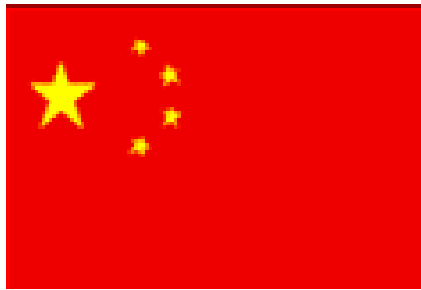


CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN CHINA



**The Capital Hotel, Beijing
January 18-19, 2000**

SESSION VI:

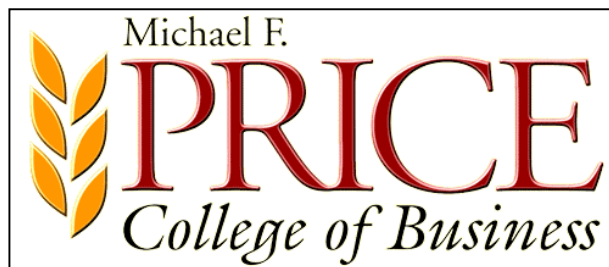
CORPORATE GOVERNANCE IN

PUBLICLY QUOTED COMPANIES

Presented by:

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Talk Will Focus On Four Key Issues In The Governance of Publicly-Traded Firms

1. How To Define Corporate Governance For Public Firms?

- Securities Laws, Disclosure Regulations Obviously Critical
- But Other Things (Accounting Rules, Competition) Also Key

2. Why Has Interest In Governance Surged Recently?

- Has Become Key Issue For Policy-Makers & Academics Alike

3. What Specific Steps Must A Government (China) Take To Create An Economically Efficient Governance System?

- Critical If Considering Share Issue Privatization Program
- Both Challenge & Opportunity For Divesting Government

4. What Is The Economic Payoff From Efficient Governance?

- Capital Markets Are Winning The Present; Will Dominate The Future, So No Real Alternative To Markets (vs Banks)
- Critical To Economic, Political Success Of Privatization

1. What Is The Corporate Governance System For Publicly-Traded Firms?

- **Corporate Governance Defined:**
 - Corporate Governance Is The Set Of Laws, Institutions, Practices, And Regulations That Determine How A Publicly-Traded Firm Will Be Run--And In Whose Interest
- **Every Country Has A System Of Corporate Governance**
 - In Capitalist Countries, Legal System The Decisive Factor
 - In Socialist Countries, Government Plays Central Role
 - All Governance Systems Are Changing Very Rapidly Today
- **Can View System From Both Macro & Micro Perspective**
 - Macro: Laws (Govt), Listing Rules (Exchanges), Regulations That Affect All Public Companies In A Country
 - Micro: Ownership Structure, Charter Of Individual Firms

Corporate Governance Involves Obvious Laws, Regulations, And Practices

- **Securities Law (And Enforcement) Defines Rights & Responsibilities Of Firm's Claim-holders**
 - Establishes Cash Flow, Voting Rights Of Shareholders (S/Hs)
 - Defines Frequency, Degree Of Public Information Disclosure
 - Key Question: How Well Are Minority S/Hs Protected From Expropriation By Insiders (Majority S/Hs)?
 - Independence, Competence Of Judicial System Also Critical
- **Regulatory Bodies Designed To Protect Public, Competitors**
 - Regulate Pricing, Service Levels For Utilities, Transport Firms
 - Antitrust Rules Promote Competition, Discourage Collusion
- **Stock Exchanges Set Initial, Ongoing Listing Requirements**
 - If Rules Set Privately, Should Be Value-Maximizing
 - All Governments Mandate Additional Disclosure, Other Rules

