Comparing the Chinese and German Capital Markets: Do Informal Institutions Jeopardize Formal Institutional Supremacy?

Shiu-fai Wong
Governance in Asia Research Centre
City University of Hong Kong

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Abstract:

While the Chinese and German governments have introduced widespread capital market reforms over the past fifteen years, the view that their capital markets are relatively 'underdeveloped' and/or 'risky' continues to be widely held. What has caused this? Answering this question from a strictly regulatory perspective (even including the cutting-edge soft and indirect regulations) is not the only, and not always the best, solution. For a wider perspective we also need to understand how informal institutions such as organisational arrangements shape the Chinese and German capital market models. This article assesses capital market development in the paradigmatic case of China and Germany, arguing that the building of a strong, healthy capital market requires not only government regulation but corresponding adjustment of informal institutions. This study indicates that, overall, weaker performance in respect of informal institutions, caused by 'smart' managers who play tricks in the spacious grey areas intersecting the unique corporate and political structure, undermines the institutional supremacy the two governments provide. An analysis of the textual components that threaten or damage the quality of their respective macroeconomic environments and public institutions follows.

INTRODUCTION

Over the past 15 years, China and Germany have each undergone massive capital market restructuring. At the same time, societal behaviour, industrial norms and corporate cultures as bundles of informal rules in terms of organisational arrangements have discouraged the appearance of new regulatory/institutional reforms. The corporate finance and governance systems of these two national economies have generally been classified as 'bank-centred' and 'relationship-based' setting them apart from Anglo-Saxon countries such as the U.S. and the U.K. which are seen as more 'market-based' and 'arms-length' (Taskinen 1999). In the early 1990s, in a bid to maintain their rapid economic growth during the 1980s and seek new sources of corporate finance as an immediate relief to massive debt-market problems, China and Germany needed to steer their capital markets away from their bank-based debt markets towards an alternative source of corporate finance.[1] The Chinese and German governments thus respectively proposed sophisticated laws and regulations on, for example, information disclosure, accounting standardisation, brokerage surveillance to protect equity investors, whilst establishing more efficient, technologically-advanced investment systems to promote/facilitate their capital markets and other new equity-linked products.

Despite the above institutional reforms and developments, the Chinese and German capital markets are today still commonly perceived as 'underdeveloped' and/or 'risky' (e.g. Nowak 2001; Macleod 2002; Vitols 2003). What prevent pro-market, pro-consumer regulations alone from promoting capital markets? Much of the recent literature on financial market development has argued in favour of formal institutions through regulation or reregulation (e.g. Vogel 1996, Craig 1998, Heo and Tan 2003). Under the general label of the 'regulatory state' or

[1] While the Chinese were willing to support virtually all technological projects that were proved to be beneficial for the country, the German banks were 'rather risk-averse … appear to have taken some care not to meddle [*sic*] too much in the development of new technologies' (Abromeit 1990: 79).

‘age of governance’ (Majone, 1997; Moran, 2001;2002; Cook, Kirkpatrick, Minogue and Parker eds., 2004; Jordana and Levi-Faur eds., 2004; 2005) of which there are some further studies on *indirect* and/or *soft* regulation (e.g. Knill and Lenschow, 2004; Scott, 2004; Painter and Wong 2006a&b), seldom supporting informal institutions such as organisational arrangements through which actors’ behaviour, corporate culture, and/or industrial norms are reorganised. The role and effectiveness of formal regulatory institutions for capital markets is not in dispute here, since there is already a great deal of literature available on this. Yet, few works have analysed capital market laggards from an informal institutions perspective as far as policy implementation is concerned, in addition to formal institutions such as those increasingly popular (autonomous) quangos which regulate target actors through various types of formal regulatory instruments. Do informal institutions matter then and how do regulators respond to them?

The objective of this paper is to discuss the impact of informal institutions on policy implementation and to develop a new parallel framework for employing informal institutions. This will be achieved by exploring how the Chinese and German governments have used formal steering instruments to protect investors, but how informal rules through organisational arrangements have broken the regulatory controls and become deadlocks in the capital markets of both countries.

The enabling/constraining force of informal institutions

To present the latest forms of ‘new governance’ in terms of regulatory instruments, Painter and Wong (2005: 3) basing their argument on Knill and Lenschow (2004: 222) classify regulatory techniques according to the ‘modes of steering’ and the kinds of instruments deployed, thus constructing a two-dimensional grid between the modes of *direct*, *semi-direct* and *indirect* regulation, i.e. ‘direct government’, ‘regulatory standards’, ‘indirect government’, ‘self-regulation’ and ‘standardisation’, on the columns of an analytical table, and the *hard, semi-hard* and *soft* controls, i.e. ‘authority’, ‘incentive’ and ‘learning’ that are employed to shape the behaviour of target actors on the rows of the grid. This proposed grid, while fairly comprehensive, could be expanded in my view to include one more column under the term ‘organisational arrangements’ (see Table 1 below), since the case studies in this paper would seem to suggest that organisational arrangements positively or negatively impact on actors' behaviour *under some specific conditions*, even overriding the other regulations in the table.

Table 1 - Modes of Regulation and Organisational Arrangement[2]

	Direct Government	***Regulatory Standards***	***Indirect Government***	***Self-regulation***	***Standardisation***	***Organisational Arrangements***
Authority (hard rules)	Ownership and direct provision or restraint	Legally binding *ex ante* rules of conduct	Procedural / framework rules and contracts	‘Shadow of hierarchy’ (fall-back rules)	Monitoring and reporting – e.g. league tables	Dualistic (or multilistic) / supranational organisation
Incentive (semi-hard rules)		‘Frame-work’ legislation	Taxes, auctions, concessions, subsidies	Delegation to private actors; facilitation of ‘industry forums’	Peer pressure	Differential organisational practices by taking advantages of different regulatory regimes
Learning (softened rules)			Education / information provision	Communication in private networks	Benchmarking / best practice models	Gradualism / soft-landing organisational strategy

[2] The table is adapted from Knill and Lenschow (2004); on the classification of tools into ‘sticks, carrots and sermons’ see also Bemelmans-Videc et al. 1998; and also from Painter and Wong (2005); on the modes of *formal/informal* and *direct/indirect* regulation.

The table is revised and placed experimentally due to the fact that the standard view of institutions that produce regulatory instruments has recently been substantially expanded to include informal ones. Institutions encompass firstly not only formal rules but '*norms*' (e.g. Olsen 1984: 734). Hall (1986) devises a concept of '*standard operating procedures*' which refer to informal rules, e.g. those unwritten political practices or settings, which generally guide actors' behaviour. March and Olsen (1989: 17) claims that 'institutions influence actors' behaviour by shaping their '*values*, *norms*, *interests*, *identities* and *beliefs*'. Alternatively, North (1990: 83) further expands the interpretation of such informal rules to include '*tradition*, *custom*, *culture and habit*'.

Meanwhile, the concept of 'organisational arrangements' here is distinct from 'public ownership' or 'organisation for direct government provision of goods and services' (alternative types of formal regulatory instruments developed by early scholars like Doern and Phidd 1983 or Hood 1983), which have already been placed in the top of the first column of Table 1. In contrast, scholars are more frequently adopting the concept of 'organisational arrangements', ranging from the structure of policymaking networks to the ways of collective bargaining, as an influential informal component of institutions in order to explain phenomena in their studies (e.g. Katzenstein 1978; Johnson 1982; Hall 1986; Pempel 1998; Thelen and Kume 1999). Hall and Soskice (2001: 9) following North (1990: 3) combine regulatory and societal features of institutions by regarding them as a set of formal or informal rules as well as *organisations' rules* that actors generally follow. Furthermore, Weiss (2003: 20-21) proposes that 'organisational arrangements' may either *enable* or *constrain* desired outcomes, depending upon the particular policy goal.

This new institutional concept implies that the manner in which companies in any industry, with corporate cross-purposes (this term will be illustrated in the Chinese case later) or in a cross-border district (this term will be illustrated in the German case later), are organised and their societal/business norms are constituted might greatly influence policy, and particularly regulatory, outcomes. Moreover, this has occurred principally in various countries/economies during the era of internationalisation (or more appropriately described as the era of erratic and fractional globalisation, e.g. the rapidly developing globalised capital market versus the continually revised national regulatory framework, as discussed below). Perhaps for this very reason, Scott (2004: 168) has seen fit to discuss the rise of 'the post-regulatory state' in the age of governance, suggesting that in the areas where regulatory reform is not yet intensive and the credibility of the regulators is not strong enough, the state should strengthen regulation by 'providing greater recognition to other types of legal and non-legal norms in processes of control'.

