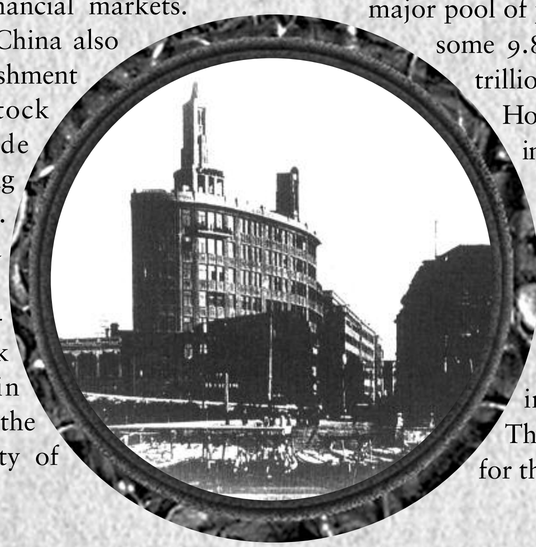
Emerging Stock Markets in the People's Republic of China

By Chen Ji and Steve Thomas

Next year will mark the 20th anniversary of the re-emergence of securities trading in the People's Republic of China. In 1984, the government approved the issuance of the first publicly issued stock since 1949. The issuing company was the state-owned Beijing Tian-Qiao Department Store, which issued a three-year fixed interest rate stock that resembled a three-year bond in Western financial markets. Beginning in 1990, China also permitted the establishment of 24 regional stock exchanges to trade the slowly expanding number of new shares. In late 1990, China formally re-established two fully functioning national stock exchanges, one in Shanghai and one in the southern Chinese city of Shenzhen. All Chinese share trading was gradually moved to these two exchanges, beginning in late 1990. After 12 years of rapid growth, China again became a major stock market in the Far East, third in size after Japan and Hong Kong.

Over the past 20 years, China's economy has made major advances, growing at about 9 percent each year and creating a major pool of privately held savings, some 9.8 trillion yuan ($1.18 trillion) by the end of 2002. However, most of that savings has been deposited in China's banks rather than invested in stocks, where it would normally go to support the continued growth of Chinese enterprises in need of capital. There are many reasons for this lack of capital mar-



British American Tobacco Company in Shanghai.

Chinese stock certificate from the Schanghai Security and Commodity Exchange Company issued in 1923.

ket intermediation. First, there is the relative newness of the Chinese stock market and a lack of consumer education about stocks. Second, there is a lack of predictability in the market and the recent downturns in the Chinese market in line with global market downturns. Third, most of the listed companies are large and medium state-owned enterprises, not the small and medium- sized companies that are normally among the most profitable and in most need of capital. Fourth, there is a lack of company transparency, a lack of modern accounting standards, a still developing financial institution infrastructure, and a pattern of scandal and market manipulations that have hurt investors' trust in stock. Finally, proceeds from stock listings have often been used for purposes other than those listed in the stock prospectuses, usually to loan to the parent company, to speculate in the market, or to make other investments such as lending in the black market or investing in real estate.

After 14 years of difficult negotiations, China was finally admitted to the WTO in 2001. Financial services were one of the central points of contention between China and the WTO members, particularly with the U.S. As part of the agreement with the U.S., China will open its securities industry in various ways. The major reform is that foreign financial institutions have been allowed a 33 percent stake in fund management enterprises since China's formal accession to the WTO. That stake is permitted to rise to 49 percent three years after China's WTO accession. Also, U.S. underwriters are allowed to invest up to 33 percent in joint ventures. In addition, joint ventures with U.S. minority stakes are permitted to underwrite domestic securities issues, as well as to underwrite and trade in foreign-currency denominated securities (debt and equity), and are allowed to carry on fund management under the same conditions as Chinese companies.

Parallel Markets

China was first opened to foreign commerce as a result of the first and second opium wars of 1839–42 and 1856–60, when foreigners forced the country to open "treaty ports" in its coastal cities of Shanghai, Guangzhou (Canton), Fuzhou (Fukien), Xiamen (Amoy), and Ningbo (near Shanghai). In these cities, foreigners imported opium and tobacco, exported tea and silk, and conducted business including shipping, mining, railway construction, banking and insurance. Capital for the various foreign enterprises was raised abroad in cities such as London, and in colonies such as India and Hong Kong.

