

Red Bull Rising

*The Stock Market in China:
Obstacles to Efficiency*

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Introduction: Function of the Stock Market

Capital is the lifeblood of any economy, socialist, capitalist or otherwise; without it, nothing can function. In the evolution of human history, economies have developed an efficient way to allocate such capital through capital markets. Indeed, capital markets are the most efficient way to allocate capital between suppliers of capital (investors) and users of capital. Capital markets include banks, stock markets and bond markets. In China prior to 1978, the entire financial system was controlled by the four large state-owned banks. They were and continue to be the most significant source of capital in the economy; though due to their size and mandate, they were overly bureaucratic, slow, and subject to careless lending assessments. Banks have been used by the government as a “quasi-fiscal instrument to bailout loss-making state enterprises or to deliver specific policy loans without consideration for efficiency.”¹ The enduring result of the banking sector is a massive accumulation of non-performing loans (NPLs). In the wider context of China’s industrial policy which still to this day places great importance on the massive state owned enterprise sector, banks have had to restructure away from their heritage of bailouts and careless lending. Alternative markets have been developed for latent capital savings held by an increasingly wealthy society to invest into the economy. The basic premise of a stock market is that firms issue shares of the company in the form of equity that represents a claim to ownership, future profits, and residual assets in the event of bankruptcy. These shares are divided (allocated or bought) among investors and the shareholders’ meeting represents the highest organ of control in a modern corporation.² The stock market functions as a venue for these shares to be bought and sold at freely mobile prices. A smoothly and efficiently running stock market provides several functions:

- prices provide information on the true cost of capital which is used by firms to help determine their capital structure
- long-term capital requirements are financed by a series of short-term investors
- shareholders act to supervise and monitor firm performance.³
- pricing of a stock (or bond) reflects the supply and demand of investors and signals the investors’ assessment of the value of the company and its future returns

Establishing a stock market however, is no easy task; it requires broad institutional support. The very concept of share holding implies the right to hold private property, a foreign concept in the centrally planned socialist economy. It also is built upon freedom of information and transparency in financial reporting and accounting standards, as well as a framework of regulation to equalize the asymmetry of information between investors and insiders. Such conditions for a free and efficient are well known to stock market officials and regulators; however, the stock market remains in the context of China’s ‘socialist market’ industrial policy. This industrial policy in the past centred around a planned economy with central importance

¹ Boyreau-Debray, Genevieve. (2005) *Financial Intermediation and Growth: Chinese Style*, The World Bank Policy Research working paper 3027. p. 15.

² Green, Stephen and David Wall. *This Little Piggy Becomes a Market*. 8 December, 2000. OECD <<http://www.oecd.org/dataoecd/59/57/1947237.pdf>> 2 January, 2006.

³ Ma, Shiguang. *Efficiency of China’s Stock Market*. Hants, UK: Ashgate, 2004. p. 1.

given to large, industrial state owned enterprises (SOEs). Though China has liberalized significantly towards a market economy, it has done so slowly. The key features of China's economic reform: incrementalism and experimentation, apply equally well to the stock market formation. Much of the 1990's was such a process of 'groping for stones to cross the river'⁴ in the formation of the stock (and bond) market. The result was slow in the making with numerous scandals, profiteering, distortions, and fraud common in its development. Many individual investors have lost their life savings as corrupt managers and officials walked away millionaires.

Serious hurdles remain for China's stock markets to be truly efficient and viable long term means to efficiently allocate capital in the economy. Three structural features remain as an obstacle to this reality: market segmentation, enforcement of regulation, and government intervention.

