



Training Course for China Everbright

The Role of Capital Markets in SOE Reforms

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Functions of Securities Markets

- ◆ **Price discovery** - pricing of risks and valuation of property rights
- ◆ **Resource allocation** - exchange of property rights
- ◆ **Investor choice** - timing of consumption vs savings
- ◆ **Risk management** - enable diversification of risks
- ◆ **Role in corporate governance**



Objectives of Financial Reforms

- ◆ Improve resource allocation
- ◆ Improve price discovery
- ◆ Improve risk management
- ◆ Improve corporate governance
- ◆ ∴ need to develop balanced bank, equity and bond markets



Information & Markets

- ◆ Markets need real time, reliable information to make correct decisions, especially for risk management in highly volatile environment
- ◆ High quality information needs :
 - Good accounting standards,
 - Reliable, timely statistical & reporting processes
 - Capacity to process, analyze and decide on information critical to competitive success
- ◆ Bad accounting = bad information = poor decision making = bad risk management → financial crisis



Conditions for Successful SOE Reforms

- ◆ Clear linkage with bank re-structuring
- ◆ Stable macroeconomic environment - strong fundamentals
- ◆ Strong political will, effective restructuring leadership and credible policies
- ◆ Transparent accounting standards
- ◆ Legal framework favouring financial discipline
- ◆ Incentives favouring self-discipline and competition
- ◆ Cadre of professional managers
- ◆ Corporate Governance
- ◆ Robust financial infrastructure



SOE Reforms - 4 Main Themes

- ◆ **Internal Governance** - sound management
- ◆ **Official Oversight** - effective bank and securities supervision
- ◆ **Market Incentives** - returns must reflect risks
- ◆ **Risk Management & Infrastructure** - efficient accounting, information, legal and market infrastructure



Internal Governance

- ◆ **Internal management's own risk controls**
 - **internal dual controls**
 - **use of internal auditors**
 - **use of external auditors**
 - **information disclosure**

- ◆ **Role of Non-Executive Directors**
 - **Audit committees**
 - **Remuneration committee**



Market Incentives

- ◆ Management must be rewarded for taking risks, but punished for not obeying internal controls and law
- ◆ There should be adequate pay (or penalty) structure that causes the private sector or market to regulate itself
- ◆ Internal audit committees should consider implications for the risk preferences of pay structures
- ◆ Use market to enforce discipline



Financial Supervision = Risk Management

How well does SOE manage these risks?

- ◆ Credit risks
- ◆ Market risks
- ◆ Liquidity risks
- ◆ Settlement risks
- ◆ Operational risks
- ◆ Legal risks
- ◆ Regulatory risks
- ◆ Systemic risks



Entry into WTO brings World class Competition

- ◆ Competition is now global
- ◆ Global Competition is not national - it is at enterprise level
- ◆ WTO gives roughly 6 years time to prepare
- ◆ Chinese SOEs must reform to compete
- ◆ How to reform?
- ◆ What to reform?
- ◆ How can capital markets help?



What is your core business?

- ◆ **Focus on Policy** - What is your strategic goal?
- ◆ **Focus on Product** - What is your comparative advantage?
- ◆ **Focus on People** - Are your skills competitive?
- ◆ **Focus on Process** - Is your technology competitive?
- ◆ **Focus on Risk Management** - Do you know your risks?



Technology and Competitiveness

- ◆ **Technology critical to competitiveness**
- ◆ **Technology can be bought**
- ◆ **But, ability to manage technology for market depends on management skills, which take time to build**
- ◆ **Building strong management & incentives critical**
- ◆ **Building up of knowledge → building up of a critical mass → attracts foreign capital → sustains economic growth**



SOE Reforms and Capital Markets

- ◆ **Bad loans = poor economic efficiency = over-leveraged borrowers/corporations = undercapitalized banks**
- ◆ **∴ SOE reforms mean re-capitalizing borrowers**
- ◆ **i.e. SOE reforms require efficient capital markets**
- ◆ **Capital markets de-leverage SOEs and borrowers, and improve economic efficiency**



