CHINA'S STOCK MARKET

EIGHT MYTHS AND SOME REASONS TO BE OPTIMISTIC

A Report from The China Project

Stephen Green

February 2003

THE ROYAL INSTITUTE OF INTERNATIONAL AFFAIRS | Asia Programme

UNIVERSITY OF CAMBRIDGE

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Stephen Green
Head of Asia Programme
The Royal Institute of International Affairs
Sgreen@riia.org

This report is published by the China Project, a research project run jointly by the Royal Institute of International Affairs (RIIA) at Chatham House in London and the Centre of International Studies at Cambridge University. China research at the RIIA focuses on the country's economic reforms, in particular privatization, mergers and acquisitions (M&A) and financial-sector reform. For more information, please visit our website *www.riia.org/asia*.

Royal Institute of International Affairs
10 St James's Square, London, SW1Y 4LE, UK
www.riia.org

Contents

Tables

About the author

Stephen Green is the Head of the Asia Programme at the Royal Institute of International Affairs. He holds a Ph.D. from the London School of Economics and Political Science and a First Class Honours degree from Cambridge University. His book *China's Stockmarket: A Guide to its Progress, Players and Prospects* (Profile Books/The Economist) will be published in April 2003.

Acknowledgments

I am grateful to the Economic & Social Research Council (ESRC) who supported my Ph.D. research (Award No. R00429824432) from which this paper derives. I would also like to thank staff at the Shenzhen and Shanghai stock exchanges, as well as at the CSRC, for their support during 2000–01.

The China Project has been generously supported by BP.

Summary

Mainland China's stock market is opening up. It has attracted considerable interest from foreign investors since its official inception back in 1986. But with the news in late 2002 that they will finally be allowed to trade A-shares and to buy controlling stakes in listed companies, foreign investors have begun to take the market more seriously as an investment proposition. What kind of market is it, however? Is it large or small? Has it an important role in the economy? Does it reflect the strengths and weaknesses of the economy? Is the stock market improving the efficiency with which capital is allocated in China and is it a popular place for Chinese individuals and institutions to invest? What are the listed companies like – and are they improving? Is the stock market facilitating privatization, or it is simply a crude means of financing what remains of state-owned industry? And after having hit a three-year low in January 2003, what will it take for prices, and the quality of regulation, to improve?

This report attempts to answer these questions by picking apart eight myths that are often propagated about China's stock market.

Myth #1. China's stock market has grown extremely large, extremely quickly. It is only reasonable to expect the quality of regulation to be poor given the rapid speed of growth.
Reality #1. China's stock market is still small, relative both to the size of the economy and to other markets in the region. Its regulatory problems are explained by factors unrelated to its speed of development.

Myth #2. Initial public offerings (IPOs) are now just as important a source of investment capital for listed companies as the banks.
Reality #2. IPOs are still a marginal source of funds for industry. The banks remain dominant.

Myth #3. The stock market allocates capital more efficiently than the banks, especially the state banks.
Reality #3. Barriers on entry mean that the stock market is probably not (yet) much of an improvement on the banks in terms of the efficiency with which it allocates capital.

Myth #4. Restructuring a state-owned enterprise (SOE) into a shareholding firm and listing it improve the firm's performance. Shareholders, a board of directors and the oversight of the CSRC – all the institutions of an efficient Western corporation – result in the right incentives being created, which in turn leads to better performance.
Reality #4. Although separating ownership from management via the shareholding structure is a good strategy, it has failed to work in practice. Restructuring and listing SOEs introduces new problems into their corporate governance structures. Administrative officials remain involved in running the firm, asset stripping is facilitated and the firm's soft budget constraint is not hardened.

Myth #5. China's stock market is dominated by small, individual investors. The high numbers of individuals in the market, normally holding shares for less than one month, explain the high trading turnover and the volatility of share prices.
Reality #5. Individual investors account for only a small proportion of the market. The majority of individual share accounts are empty, disused or have been opened fraudulently by institutional investors.

Myth #6. The market lacks institutional investors. Analysts argue that to mature, many more of them are vital.
Reality #6. Though wise counsel in principle, this market is in fact already dominated by institutional investors. It is just that these fund managers are not formally registered. The key

to maturing China's stock market lies in improving the quality of the companies whose shares are traded and the institutions which govern trading.

Myth #7. The CSRC as well as securities and fund management firms (all of which are state-owned) are ultimately run by the Communist Party's Central Committee. Listed companies enjoy political protection from their local government. These extensive political controls mean that little improvement in the quality of regulation is likely.
Reality #7. As their policy priorities change, and privatization rises up the agenda, the senior leadership will come under immense pressures to alter the way in which China's stock market operates. The central government will have an increasingly strong interest in regulatory improvement.