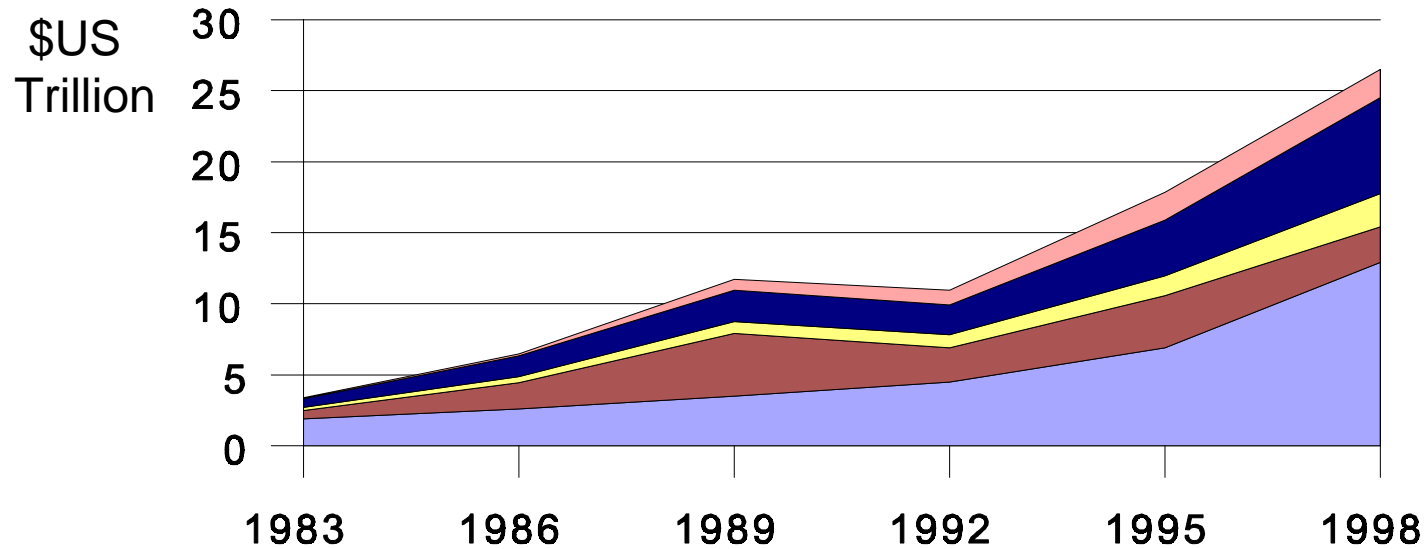
Governance System Also Involves Legal, Regulatory Features Not Specific To Control

- **Product Market Competition Limits A Firm's Ability To Exploit Claim-Holders, Customers**
 - Domestic Competition Helped By De-regulation, Technology
 - Foreign Competition From Trade Liberalization (i.e., WTO)
- **Adopting International Accounting Standards Key Step**
 - Ensures Consistent, Transparent Information Disclosure
 - Important For Domestic S/Hs; Essential For Foreign S/Hs
 - Perhaps Most Important (And Difficult) For Banks
- **Fiscal And Macroeconomic Stability Very Important**
 - Low Inflation, Low Govt Deficits Required for L-T Investment
 - Corporate & Personal Tax System Mustn't Be Confiscatory
- **Rules Should Allow, Even Promote Control Contests**
 - Hostile Takeovers Should Not Be Prohibited

2. Why Has Interest In Corporate Governance Increased So Dramatically?

- **Until Recently Governance Only Of Interest To Academic, Legal, Regulatory Specialists In Western Countries**
 - Long An Important Specialty In U.S., Less Interest Elsewhere
- **Since 1990, Has Become Central Issue For Policy-Makers, Economists, Business Managers--For Three Reasons:**
 - Size & Role Of Capital Markets Has Massively Increased In Almost Every Country
 - Academic Research Has Documented That Economic Performance Significantly Related To Governance System
 - Privatizing Governments Have Had To Address (Sometimes Create) Governance To Achieve Program's Success
- **Examine Each Reason Briefly In Turn**

World Stock Market Capitalization, 1983-98



Capital Markets Have Grown Enormously-- Both Absolutely & As Percent Of GDP

	Stock Mkt Capitalization As % Of GDP	
	1990	1997
Low & Middle Income	18.9%	31.3%
East Asia & Pacific	16.3	26.4
Europe & Central Asia	2.1	23.2
Latin America & Carib	7.6	30.3
China	0.5	22.9
Hong Kong, SAR	111.5	241.1
High Income	56.4	97.8
Europe EMU	22.4	46.5
World	51.8	84.6

Value (In \$US Billion) Of Worldwide Security Issues In 1998 Versus 1990

<u>Security Type</u>	<u>Value 1998</u>	<u>Value 1990</u>
Total Debt & Equity	\$2,532	\$504
Total Debt	\$2,308	\$465
U.S. Issuers	\$1,820	\$313
International Debt	\$888	\$184
Eurobonds	\$606	\$172
Yankee Bonds	\$241	\$13

