Corporate Governance and the Challenge of Development

Speech delivered at the International Conference on Building the Institutions for a Modern Market Economy: Corporate Governance Reform in Post-WTO China

by

James D. Wolfensohn
President
The World Bank Group
Beijing, China, May 26, 2002

Good morning. Thank you Minister Wang, and President Liang for co-hosting this important event. Thank you all for coming. It is a pleasure for me to be here today and to have this opportunity to address such a wonderfully diverse audience comprising policy makers, company directors and managers, academics; representatives of the media, chief accountants of large companies. I am particularly pleased to have this opportunity to interact and exchange ideas with the participants in the campus of Ningxia University, who have joined us through the Global Development Learning Network facilities. The Global Development Learning Network is an initiative that I have a strong personal interest in and it is great to take advantage of the network today to reach this wonderful audience in Yinchuan city.

I would like to share with you some ideas about corporate governance and development. Let me start by thanking the Development Research Center for their partnership and support for the successful completion of this study on corporate governance. We appreciate very much DRC¡¯s role and achievements in promoting good policies in corporate governance and enterprise reform and look forward to continued fruitful cooperation in this and other fields.

It is hard to think of a more appropriate venue to discuss the topic of corporate governance than the National Accounting Institute. Within the broad framework of corporate governance, transparency and information disclosure are absolutely central for well informed investment decisions and the protection of small investors. Transparency and adequate disclosure can not, however, become established business practices without well trained, competent, and honest accounting professionals. The National Accounting Institute, our co-host today for this event, is an excellent example of the type of institutions that are needed to support improvements in corporate governance practices. We in the World Bank are very proud to be associated with the work done by the National Accounting Institute and the Chinese Institute of Certified Public Accountants through the assistance we provided in the Accounting Reform and Development Project. Although the National Accounting Institute opened

just a year ago, many professional CPAs and financial managers from both public and private sectors have already benefited from its high quality training programs and many more will follow.

The establishment of this Institute and the strong demand for its services is an indication of the growing public awareness in China of the importance of good corporate governance. The Institute is one among a number of recent important initiatives such as the establishment of a system of independent directors for Chinese listed companies and the introduction of a code of corporate governance, which reveal the increased importance given by the authorities to the improvement of corporate governance practices in China. As China begins to implement its commitments under the WTO, the policy focus on corporate governance in China sends a strong signal that the government is committed to further market reforms. This in turn provides a strong reassurance that the significant gains that China has made in development and poverty reduction over the last two decades will be sustained and enhanced.

China's impressive achievements in improving the living standards of its people are well recognized throughout the world. Given China's success in generating growth and reducing poverty, one may ask the question what drives China¡¯s recent focus on corporate governance reforms.

The policy focus on corporate governance in China reflects new external realities. China has made a major step towards a greater involvement and a more prominent role in the global community with its membership in the World Trade Organization. However, the crisis in Asia indicated that integration into the global economy without the proper institutions of governance can create vulnerabilities that can partially reverse gains in development and poverty alleviation. Thus good corporate governance institutions are critical for sustainable growth, development, and poverty alleviation in a highly interdependent world because good institutions of corporate governance are central to the ability of getting money and resources to countries to create opportunities for jobs and lift people out of poverty. It is very impressive that China has learned from the crisis in Asia and has intensified its efforts to develop the institutions of modern corporate governance.

The current focus on corporate governance also builds on past and ongoing market reforms and should be viewed in the context of the natural progression of market reforms in China. It reflects the fact that market reforms in China have deepened and progressed to the stage of so-called second generation of reforms, where there is a need to tackle issues in a more integrated and comprehensive manner.

Reform issues typically become more intertwined and complex at this stage. For example, corporate governance issues are closely linked with issues of corporate restructuring, and corporate restructuring can not be separated from the soundness of the financial system and the social security issues related to layoffs in the context of restructuring. Complex reform issues, including corporate governance issues, often pose difficult trade-offs. It is important, as problems are being addressed, to keep a balance and not to undermine some of the key elements of a functioning market system. For example, it is important not to sacrifice

financial stability and efficiency in order to mitigate the social costs of restructuring by shielding companies from market discipline and pressure.