The Stock Market in China: History and Characteristics

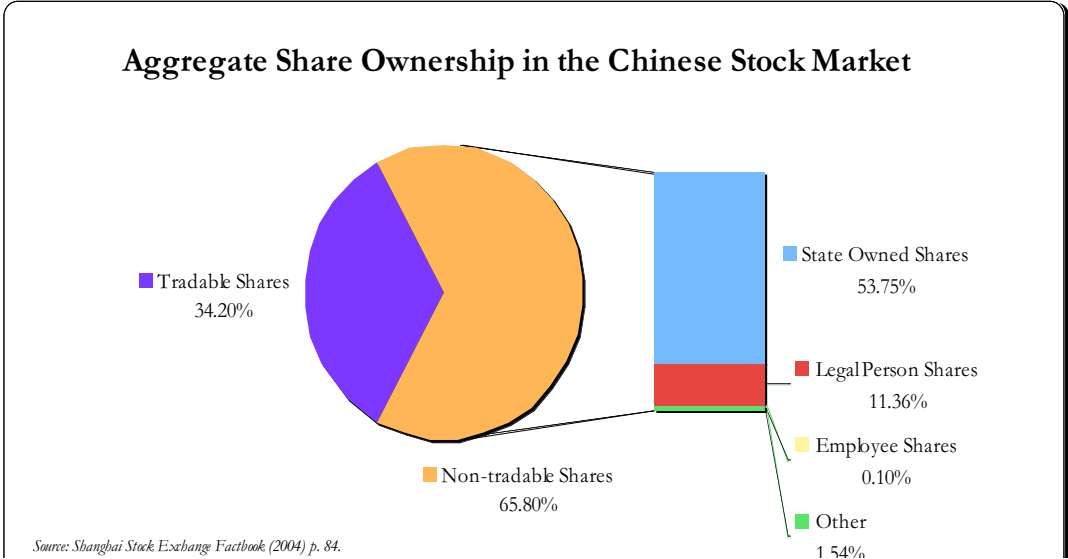
With the broad initiatives of the post-1978 economic reforms, a stock exchange was established in China, in the historical financial hub, Shanghai. When the first shares began trading on December 19, 1990, China took a monumental step towards a more developed market economy. From the beginning the purpose of establishing the Shanghai stock exchange, and Shenzhen Exchange one year later, was very narrow—to raise funds for restructured state owned enterprises. It was not initially intended to be a wider market institution to provide a trading market for security traders. As government handouts and subsidies channelled through the big banks decreased year after year for hundreds of large SOEs, the government could shift SOEs' capital requirements to investors instead. Thus, the primary goal of establishing a market was to support restructured SOEs and pump funds into the industrial giants. However, in order to retain control over the restructured state owned firms, several categories of shares had to be created, of which the state would control the majority.

In the birth of the stock market structure, officials were concerned that capital flows might have a destabilizing effect on the market. China restricted foreign investors by issuing separate A and B shares. A-shares are denominated in local renminbi currency and are available only to Chinese investors. B class shares were originally setup with identical voting rights and dividends, but denominated in either American or Hong Kong dollars and restricted to purchase by foreign investors only. B-share listing required stricter, more transparent disclosure and reporting to be able to attract foreign investors, but these standards fell well below international norms. As a result, fewer than 10% of all listed companies had issued B-shares.⁵ Together, A-shares and B-shares represent the only shares that can be market tradable and historically comprised only a third of all shares issued. The remaining two-thirds of all shares were issued directly to government bureaus or to legal persons (LPs). LP shares are issued to financial institutions, SOEs that contribute capital, and some government bureaus. Employee shares had been issued

⁴ Bo, Hong. Lecture, School of Oriental and African Studies. London: 18 October, 2005.

⁵ Green, Stephen. *China's Stock Market*. London: Economist/Profile Books, 2005. p. 48.

as part of SOE restructuring in the early nineties but have since been phased out. These government, employee, and LP shares were completely barred from being traded. Thus there was a share structure with the majority of shares being illiquid and non-floatable on any exchange.



Nonetheless, the market soon became an incredible source of capital for anaemic SOEs. With increased domestic savings, individual investors, especially young urban professional with high-tech savvy poured billions into the market hoping for a quick payday.⁶ By 1992, with just over a year of active trading, 9.4 billion RMB (\$1.7 billion 1992USD) had been raised in the market and the aggregated sum for the next ten years totalled some 75.7 billion RMB (\$9.12 billion 2002USD).⁷ In general, the collection of listed firms on both stock exchanges comprise disproportionately manufacturing sector firms in geographic areas close to the exchanges themselves—62% of listed firms were located along the coastal region. This contrasts with other markets that have a broader range of industries listed such as retailers, financial firms, insurance companies, hotels etc.

The controlling body overseeing the creation and operation of China’s stock market is the China Securities Regulation Commission (CSRC), though it was given a twin-mandate: As the national regulator, it is charged with creating and enforcing the rules, maintaining order, and protecting small investors. Yet, at the same time, as a state agency, it is also in charge of developing the markets and ensuring they can be maximised for SOE recapitalisation.⁸ As such, it has endured a rocky start as an agency, but it has recently, since 1997, assumed greater and greater autonomy and control over the market. For example, while trading at the stock exchanges in Shanghai and Shenzhen fell under the jurisdiction of the CSRC, it was also under the supervision of provincial

⁶ Ibid. pp.72-73.

