Reassessing "Control" of Chinese firms within Bamboo Capitalism

The challenge of corporate responsibility & accountability amid increased global uncertainty

Peter Verhezen[1]
Vlerick Leuven Gent Management School,
Leuven, Gent & St Petersburg Campus, Belgium-Russia

Ash Institute for Asian Studies and Governance
Harvard Kennedy School, USA

Verhezen & Associates Ltd
Sampoerna Square, Jakarta, Indonesia/Singapore

In collaboration with
Paul V. Morse[2][3]
Great Union Group
Bangkok and Hong Kong

Cimad Pacific Energy
Singapore, Vietnam, Cambodia

ABSTRACT: China has gained considerable economic & political power since the global financial crisis, mainly due to the perceived failure of the Western capitalism. It can be questioned whether the Chinese bamboo version of capitalism is so different. Therefore the question begs whether this form of *bamboo* capitalism is indeed sustainable within a global economy. Most likely, globally accepted best corporate governance practices will need to be implemented by Chinese firms in order to gain global recognition. The focus here will be on some formal and informal governance mechanisms of control. Hence the forthcoming banking reform in China to improve performance by starting to implement internationally accepted governance principles. Moreover, this success recognizes the importance of partially privatizing SOEs with the inclusion of minority foreign ownership. This open corporate mindset - that goes beyond *guanxi* and an often opaque patriarchical culture - will hopefully enhance the chances to respond to the main crises in a responsible, innovative and sensible manner.

KEY WORDS: *the emerging economic power of China amid global uncertainty, informal & formal mechanisms of corporate control amid globalization, sustainability of bamboo capitalism, Chinese banking reform with foreign minority shareholding*

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[1] **Peter Verhezen** is an Adjunct Professor at the Vlerick Leuven Gent Management School, Belgium, and a Visiting Associate Professor at the University of Melbourne, Australia. Recently he was appointed as a Fellow at the Ash Institute for Governance and Asian Studies at the Harvard Kennedy School-USA. He advises corporations on risk management, governance and strategy in Asia and the Pacific, among which Cimad Pacific Energy Ltd (Singapore). He received his MA Applied Economics from the Antwerp University, his MBA from the Leuven Business School and his MA and PhD in Philosophy from the University of Leuven, Belgium. His current interests are governance and integrated risk strategies. E-mail: peter@verhezen.net & peter.verhezen@vlerick.com.

[2] **Paul V. Morse** is the Chairman of the Great Union Group Limited and its subsidiary Great Union Oil Investments Limited (oil and gas companies) in Hong Kong and Chairman of MAPE Investments in the USA. He is also an Executive Director and Board member of Cimad Pacific Energy Ltd (Singapore). He received his BA in Political Science and BS in Civil Engineering from Stanford University, United States, his MBA and PhD in International Relations from Middleham University, United Kingdom. His current academic interests are international relations and politics in emerging markets (especially China), and governance strategies. E-mail: wsl@loxinfo.co.th

[3] In order to further expand our research, Paul V. Morse will facilitate unique access to Chinese authorities to test our propositions and hypotheses as put forward in this paper – possibly through case studies and or empirical data testing.

This paper analyzes the new institutional reality of corporate players in China within a fast changing geopolitical framework of power and influence after a debilitating financial mortgage meltdown and economic crisis. Economically, Asian nations and corporations are moving into a position that will subtly push them to share some of the leadership responsibilities coming along with enhanced global power while they are expected to play by the (globally accepted) rules. This analysis focuses on the challenge of [global] Chinese firms, both private-owned and state-owned, to continue to effectively and efficiently grow in the global economy. We will decipher how Chinese emerging multinational firms use *formal and informal governance mechanisms* to exert control over corporate assets. Specifically, the banking reform in China indicates how the Chinese government is aware of the pressure to make firms more efficient within an increasingly global and intertwined competitive market. The lingering question will be how formal control mechanisms function within the unique socio-political and institutional context of China, and how informal Chinese corporate governance principles will be exercised when competing in a global open economy. Interestingly, the Chinese corporations will paradoxically need to engrain a certain corporate openness to new ideas in a rather patriarchical and often opaque traditional culture to remain globally competitive. Moreover, formal transparency rules of accountability and responsibility could but do not have to clash with informal power-relationships of trust which more often than not remain oblique.

This paper will firstly analyze how the growing global interdependence and fast growing Asian economies are slowly changing the current geopolitical context, likely resulting in a multipolar geopolitical order with a functioning core of a number of superpowers or partners. The result of this global financial crisis has been the rise in prominence of the Chinese economy that brings along with it increased economic, business and political responsibilities as well. Secondly, state-owned enterprises and privately held family companies have thrived through "bamboo" networks in the past. It remains to be seen how close and sometimes too cozy relationships might be challenged by global governance principles. Aspiring global Chinese corporations will need to remain innovative and competitive in this global economy which will require a certain "openness" that may challenge the formal and informal control mechanisms the family patriarch and top officials have exercised over the assets of these emerging Chinese "dragon" firms for so long. The banking reform of major Chinese state banks, allowing foreign minority shareholding, indicate such an openness to stimulate global competitive efficiency. Finally, a quest for more conscious and open minded corporate responsible behavior in those increasingly global Chinese firms could be translated into (1) implementing converging good governance principles on the one hand (2) by a visionary and committed leadership that hopefully (3) can sensibly emphasize the importance of "responsible" investments in sustainable energy, more ecologically sound products or services and more affordable health care and improved sustainable health care technology on the other hand. A reformed financial & banking sector in China for example might play a significantly greater role in achieving these "responsible" investments.

GLOBAL UNCERTAINTY and CHINESE INCREASING ECONOMIC POWER

It is fair to state that the world currently faces three main clusters of global uncertainty: (1) a global financial crisis that is partially caused by macro-economic imbalances and micro-economic inefficiencies, (2) increased global inequality that refers to enormous imbalances in the access to food, water and energy, and finally, (3) a growing global institutional vulnerability that finds its roots in weak governance structures that has resulted in illegal trade and corruption among other unwanted global "diseases". It is the former that paradoxically has catapulted a more powerful China in the global limelight. Such rise will definitely galvanize Chinese corporate aspirations, but it will also require some sense of *legitimacy* and *global connectedness*[1].

How to address those global challenges? Economically, Asian nations and corporations are moving into a position that will subtly push them to share some of the leadership responsibilities coming along with enhanced global power. How to responsibly deal with a more chaotic future – by definition uncertain – through enhanced cooperation and global collaboration in a multipolar world order? Globalization does not need to be the battle ground of increased poverty and ecological disasters but instead could hopefully also function as a fertile ground of reasonable peaceful co-existence and responsible collaboration among firms and governments that might benefit all the participants of this functioning core of interdependent global members and a number of leading "super-partners".

The Sub Prime Mortgage Crisis in the U.S.A. shows that the price to be paid for lacking transparency and accountability in the securitization process of mortgage loans (Collateralized Mortgage Obligations or CMOs) has proven to be very costly in terms of loss of credibility, reputation, market share and value. Excessive credit, excessive leverage and excessive funding were at the root of the subsequent panic in September-October 2008 that led to systemic illiquidity and insolvency to be rescued by the respective governments in the world[2]. What can be learned from this particular crisis? Illiquidity is contagious. Moreover, more responsible behavior in terms of appropriate risk and oversight management (as part of corporate governance) is a *conditio sine qua non* to possibly avoid such debacles in the future[3].

The "*Washington consensus*" who advocated a strong belief in open, free markets, and general acceptance of faith in the efficiency of the market, presumably worldwide, seems to be in retreat in the face of the current global financial meltdown. Moral hazards linked to the market mechanism needs to be minimized by better oversight, less opacity and stricter accountability – in other words by better governance -, not by more bloated regulations that could cause to aggravate the current crisis situation. It can be suggested that in the short term the government had no choice but to bail out[4] which unfortunately had the side effect of encouraging and aggravating moral hazard as in people acting irresponsibly because they expect a bail out in case of failure (Shiller 2008; Rajan 2010). In the long term, an improved information infrastructure and thus transparency and

accountability is needed allowing people and firms to use an improved knowledge base through transparency processes. The role of policy-makers is not only to enforce current laws, but to promote institutions that facilitate market discipline (Low, 2005). Secondly, commitment to value creation through or under the constraint of moral values, social norms and a functioning legal framework will help a more conscious, responsible and accountable corporate leadership to prepare and implement visionary strategies. It is within these limit(ation)s that a system can optimally function.

