The Institutional Basis for Securities Markets in China

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A Historical Perspective

China's history, economics, and politics have been shaped to considerable degree by its weather. Weather patterns peculiar to China have produced great famines and floods often simultaneously. The ability of monarchs and warlords to deal with these changes has been critical to their success. Another thread of history is China's xenophobia. The Great Wall is a living testament to history in this regard. Throughout ancient history concentrations of wealth, be it in cities, castles, or fabled kingdoms, have attracted nomadic warriors who pillaged and plundered them. The castles of Europe endured Vikings and Rome endured the Vandals but no civilization has endured this manner of international economics as long as China has. For many thousands of years China existed as an enclave of relatively highly evolved agricultural and artisan civilization with enormous relative wealth surrounded and besieged by a barbarian world of stone-age hunter-gatherers and looters. Incredibly, they survived; and they are today the oldest continuously existing civilization on earth. In modern times the nation has endured invasions by the Manchurians, Japanese, Koreans, and Europeans. The fear of outsiders runs deep in China and impacts political developments and economic policy.

The origin of many elements in the socio-economic makeup of China can be traced to its sustained "booty-looter" relationship with the outside world. For example, "gwai lo" literally means "foreign devil". The term is used in everyday language to refer to foreigners, particularly Europeans. The Chinese are afraid of foreigners. Reform era developments in this context offer new insights. Normal international trade relations by Western standards are to them a "great opening". WTO membership obligations present culture shocks that are not easy to appreciate without a historical context. Xenophobia in China is pathological and universal and it runs across generations. An informal conversation with bright, young, modern Chinese university students exposed an irrational fear among them that WTO membership would let in the outsiders who would plunder China and take China's wealth with them back to their country. It is noteworthy that their fear of the outside world follows the barbarian-pillaging model with such remarkable precision.

The first recorded encounter with the barbarians goes back to 770 BC. Repeated attacks by nomadic looters forced the Zhou to move their capital from Hao to the geographically more defensible Luoyang. But even Luoyang was not safe. Five hundred years later, continual pillaging campaigns forced to the Qin to build the Great Wall as a way of keeping outsiders outside.

Within China itself, patterns in cycles of conflict has had to do with feudalism followed by the rise of peasant power; and a tug of war between the rule of law and the rule of Li.

In Confucianism all rules of proper behavior flow from a store of reason and ethics called Li which already exists as a part of nature and to which all humanity is subject. This relationship is akin to what we would call a rule of law. The Li, however, is not precise and its utility depends on its correct interpretation and application by sages and natural leaders. In the past the natural leaders have been the emperors whose legitimacy was derived from this relationship. Communist leaders have attached themselves to the same structure. Strange and ritualistic titles are often used to gain natural legitimacy. In this social system the rule of law as we understand it in the west is subverted to the whims of the legitimate leader whose interpretation of Li is thought to be correct.

China has never known democracy or the rule of law. In its relationship with the industrial countries of the 19th century, China has been at a legal disadvantage because it did not have legal institutions to support the activities of commercial enterprise. The results were often disastrous.

At the beginning of the 19th century, the British signed a trade agreement and set up a commercial beachhead at Guanzhau. The trade agreement imposed severe trade restrictions on the British. Trading may be carried out only in Guanzhau, all trade must be channeled through an officially sanctioned trade association, high duties must be paid on imports, and exports are to be strictly controlled through export permits. The British abided by the contract and sold opium in exchange for silver. In 1839 the emperor abrogated the contract, ordered the trade to be halted, and seized all opium stocks. The British considered these actions to be a breach of a contractual obligation and went to war. The Royal Navy terrorized coastal cities and seized Shanghai. The emperor, faced with superior firepower quickly agreed to a new trade contract. The Treaty of Nanjing was more of surrender than a contract. The British gained lower tariffs, four new trading centers, liberal trading terms, and the island of Hong Kong.

Legal Foundations for Capital Markets

Property rights, the rule of law, and comprehensive company and contract law are pre-requisite to the development of securities markets. These institutions have gradually evolved in China as a means of implementing economic reforms and WTO guidelines. Institutional pre-requisites for securities markets form a complex interwoven matrix that includes a functional and effective regulatory mechanism.