⁷ Ma, p. 36.

⁸ Green, et al, p. 28.

securities bureaus. As such, it was not uncommon during the markets' infant years for provincial regulators to collude with local SOEs wishing to list to provide faulty financial disclosures for presentation to the CSRC. Of course, since share trading was taxed at the provincial level, the more local enterprises that could list, the more tax revenues could flow into provincial coffers. This echoes larger features of the economic reforms as provinces engaged in fierce competition under the fiscal contracting system which provided the incentive for provincial governments to exploit every money making opportunity available, legal or illegal.

It is fair to compare the first ten years of China's markets to the Wild West of America in the 19th century where lawlessness and opportunity abound. Government agencies, listed companies, bureaucrats, inside traders, all worked the loosely regulated and enforced stock market for their personal gains, more often than not through illegal or quasi-legal means. At the same time, the markets funnelled large amounts of money to restructured SOEs and the markets experienced tremendous growth. However, in the wake of such events, the faults in the market have erupted to the surface and the market has reacted. Between 1996 and 2001, well over 100 new firms were listed each year. But since then, only between 60 and 70 have been listed annually. Almost every index has fallen, as has the total market capitalization. A total of 45.7 billion RMB was raised in 2004, down 18% from the previous year.⁹ What are the issues that need to be resolved before investors will have long term confidence in the market; how can this bear become a bull?

Major problems in the market

a) Market Segmentation

The problem of market segmentation refers to two issues that need to be resolved: the classification of shares (A-shares and B-shares) and the share ownership structure. B-shares, denominated in US and Hong Kong dollars, could only be bought by international investors with a broad range of investment alternatives; however, given the relatively low disclosure and transparency standards, B-shares were largely unattractive to the international investor and thus trading was light and the market fairly illiquid. As such, thinly traded B-share prices became highly volatile and before long, Chinese investors found ways of illegally trading B-shares as their prices were 20-30% discounted from identical A-shares. Eventually, realizing that Chinese nationals were performing the majority of B-share trading anyways, in 2001, the B-share market was opened to Chinese investors (but not institutions), however new B-share IPOs were terminated. However the problem still remains that B-shares though obsolete, still exist and are traded. Relative to the A-share market, B-shares have been mostly stuck in a vicious cycle of inactive trading and small capitalization. For a brief period after Chinese investors were allowed to trade B-shares, trade volume and prices increased dramatically as Chinese investors expected a merger of the A- and B-share markets (with the expectation that B-shares would have to rise to the same price as A-shares) but then fell flat again, and now four years later, B-shares continue to

⁹ "Shanghai Stock Exchange Handbook 2004" Shanghai: <www.sse.com.cn/en_us/cs/about/factbook/factbook_us2004.pdf> 10 January, 2006. p. 3.

be traded at significant discount. Indeed, the CSRC realizes full well that A-shares and B-shares must eventually be merged, but the transition is proving complicated. Indeed, “the main issue now facing the CSRC is how to bury it [B-share market].”¹⁰

The other component of the segmentation problem is share ownership structure. As a method of retaining control while engaging in the ‘market process,’ the government owns the majority of shares in the restructured SOEs. Shares are either owned outright, mostly through the Ministry of Finance, or through legal persons. As can be seen from the graph below, though they total to roughly two-thirds of all shares, state, LP, and employee shares are all entirely non-tradable on the stock market. The remaining 34.2% of shares are issued to the public and are tradable by individuals and institutions on the stock market. Because market investors only control a minority of corporation control, traditional management practices continue; managers are nominated by government departments, rather than by stockholders.¹¹ The result is that stockholders have no power to supervise their investment; thus there is a misalignment of objectives between majority (government) and minority (public investors) shareholder interests. Because of a lack of sound legal framework for minority shareholder protection, it is difficult for minority investors to monitor large shareholders and leads to insufficient and often fraudulent information disclosure, to be discussed further in later sections. The ultimate result is inefficiency in the market. Shiguang Ma concludes in her analysis of the market from 1992-2002 that price shocks are amplified by the relative scarcity of tradable shares. Rumours of state-share conversion into tradable shares cause rampant price fluctuations in the market.¹²

New issues of B shares ceased in 2001 as officials long realized the B-share experiment had failed. Lack of foreign demand made the market illiquid and thin, and less than 8% of capital raised by IPOs since 1991 was through B-shares.¹³ Positive steps have been taken to essentially phase out B-shares altogether. In 2002, the Qualified Foreign Institutional Investor (QFII) Act passed which has allowed foreign financial houses to invest in the domestic A-share market. With this development, it is possible for firms to buy back their B-shares from foreign investors (foreigners owning only 20% of B-share capitalization) and converting the remaining B-shares into renmenbi A-shares. However, no official move has been yet made to merge the markets.