China: Excessive reliance on Banking system (% of GDP 1998)

	Bank Assets	Equity Market	Bond Market
Hong Kong	214	206	32
China	139	25	12
Singapore	220	112	20*
US	65	158	141
Japan	145	64	101
Germany	273	51	97
S. Korea	233	35	53
Thailand	176	30	21#

Remark: * figure for Singapore includes government bonds only; # 1997 figure
Sources: FIBV, IFC, World Bank and various central banks



Weaknesses of Chinese SOEs

- ◆ Too much leverage - 5:1 1:2 for US
- ◆ Burdened with employment welfare
- ◆ Incentive structure not linked to performance
- ◆ Weak accounting information
- ◆ Not customer focused
- ◆ = weak competitive efficiency



Capital Markets Improve

- ◆ Transparency of bank/enterprise operations
- ◆ Price discovery process
- ◆ Attract risk capital to recapitalize enterprises/banks
- ◆ Liquefy NPLs through securitization
- ◆ strengthen corporate governance
- ◆ = improve overall efficiency



Conditions for Reform process

- ◆ Reform process has winners & losers
- ◆ Must have growth to generate resources to pay off losers
- ◆ Internal reform possible but slow & painful
- ◆ Must create incentive structure for reform
- ◆ Hive off new to grow
- ◆ New growth can resolve old structure
- ◆ **Examples: ATT - Lucent Technologies**
- ◆ **NTT - NTT DoCom**
- ◆ **China Telecom**
- ◆ **Schwab - eSchwab**

