicated before, the issue in China is rather one of government governance rather than corporate governance. As China's government privatizes, however, protection of private minority shareholders will become more important.

Differences highlighted by participants included the following:

- In both systems the people who manage are different from the owners: in the United States, managers are appointed through meritocratic competition; in China, in contrast, SOE managers are appointed from the ranks of officials who rise through the government bureaucracy.
- Unlike U.S. managers who often take bold steps to separate their companies from the competition, Chinese managers are more afraid of making mistakes; mistakes will cost them their jobs but success will not add significantly to their compensation.
- Although China has revamped its corporate governance procedures and involves outsiders as independent directors and as members of boards of supervisors, these officials have much less power than their counterparts in the United States.

Several participants stressed that until the Chinese government withdraws from the picture, it will be difficult for China to have effective corporate governance. There was an acknowledgement that this would only occur in the long term and only after the private sector grows to a level where it is able to influence the system.
However, there was a consensus that the situation is changing for the better: the catalyst is the listing of companies, which is leading to many changes. When these companies list, there is an increased pressure by the boards to try to follow U.S. standards as much as possible.

Is there convergence on one best corporate governance approach?

Several participants noted that the experience from around the world supports the contention that corporate governance approaches are converging. Moreover, the fact that so many countries have chosen to privatize demonstrates that government ownership is acknowledged as not the best way to proceed.

That being said, there was agreement that there are important differences among current models – for example, the United States relies more on the use of outside directors on corporate boards; Europeans rely more on the use of external committees to perform supervisory functions;

and Japan relies on a bank-based model. All these models have their strengths and there was no consensus as to which is the best way.

One participant suggested that China also study Australian and New Zealand reforms for developing an efficient system for partially-privatized state enterprises. Another participant suggested that China adapt the Japanese bank-based model for use in China. However, other participants were less confident in the application of a Japanese-based model since the banks in China have much less leverage over their borrowers than do Japanese banks. They noted that Chinese banks have difficulty enforcing discipline over borrowers and even in getting financial information from them. In addition, Chinese banks, unlike Japanese banks, rarely have representation on the boards of directors of their borrowers. Also, given the prolonged Japanese financial crisis, it was far from clear that the Japanese model worked well in Japan itself.

However, there was consensus that agreement can be reached on best practices that facilitate good corporate governance and on principles that are benchmarks against which systems can be measured. Reference was made to recent projects of multilateral organizations like the OECD and the ADB that provide substantial resources for countries in the process of reforming corporate governance procedures.

SESSION 3:
HOW FINANCIAL ISSUES BETWEEN CHINA AND THE UNITED STATES AFFECT THE FLOW OF INVESTMENT AND TRADE

The root of the problem is capital controls, not flexible exchange rates

Two of the most important issues affecting the flow of investment and trade between China and the United States – which are the subject of high-level government discussions between the two countries – are China's capital controls (on capital outflow) and China's exchange rate policy. At the Symposium the discussion of these issues focused on four primary areas:

- Which issue should be resolved first: capital controls or the exchange rate?
- Will liberalizing controls on outward capital flows destabilize China's financial system?
- At present, how much leakage is there in China from the capital controls?
- Is the Asian financial crisis, which included the risks from short-term capital inflows, relevant to Chinese policies on capital controls?

Which issue should be resolved first: capital controls or the exchange rate? Will liberalizing controls on outward capital flows destabilize China's financial system?

These two issues were discussed in tandem. There was a consensus at the Symposium that the root of the problem was capital controls and not exchange rates – that China should address the issue of capital controls before making exchange rates more flexible. The central concern was that liberalizing capital controls before China was ready would most likely lead to massive outward capital flows out of China that could destabilize the country.

Most participants believed that before capital controls could be significantly loosened, China must complete its overhaul of the banking system. One participant suggested that there are two ways to complete this overhaul: continuing the restructuring of China's banks and allowing foreign investors to make strategic investment in Chinese banks. There was a consensus that China would likely pursue the first option for the larger banks, but allow the second option for some of the smaller banks

One U.S. participant said that it is a misconception that China and the United States are in disagreement as to whether the RMB exchange rate needs to be made flexible. He said that the United States is not pressing China for change: there is agreement on this issue; the disagreement has to do with the timing of the changes.

As for when China should make its exchange rate more flexible, one U.S. participant suggested that China should not move towards flexibility until it is confident that it can beat off George Soros.

How much leakage is there from the current capital controls?

One of the difficulties with capital controls is that there is often leakage. One participant referred to a study that says that capital controls are often evaded and lead to inefficiencies because people find ways to evade them. This led to a discussion as to just how much leakage there currently is in China. Many participants believed that the controls on capital outflow were fairly effective.

