Chinese financial markets – how have they evolved and where may they go to?*

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Introduction

Chinese financial markets have grown rapidly since their inception in the early 1990s, although financial intermediation still remains primarily bank-based.[1] The rapid growth has called for an effectual regulatory framework and the China Securities Regulatory Commission (CSRC) has improved its work substantially over the recent years.[2] However, deficiencies still prevail due to market fragmentation, lack of institutional investors, weak transparency and market irregularities. Furthermore, the listed companies themselves are problematic, because they are dominated by state controlled and financially weak enterprises. While WTO accession has fostered financial market reform together with a gradual capital account liberalisation in China, much still remains to be done (cf. Zhang Ruosi 2002: 21).

Stock markets

The development of China's stock markets has been impressive. Until early 1990 China had no stock market at all. At the end of April 2005, the two Chinese stock markets, the major one in Shanghai and its smaller counterpart in Shenzhen, together had about 1,463 listings and a market capitalisation of close to 406 billion US$. Together, these two markets comprise the second largest market in Asia after Japan and the largest emerging stock market in 2005 (see Chart 1 and Table 1).[3]

The indicators do not reveal some important specialities of Chinese shareholdings. Institutional investors still play a minor role on the stock markets even though changes are gradually implemented. Open-end funds have been made available since September 2001 and social security funds are assuming more importance in the capital markets as China wants to finance the retirement provisions by a combination of funding principle and pay-as-you-go.[4] Gradually, also insurance companies and commercial banks will be permitted to acquire shares. In early 2005 the China Insurance Regulatory Commission approved direct purchases of domestic stocks to selected insurers in order to boost the stock market after a downturn of the A index in 2004. Most recently, the government has outlined steps to boost demand for equities, including allowing commercial banks to set up fund management arms and permitting insurance companies to acquire shares (FT, 12.7.05).

Table 1: Stock market indicators in China

	Market capitalisation (in % of GDP)	Listed companies
1992	4.4	52
1993	9.4	183
1994	8.0	291
1995	6.0	323
1996	13.9	540
1997	23.0	743
1998	24.4	853
1999	33.4	950
2000	53.8	1,086
2001	45.2	1,154
2002	37.4	1,235
2003	36.0	1,296
2004	27.0	1,377
2005/03/18	24.0	1,463

Source: World Bank 2004; Datastream.

Presumably about two third of listed companies in China are state-owned and ownership is usually concentrated at one major shareholder. Due to this split shareholder structure as less as one third of shares of listed companies may be traded on stock exchanges (cf.