Policy-decision-makers should not overreact and should focus on prudential not excessive regulation of the financial system. Greed needs to be tempered by fear of losses; if you bail people out, there is logically less fear. Prudential regulation and supervision should avoid certain excesses. It is recommended that policy makers enhance sensible and market oriented regulatory constraints that allow entrepreneurial creativity and innovation but also penalize those that act irresponsibly and deliberately cross ethical and ecological thresholds. Legal threats and governance oversight enhancing responsible behavior should therefore be strictly enforced. As figure 1 indicates, a clear and well communicated vision that specifies the risk appetite and strategy of the firm will inspire towards opportunities and protect management from possible threats. Boards need to oversee the executives of implementing the vision, risk scenarios and strategy. We will argue that a similar attitude will be needed in BRIC countries to address such potential crises in the future.

Figure 1: Corporate Governance and Risk Management

Similarly, the Asian Crisis of 1997 – exactly a decade earlier – also highlighted the inadequacy of systems of governance and thus the malfunctioning of adequate control mechanisms at the state level as well as at the corporate level[5]. It should be noted that the prevailing relationship-based transactions and governance can work quite well when (1) contracts are poorly enforced and (2) capital is scarce (Claessens *et al* 2002; Rajan *et al* 1998), reinforced when (3) the number of participants in the industry is relatively small. Weak legal institutions for private and public governance were key contributors in exacerbating the stock market declines and loss of trust during the 1997 financial crisis in Asia (Johnson *et al* 2000). Important for our analysis seems to be the fact that research has consistently shown that ownership structure plays an important role in determining the incentives of insiders to expropriate minority shareholders. Indeed, performance seems to be better in firms with higher accounting disclosure quality – as in proxy of using the big recognized auditors – and higher outside ownership concentration (Claessens *et al* 2002). Overall, it is widely agreed that weak public and corporate governance structures and processes were crucial in aggravating the Asian financial crisis.

The Asian tigers' got themselves out of the crisis by imposing governance structures and processes and by (re)focusing on export-driven industries while at the same time benefiting from America's consumer boom of the last years. Therefore, Asian manufacturers were bound to be hit hard by a sudden downward trend. This plunge in exports has been aggravated indeed by the global credit crunch in 2008-2009, which made it harder for corporations to get trade finance. China's USD 5.4 trillion economy – the 2nd biggest in the world after overtaking Japan in December 2010 - is a case in itself since China's exports account for about 36% of GDP from which half contain imported components. Thus the impact of a fall in exports is partially offset if imports fall too. Pure value-added from exports therefore can be estimated to be a more modest 18% of GDP. Consumer spending in China is just over 35% of GDP, half the American share (The Economist, Jan 31, 2009; Roach, 2009), but the savings are considerable and assuming that private households can be stimulated to spend more, private consumption could become an important growth engine for the Asian region. Stephen Roach, the chairman of Morgan Stanley Asia, argues for a more balanced globalized world that needs to "move from one consumer to many"[6] (2009), as long as this consumption is [more] sensible and sustainable we like to add. Every government in the Asian region has cut interest rates and announced fiscal stimulus, and the Chinese public spending – especially to upgrade or expand their infrastructure - is impressive. However, on the contrary, fiscal spending in the other Asian emerging countries after the 1997 crisis resulted in significantly reduced government capital spending, especially in Thailand and Indonesia in which the public infrastructure is probably worse today than a decade ago. This situation makes enough room to introduce some sensible public spending. The less open economies of China, India and Indonesia may resist the current crisis slightly better with growth rates of 8%, 5% to 6% respectively. Taking into account the rising productivity, high savings to finance investment and low import barriers to speed up competition, one can assume that Asia might fare much better to overcome the current crisis than its debilitating crisis of 1997. Asia's room to increase local consumption could function as the engine for more growth. One of China's main challenges is to inspire cost and profit efficiency that may not fit too well under this form of *bamboo capitalism*. In other words, limited governance – the focus of this paper – may still remain the weakest factor to sustain this albeit remarkable economic growth process of the last 3 decades.

When the Cold War ended in 1989 with the fall of the Berlin Wall and Europe looked confidently into the future, while China was chastened and traumatized by Tiananmen, few would have predicted that the geopolitical power structure would change so dramatically over these past two or three decades. The US has become a nation of debtors at a dangerous level. Moreover, the "rise of the rest" (Zakaria, 2009) – best symbolized by the economic rise of China and its creditor's role vis-à-vis the USA – have undermined the superpower position of the USA. The new powerhouses, Brazil, Russia, India and China (BRIC) dare to stand up against the West, the USA in particular. The increasingly powerful and vocal BRIIC-group could, indeed, possibly counterbalance the fledging Western hegemony. Global power, nonetheless, is above all incarnated in the dominance over ideas,

agendas, and models (Zakaria 2009; Nye 2004, Shapiro 2008). The result of the current crisis is that the liberal market capitalism of the USA and UK and the coordinated market economies in Continental Europe and Japan now "competes" with *state capitalism* and *bamboo capitalism*. The intriguing question is whether this latter form of capitalism based on state interventionism and network-relationships is indeed so fundamentally different from the current Western models[7].

Crises do not come unannounced. The credibility of American-style capitalism suffered a serious blow from the 2007-2009 global financial crisis. In the aftermath of the crisis, China's brand of state-led capitalism or "relationship-based" *bamboo capitalism* may have gained some global prominence amid the current financial system. That does not mean that this Confucian-inspired "new interventionism" would become the alternative for the Western failure. We will argue here that both systems may be more interdependent than one might imagine or that the underlying necessary governance mechanisms of control might indicate some remarkable similarities.

The Chinese strong economic growth could tentatively be described as a triumph of economic technocracy without a human face, in which the Communist Party pragmatically engineered a gradual transition from "Marxism" to an economic market system while still retaining political monopolistic power. One can argue that early local experiments with financial liberalization and private ownership in the 1980s generated an initial boost in rural entrepreneurialism, followed by the massive state-led infrastructure investments and urbanization drive of the 1990s that lead to the Chinese miracle. However, Professor Yasheng Huang from MIT argues in a McKinsey research that state-led capitalism may lift urban skylines and GDP statistics but not actual living standards (2009). It should be acknowledged that most of the foreign multinational companies are very familiar with the three main socio-economic clusters of the Yangtze River around Shanghai, the Pearl River Delta region running from Hong Kong to Guangzhou, and the region around Beijing and its neighbor Tianjin which in total account for almost half of China's GDP and represent a relatively high per capita GDP of about USD 5000-6000 (Tse 2010b). However, it is also true that the fastest growth stems from the "rest of [well-known] China" where rapidly urbanized consumers who have been experiencing new transportation and well developed communication links will become a source of growing global competition. Nonetheless, the differences between regions are considerable. Moreover, the gap between rural and urban residents on the one hand and between permanent residents and immigrant laborers on the other hands remains a course of enormous inequality and imbalance. The Chinese Prime Minister, Wen Jiabao, acknowledges that China faces serious challenges especially concerning their increasingly unbalanced, unstable, uncoordinated and unsustainable economy (Roach, 2009).

Though interesting in its own right, this paper will not focus on the immanent struggle between two trends within Chinese *bamboo capitalism*, the entrepreneurial market-driven countryside with a lot of family companies vying for customers, and a state-led capitalism in the big cities where massive infrastructure and real estate projects may have resulted in high growth. We will emphasize the importance of market mechanisms to enhance the efficiency of aspiring Chinese firms and the

significance of particular governance mechanisms to compete on the global stage. Despite these internal challenges within China, the next stage of success might depend on how the Chinese economy will or will not get more intertwined with a growing international interdependency and how Chinese firms will take advantage of this trend. Notwithstanding the current enormous global uncertainty, China could benefit from globally competitive Chinese firms that are able to use informal and formal governance mechanisms of control and transparency or openness to their advantage. It should be said that transparency is not quite a feature characteristic to a traditional culture that favors "opaqueness and discreteness". Deng Xiaoping's keep-your-head-down policy of *taoguang yanghui* – i.e. hide brightness, nourish obscurity – reveals such a typical Chinese approach to avoid too much international limelight. Can such an attitude be reconciled with the increasing pressure on firms to become more global and therefore pressed to endorse transparency and accountability principles? How will emerging globalizing "dragon" companies stepping beyond China's borders – whether it be giant state-owned enterprises or nimble innovative entrepreneurs pioneering new ways of doing business in China - *keep control* over their main tangible or intangible assets in competition with other local or global competitors?