Households invest their savings in risk capital purely on a projection of future growth and stand to lose all their investment if the growth does not materialize or if market insiders, majority shareholders, or the managers of the firm are dishonest. Well-developed securities markets are able to carry out capital formation efficiently in spite of these agency costs by virtue of institutions that monitor managers and insiders and provide standardized information to investors[1].

The Nature of Transition

It is a peculiarity of transition economies that as institutions of central planning give way to institutions of market economics the process necessarily includes a period of institutional weakness. In that netherland of legal and regulatory regimes the hegemony of the centrally planned state has been weakened by reforms but the discipline of a well-developed market economy has not yet taken hold. The transient nature of transition has been very visible in the CEEFSU countries. In China dual track gradualism has reduced the visibility of these problems but not the severity.

Scholarly case studies developed with extensive fieldwork in China reveal a pattern of corruption and asset stripping by state functionaries who seem to operate without any accountability or discipline. Far from being the autocratic central planner it once was the State appears in many instances to be a hapless victim of self-serving party cadres, bureaucrats, and SOE managers working in collusion. Their procedures and methods may be described as corrupt, illicit, and even criminal. Yet it may be argued that the result is not very different from that of privatization. It is a characteristic of the Chinese reform experience that "unintended consequences" of State policies are moving Chinese reforms faster than the State had intended and in ways that its leaders may not have anticipated.

The case involving Yuan Ye Industries Co. in Shenzhen is well known and has even been successfully imitated by individuals who refer to it as the Yuan Ye Model. On the surface two state-owned enterprises, Xin Ye Garments and Shen Hai Trading, were combined into a joint stock company and partially privatized with a successful IPO on the Shenzhen Stock Exchange; the state apparently retaining majority ownership and control. Beneath this veneer is a scheme put in place by government insider James Peng. Mr. Peng was the Managing Director of Shen Hai Trading and had powerful connections in the bureaucracy. As manager of the new joint stock company, Peng was able to manipulate incomplete corporate governance and disclosure rules to assume control of Yuan Ye through a shell company in Hong Kong.

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[1] Bernard Black, "The Core Institutions that Support Strong Securities Markets", Stanford Law School Working Paper, June 2000

Such informal methods of “privatization” have been even more pronounced in the TVEs (township and village enterprises). In many instances local government officials have organized a portfolio of public enterprises into a de facto private corporation. Other TVEs have been leased to the private sector for a fixed annual payment or sold at a discount to insiders. Even when they are privatized, the owners of the new enterprise choose to pay a fee to local officials to register the firm as a collective or a township enterprise in order to get favorable access to raw materials, energy, land, markets, and capital. In the books these firms appear to be publicly owned township enterprises but they are in fact operated as if they were private enterprise. Research in many areas of China’s new economy is often frustrated by perverse data of this nature.

Accounting

Firms that list shares exclusively for domestic shareholders are required to submit financial statements according to the Chinese mainland accounting standards. These accounts are audited by Chinese accounting firms and are subject to Chinese disclosure and liability regulations. But firms that issue shares for foreigners in domestic markets are also required to include accounting information according to International Accounting Standards or IAS. These statements are audited twice. Domestic accountants audit the Chinese accounts while international accounting firms audit the IAS accounts.

Firms that list in overseas markets including Hong Kong are of course subject to regulations in the foreign regime. Normally they would submit their financial statements according to IAS. A duplicate set may be required to conform to local accounting standards. The auditors are normally local agents of internationally recognized firms. Chinese government involvement in these listings is limited to giving permission to list overseas. In the case of an SOE the state would also be involved in the carve-out and re-structuring of the new corporation that is to be listed in the foreign market.

All firms that issue securities to foreigners are considered to have incurred foreign currency obligations. Since capital controls is an important device in Chinese currency policy, these firms are required to show in their financial statements that their normal business operations generate inflows in a fully convertible hard currency and that these inflows are sufficient to meet their new foreign currency obligations. The state makes that determination during the review of the firm’s application for a permit to issue shares to foreigners.