Academic Research Documenting Importance Of Corporate Governance

- **Most Important Recent Stream Of Literature From LaPorta, Lopez-de-Silanes, Shleifer, and Vishny [LLSV]**
 - LLSV (JF 97): Show That Countries Which Protected Minority S/Hs Relied More On External Finance (vs Banks)
 - LLSV (JPE 98): Find That English Common Law Countries Had Larger Capital Markets Than Other Legal Systems
 - LLSV (JLEO 99): Find Quality Of Government Systematically Related To Govt Size, National Economic Performance
 - LLSV (JF 99): Show That Dispersed Share Ownership Rare Outside of US, UK, Japan; Family Control Typical
 - LLSV (JF2000): Find National Dividend Payouts Directly Related To Ability To Control Agency Problems
 - LLSV (JFE 2000): Show That Common Law Counties Assign Higher Valuations To Publicly-Traded Stock

Research Documenting Importance Of Corporate Governance (Continued)

- **Examples Of Successful And Failed Governance Reforms**
 - Most Dramatic: Black, Kraakman, Tarassova (SLR 2000)
Show Disastrous Effects Of Russian Insider Control
- **Other Researchers Have Documented Direct Relationship Between Size Of Capital Markets And Economic Growth**
 - Levine (JEL 97), Levine & Zervos (AER 98), Demirguc-Kunt & Maksimovic (JF 98), Rajan & Zingales (AER 98)
 - Vast Literature On Merits Of Banks Vs Capital Markets
- **Growing Literature Showing Superiority Of State Vs Private Ownership; Performance Improvements In Privatization**
 - Ownership: Boardman & Vining (JLE 89); Dewenter & Malatesta (AER 2000)
 - Privatization: Megginson, Nash, and Randenborgh (JF 94), Boubakri & Cosset (JF 98); D'Souza & Megginson (JF99)

Research Documenting Importance Of Corporate Governance (Conclusion)

- **Several Recent Survey Articles Have Examined Corporate Governance And/Or Privatization**
 - *Corporate Governance*: Mayer (OECD 96), Shleifer & Vishny (JF 97), Maher & Andersson (OECD 99), Claessens, Djankov & Lang (WB 99)
 - *Privatization [General]*: Megginson & Netter (NYSE 99), Coffee (WP 99), Sheshinski & López-Calva (HIID 99)
 - *Privatization [Developing Countries]*: Nellis (IFC 99), Shirley (WD 99), Havrylyshyn & McGettigan (IMF 99)
- **Many Papers Have Examined Chinese Economic Reforms**
 - Except For Bai, Li & Wang (JCE 97) and Lin, Cai & Li (AER 98), Most Find Positive Results: Groves, et al (JPE 98), Xu & Wang (WB 97), Li (JPE 97), Cao, Qian & Weingast (ET 99)
 - Cyril Lin (ADB 2000): Excellent Survey Of Governance

Privatizing Governments Must Address Governance For Program's Success

- **Cumulative Value Of Privatization Revenues Received By Governments Exceeded \$1 Trillion In 1999**
 - Money Retained By Government, So Success Very Important
 - Most Proceeds From Share Issue Privatizations (SIPs)
- **SIP Programs Designed To Attract & Favor Domestic Investors--Most Of Whom Are First-Time Investors**
 - Favor Citizens To Promote Reform, Win Votes
 - Study (Next Slide) Examines Offering Terms In SIPs
 - SIPs Protect Citizens' Interest Better Than Voucher Schemes
- **Large-Scale SIP Program Drastically Increases Stock Market Capitalization & Liquidity And Number Of Individual S/Hs**
 - Leads To Demand For Effective Securities Laws, Regulation
 - Initially Create Many Individual S/Hs; Later Institutional S/Hs

How Politicized Are Pricing & Share Allocation Terms In SIPs?

