CHINA' S STOCK MARKET: DEVELOPMENT AND PROSPECTS

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ABSTRACT

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This thesis provides a comprehensive overview and some economic analyses of the development and prospects of China's stock market. The significant progress that China's stock market has achieved has been widely recognized around the world. Based on a basic framework of China's economic reforms and stock market development, the thesis attempts to discuss several major bottleneck issues that impeded the development of China's stock market.

It is my personal hope that this thesis will contribute to some extent to the vast literature on China's stock market with its most up-to-date information within a systematic framework. China is experiencing rapid changes in all aspects of its stock market, and almost all the research on this sector needed most updated data to support. However, most of the research so far is limited to a historical overview of China's stock market, very few are recent enough to address the issues facing China's stock market, such as, state shares and legal person shares, A shares and B shares, as well as the stock market under the WTO accession. This thesis will be helpful to those people who are interested in studying China's stock market.

The thesis is organized as follows. Part I briefs China's economic reforms and their impacts on the emergence of the stock market, with a focus on financial system reform. Part II presents a brief history of the development of China's stock market. After the overview of the stock market as a whole, the second part describes the main compositions of the market, the primary market and secondary market, and provides a discussion of the listed companies, securities companies, investors and regulatory framework. It is concluded in this part that although the growth of the market has been impressive, they are still primitive and imprint many elements of the central planning system.

Part III addresses three major issues that obsess the policymakers and academic circle, the non-tradability of the state shares and legal person shares, the segmentation of A share market and B share market and the performance of the listed companies. The author points out that some feasible measures on solving these problems should be taken as early as possible. The last part reviews the process and prospects of internationalization of China's stock market. Section 1 and section 2 look at the B share market and overseas listing as well as foreign participation. Section 3 points out the gap between the China's stock market and other emerging and mature markets in the world in terms of market size, assets structure and market operation. The last section of this part turns to a prediction of the impact of WTO accession on China's stock market.

PART I ECONOMIC REFORMS AND THEIR IMPACTS ON THE EMERGENCE OF THE STOCK MARKET

From Planned Economy to Market Economy

The economic system in China was highly centralized in the past. The government initiated serious economic reforms starting 1978. The reforms were aimed at: a) moving the economy toward greater decentralization of decision-making; b) an increasing reliance on market forces and on material incentives in order to provide motivation for the desired economic behavior and resource allocation; and c) the opening of the economy to external competition through foreign investment.

During the first period of reform (1978-1984), the decision to decentralize was initiated at the Third Plenary Session of the 11th Central Committee of the Chinese Communist party held in late 1978. The measures aimed at state-owned enterprises (SOEs) reforms were mainly focused on expanding enterprise autonomy and the restoration of entrepreneurial financial incentives (*fangquan rangli*). In stage two (1985-1991), the goal of the Chinese government was to change China's economic system to ensure that resource allocation could be dictated by markets to a greater extent. In December 1986, the State Council proclaimed the Several Measures on Deepening Enterprises' Reform and Enhancing Enterprises' Vitality, granting experimentation of the shareholding system within large- and medium-sized enterprises at both the provincial and local level. The pace of the reforms accelerated dramatically in the early 1990s and the reform entered the third stage when the 14th Party Congress, in late 1992, cast aside the concept of the planned economy and proclaimed the establishment of a fully fledged market economy in China as the country's primary reform objective. After the 15th Party Congress in 1997, great importance was attached to the development of stock markets and as such they were regarded as a major step forward in the governmental administrative program. This policy was codified in the Ninth Five-year Plan and Long-term Program for 2010 for the national economy and social advancement of People's Republic of China (PRC).