Myth #8. China's stock market is not a vehicle for privatization. Only a small minority of the shares are sold to the public; the state retains the rest.
Reality #8. While true for most of the 1990s, this claim is rapidly also becoming a myth as the acquisition market for state-owned shares develops. Private firms are now keenly making back-door listings via purchases of shares previously owned by state organs.

Myth #1. China's stock market is large

The rise of China's stock market fascinates not only because of its strangeness – this is after all a country still run by a Communist Party – but also because of the size the market has apparently assumed in such a short space of time.[1] Two stock exchanges in Shanghai and Shenzhen opened in December 1990. Over-the-counter trading had begun in Shanghai four years earlier. By 2001, officials were claiming that the market had become Asia's second largest. Table 1 shows the world's largest equity markets at year-end 2001.[2] With an official capitalization of Rmb4.3 trillion ($524bn) China's ranked eighth, an extraordinary achievement for a market only fifteen years old. As of year-end 2002 the official market capitalization was Rmb3.8 trillion ($458bn), a decline of 14%.

Table 1: The world's largest stock markets, year-end 2001 ($bn)

Country	***Market capitalization***
United States	13,810
Japan	2,252
UK	2,217
France	1,174
Germany	1,072
Canada	701
Italy	527
China	524
Switzerland	521
Hong Kong	506

Source: Standard and Poor's

Unfortunately, China's official market capitalization figure is questionable. The reason is that it includes non-tradable legal person (LP) and state shares. In 1992, the State Council invented three different share categories in order to prevent the mass privatization of state-owned enterprise. Since then, whenever an SOE has restructured into a shareholding company it has had to issue these three different types of shares.[3]

- About a third of the shares can be publicly issued and are freely traded by private individuals and institutions on the exchanges. These shares are known as **individual person (IP) shares** (*geren gu*).
- About a third of a company's equity is made up of **state shares** (*guojia gu*). While the ultimate owner is the State Council, these shares are now held (and supposedly managed) by bureaux of the Ministry of Finance (MoF).[4] State shares cannot be listed or traded in the market, and their transfer is subject to multiple administrative approvals.

[1] China's is not the first stock market to operate under Communist Party rule. Communist Hungary operated a market in the shares of state banks, although only state banks participated in trading.
[2] Market capitalization is a measure of market size calculated by multiplying the number of shares by the share price.
[3] The *Law of Enterprises Owned by the Whole People* was promulgated in 1988 and defines an SOE as a legal person with the state as the sole or majority owner. Since 1994 the process of converting an SOE into a shareholding company has been governed by the Company Law. This allows for the use of two corporate forms in which owners assume limited liability. For small companies, the limited liability company form is available. For larger ones, the shareholding company, the only company in Chinese law which can issue shares publicly is the preferred structure. Limited liability company owners are issued with ownership certificates. Shareholding company owners are issued with shares; see OECD 2000, p. 18.
[4] State shares were previously managed by the State Administration for State Asset Management, but this agency was absorbed by the MoF in 1998.

- **Legal person (LP) shares** (*faren gu*) make up the final third. They are allocated to other SOEs that contribute capital to the restructuring company before the IPO, mostly other shareholding companies, non-bank financial institutions (NBFIs) and SOEs with at least one non-state owner. They cannot be traded on the stock exchanges, although they can be exchanged (see below).

Table 2 shows how the share capital of all listed companies at the end of 2001 was divided up. State and LP shares form the dominant part. Individual shares – the tradable privately-owned ones – were in the minority. This breakdown of share types has been in place since 1992 and shows no signs of changing.[5] It facilitates high concentrations of ownership by state and LP shareholders, a problem examined below.[6]

Table 2: The capital structure of listed companies at year-end 2001 (%)

Type of share	*Proportion of total share capital*
State shares	37
Legal person shares	26
Other	2
Individual A-shares	26
Individual B-shares	5
Individual H-shares	4

Source: CSR 2001.

When one calculates the value of the shares listed on the market, one should not include state and LP shares: it seems only reasonable that 'market capitalization' should only include shares 'in the market'. Since they cannot be freely traded, they cannot be ascribed a price – certainly not the market price (which they are given when the official market capitalization figure is calculated). In fact, the non-tradable shares that have changed hands, at auction and in one-to-one deals, have been priced at large discounts to the listed individual shares, often only a tenth of that price.[7]

If one recalculates the size of China's stock market using only the tradable shares, it had a value of some of Rmb1.4 trillion ($170bn) at year-end 2001, and some Rmb 1.2 trillion ($145bn) at year-end 2002.[8] Among the world's markets in 2001 that put it in 20th place in 2001, after Brazil, Finland, Argentina and Taiwan. More perspective is gained when one notes that China's stock market was 1.2% the size of that of the United States at year-end 2001.