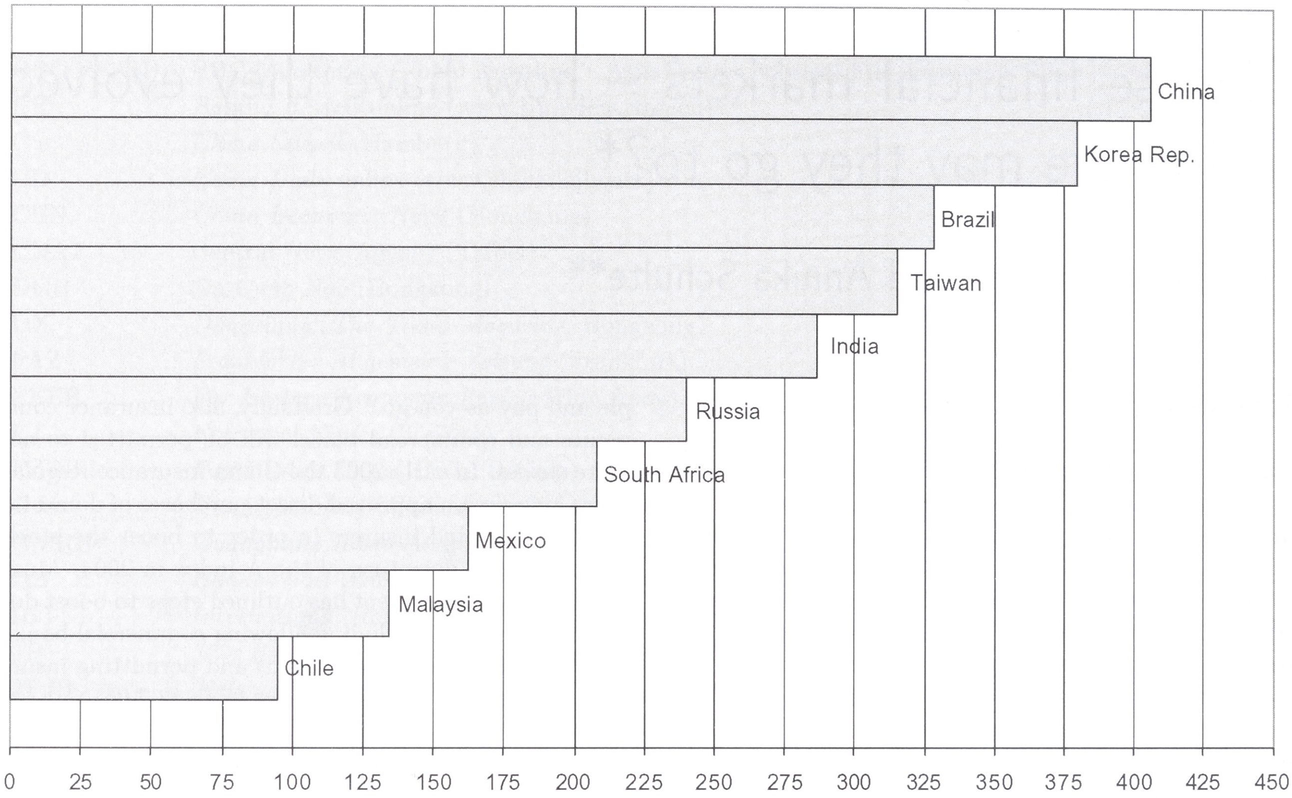
[1] For the first quarter of 2005 stock and bond issues have only accounted for about 1 percent of funds raised by companies with the rest coming from the vulnerable banking sector. FT, 12.7.05: 5; data refer to the first quarter of 2005.

[2] After its work seemed to be ineffectual for years, it improved since Zhou Xiaochuan, the present governor of the People's Bank of China (PBC), was in charge of the CSRC (2000-2002). Cf. Heilmann 2001: 9ff.

[3] Chinas market value comprises the value of A and B shares traded in Shanghai and Shenzhen.