State-owned Enterprises under the Transition

On the eve of the reforms in 1978, decisions regarding current input and output levels as well as investment were made at either the central or the local government level. Until the early 1980s, state-owned enterprises relied totally on state budgetary allocations or state bank loans for their production funds and investments. The state-owned enterprises had to hand over all of their operating profits to the state treasury. In 1979, with the introduction of expanded enterprise autonomy, the profit-retention (*Lirun Liucheng*) system was adopted. The government allowed an enterprise to retain sufficient funds from its profit to meet its decentralized investment expenditures and pay bonuses to workers.

Since enterprise profit was the main source of state revenues, the latter dwindled as the enterprise share increased over the years. Government revenues declined by two-thirds relative to output between 1978 and 1995.[1] This is evident from Table 1-1 that shows changes in the savings levels of households and enterprises as well as state budget. From 1985, funding for basic capital investment was changed from state budget grants to bank loans (*Bo Gai Dai).* The state-owned enterprises have come to rely more and more on borrowing as grants have been cut back and bank credit became the main financing channel.

[1] See Lardy (1998).

Reform of Financial System

During the pre-reform period, enterprise capital came from the state budget and People's Bank of China. The budget provided state and collective enterprises with fixed capital and quota working capital; both types of capital were interest free and non-repayable whereas People's Bank of China provided them with credit to finance beyond quota working capital. The control of state-owned enterprises' money supply was mainly implemented through the state budget and credit plan. The state budget specified the amount of fixed capital and quota capital whereas the credit plan specified the amount of credit to be allocated to enterprises.

In 1984 a two-tiered banking system was created and People's Bank of China was transformed into a central bank only. Apart from the four specialized banks, the Agricultural Bank of China, the Bank of China, the Industrial and Commercial Bank of China and the People's Construction Bank of China, many diversified forms of banks and non-banking financial institutions were established, such as the Shenzhen Development Bank, the Urban Credit Cooperatives, and the Trust and Investment Companies. As of the late 1970s, investment funds originating from the budget have gradually decreased, and the proportion of finance provided by banks has significantly

<Table1-1> Composition of Savings, 1978-1991 (% of GDP)

	Total Savings	Household	Enterprises	Budget
1978	33.2	1.1	17.0	15.1
1979	34.6	3.1	21.4	10.0
1980	32.3	4.4	20.7	7.3
1981	30.3	3.4	20.0	6.6
1982	31.6	7.5	18.7	5.4
1983	1.5	9.9	15.9	5.7
1984	32.8	14.4	11.8	6.6
1985	34.5	13.4	14.4	7.0
1986	36.1	14.4	15.9	5.8
1987	39.1	16.2	18.4	4.5
1988	38.0	17.0	17.8	3.2
1991	40.4	18.7	19.9	1.8

Source: Lardy, China's Unfinished Economic Revolution, 1998.

increased. As Table 1-2 indicates, prior to 1979, more than 60 percent of investment in fixed assets of state-owned enterprises came from budgetary grants. By 1985, this had decreased to 26.4 percent and after that it decreased further.

From the mid 1980s attempts were made to turn these four specialized banks into commercial banks responsible for their own financial profits and losses. However, banks were not yet entirely free to lend according to commercial criteria. They need to devise and implement a coherent strategy for dealing with a relatively high share of non-performing loans. More than 75 percent of bank loans went to the state-owned enterprises in the name of "policy loans" (*zhengce daikuan*), to support the development of state-owned enterprises. It created a large amount of non-performing loans due to the poor performance of state-owned enterprises. It was estimated that such bad loans accounted for morn than 20 percent of the state-owned bank loans. The banks have continued to extend new lending using funds from the People' s Bank of China re-lending facility and from the steadily increasing deposit base. It indicates not only a heavy reliance on distributed funds from the central bank, but more import-

<Table 1-2> Major Sources* of Funds for Fixed Capital Investment in State-owned Enterprise (%), 1970-1990

	State budget	Self-raised funds	Domestic credit
1970	75.3	23.9	0.8
1975	64.4	34.9	1.6
1979	61.4	31.1	3.6
1980	44.7	36.5	11.7
1981	38.6	42.4	13.6
1982	31.4	45.3	16.2
1983	35.9	43.5	14.3
1984	35.3	43.4	15.4
1985	26.4	40.4	23.0
1986	22.2	38.4	22.7
1987	20.6	38.2	24.6
1988	14.7	40.5	24.2
1989	13.4	42.8	20.9
1990	13.2	42.1	23.6

Source: Statistical Yearbook of China, various issues.
Note Foreign and other sources of funds are not included.*

antly a barrier to the change of specialized banks to genuine commercial banks as well as limiting the development of the capital market.

