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Global Financial Crisis: Implications for Chinese Corporate Governance

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Global Financial Crisis: Implications for Chinese Corporate Governance

Summary

This paper analyses the role of corporate governance failures and weaknesses in the global financial crisis with reference to the evolution of post-crisis corporate governance arrangements in China. The current crisis presents China with an opportunity to analyse its governance problems, reflect on its weaknesses and implement a strategy to address areas which need attention. This paper opens with a description of China's exposure to the current global financial crisis and continues to critically evaluate the effectiveness of a free market system on corporate governance. Bratton (2002) maintains that incentive structures that motivate the self-regulatory systems generate less powerful checks against abuse than scholars and practitioners have believed. The paper highlights the need for corporate regulatory bodies and policy makers to revise and re-develop financial services sector regulations. Finally, the paper discusses the need of ethics in organizations - an issue that is beyond legislation.

In an increasingly interconnected global economy, it is imperative to increase our understanding of what constitutes an effective corporate governance system. The paper contributes to the corporate governance body of literature within the Chinese context by providing insights into the contributing factors to 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.

Main body

Contrary to most global crises in recent decades rooted in developing and emerging economies due to abrupt reversals in capital flows and loose domestic monetary and fiscal policies (Mohan, 2009), the current global financial crisis originated in the U.S. and spread quickly to the rest of the world. China's economy has not been immune to the effects of the global financial crisis given its heavy reliance on trade and foreign direct investment (FDI) for its economic growth (Morrison, 2009). Issues arose such as 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). The crisis has hit the manufacturing and financial service sectors particularly hard (Morrison, 2009). Scholars (Barker, 2009, Clarke and Klettner, 2009) now believe that the causes of the global financial crisis are multidimensional - loose monetary policy, excessive credits, low interest rates, unsatisfactory functioning of credit rating agencies and inappropriate rewards incentives in modern finance. Consequently, the economic downturn and ineffectiveness of market mechanisms eroded investors' confidence.

The crisis that sparked in 2008 has exposed a variety of significant corporate governance failures – the dysfunction of market mechanisms, inadequate supervision, lack of transparency and accountability, misaligned compensation arrangements that encouraged management short-termism, poor risk management, as well as some fraudulent schemes. The meltdown of high-profile companies, such as Lehman Brothers, Fannie Mae and Freddie Mac in the U.S. suggests that the corporate governance mechanisms by themselves may not be adequate to monitor, control and discipline business affairs. Based on the concept of market capitalism, the Anglo-Saxon governance system is founded on the belief that self-interest and de-centralised markets can function in a self-regulating manner (Cernat, 2004). The reinforcement of profit-oriented behavior and a struggle for material success have shaped the practice of short-term shareholder value maximisation behaviour (Moerland, 1995). Current crisis raises a significant doubt regarding the effectiveness of "American style" corporate governance system in serving its stated purpose, to safeguard shareholders value (Berle and Means, 1932, Cadbury, 1992, Cadbury, 2000, Shleifer and Vishny, 1997).

The corporate governance system in China was modeled on the Anglo-Saxon system practiced within the U.S./U.K that promotes the free market system in a self-regulating manner. In his book *The Wealth of Nations*, Adam Smith (1776) positioned that a free and competitive market economy enables corporations to efficiently and effectively use society's resources in creating value and market mechanisms prevent corporations from abusing their power and defrauding their stakeholders. However, Smith (1776:50) was aware of some of the limitations of "free" markets and that markets, by themselves, often destroy the possibility of a decent human existence 'unless government takes pains to prevent' that from happening. Former Chairman of the Federal Reserve Bank, Alan Greenspan, during his leadership presumed that the self-interests of organizations were best capable of protecting their own shareholders and equity of the firm (Mertzanis, 2009). The turmoil, however, indicates that the consequence of the laissez-faire philosophy that allowed financial services to innovate and use high leverage has created a complex system prone to risks and fraud (Spitzer,

2009). Investment banks traded heavily on their accounts. For example, Merrill Lynch is one of the most leveraged companies, which is using about $30 billion of equity to finance $1 trillion of assets (Economist, 2008). When the markets are rising, gearing like that creates stellar returns on equity (Economist, 2008). In the falling market, a small fall in asset values can wipe out shareholders.