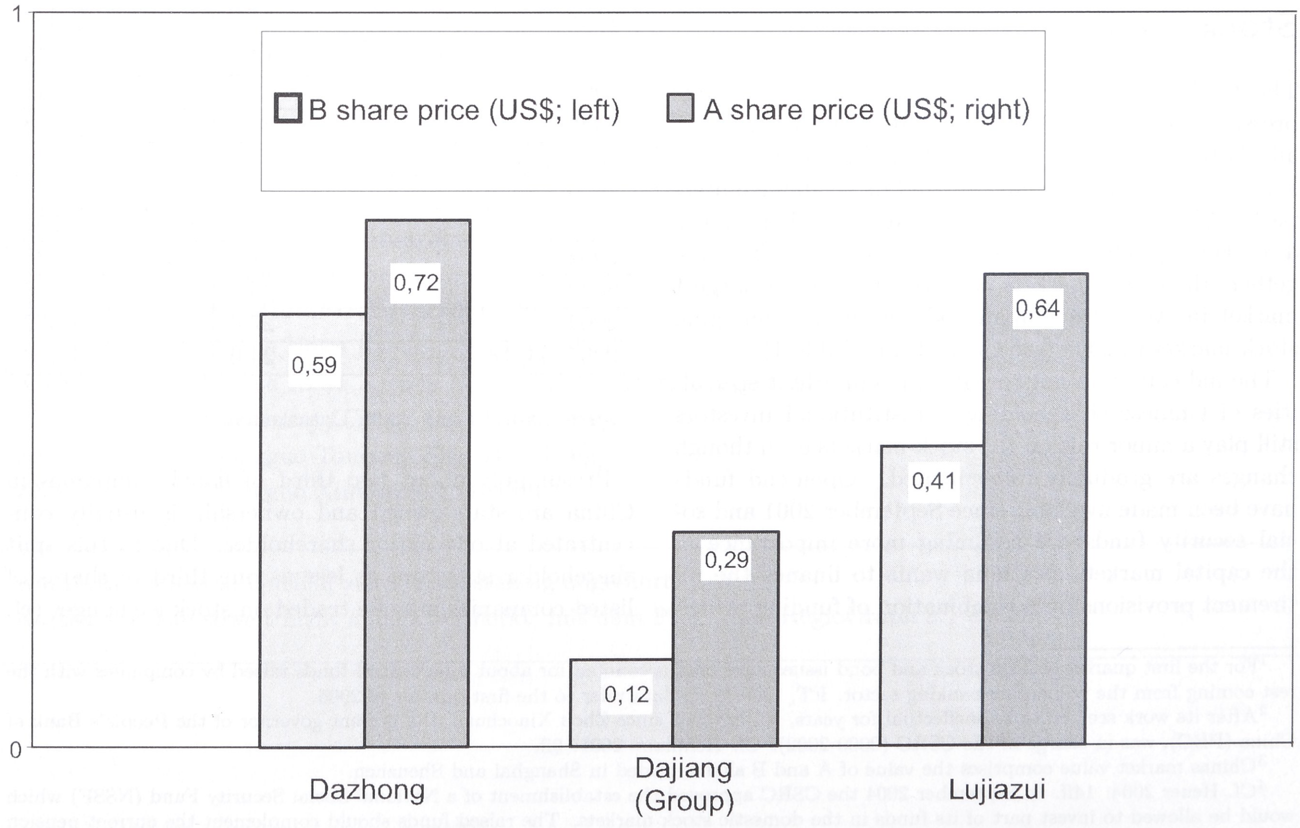
[4] Cf. Heuer 2004: 14ff. In September 2004 the CSRC approved the establishment of a National Social Security Fund (NSSF) which would be allowed to invest part of its funds in the domestic stock markets. The raised funds should complement the current pension system overloaded with an increasing amount of aging people. Cf. Pun 2005.

Chart 1: Market capitalisation of the top 10 emerging stock markets in 2005 (in billion US$)



Source: Datastream, China Stock Markets Web, 27.4.05; World Bank 2004.

Chart 2: Price comparison of A and B shares (in US$) of enterprises listed on both markets (April 2005)



Source: Thomson Financial Datastream.

Chart 3: Markdown of B share prices compared to A share prices of enterprises listed on both markets

Source: Thomson Financial Datastream; own calculations.

Pißler 2002b: 5-7; FT, 12.7.05). Trading takes place in different markets for A, B and H shares. A shares are denominated in Renminbi and issued in China (Shanghai and Shenzhen), B shares are denominated in foreign currency and also issued in China, while H shares of Chinese companies are denominated in Hong Kong dollars, issued in Hong Kong and targeted at foreign investors. Foreign investors can also buy so-called "red chips", shares of companies based and listed in Hong Kong with Chinese interest up to controlling interest.[5] As of the end of January 2005, 1,353 companies were listed on the A share market, while 110 were listed on the B share market and 109 on the H share market (cf. Lin 2005: 2).

Because of this market fragmentation, price differences occur between A and B shares. Prices for A shares, which are mainly restricted to domestic investors, are higher than of corresponding B shares, which are accessible to foreign investors, and considered to represent more appropriate pricing levels. In Charts 2 and 3 this is shown exemplarily for three shares of fairly large Chinese companies that are regularly traded on both markets, Dazhong, Dajiang, and Lujiazui. This phenomenon can possibly be explained by the fact that Chinese investors, with fewer investment opportunities, are less sensitive to the price level of domestic shares. The government chooses the optimal issuing volume for each firm so as to maximize the value of state-owned property akin to what a monopolist supplier would do in a segmented market (cf. Diao & Levi 2004: 1-6).