GLOBAL INTERDEPENDENCE and CONTROL of CHINESE FIRMS WIHIN BAMBOO CAPITALISM

Our personal experience in Asia confirms that one cannot ignore the importance of personal *guanxi* and reputation of leadership – so prevailing in *bamboo capitalism*. Nonetheless, in most ASEAN countries and other emerging economies, poor enforcement of disclosure laws and accounting standards stifle regulatory authorities unable to monitor banks and public companies for example (Randhawa 2005; Claessens *et al* 2002). In those emerging markets, majority and family ownership are quite common, disclosure levels are low, shareholders' rights are sometimes ignored, and judicial recourse is often very uncertain. In China the lack of trust beyond extended family, collectivism and cultures of power distance based on hierarchical status elevate the importance of certain socially acceptable behaviors such as loyalty and close personal relationships in business. These specific cultural and organizational characteristics, important to sustain *social capital*, may turn into cronyism which selects and favors some "in-group members" based on relationships and loyalties, or can overemphasize relationships and loyalties that can result in corruptive behavior (Khatri *et al,* 2003; Verhezen 2009; Kurzman, 2004 & 2007). Such cultural complexities may hinder and even undermine the development and implementation of the good corporate governance required for sustainable 'modernization' in a global interdependent world (Verhezen & Morse 2009 & 2010).

China did not necessarily "discover" a new formula more effective than free markets. Although one often characterizes the Chinese system as a "bamboo-network" of interlinked entities and organizations, one should not ignore the fact either that it remains a form of capitalism. Market capitalism functions best when public and corporate governance mechanisms are well oiled and implemented protecting individual property rights while acknowledging the importance of pursuing common good as constraining and limiting factors. Notwithstanding the specific characteristics of bamboo capitalism the Chinese economy actually grew remarkably conventional through private entrepreneurial ownership and free-market finance (Huang, 2009), enhanced by state-driven infrastructural projects and other major investments aligned with an increasingly interdependent international supply chain. It should be reiterated, nonetheless, that bamboo capitalism has a very dark side in the form of corruption, collusion and nepotism (Verhezen 2008; Braendle *et al* 2005).

China is not always very subtle or shall we say efficient when it comes to governance controlling mechanisms. Insider managers, often with the support of associates who are Party Officials, hold the control of majority of the Chinese listed (often state owned) companies. The state as owner obviously faces some conflict of interest as it not only owns majority stakes in 70% of Chinese publicly listed companies, it also regulates and enforces laws, regulates and often controls the banking sector. Moreover, the state may generally be quite concerned about employment factors within those controlled firms. It all may have an effect on the performance of those companies. The nominal representation of the dominant shareholders often exercise little influence in the governance of China's listed companies. Chinese state owned enterprises sometimes benefit from politicians' services on boards in creating economic rents and enforcing transactions. Professionalization of management and boards on the other hand may jeopardize such opaque practices since it may potentially reveal information about such firms' rent-seeking activities (Claessens *et al* 2002).

Nonetheless, despite the enormous differences in the institutional context, one can argue that Chinese firm accounting performance is negatively related to the level of state ownership (Xu & Wang 1999; Qi *et al* 2000)) although that may not be that straightforward in the case of the banking sector where large ownership may have less of a negative role in banking performance especially when aligned with minority professional private shareholders' interest (Claessens *et al* 2002). To emphasize the ambiguity of the role of particular governance mechanisms, some research indicates that good performing firms may be the most opaque and poorly governed because they derive profits from rent seeking (Fan & Wong 2000). These well performing but opaque firms do not want to be more transparent as good corporate governance would require because such open disclosure of particular practices would only attract financial markets and other social sanctions. Hence, why private, public and even institutional investors may prefer poor firm governance in such cases (Claessens *et al* 2002). Under those specific circumstances, institutional investors may not use firm-specific information, but invest on the basis of country or industry criteria given that there is little or

rather only opaque firm-specific information available. The enormous potential returns here likely supersede the dangers of opaqueness of weak governance (and thus perceived risk).

However, other empirical research indicates that there is a significant pay off for climbing up the governance ladder (Bai *et al* 2002). It is the crucial idea that we like to emphasize: "best" governance principles somehow function in China as well, especially with foreign investment in China or with global Chinese companies investing abroad. The banking reform shows us the importance of such international governance standards (Berger *et al* 2008).

We hypothesize that Chinese firms who have gained prominence through "informal" *guan xi* and a patriarchical corporate culture of interlinked loyalties among clan members, will need to adapt to some "formal" governance principles as they are implemented in a Western context. Combining the forces of both models may be a winner, as graphically presented in figure 2. Here we re-formulate the main question: how do Chinese firms preserve control in an appropriate and effective way taking into account a specific Chinese institutional context?

Figure 2: informal and formal governance mechanisms of control

We here suggest to focus on 4 controlling mechanisms that are related to the traditional formal governance model to counter the traditional *agency problems* as result of information asymmetry (Fama 1983; Huse 2007; Dimma 2002; Jensen 1986 & 2002). One usually assumes that the efficiency and therefore subsequently the performance of the organization is positively affected by a relatively high number of independent directors on the supervisory board. Secondly, one often sees a negative relationship between concentrated ownership - where top officials or the patriarch assumes most of the management and ownership power - and quarterly performance of the firm. Thirdly, if the chairman and the CEO – which by law are separated in the Chinese dual tier governance system, in contrast to the USA single tier system – are from the same shareholding family-clan, it will have a negative effect on the performance of the company. The notorious exception may be the extremely competitive and innovative ICT industry where the founding entrepreneur is often also the CEO in China. Fourthly, the (un)reliability of professional second-tier auditing firms in China and questionable auditing standards will have a negative effect on performance. We can therefore summarize the following hypothetical propositions within a Chinese context which need to be tested:

P1: the more independent directors representing minority shareholders are appointed to the [supervisory] board, less expropriation is expected which has a positive effect on firm's performance.

P2: the higher concentration of owners, the less efficiency reasoning may play a role and thus negatively affecting firm's performance.

P3: the more auditing is professionalized and reliable, transparency and institutional investors' trust will increase that has an immediate positive effect on firm's performance.

P4: if both the chairman and the CEO are nominated from the same "ownership" group/clan, performance will be negatively influenced.

Moreover, the informal governance mechanisms - exercising a certain control over the corporate assets - can be situated within *resource-based theories* (Pfeffer 1978; Hilman 2000). Both well-known *guan xi* or relationships and a characteristic patriarchical culture will shape informal control. The outcome of those informal controlling mechanisms is quite ambiguous. We assume that the integrity and the quality of the relationships and patriarch will determine whether such mechanisms will have a positive influence on performance.

Therefore, we propose the following hypotheses or propositions:

P5: the more reliable and close the relationships are, the more loyalty will play a role which may negatively affect the performance of the firm.

P6: the higher the moral integrity and socio-economic reputation of success of the patriarch was in the past, the higher likelihood that it will have a positive effect on the performance.

It is suggested to empirically test those 6 propositions (4 related to formal governance mechanism of control, and 2 linked to informal governance mechanisms), *in casu* the recently reformed banking financial sector.