These less impressive figures should not detract from China's achievement, however. Successful stock market development, wherever it takes place, is strongly correlated with low inflation, a legal framework that protects minority shareholders' rights, and the existence of sizeable institutional investors.[9] In contrast, China's market has had to cope with a

[5] A number of studies have examined how the relative proportions of these share types impact upon the company. For instance see, Xu and Wang 1997, Liu and Pei 2002, Tian 2001.
[6] In 1999, the top three shareholders of the average listed firm held 58% of the shares. See Tenev and Zhang 2002, p. 78.
[7] Excluding non-tradable shares entirely from the market valuation is also problematic, however, since non-tradable shares are obviously worth something. Tenev and Zhang use book value as a proxy for the prices of non-tradable shares (Tenev and Zhang 2002, p. 107). However this is only a rough measure of their worth. Many listed firms are thought to be worth less than their book value.
[8] In other Asian stock markets there are large bodies of shares that are held by the original owners of the business and which are not traded. However, these holdings are not directly comparable with China's non-tradable shares since in other jurisdictions there are no interdictions on their sale, and when they are transferred, the price tends to reflect the listed share price.
[9] Claessens 1995.

Communist government, two bouts of double-digit inflation during 1988–9 and 1992–3, few institutional investors (at least formal ones), and weak rule of law.

Myth #2. The stock market has replaced the banks as the dominant source of financing for Chinese industry

Another common misperception is that China's stock market is equal in size and significance to the country's banking sector. One would be forgiven for thinking so given the huge amount of coverage that shares receive in the media, and the obvious concern that senior leaders have for their prices. Some reformers have supported rapid stock market development as a source of financing for state industry while the banks' bad debts (which have limited their lending activities since the late 1990s) are resolved.[10] However, the stock market is still small, relative both to the size of China's domestic economy and to the amount of finance provided by the banks.

Table 3 shows the size of Asia's major stock markets compared to the size of their host economies as measured by GDP at market exchange rates at year–end 2001. The stock markets in United States (the NYSE and the Nasdaq), one of the world's most developed, had a capitalization of $13.4 trillion, worth some 130% of GDP at year-end 2001. Hong Kong's market had a capitalization of over 300% of GDP. The markets of Malaysia and Singapore also appear to have grown in significance to their economies. China's stock market, however, using the tradable capitalization figure, was worth only 17% of GDP, which put it on a par with Indonesia at the bottom of the Asia rankings. Most Asian countries established stock markets in the 1950s or 1960s, and so this ranking is perhaps not surprising. But while China's stock market has surpassed most of the markets of Eastern Europe in absolute size, it lags behind them in size relative to their national economies. This is significant since these markets were established at around the same time as China's. Hungary's stock market was worth 34% of GDP at year-end 2001, and the Czech Republic's 25% of GDP.[11] Russia's stock market had a capitalization of $76bn, some 25% of its GDP.

Table 3: The largest stock markets in Asia, year-end 2001

Country	*Market capitalization, $bn*	*GDP, $bn at market exchange rates*	*Market capitalization as a proportion of GDP, %*
Japan	2,252	4146	54
China (1)	524	1159	45
Hong Kong	506	162	312
Taiwan	293	282	104
Korea	220	422	52
China (2)	170	1159	17
Malaysia	120	88	136
Singapore	117	86	136
Philippines	42	-	-
Indonesia	23	145	16

Sources: Standard and Poor's; Economist Intelligence Unit.
Note: China (1) shows the official market capitalization. China (2) shows the 'real' market capitalization, i.e. with non-tradable shares excluded.

During the 1990s, the stock market grew in significance for Chinese firms, or at least for former SOEs which could access it. However, in terms of financing, enterprises in China still rely far more heavily on the banks.[12] In 2001, enterprises raised Rmb118bn ($14bn) from share issues, and borrowed more than Rmb1.3 trillion ($157bn) from the banks. In other

[10] Li Jiange, then a deputy chairman of the CSRC, provides the best defence of this policy. See Li 1996.
[11] Claessens, Djankov and Klingebiel 2001.
[12] A point made by Zhang 1997.

words, the share market supplied only a tenth of the amount of capital that the banks did. Figures for 2002 suggest that the stock market's role is now in decline as a source of capital. IPOs and rights shares issues raised only Rmb73.9bn ($8.9bn), down some 30% year-on-year. Bank financing during January and September 2002, in contrast, rose 55% (well above the rate of economic growth) to Rmb1.4 trillion ($170bn).[13] For the year as a whole, the stock market provided around 5% of official corporate financing.

[13] *Xinhua Financial News*, 'China's central bank to spur capital market development', 27 October 2002.

Myth #3. China's stock market allocates capital more efficiently than the banks

Stock markets are supposed to increase the efficiency with which capital is allocated.[14] They allow borrowers and investors to make transactions without the intermediation of banks. A stock price is supposed to be the most brutal and transparent way of valuing a firm. In countries whose financial sectors are dominated by banking systems – and that still applies to most of Asia – it is thought to be good policy to develop the capital market in order to introduce more competition, and more choice, in the market for finance.[15]

But a stock market does not automatically allocate capital efficiently. There are conditions that need to be met before it can do so. First, firms must be able to compete freely, and on merit alone, for the capital available there. Second, a soft infrastructure of reliable accountants, lawyers, underwriters, journalists, even equity analysts, must be providing information on the companies in the market. Such an infrastructure is what emerging markets often lack. This is why some economists recommend putting off creating a stock market until later stages of development.[16] Third, it is important that other areas of the financial system are working efficiently. Banks and bond markets need to be able to compete for household savings with the stock market.