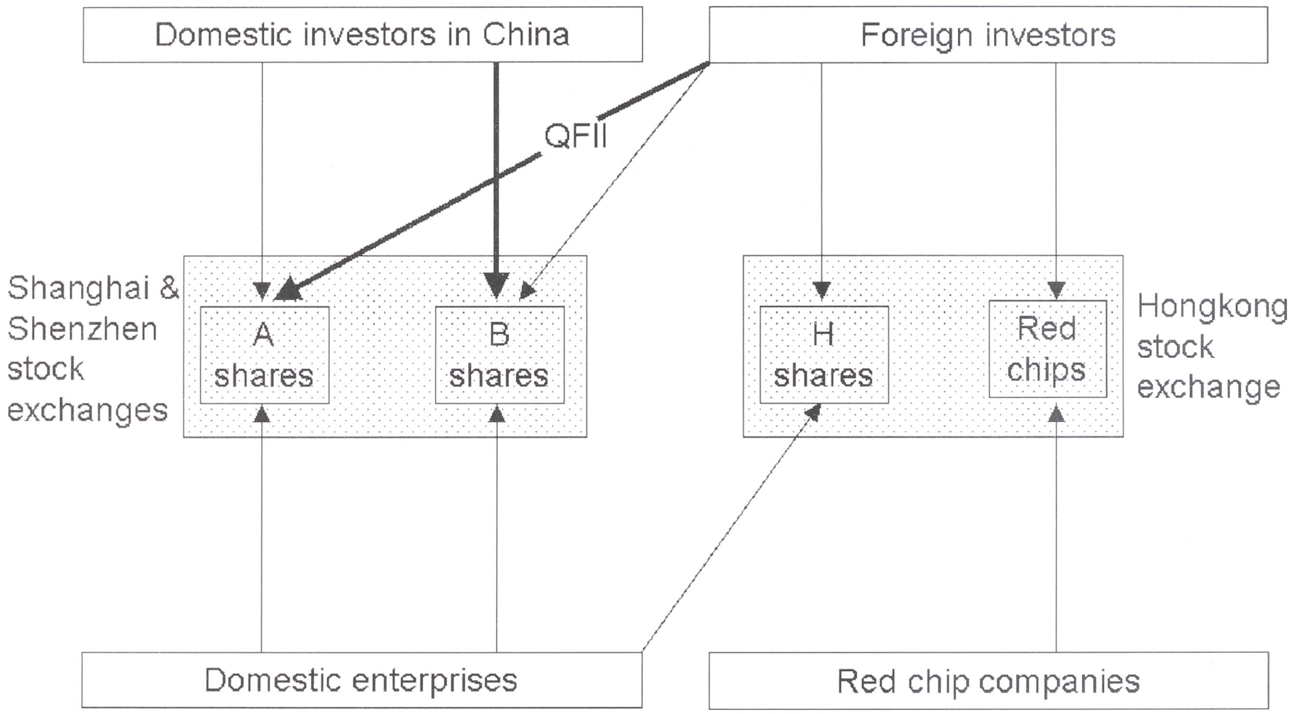
Some reform steps have reduced this market fragmentation. Since February 2001 domestic individual investors can also invest in B shares, which were originally sold exclusively to foreign investors. This possibly contributed to the decrease of price differences between A and B shares as shown in Chart 3. Furthermore, since December 2002 the qualified foreign institutional investors (QFII) scheme has paved the way for the entry of the first batch of foreign investors to the A share market (cf. Pißler 2002a :4-6.[6] Chart 4 gives an overview of the structure of Chinese financial markets. Bold arrows mark the two changes that have reduced the market fragmentation.

Although the QFII is a further step to the opening of the capital markets for foreign investors, a deeper investigation reveals several disadvantages. Size and duration of business activity seem to be important criteria for foreigners to be licensed as QFII, while the CSRC still retains some degree of discretion regarding which investor finally gets the licence. By April

[5] Interest in some Chinese companies can also be bought via American Depository Receipts (ADRs), shares of Chinese companies denominated in US Dollar and issued in New York, London and Singapore.

[6] QFIIs can also invest in treasury bonds, listed corporate bonds and convertible bonds, closed-end and open-end investment funds and any other investment instrument approved by CSRC. Cf. http://www.kasbank.com/news/news.asp?a=r&artID=333.

Chart 4: Structure of the stock markets



Source: Own presentation based on Jingu 2002: 3.