As a consequence, the state-owned banks are more and more reluctant to lend money to state-owned enterprises when they have to be responsible for their own gains and losses. Enterprises found that borrowing from banks became increasingly difficult and came to demand new sources of financing. Meanwhile, a large number of enterprises have been established and expanded, further fueling the demand for funds. In 1995, the enactment of China's new Commercial Bank Law meant to encourage market-based management and pricing principles.

In sum, as the economic reform deepens, the sustained growth and stability of the economic development depend increasingly on the availability of new sources of financing. The China's stock market emerged, as the times demanded.

PART II A BRIEF HISTORY OF CHINA’S STOCK MARKET DEVELOPMENT

An Overview of China’s Stock Market

The development of China’s stock market is one of the most important elements of China’s reform in the financial system.

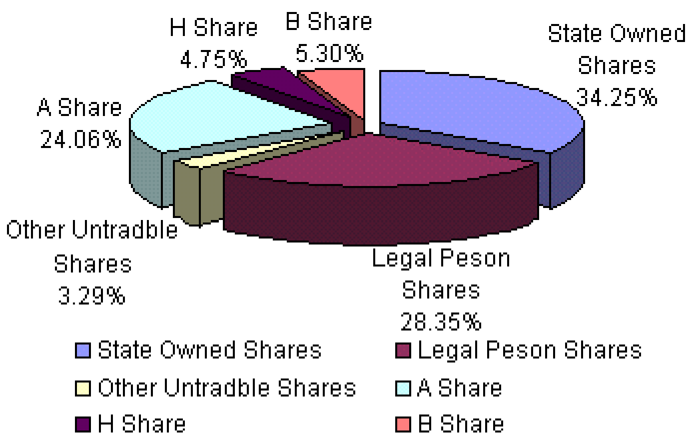
Form 1981, the central government began to issue treasury bonds to finance deficits. Since then, various provincial and local governments, financial institutions, and enterprises have also come to issue bonds. In 1986, the Shanghai branch of People’s Bank of China set up the first over-the-counter (OTC) market in Shanghai. The first stock sale in Shenzhen market was by the Shenzhen Development Bank in 1987. By the end of 1989, thousands of shareholding companies were set up all over the country and issued 3.8 billion yuan (US$700 Million) worth of shares. However, 70-80 percent of the shares were from conversion of existing state owned assets, and relatively little new capital was raised by issuance of stocks. Most of the stocks were issued to related companies or to employees in the companies and fewer than 2 percent were public issues to general investors.

In December 1990 and July 1991, two stock markets, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) were established. By the end of 1991, 14 companies were listed in the two stock exchanges. This marked the stock market’s entry into the Chinese economic system officially and China’s capital market’s entrance into its formative stage.

Since China’s two stock exchanges were established, two main types of shares are offered by Chinese companies: A shares and B shares. A shares are exclusively sold to Chinese nationals. B shares are denominated in renminbi but traded and purchased in foreign currency exclusively by foreigners. Besides the two shares, H shares are issued by Chinese companies and traded on the Hong Kong Stock Exchange. N shares – American Depositary Receipts (ADRs) are issued by Chinese companies and traded on the New York Stock Exchange in the form of American Depositary Receipts. S shares are floated by Chinese companies and traded on the Singapore Stock Exchange. The relative sizes of the final two types of shares are small.