As regards the formal regulatory pressures enforced by state agencies in the cases of China and Germany discussed below, there are some other aspects influencing the outcomes of corporate governance, which have been largely ignored by empirical-based scholars. I regard these, following the ideas of Weiss (2003: 20-21), as the *enabling* or *constraining* force of informal institutions in terms of informal rules or organisational arrangements. In contrast to the *constraining* aspects of informal rules such as corruption and cronyism, there are *enabling* aspects of informal rules that include, for example, harmony and cooperation. Similarly, in contrast to the *constraining* aspects of organisational arrangements, there are also *enabling* ones of them. In any particular policy sector such as capital markets, if the *constraining* aspects override the *enabling* ones, actors tend to explore the *grey areas* of their organisational arrangements, leading to inefficient and ineffective policy implementation at length. By contrast, if the enabling aspects supersede the constraining ones, formal rules will prevail.

There are some tangible forms of ‘organisational arrangements’. If they are well managed and/or rearranged by the state (or by cross-border hegemony), they could be *enabling*, otherwise they could be *constraining*. Through observing empirical facts, they normally adopt three main features:

Type 1) *Dualistic(or multilistic)/supranational organisations* – organisations made up of two (or more) independent, conflicting parts or aspects are subject to two (or more) different jurisdictions respectively , or they are not confined to the laws and regulations of a single nation-state;

Type 2) *Differential organisational practices* – corporate operations are specially carried out so as to freely take advantage of infinitesimal (or possibly enormous) differences between national and cross-border regulatory requirements;

Type 3) *Gradualism/soft-landing organisational strategy* – organisations are specifically conditioned to adopt gradual or soft-landing measures by (deliberately) placing or maintaining political or societal ‘barriers’.

These different forms of organisational arrangements, albeit that they appear in different policy timings and patterns, represent different informal regulatory instruments or techniques which play a role in managing economic transformation in any particular industry or policy sector. What were these informal techniques or instruments exactly in the capital markets of the two countries and how were they chosen and implemented? Who are the policy-makers and regulators? How much and since when, if at all, did the respective governments rely on them to supplement their formal regulatory instruments? Also, what other factors shaped the respective informal institutions? These questions point to a new research agenda, which concentrates on the *enabling* and/or *constraining* forces of the above-mentioned organisational arrangements.

This paper is one of the first to source empirical data for filling in the blanks of this knowledge gap. It will also add to the moral-free capitalist literature (e.g. Bell 1979, Hirschman 1997, Schumpeter 1989 translated by Heinz Norden, Soros 2000) so as to streamline them with *enabling* informal rules in terms of organisational arrangements. This paper highlights the deficiencies in China's and Germany's less dynamic organisational arrangements in their more dynamic developmental contexts respectively, and observes how economic actors utilise informal practice in grey areas of organisational arrangements to maximize individual/corporate benefits, and how such constraining force can be then turned into enabling one. These cases constitute the argument that, despite the (static) regulatory supremacy of the Chinese and German governments in this particular sector, reforms of informal rules through organisational rearrangements to rebuild corporate culture or societal quality and eliminate the organisational grey areas are urgently needed to pave a way for the development of healthy capital markets.

While the two countries in this study are well-known for the way in which they have focussed intensely on capital market reform and emphasised pro-market, pro-investor regulation from the very beginning, they have gradually become aware of the equal importance of state efforts to adjust corporate behaviour through organisational rearrangements. In the case of both markets new, sophisticated institutions and relevant regulations obviously and immediately evolved in very similar contexts, soon to be overcome by different informal institutional factors respectively. For this reason they are ideal case studies and they comprehensibly demonstrate the prevailing impact of informal steering instruments in terms of organisational arrangements on various collective societal/corporate behaviours.

The next section will deal with the institutional/regulatory revolutions for the promotion of capital markets (mainly through the protection of stock exchange investors) in the two countries. An analysis of existing regulatory arguments on capital market developments will then be followed by the development of a three dimensional (rather than a two dimensional) institutional explanation with focus on some significant impacts of different informal rules in terms of organisational arrangements within Chinese and German capital-market developments.

CHINA'S CAPITAL MARKET REFORMS

Establishing Capital Markets

Since the early 1980s the Chinese economy has seen the rapid growth and development of its township and village enterprises (TVEs), including significant reform of its state-owned enterprises (SOEs). Yet, only the coastal special economic zones (SEZs) could absorb foreign direct investment (FDI) steadily but remained relatively low and largely confined to Sino-foreign joint venture projects. In the late 1980s, the Chinese government found the financial burden of non-performing loans (NPLs) of SOEs unbearable.[3] Therefore, the Beijing government made a decisive move toward capital markets, i.e. the establishment of two stock exchanges respectively in Shanghai and Shenzhen at year-end 1990 for attracting more domestic high savings and, particularly, more foreign capital.[4] Another important purpose of the introduction of the two

[3] The financial burden of the SOEs caused the Chinese government to have a debt equivalent to some 90 percent of GDP, consisting of a combination of mostly domestic and international Treasury bonds, and the amount for recapitalising the four state-owned banks and the asset management companies (AMCs) and policy banks (Lardy 2000, Bottelier 2001, Steinfeld 200, and Ma and Fung 2002, abstracted from Green 2003: 19).

[4] The paper does not intend to conflate the regulatory instruments for the divestment of SOEs with those for the development of capital markets. Yet, the text will follow this trail by describing how formal instruments finally became stuck at the quagmire of further capitalisation of SOEs through stock market share sales and a variety of other market vehicles.

stock exchanges was to improve the poor corporate governance of SOEs by broadening ownership for foreign institutional investors.

The establishment of the two stock exchanges, in addition to the Yuan devaluation in 1993, helped stimulate an immediate rise in the percentage of China's FDI volume to its GDP,[5] which accelerated from some 10 percent in 1991 to over 36 percent in 1994 (Chart 1).[6] However, the percentage has declined since 1994 mainly due to the fact that foreign (and local) investors have found it difficult to discern 'quality' and 'inferior' Chinese companies, even though the gross amount of FDI has continuously poured into the country. In consequence, the Chinese government has kept revising regulations to gain confidence from investors, and special arrangements, for example, allowing some 'qualified' SOEs and Chinese companies to be floated in foreign stock exchanges. The channels of foreign investment in China include direct investments in projects, trading in A shares (originally for locals in RMB but gradually being opened up for foreigners since 2003),[7] trading in B shares (originally for foreigners but extended to Chinese investors in 2001) and H shares (for foreigners on the Hong Kong stock exchange), red-chips (for foreigners buying shares in Chinese companies registered overseas and listed abroad principally in Hong Kong), Chinese funds, treasuries and corporate (convertible) bonds. An increase of foreign investment in the country occurred again after China's accession to the World Trade Organisation (WTO) in December 2001. A year later, on 1 December 2002, the Chinese government granted foreign investors Qualified Foreign Institutional Investors (QFII) Scheme to invest in A-shares, treasury bonds, corporate bonds and other approved financial

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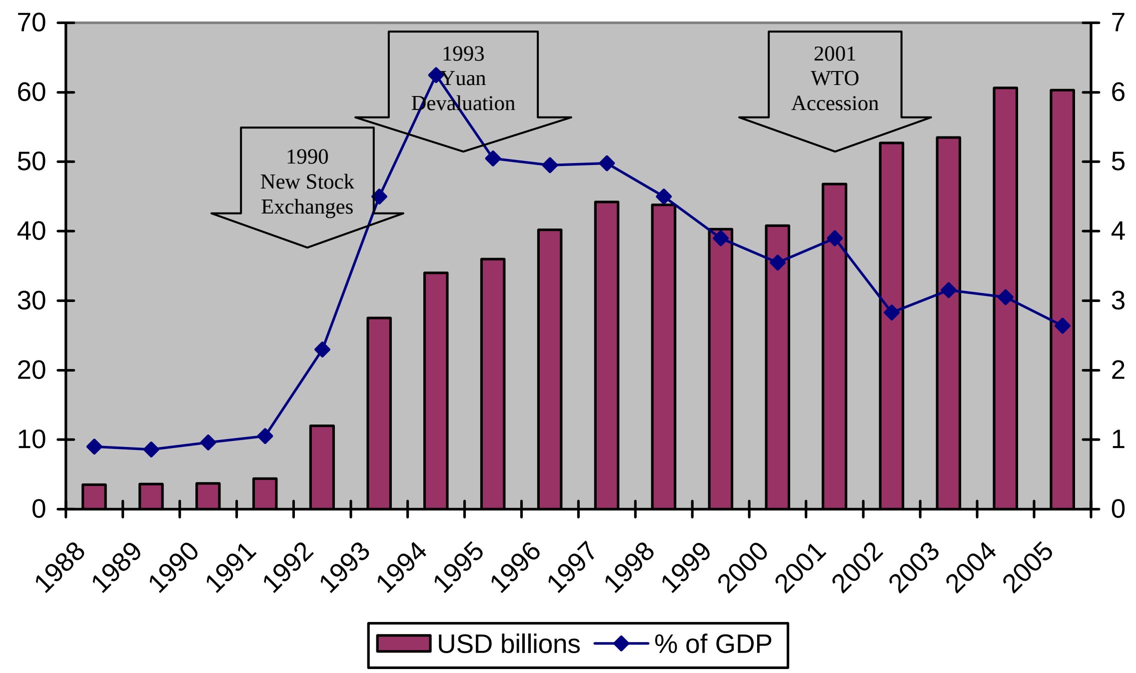
[5] China's per capita GDP in 2004 dramatically increased to US$4,580 according to the "Human Development Report 2004" released by the United Nations Development Programme (UNDP), who calculated by purchasing power parity (PPP) rather than the China's usual method by nominal exchange rate, which would lead to only US$1 ,087 in 2003. See more explanation on the Web page of People's Daily On-line at < http://english.people.com.cn/200408/05/eng20040805_151944.html>.