In theory the firm’s continued ability to service foreign currency obligations is monitored by the state. Firms that issue shares to foreigners in domestic markets submit annual financial statements to the state. The state is able to review these financial statements to determine whether the foreign currency cash flows of the firm’s business operations will cover their operating and financial foreign currency obligations.

However, the linkage from regulation and monitoring to enforcement is fragile. It is uncertain what action the state could take if in future years the firm’s foreign currency inflows become insufficient to make dividend distributions. The state’s ability to limit such distributions is complicated by its own rules which set a minimum dividend payout and which make it impossible for the firm to discriminate between domestic and foreign shares in any respect except the citizenship of the shareholder.

The state plays a dual role in these disclosures. As regulator it protects minority shareholders from fraud and market manipulation. As majority shareholder it overseas its own interests. The two roles are in conflict and this conflict is an important structural weakness in Chinese capital markets.

Once the state allows a firm to list overseas, its continued role is uncertain. In the case of firms that list overseas as Chinese corporations the state continues as its regulator under the Companies Law and it usually is the majority shareholder. In either role it may require periodic financial disclosure and demand that these statements be audited. But so-called “Red Chip” firms that register as Hong Kong

corporations are disciplined mostly be Hong Kong. Once the Red Chip structure has been set up, the State's role may be primarily that of majority shareholder.

The pattern of financial disclosure described above was altered significantly in December 2000 by a small firm called Minsheng Bank[2]. Already an oddity as the only private bank in China and a rarity as a private sector IPO firm, it issued shares in the domestic market exclusively to domestic shareholders but voluntarily submitted financial statements in both Chinese and IAS formats and it voluntarily subjected these statements to the examination of international auditors.

The difference between Chinese and IAS accounting is particularly striking for banks because of their treatment of classified loans. Chinese accounting rules are much more tolerant of delinquency. The move by Minsheng Bank to voluntarily conform to international standards in this regard thus set a de fact standard for domestic banks. In particular, subsequent bank IPOs that do not do so would come under sharper shareholder scrutiny.

More important, the move by Minsheng Bank put pressure on Chinese regulators who eventually surrendered to investor demands to supply IAS accounting information audited by international accounting firms. In keeping with the "gradualism" of reforms however, the surrender was incremental in nature. New regulations were introduced to force domestic share issuers to disclose internationally audited IAS accounting information but this regulation was initially limited to financial institutions. But it is a development whose logical evolution may be expected to raise the quality and transparency of Chinese accounting and auditing to international standards.

In the meantime, the quality of financial information may be compromised due to inadequate accounting and auditing standards so that shareholders may not be satisfactorily informed about the risk and return possibilities of their investment. Poor accounting and auditing standards facilitate a process of "financial packaging" of SOEs for a public share offering. The only possible purpose of financial packaging is to deliberately mislead investors[3].

The conversion from socialist fund accounting to corporate accounting permits a degree of discretion that may be abused. Also, since sales are usually to other SOEs or to the remaining portion of the SOE from which the IPO firm is being carved out, costs, revenues, accounts payable, and accounts receivable amounts may be distorted to inflate earnings and compete for an IPO permit from the state or meet simplistic listing requirements that overemphasize earnings. Inflated earnings produce high IPO pricing when the pricing is based primarily on historical P/E ratios.

In addition, the carve-out itself may be structured to bring to market a temporarily profitable portion of the enterprise. The empirical data clearly show that the reported accounting income of IPO firms rise to required levels in the years immediately preceding the IPO and then fall in the subsequent years. After the IPO, the parent SOE may recover the cost of financial packaging either by readjusting transfer pricing or by predatory dividend extractions.

Rights issues by listed firms show similar patterns in earnings management[4]. Regulatory reform, stiffening of accounting rules, and enforcing competent and independent auditing would significantly reduce the incentive and the opportunity for these kinds of deceptive practices.

Privatization

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[2] South China Morning Post, "Beijing tightens rules for listing hopefuls", 15 Feb 2001

[3]Aharony, Joseph, Chi-Wen Jevons Lee, and T. J. Wong, "Financial packaging of IPO firms in China", Journal of Accounting Research, Winter 1999

[4] Chen, Kevin and Hong-Qi Yuan, "Earnings management and capital resource allocation: evidence of China's accounting-based regulation of rights issue", Working paper, Hong Kong University of Science and Technology, October 2000.

