THE FINANCIAL SYSTEM REFORM IN CHINA: THE LESSON LEARNT FROM THE GLOBAL FINANCIAL CRISIS

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Abstract

This paper reviews the impact of the global financial crisis on financial system reform in China. Scholars and practitioners have critically questioned the efficiencies of the Anglo-American principal-agent model of corporate governance which promotes shareholder-value maximisation. Should China continue to follow the U.K.-U.S. path in relation to financial reform? This conceptual paper provides an insightful review of the corporate governance literature, regulatory reports and news articles from the financial press. After examining the fundamental limitations of the laissez-faire philosophy that underpins the neo-liberal model of capitalism, the paper considers the risks in opening up China’s financial markets and relaxing monetary and fiscal policies. The paper outlines a critique of shareholder-capitalism in relation to the German team-production model of corporate governance, promoting a “social market economy” styled capitalism. Through such analysis, the paper explores numerous implications for China to consider in terms of developing a new and sustainable corporate governance model. China needs to follow its own financial reform through understanding its particular economy. The global financial crisis might help China rethink the nature of corporate governance, identify its weakness and assess the current reform agenda.

Keywords: China’s financial system, corporate governance, global financial crisis

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Introduction

China’s financial system has experienced a series of major reforms in recent years. Efforts have been made towards introducing the shareholding system in state-owned commercial banks, restructuring of securities firms, re-organising equity of joint venture insurance companies, further improving the corporate governance structure, managing financial risks and ultimately establishing a system to protect investors (Xinhua, 2010). Financial product innovation, with the further opening up of financial markets and the development of the insurance and bond market, has increased liquidity as well as reduced financial risks. The U.S. subprime crisis indicated the benefit of financial innovations for the economy, but without proper control, they may lead to unexpected consequences. Kirkpatrick (2009) argues that failures and weaknesses in corporate governance arrangements and insufficient accounting standards and regulatory requirements attributed to the financial crisis. Similar to the financial crises of the last decade, the global financial crisis which sparked in 2008, surfaced a variety of significant corporate governance failures: the dysfunction of market mechanisms, the lack of transparency and accountability, misaligned compensation arrangements and the late response of government, all which encouraged management short-termism, poor risk management, as well as some fraudulent schemes. The unique characteristics of the Chinese banking system are an interesting point for studying post-crisis corporate governance reform. Considering that China modelled its governance system on the Anglo-American system, this paper examines the impact of the financial crisis on corporate governance reform in developed economies, and particularly, China’s reform of its financial sector. The paper further analyses the Chinese government’s role in bank supervision and risk management. In this regard, the paper contributes to the corporate governance literature within the Chinese context by providing insights into the contributing factors to the corporate governance failure that led to the global financial crisis. It also provides policy recommendations for China’s policy makers to seriously consider. The results suggest a need for the re-examination of corporate governance adequacy and the institutionalisation of business ethics. The paper’s next section provides a review of China’s financial system with reference to the financial crisis, followed by a critical evaluation of a capitalistic system and a review of
Anglo-American and Continental European models. It then analyses the need for a new corporate governance model in China by considering the bank failures in developed economies and the potential risks and inefficiencies in a current State controlled system. The paper closes by reflecting the need for Chinese policy makers to continually develop, adapt and rewrite corporate governance practices capable of meeting the new challenge, and to pay attention to business ethics, an issue which goes beyond regulation.

**China's Financial System and the Global Financial Crisis**

With its roots in the U.S., the 2008 sub-prime crisis spread quickly to the rest of the world. The causes were multidimensional - loose monetary policy, excessive credits, over-reliance on leverage/wholesale funding, low interest rates, unsatisfactory functioning of credit rating agencies, late response of government and inappropriate incentives in modern finance (Barker, 2009, Clarke and Klettner, 2009). China’s economy has not been immune from the effects of the global financial crisis given the ongoing process of economic globalisation and its heavy reliance on trade and foreign direct investment (FDI) for its economic growth (Morrison, 2009, Torres, 2011). China has faced a drop in GDP, high inflation, a sharp slowdown in industrial profit growth and fiscal income, the poorest performing stock market in history and high unemployment (Ljungwall, 2008, Lo, 2010).