The state-owned enterprise shares are compartmentalized to ensure state control while diversifying shareholding in an effort to modernize state-owned enterprises. Share capital of incorporated state-owned enterprises is segregated into several compartments, including the state shares, which are owned by the state and the legal person shares, which are held by state companies or institutions as well as individual shares. In general, the state shares and the legal person shares are subject to restrictions on transfer. As the result, 65.89 percent of the total share capital of the listed companies is untradable, leaving only around 34 percent of listed companies' shares that are traded on the stock exchanges. The tradable shares are basically owned by individual shareholders and only account for a small part of A shares, as figure 2-1 indicates.

<Figure 2-1> Capital Structure



Source: http://www.csrc.gov.cn/CSRC/eng/esmintr.htm

After years of inactive transactions during the late 1980s, the stock markets became quite active in Shenzhen and Shanghai in the early 1990s. Because very limited stocks were available on the markets, prices rose very quickly. By August 1993, stock prices in both Shenzhen and Shanghai reached the highest level in terms of the records of past two years and then dropped dramatically. The markets then experienced more than two years stagnation and recovered only after early 1996. From April to mid December 1996, the stock index rose by 120 percent in Shanghai and over three times in Shenzhen. The government then took measures to cool the markets. On December 16, 1996, People's Daily openly warned the great risk investors were facing with their speculation in the form of the special comments – Understanding Correctly of Current Stock Markets. The stock prices fell considerably after that day. But, contrary to some experts' predictions, the market did not stagnate for long and soon recovered and even reached a record high again in April 1997, making the government find it necessary to cool it down again. The quota of stock issuance of 30 billion yuan in 1997 was announced. Then, the market didn't recover from more than two years of bearish behavior until May 19 1999.

In sum, since the stock exchanges were established, the China's stock markets experienced several cycles of boom and bust and turnover levels on the markets also experienced several ups and downs. It is indicated in figure 2-2 and appendix 1.

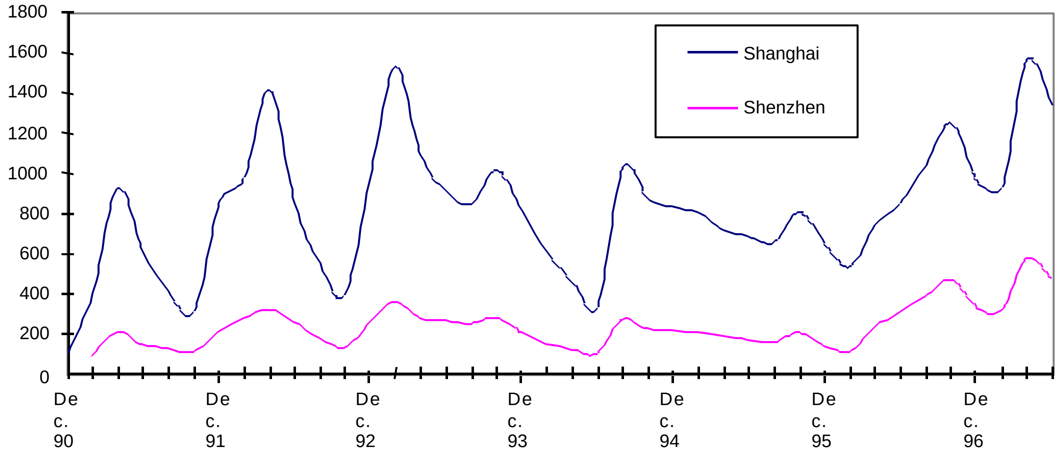
China's stock market developed quite rapidly. Compared to the initial 8 listed companies on Shanghai Stock Exchange and 6 on Shenzhen Stock Exchange in 1991, 851 companies had been listed on the two Stock Exchanges by the end of 1998, having issued a total of 74.61 billion shares in the market and raised a total of RMB 355.31 billion (US$ 44.55 billion). The total from 1987 to 1998 can be broken down as follows: (1) A share market: 34.302 billion shares (RMB 168.709 billion; US$ 20.6

billion); (2) B share market: 9.598 billion (US $ 4.745 billion) and (3) H share markets: 30.719 billion shares (US$ 10.02 billion). (See table 2-1; figure 2-3)