The Chinese government recently allowed minority stakes of private ownership in the biggest four banks in China. Indeed, China's reform in the banking system by partially privatizing and taking on minority foreign ownership of three of its dominant ''Big Four" state-owned banks indicate such an "open mindset" to achieve better efficiency through "best corporate governance practices" that come along with foreign ownership or private ownership (Berger *et al* 2008). Empirical data suggest that the Big Four banks are by far the least efficient compared to the much more efficient foreign banks. It can be expected that credible governance mechanisms through this minority foreign ownership may increase Chinese bank efficiency and its performance. The IPOs of the three main banks – China Construction Bank (CCB), Bank of China (BoC) and Industrial and Commercial Bank of China (ICBC) – totaling over USD 40 billion resulted in increases in efficiency. The remaining bank of the Big Four – Agricultural Bank of China (ABC) – is currently restructuring its bad loans, presumably to prepare bringing in foreign minority shareholders in the future (Berger *et al* 2008). Foreign minority bank shareholders is not only associated with higher efficiency, it also implies to "leverage" and improve the corporate culture and management of the banks by imposing market discipline (Berger *et al*, 2008).

Although speculative, we may attempt to argue that removing some current restrictions and allowing more openness to foreign minority shareholders in other till now monopolized industries

may benefit those Chinese firms and industries in terms of higher efficiency that may result in better competitiveness and thus potentially higher returns that would otherwise be unavailable. Moreover, we also believe, indeed, that controlling [Chinese] owners can mitigate some of the traditional agency problems by employing some monitoring tools such as enhanced controlling or bonding through improved auditing, the use of equity analysts, taking advantage of institutional investment and possibly even foreign listing. Those *external* [institutional] governance mechanisms are additional tools to strengthen *internal* governance mechanisms – the focus of this paper - as indicated in figure 2 above.

As indicated earlier, the highest growth rates in China took place in the private "unlisted" sector where rural entrepreneurial families established companies that were funded through relationship-based channels, i.e. based on reputation and *guanxi,* not through the formal bank sector or capital market. A better banking system that gives access to finance to those entrepreneurial small dragon companies, along with improvement in the legal financial infrastructure – contract enforcement, private ownership, and reduction of expropriation risk – could become important determining factors in fuelling and sustaining growth. Due to the enormous size of the banking sector in China, getting reform successfully under way there will positively affect the whole Chinese economy. Indeed, research on the nexus of financial sector and economic growth strongly indicates that continuous high economic growth can only continue with significant institutional reform in the banking system and the legal financial infrastructure (Allen *et al* 2005). The real reward of such important reforms may be sustainable growth because of such an open and efficient banking sector that not only provides more credit but also better allocation of credit that ultimately will result in positive net present value projects and that contribute to sustainability (Berger *et al* 2008) and we like to add hopefully more responsible growth.

Over the next five years, as the business climate and global economy likely continue to shift eastward, the ownership of Chinese companies will matter less than the firms' ability to attract managerial talent and become as innovative as possible. In other words, Chinese firms who will compete in a global economy will need business practices and management that can absorb new ideas into competitive products and services. The criteria of success will depend on "the degree of openness" – that is transparency and receptiveness to new ideas – that likely constitutes the new competitive global Chinese firm in the next decade or so. In other words, the mitigating factor and or complicating variable of the above 6 propositions will depend on the ability of global Chinese companies to absorb and adapt to new [global] ideas. As long as the Chinese emerging "dragon" companies are capable to be cost-innovative, aligned with flexible and "dynamic capabilities" while using their experience in building "relationship-based" networks, the global market may tilt to the Chinese companies combining those strengths (Williamson *et al* 2008). Somehow, such a corporate ability is directly related to its ability to innovate and to be ahead to competitors on cost leadership while remaining somehow differentiated as well at the same time.

GROWING PRESSURE ON CHINESE FIRMS TO PLAY BY THE RULES

The Asian newly founded might will need to be translated into sustainable policies that accommodate its new international position of reciprocal "power" and authority. The BRIIC's (or BICI; Brazil, India, China, Indonesia replacing Russia) new international position also implies some expected responsibility and accountability towards their neighbors and the international global community. In September 2008, Robert Zoellick, the President of the World Bank, called upon China to become a "responsible stakeholder" in the international system. The Chinese elite treasure political "peace, friends and time" as one of the most important contributors to creating an environment in which its 1.3 billion citizens can live comfortably in peace and harmony with its neighbors. We are convinced that good relations between the leaders of the multipolar power centers in the world, with the USA as *primus inter pares* as a fact of current socio-political life, are necessary to materialize rationally objective economic and political stability. If one rids oneself of ideological assumptions and presumptions and keeps an open mind, one can most likely find pragmatic solutions to communicate with others. As Deng Xiaoping famously stated it: "it does not matter whether a cat is black or white; if it catches mice, it is a good cat". It is this unwavering pragmatism that has deeply influenced political and economic policies in China. Adhering to an attitude of sensible common values might give us a chance to resolve some (global) problems.

Corporate governance principles of publicly listed, private and state owned corporations are the best chance to pragmatically harmonize the "rules of the international corporate game"[8] to preserve international collaboration (Bainbridge 2008; Banks 2004; Clarke 2007; Dimma 2002; Markarian *et al* 2007; Roche 2005; Verhezen & Morse 2009) and responsible corporate behavior while acknowledging the global connectivity and interdependence in the socio-economic sphere (Elkinton 2008; Korten 2009; Kahler *et al* 2003; Mirvis *et al* 2006; Millar *et al* 2005; Ocampo 2008; Stiglitz 2001 & 2009). Moreover, implementing good corporate governance principles most likely will decrease the cost of capital for those well governed firms, combined with a reduced moral hazard of public safety standards – the opposite of what we have experienced in the last global financial crisis.

Nonetheless, besides the institutional contextual disadvantages, Chinese global "dragon" companies also face acute competitive disadvantages particularly in (1) businesses where the market is immature or nonexistent in China such as M&A activities that constituted less than 5% in China compared to the total M&A activity in 2005; (2) industries in the early stages of the product lifecycle when limited capabilities of Chinese emerging multinationals as result of limited innovative high technology as demonstrated by the lack of Chinese penetration in the mobile phone handset business; and (4) industries where strong brands and intangible reputation provide a critical advantage (Williamson *et al* 2008). Despite some aggressive tactics by the Chinese elite, their investments in R&D (among which greener and more sustainable products) are booming at about 1.7% of GDP or

USD 103 billion – compared to 2.7% of GDP or USD 402 billion for the USA (Hout *et al* 2011) - which hopefully may bear some fruit in the near future.

The subsequent question begs to what extent Chinese privately held family companies will be as well equipped to compete with the usually bigger state-owned companies (1) in establishing global partnerships, (2) being part of an international supply chain, (3) increasing R&D investments to guarantee useful innovation and (4) to attract the best talent in the Chinese market. Western companies need to recognize the importance of the changing character of Chinese companies, especially those who prove to have an "open" mind pursuing their global ambitions in a competitive manner. It is the well governed Chinese pioneers and migrators – as graphically depicted in Figure 3 – that will likely become the driving engines of the Chinese economy.

Figure 3: Globalization: Functioning Core versus Disconnected Gap

Globalization – despite its unpredictability or uncertainty, increased poverty, unethical greedy corporate behavior and ecological disasters - could become the fertile ground of reasonable peaceful co-existence and collaboration that might benefit all the participants of a *functioning core* of interdependent global members (Barnett, 2004). Within this functioning core, as shown in figure 4, firms achieve a competitive edge through soft power which is only possible when the company or nation has the knowledge and technological capacity to keep innovating. This [soft] objective to gain the hearts and minds of the world will remain elusive to the Chinese as long as they do not take full moral and economic responsibility for their new-found economic might.

Figure 4: Corporate Governance within a socio-political global context

Global connectivity[9] has benefited America and Europe economically so far by increasing their access to the world's innovative goods and services while promoting their exports (Barnett, 2004). Such connectivity also significantly enhances the political collaboration and interdependency. However, those at the center of power, having the authority to make decisions, should also engage in corresponding duties, i.e. being accountable and sharing responsibility for their actions. Moreover, when Western societies are confronted with global crises it often leads to a return of psychological and economic protective measures where specific, often biased interests, (of a select few) trump values[10].

Corporate social responsibility should be enacted through continuously integrating the objectives of the primary stakeholders, i.e. the shareholders' rights for a decent financial return on their investment and the non-financial aspirations and objectives of other principal stakeholders, such as upholding the highest form of integrity with respect to environmentally friendly input to make and deliver "green" and ethically sound wanted products and services for their customers. This will definitely become a high priority for merging global Chinese firms.