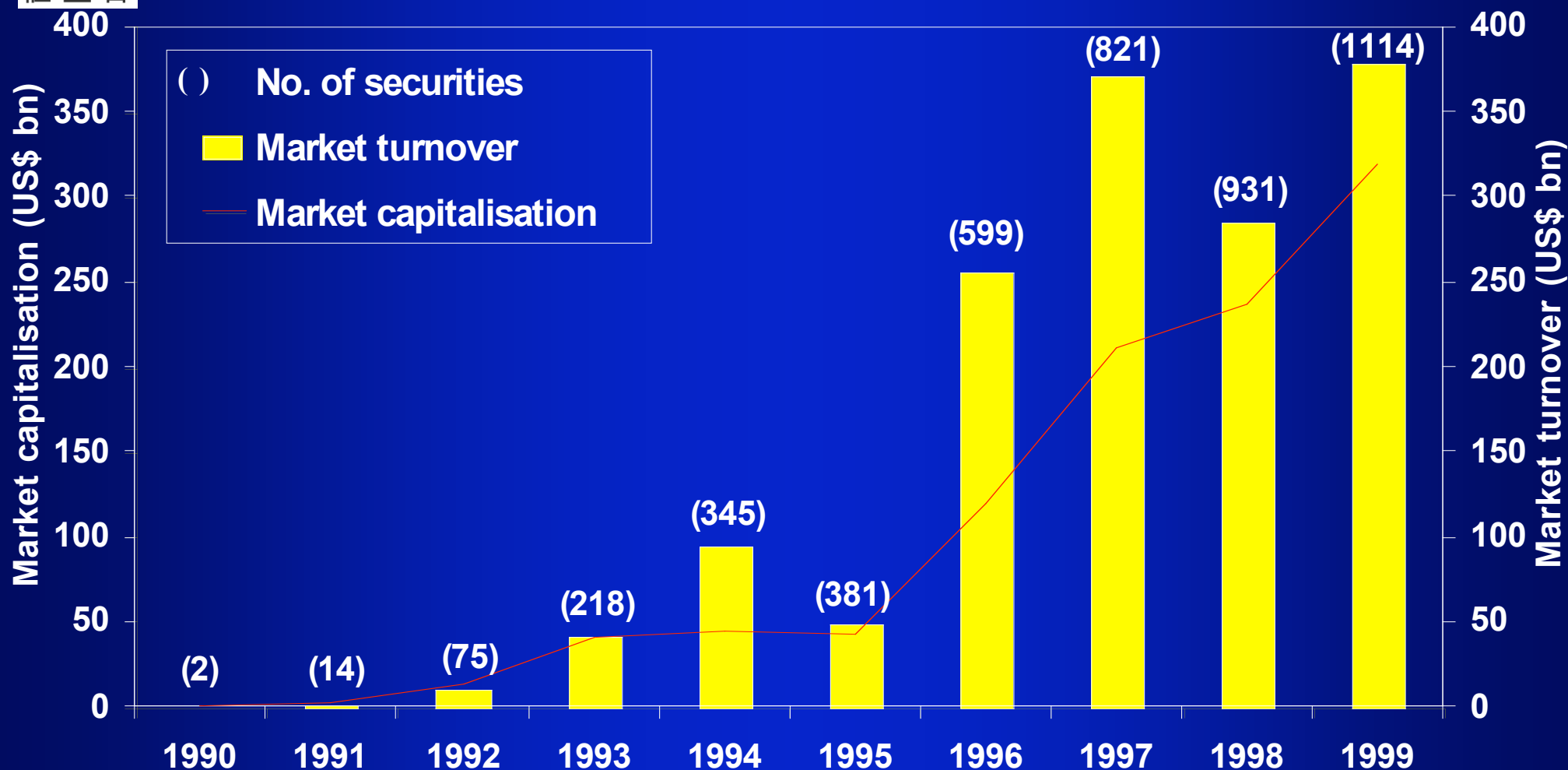


The Stock and Bond Markets to Fill the Gap

- ◆ Private enterprises can raise funds from:
 - banks;
 - the stock market; and
 - the bond market
- ◆ BUT, the banking sector is largely responsible for **financing the state sector**
- ◆ The **stock and bond markets are needed to fill this gap**
- ◆ The development of these markets also **reduces the pain of a credit crunch** as a result of bank re-structuring



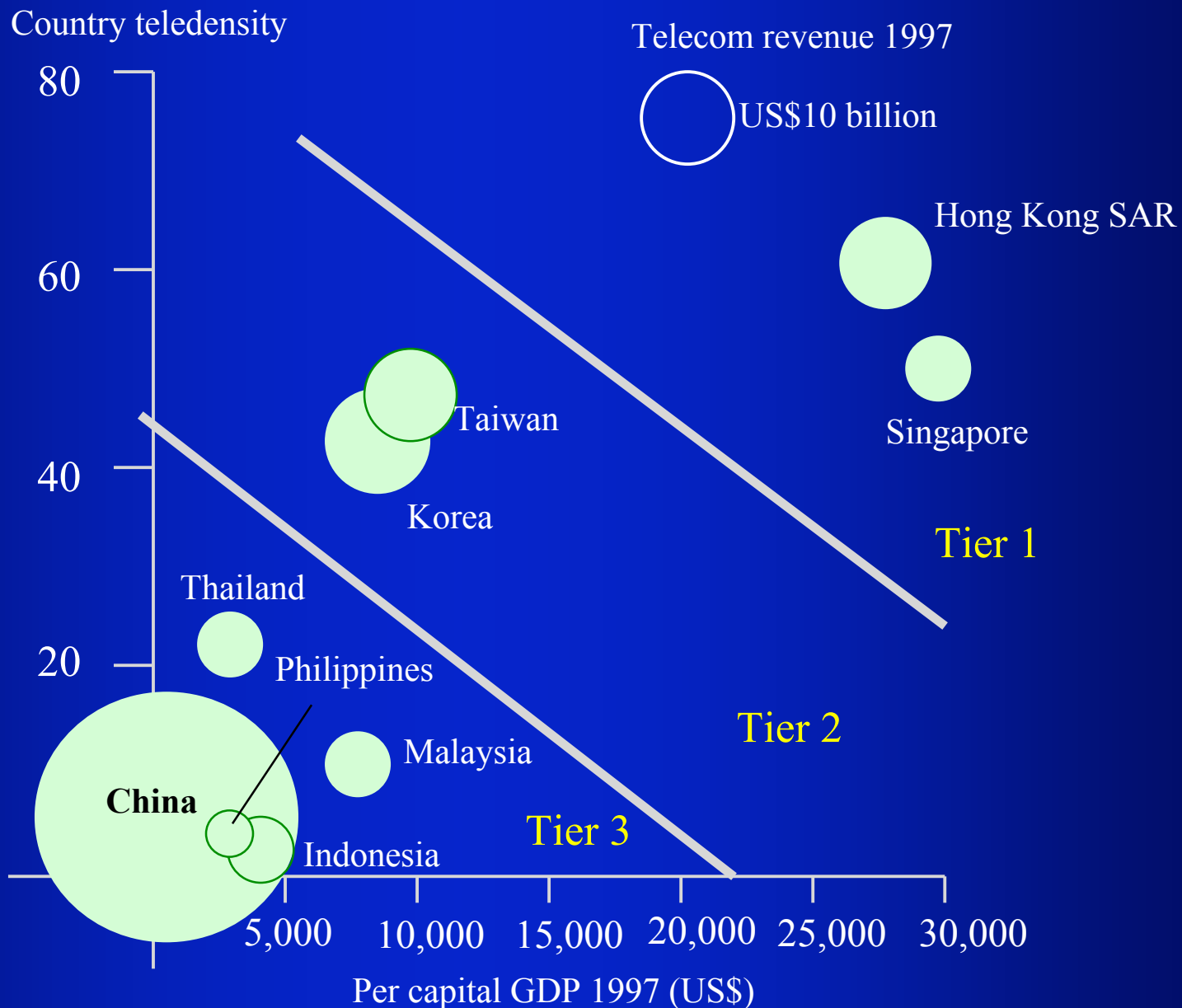
Tremendous Growth in Mainland Stock Markets