Currently, China's stock market exchange trading system reaches all large and medium-sized cities with more than 2,420 retail branches all over the nation. The scale of securities trading is rising. By the end of 1998, the total market capitalization was RMB 2,233.6 billion, equivalent to 24.5 percent of GDP. [2]

It is worth noting that the development of the stock market is accompanied with the reform of state-owned enterprises' ownership and corporate governance structure, namely, the reform of the shareholding system and incorporation of state-owned enterprises. The stock market played a very important role during the process of the state-owned enterprise reform. Establishment of the stock markets played the greatest role in the promoting the reform of state-owned enterprises. At the beginning, due to the stock quota system and a limit of market capacity, many of the listed companies were relatively small. Since 1996, the government expanded the scale of stock issuan-

<Figure 2-2> Securities Exchange Composite Indices in China



Source: China Securities Newspaper, 1991-1997.

[2] See Zhou Zhengqing (1998).

ce so as to support the capital demand of the large-, and medium-sized state-owned enterprises according to the table 2-2. Since then, a great number of key state-owned enterprises, especially enterprises related to the strategical and pillar industries began to issue their own stocks.

In China, most listed companies are state-owned enterprises. By October 1999, these enterprises have raised more than RMB 400 billion (US$ 49 billion) from the stock markets, which has helped them improve their financial condition, promote their technical creation, and expand their profit base. [3]

Primary Stock Market

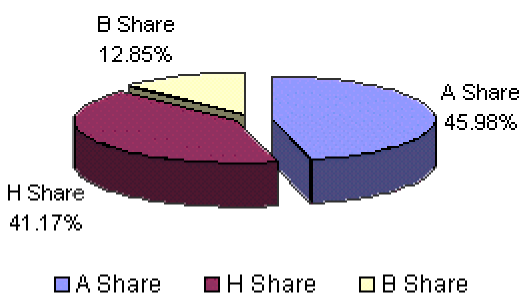
As with the stock markets in other countries, China's stock markets consist of the

<Table 2-1> Shares Offering from 1990-1998 (RMB Billion)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Shares Issued	0.4	0.5	2.1	9.6	9.1	3.1	8.6	26.8	10.2
A Share	0.4	0.5	1.0	4.3	1.1	0.5	3.8	10.6	7.9
B Share			1.1	1.3	1.0	1.1	1.6	2.5	1.0
H Share				4.0	7.0	1.5	3.2	13.7	1.3
Capital Raised	0.4		9.4	37.6	22.7	15.0	42.5	129.4	83.9
A Share	0.4		5.0	19.5	5.0	2.3	22.4	65.5	44.0
B Share			4.4	3.8	3.8	3.3	4.7	8.1	2.6
H Share				6.1	8.9	3.1	8.4	36.0	3.8
Rights Offering of A and B Share				8.2	5.0	6.3	7.0	19.8	33.5

Source: www.csrc.gov.cn, *1999.*

< Figure 2-3> Structure of Shares Issued



Source: www.csrc.gov.cn, *1999.*

primary market, in which firms make their initial offering, and the secondary market, where shareholders trade their stocks.

In China, an enterprise wishing to issue stocks may elect to arrange either a private placement or a public offering. Public offering is public-oriented stock issuance, in which all legal investors invest. In a private placement, an enterprise sells its stocks only to a few designated investors, such as employees, financial institutions or other enterprises closed to the issuers.