None of these three factors are yet in place in China. First and foremost, the key role of the stock market in China has been to raise capital for non-privatizing former SOEs. Entry to the market has been controlled to favour these firms. However, they appear as a group to be the most undeserving of capital. Gary Jefferson and colleagues have examined the productivity of different types of firms in recent years.[17] There are numerous difficulties involved in measuring productivity growth in China, especially of different types of firms since the data are frequently unavailable or unreliable. However, Jefferson's results are still interesting. While SOEs performed badly, shareholding firms – listed firms all fall into this category – did even worse, as Table 4 shows. Shareholding enterprises sustained an annual -8% decline in their total factor productivity (TFP) during 1993-96. In other words, they became progressively less efficient in using resources: a signal that they were wasting the resources available to them. Non-state firms did the best, sustaining positive productivity growth over the 1988-96 period. But the government has largely prevented them from accessing stock market finance. Of the 1,160 listed companies at year-end 2001 only 57 were non-state companies that had won a listing in their own right.[18]

Table 4: Average annual growth of total factor productivity, 1988–96 (%)

	State-owned enterprises	*Collectives*	*Foreign invested enterprises*	*Shareholding enterprises*	*Others*
1988–92	2.11	3.13	1.11	-	2.11
1993–96	-2.91	0.43	-3.14	-7.96	0.64

Source: Jefferson et al. 2000.
Note: A collective is a legal person with assets owned by workers and other economic entities, usually sub-provincial governments. 'Others' refers to officially registered private firms employing more than eight workers, as well as shareholding cooperatives that are not part of the collective sector.

Second, the stock market's essential soft infrastructure is not yet present, although since 1999 there have been significant improvements here. Underwriters, journalists and accountants

[14] Levine 1997; Calvo and Frenkel 1991; Fischer and Reisen 1993, p. 105; Pardy 1992.
[15] See for example, World Bank 1995.
[16] E.g. Stiglitz and Weiss 1981.
[17] Jefferson et al. 2000.
[18] Lang and Zhang 2002.

have been frequently bought off and have had few disincentives for doing so.[19] But now increasing numbers of them are facing criminal prosecutions, something unheard of a couple of years ago. As of August 2002 there were some 80 cases of alleged securities crimes making their way through the courts. [20] There is still no independent press in China, so investigations into corruption are limited. However, publications like *Caijing* magazine are raising the quality of journalism and have been effective in investigating crimes and embarrassing the CSRC into making its own investigations.

Third, other parts of China's financial sector are only partially reformed, and this skews the incentives for investment in equities. Interest rates are set administratively, and they are set low in order to allow the SOEs to borrow money cheaply. The corporate bond market is still tiny – fewer than 20 bonds are currently listed.[21] Capital cannot be remitted easily out of the country as capital account controls remain in force.

Facing few alternatives, household, corporates and government organs became keen stock market speculators during the 1990s. The result of these factors, and the limited float of listed companies, is that shares are valued at artificially high levels. Consider one crude valuation: price-earnings (P/E) ratios, a company's share price divided by its earnings. As a general rule, P/Es in Western markets tend to float between 10 and 20. In marked comparison, for much of the 1990s P/Es in Mainland China were above 40, and they remain, despite recent falls, at high levels.[22]

[19] Caijing 2001.
[20] In November 2002, three former senior officials of SHGSE-listed retailer Zhengzhou Baiwen were given suspended jail terms for financial fraud. This was the first successful criminal prosecution of a stock market-related crime; see Bei Hu, 'Company trio get suspended jail terms for fraud', *South China Morning Post*, 15 November 2002.
[21] However, corporate bond market development is now a priority of the government. Corporate bond issuance for 2003 could reach Rmb50bn $6bn, up from around Rmb32bn $4bn in 2002. For an introduction to the PRC's bond market, see Zhang and Hui 2001.
[22] By year-end 2002, the average P/E ration of Shanghai's A-shares was 35, and those in Shenzhen 38, *www.csrc.gov.cn*.

Myth #4. Restructuring and listing have a positive effect on SOE performance

An SOE has no real owners. In practice no one person or entity ever has control of the use of the SOE, can lay a clear claim to its revenues, or can unilaterally transfer it. These property rights are diluted throughout the bureaucracy to such an extent that they fail to exist in any meaningful sense. Since funds from the budget to the SOE are essentially free, and the products the SOE makes are allocated to other firms, there are no profit or loss accounts. A lack of ownership rights and a lack of market disciplines are widely agreed within government circles to be a problem, since no one within the SOE or above it in the bureaucracy has incentives to use capital efficiently. In addition, because of the lack of real pricing of inputs and outputs it is extremely difficult to gauge the efficiency of the firm.