[6] In any case, Mira Wilkins, who is sharing the view of Peter Gray, argues that 'the impact of FDI on stock markets tends to be indirect' (1999: 101).

[7] In 2003, Deutsche bank and HSBC Holdings have successfully sought approval from Chinese regulators to invest up to $50 million each in A-shares.

instruments. On 25 June 2004, a Small & Medium Enterprises (SMEs) Board was established to accommodate smaller and faster-growing Chinese companies. The latest official figures are those in November 2005,[8] when there were 1,381 listed companies (as ‘A’ or ‘B’ shares) in the mainland, with a total market value of US$ 801.7 billion (Rmb 6,522.7 billion). They are meant to be declining in comparison with the figures of the previous years. For example, as of 31 December 2003, China’s capital markets had expanded to a total number of 1,589 listed companies and market capitalisation of US$ 756.3 billion. This declining episode can also be indirectly reflected by Chart 1.

CHART 1- China’s Foreign Direct Investment (1988-2005)



Source: The Ministry of Foreign Trade and Economic Corporation; *the monthly publication of Crown Agents Asset Management Limited, December 2002, No. 294*

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[8] Source from the essay ‘China Makes Headway in Share Reform’, available on December 05, 2005 at <http://english.people.com.cn/200512/05/eng20051205_225758.html>

China's Regulatory Changes to Protect Investors' Interests

In the early 1990s, thanks to the two new stock exchanges, China's opening economy was able to continuously attract more capital and resources for more productive uses. This temporarily counteracted the problems of SOE inefficiency, corruption and cronyism (the constraining informal rules as described above). Some suggested that these reforms introduced market principles and decreased state control. Particularly, the former Chinese premier Rong-qi Zhu's supporters and followers suggested that greater competition derived from China's further opening to the international market through stock markets and FDI might solve the issue of government corruption and corporate dishonesty. Especially under the impact of WTO membership, Chinese companies have had to become competitive in order to compete against foreign companies without state protection and preferential treatment. The Chinese government was thus essentially forced to initiate SOE reforms and favour mergers as the best form of privatizing SOEs (Jie and Jie 1995). Legal protection of investors has since been widely introduced and has rested on the depth of capital markets and diversity of ownership (La Porta et al. 1996).

To better regulate China's securities and futures markets, the China Securities Regulatory Commission (CSRC) was founded under the State Council as the sole national securities regulatory body mandated in October 1992. Yet, in the first few years of operation, the CSRC had no independent statutory power to verify applications for the issuance of shares, regulate the securities market, and thus be subject to state direct supervision, until the Securities Law of the People's Republic of China was enacted in December 1998 (the Securities Law was revised in October 2005), though current applications for share issuance still have to be finally approved by the State Council.[9] Nevertheless, the Securities Law empowered the CSRC to formulate relevant regulations, qualification criteria and a code of conduct for persons engaged in the securities business. These include some regulations on information disclosure to increase the transparency of the business of listed companies,[10] such as *Measures on Further Promoting Standardized Operations and Deepening the Reform in Overseas-listed Companies* in March 1999, *Code of Corporate Governance for Listed Companies* (the Code) in January 2001 and *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* (the Guidelines) in August 2001. Moreover, the Securities Law has given the CSRC further statutory powers to perform brokerage surveillance. For example, its Article 168 has allowed CSRC officials to enter sites in order to question suspects, inspect and make copies of relevant securities trading records, records of change in ownership, financial and accounting information and other relevant materials. Furthermore, persons directly in charge are answerable to serious legal liability. For example, According to Article 175 of Chapter XI of the Securities Law, any person directly in charge 'shall be given a disciplinary warning and also be fined not less than 30,000 Yuan but not more than 300,000 Yuan. If the offence constitutes a crime, criminal liability shall be pursued according to law'. In parallel, and in addition to the state laws and CSRC regulations, there are also administrative regulations such as *Methods of Punishment against Financial Malfeasances* promulgated in February 1999 by the State Council to protect and promote confidence among investors, a measure that is increasingly proving essential for

[9] The scope of the Securities Law includes shares, corporate bonds and other such securities. Other activities of issuing and trading beyond the coverage of this Law are regulated by the provisions of the Company Law, administrative regulations and other relevant laws and regulations (e.g. the Administrative Punishment Law of the People's Republic of China enacted in March 1996).

[10] Details can be found from the 'Code of Corporate Governance for Listed Companies in China' issued by the China Securities Regulatory Commission of State Economic and Trade Commission, available online at http://www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1061968722100&type=CMS.STD

helping maintain investment momentum.[11]

Meanwhile, four state asset management corporations (SMCs), have been delegated by the Chinese government via the Ministry of Finance (MOF) to manage the problems of NPLs, the mountain of sour assets of inefficient Chinese SOEs and banks, and the task of auctioning off dud loans to foreign investment banks.[12] Moreover, in March 2003, the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) was established to improve the protracted problems of the debt-ridden SOEs. SASAC promulgated 'Provisional Rules on Mergers with and Acquisition of Domestic Enterprises by Foreign Investors', which went into effect on 12 April 2003.[13]

China's Corporate Governance Problems and the 'Rules of Cadre-Manager'

In spite of new statue laws, institutional formations and regulatory changes such as the consecutive establishment of property rights, comprehensive company and contract laws, CSRC, SMCs, SASAC and the above-mentioned investor protection regulations, the problems of Chinese corporate governance have not been solved. Investors still deem China's capital markets today to be very risky. Corporate fraud and dishonesty has dominated the headlines of Chinese capital markets' news. There might have different reasons for it. Schleifer and Vishny (1994) suggest that SOEs perform poorly because politicians maximize their personal objectives such as

[11] Details of new and previous Chinese stock market laws and regulations can be found on the Websites of the two stock exchanges, available online at <http://www.szse.cn/main/en/Catalog_1397.aspx> and <http://www.sse.com.cn/sseportal/en_us/ps/support/law.shtml>.

[12] There are four state asset management corporations: Cinda Asset Management, Hua Rong Asset management, Great Wall Asset Management and China Orient Asset Management. According to The Standard report on 16 December 2004, these four asset management companies, established in early 1999, bought up around 567.3 billion Yuan of bad loans from China's Big Four state-owned banks - the Bank of China, the Construction Bank, the Agricultural Bank, and the Industrial and Commercial Bank of China. These institutions are suffering from an approximate amount of US$500 billion (HK$3.9 trillion) of China's NPLs.

[13] The Provisional Rules on Mergers with and Acquisition of Domestic Enterprises by Foreign Investors are designed to prevent negative influences of multinational corporations upon competition. If the rules apply, the investors submit a report thereon to the Ministry of Commerce and the State Administration of Industry and Commerce.

employment at the expense of profitability. To solve this problem, Qian and Roland (1994) proposed that tough budget constraints can be achieved by a combination of fiscal decentralisation to SOEs and monetary centralisation by the Beijing authority. However, Cao et al. (1997) argued that the rise of ‘hiding-revenue-in-local-economy’ is one of the failures of the centralised (non-fiscal) control mechanism of SOEs. Therefore, the fiscal decentralisation to SOEs is deemed to have failed due to the same old problem of finding ways to improve Chinese corporate governance. Munshi (2001: 8) states that ‘state enterprises issuing shares face a higher cost of capital because foreign investors perceive higher political risks (through manipulations by cadre-managers rather than “rules of law”) in Chinese capital markets’. This shows the negative impact of poor Chinese corporate governance on the development of Chinese capital markets, even though now they operate in a more stringent regulatory climate than before. In general, according to a cover story in *Hong Kong Securities* of July/August 2004, China’s capital markets today are replete with corporate governance standards, fraud and corruption problems.