The more pressing and complicated issue is what to do with the huge number of non-tradable shares owned by the government and LPs. The non-liquidity of these securities remains an artificial obstacle in to improving market efficiency. By converting non-tradable shares to tradable shares, the market will better be able to provide correct assessment of those assets. Even if state-shares are tradable, the state is not required to actually trade them and can retain ownership control if desired and would act just as any other majority institutional investor. On February 1, 2004, the State Council issued a guideline to reform the capital market. When referring to the ownership segmentation, the guideline iterates to “prevent state-owned assets

¹⁰ Green, p. 50.

¹¹ Ma, p. 244.

¹² Ma, p. 245.

¹³ Green, p. 50.

from devaluation...and protect the lawful rights of investors, in particular, the public investors.” It seems the task of better protecting minority shareholders is on the front burner. It is expected that the CSRC will soon release a differential voting system, which requires approval of major corporate events by more than 50 percent of floatable shareholder votes.

The outright sale of state shares would literally flood the market, driving prices down. This is exactly what happened in June 2001, as the government announced that it would allow the sale of some non-tradable shares and use the proceeds to fund a national pension scheme. Investors panicked, fearing a flood of new shares would drive down prices. Although the government quickly reversed its decision, the markets lost a quarter of their value in three months, and they have kept falling ever since.¹⁴ Investors have been weary ever since of the eventual sell off of state owned shares. Thus the conversion of non-tradable shares into tradable shares remains a complex problem, one whose resolution will surely affect some investors unfavourably, but will benefit the long-term efficiency of the market.

b) Enforcement of Regulation

The CSRC is led and staffed by some of the brightest minds in government. Many have studied abroad and are well-versed in economics and accountancy, knowing how the market should function. Unfortunately, the CSRC does not operate as an independent regulatory body; it still is subject to political influence from the State Council, though more autonomy has been granted in two steps, once in 1997 after the Wangua scandal, and again in 2001.¹⁵ In the process of ‘groping for stones’ the CSRC has had to learn by trial and error how to implement rules that serve their changing mandates and patch holes in the regulatory framework as they are discovered. At first, as previously noted, the CSRC as the de facto overseer of the establishment of the stock market as part of SOE restructuring, the primary goal was to transfer direct government ownership into share ownership and finance the SOE sector. As the economy has developed, the mandate has become to further liberalization and achieve an efficient stock market by improving corporate governance, facilitating the eventual sale of state assets, and providing higher return investments for long term savings. As a result, the CSRC is now a legitimate regulatory body, with legal foundation and authority; it has produced a solid institutional framework for China’s stock markets. However, enforcement still remains a huge obstacle; no matter how good the law, if it is not followed and uniformly enforced, it is useless.

The history of the stock market in China is littered with stories of corruption, fraud, and scandal. Many see the market as a casino, where only one in ten will make money, and more than likely, that one is sure to have inside information.¹⁶ Traditionally, listed companies have been haphazard in their announcement of important events, disclosure of financial statements and accounting practices, which all leads to fraud and insider trading. Collusion with underwriters, auditors, and

¹⁴ Forney, Matthew. *China’s Market Maladies*. Time Asia, 7 February, 2005.

<<http://www.time.com/time/asia/magazine/article/0,13673,501050207-1022650,00.html>> 7 January, 2006

¹⁵ Ibid, p. 182.

¹⁶ Green, p.70.

local governments was not unusual to manipulate stock prices; and when discovered, was rarely punished with more than a slap on the wrist.

c) Government Intervention

Random and arbitrary government intervention remains another hurdle for China's stock market. Until recently, IPOs did not list based on financial and regulatory qualifications, but on government rationing of IPOs, exclusively for large, restructured SOEs. Fortunately, new listings are now subject to more rational, objective financial criteria, though are still subject to State Council sanctioning, and thus are still not free of government control. However, only around 70 new listings go on the boards every year, and most of them still are restructured SOEs, with few private firms being allowed to list. Presumably, if companies that met specific criteria were automatically allowed to launch an IPO, many more companies would appear on the market and perhaps the government fears that restructured SOEs are less attractive investments compared to their new brethren who will drive state-controlled companies' prices downward, more accurately reflecting their true market worth.