Shares issued by a typical SOE consist of three types: state shares, legal person shares and individual shares. Individual shares are tradable shares that are owned by individual and institutional investors. State shares and legal person shares constitute the majority of total shares. Corporate employee shares and staff shares account for only a small part of the total issuance. According to Provisional Regulations concerning Share Issuance and Trading, the amount of corporate employee shares issued may not exceed ten percent of the total shares outstanding. Corporate employee shares cannot be traded until six months after the initial offering has been listed on the stock exchange. Staff shares, however, which are issued by the company only through the internal offering to finance, so-called targeting finance (*Dingxiang Muji*), cannot be traded on the stock exchange. Since 1993, The State Council has stopped the approval for issuance of internal staff shares. By the end of 1997, however, it was estimated that there was still 1.55 billion untradable internal staff shares that had been issued by listed companies on Shanghai Stock Exchange, accounting for 1.47 percent of total shares outstanding.[4]

Public offering in China is quite similar to the Western practice. Before, the China Securities Regulatory Commission (CSRC), the State Planning Committee, the State

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[3] See People's Daily (November 3 1999).
[4] See Zhou Zhengqing (1998).

Economic System Reform Commission, and the People's Bank of China jointly determine the annual stock issuance, which stipulated the total number of new stocks to be listed on the exchanges. With the governmental reform, China Securities Regulatory Commission became the most powerful organization with regard to the authorization and supervision of stock listing and issuance.

Because China's stock market is still in its infancy, accession to the market has therefore been strictly controlled concerning the checking and approval system and quota system. As table 2-2 shows, during a quite long time, the number of stocks to be listed was limited by the quota. The state competent securities authorities proposed the number of new stocks for the next year in terms of macroeconomic financial circumstances, development of state-owned enterprise reform and stock market operation situations. State Planning Committee implemented the overall balance of the quota allocation at both provincial and industry level. Then, the quota was allocated to provincial authorities and ministerial levels, and candidate issuers were then chosen and approved at the provincial and ministerial level before being submitted for approval at the central government level. China Securities Regulatory Commission then reviewed all documents and determined the suitability of qualification for being listed, and the time and size of the shares to be listed on the exchange. If authorization is not given, the public offering will be aborted because it will not be listed anywhere.

In March 2000, the State Council promulgated the Rules on Approval for Stock Issuance, the quota system was abolished and the checking and approval system was also abolished under the new Securities Law instead of approval system only.

<Table 2-2> Quota of Stock Issued, 1993-1997 (RMB Billion)

	1993	1994	1995	1996	1997
Issuance Quota	5	0	5.5	15.0	30.0

Source: Introductory Theory of Securities Market, 1999.

According to the new Rules, the securities companies will select the candidate issuers and then recommend it to China Securities Regulatory Commission with the approval of local government. Based on Securities Law (Article 14), China Securities Regulatory Commission shall set up a Public Offering and Listing Review Committee, examining and verifying issuance application in accordance with law. Comprising professionals in the agency and relevant experts specially engaged from outside. The Committee shall cast votes over a stock issuance application and reach a resolution on it.

When a company issues stocks through a public offering, it must fulfill the following requirements according to the Provisional Regulations concerning the Share Issuance and Trading:

All shares in companies proposing to issue shares to the public at any one time must be of a single class and enjoy the same rights. The promoters of the company must not have been found guilty at any time during the previous three years of grave breaches of the law. They must hold at least 35 percent of the shares while making contributions to the equity of the company equivalent to at least RMB 30 million (US$ 3.7 million).

The proportion of the company's shares, which are offered to the public, must correspond to at least 25 percent of the share capital of the issuing company. A ceiling of 10 percent of the share capital applies to the number of shares that may be placed among employees of the issuing company. Issues of shares in companies with share capitals of at least RMB 400 million (US$ 48 million) may, subject to the approval of the China Securities Regulatory Commission, carry out public issues of less than 25 percent of their capital but a floor of 15 percent is applicable.