- **Governments Have Learned How to Achieve Political And Economic Objectives In SIP Programs**
 - Balance Revenue Maximization Vs. Political Objectives
- **Jones, Megginson, Nash & Netter (JFE 99) Test Perotti (AER 95), Biais & Perotti (WP 97) Models:**
 - Find SIPs Significantly & Deliberately Underpriced
 - Govts Almost Always Choose Fixed Price Offers
 - Allocate Shares To Citizens, SOE Employees
 - Govts Almost Never Sell 100%, Rarely Sell Control
 - Often Have Control Restrictions (“Golden Share”)
 - IR Directly Related To % Capital Offered, Gini Coeff
 - IR Negatively Related To Govt’s “Populism”
 - IR Not Significantly Related To Firm Size (Not AI)

Privatization's Impact On Stock Market Capitalization

- **Total World Market Cap Rose From \$3.38 Trillion In 1983 To \$26.5 Trillion In 1998 (Sevenfold Increase)**
 - Market Cap Of SIPs Rose From <\$50 Billion To \$2.44 Trillion
- **84 of 1999 Business Week Global 1000 Are SIPs**
 - SIPs 10% Of Total, 21% Of Non-US Market Cap
- **49 of BW Top 200 Emerging Markets Firms SIPs**
 - Five Largest--And 7 Of 8 Largest--Firms All SIPs
- **Under-states True Importance Of SIPs**
 - Play Very Important “Bellweather” Role
- **SIPs Usually A Country's Largest Cap Firm**
 - Also Most Actively Traded--Usually By Wide Margin

SIPs Often The First, Second, And/Or Third Most Valuable In A Nation's Stock Market

Country	Largest	Second	Third
Australia	X		X
Britain	X	X	
Denmark	X		
France	X		
Germany	X		
Italy	X	X	X
Japan	X	X	
New Zealand	X		
Portugal	X	X	X
Singapore	X	X	
Spain	X		

Market Value & Market Capitalization of Privatized Firms (BW Global 1000)

Company	Country	Mkt Cap
BP Amoco	United Kingdom	173,870
NT & T	Japan	156,770
Deutsche Telekom	Germany	115,023
British Telecom	United Kingdom	107,142
NTT DoCoMo	Japan	106,140
France Telecom	France	79,925
Telecom Italia	Italy	66,446
Telstra	Australia	63,890
Telefonica	Spain	51,150

Market Value & Country Rank of Privatized Firms (Emerging Markets)

Company Name	Country	BW Rank	Mkt Cap (\$ mm)
Telmex	Mexico	1	33,305
China Telecom	HK/SAR	2	25,294
Gazprom	Russia	3	24,502
Korea Elec Power	Korea	5	19,752
YPF	Argentina	7	15,146
Korea Telecom	Korea	8	14,731
Petrobras	Brazil	10	13,317
Hellenic Telecom	Greece	14	10,926

Privatizations As Equity Issues

- **21 Largest Share Offerings Are All SIPs**
 - 36 Of 41 Largest Are SIPs
- **31 SIPs Larger Than \$5.5 bn UPS IPO (Jul 99)**
- **700+ SIPs Have Raised > \$650 bn Since 1977**
- **125 SIPs Have Raised More Than \$1 bn**
- **Differences From Private-Sector Issues:**
 - Typically Pure Secondary Offerings
 - Highly Politicized Offer Terms & Share Allocations
- **SIPs Almost Always Nation's Largest Share Issue**
 - True For Every Major Country Except U.S.