As commonly recognised, ‘*guan xi*’ (personal relations) are very important in Chinese society and play an important role in conducting business in China, but it can cross the line beyond fair play to become insider trading. Although the Chinese government has introduced new laws and regulations, and particularly tightened disclosure requirements to create a fair and transparent investment environment, this has not necessarily brought about the desired outcomes. Since China is a communist country, virtually every business activity must be carefully examined and approved by bureaucrats who may or may not have a neutral attitude towards their decisions. Managers in Chinese firms might use their (close) relationship with bureaucrats to list corporate shares or bonds without a serious examination of corporate business performance. In particular, as a high percentage of SOE shares are owned by the government, bureaucrats are empowered to appoint boards of directors. Conflicts of interests between managers who represent both the government and private shareholders always exist. Although there are laws and regulations to regulate this, it is a norm to ignore opinions of private shareholders while recruiting members for management usually dominated by political representatives.[14] Scandals and dishonesty among Chinese publicly listed company's management continue, and regulations and institutional arrangements to stamp out corruption have seemed virtually futile, since they are structural/organisational problems rather than regulatory ones. Repeated scandals among large SOEs have demonstrated that Chinese regulators cannot overpower influential political and business interest groups that hinder the proper development of China's capital markets.

In order to cope with this formidable problem, Chinese senior leaders have adopted a moderate attitude. During the course of the reform away from central planning towards fiscal and administrative decentralisation, and market economy, the Chinese government has faced transitional problems of political and societal resistance (due to abuse of delegated discretion and authority)which have also troubled transitional economies in Central and Eastern Europe and the Former Soviet Union. Nevertheless, during the course of the past two decades of structural change in the economy, the Chinese government has differentiated itself from the latter two economies by responding to political and societal resistance through '*dual-track gradualism*' (Munshi 2001). In stock markets, '*dual-track gradualism*' is reflected by 'gradual' regulation over 'dual' companies (e.g. unlisted and listed SOEs under a common management) and 'dual' accounting systems (e.g. domestic and international accounting practices for same business). Although 'dual-track gradualism' has decreased political and societal resistance to reform, it is a 'two-edged sword'. Chinese 'dual-track gradualism' has provided a regulation-free haven to

[14] The norm has been an 'open secret' for years since the author was involved in Chinese business throughout the 1990s.

those corrupt, dishonest cadre-managers. Three types of such a '*dual-track gradualism*' can be further explained as follows:

First, due to the popular 'rapport' between unlisted SOEs and their publicly-listed affiliates, laws and regulations have failed to require cadre-managers to make businesses of unlisted SOEs more transparent or to provide a comprehensive, quality information disclosure of corporate activities. Under such a grey area of regulation, Chinese cadre-managers who possess management powers over considerable assets and capitals are easily tempted to commit dishonesty for their own benefit. Regulators usually have difficulty recognizing and regulating corporate frauds and dishonesty until a tremendous loss in an account is found. For example, the China Aviation Oil (Singapore) Corp (CAO) had breached the rules of the Singapore Stock Exchange. Since December 2004, CAO had been investigated by Singapore's white-collar crime unit of the Commercial Affairs Department and China's SASAC into a $550 million loss on derivative trading by CAO. Its parent company, state-owned China Aviation Oil Holding Company (CAOH), which is a specialist company handling the largest Chinese flag carriers' aviation fuel needs, was investigated for an internal share sell-off in October 2004 in which CAOH sold its shares in CAO from 75 per cent to 60 per cent on 20 October 2004, cashing in about US$120 million shortly before the disclosure of the colossal amount of loss of its listed branch. Such a sudden sale of a stake without informing the public of the loss could be regarded as a case of insider trading under Singapore's Securities and Futures Act. It has revealed that the regulators would have had difficulty preventing the alleged fraud at an earlier stage and charging the mother company in Beijing. This is just another example of the previous repeated revelations about the 'grey area' beyond the control of regulators.[15]

[15] According to The Edge Daily on Aug 3, 2006, the lawyer of the CAO's ex-CEO Jiu-lin Chen will plead guilty to the charges,

Second, the 'dual track' accounting system has enabled the possibility to reshuffle debt between the international accounting system for a regulated capital market and the Chinese one for the Chinese communist party, enabling cadre-managers to take advantage of the two different accounting systems to their companies' benefit. Yet, this 'grey area' of accounting systems has also given corrupt cadre-managers the opportunity to utilize the dual accounting systems by selling unlisted state assets to listed companies and then treating the latter as a 'cash cow' with or without shareholders' approval. Under the shield of the dual-track accounting systems, many unlisted Chinese enterprises do not properly disclose their trading activities and present their accounting information as true, accurate and complete. Dr. Francis Siu, Senior Partner, KPMG, Shanghai remarked that 'the accounting information compiled according to the Chinese accounting norms and system is likely to be regarded as untrue and inaccurate'.[16] Since then China has been simultaneously developing its Chinese uniform accounting system (UAS, which was originally imported from Russia in the 1950s) and international accounting standrads (IAS).[17] The problem is that many Chinese companies are using both UAS and IAS simultaneously. Even though the Chinese Ministry of Finance has fully integrated the accounting system (a new UAS reconciled with IAS being effective from January 1, 2001), such a accounting and regulatory adjustment has not been able to solve the fundamental problem of the traditional use of dual systems (Xiao, Weetman and Sun 2004). Without touching organisational arrangements, an increasing number of scandals has arisen from this dual accounting systems arrangement. For example, China Life Insurance Company Limited (CLI) recently experienced a

after the CAO's former finance head, Peter Lim, was sentenced to prison for two years and was also fined S$150,000 last month for fabricating false financial information. Meanwhile, CAOH is undergoing a sell-off of the majority stakes in CAO to British oil firm BP and Singapore's state investment arm Temasek.

[16] Source retrieved from the Centre for International Private Enterprise, on 18 January 2006 available at < http://www.cipe.org/china/p3_accsys.htm>

[17] China is not the only countries to adopt dual accounting systems. For example, dual systems are also adopted by many US companies with one main book using generally accepted GAAP system for creditors' perusal, and with a second book being readjusted to show more allowances and depreciation for tax authorities' examination.

scandal of this kind (organisational arrangements in terms of dual accounting systems), even though the company was heavily regulated and monitored by regulators for the exchanges in New York and Hong Kong. CLI, China's largest life insurer, whose share price was worth $3.4 billion, was listed in New York and Hong Kong in December 2003. Investors who flocked to purchase the shares were encouraged by the enormous size of China's life insurance market, which allegedly comprised a national savings rate of more than 40 per cent of GDP. The furore of the initial public offer (IPO) quickly pushed up the share price by 26 per cent acquiring an oversubscription of 25 times on the IPO, becoming the world's biggest offering in 2003. However, two months after the IPO, many investors lost money due to dishonest corporate governance when China's National Audit Office, on 4 February 2004, exposed accounting irregularities of its parent company involving 5.4 billion Yuan (652 million U.S. dollars) during a routine audit by the Chinese authorities. Foreign institutional investors immediately rushed to sell. Shares dropped from HK$5.35 on 4 February 2004 to $3.88 on 17 May 2004. CLI saw its share price plummet to become one of the biggest ever falls on the Hong Kong stock market. Lawsuits from investors against CLI were filed for its failure to disclose accounting irregularities in regard to such a large quantity of funds in its listing documents.