The Chinese government has gradually relaxed its control in financial service sectors during the recent economic reforms (Lu et al., 2009). The opening up of Chinese financial markets and relaxing monetary and fiscal policies may encourage large scale companies to engage in speculations in securities and real estates markets that create the possibility of asset bubble. China's unique business culture and development history would suggest that market-driven corporate governance may not be enough to enforce good practice although the market-oriented model is more effective in assuring adequate control (Liu, 2005). China is in its early stage of corporate governance reform. The external control mechanisms, such as a well functioning stock market and legal systems, are still in their embryonic stage. Further de-regulation is likely to cause more severe problems in China. The institutional and legal environment in China is substantively different from that of the U.S. and U.K. Despite improvements to date, China still has a weak legal system with overly strong influence of private connections, the "*guanxi*" (Braendle et al., 2005). Yuan and Yuan (2007) suggest that China's corporate governance effectiveness ranks last amongst nine countries in East Asia, despite Chinese corporate governance laws and regulations ranking highest. A strong and enforceable legal system needs to support an effective corporate governance mechanism (Spitzer, 2009). When the penalties for irregularities are not severe enough, China Securities Regulatory Commission (CSRC) has met many practical difficulties in the course of law enforcement, including complications in seeking evidence, lack of the means to enforce the law and the cooperation of other judicial departments (Lu, 2006). Weak law enforcement results from the lack of an independent judiciary, a weak legal culture and powerless enforcement systems (Lin, 2004). Without an effective law enforcement system regarding the securities market, insider trading and market manipulation frequently occur in China (Lu, 2006). Wolfensohn (2002) notes that the implementation of an effective law enforcement system will be increasingly challenging and will require change of roles and behaviours by institutions, enterprises and individuals, faced with new rules and new incentives. An evolution towards stronger legal protection for investors will lead to more successful corporate governance systems and greater economic development (Jing et al., 2004). In turn, more effective regulation will require increased enforcement capability for regulatory bodies, which means greater reliance on legal instruments and the ability to enforce them (Wolfensohn, 2002). With stronger market regulation, we can minimise the problems of the quality of judges, weak enforcement of judgments, government interference and corruption.

Apart from the weak legal system, the deficiencies in China's capital markets may explain other corporate governance inefficiencies. For example, the falsification of earnings and misappropriation of funds are prevalent amongst parent companies (Takeshi, 2007). Seventy percent of the companies listed on China's domestic market do not meet international standards in terms of profits, returns and other indicators (Cheng, 2007, Takeshi, 2007). China's poor performing stock index illustrates that the stock market is illiquid, inefficient and unreliable; however, this bears little

correlation to China's underlying economic growth (Cai, 2007). From 2001 to 2005, the Shanghai and Shenzhen indexes were the world's worst performing markets out of 77 major benchmarks and the total market value of China's capital market shrank 30.7% from 2003 to the end of 2005 due to investor's disappointment in the market despite a lack of change in market fundamentals (Cai, 2007). There is actually no outside market mechanism for corporate control because share prices fail to indicate an enterprise's value. Shareholders of non-tradable shares have been unable to sell their shareholding on the stock markets and therefore have been indifferent to the prices of tradable shares (Takeshi, 2007).

Investors in China's domestic stock markets remain unsophisticated with individual investors characterised as gambling on a quick increase in share prices (Cooper, 2002, Jiang et al., 2008). Compared with only 38 per cent in the US, China's individual investors account for two-thirds of the trading in China's stock market (Jiang et al., 2008) with an average two months holding period (Wang, 2004). These investors are highly speculative and lack incentives to monitor company behaviour, thus investors popularly blame a collapse in stock prices on the government (Cooper, 2002). Investors operate on a hearsay basis and are usually in the market for short-term gains (Leung et al., 2002). Holding underperforming local companies has adversely affected these investors since potentially higher earnings induces many valuable Chinese companies to list overseas (Beltratti and Bortolotti, 2006). Companies broadly do not understand that they owe their primary duty of care to their investors and that they need to optimise resources allocation (Li and Liu, 2006). Consequently, they have undermined and almost destroyed the basic function of the capital market (Li and Liu, 2006). Additionally, China's capital markets lack real blue-chip stocks with high profitability and, as such, investors are overwhelmed with small-capitalisations (Wang, 2004:12). China's Premier, Wen Jiabao, felt remorseful and sympathetic to investors in remarks bemoaning the collapse of China's stock markets and he blamed China's lack of know-how and experience, along with inadequate stock-market regulations (People's Daily, 2005).

The global financial crisis may lead to legislative changes in China regarding corporate governance. However, adopting new regulation is one thing; whether the reforms actually change the way boards operate is another (Lawler and Finegold, 2005). China needs to improve in areas beyond legislation. 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. Organizations cannot merely legislate good corporate governance systems because there is no singular model or a perfect system (Gonzalez., 2007, Kakabadse and Kakabadse, 2008, Kakabadse and Kakabadse, 2009). Corporate governance involves tradeoffs between competing goals (i.e. the shareholder maximisation or long-term sustainability of the firm 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 a capital markets point of view and from a sociological and ideological point of view (Voß and Xia, 2006). We also must understand the incentives of the decision makers in order to improve corporate governance technical mechanisms and measures. The Chinese government needs to continue building trust in the Chinese people and further develop its unique market economy model. The Chinese government must use an effective communications

mechanism in order to generate trust and openness in the boardroom (OECD, 2007, Kakabadse and Kakabadse, 2008, Kakabadse and Kakabadse, 2009). Rather than proclaiming a universal mode of corporate governance, the government needs to locate its understandings of a particular economy with its specificities (O'Sullivan, 2000). A better understanding of how individuals behave in the real world may, at the very least, improve the chances of preventing future corporate disasters (Marnet, 2007). China needs to continually develop, adapt and rewrite corporate governance practices capable of meeting the new challenge and pay attention to individual and business ethics.

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