Sources: Shanghai Stock Exchange & Shenzhen Stock Exchange



Relative Development of Asian Telecom Markets, 1997



Source: EIU forecast of 1997 GDP; ITU teledensity data



Asia Pacific Telecommunications Index

	Rankings in		
	2000	1999	1998
Australia	1	2	4
Hong Kong	2	3	3
Japan	2	4	2
Singapore	4	1	1
New Zealand	5	6	---
Korea	6	5	4
Taiwan	7	7	6
Malaysia	8	8	8
Thailand	9	9	7
Philippines	10	10	10
Indonesia	11	11	9
India	12	12	---
China	13	13	---



Potential of Chinese Securities Market

- ◆ Two markets - Shanghai & Shenzhen
- ◆ Market capitalization - about 33% of GDP at end-1999 and growing fast
- ◆ Policy to use stock market to reform state-owned enterprises
- ◆ 40 million individual investors
- ◆ RMB not yet fully convertible, so Hong Kong securities market major window into China
- ◆ **China's entry to WTO** - allowing foreign ownership of asset management company up to 33% (and up to 49% by 2003)



Chinese Economy Remains Robust

- ◆ **China's entry to WTO** - further boosts confidence, external trade, efficiency and economy
- ◆ **RMB** is very stable
- ◆ GDP growth: 7.8% in 1998, 7.1% in 1999 and forecast of 7% in 2000
- ◆ Current account surplus at US\$30 bn, 3% of GDP in 1999
- ◆ FX reserves at end-1999 amounted to US\$154.7 bn > external debt
- ◆ Fiscal deficit at about 3% of GDP in 1999
- ◆ Inflation CPI : -1.3%, RPI : -2.9% for 1999
- ◆ China meets Maastricht criteria!



Conclusion

- ◆ **WTO makes reform urgent priority**
- ◆ **SOE reform critical to China competitiveness**
- ◆ **Focus on core business**
- ◆ **Get incentive structure right**
- ◆ **Deeper capital markets will improve corporate governance, risk management and overall economic efficiency**



End of Presentation