In 1864, the first foreign-funded company, a British company, issued stock for 50,000 taels of silver; a tael was 1 1/3 ounces. Later other foreign companies, including Jardine Matheson, British American Tobacco Company, the Bank of France, and the Hong Kong and Shanghai Banking Corporation—the same HSBC still in business—also began to issue stocks and bonds. Their shares in China were traded privately until 1869, when the British Stock Company opened in Shanghai to trade shares in foreign companies. In 1891, the Shanghai Shareholder's Association was established, but trading was slow and took place mainly in the Western Chamber of Commerce Building and in front of the HSBC front door until 1898.

Foreign business activity greatly expanded in the wake of China's loss in the Sino-Japanese War of 1895. The eight foreign powers forced the Qing Imperial government to permit foreign enterprises to operate throughout China with the protection of the unequal Sino-foreign treaties. Foreign business activities boomed, particularly in railways and banking, and the number and value of foreign stocks skyrocketed. As a result, the (foreign) Shanghai Stock Exchange was restructured in 1903, and registered in Hong

British Mining Company stock issued in 1925.

Kong with 100 members: 87 foreign and 13 Chinese.

A parallel market began when Chinese companies began to establish foreign-style enterprises and raise capital by issuing shares to private investors. The first Chinese joint-stock company, the Shanghai-based China Merchants Steam Navigation Company, was set up in 1872 by the Zhu brothers under the guidance of the Chinese government's major advocate of western industrialization, Viceroy Li Hongzhang. By the early 1880s, more than 15 Chinese-owned companies had been established and had floated stock in Shanghai. Shares were traded informally among shareholders' relatives and friends. The Qing Imperial government also began to issue government bonds for industrialization and other needs, particularly financing wars with foreign powers.

The first Chinese-owned brokerage, the Shanghai Pingzhun Stock Brokerage Company, began trading Chinese stocks in 1882. After a year of growth and active trading, a combination of over-speculation, failure of silk investments, and the coming Sino-French War of 1883 led to the company's collapse in 1883. Trading then took place informally as "Teahouse Trading" until 1914, when the Shanghai Chinese Brokers' Association was founded. Organized trading resumed based on China's first security exchange law. Chinese security trading floors were set up in Beijing in 1918 and in Shanghai in 1920 with the Shanghai Security and Commodity Exchange, and in 1921 with the Shanghai Chinese Security Exchange. Also in 1921, China's first corporate bonds were issued for the Tonghai Farming Company. The two Chinese Shanghai exchanges merged in 1933 and were housed in a new Shanghai securities building opened in 1934, which became the largest and most advanced securities market in the Far East.

Most stock trading ceased after 1937, when Japan invaded China and took over most of its territory and all of its coastal cities. Stock trading moved to the over-the-counter market and to black market transactions. A year after the Chinese and allied victory over Japan in 1945, the Shanghai Stock Market reopened. In addition, trading in government bonds, as well as unlisted and foreign company stocks, took place outside of Shanghai's newly reopened stock market. In 1948, with changes in the official Chinese currency and rampant inflation, China's stock exchanges again stopped trading until March 1949. That May, when the communists took over Shanghai, the Shanghai Stock Exchange was officially closed and all foreign companies withdrew their operations in China.

The government of the People's Republic of China reopened the Tianjin Exchange in 1949 and the Beijing Exchange in 1950, but both were closed again in 1952. In 1953, China adopted Soviet Russian central planning methods to allocate capital. From 1953 to 1956, the government gradually purchased Chinese private shareholding companies. The 5 percent fixed dividend paid by the government was based on the government-assessed value of the private shares. These government payments, amounting to 120 million yuan per year to 1.14 million individual Chinese shareholders, continued from 1956 to 1966, when payments ceased. From 1953 to 1958, the government issued bonds to raise funds for "socialist construction," but they were never traded.

By the end of 2002, listed companies had increased to a total of 1,224 domestic companies with a total market capitalization of 3.8 trillion yuan ($457 billion). There are currently 68.8 million Chinese stock brokerage accounts. Related financial services industries have also boomed, and there are currently 126 securities brokerage houses with branches throughout China. The country also has 21 fund management companies that oversee 71 investment funds (closed-end and open-end), with total assets of 131.9 billion yuan ($15.9 billion).