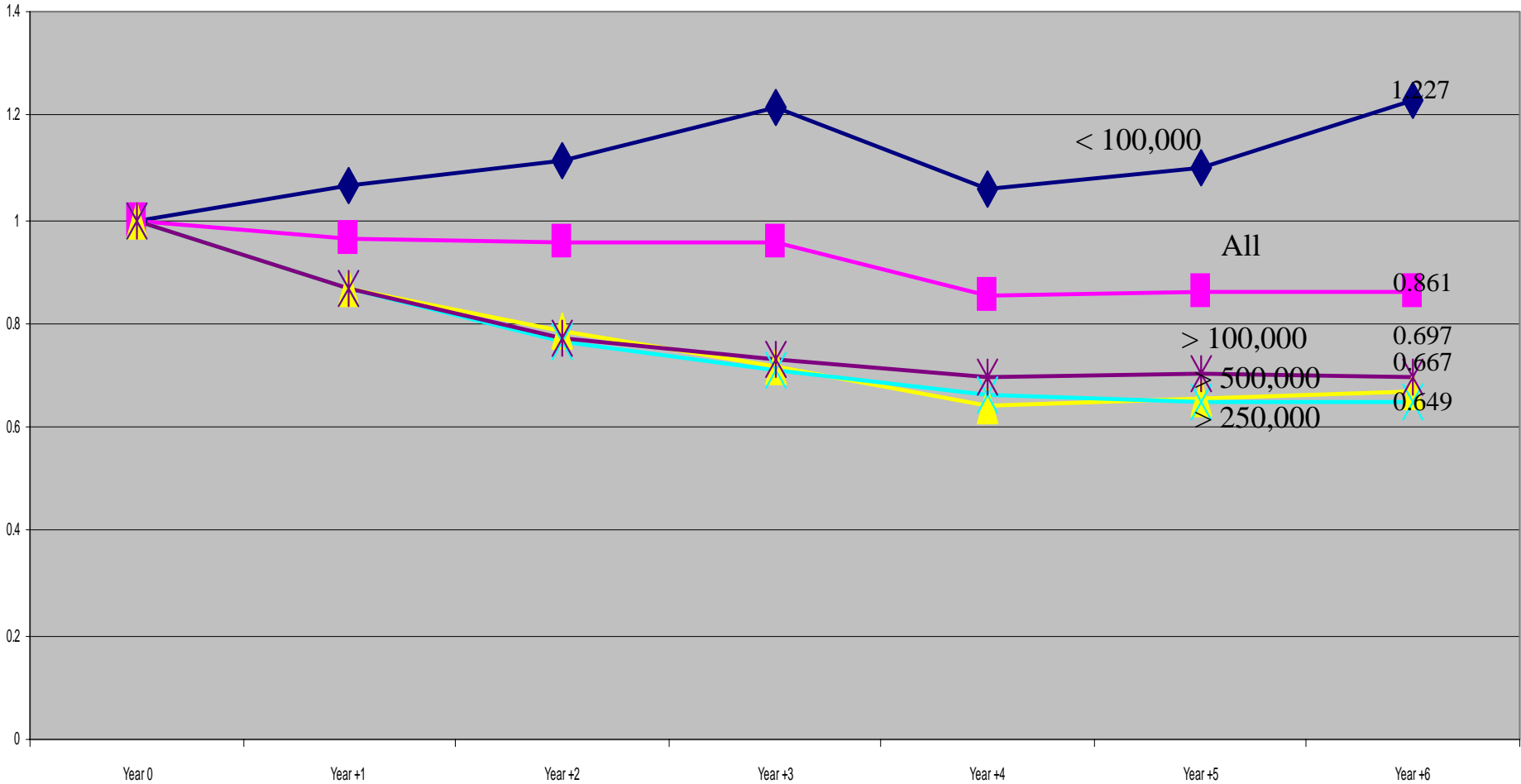
Share Issue Privatization And Individual Stock Ownership

- **Many Governments Try To Create “Equity Culture”**
 - Design Offer Terms To Maximize Number Of Individual S/Hs
 - Allocate Shares To Favor Citizens Over Foreigners, Encourage Individual Ownership
- **Large SIPs Often Create 1 Million+ Shareholders**
 - France Telecom 3.9 Mn, Deutsche Telecom 3 Mn, Credit Lyonnais 3.4 Mn, Telecom Italia 2 Mn+, Endesa 2 Mn+
 - New S/Hs Often Own Shares In Only One Company
- **Must Create A Governance System That Protects S/Hs**
 - Democratic Governments Very Sensitive To Small S/H Losses
 - Major Problem In CEE--Especially Russia