Third, having responded to the most respectable reform leader, Deng Xiao Ping's, most popular early 1980s metaphor that 'wading across the river by stepping on one stone after another', 'gradualism' has become consensus with mainland Chinese officials. Yet, it has also given those corrupt managers the opportunity to defend themselves against state controls and regulations. Given the need for a gradual improvement of the Chinese capital market, only a little elbow-room was inevitably left for mainland regulators to effectively punish those transgressors without strong judicial support. The power of the mainland regulator is confined to introducing measures to cool the stock market's over-speculation when it is bound by its 'gradual' (better described as 'slow' from regulatory point of view) improvement of judicial and law-enforcement work. The increasing number of scandals occurring within dishonest Chinese corporate management, such as the recent case of Skyworth Digital Holdings Company Limited (SWD), has demonstrated that 'gradualism' has been seriously abused. In December 2004, ten company executives including the chairman and three executive directors and the financial controllers of China's third largest TV maker after TCL and Changhong, SWD,[18] which was listed in Hong Kong, were charged by Hong Kong's Independent Commission Against Corruption for a $48,378,169 theft. It was alleged that its mainland unlisted parent company based in Shenzhen misappropriated funds from its listed branch by consecutively using nine cheques to draw that amount between November 2000 and April 2003. Since pursuing the state policy to encourage Chinese companies to list their shares on overseas exchanges, regulations and controls on them have been 'carefully' (very slowly) done, lest the development in this regard should be impaired. Rules and regulations on overseas-listed corporate governance have thus been confined to *non-disciplined* supports such as 'Measures on further Promoting Standardized Operations and Deepening the Reform in Overseas-listed Companies' issued in 1999.

GERMAN CAPITAL MARKET REFORM

Rebuiding Capital Markets

Before WWI, the German capital market was considered the most highly developed in the world and even more prosperous than its U.S. counterpart. In 1914 Germany counted almost 1,200 publicly listed firms whereas the U.S. had only some 600 stocks listed on the New York Stock

[18] Source retrieved from the *Interactive Investor Journal*, information on 20 January 2006 at <http://www.yeald.com/Yeald/a/33151/article.html>.

Exchange (Nowak, Ehrhardt and Weber 2004: 2). However, for years after the war period, the German financial system became obsessed with its *weak* corporate stock and bond markets, strong universal banks, and high levels of ownership concentration (Dietl 1998). Before 1990, there was virtually no unified capital market law in Germany. After German reunification in 1990, reform of capital markets to meet immediate western German development needs was initiated. The 1990 Securities Prospectus Act (*Wertpapier Verkaufsprospektgeset*z) was enacted to govern the prospectus requirements for all publicly listed companies to protect investors. In addition, the 1990 1st Financial Market Promotion Act (*Erstes Finanzmarktförderungsgeset*z) helped kick-start secondary capital markets by allowing investors in company debt to trade bonds; removing some anachronistic taxes, e.g. the capital transfer tax and the stock exchange turnover tax; and requiring listed firms to draft investment guidelines and to disclose business opportunities and investment possibilities for trust companies and mutual funds. In January 1993, the Frankfurt Stock Exchange was privatised and became part of the newly established *Deutsche Börse* AG which consisted also of an electronic trading system (Xetra) recently joined with the Swiss Exchange to become a cross-border derivates market Eurex.

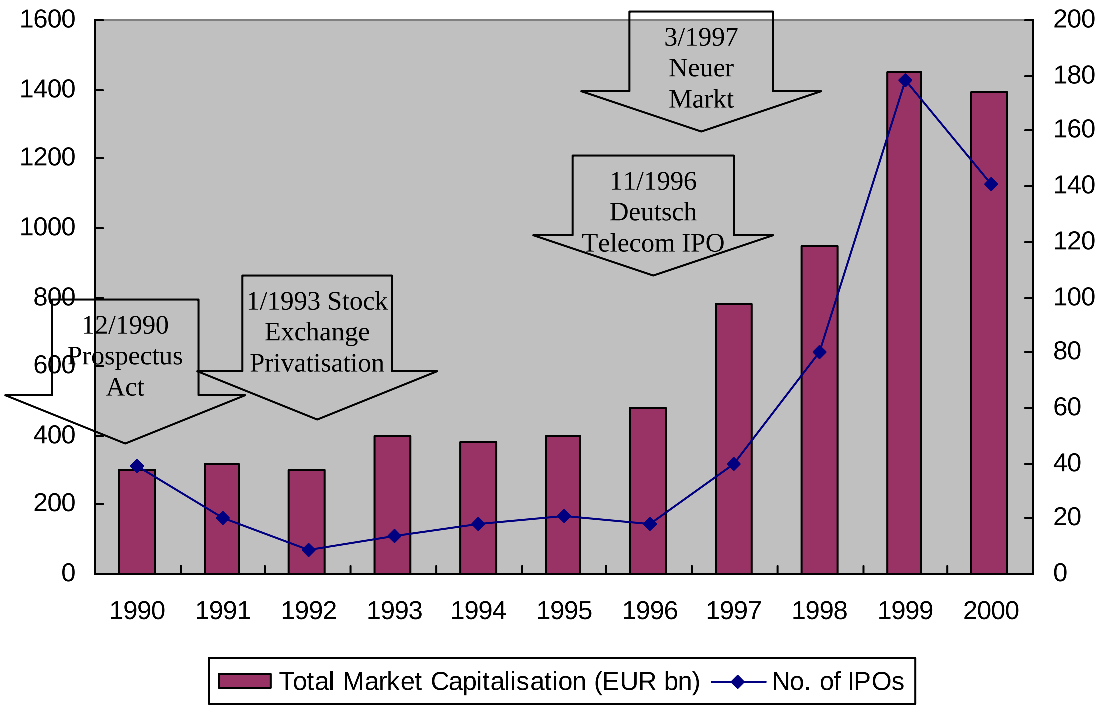
Continuous Regulatory Reforms from the mid-1990s

Despite these events, the early regulations above were insufficient to encourage large multi-national German firms to seek capitals in their domestic market. For example, on October 5, 1993 Daimler-Benz opted to list its shares on the New York Stock Exchange instead of its German counterpart. This prompted the German government to upgrade its regulations vis-à-vis U.S. stock exchanges while European integration further prompted German laws to fall in line with the corresponding EU Directives on insider trading (89/595/EC), transparency

(88/627/EEC), and investment services (92/22/EEC). Thus, the 1994 2nd Financial Market Promotion Act (*Zweites Finanzmarktförderungsgesetz*) was then devised to overhaul German financial law. The new law was accompanied by the 1994 Securities Trading Act (*Wertpapierhandelsgesetz*), which gave rise to a Federal Securities Supervisory Office *(Bundesaufsichtsamt für Wertpapierhandel*) opening in Frankfurt am Main on 1 January 1995 to implement the new regulation of prohibiting insider trading and ensuring investor protection, market transparency and market integrity. To confer the regulator with more power, the *Ad-Hoc* Disclosure (*Ad-hoc-Publizität*) was promulgated to require listed companies to disclose immediately from 1 January 1995 any 'private' information that would have a material effect on their profitability, value, or financial condition. Nowak (2001: 7) finds that the Federal Securities Supervisory Office and the *Ad-Hoc* Disclosure *positively* impacted on the German stock market boom in the second half of the 1990s.

Yet, the existing laws and regulations rapidly became less effective since the *Deutsche Börse* has been heavily challenged by foreign exchanges such as the New York Stock Exchange, London Stock Exchange (LSE) and Euronext (a merger of the Paris, Amsterdam, and Brussels exchanges). For example, in November 1996, the listing of *Deutsche Telekom*, which was the largest ever IPO in Europe, was launched not only on the *Duetsche Börse* but also on the New York Stock Exchange. The German government responded to this heavy foreign competition of capital markets and also followed the world trend of installing an alternative stock market by establishing the *Neuer Markt* (New Market) for young, innovative (technology and growth) stocks in March 1997. Even though capital markets throughout the world were collapsing at the very moment the *Neuer Markt was* being developed, the number of publicly listed German companies quickly increased from 34 in 1990 to 175 in 1999 and the total amount of capitalisation surged from some EUR 300 billion to EUR 1,400 billion over the same period (Chart 2).