Institutional investors can only be attracted to buy Chinese shares if *basic standards of corporate governance* at an international level are being adhered to[11]. There are *no "best"* or optimal systems of governance[12], but there are only *better* practices[13]. Indeed, it is acknowledged that a 'one size fits all' approach is unrealistic and often perceived as alien because experience has demonstrated that the Anglo-American capitalistic structures cannot be automatically transplanted or imposed globally. Respect for widely accepted governance practices that focus on integrating economic, environmental and ethical (the "3E"s) values and principles (Elkington *et al* 2008; Emerson 2003; Mirvis *et al* 2006; Verhezen & Morse 2010) as the overlapping consensus of the "playing framework of core connectivity" might reduce some risks in this new highly uncertain geopolitical reality. Call it corporate transformative sustainable value creation that embeds profit optimization and social corporate responsibility. Steering – i.e. governing – Chinese firms towards such responsible and "greener" investments will likely help them to gain soft power [besides hard won economic competitiveness] and enhance their international status within an interdependent global multipolar order.

No matter how powerful and technologically sophisticated the train, it is only as good as the track on which it runs and as the conductor who steers the train. The mortgage crisis has revealed that the regulatory and insurance institutions are like old tracks not suitable for the new challenges. Moral hazard can only decrease when institutional reform provides a stronger framework within which the real estate and financial markets can effectively operate (Shiller 2008). Such institutional reform does not equal more regulations; more likely it will require streamlining, adopting, and fine tuning the existing regulations. Moreover, the lack of corporate governance principles and too much greedy focus on quarterly bonuses has definitely aggravated the financial meltdown. Whether corporate governance - certainly reducing some risks - would have been able to prevent the crises altogether is more difficult to assess. Giving it the benefit of doubt, implementing globally acceptable governance rules by increasingly global Chinese corporate players might be a good start to address the increasingly global challenges.

CONCLUSION: DEMAND for a more "OPEN COMPANY" in CHINA

It has been argued that the growing global interdependence and fast growing Asian economies are changing the current geopolitical context, likely resulting in a multipolar geopolitical order with a functioning core of a number of superpowers or partners. Such a changed geopolitical context will have immediate consequences for Chinese companies who decide to compete beyond their own borders. Will they impose a typical Chinese management style that has been perceived very different and quite opaque from the traditional mainstream Western management?

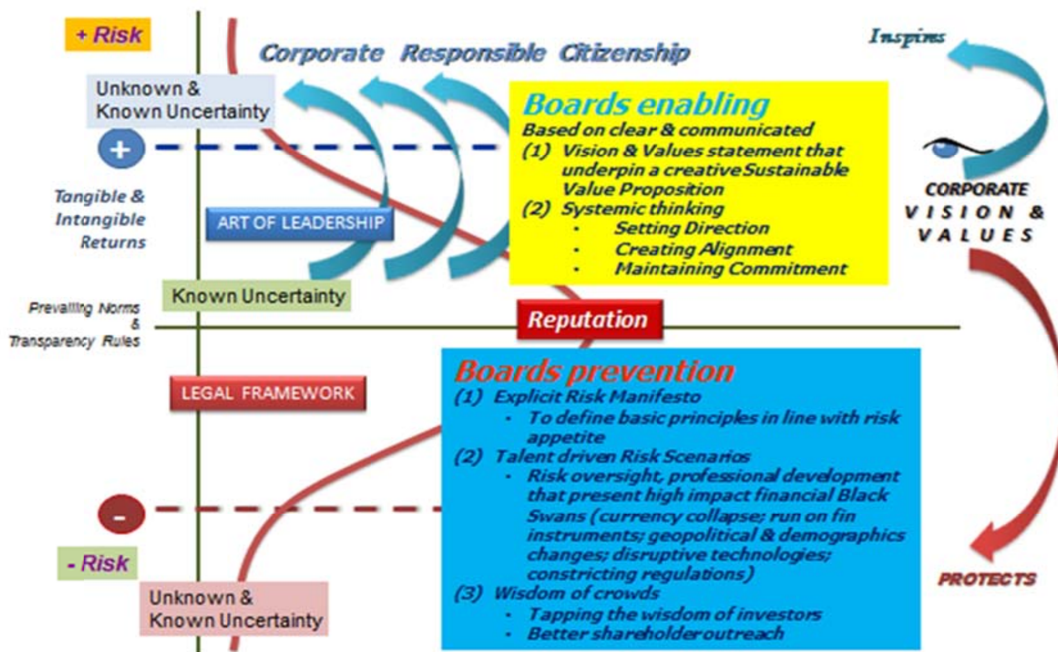
The authors believe that Chinese firms will need to play by international "best" corporate governance principles in order to gain international credibility. It is because of this insight that the Chinese government has decided to impose strict reforms that are often in line with these mainstream governance principles. Nonetheless, we have also argued that, besides the *formal* governance mechanisms to control the firm, China still relies a lot on *informal* governance mechanisms that are resource-based or relationship-based. Moreover, if used in an effective appropriate manner, those informal mechanisms could strengthen the formal control mechanisms. However, we also need to highlight that quite often those informal mechanisms have led to rent-seeking activities and often destructive behavior that undermined corporate value through expropriation and corruption.

Our research may indicate how good corporate governance implementation in the Chinese banking sector – initiated by allowing minority foreign banks to take participation in the Big Four Banks – may be seen as an example of how governance may install a positive virtuous cycle that stimulates sensible, responsible and sustainable growth in China. At the same time, we have argued that *formal governance principles* as practices in an Anglo-Saxon institutional context – and significantly different in China and Asia in general – could be enhanced by *informal resource-based governance mechanisms* if applied in a rather open and sensible manner, avoiding the pitfalls of expropriation and nepotism. More empirical research will need to be done to prove this prediction, as well as more data testing in other industries besides the banking sector in China.

Corporate responsibility and its enormous soft power in the form of acknowledged international credible reputation on the contrary is more about (1) aligning economic and ethical-ecological sustainability principles in all corporate activities; not just an add-on and about (2) directing attention and focus on resources where new opportunities exist to create sustainable value. If global Chinese firms would engrain such an approach, one can be a little more hopeful that global firms (Chinese, Western and alike) may result in more corporate responsible behavior worldwide, adhering to principles that are widely acknowledged and underwritten by most global institutional investors. Recognizing the importance of corporate governance practices will allow open-minded Chinese firms to integrate their financial and non-financial objectives, constituting their unique legitimacy or even legacy. Only in such a changed context one will have a chance to start addressing the global challenges and hopefully reduce global uncertainty in the process.