In contrast, there was consensus that the government is pursuing a more flexible strategy in allowing Chinese companies to seek capital inflows outside China. Several participants stressed that start up and small- and medium-sized companies in China have a difficult time in competing with larger companies in accessing liquidity in China. One U.S. participant noted that one solution that some companies pursue is to seek special approval from the government to allow these small Chinese companies to move offshore; special approval is necessary because the existing rules are not clear.

Other participants agreed that there are definite advantages for Chinese companies to move offshore, including regulation leverage and making it easier for foreign investors to own shares overseas. In addition, foreign investors are often happier with the legal regime in these offshore jurisdictions where it is easier to enforce shareholder rights. There was consensus that going forward the need for these capital inflows will disappear – or at least decrease – when liquidity improves for these smaller companies and a Chinese NASDAQ develops. Moreover, several participants stressed that these "special exceptions" are being made only for capital inflows, not outflows. As one U.S. participant put it, there is an asymmetric relationship: it is easier to bring money into China than it is to take it out.

Is the Asian financial crisis, which included the risks from short-term capital inflows, relevant to Chinese policies on capital controls?

Given the far-ranging ramifications of the Asian financial crisis of 1997, it was only natural that the 1997 crisis was on the minds of many of the Symposium participants, and there was lengthy discussion as to whether the 1997 crisis had any lessons for China's current situation. There was a consensus that China should be able to avoid the key problem that was at the heart of the Asian financial crisis, which s was that the type of investments being made in Asian countries – short-term bank loans and portfolio investments – could easily be reversed once those countries encountered currency or financial problems. Thus, substantial levels of investments that had come in quickly were able to exit just as quickly. In contrast, there is less of a short-term capital flow into China than there was into other Asian countries pre-1997; foreign investors have made substantially higher levels of direct investments that cannot be repatriated as quickly. In addition, there are the controls on capital outflows discussed above.

There also was a strong consensus that China is in a much stronger position than other Asian countries were at the onset of the financial crisis of 1997. One participant noted some factors that make China unique:

- There has never been a developing economy with US$50 billion per year in capital inflow, a level that demonstrates great confidence by international investors.
- No developing country has also had a Hong Kong and a Taiwan that account for another US$20 billion per year in inward flow (e.g., Hong Kong and Taiwan companies make huge investments in China; and foreign international investors can invest in mainland Chinese companies by buying H shares, which are listed in Hong Kong).
- There has never been a developing economy with a modern investment bank like China International Capital Corporation, which has a US$200 billion backlog in transactions.

Differences from Japan

One U.S. participant pointed out that in Washington, D.C., there is a tendency when discussing these issues to group China and Japan together—he stressed that this is a mistake and that the trade and investment issues in Japan and China are quite distinct. When the United States was competing in trade with Japan there were no – or at least quite limited – investment opportunities for U.S. companies in Japan. In contrast, U.S. investment in China is at a very high level. Therefore, the conclusion supported by a majority was that the United States must be careful not to push so hard on trade and currency issues that China responds by cutting back on investment opportunities for U.S. companies.

Where is China heading?

There were discussions as to both the short term and the longer term. As for the short term, most participants – at least most of the U.S. participants – were confident that Chinese banks would have trouble competing with foreign banks once foreign banks are able to compete in the Chinese market. One U.S. participant, however, offered a more hedged view. He called attention to the recent developments in the insurance industry and noted that foreign institutions pursue a different game plan than local companies. Foreign institutions strive for maximizing profit; market share is secondary. Chinese entities pursue the opposite strategy. This participant noted that the Chinese strategy is risky, but did acknowledge that local Chinese insurance companies were growing faster than foreign companies. The same could perhaps be true – at least in the short term – once the banking industry is opened to competition. If so, it might prove hard for the foreign banks to compete because they will never make loans on the same terms as the local banks. Of course, if the Chinese banks shift to a profit strategy, then the foreign entities would have a better chance. This recently happened in the insurance sector in the aftermath of the listing travails of China Life. Chinese insurance companies have stopped growing so fast, and foreign insurance companies are now able to compete effectively because of their advantages with customer relations and reputation for safety.

Looking ahead fifteen years, there was a bullish consensus as to where China will be positioned. Among the predictions by participants were the following: the RMB will be a reserve currency; Shanghai will be the financial center in China; and China will be the largest investor in Asia. One U.S. participant put things in historical context: When Deng Xiao Ping opened up China in 1978, people worried about whether the Chinese economy could survive; it did. When China recently joined the WTO, many predicted that Chinese industries would be wiped out by multinationals; so far, the situation in China does not appear so bad. If you believe in markets and that the Chinese people and government can handle the current problems regarding the liberalization of China's capital controls and currency exchange rate , then over the long run Chinese companies should be able to adjust and benefit.