The idea that public sector enterprises can be privatized subsumes that there are only two states of nature in terms of property rights - public and private. In this regime privatization can be described as the process of transforming public ownership of productive assets into private ownership.

But property rights may be more complex. Demsetz[5] describes “a bundle of rights” where he recognizes different components of ownership that may be unbundled in parts to define a wide range of ownership regimes. Control rights, cash flow rights, and the right to re-assign these rights are separable. The nature of these rights and the extent and manner of their separation and recombination depend on how they are specified and the manner and extent to which they are enforced. Further, specification and enforcement may depend on cultural and social norms so that technically equivalent sets of property rights may yield entirely different ownership and incentive phenomena in different cultural settings.

Economic innovations in China have created complex ownership structures with variations over time, among sectors, and across regions. Careful study and analysis of each form is necessary to assess its “private” nature in terms of the expected impact on incentives, efficiency, and economic reforms. At least four different categories are described by Oi and Walder[6] to classify these ownership structures. Even so one must deal with a continuum of variations within the spectrum. Between well-understood public and private ownership states Oi and Walder recognize two other types of ownership rights in China. Somewhat more “private” than pure public ownership is the “responsibility system” in which the state yields certain control rights to managers to create incentives. And somewhat more “public” than pure private ownership is the lease structure in which the state collects fixed rents for state assets from entrepreneurs.

The Oi and Walder analysis was based primarily on local government enterprises. Large state owned enterprises whose control may be traced directly to the State Council have been partially privatized in yet other forms by utilizing securities markets.

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[5] Harold Demsetz, “Toward a Theory of Property Rights”, in “Ownership, Control, and the Firm: The Organization of Economic Activity”, Oxford University Press, 1967, pg 104

[6] Jean Oi and Andrew Walder, “Property Rights and Economic Reform in China”, Stanford University Press, 1999, pg 7

Cultural Transition

Transition economies face formidable cultural challenges. The profit motive interferes with the moral compass of the socialist cultural value system and yet market economies depend on it. Socialism abhors income disparity and yet it is a structural characteristic of market economies. Successful transition requires an optimal balance in regulated greed. As one might expect, gross deviations on either side of the optimal are observed during the transition process.

Harnessing the power of greed with just the right form and amount of regulation is not an easy task. Another problem with transition: crossing the river on pebbles is easy because there is a well defined other side. In transition there is none. No economic formula known to man has all the answers. There are too many flaws in even the best market systems. We know we are leaving but we don't know where we are going.

History shows that the same kinds of problems exist in other forms of transition. Dickension England and the "Robber Barron" phase of American industrial development may also be thought of "transitional" along the same lines. China's approach to the management of cultural and social problems of transition has been to adopt a philosophy of gradualism.

The Dual Track Gradualism Philosophy

Particularly in the development of equity markets, it may be argued that the economic cost of inaction may be offset by the high cost associated with failure. Investor confidence is an important factor in the valuation of equity by stock markets. A rush to securities trading entails the risk that there are inadequate market and regulatory mechanisms in place. Poorly designed stock markets expose investors to risks they are not prepared or willing to bear. Investor confidence is characterized by frailty and meta-stability. It is easily lost but once lost it leaves a long-term effect on the market and the economy.

Although we take the stock market concept for granted in developed market economies, what occurs in this forum is unusual and counterintuitive. It has even been described as "magic"[7]. It is a magic that somehow motivates perfectly rational individuals to put their savings at risk in exchange for vague promises of unspecified future cash flows. Critical to this kind of investment decision is investors' belief that insiders will not cheat them and that the system is not rigged against them. Once they see evidence to the contrary it is very difficult to resuscitate their belief. A comparison of securities market development in Poland with that in the Czech Republic serves to clarify these effects.

A Historical Perspective of the Private Sector

Prior to socialism the private sector was the primary economic engine of China. In 1820 it made China the largest economy in the world and by 1860 Shanghai had become the financial and commercial hub of the East. Private enterprise was universal, robust, and vigorous and the private sector exercised considerable political power. In fact it was the attempt by Empress Dowager to nationalize the railroads that brought about the demise of the Qing Dynasty and ironically, by way of Sun Yat Sen's popular revolt, the ascent of the Communist Party of China (CPC).