The crisis, however, has less affected China’s financial industry due to China’s ‘closed’ capital account and insulated banking sector, primarily relying on deposits with no exposure to risky Western financial instruments (Schmidt, 2009). When bank share prices in the U.S., Europe and Japan dropped sharply during the crisis, China’s three state-owned banks were rated as the top in the world based on market capitalisation, well ahead of JPMorgan Chase Bank and HSBC (Hung, 2009). Ma (2008) summarises that large foreign exchange reserves, unconvertible RMB and an underdeveloped banking sector have helped to explain why China has not been too much affected by the crisis. Given the government’s huge fiscal stimulus package (RMB 4 trillion or approximately $585 billion), the sector has maintained impressive resultant growth, evidenced by the 8.7 per cent increase in GDP in 2009, by far the best among the G20 economies (Lo, 2010). Bell and Chao (2010) argue that this strong growth is not sustainable. China's financial system has faced the problems that have arisen as a result of the surge in bank lending as part of the fiscal stimulus programme, the further financial liberalisation, the internationalisation of Chinese banks and the eventual convertibility of the RMB (Bell and Chao, 2010).

China’s financial system is bank-led which primarily relies on state-owned banks to provide access to finance (Witt, 2010). Bell and Chao (2010) indicate that close to 90% of intermediated Chinese enterprise financing comes from the banks, a contrast to the situation in the U.S., where the capital markets account for about half of total business financing. This situation is unlikely to change much. The most salient characteristic of China’s financial system is the dominant role of the State as a means of maintaining control over the financial system (Naughton, 2007). The State owns 100% shares in three policy banks, controls stakes in the largest five commercial banks and significant equity in the remaining shareholding commercial banks and postal saving banks (Bell and Chao, 2010). The high proportion of state ownership in banks distinguishes its corporate governance structures from those in developed economies. Although there is a trend towards the Anglo-American model to maximise shareholder wealth, the banks place a higher priority on achieving the government’s political objectives. We can characterise China’s governance system by a minimal role for individual and family ownership, a limited role for financial institutions and institutional investors and a dominant state ownership position (Ewing, 2005). The decision making in Chinese banks are not commercially based since the State acts as the principals. The government appoints, motivates and disciplines managers and finances firms' projects, implying that the investor of the firm is a complete outsider, with no inside ownership existing at all (Zhang, 2006). Chang and Wong (2004) examine the trade-offs between political costs and agency costs. Political control increases political costs by serving political and social objectives, but prevents managers from serving their own personal objectives at the expense of firm performance (Chang and Wong, 2004). Because of ultimate state ownership, a corporate governance system is distorted from inside with a lack of outside market discipline (Qiang, 2003). The State involvement in both employee relations and the firm’s other operational matters results in an insider system with the State supporting insider managers without the interests of shareholder value maximisation (Braendle et al., 2005, Lin, 2001, Tam, 2002, Yuan et al., 2009, Li et al., 2011). Tenev and Zhang (2002:99) suggest that the state’s dual role as owner and regulator implies that political intervention is likely. The ownership by all of the people really means a sense of ownership by none of the people (Mar and Young, 2001). Since the owner is far away from the management team and the manager has no stake in the firm, the agency problem of State controlled banks on the management side is
potentially far more serious than that of any capitalist countries where the CEO holds a considerable stake. The government’s key objective is to maintain a substantial control of the banks in order to actively pursue its macroeconomic policy goals, leading to conflict between objectives (Bell and Chao, 2010). This creates the agency problem of how to motivate and monitor bureaucrats to behave like capitalists in selecting, disciplining and motivating management. According to Tian’s (2005) findings, bank loans facilitate managerial agency costs in the firms that a controlling government shareholder owns since the debt financing does not help to improve the quality of corporate governance when the government owns both creditors and debtors.

Related to this, the Chinese financial regulator has recently opened the Chinese financial system to the global market, introduced more interaction and competition, and relaxed its monetary and fiscal policies, similar to the Anglo-American “free market” model. However, the meltdown of high profile companies, such as Lehman Brothers, Fannie Mae and Freddie Mac in the U.S., suggested that Anglo-American governance mechanisms by themselves were inadequate to monitor, control and discipline business affairs. Practitioners and scholars have cast significant doubt on the traditional capitalist Anglo-American model with minimal state intervention. China’s financial policy makers should adjust the focus and strengthen the commitment to the path of reform by learning lessons from global volatility in financial markets. China’s new financial policies may encourage large-scale companies to engage in speculations in securities and real estate’s markets that create the possibility of an asset bubble (Xu and Oh, 2011). Should China follow the U.K.-U.S. path with more competition, liberalisation and financial products innovation, and at the same time less direct control in relation to financial reform? The following sections provide a comprehensive review of the Anglo-American system and investigate the rationale behind the adoption of the Anglo-American model in China where significant differences exist in its institutional, culture and legal environment.