The restructuring that a SOE goes through to become a shareholding company and to win a listing is supposed to resolve these problems. By taking on the modern corporate structure, by creating a board of directors and a group of shareholders – the owners – the hope is that these firms could become as efficiently run as modern Western corporations. There is, however, a growing body of evidence that suggests that shareholding reform is not working. Consider the earnings and returns on net assets of listed companies. As Table 5 shows, they both show a steady decline, one that accelerated in 2001.

Table 5: Listed company financial results, 1990–2001

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Average earnings per share, Rmb	0.31	0.31	0.25	0.24	0.25	0.19	0.21	0.20	0.14
Average return on net assets, %	13.82	13.82	11.03	10.14	10.05	7.62	8.28	7.72	5.56

Source: www.cninfo.com.cn.

There have been changes to accounting rules in recent years that increase, for instance, the amount of provisioning of bad debts that firms must make. Rules governing the accounting of receivables have been tightened up. These account for some of the decline in performance, but not all of it.[23]

By the end of 2001 the official number of listed companies making losses increased to 150, nearly 13% of all listed firms, as Table 6 shows. In 2001 loss-making companies lost some Rmb144m on average. The real numbers of losses are almost certainly higher. The National Audit Office, in a random check of 32 audits of listed firms late in 2001, found 23 to have 'gravely inaccurate' accounts.[24] If this survey was representative then 72% of China's listed firms had similarly problematic reports. Some observers put the number of companies worth long-term investment at only 40 to 60.

[23] Earnings forecasts for 2002 show the first significant improvement. In the first three quarters of 2002, the average earnings per share EPS of all listed companies was Rmb0.127, compared to the EPS for the year 2001 of Rmb0.137. However, this appeared to be due more to reduced losses at loss-making firms rather than an overall firming of profits, Sun Min, 'Recovery signs in listed companies', *China Daily*, 8 January 2002.

[24] Green 2003a forthcoming.

Table 6: Listed company losses, 1994–2001

	Number of loss-making companies	***Proportion of total listed companies, %***	***Total losses of loss-making companies, Rmb m***	***Average loss per loss-making firm, Rmb m***
1994	2	0.7	33	16.5
1995	17	5.3	692	40.7
1996	31	5.9	2,075	66.9
1997	41	5.5	4,776	116.5
1998	77	9.2	11,965	155.4
1999	-	-	-	
2000	95	8.7	13,500	142.1
2001	150	12.9	21,500	144.3

Sources: CSRC, assorted press reports.

Why does restructuring and listing generally fail to deliver better performance? Consider first these firms' ability to access capital. One of the problems from which publicly owned firms suffer in semi-reformed planned economies is that their budgets are 'soft'. If they run into financial difficulties, official budgetary funding is provided, or officials use other means at their disposal to provide funds to ensure the firm continues to operate.[25] The government – perhaps to maintain employment or strategic control of an industry – protects its own firms. This is problematic since capital is not extended at market prices, and the management of the SOE, knowing that the firm cannot be bankrupted, tends to act irresponsibly.

Converting SOEs into shareholding companies and listing them has not resulted in their budgetary constraints being hardened. These firms have been denied access to budgetary funds and other direct subsidies. However, privileged access to the stock market means that former SOEs do not have to compete for funds on a market basis, exactly the same situation which held previously. There are barriers in place which attempt to ensure that capital only goes to productive firms, such as the requirement that a firm has recorded a 10% return on equity for the three years previous to the initial share issue. However, such administrative barriers have only been partially effective (see below).

Once listed, the firm becomes more important, not less, to the local government. Provincial and central government officials remain tied to listed companies via their indirect holdings of LP shares.[26] This is a poor result if good corporate governance can only be ensured if government officials are indifferent to the firm's performance. What often happens is that the listed company becomes the cash-raising vehicle for a state-owned group. The listed firm is then administered via the board of directors by the local government.

At the same time as restructured SOEs gain access to additional capital, oversight of their activities is diminished. Many of the oversight functions of the SOE's line ministry, such as ensuring that public funds are used responsibly, are taken over by new institutions, including the CSRC. However, making such institutions effective is extremely difficult. Regulatory institutions have been undermined by the industrial policy to which the stock market has been subordinated. In addition competition between local and central government officials to profit

[25] Kornai 1980. For a contrarian view, Schaffer 1998.