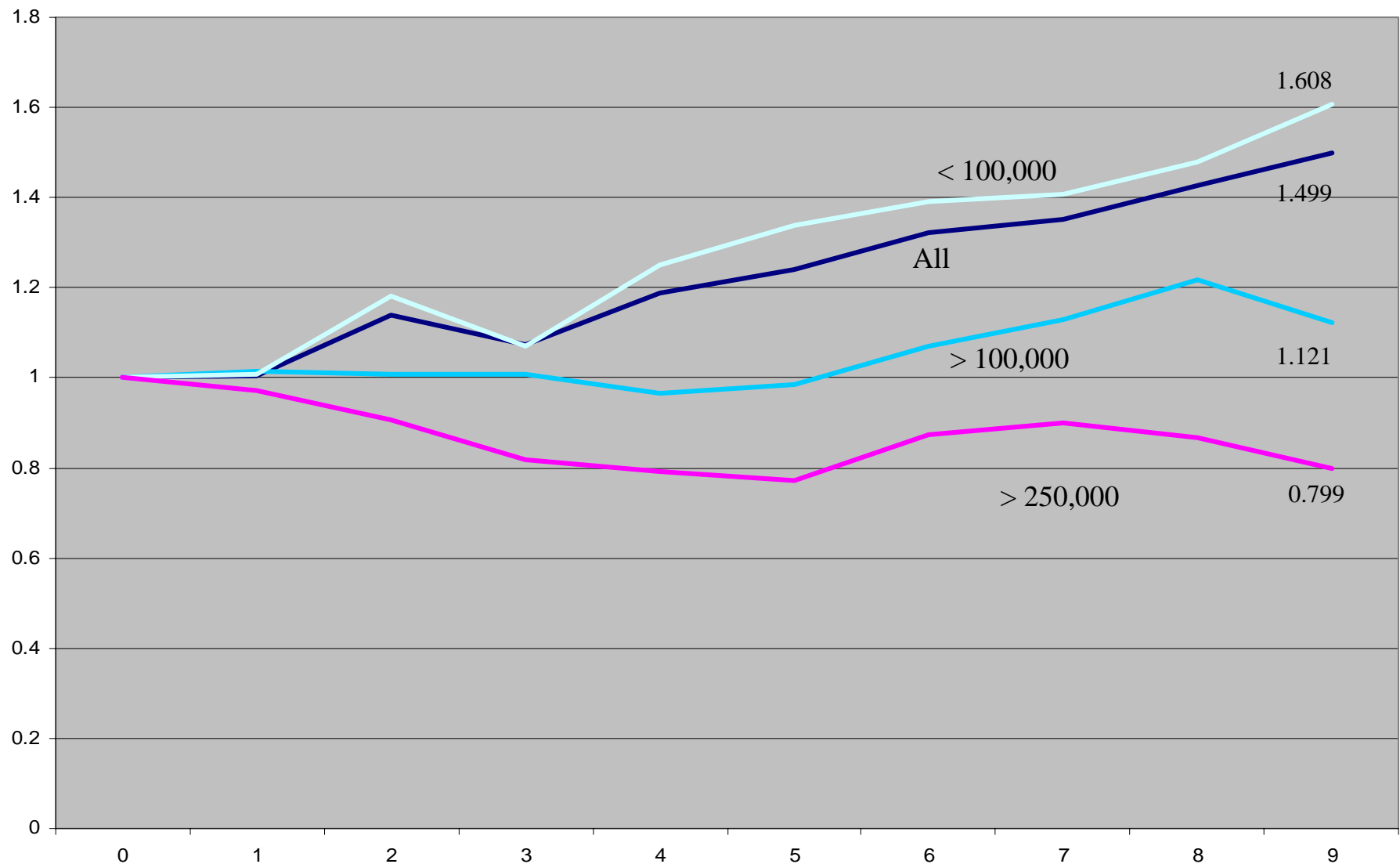
Share Issue Privatization And Individual Stock Ownership (Continued)

- **Boutchkova & Megginson (WP 99) Compare Number Of Shareholders In SIPs To Those In Private Firms With Closest Market Capitalization**
 - WorldScope Disclosure: 6,400 Firms With # S/Hs
 - Number Of S/Hs Highly Skewed: <2% Of All Firms Have >250,000 S/Hs; 915 Have <50,000
 - 55 Of 89 Non-U.S. Firms 500,000+ S/Hs Are SIPs
 - SIPs Have Significantly Larger # Of S/Hs Than Private Firms
- **Key Finding: Large Numbers Of S/Hs Not Stable**
 - Firms With 250,000+ Initial S/Hs Decline By 20% In 6 Years
- **Apparently Individuals Sell To Institutional Investors**
 - Foreign Investors Now Own Half Of Many European SIPs
 - May Help Over Time To Create Funded Pension System

Relative Number of Shareholders Over A 6 Year Period After A Share Issue Privatization



Relative Number of Shareholders Of Non-Privatized Companies Over A 9 Year Period



3. What Specific Steps Must Be Taken To Create An Effective Governance System?

- **Laws, Regulations, Courts Must Protect Minority S/Hs From Exploitation By Insiders, Discourage Self-Dealing**
 - Without This, Capital Markets Will Remain Small, Ownership Will Remain Concentrated
 - Black, et al (99) Shows Catastrophic Result For Russia
- **Promote Adoption Of International Accounting Standards**
 - Mandate Consistent, Nation-wide Use Of IAS or GAAP
 - Also Encourage Firms To List On Foreign Exchanges
- **Set Clear Rules For Corporate Control Contests**
 - Don't Automatically Discourage Hostile Or Foreign Takeovers
 - Mandate S/H Meeting And Voting Rules That Encourage Competition For Control (i.e., Proxy Contests)