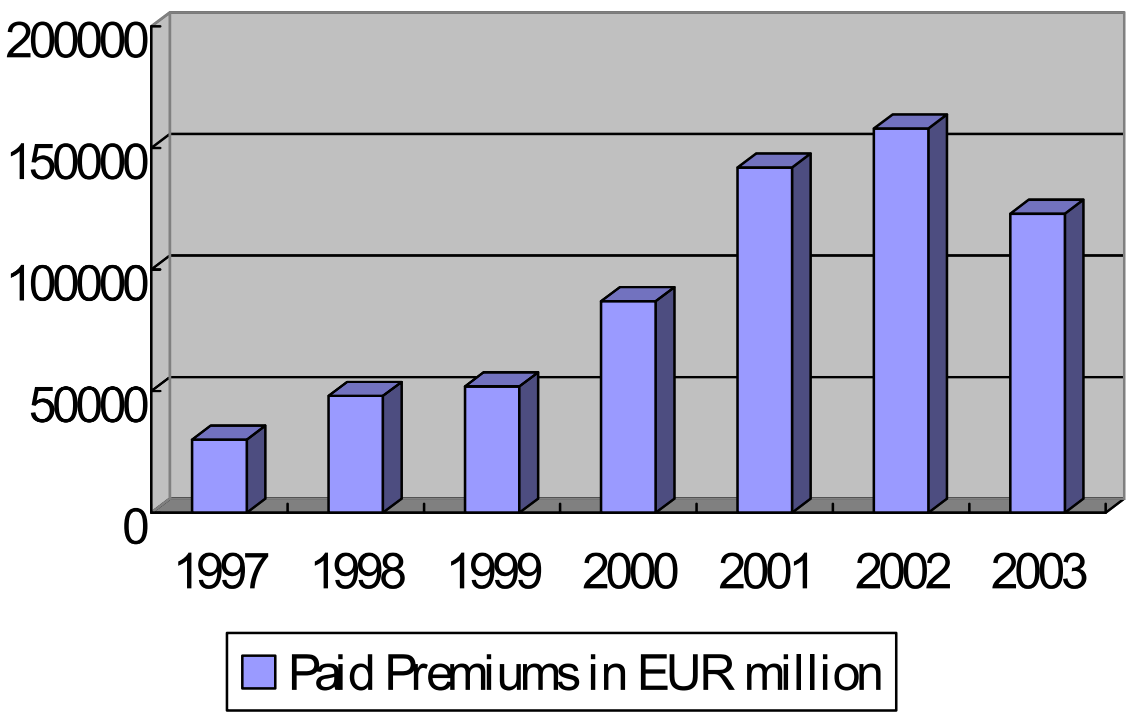
CHART 2 - Stock Market Capitalisation and Number of IPOs in Germany in the 1990s



Source: Deutsches Aktieninstitut, DAI Factbook 2000

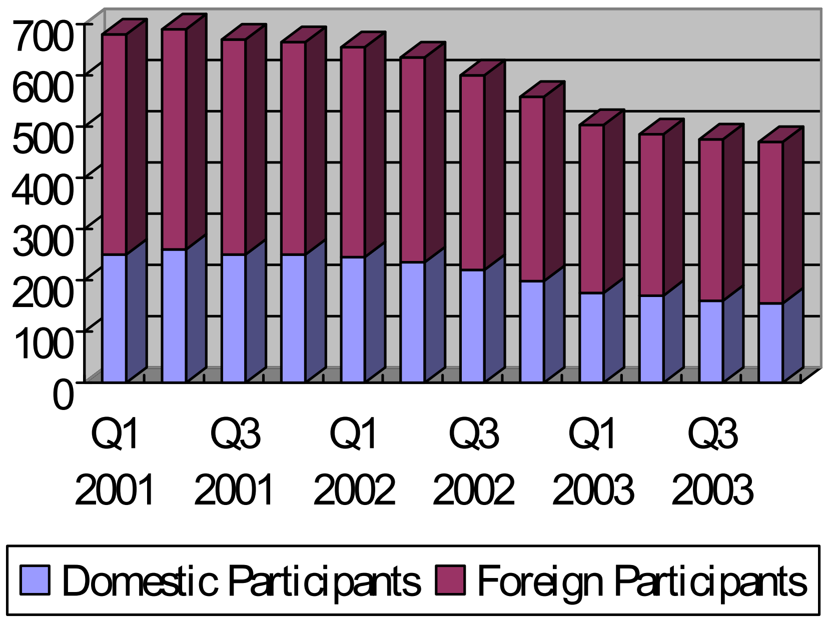
Nevertheless, although this figure at the end of the 1990s represented a 67.6 percent of total German GDP, it was still much smaller than the 184 percent in the U.K. and 153 percent in the US. On entering into the new millennium, the German government was set to further promote its capital markets by exposing the German market to foreign investment. On January 1, 2001, the Investment Modernisation Act (*Investmentmodernisierungsgesetz* and amended on November 7, 2003) was enacted for this purpose and has brought the German law into conformity with European law such as the one removing tax disincentives on international fund sales. The problem of shrinkage of the capital market, however, has not improved over time. According to *Deutsche Börse*, as at 30 September 2004, there were only 292 participants at Xetra and 405 participants at Eurex in Germany, and the number of German publicly-listed companies today is still relatively small and has been on the decline since the early 2000s (Charts 3, 4 and 5).

CHART 3 - Paid Premiums of Eurex



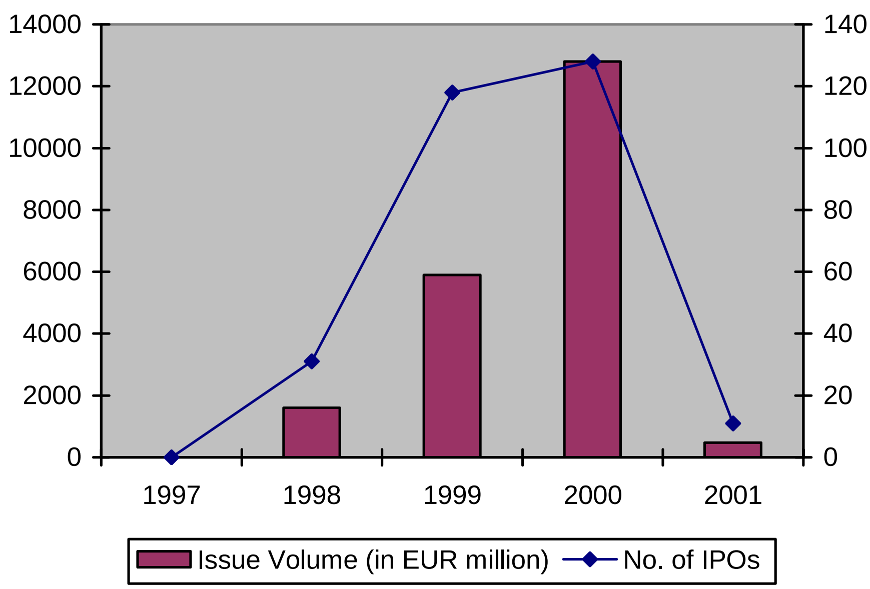
Source: Frankfurt Stock Exchange

CHART 4 - Number of Xetra Participants



Source: Frankfurt Stock Exchange

CHART 5 - Number of IPOS and Issue Volume at the *Neuer Markt*



Source: the Center for Financial Studies (CFS) quoted from Jörg Rocholl (2004)

Germany's Corporate Governance Reforms

What has caused the irregular growth and decline of the German capital market? Do laws and regulations or any other formal institutional factors have a bearing on this? Macey (1998) argues that, due to the small size of the voting rights premium for voting shares (against the non-voting shares of shareholders), German companies habitually issue dual-class shares to gain control of their companies by small premiums. Since the Voluntary Takeover Code (*Übernahmekodex*) introduced in July of 1995, the voting premium dropped drastically in the second half of the 1990s, and fell below 20 percent at the end of 1998. In fact, from 1990 to 1994, more than 20 German companies went public each year but from 1995 to 1999 the number of IPOs sharply increased to, for example, 175 in 1999. This implies that the regulatory arrangement for a lower voting premium may be one of the causes for the expansion of German capital markets.

The shareholder-friendly legal requirements for more corporate transparency may also have a positive impact on the stock market. Kaplan (1994) indicates that poor stock performance and negative earnings accelerated the management turnover. This is supported by the findings of Franks and Mayor (2001) that supervisory and management board turnover are usually caused by poor corporate performance, as mostly reflected by accounting earnings losses. Nowak (2001) examines the number of turnovers in managing boards disclosed by listed firms since *ad hoc* reporting was required by new regulations in 1995. He shows that in the second half of the 1990s the number of top management replacements had sharply increased from 43 in 1995 to 213 in 2000, arguing that such improvement of corporate governance (through increasingly demanding laws and regulations) had promoted the growth of the German stock market over the period.

Yet, given that the German government has constructed a new equity culture and a shareholder-friendly governance system, why did the number of IPOs decline from the climax of 175 in 1999 to 142 in 2000 and 26 in 2001? Nowak (2001) points out that in the 1980s there were only 147 IPOs of German firms with an amount of capitalisation of 50 billion Euro, but in the 1990s, a sharp increase to 412 IPOs occurred of which some 300 new IPOs have appeared since the inauguration of the *Neuer Markt* in 1997 accompanied by strict regulations for investor protection. It was then that the speculative bubble on the *Neuer Markt* burst in March 2000. Nowak (2001: 14) concludes that although the new shareholder-friendly system and legal protection for stronger corporate governance have facilitated the ability and willingness of entrepreneurs to make IPOs of stock, 'the after-effects of the plunge in *Neuer Markt* prices (even more devastating than that of the NASDAQ) and the current threat of global recession' are the most formidable obstacles.