At the time there were about half a million private enterprises in China active in a variety of sectors including mining, manufacturing, transportation, finance, and munitions. The private sector continued to drive the Chinese economy even under socialism. It supplied the People's Liberation Army during the Korean War. The initial position of the CPC was that private enterprise could co-exist with

[7] Many authors have referred to the magic of the market. John Coffee, Jr. has been particularly descriptive. See for example the Columbia University School of Law Working Paper Number 144, January, 2001

socialism. But after the Korean War the CPC reversed itself and began to appropriate private sector assets citing ideological reasons. It is unacceptable in socialism for an individual to profit from the labor of another. It was therefore deemed necessary for the party-state as the representative of the people to own all factors of production except for labor. During periods of recession and unemployment these ideologies were more liberally interpreted and the private sector was called upon to provide employment but by 1966 a continued program of appropriation had completely eliminated private enterprise from China.

Socialist ideology was re-interpreted again in 1977 during the Eleventh Party Congress when the CPC articulated and adopted a doctrine called the “Deng Xiaoping Theory”. The essence of the “theory” is that socialism in China is in its infancy and it is necessary for China to grow to the next stage of socialism called a “socialist market economy”. To do so the concept of state ownership of capital assets is to be broadly defined. The broader definition permits a wide variety of ownership structures including private enterprise. A period of reform ensued and various forms of private ownership began to re-appear in China as the State sought to improve the efficiency of the public sector by creating incentives.

Within a decade of this policy a complex portfolio of ownership structures had emerged in China. These may be roughly categorized as either State owned enterprises (SOE) or non-State owned enterprises (NSOE). By ‘State’ we mean the central party-state so that State ownership implies ultimate control by the State Council in Beijing. The SOE may be further divided into two categories. Strategic industries (SOESI) that are considered to be in the national interest are to remain completely in State hands under direct supervision of the State Council.

But in what are deemed non-strategic industries (SOENS) the State seeks to identify the profitable enterprises and improve their efficiency by giving managers greater autonomy, by downsizing them, and by partially privatizing them. There are approximately 300,000 SOENS of which 200,000 are to be retained and restructured. The rest will presumably be mothballed. The State’s tolerance of private enterprise likely arises from the expectation that the private sector will absorb the unemployed workers of SOENS and forestall social unrest.

SOENS may be re-organized as joint stock corporations and they may issue shares to the public. They may also form joint ventures with foreign firms. Partial private ownership of SOENS by domestic and foreign investors is encouraged as a matter of policy. Accordingly a large number of SOENS have been partially privatized with shares issued in domestic exchanges, in Hong Kong, and even in Singapore and New York. The actual structure of the IPO varies and one may use these structural differences to distinguish between H-share firms, Red Chip firms, A-share firms, B-share firms, and so on. In all cases the state holds a controlling interest and the state bureaucracy retains managerial control. The rapid pace of these IPOs has been one of the most visible characteristics of reform and transition in China.

There are two primary classes of the NSOE, publicly owned (NSOEPO) and privately owned (NSOEPV). The pure form of NSOEPV consists of new businesses started at the grassroots level by entrepreneurs. These businesses had never existed as a public enterprise. The NSOEPO are owned and operated by local government and their agencies down to the village level and they are collectively referred to as “Town and Village Enterprises” or TVE. Some of these TVE enterprises are turned over to private ownership using a variety of privatization methods. We can identify three specific forms; they are sold outright to an insider, they are leased to an outsider, or they are simply taken over by the principal officers or party cadres and operated as if they were private enterprise. These TVEs display all the characteristics of private enterprise and may be treated as NSOEPV along with the pure form of private ownership.

The WTO and the Rule of Law

Throughout history economic de-centralization in China has also led to political de-centralization; a weakness at the center has triggered the rise of the provinces and regional warlords and eventually a

violent change in leadership. These relationships are relevant in the reform era. Economic reforms will necessarily lead to expanded individual freedoms and a coincident weakening of the totalitarian system of social control. This process is already in evidence. For example, after almost two years of an all out campaign the State has been unable to stamp out a loosely organized semi religious group. It is not a coincidence that this confrontation has taken place entirely during the current period of reforms.