It is important to keep in mind that legal reform is part of these interrelated and complex issues. Sound legal rules in company laws and securities regulations are a first step towards effective corporate governance. Here, comparative practice can be quite helpful, and today's conference is an opportunity for just this sort of exchange of views among practitioners and thinkers from a world of experience.

But rules on the books are not enough. Corporate directors, public accountants and government regulators alike must believe that these rules reflect commonly-shared and socially-reinforced values. So we see that compliance by private parties with corporate governance rules depends in part on a country¡¯s legal culture and respect for rule of law, reinforced by a belief that the rules have "teeth."

At the same time, more effective regulation will require increased enforcement capability for regulatory bodies, which, in turn, means greater reliance on legal instruments and the ability to enforce them. Thus, the problems faced by many judicial systems¡ªquality of judges, weak enforcement of judgments, government interference and corruption---can stand in the way of stronger market regulation.

Permit me to take a moment here to recognize China's decade of achievement in developing the legal framework for its market economy, putting in place the building blocks on which corporate growth and governance rest, such as company law, securities law, banking laws. The next stage, already underway--implementation---can often be even more challenging, as it will require changed roles and behaviors by institutions, enterprises and individuals, faced with new rules and new incentives. The Bank has had the opportunity to assist China in its legislative developments over this period, and we are ready to continue to provide advice and support to the ongoing transformation of the institutions of its legal system .

The fact that corporate governance reforms are complex reforms implies a strong need for countries to share experiences, knowledge, and lessons learnt while maintaining full ownership of reforms. China's experience is a case in point. While China has followed a unique path in market reforms, it has also creatively borrowed and applied market concepts and lessons from the experience of other countries. China has shown a great capacity to learn and modernize in the area of corporate governance as well.

On the other hand, China's experience also offers valuable lessons for other countries struggling with reforms. China has shown that grafting of imported concepts and institutions into old and traditional institutions is possible and can result in improved functioning of market institutions. China¡¯s approach also illustrates that imperfect, but functioning institutions are to be preferred to institutional vacuum. We have seen the negative impact on growth, poverty alleviation, and the

legitimacy of the market order of institutional vacuum created by shocks and rapid change in some transition countries.

For the World Bank Group, the generation and dissemination of knowledge, and building capacity in developing countries in partnership with domestic and international institutions is at the core of our mission. Our partnerships with a number of government agencies in China in the area of corporate governance have produced good results. I already mentioned our cooperation with the Development Research Center on the production of this study on corporate governance.

IFC and the World Bank have been working with the Chinese Securities Regulatory Commission, which is one of the most active champions of corporate governance reforms in China, to develop capacity to improve corporate governance practices in the securities industry and to train independent directors of Chinese listed companies.

Creditors have a key role to play in corporate governance, and in this context the work of the People's Bank of China on regulating and supervising commercial banks is of central importance. The World Bank has been supporting the efforts of the Central Bank to strengthen the corporate governance of commercial banks through studies and policy notes.

At the company level, IFC is playing an important role in bringing Chinese companies closer to international standards in corporate governance through technical assistance, institution building in the area of financial markets, and incentives embedded in financial instruments.

I don't want to finish, however, without emphasizing that while corporate governance reforms are central to development, they are part of a much broader framework of development. Corporate governance needs to be viewed as an essential element in terms of job creation, in terms of distribution of resources, in terms of the spreading of wealth, in terms of integration into the international community. But it is also a part of a broader paradigm of development and it should be looked at in this way. The World Bank Group follows a holistic approach to development. It emphasizes the interdependence of all elements of development - social, structural, human, governance, environmental, economic, and financial- and builds on partnerships for its implementation. We in the World Bank Group look forward to working with you on the challenging issues of development in China. Thank you very much.