Triggering Supranational Organisational Arrangements

With the collapse of the over-speculated *Neuer Markt* and with the global recession driven by the US markets starting to tank in 2000, the dollar began to decline sharply. Yet, these are not necessarily independent variables. In any case, since entering into the heady days of the early 2000s, the German corporate governance reforms have faced new challenges. The *Bundesbank* has become part of the European System of Central Banks (ESCB) and has lost its power to regulate the country through monetary policy. Whilst performing partial liberalisation, the German government soon found itself 'unable to prevent a wholesale integration of capital markets' (Goodman and Pauly 1993). Rajan and Zingales (2001) argued that the degree of openness of cross-border trade and capital flows has inspired 'interest groups' to oppose the development of the German capital market, and this has led to the low number of IPOs and venture capital financing instruments in Germany. However, Franzke, Grohs and Laux (2003: 26-27) reject this argument and instead propose that 'the "backwardness" of the stock market may have been an integral part of the German financial system, which was advantageous in times of relative stability'.

After all, the accelerated integration of Europe has radically changed the shareholding structure and corporate behaviour of many German companies. One of the largest impacts has been the effect of the introduction of the Euro. Dr Jürgen Stark, Deputy Governor of the *Deutsche Bundesbank*, commented that

> '*For the German credit institutions, the euro means that they no longer have the competitive advantage of the D-Mark, whereas for others it means that they no longer face the "D-Mark home currency" barrier to entering the market. Competition is becoming more and more intense within Europe and globally. Increasingly, credit institutions not only have to withstand growing competition from other banks but are also competing to a greater extent with insurance enterprises, investment and pension funds as well as online brokers - in some cases even from within their own groups*'.[19]

The 'EU effect', in addition to the above German laws and regulations, has not only challenged the traditional structures of German credit institutions but also challenged the new financing models of German stock markets because there have been an extraordinary growing number of M&A. Narusawa, Emori and Ohmori (2001) found that more market-oriented corporate governance reforms such as increasing the ratio of shares owned and influenced by

[19] The comment from Dr Jürgen Stark was made at the Euromoney Conference, held in Frankfurt, on 19 September 2000.

institutional investors, the possibility of M&A, and leveraged buyouts are necessary. Although public opinion in Germany was strongly averse to hostile takeovers and even Chancellor Gerhard Schröder commented that ‘hostile takeovers destroy the (German) corporate culture’, nobody could reverse the trend. For example, Mannesmann AG, a large German publicly-listed telecom company, became an affiliate of the British Vodafone group after a successful hostile takeover bid in February 2000, which was approved by the European Commission in April 2000. More takeovers, such as FAG Kugelfischer (one of the leading German manufacturer of precision rolling bearings) being bought up by INA-Holding Schaeffler KG (a German-based but multi-national manufacturer of machine tools and engine components) in October 2001, followed consecutively.

Also, the tide of European integration has not only caused a surge of large listed German companies with M&A but has also dramatically increased the number of small listed German companies with heavy foreign competition. The *Neuer Markt* faced severe rivalry from a number of other European growth markets such as the *Nouveau Marché* in Paris, the *Nuovo Mercato* in Milan, the SWX New Market in Zurich, the Alternative Investment Market (AIM) in London, and NASDAQ Europe (EASDAQ) in Brussels. Nowak (2001: 8) stated that rules and regulations for *Neuer Markt* to increase possible transparency and to protect investors successfully expanded the size of *Neuer Markt* during its first few years. But European liberalisation may have exposed the vulnerability of the German venture capital market. The German government put forward the 1998 3rd Financial Market Promotion Act (*Drittes Finanzmarktförderungsgesetz*) to help prepare the way for a massive increase in German venture capital by lowering the costs of securities issues, to accept listing of small- and medium-sized enterprises and also by allowing the creation of new products such as those related to private pension schemes; and the 1998

Transparency Act (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*), which was designed to improve auditor independence and to increase shareholder influence, sought to increase both the supply and demand for risk capital. However, they still failed to attract quality high-tech IPOs, venture capital investments, or private pension plans. The number of IPOs on the *Neuer Markt* began to drop dramatically in 2001 (Chart 8). Unfortunately, the *Neuer Markt* closed down on 24 March 2003 after the bursting of the high-tech bubble from its peak in March 2000 down to less than 20 per cent of the value of the Nemax index of all shares on the *Neuer Markt*. Technology stocks are now placed in the new TecDAX (part of the prime standard) acted as a successor to the technology-oriented new economy index, Nemax 50.[20]

So, was market liberalisation the culprit of the recent German capital Market recession and did regulations then fail to promote capital inflows? The government reacted to this question by further regulating speculative and insider trading activities. On September 4, 2001, the draft proposal for the 4th Financial Market Promotion Act (*Viertes Finanzmarktförderungsgesetz*) suggested a greater investor protection, transparency, and market integrity. For example, market and price manipulation will be regarded as a criminal act. Triggered by the court verdict in September 2001, which required a listed software firm Infomatec to compensate investors for providing misleading statements about future sales, additional new rules requiring the complete disclosure of hidden agreements have been introduced. The *Viertes Finanzmarktförderungsgesetz* finally took effect on 1 July 2002 and the Securities Acquisition and Takeover Act (*Wertpapiererwerbs-und-überrnahmegesetz*), which took effect on 1 January 2002, was introduced to streamline operations and protect investors by way of stricter supervision of, and penalties for, share price and market manipulation, and greater disclosure

[20] Since January 2003, companies in Germany have been classified as either prime standard subject to a range of internationally accepted transparency rules, or general standard subject to other minimum rules.

obligations. Yet, the reason that regulations can promote capital markets by simply boosting investors' confidence is not only implausible but also superfluous. It is simply because organizational grey areas can allow cross-border companies to manipulate operations without juridical consequences. The following two regional rulings can further explain this.

The European Court of Justice delivered two verdicts, *Überseering* of November 2002 and Inspire Art of September 2003, under which a company of any member state of the EU may relocate to, or establish its entire operations in, any other member state. The latter is not allowed to restrict or deny the legal capacity of the former. That is, the status of the former, such as liability of limited partners and managing directors, or capital requirements, must be regulated by the law of the state where the company is incorporated. The two rulings greatly helped foreign investors solve the usual difficult issues in structuring acquisitions on capital maintenance, the resistance from the lawful workers' co-determination rights, and the 75 percent super-majority vote required for capital expansion or M&A activities, and helped foreign investors do German business without substantial M&A. Domestic M&A transaction volume substantially reduced from $124 billion in 2003 to $82 billion in 2004, dropping by about 30 percent. In addition to this expected outcome, yet, due to capital gains from sales of participating interests, high corporate tax rates and the complex German tax system, many German firms moved their incorporation out of the country but maintained their German operations after the European integration. Since then, 'supranational' organisational arrangements have emerged.

The Impact of Supranational Organisational Arrangements

The argument in this case study centres on recent German 'supranational' organisational arrangements resulting from the European wholesale integration of capital markets. These arrangements have contributed to the recent collapse of the German capital market. They facilitate corporate borrowings, rather than capital financings. A clear indicator of this trend is the German supervisory board's co-determination (worked in tandem with the managerial board) which has been the most far-reaching system of employee participation in corporate governance among European countries.[21] This specific corporate culture has prevented German companies from entering the German stock exchanges because the German labour unions have adamantly opposed any attempts to allow their firms to shift from labour-friendly long-term debt markets to market-based volatile capital markets. Meanwhile, debt financing has become more readily available and popular, however, not through domestic facilities, but through the formation of a supranational corporate structure facilitated by the recently-introduced *Societas Europaea* (the European company).