The Debate on Financialized Capitalism

Adam Smith (1776b) states that a free and competitive market economy enables corporations to efficiently and effectively use society’s resources to create value and use market mechanisms to prevent corporations from abusing their power and defrauding their stakeholders. The existence of free markets may facilitate reallocations of scarce resources in their most productive way (Moerland, 1995). The competitive market economy is in the best interest of shareholders, but also of the economy as a whole. Based on the concept of market capitalism, the Anglo-American governance system is founded on the belief that self-interest and decentralised markets can function in a self-regulating manner (Cernat, 2004). Well-developed financial markets, dispersed equity ownership, large institutional holdings, a strong emphasis on shareholder value maximisation, protection of minority interests through the law and regulation and strong requirements for disclosure characterise the Anglo-American model (Walsh and Seward, 1990, Shleifer and Vishny, 1997, Reinecke, 2004, Shleifer and Vishny, 1986). The Anglo-American tradition bases the corporate concept on the fiduciary relationship between shareholders and managers (Jensen and Meckling, 1976). The system stresses the importance of the enhancement of monitoring and accountability mechanisms (Walsh and Seward, 1990). An active external market for shareholders allows for the threat of hostile takeover which disciplines and replaces inefficient managers and exerts pressure on corporate bosses to act in the interest of shareholders (Goldstein, 2000; Reinecke 2004). Kay and Silberston (1995) assert that the threat of hostile takeover has led to an increased focus on shareholder interests and that corporate control is nothing more than a nexus of contacts between managers and shareholders.

The system is certainly imperfect. The main criticisms of the Anglo-American regime include the shareholders’ short-term perspective, the abuse of management power and the overriding of other stakeholder interests. The reinforcement of profit-oriented behaviour and a struggle for material success have shaped the practice of short-term shareholder value maximisation in the Anglo-American model (Moerland, 1995). The exclusive focus of corporate governance on shareholder wealth maximisation conflicts with the interests of other corporate constituencies and those other interests will remain ignored, unless managers are legally required to take those interests into account (Maassen, 2002). Marx (1867) termed shareholder-value capital as ‘fictitious capital’ since the return to shareholders in the form of dividends and capital gains is not derived from the physical properties of the company, but from anticipated future earning power (Ireland, 2008). Consequently, companies operating within the Anglo-American regime have been exposed from their inception with fraudulent manipulation of expectations, speculative bubbles, periods of frenzied company promotions and spectacular financial collapses (Taylor, 2006, Aguilera, 2005).

corporate ownership and governance structures were seriously defective through pursuing short-term shareholder returns over longer-term prosperity. Motivated by remuneration that was geared to short-term gain, bankers, fund managers and board directors have pocketed bonuses with no seeming thought for longer-term consequences (The Economist 2008). Smith (1776a:50) was aware of some of the limitations of “free” markets as markets, by themselves, often destroy the possibility of a decent human existence. During the 1990s and 2000s, the trend towards neo-liberalism led to deregulation in many of the formerly regulated industries (e.g. banking, electricity, airlines and telecommunications) (Baker and Quéré, 2010). During his leadership, former Chairman of the Federal Reserve Bank, Alan Greenspan, presumed that organisations’ self-interests were best capable of protecting their shareholders and the firm’s equity (Mertzanis, 2009). He stated that increasingly complex financial instruments have contributed to the development of a far more efficient, flexible, and hence resilient financial market (The Economist 2008). The post global financial turmoil, however, indicated that the consequence of a laissez-faire philosophy encouraged financial services to innovate and leverage resources which created a complex system prone to risk and fraud (Spitzer, 2009). Bratton (2002) concludes that the incentive structures and their reliance on sophisticated institutional monitoring and the development of “best practice” governance codes, in fact, generate less powerful checks against abuse.