[26] Of the 1,224 companies listed at year–end 2002, roughly 1,110 were formerly SOEs administered by provincial government-level organs. The LP and state shares were thus held locally. The remainder were previously administered by organs of the central government and their non-tradable LP shares were held mostly by central government enterprises.

from the market has also damaged efforts at improving governance standards.[27] Before 1998, local securities offices were managed by provincial leaders and did not actively monitor listed companies in their province. Instead, they operated as part of the local industrial policy apparatus, often listing former SOEs purely on the basis that they needed the cash injection. The governments of Shanghai and Shenzhen were also interested in rapid development of the market during the 1990s and as a result the local securities offices in these cities were complacent in enforcing regulation on trading activities, a problem which came to a peak during 1996-97.

There have been improvements in the regulatory institutions since 1998. The CSRC has absorbed local securities offices and as a result monitoring of listed company reports and financial statements, as well as share issuance applications, has improved. In the same year, the regulatory responsibilities of the central bank over securities firms were transferred to the CSRC and the commission received State Council ranking. While the institutions have improved, problems still remain.

Given weak regulatory and legal constraints on their activities, LP shareholders have tended to abuse their control rights and have engaged in asset stripping of listed firms on a huge scale.[28] The CSRC has made some progress since 2000 in strengthening the constraints on LP shareholders.[29] For instance, it has demanded that listed company boards (on average numbering ten members) each include at least three independent directors, it has increased penalties for directors and senior managers engaged in fraud, it has banned listed companies from making loans to their parent companies (a common means of asset stripping), and it has introduced a penalty system for underwriters who collude with the firm to make false statements. The government also appears poised to allow civil suits against firm managers and directors for making fraudulent disclosures.[30]

[27] The historical development of the share market – and the politics behind it – are examined in depth in Green 2003b forthcoming.

[28] Even star companies are vulnerable to such bad practice. Guangdong Kelon, a Hong Kong-listed white goods maker, was a favourite among equity analysts. But its shares were suspended in December 2001 after it was discovered that the group's former parent, the Guangdong Kelon Group, had been stealing the company's funds. Up to year-end 2000, 'loans' from Kelon to its parent totalled Rmb28.6m $3.4m. Kelon was forced to announce a Rmb1.6bn $192.8m net loss in April 2002.

[29] H-share listed companies, former SOEs listed in Hong Kong, appear to suffer similar problems; see Huang and Song 2002.

[30] On the legal problems involved in pursuing such suits, see Cai 1999.

Myth #5. China's stock market is dominated by small, individual investors

The classic image of China's stock market is of a brokerage filled with dozens of pensioners transfixed by a screen displaying red (rising) and green (falling) share prices. Officially, some 68.7m individual share accounts had been opened at the two exchanges by year–end 2002. However, the truth is that individual investors are far fewer than the official figures – which actually represent the number of share accounts – suggest. The two differ enormously for a number of reasons.[31]

1. Tens of thousands of investors have opened share accounts at both stock exchanges, and these accounts are double-counted in the official figure.
2. A large proportion of accounts have been opened for the express purpose of entering the IPO lottery. For much of the 1990s, if one's application to subscribe to an IPO was successful, one could make an instant return of over 100% by selling the shares on the first day of trading. This was because of rules that set IPO prices at a large discount to market prices to guarantee take-up of shares of questionable value. Millions of accounts were opened for the sole purpose of subscribing to, and then selling, IPO shares.[32]
3. Wealthy individuals and institutional investors have fraudulently opened millions of accounts to allow them to engage in complex schemes to manipulate share prices. Many travelled into rural areas to rent farmers' ID cards with which they illegally opened individual share accounts. Such accounts probably number between 10m and 30m.

A recent survey by the SHGSE found that only 20m of its 35m accounts had any shares in them, and that only 8m of them were actively traded.[33] As a result, one might estimate that as of year-end 2002, there were only 10–20m individual investors active in China's stock market, a tiny proportion – some 0.8% to 1.6% – of the total population (compared to the United States, where over half of the population owns shares in some form). It is unlikely that individuals in China own more than 20% of tradable market capitalization. This finding is important: it suggests that the stock market has so far failed to draw out private savings from the banks. This was a key aim of senior policy-makers in 1996 when the decision was made to enlarge the stock market and make it a national, rather than local, institution.

[31] The following information and estimates are derived from the author's interviews with Shanghai and Shenzhen stock exchange and CSRC staff in 2000 and 2001.
[32] This system was altered in May 2002 to require any subscriber to an IPO to already be holding Rmb10,000 $1,200 worth of shares in the secondary market. The rule was designed to introduce some risk to the IPO lottery and to increase the costs of making multiple applications. Thousands of investors have issued hundreds of accounts to enter the IPO lottery. By year-end 2002, there had been only three exceptions, including the Rmb11.5 billion A-share offer of China United Telecommunications and the CITIC Securities offer in December which were sold to the general non-shareholding public, Bei Hu , 'Investors rush for mainland's first brokerage IPO', *South China Morning Post*, 21 December 2002.
[33] Richard McGregor, 'Downturn punctures China's trading myth', *Financial Times*, 4 January 2002.