Despite the Single European Act in 1985 and the long-awaited *Societas Europaea* which was finally agreed upon at the Nice summit in December 2000,[22] the liberalisation of capital markets and the assurance of equal protection for small investors across member states have long been obstructed by the deeply-rooted German two-board (or two-tier) corporate culture. Although corresponding German laws in line with the EU Council Regulation on the European company's statute itself and a Council Directive on employee involvement in the *Societas Europaea's* corporate governance being gradually in place to dismantle the co-determination, they are valid only for international M&A. While the 2000 Summit in Nice, which had the intention of harmonizing EU external and internal policies, has notably impacted less on British

[21] German companies have a two-board system, which is different from the one-board system of any other country. That is, the managerial board is responsible for the daily management of the company, while the supervisory board recruits or dismisses the managerial board's members, decides the managers' remunerations, and many other fundamental decisions.
[22] The EU has sought a unique European company structure through continuous negotiation among its member states. As a result, a number of directives have been issued to increase the power of shareholders over that of employees for the desired European company structure.

strongly market-oriented institutions, it has made a dramatic change to the German financial system. Debt financing sourced from foreign countries has increased dramatically. For example, according to the Monthly Report in March 2004 of *Deutsche Bundesbank*, there was a net shift of capital abroad to 312 billion Euros in 2003 from 32 billion Euros in 2002 through securities offered by foreign banks. This has happened instead of financing through the domestic market since an increasing number of FDIs in Germany were caused by the introduction of the *Societas Europaea* in December 2000 and the removal of the old Corporation Tax Act (*Korperschaftsteuergesetz*), which provided tax privileges for corporate borrowing enjoyed by German shareholders if the borrowed funds were not larger than one-and-a-half times the *pro rata* share of one's own capital (this tax privilege was cancelled on January 1, 2004).[23] This encouraged more German-foreign shareholdings and their corporate borrowers were thus entitled to more tax privileges. Yet, either way of financing foreign-registered German operations discourages the domestic capital markets.

This confirms the findings of Ramb and Weichenrieder (2004) that the increasing numbers of supranational companies in Germany are also indirectly caused by tax-saving behaviour. Yet, such a tax-saving behaviour has been shaped by the German cross-border organisational arrangements. German companies are inclined to become multinational firms because they can evade a large portion of their statutory tax burden (at least until the recent tax reform of 2001) by relocating income out of high-tax German jurisdictions. During the course of the 1990s Germany was renowned for having the highest tax rate on retained corporate profits among OECD countries. German companies in the form of supranational companies are able to shift their incomes in terms of 'excessive' management and overhead fees, internal non-market

[23] The tax privilege provides that German holding companies, regardless of their financing structure, could treat their loans granted by their German parent company as an interest-free loan/operational expenditure and thus reduce their tax burden.

loan interest rates, tax-efficient transfer prices on intra-firm trade, and financial structure to minimize taxes. In the 1990s the net German FDI inflow was largely financed by intra-company debt which arose outside Germany. According to *Deutsche Bundesbank* in 1993, 61.9 percent of the German FDI inflow in 1990 and 1991 was financed by intra-company loans, and this high percentage was seemingly caused by the German high corporate tax rate (*Deutsche Bundesbank* 1997: 63-76). Between 1996 and 1999 the balance of FDI more than doubled each year. In 2000, Germany's inward FDI hit an all-time record reaching a volume of EUR 215 billion. Many companies enjoyed considerable tax benefits through their supranational organisational arrangements.

Apart from tax reasons, although the German economy is increasingly based on free market operations, its labour, wage, and regulatory burdens and complexities have created high tensions between government, business and labour. Since the reunification in 1990, German businesses have faced persistent slow economic growth, persistent high unemployment rate, large government debt, high tax imposition, continued high government expenditure on eastern Germany, high unit labour costs, and growing social security and non-wage labour costs. Budget consolidation and structural reform through market-oriented capitalisation is envisaged, but competitive German exporters are afraid of jeopardizing their valued relationships with workers, debt creditors, and the protected groups who dominate Germany's industry associations and political parties (Vogel 2001). They have thus employed a 'soft-landing' strategy by maintaining the traditional financial channels to avoid possible domestic conflicts and at the same time, apart from rigid resistance from these factors, the financing channels of German companies are increasingly going abroad. As a result, there are a higher number of strategic M&As occurring in German companies, which are *ironically* regarded by the proponents of economic neo-liberalism as an important solution for replacing inefficient and unproductive management.[24]

Also, lower profitability in recent years in Germany has triggered a higher number of cross-border intra-company loans (Ramb and Weichenrieder 2004). For example, as at December 2003, foreign investors remitted long-term loans in the amount of Euro 14.5 billion for their operations domiciled in Germany, but a large portion of it existed in terms of equity capital in their German branches.

Furthermore, the hostile takeover, e.g. the Mannesmann case in 1999, has demonstrated that German companies which rely on stock markets would face a threat under different national institutional endowments (Höpner and Jackson 2001). This incident discouraged the domestic capital markets and prompted a higher amount of foreign debt financing for supranational German firms. That is, although their domestic debt markets are problematic, they tend to not necessarily rely on the domestic capital markets (to avoid the possibility of hostile takeovers) but on the foreign debt markets which the employee-participated supervisory board would prefer.

Last but by no means least, the supranational organisations can avoid increasingly stringent regulatory controls. In contrast to the ever demanding regulations in Germany,[25] international institutions such as the OECD and stock exchanges in Anglo-Saxon countries promote self-regulation and voluntary codes for corporate transparency and investor protection in Anglo-Saxon countries (DiMaggio and Powell 1991). The European Works Council Directives are welcomed by German companies because the former does not interfere with the

[24] Germany promulgated a voluntary takeover code in 1995. However, in the Takeover Commission only 540 of 933 listed companies and 79 of the *Deutscher Aktien* Index 100 (DAX 100) companies participated. In addition, the imperfect regulations that gave rise to hostile takeovers e.g. German Mannesmann in 1999 by British Vodafone, has exposed the urgency of binding regulation on bidding procedures and possible defensive actions. In March 2000, the Chancellor's Office formed an expert commission for solving the problem.

[25] In addition to the four Financial Market Promoting Acts which produced more and more regulations to take control over corporate management, a German Code of Corporate Governance was enacted in February 2002.

German systems of company interest representation.[26] Since the standpoints of European Works Councils are largely shaped by company-level negotiations and home country practices, the councils have varying impacts on countries. German Works Councils interpret European institutions as supportive institutions for their practices to be extended to Europe, in terms of an extended arm of national labour representatives. From this perspective, EU regulations have provided an exit for German employee-participated institutions to exert influence on German companies to seek financing from debt markets more favourable to German employees than financing from capital markets.

CONCLUSIONS

In this paper, I sought to demonstrate that laws and regulations are not the only factors that impact on the development of capital markets in China and Germany. To explain this enigma, I propose that there exists an informal institutional explanation for the different societal/corporate backgrounds leading to an abuse of or even an alteration of organisational arrangements and thus to the capital market crisis. Although this review of the informal institutions in terms of the unique organisational arrangements of the two countries would be too brief to reach a definitive theory, it may already provide significant insights into the impact of different informal institutions on capital market development and thus has incorporated the informal/behavioural part of institutions discussed by North (1990), Hall and Soskice (2001), and Weiss (2003) into the gap of Martin and Wong's (2005a&b) steering mechanisms and modes of regulation, and

[26] In September 1996, the European Works Council Directive was established, requesting large companies conducting business in the region of the European Union to establish groups and multi-lingual forums for the purposes of informing and consulting employees.

also into the debate on Scott's argument of not neglecting the non-instrumental, non-state dimension of regulation (2004). The findings in this paper have thus suggested a new look beyond the formal institutions. It would be necessary for the sovereign state (or the sovereign district such as the EU) to treat informal institutions in terms of, for example, the Chinese dual-track, cross-purpose and gradual organisational arrangements or the German supranational, cross-border and soft-landing organisational arrangements as essential elements of institutional characteristics to be considered for underpinning regulation, i.e. making the informal institutions *enabling* rather than *constraining*. To shed light on these sorts of issue, a large volume of the comparative case study represents a pioneer attempt to explore the multifarious ways in which many *informal, tailor-made* societal/corporate rules and regulations can also be seen as important society-shaping institutions and thus to call for further research for incorporating more detailed societal/informal institutions into the regulatory literature.

China and Germany have not properly/steadily developed their domestic capital markets through regulatory institutions where the social and/or financial cost of non-compliance with their societal/corporate standards/norms becomes lower than that of compliance with government regulations. Although their capital markets have in each case been heavily regulated, the two case studies indicate that the overall institutional supremacy provided by each of the governments is offset by the *constraining* informal rules and Chinese organisational arrangements through its unique 'dual-track gradualist' and German 'soft-landing supranational' organisational arrangements in the era of European integration, which in each case threatens or damages the quality of their respective macroeconomic environments and their public institutions in capital markets. These phenomena suggest that, despite the institutional supremacy of the Chinese and German governments, their institutional regulations were static in nature and thus could not catch up fast-growing global challenges. Organisational grey areas are then produced and reforms of organisational arrangements through new regulations to eliminate the grey areas are thus needed so as to further develop capital markets.

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