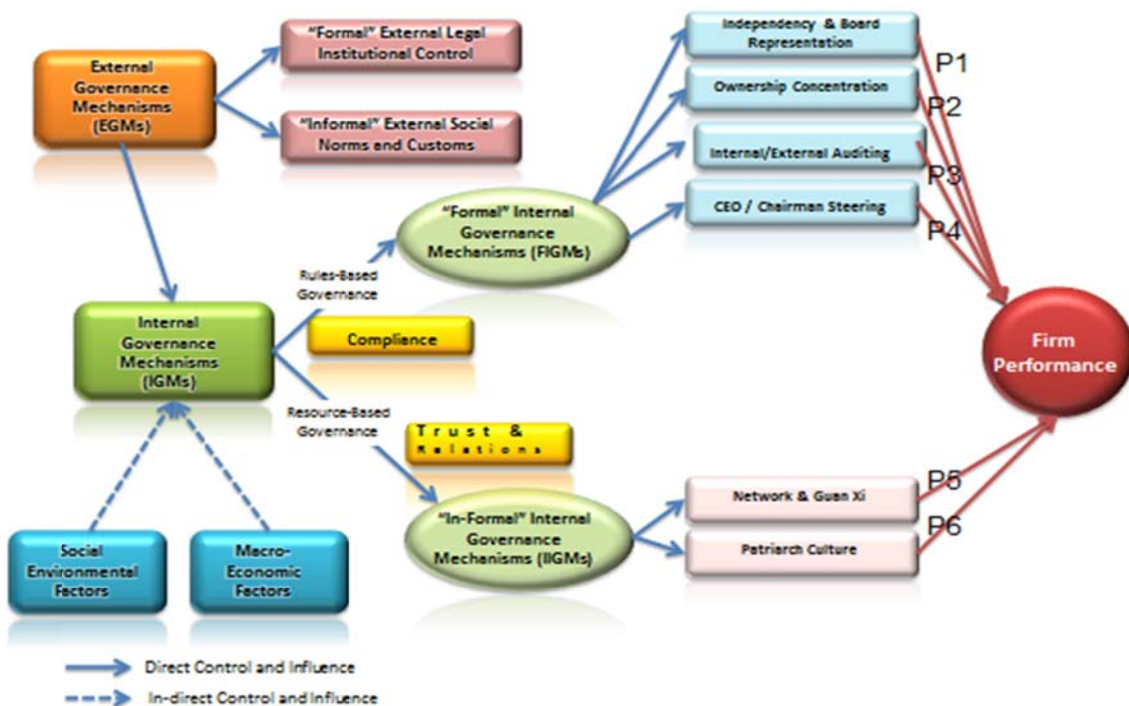
Appendix

Figure 1: Corporate Governance & Risk Management



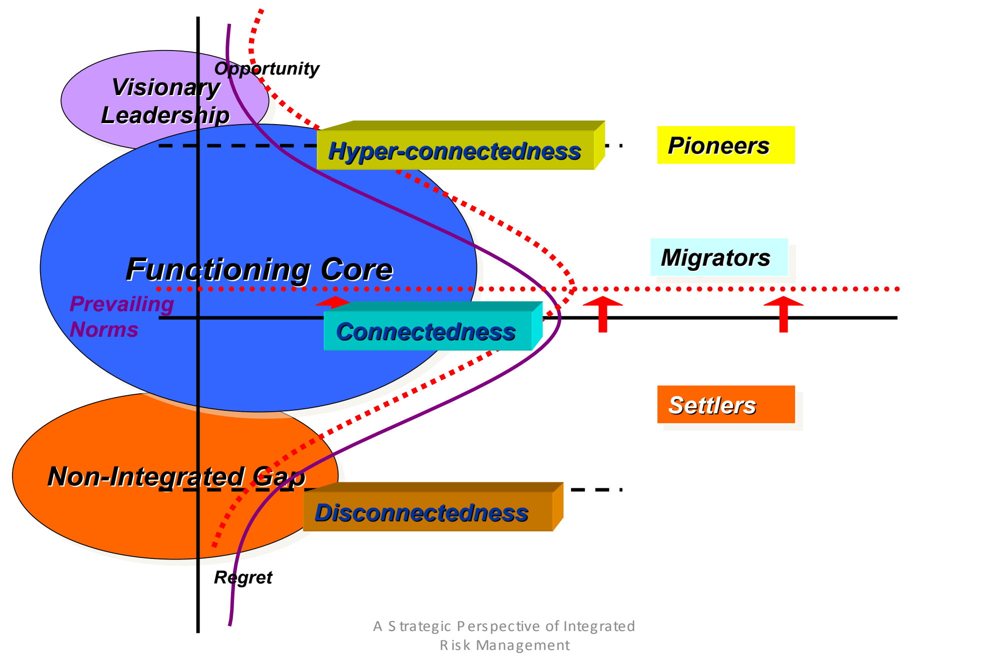
Source: based on Verhezen 2010 and presentation at Hong Kong University, April 2011

Figure 2: Informal & Formal Control through governance principles



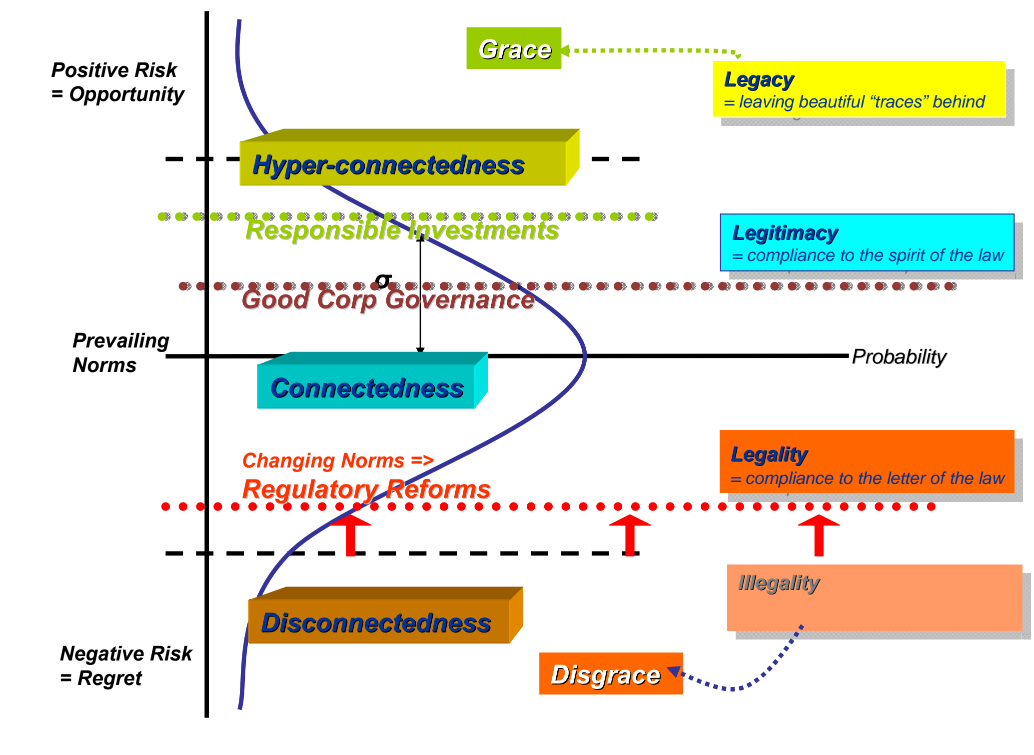
Source: reformulation based on Verhezen & Morse (2009), "Common Governance Practices?"

Figure 3: Globalization: Functioning Core versus Disconnected Gap



Source: based on discussions with Paul V. Morse et al in Political Science

Figure 4: Corporate Governance within a Political Global Context



Source: Verhezen, P., (2010), "Giving Voice in a Culture of Silence"

Notes:

[1] See Sachs (2008): 7. "The paradox of a unified global economy and divided global society poses the single greatest threat to the planet because it makes impossible the cooperation needed to address the remaining challenges. A clash of civilizations […] would undo all that humanity has built and would cast a shadow for generations to come". Since 1914 (WW I) and 1945 (WW II), we have never been so close to another disaster, this time "natural" in its nature. A natural disaster as result of ecological imbalances, caused by human behavior, may lead to global instability. The real benefits of introducing free market economics within specific constraints is the impact it has on reducing poverty. However, ecology and ethics should not become the collateral damage of such free initiative and should be contained by reasonable regulations to internalize those unwanted externalities as much as possible and make organizations and individuals fully accountable.
[2] This brief analysis of the Global Mortgage crisis is based on a Lecture "Causes and Consequences of the Current Financial Turbulence" by Professor Raghuram Rajan, Professor Finance of the Graduate Booth School of Business in Chicago and his recent book *Fault Lines*, at the University of Melbourne on 5 November 2008, and a Lecture "Could Good Governance have prevented the current global Mortgage Meltdown?" by Peter Verhezen at the University of Fudan on 17 October 2008. The analysis has been influenced as well by Shiller's analysis (2008). The analysis is meant to be indicative rather than exhaustive. Excessive credit was made possible through "dumb money" where investors were looking for yield in high rated securities, hind insight wrongly rated as non-risky by the international rating agencies. Since investment banks and the securities packaging companies started to sell more and more of this "toxic waste" without recognizing the potential risks, fed by cheap credit that lured subprime borrowers to take advantage of the free lunch available, a lack of oversight made the meltdown, hind insight once more, inevitable. Competitive pressures at the top of those banks and a well-known herd-effect pushed them to purchase and keep those securitized loans on their own books instead of further mitigating the risk. Moreover, one can argue that there was a lack of full internalization of those risks in the banks buying and selling those CMOs. Even if risks were expressed by the respective risk departments, they became less efficient as the cycle of buying and selling those securitized loans was progressing and in fact at the height of the danger, risk management was at its weakest. There was a total breakdown of applying the appropriate governance principles because more leverage was taken on the balance sheet without providing any cautionary cushion. In addition, the short term credit was considerably cheaper than long term capital with the idea that one could keep the borrower on a short leash. No one was building reserves, one paid out the cash to their top executives as bonuses for the short term profits generated through this apparently profitable securitization process till the presumably golden eggs broke in August 2008. It seems that the institutions were not prepared to support the increasingly complex financial securization process and the related mortgages which were not that risk-free as wrongly presumed. Moral hazards and the failure to anticipate quite obvious risks aggravated by "irrational exuberance" at the prospects for profits partially explain the bubble (Shiller 2008). Finally, the excessive funding for mortgage loans paradoxically lead to illiquidity and insolvency as those loans unexpectedly started to mount, securitization became increasingly more complex (un)consciously hiding any risk. Pricing of these mortgages-backed securities became harder by the day. The myth that there was plenty of money available was finally unravelled in August 2008 and panic erupted when Lehman Brothers were not bailed out by the USA government. The rest of this mortgage story is history in process now.
[3] Although hedge funds are usually better equipped than regulators to monitor risk, one pushed the bottom of risk-taking profitability a little too far. By imposing enormous reserves for risk taking, money was pushed away by securities houses and investment banks – which are comparably less dictated by regulatory oversight than traditional banks - to off-balance sheet activities out of sight of the regulator. Excessive greed motives for example overtook the fear for too high risks within the opaque hedge-fund business based on the (apparently correct) assumption that the downside risk could be mitigated to government[al bail out]. It is acknowledged that a governance problem should not be equated to a regulation problem. Having a variety of markets and instruments, institutions, government intervention and global oversight coordination can help the system to regain some form of confidence rather quickly. Financial infrastructure should be strengthened. Moreover, central banks should be able to make the distinction between financial engineering and financial innovative "risk-taking". Obviously, the private sector needs mechanisms to absorb this crisis, and not just put the tax burden on the public at large. Such improved mechanisms will imply some form of governmental regulation that underpins the support for the financial sector without stifling innovative and creative new products and services.
[4] The USA, UK and Japan opt to "spend" their economics out of the crisis by an enormous stimulus package under the minimum regulatory constraints of systemic risk. The EU, especially Germany and France, emphasize the need for global regulation to prevent such contagious international crises again in the future. Their aim is to push for far more transparency in the financial global transactions, relying on an existing social security system on the old continent that hopefully will cushion most of the atrocious social consequences of this crisis. That leaves China and to a lesser degree Russia to strategically exploit the division in interpreting a contextual solution. Moreover, the G20 – taking over the function of the G7 and G8 - has recently agreed on some global principles to address the current economic financial crisis and prepare the framework of a new "global world order", whatever that means. The devil – as always – lies in the details.
[5] During that crisis, the five most heavily affected countries - Indonesia, South Korea, Thailand, Malaysia and the Philippines - lost more than USD 600 billion in market capitalization or around 60% of their combined pre-crisis gross domestic product. Total private capital flows to emerging markets are estimated to have fallen in 2002 to levels last seen in the early 1990s (Cornelius 2003). The predominant relationship-based style of corporate governance in Asia can be seen as one of the fundamental drivers of concentration of ownership, accompanied by a lack of transparency has turned out to be one of the causes of the region's economic crisis (Millar *et al* 2005; Pye 1997). However, the Asian Crisis has brought considerable progress in more transparent corporate governance mechanisms and more comprehensive and internationally converging accounting standards in the respective inflicted countries. In the ASEAN banking sector for example, a substantially improved transparency and decision to adopt the International Basel II standards , allowed for a drastic change

from close and intrusive regulation to a risk-based supervisory regime in most of those ASEAN countries (Rhandawa 2005). Such amelioration may prepare them for a more robust and sustainable growth in the future. However, early 2009, the GDP probably fell by an average of 15% in Hong Kong, Singapore, South Korea, and Taiwan, the four traditional Asian tigers. Stock prices on the respective Asian exchanges have plunged by almost as much as during the Asian financial crisis a decade ago, though they all recently regained some share.

[6] See Roach (2009). The US consumption reached an astonishing 72 percent of GDP in 2007 – a full 5 percent point above the 67 percent that prevailed from 1975 till 2000 – which can be easily interpreted as a record in modern economic history. This overextended demand side is met by an unwavering but nonetheless unbalanced export-led growth in developing Asia where exports in China for instance jumped from 20 percent to 40 percent of their GDP in less than 2 decades. Although the US now accounts for about 20 percent of total Chinese exports, with Europe and Japan taking in another 30 percent, the remaining bulk is shown in the form of a sharply growing intraregional Asian trade. However, according to Roach, the insufficient internal private consumption and the overreliance on exports as a major and increasing source of growth contains inherent imbalances for China and Asia themselves. The Chinese consumption as share of GDP fell to a record low of around 35 percent in 2007. "An increasingly integrated Asian economy also discovered the new synergies of a China-centric supply chain. Moreover, commodity producers around the world – especially, in Australia, Russia, Canada, and even Brazil – drew great sustenance from a resource-intensive, export-led Chinese economy. […] America's consumption binge – accompanied by record debt burdens, zero saving rates, and a multiplicity of bubbles in asset markets (equity and property) and credit. It was also true of Asia's export boom, which spawned ever-rising current account surpluses, enormous reservoirs of foreign exchange reserves, and a mega-bubble in commodity markets" (Roach, 2009: 84), creating a fundamentally unbalanced global economy.

[7] State capitalism in China and Russia, and [Keynesian] *interventionism* has gained prominence again in the aftermath of this severe global crisis. China and Russia are leading the way in the strategic deployment of state-owned firms and their example is followed by a number of other governments. Some may argue that free markets may not be the sole drivers of success anymore and may claim that the free market mechanism has lost some of its previous shine although it still remains enabling to help to make the provision of products and services in the most efficient and effective countries.

[8] We like to note that the international institutions will also need to adapt to the new situation. The common thread is not market returns but rather commitment to a common goal that somehow implies that businesses promote broad social objectives that are consistent with core business principles, values and practices. Sustainable business goals and strategies attempt to align profitability and economic earnings to socio-ethical and ecological objectives that underwrite those common goals. The global interdependence in financial and security terms have become obvious after 9/11 and reconfirmed during the current economic crisis. The world has shrunk in a sense that the ecological challenges have shown us that nobody can escape their responsibility to pursue real sustainability and to avoid an increasingly dangerous luring ecological disaster. However, if global governance – not a global government or a super-regulator – may incorporate the possible answer to the current global challenges, it will to develop both institutions and rules to manage those challenges. Democracy implies one citizen, one vote, or one nation, one vote. In some instances, one rightfully could weight those democratic measuring in order to take into account mere demography (Luxembourg may not carry the same economic weight as China for instance). Paradoxically, "direct global democracy" – where majority overrules minorities may not be the best solution. However, democracies carry a greater moral legitimacy than non-democratic societies. Currently, the UNSC may take legal decisions to rule the world, but they face a crisis of (moral) legitimacy. It is well documented how the USA for example uses it overwhelming hard (both economic and military) power to reach bilateral deals with other permanent or temporary UNSC members at the expense of global interests. Moreover, American power often trumps international law if it does not provide them enough leeway to preserve US interests. Parallel to corporate governance, we suggest that the board (i.e. UN Security Council) representing the shareholders and stakeholders (i.e. UN General Assembly), selects a top executive management (UN Executive Committee) that is accountable to the Board. Like in corporate governance, board members are chosen based on merit or "knowledge" and power, but their time should be limited or to be extended under strict conditions. In other words, it would end the perpetual rule of the five permanent members, which is quite unlikely at this point in time. Especially the European three member states (England, France and Russia) might object such a change. However, new Asian powers like Japan and India, and Germany for example should be given veto rights to reflect their economic weight in the international system. Adapting the corporate governance principles of meritocracy, one should select heads of relevant global institutions according to their merit in a clear and transparent manner, not based on nationality as it stands now. At this point in time, none of the permanent UNSC members are really accountable for their actions and thus undermined its own legitimacy. Similarly, the IMF and the World Bank are losing their legitimate basis under the current crisis, unless more power will be given to China and the other countries-regions that support to bail out the USA and to a lesser degree Europe.