The old-fashioned German “social market economy” styled capitalism has shown its strength during the financial crisis due to its lesser dependence on the financial market (Gumbel, 2009). The German trusteeship model positions corporations as institutions of the social market economy, which require the manager to ‘balance the conflicting interests of current shareholders and additionally to weigh the interests of present and future shareholders’ (Ireland, 1996:298). Many commentators believed that the more stakeholder-friendly models developed in Germany and Japan are more socially cohesive than their shareholder-oriented counterparts in the U.S. and the U.K. (Ireland, 2008). Stakeholder theory, as an extension of the agency theory, has developed gradually since the 1970s (Solomon, 2007). As an original proponents of stakeholder theory, Freeman (1999:234) proposes:

“If organisations want to be effective, they will pay attention to all and only those relationships that can affect or be affected by the achievement of the organisation’s purpose. That is, stakeholder management is fundamentally a pragmatic concept. Regardless of the content of the purpose of the firm, the effective firm will manage the relationships that are important”.

Hence, stakeholder theory is economically more efficient than agency theory. Freeman et al (2004) suggest that the idea of value creation and trade is intimately connected to the idea of creating value for shareholders because business is about putting together a deal so that all stakeholders win continuously over time. Stakeholder theory claims that whatever the ultimate aim of the corporation, managers must take into account the legitimate interests of those groups and individuals who are affected (or will be affected) by their activities (Freeman, 1984, Donaldson and Preston, 1995). Donaldson and Preston (1995) suggest that stakeholder theory offers a framework for determining the structure and operation of the firm to seek multiple and diverging goals. Solomon (2007) states that a sustainable organisation recognises the interdependencies and synergies between the company, its stakeholders, its value-based networks and society. Filatotchev and Nakajima (2010) indicate that corporate governance should relate to the structure of rights and responsibilities of all stakeholders and guarantee that stakeholders act responsibly regarding to the wealth creation and distribution in the firm. Jensen (2001) argues that we should not view stakeholder theory as a legitimate contender to value maximisation because it fails to provide a complete specification of the corporate purpose and directs corporate managers to serve ‘many masters’. The most recent series of corporate scandals, however, all took place under the veil of shareholder value maximisation because focusing upon a single objective in a complex and uncertain business world leads to short termism and a misguided perspective concerning firm performance (Cullen et al., 2006). Knight, Kakabadse et al. (2011) argue that the requirement of “socialised capitalism” is for the public good rather than for the benefit of the selected few and urge for a paradigm shift from neo-liberal market economies to a more stakeholder oriented model of capitalism.

Although democracy is an aspirational and desirable model of governance, the democratic model that Anglo-American governance promotes in terms of capitalist markets and WTO trade rules is ‘clearly conceived within the fundamentals of market ideology’ (Sussman and Krader, 2008:93). For example, Sussman and Krader (2008) show that the democratic motives of the principal U.S. based institutions are to identify ‘targets of opportunity’ interventions in Eastern Europe, and in turn have created a number of the “coloured revolutions” in order to advance US economic, military, and strategic political objectives under the banner of promoting democracy. Moreover, liberalisation of trade though GATT/WTO, with neo-liberal recipes
pushed by the World Bank and the IMF, have empowered and engaged transnational corporations ("corporacy") and weakened governments to the point where elected officials alone can no longer decide national economic policies, but must take into account, if not favour, the interests of huge corporations (Klein, 2007, Kakabadse et al., 2006, Hassard et al., 2002). We, therefore, suggest that practitioners and scholars need to examine the Anglo-American model of corporate governance in order to understand the underlying motives that underpin it. After the global financial crisis, precipitated by the sub-mortgage market failure, we can no longer regard shareholder primacy in corporate governance as the only intellectually respectable efficiency theory. The Anglo-American corporation defines its own terms without undue legislative interference.

Towards a New Model of Corporate Governance for China?

We can trace the development of the Chinese corporate governance system to the late nineteenth and early twentieth centuries when China began its industrialisation and attempted to transplant Western institutions into a non-Western economy (Morck and Steier, 2005). Series of reforms have been implemented after the opening of the stock market in Shanghai in the 1860s, including the introduction of a new corporations law based on contemporary English and Japanese law (Koll and Goetzmann, 2004). Due to the absence of standard accounting and disclosure rules, the reform was unsuccessful. The capital market was viewed as a source of finance without playing an active role to discipline corporate insiders and provide portfolio investors opportunities to influence the governance of the companies. Such pre-Communist capitalism provides a model of today’s ‘market economy with Chinese characteristics’ (Morck and Steier, 2005, Morck and Yeung, 2010). Starting in 1978, the Chinese government has committed itself to institutional reforms. In order to move towards a “socialist market economy”, the State has implemented a series of reforms, including the establishment of China’s two Stock Exchanges, conversion of non-tradable shares, introduction of Qualified Foreign Institutional Investor (QFII) and the most recent opening of Chinese financial markets (Tucker, 2006, Chi and Young, 2007, Yam, 2005). The major reform in the banking industry includes listing four large state-owned commercial banks on both the domestic and foreign stock exchanges and selling a minority of shares to foreign strategic investors (Bailey et al., 2010). The rationale is to encourage foreign investment, but at the same time ensure the State’s dominant control. China adopted a legalistic approach when developing its own corporate governance model based on the Anglo-American regulatory framework (Tam, 1999, Clarke and Du, 1998, Hovey, 2004, Yuka, 2010). However, it deviates from the idealised model due to the lack of market for corporate control and protection for minority shareholders (Tam, 2000).