2005 twenty-seven international financial institutions[7] formed the QFII scheme to invest in domestic equity and bond markets with a total quota of 3.75 billion US$, compared to six in February 2004 with a total quota of 1.7 billion US$. The authorities, however, announced in July 2005, that the total quota could be increased to 10 billion US$, thus more than doubling the amount of money foreign investors can put into Chinese stock markets (FT, 12.7.05). In general, an individual QFII can only hold up to 10% of the share capital of a listed company, while the sum of all QFIIs in a company shall not exceed 20%. Furthermore, the restriction of capital transfers is strongly criticized by foreign investors. Chinese banks, of which quite a lot have a doubtful reputation, must act as trustees for foreign funds. Usually these funds cannot be transferred abroad before one year and only with admission of the foreign exchange office.[8]

Thus, the implementation of the QFII scheme does not seem to change the priorities of the Chinese authorities. For them a major function of capital markets is fund raising for the transformation of state-owned companies into stock companies. Foreign funds and know-how are welcome to solve these financing problems, but only in a state-controlled manner. The restructuring of two of the four large state banks, Bank of China (BoC) and China Construction Bank (CCB), gives just one example. They have been recapitalized with 45 billion US$ of foreign reserves at the end of 2003 and transformed into private limited corporations. The Initial Public Offering (IPO) of both banks is prepared for the end of 2005. Foreign banks, however, can currently only hold up to 20% of shares of Chinese financial institutions. To put forward the bank restructuring process, a similar approach to recapitalization is being projected for a third state bank, the Industrial and Commercial Bank of China.[9]

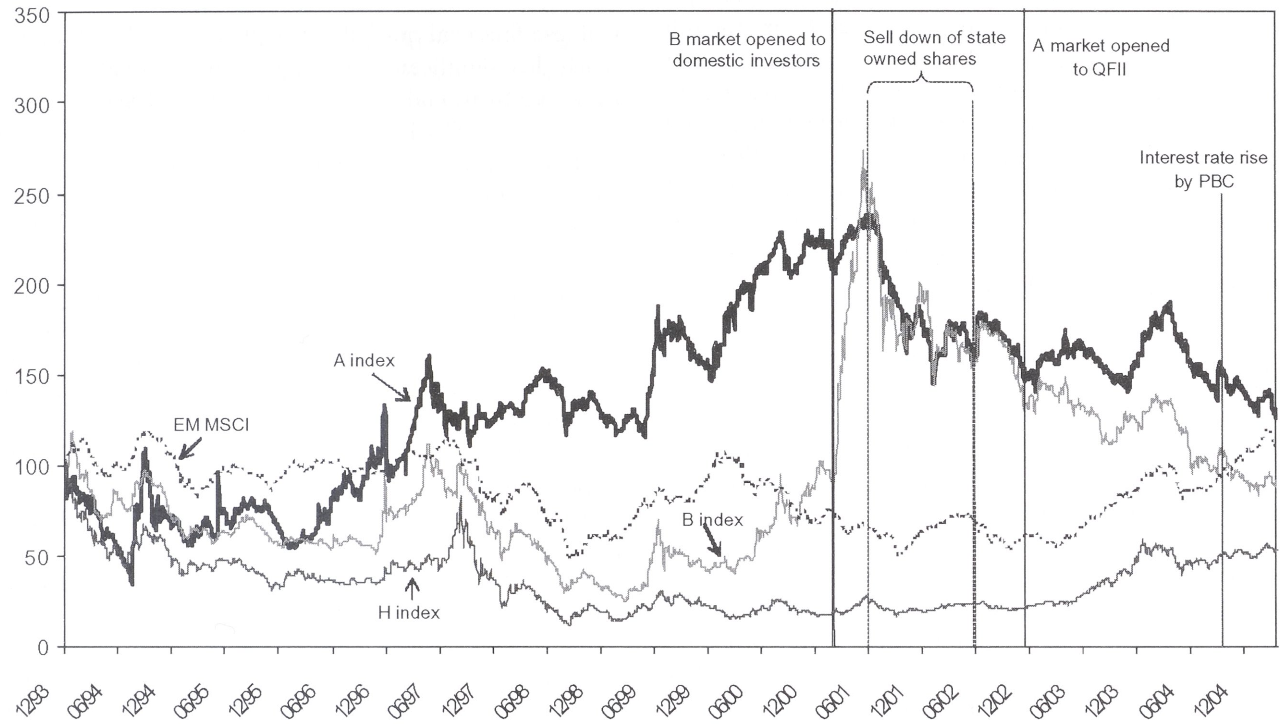
The recent changes in Chinese financial markets have led to an unbalanced opening of the capital account. While the implementation of the QFII scheme allows limited inflows of funds to the Chinese financial markets, there are still no comparable and realized reform steps for outflows. The CSRC plans the implementation of the qualified domestic institutional investors (QDII) scheme which enables domestic institutional investors to buy H shares and red chips, both traded in Hong Kong. Furthermore, similar to ADRs in New York, the