[9] See Barnett (2004). Global connectivity refers to the system or community of states, individual nation-states (both good and bad) and individuals operating both within societies and across them. Such connectivity is expressed in nations joining a core, which expects their societies to play by the rules of the game (such as transparency and accountability). Nations, firms and individuals function within globalization whereby this functioning is based on the harmonization of internal rules with rule of democracy, rule of law and free markets.

[10] Mahbubani (2008). For example, the EU and US spend an average of USD 67 billion and USD 20 billion respectively on agricultural subsidies in 2005.

[11] See Mallin, 2002; Huse, 2007; Brown & Caylor, 2006; Clarke, 2007; Solomon & Solomon, 2004; Puffer et al, 2003; Banks, 2004; Mobius 2003. It is worth asking what good governance principles and "best" practices are. Good corporate governance refers to the exercise of power and responsibility for corporate entities to become distinctive and differentiating "pioneers" and examples for others. Corporate Governance can be re-defined as the interactions between coalitions of internal and external actors and the board members in directing and steering a corporation for value creation. It fosters the competitive performance required to achieve the corporation's primary objective of profitability. Moreover, good corporate

governance's concern for capital providers or investors is related to assessing risk in investments in a firm's resources, to evaluating capital allocations to provide reasonable returns and to monitoring how capital is managed over time. One of the main objectives of corporate governance is to provide reliable information about the firm through transparency and disclosure to all shareholders. Indeed, we can safely assume that good corporate governance principles refer to and are concretely translated into an (informal) obligation of care and formal fiduciary duty of officers and directors that accommodate the shareholder value. The former refers to an attitude of responsibility towards all shareholders and stakeholders embedded in informal social capital structures affecting the company; the latter to a legal fiduciary contract that prevails in corporate law in most developed countries. The Delaware Supreme Court (Delaware Corporate Litigation Reporter, 2002) stated that loyalty "as a public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of corporate officers and directors, peremptorily or inexorably, the most scrupulous observance of his duty". In fact, one can assume that there shall no conflict between duty and self-interest according to this ruling. In other words, dramatic changes in cultures of information require access about and from centers of power and their accountability leading to the "right to know" and expanding the "duty for disclose".

[12] See Markarian (2007): 298. The main issues regarding good corporate governance concern that (1) a majority of non-executive board members have to be independent and perceived as professional while the board itself should be characterized by diversity; (2) several committees should be established within the board (i.e. remuneration, auditing, nomination); (3) remuneration for executives should be decided only by non-executive directors; (4) the majority of the audit committee has to be independent and non-executive; (5) there is a preference of a separation of chairman and CEO function; (6) it has been suggested that there is a maximum duration for non-executive directors who should be evaluated on a regular basis, (7) attention should be given to social and environmental issues.

[13] We here refer to the very useful and well-organized criteria used by CalPERS who manages more than USD 200 billion to invest in a variety of international firms.

The first main factor investing in a firm is related to the **country risk** in which that firm is operational: 1. *Political Stability* (a. Civil liberties; b. Independent judiciary and legal protection; c. Political risk); 2. *Transparency* (a. Freedom of press; b. Accounting standards; c. Monetary and fiscal transparency; d. Stock exchange listing requirements); 3. *Productive Labor Practices* (a. ILO ratification; b. The quality of enabling legislation to explicitly protect or prohibit the rights described in the ILO Convention; c. The institutional capacity of governmental administrative bodies to enforce labor law at the national, regional and local level; d. Effectiveness of monitoring and enforcement of laws in the ILO Convention areas).

A second criteria to establish an investment will require an in-debt analysis of the **market risk**: 1. *Market Liquidity and Volatility* (a. Market capitalization, the overall size of the country's stock market; b. Change in market capitalization, the growth of the country's stock market over the last five years; c. Average monthly trading volume relative to the size of the market; d. Growth in listed companies over the last five years; e. Market volatility as measured by standard deviation over the last five years attributable to both currency volatility and local market volatility; d. Return/risk ratio in each market); 2. *Market Regulation / Legal system / Investor Protection* (a. Adequacy of financial regulation; b. Bankruptcy and creditors' rights; c. Shareholders' rights); 3. *Capital Market Openness* (a. Trade policy, measuring the degree to which there is oppressive government interference to free trade; b. Foreign investment, measuring governmental barriers to the free flow of capital from foreign sources including unequal treatment of foreigners and locals under the law; c. Banking and finance, measuring government control of banks and financial institutions and allocation of credit and the degree of freedom that financial institutions have to offer all types of financial services, securities, and insurance policies; d. Stock market foreign ownership restrictions; e. Settlement Proficiency = the country's trading and settlement practices to determine the degree of automation and the success of the market settling transactions in a timely, efficient manner; f. Transaction Costs = the costs associated with trading in a particular market and includes stamp taxes and duties, amount of dividend and income taxed, and capital gains taxes).

Finally, one will need to analyze the **specific risk factors of a firm** which are often related to their specific organizational corporate governance principles or lack of them and the quality of the top management who is supposedly developing strategies and economic fundamentals which are sensible for the creation of long-term value of the firm.

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About the authors

Peter Verhezen is an Adjunct Professor in the area of Management Decision Making at the *Vlerick Leuven Gent Management School* (Belgium), a Visiting Associate Professor in the field of International Governance at the *University of Melbourne* (Australia), and a Fellow at the Ash Institute for Asian Studies and Governance at the *Harvard Kennedy School* (USA). For about 25 years, he used to work as an international management consultant, among which IBM-Cimad, Swift, Brookshire Hotels International, IBRA (Ministry of Finance of Indonesia) and a variety of corporations and banks in Southeast Asia. As the Principal of *Verhezen & Associates Ltd* he currently advises companies on Risk Management, Strategies and Governance, mainly in Asia and Australia. He regularly publishes around governance and business ethics in international journals and is a regular speaker at international conferences. He was recently appointed as a board member of Cimad Pacific Energy Ltd in Singapore. Peter, a Belgian citizen, received his Master's in Applied Economics from Antwerp University (Belgium), his MBA from Leuven-Chicago Business School in association with the Chicago Business School, and his Master's and PhD in Philosophy from the University of Leuven (Belgium). His current interests are Governance, Business Ethics, Creating Sustainable Value and Integrated Risk Strategies in organizations.

peter@verhezen.net & peter.verhezen@vlerick.com

Paul Morse has been a successful international businessman and influential political scientist for almost four decades. He started his entrepreneurial and corporate career as founder and president of Earth Resources, Inc. in the USA from 1973 till 1983 (in close collaboration with Kerr Mc Gee Oil Company). Subsequently, he became the founder, co-owner and president of Metamil Ltda from 1984 till 1990 (a Brazilian Gold & Precious Metals Refining Company) and Mineracao Rodeodor Mining, Ltda.., Mineracao Transamazonia, Ltda., Mineracao De Rei San Jorge Ltda Mining Companies in Brazil. In addition, he served as the USA Commercial Ambassador in Brazil (1983-86). He has been active in a number of business ventures in the USA, across South America, Europe and for the last 20 years very much in Asia. Currently, he serves as director of a number of corporations in Asia among which are Integrated Technology Solutions (Thailand) Limited and Agri-Asia Development Group Ltd (Thailand – Hong Kong), PanPacific Ventures Limited and Great King World Wide Enterprises Ltd (Hong Kong). Since 2007 he is the Executive Director and a Founding Partner of the Great Union Group Limited and Great Union Oil Investments Limited (Hong Kong, SAR). His current business interests focus on his executive and board function at Cimad Pacific Energy in Singapore with gas-& oil investments in Vietnam, Cambodja and China. Paul, a US citizen, received his BA Political Science (major in International Relations) from Stanford University USA, his BS Civil Engineering from Stanford University (USA). Furthermore he obtained a Postgrad Degree in Finance from the University of Rio de Janeiro (Brazil), and an MBA and PhD International Relations from Middleham University (UK).

wsl@loxinfo.co.th