The CSRC has reached the stage where it can be a relatively independent and autonomous regulator without the intervention of politics and government agendas in its daily operation. It is not just the central government that has had a historical intervention in the markets, but also local governments. As mentioned, local governments have involved themselves in campaigns for local companies to list. Such intervention seriously affects the quality of firms listed on the market. Often, successful companies with good governance, high accounting standards, and transparent financials opt to list on foreign exchanges rather than domestic ones bypassing the layers of corruption and inefficiencies.

Consequences and Outlook

Though the key role of the market has been and remains largely a capital raising mechanism for SOEs, China's stock market, like much else, has great potential for being a legitimate capital market for the country's economy. Its growth and development have been significant, but the market still pales in comparison to the banking sector as a source for raising capital. Each year, for the past decade, the markets have only been raising between four and ten percent of all capital requirements.¹⁷ For the market to grow and prosper, several hurdles must be cleared. Market segmentation only distorts market prices; in the future, public and private companies must be able to trade on an equal playing field. In order to benefit the entire economy, not just the SOE sector, share structure must be corrected. Government intervention as well has been arbitrary and intrusive into the operation of the market; all ties that bind the market to the state must be severed. Lastly, rules on the books only go so far; only when listed firms are held accountable to the regulations, will corporate governance be good. The stock market should exist not for the benefit of fraudulent officials, executives and insiders to have their payday; rather, a company's performance and reputation must be based on good governance, transparency and disclosure. By following the rules will China's stock market be legitimate and

¹⁷ Green, p. 29.

efficient. As the CSRC well understands, change must start with the listed companies themselves. Obviously, any successful market needs good products. The problem of China's stock markets is that, in general, they list poor quality, restructured state owned enterprises. Some 30% of them are loss-making and should not be remain listed. One foreign investor speaks for many when he says; "Why would I buy some piece of paper...when the entity issuing it is not for profit, run by a bunch of bureaucrats with no prior experience - no one you would hire - with no rule of law, or representation on the board?"¹⁸

If such obstacles are resolved several important results become conducive. By un-segmenting the share structure seen today, the rationale that sees the state both owning and managing 'publicly' listed firms is obsolete. Ideological opposition to the market has largely subsided within the party and the further move to separate owners and managers is crucial. With increased accountability and enforcement, companies will have the incentive to practice good corporate governance which will lead to better disclosure and transparency. This aids in correcting informational asymmetry and hence investors are better able to make assessments on the value and expected returns of their investments. Improved enforcement also means protecting the rights of minority shareholders. Dick Foster, director of McKinsey & Co. has remarked, "China and India and other Asian countries will not be successful at innovation until they have successful capital markets, and they will not have successful capital markets until they have the rule of law which protects minority interests under conditions of risk."¹⁹ Government intervention which for example, currently hinders institutional investor participation needs to likewise be removed. Large mutual fund, pension funds, insurance, and other institutional investors play significant roles in developed financial markets. With their expertise, size and resources, they are able to evaluate and price securities better than individual investors.²⁰

Conclusion

Experiments began on large SOEs in 1993. SOE corporatization entailed the creation of enterprises as independent legal persons, a clear delineation and distribution of their assets, and the unambiguous separation of owners (shareholders, usually the state) and managers. It also entailed the establishment of such things such as boards of directors, supervisory boards, and shareholders' meetings. However, the transformation of China's once socialist planned economy into the modern, capitalist one seen today has been a great ongoing experiment. Like many of the other economic developments in China's growth, it is a story of incremental liberalization and letting go of centralized power. The stock market is one of those highly symbolic institutions that is the ultimate shrine of capitalism, and would be shocking to any communist ideologue; yet it will continue to reform the entire economy as firms will turn to markets, and not government bureaus for their capital requirements.

¹⁸ (Yuen, et al, 1999) cited in Green et al, p. 33.

¹⁹ Friedman, Thomas. *The World is Flat*. New York: Farrar, Straus, & Giroux, 2005. p. 245.

²⁰ Su, Dongwei. *Chinese Stock Markets*. London: World Scientific, 2003. p. 27.

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