[7]UBS Warburg, Nomura Securities, Morgan Stanley & Co, International Ltd, Goldman Sachs & Co, Citigroup Global Markets Limited, Deutsche Bank, The Hongkong and Shanghai Banking Corporation Limited, ING Bank N.V., JPMORGAN CHASE BANK, Credit Suisse First Bank (Hongkong) limited, Nikko Asset Management Co. Ltd, Merrill Lynch International, Hang Seng Bank, Daiwa Securities SMBC CO. Ltd., Lehman Brothers International (Europe), Bill & Melinda Gates Foundation, INVESCO Asset Management Limited, ABN AMRO Bank N.V., Société Générale, Templeton Asset Management Ltd, Barclays Bank PLC, Dresdner Bank Aktiengesellschaft, Fortis Bank SA/NV, BNP Paribas, Power Corporation of Canada, CALYONS.A. Cf. CSRC homepage: http://www.csrc.gov.cn/.

[8]The time limit rises to three years for closed-end funds.

[9]Because of significant structural changes during a policy support to the agricultural sector, the fourth of the large state banks, the Agricultural Bank of China, will be included in the overall reform of rural financial institutions. Cf. IMF 2004a: 17f.

Chart 5: The development of Chinese stock indices



Source: Thomson Financial Datastream.

stock exchange introduction of China Depository Receipts (CDRs) in Shanghai and Shenzhen could make shares of foreign companies available to domestic investors. As a first step toward that goal, the social security fund and some insurance companies have been allowed to invest in overseas security markets in May 2004.

Chart 5 gives further evidence of the segmentation of Chinese stock markets. It presents the development of a stock index comprising A shares (A index) compared to two stock indices comprising B and H shares respectively (B index and H index).

Until the B market has been opened to domestic investors in February 2001 the development of the B index has been much closer to that of the H index. The A index evolved differently, as it grew rapidly and reached record levels in 2001 before suffering a downturn. After opening up of the B market to domestic investors, the B index quickly got ahead of the A index reaching even higher record levels and a more severe downturn than the A index. However, after the A market has been opened to QFII in December 2002, the A index clearly moved above the B index while both indices have declined further after the People's Bank of China (PBC) signalled tightening steps with an interest rate increase in October 2004.[10]

Furthermore, Chart 5 compares the Chinese indices with the MSCI index (Morgan Stanley Capital International Inc. index) for emerging markets (EM MSCI), which can be used as an international benchmark for institutional investors capturing common market sentiments towards emerging markets such as the Asian Crisis in 1997 and the Russian Crisis in 1998. The H index follows most closely these common trends, the B index had done so until it was opened to domestic investors, while the A index develops independently partly due to the non-convertibility of the Renminbi (RMB), in which A shares are denominated, but partly also due to the Chinese domestic stock markets themselves. Reasons are ineffective regulation, trading restrictions, lack of transparency with listed companies, but also Chinese market participants themselves, who are often claimed to behave like gamblers rather than investors (cf. Barboza 2005). Since the B market has been opened to domestic investors, they seem to dominate its general trend, which has become much closer to that of the A index since then. The H market, therefore, may appear as a safer investment alternative for international investors.

The impact on the unresolved status of state shares on Chinese domestic stock markets, of which many are not yet listed and traded, is also shown in Chart 5. During 2001 and 2002 the government sold part of its shares and thereby contributed to a downturn of the stock markets. During its first announcement to sell 10% of state shares in newly-listed companies on June 14th 2001, and its halt of the sell down in the middle of 2002 due to ongoing pessimistic sentiments, the B index lost over 40% and the A index over 30% of its value.