China's newly emerging stock markets are unique in many ways. First, the majority of Chinese listed companies are large or medium-sized state-owned enterprises (SOEs) that have been selected by the government,

The Shanghai Stock Exchange hall.

such as Haier Electronics (producing appliances and electronic products) and Tsingtao Beer. Shares are issued in three categories: state-owned shares, which are the majority (about 60 percent) but not publicly traded; legal person shares (25 percent) owned by government institutions and also not publicly traded; and the rest, individually–owned shares, publicly traded on the two exchanges and comprising up to only 15 percent of the total shares. This structure has guaranteed continued Chinese government majority ownership and control.

A second distinct feature of the Chinese securities markets is that tradable shares are divided into two classes: "A" shares trade exclusively in Chinese currency, comprise about 95 percent of tradable shares, and are available only to Chinese investors. The remaining 5 percent of tradable shares, called "B" shares, are traded in U.S. currency in Shanghai and in Hong Kong currency in Shenzhen and are purchasable by both foreigners and Chinese possessing foreign currency. "A" and "B" shares give equal ownership rights in Chinese companies, although there continues to be a major discrepancy in price between the same "A" and "B" shares, with "B" shares discounted from a high of 70 percent to a recent low of 40 percent. This division of shares was intended to protect China's infant "A" share market from possible foreign financial control. "B" shares were designed for foreign investors, but became available to Chinese investors holding foreign currency in 2001.

Secondary share transactions are conducted electronically, similarly to the Nasdaq Stock Market. Over the past 10 years, China's two stock exchanges have grown rapidly and experienced extreme volatility. The major reasons for market volatility have been changing government policies (such as deciding how many companies can be listed, permitting selected foreigners to invest in "A" shares, and deciding when to sell government-owned shares), market manipulations such as insider trading, the relatively small size tradable shares, and a lack of institutional investors. To counter these swings and upgrade China's emerging stock market system, the government has established the Chinese Securities Regulatory Commission, similar to the SEC in the U.S., to oversee securities issuing and secondary market trading practices. A modern legal and regulatory framework based on internationally accepted practices has also been established.

As mentioned, foreigners, mostly institutional investors or overseas Chinese, were initially limited to tap China's "B" share market of about 120 share-issuing companies. Recently, however, the Chinese government opened the "A" share market to more foreign investors in the form of "qualified foreign institutional investors," but with limitations and restrictions that are still under discussion. The securities service sector (investment banking services) had been almost entirely closed to foreign investment bankers with the exception of the China International Capital Corporation (CICC), which is Morgan Stanley's joint venture in China with the China Construction Bank and three smaller partners. FH

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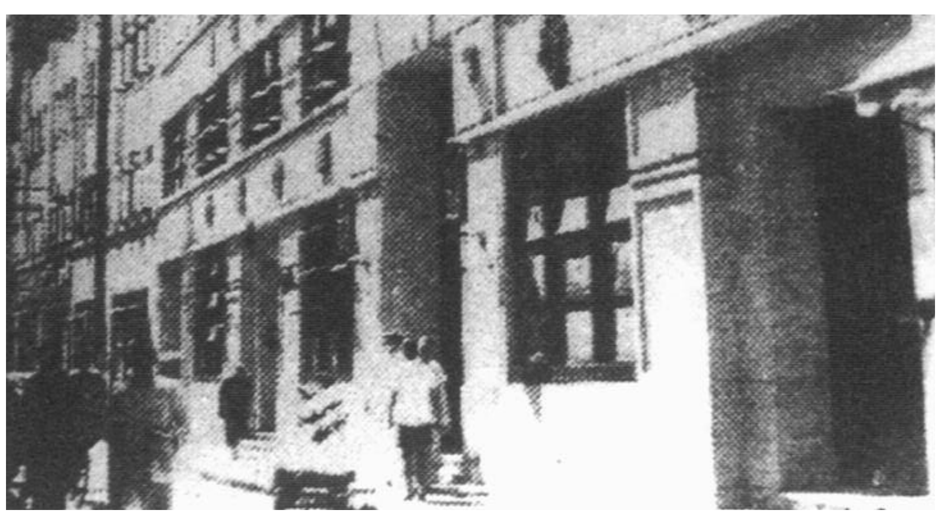

Shanghai Security Exchange before 1949.