Specific Recommendations (Continued)

- **Allow/Encourage International & Institutional Investors To Become Important Players In National Markets**
 - Foreign Participation Promotes Transparency, Efficiency
 - Institutional Investors Bring Liquidity, Sophistication
- **Emphasize Transparency In Disclosure Regulations**
 - Disclosure Reduces Need For Intrusive Regulation
 - Firms Will Not Voluntarily Disclose Key Information; Must Be Mandated By Government And/Or Exchanges
- **If Large-Scale Privatization Program Being Considered, Use Offering Terms To Achieve Governance Objectives**
 - Promote “Equity Culture” And Wide Share Ownership
 - Privatized Firms Can Be (And Often Are) Models Of Good Corporate Governance Practices

Specific Recommendations (Conclusion)

- **Establish Workable, Efficient Bankruptcy Rules**
 - Must Protect Creditors As Well As Debtors
 - Especially Critical (And Difficult) For State-Owned Enterprises
- **Clarify--But Limit--Government's Role In Governance**
 - Should Act As Unbiased Referee And Regulator
 - Core Governance Policies Should Be Set At National Level, Though Competition/Experimentation Useful In Other Areas
 - Govt Shouldn't Interfere In Day-to-day Affairs Of Partially-Privatized Companies; Use Golden Shares For Key Issues
- **Specific Steps Recommended For Chinese Context Aply Presented In Lin (ADB 1999)**
 - Other Academic Research Suggests Reforms Since 1978 Have Left China Well-Positioned For Success

4. What Is The Economic Payoff From Efficient Corporate Governance?

- **To Achieve Acceptable Levels Of Economic Growth, Must Develop Large & Efficient Capital Markets**
 - Banks No Longer Offer Real Alternative To Capital Markets
 - Cannot Develop Large Stock Markets Without “Solving” Key Corporate Governance Problems
 - Large Stock Markets Promote Large Debt Markets; Markets Are Complements Rather Than Supplements
- **Though Still Debated In Some Quarters, Efficient Capital Markets Have Decisive Competitive Advantages**
 - Technology Favors Markets Over Bank (Or Govt) Financing
 - Markets Promote & Support Firm-Level Restructuring
 - Stock Markets Are Essential For Developing Venture Capital, Developing Entrepreneurial Growth Companies

The Economic Payoff From Efficient Corporate Governance (Continued)

- **An Efficient, Fair Governance System Helps Attract & Retain Foreign Direct And Portfolio Investment**
 - FDI, In Particular, Has Been Very Important For China
 - Better To Attract Foreign Capital Thru Markets Than Banks
- **Efficient Stock Market Provides Some Primary Financing**
 - Far Less Important Than Usually Believed--Net Equity Issues **Negative** In Most OECD Markets (Especially U.S.)
 - Most Important As A Market For Corporate Control And As A Compensation Tool For Managers
 - Key Benefit: Stock Market Growth Promotes Bond Market
- **For China, In Particular, Financial Condition Of State-Owned Banks Is Unsustainable**
 - Capital Markets Provide Alternative Corporate Funding Tool
 - Can Provide Mechanism For Cleaning Up Problem Loans

The Economic Payoff From Efficient Corporate Governance (Conclusion)

- **Payoff From Efficient Corporate Governance Can Be Enormous If Coupled With Privatization Program**
 - SIPs Require Good Governance System For Success
 - Asset Sale Privatizations Also Require Corporate Investors To Trust National Governance System
 - D'Souza & Megginson (JF 99), Others Find That SIP Programs Lead To Increased Output, Efficiency, Profitability & Capital Investment; Stable Employment, Lower Firm Debt
 - Recent Paper Finds Chinese SIPs Have Opposite Results: Performance *Declines* After Privatization
 - Successful SIP Program Increases Political Support For Other Economic Reforms

Summary

- **Steps Needed To Implement Governance Reforms Are Easy To Describe, Though Difficult To Achieve**
- **Success Of Chinese Economic Reforms To Date Suggests Reforms Of Governance Practices Can Be Successful, Though Success Is Not Assured**