Myth #6. China's stock market lacks institutional investors

This is the mirror-image of Myth #5. Because of the relative lack of formal fund management companies – the 61 funds at year-end 2002 held only some Rmb130bn ($15.7bn) in net assets, some 10% of tradable market capitalization – observers assume that the other shares must be owned by individuals.[34] The next step in this logic is that individuals – who are generally shorter-term investors than institutions are – are the reason for the market's price volatility and high turnover rate. This argument has just one flaw: the largest single block of shares is owned and traded by institutional investors.

Since 1997, the CSRC has very consciously sponsored the development of fund management companies. These have usually been established by securities firms. However, demand for asset management services has outstripped the capacity of these 15-odd formal fund management firms. Since 1995 several thousand 'financial management' and 'financial trust' companies have been established. These have secured funds from rich individuals, SOEs, and non-state firms and now engage in asset management on a huge scale. They are known as *simu jijin* (privately raised funds) and are institutional investors in everything but formal registration. The CSRC has not issued rules for them, and since they are not formally financial institutions its jurisdiction over them is unclear.

According to research by Xia Bin, a senior official at the PBoC, there were at least 7,000 *simu jijin* operating in Shanghai, Shenzhen and Beijing and probably hundreds more dotted around the country by year-end 2000.[35] Most securities companies also offer asset management services (another legal grey area). There are various estimates of their total size. According to Xia, including those funds raised by securities companies, they were worth about Rmb700bn ($980bn), some 40% of the total tradable market capitalization at year-end 2000, as Table 7 shows.

Table 7: Market capitalization of the formal funds and the simu jijin, year-end 2000

	Formal funds	***Simu jijin***
Market capitalization (Rmb bn)	80	700
Proportion of tradable market capitalization (%)	5	43

Source: Xia 2001.

The development of the *simu jijin* is, on balance, a positive development. They increase the number of long-term participants in the market. In addition, many of these companies are professionally run and highly competitive (although many others are little more than fundraisers for manipulation scams). Many of the fund managers working in the sector involved have passed CSRC exams for securities professionals. The firms have built their businesses on the quality of their service, rather than on the basis of a government-issued licence.[36]

[34] Liu 2003.
[35] Xia 2001.
[36] Admittedly, these institutions do differ in important ways from institutional investors in more developed markets. They are, of course, far more lightly regulated, and do not have to meet rules on matters such as portfolio allocation or capital adequacy and prudential rules on investment strategies.

The presence of these informal institutions is very important when one considers what measures are needed to help mature the market. It suggests that individuals are not to blame for the volatility of stock prices or high turnover rates, something often assumed. Rather, the problem appears to lie with the companies that are traded. With their unreliable disclosures, poor operational performance and small share float, the incentive for any investor – individual or institutional – is currently to hold shares for only a short period of time.

Myth #7. Little improvement is likely in regulation given the current political system

The CSRC, as well as all the securities and fund management firms (all of which are state-owned), are ultimately controlled by the Communist Party's Central Committee. All operate party committees which are made up of their senior managers. The central government has a clear interest in using the stock market to finance its own firms. Moreover, listed companies usually enjoy the political protection of their local government. Some believe this nexus of interests and controls means that regulation of the market, and the quality of the firms listed there, is unlikely to change. However, as economic reforms bite, and the policy priorities change, the leadership will come under immense pressure to alter the way the stock market operates. The central government will have an increasingly strong interest in making regulatory improvements.

One reason is that the industrial policy plank on which stock market policy was based through much of the 1990s is slipping. This is happening for two reasons. First, as discussed above, state-controlled shareholding companies are failing to improve their performance and are becoming more of a liability than an asset. This creates incentives for selling the state's remaining equity holdings.

Second, an increasingly indebted government is having to find ways to fund its liabilities. The sale of state assets is one way of achieving this. The PRC government has, if all its obligations are included, a debt equivalent to some 90% of GDP, well beyond the standard safety barrier of 40% of GDP. The figure is made up of an amalgam of official liabilities – mostly domestic and international Treasury bonds – plus the amount needed to recapitalize the four state-owned banks as well as finance the bonds issued to fund the asset management companies (AMCs) and policy banks.[37] The government also has huge unfunded pension liabilities (estimated by the World Bank to be 70% of GDP in 1997). However, since these are long-term in nature and the size of this liability depends on the pension framework finally implemented nation-wide, these figures have not been included in Table 8, which shows the liability structure.

Table 8: Estimates of the state's total liabilities at year-end 2001 (% of GDP)

Government liability	*Amount*
Domestic bonds	16
Recapitalizing the four main state banks*	30
NPLs at other state-owned financial institutions	12
Bonds issued to finance the asset management companies	14
International sovereign bonds	5
Bonds issued by the three policy banks	11
Total	88

*Official estimate.

Sources: Bottelier 2001; official and press reports.