During the last few years, China’s governance has made great efforts to overhaul the corporate governance framework, including professionalism and transparency in financial reporting, fostering a healthy capital market culture based on rules and regulations, strengthening the role of the board of directors and increasing stock market liquidity (Lu, 2009). However, compared to the modern corporate governance system, the Chinese banking industry still lags behind in corporate governance, strategic positioning, financial innovations and risk management (Wang, 2009). Despite the trend towards the ‘free market’ system, Bell and Chao (2010) argue that the current State-controlled financial system could create misaligned incentives that increase risks and efficiencies in the system over time because governance and risk management practices at the Chinese banks have yet been market-based. The non-market strategies offer additional governmental support, favourable laws and effective ways for banks to work with governmental agencies which in turn alter market conditions. The government agency is the unique customer and, at the same time, a provider of scarce resources, legitimacy and recognition. Local firms need to understand this in order to grow and further develop (Li and Zhou, 2005). China’s corporate governance system needs to mitigate the two conflicting goals of the allocation of scarce resources and local needs. The system has made a trade-off between immediate economic growth and long-term sustainability. The State has to decide the extent of the control in the financial system. If the Anglo-American model is not the correct one to follow and the free market discipline does not work appropriately, the regulator needs to consider a model which would benefit the economy in the long run and prevent banks from failures by strengthening its legal enforcement and monitoring the market.

Conclusion

Despite practitioners and scholars recognising the Anglo-American model’s ‘free market’ philosophy as a superior system in corporate governance for many years, the recent global financial crisis has led to the criticism of its emphasis upon profit-seeking behaviour. Bratton (2002) argues that at a time when corporate self-regulation had been, supposedly widely successful due to proliferating good practices and sophisticated institutional monitoring, disaster occurred because management pursued short-term growth that their business plans
could not deliver. Once the business cycle turned
down, the pursuit of immediate shareholder value
caused them to be risk-prone, engaging in levered
speculation, earnings manipulation and
camouflage of critical information (Bratton, 2002,
Deakin, 2003). Clarke et al. (2003) argue that many
regulation and deregulation fail to address the core
problems of corporate governance failures. When
the recurrence of crisis points to a potential inadequacy of legislative responses, it gives rise to
the question as to whether the corporation is
neglecting more fundamental issues. To whom the
corporation should ultimately be accountable is still
an important issue (Marnet, 2007).

China’s unique business culture would suggest
that market-driven corporate governance might not
be enough to enforce good practice. China needs to
improve in areas beyond legal regulations (Ewing,
2005). Tenev and Zhang (2002) suggest that the
corporate governance failures in both emerging and
developed markets indicate that there is no perfect
corporate governance system. China cannot merely
legislate good corporate governance systems and
practices, nor is there a singular model because
there is no perfect system (Gonzalez., 2007).
Creating corporate governance goes beyond
regulation and legislation. It also must consider
ethics within a social context. It involves tradeoffs
between competing goals (i.e. the shareholder
maximisation or the firm’s long-term sustainability
or that of an entire economy) and thus, can only
ever achieve “second best” options (Wong et al.,
2005). China must develop a corporate governance
system that makes sense from both a capital
markets and from a sociological and ideological
point of view (Voß and Xia, 2006). Understanding
decision makers’ incentives is equally important as
the improvement of technical measures. The
Chinese government must continue to build trust in
a market economy. It requires an effective
communications mechanism to achieve this as well as
openness in the boardroom (OECD, 2007). Rather than proclaiming a universal model of
corporate governance, the respective government
needs to understand the specificities of their
particular economy (O’Sullivan, 2000). Hence,
China needs to follow its own financial reform
path. The global financial crisis might help China to
rethink the nature of corporate governance, identify
its weaknesses and assess the current reform
agenda.

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