The methods used by the State in its crusade against the group share some of the characteristics of those used in the Cultural Revolution. The primary difference is in the dogma applied. In the Cultural Revolution the CPC accused their perceived enemies of “anti-revolutionary activities”. By contrast, this time they are alleged to be an agent of unspecified external forces who are trying to destroy China. They are also accused of being evil and of carrying out anti-China activities.

The fear of “external forces” harkens back to the Boxer Rebellion and revives the kind of xenophobia that has characterized China for most of history. Surprisingly it comes during one of its rare “openings” when the government is promoting reforms, foreign trade, globalization, and the WTO. The failure of the state’s crusade and the simultaneous entry of China into the WTO seem to indicate that the CPC’s role in China has undergone fundamental changes since the Cultural Revolution. The CPC is weaker and civil society is stronger.

Further, the crusade has become a liability for the State at home and abroad. At home citizens can sense the vulnerability of the party-state and overseas the CPC is accused of violating international norms of human rights. The embattled leadership finds itself in a trap; unable to win quickly or to retreat honorably.

The affair compromises the rule of law and thereby imposes a political risk premium on the cost of capital in China. It shows that the government is not constrained by law and that the leadership is able to bring state resources to bear against citizens on an arbitrary and capricious manner. Such a government cannot credibly commit to reforms or to fair capital markets. State enterprises issuing shares face a higher cost of capital because foreign investors perceive higher political risks in Chinese capital markets. The loss of credibility is costly for the State.

However, the government cannot, in its present state, voluntarily adopt constraints that it feels would further weaken its position with respect to social control. The rule of law would give all citizens, including yogis, access to the courts and to legal protection from arbitrary persecution by the State. The State would find that particularly unacceptable now because it is locked in combat with a citizens group that it would like to eliminate prior to legal reforms. At the same time the State needs credibility in its reform program in order to strengthen capital markets.

The WTO serves to rescue the State from this trap. The government’s commitment to reforms gains credibility from its commitment to the WTO without compromising social control to any substantive extent. Of course, the WTO decision is complex with many interacting factors. It is easy to oversimplify the problem and I hope that I am not guilty of that here. However, the arguments presented give substance to the expectation that WTO membership will enhance the State’s credibility without legal constraints and thereby strengthen capital markets and lower the cost of capital to state owned enterprises even in the absence of the rule of law.

Some Concluding Thoughts

1. So far it seems that stock markets in China are part of a mechanism for restructuring and reforming SOEs and not necessarily related to privatization or private sector development. If so it would explain the delay in setting up the “second board” of the stock exchange that government announces and then postpones from time to time.
2. Since reforms began household savings/GDP has gone from 6% to over 50% and M2 from 32% to well over 100%. The introduction of anonymous banking corresponds with the beginning of these changes. Clearly, the state sees these household savings as an

answer to their banking and SOE reform problems. And that explains why they view the private sector as the enemy because they compe for these funds. This scenario is a trap for the private sector and there appears to be no way out. The traditional role of securities markets in developing the private sector is therefore neutralized. The irony is that the State needs a private sector to absorb the layoffs from their program of re-struturing the SOE sector.

3. Bank lending is not constrained once banks unload bad debt to asset management companies. It therefore appears that the State's use of asset management companies to take over the NPLs of state banks is more cosmetic than substance.
4. Securities markets and their regulators in China have an incestuous relationship. Structural reforms are needed to get out of the situation where the party-state is simultaneously the controlling shareholder of listed firms, stock market, investment banker, brokerage, and market regulator.
5. In centrally controlled economies, the party-state directly monitors managers of SOEs. Once a share-holding firm is carved out of an SOE and managers theoretically no longer take orders from the state but make business decisions, who monitors and disciplines managers? The answser may be "nobody" until a regulatory apparatus is created to protect minority shareholder rights. Even the state, the majority shareholder is not protected without such a legal overhaul. Russian style asset stripping and spontaneous de facto "privatization" by managers a problem in China as it was in Eastern Europe.