If the economy does not continue to grow at 7–8% a year, the generation of non-performing loans (NPLs) in the banking sector is not stemmed, and the recent improvement in the collection of taxes is not sustained, the government will experience difficulties in meeting its financial obligations, perhaps as soon as 2008. There have been some recent improvements in the financial sector – falls in the official figures for NPLs at the four state banks, increased consumer loans, high cash recovery rates on NPLs transferred to the AMCs, and reductions in

[37] On the government's debt problem, Lardy 2000; Bottelier 2001. On the asset management companies see Steinfeld 2001; Ma and Fung 2002.

the crippling business tax.[38] But whether these changes are fast and large enough to prevent crisis is still very much open to question.

There are signs that privatization policy has already been taken up. Listed companies' LP shareholdings are being sold off and the CSRC is trying to find a way of selling off state shares after two failed attempts.[39] More privately owned companies appear to be winning listings in their own right. The institutional infrastructure for privatization is being put into place, albeit slowly. The CSRC has released a new M&A code for listed companies which clarifies the rules regarding tender offers and opens up additional financing routes for acquisitions.[40] It also appears to overturn the ban on foreign involvement. Shenzhen has started experimenting with sales of major SOE asset to foreign investors. The move to allow foreign investors access to A-shares, albeit on a controlled basis via the Qualified Foreign Institutional Investor (QFII) system, is also significant.[41]

Privatization will have a profound impact on the quality of the stock market. During the 1990s, the CSRC largely had its hands tied since there was a political imperative to protect the state's listed firms. If these firms are properly privatized, the CSRC should be freer to do its job properly. Privatization also augurs a massive surge in the supply of equities. The government will have to nurture demand carefully. To achieve this it will need to attract small investors into the share market on a much larger scale than before. Public trust in the regulatory institutions is low and significant improvements are required to restore it.[42]

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[38] The PBoC has claimed that NPLs at the four state banks fell by Rmb59.7 billion ($7.2 billion) during the first eight months of 2002. This translated into a decline in the NPL ratio NPL/total loans, officially at 30% at year-end 2001, of 2.65 percentage points. As of year-end 2001, outstanding consumer loans totalled Rmb700bn $84bn, up from Rmb17bn $2bn four years earlier. The current cash recovery rates of the AMCs is 21%. All domestic banks pay a 6% business tax that is levied on revenue and a 33% income tax levied on profit. While the income tax is normal practice, the business tax is very damaging. Owing to pressure from the banks, it is being reduced from 8% to 5% by the end of 2003; see He and Fan 2002; Solvet 2002; Lardy 2002a.

[39] Crucially, however, the revenues of sales of LP sales accrue to the SOE, shareholding company or other organ owning them, rather than the central government's budget. State share sales benefit central government budgets. Naughton (2002) reviews the political problems involved in selling state shares.

[40] However, the most effective privatization method – bankruptcy and liquidation – is still not on the table. China's new bankruptcy law was still being drafted as of year-end 2002.

[41] Ho 2002.

[42] By year-end 2002, individual bank deposits totalled Rmb8.5 trillion ($1 trillion), an increase of Rmb1.2 trillion ($145bn) over the year. 41% of this was held in current accounts, providing a huge resource of potential demand for equities, Mark O'Neill, 'China's interest rates on hold for next year', *South China Morning Post*, 1 December 2002.

Myth #8. China's stock market is not a vehicle for privatization

These changes are already having an impact. China's share of the market is already becoming a vehicle for privatization. Increasing numbers of listed companies are having large blocks of shares (large enough to endow control rights) sold into private hands. Between 1996 and 2001, according to Changjiang Securities, 320 listed companies experienced a change in their controlling shareholder, as Table 9 indicates. The majority of these involved the largest legal person shareholder selling its equity stake to a private firm.[43] At least 150, perhaps as many as 200, listed firms have so far been privatized in this way.

Table 9: Acquisitions of listed firms, 1996–2001

	1996	*1997*	*1998*	*1999*	*2000*	*2001*
Change in controlling shareholders at listed companies	9	33	71	67	110	130

Source: Nie and Tan 2001.

Concluding remarks

China's stock market is small, compared to that of other countries and to its own economy. The market is dominated not by individuals but by (admittedly informal) institutional investors. It does not yet allocate capital efficiently and it has had a limited impact on the performance of listed companies. There is cause for optimism, however. The government is moving to privatize industry and needs to encourage the public to buy more shares. As a result, the government will become more interested in the quality of regulation and of the listed companies. As these trends take root – and there are already signs that they are – there is good reason to believe that China's stock market will grow in size, allocate capital more efficiently, help finance China's economy and become a market worth investing in.

[43] Other changes in corporate control included in the table were due to state shares being transferred between administrative bureau, LP sales being auctioned by the courts, or sales of shares to other SOEs or state-controlled companies. A forthcoming RIIA/Cambridge University report will examine this privatization process in detail; see Green 2003c forthcoming. See also Nie and Tian 2001.

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