It remains to be seen which effect the most recent reform steps will have on the stock markets development. In August 24 the Chinese authorities have announced

[10] It was the first interest rate increase of the PBC since years.

that the share merger reform would be extended to the whole market. Accordingly, all mainland-listed companies can choose a suitable time to merge their tradable and non-tradable shares. This could result in a decline of stock prices as formerly non-tradable shares will be floating the market. In order to help prevent sharp falls in stock prices, however, the Chinese authorities have announced that controlling shareholders can buy back company stock on the market and listed companies can even repurchase stock with money raised through corporate bonds or bank loans (CD, 25.8.05; AT, 27.8.05).

Bond markets

China's bond market remains fairly illiquid and there have been few corporate issues, although the issuance of government and government-linked bonds has grown over the recent years in order to finance projects on the national agenda. The control over the market is enforced by an annual state quota fixing the amount of government and commercial bond issues. In April 2005, the volume of outstanding bonds was about 360 billion US$ with approximately 63% government bonds, 33% so-called policy bonds and only 4% corporate bonds. The government has approved only a few large state-owned enterprises to issue corporate bonds. Access by foreign investors to the Chinese bond market, in the form of investments in corporate and government bonds, is still limited to QFII. In February 2005, the Chinese government issued rules allowing certain foreign development institutions, such as the Asian Development Bank and the International Finance Corporation of the World Bank, to issue corporate bonds in Renminbi. However, the proceeds of the bonds can only be used for investment projects in China, and cannot be exchanged into foreign currencies or transferred outside the country (HKTDC 2005). Furthermore, the Chinese authorities expect that the underdeveloped bond market gains more information about corporate governance, management and especially transparency. Chinese companies' opaque and dubious accounting practices still fail to provide bondholders with sufficient information (cf. Schlichting 2004: 20; Ji & Thomas 2005). In addition to that, institutional investors still play a minor role. Furthermore, the market lacks a sound legal framework and the periodic injection of new issues on a regular basis and of diverse maturity (cf. Jingu 2002: 3-7). Therefore, it is more convenient for approved domestic enterprises to raise funds through bank loans or the stock markets rather than issue bonds. A futures market for bonds is also missing, because the government shut it down in the aftermath of a trading scandal involving the Shanghai Stock Exchange in 1995 (cf. Tarallo 2002). Since none of these barriers is likely to disappear anytime soon, the corporate bond market will probably remain small for the near future.

Conclusion

Chinese financial markets have grown rapidly and have reached a significant size on an international comparison. Institutional quality, however, still shows many deficiencies. Stock market fragmentation and limited trading of stocks due to split shareholder structure, ineffective regulation, lack of transparency with listed companies, but also Chinese market participants themselves are major factors. Furthermore, the liberalisation of capital inflows and outflows still remains unbalanced. The QFII scheme has lifted restrictions on capital inflows. Regarding capital outflows, however, the reform efforts do not go much beyond the issuance of several guidelines about the implementation of the QDIIs and CDRs. While the government has (these) difficulties to implement a widely controllable outflow-system, more domestic enterprises turn away from the hindering disadvantages of the regulatory framework of Chinese stock markets shown in price differences and limited access, and prefer an IPO outside Mainland China.[11]

The unbalanced opening of the capital account also has an impact on the future development of the Renminbi which so far has only achieved limited flexibility.[12] Leaving the substantial asymmetry in the openness of the capital account unchanged can introduce a bias in the value of the exchange rate of the Renminbi relative to its long-term equilibrium (IMF 2004b: 22). A more balanced opening of the capital account offers more driving forces on the exchange rate. On the one hand a more flexible exchange rate would attract even bigger inflows of money, because investors bet on further Renminbi appreciation as it is now considered to be undervalued. On the other hand, more possibilities for capital outflows could have a dampening effect on a Renminbi appreciation. As domestic investors in China are highly limited by the governmental control, their hunger for foreign markets should not be understated (cf. *The Economist*, 2.3.05).

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[11] For example in Hong Kong, 24 IPOs took place in 2004, which is three times more than at China's stock exchanges.

[12] In July 2005, the Chinese authorities ended the Renminbi's decade-old peg to the dollar. They announced a 2.1% revaluation and a system that set the currency's value with reference to a basket of currencies.

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