China Securities Regulatory Commission also has a heavy hand in setting Initial Public Offering (IPO) prices. To guarantee the success of IPOs, their pricing is artificially set at a P/E ratio between 15 and 20, which is far below P/E ratios (currently averaging over 40) in the secondary market. This has made investment in the primary market relative a risk-free event and has driven IPO underwriters to compete fiercely. Based on Securities Law, in case premium issuance is adopted for a stock issuance, the issuing price shall be negotiated and determined between the issuer and underwriter, subject to the verification of China Securities Regulatory Commission.

Secondary Stock Market

At present, China's stock trading system mainly consists of two stock exchanges. Originally, it was made up of a group of independent local exchanges. With the improvement of the stock market's regulatory system and operational mechanisms, China's stock exchanges have developed into integrated marketplace with nationwide coverage. 90 securities companies and more than 2400 stockbrokerage agencies in large and medium-sized cities form a web for stock transactions all over the country. The Shanghai Stock Exchange and the Shenzhen Stock Exchange are non-profit legal entities governed by a board of directors and employing a membership system. Only full members are allowed to trade on the exchange. Only institutions related to the securities business can apply for memberships. Trading is limited to spot transactions, and no futures transactions are available yet.

To minimize paper works, Shanghai Stock Exchange and Shenzhen Stock Exchange use a computerized trading system based on the principle of price priority and time priority. The system automatically matches the closest ask and bid and has a capacity of 5,000 deals per second, equipped with the largest satellite-based telecommunications network for securities trading in China.

By October 1997, there were 559 members in Shanghai Stock Exchange with 5670 seats and 394 members in Shenzhen Stock Exchange with 1324 seats. More than 39 million individual investors had opened stock accounts in China. Annual turnover was RMB 2354.4 billion (US$ 287 billion) in 1998 according to table 2-3.[5]

Listed Companies

In the early stages of the establishment of Shanghai Stock Exchange and Shenzhen Stock Exchange, the number of listed companies totaled only ten. Consistent with speeding up the state-owned enterprises reform and the rapid development of the stock market, the number of listed companies was up to 909 according to table 2-4 and with the total of raised capital RMB 394.9 billion (US$ 49.4 billion) by July 1999.

Listed companies were mainly distributed in coastal regions at the beginning of the reform, and then gradually extended inland toward mid-west areas. Currently, the distribution of listed companies covers almost all the provinces and municipalities in

<Table 2-3> Turnovers of the Two Stock Exchanges, 1992-1998 (RMB Billion)

	1992	1993	1994	1995	1996	1997	1998
A Share	65.02	356.2	800.3	431.8	2105.2	3029.5	2341.8
B Share	3.11	10.5	12.5	7.79	27.99	42.66	12.65
Total	68.13	366.7	812.8	439.97	2133.19	3072.16	2354.45

Source: China Securities and Futures Statistic Yearbook, 1998.

<Table 2-4> Changes in Number of Listed Companies, 1990- July 1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	7/1999
SHSE	8	8	29	106	171	188	293	383	438	n.a.
SZSE	2	6	24	77	120	135	237	362	413	n.a.
Total	10	14	53	183	291	323	530	745	851	909

Source: China Securities Newspaper, Jan 1, 1999; CSRC.

[5] See Zhou Zhengqing (1998).

China.

An enterprise that wants to be listed on the exchange has to transform its structure into company limited by shares and its setting up has to receive the administrative approval from higher authorities, mainly from the State Economic and Trade Commission. Listing requirements according to Company Law and Provisional Regulations concerning Stock Issuance and Trading are as follows: a) It must be company, which was established as or has changed its structure to that of a shareholding company with the approval of the competent governmental authorities and issued its stock to the public. b) The value of all issued shares (face value) could not be less than RMB 50 million (US$ 6 million). c) The company must have been profitable for the past 3 years. d) The number of shareholders who own more than 1000 yuan (face value) should not be less than 1000, and the proportion that is offered to the public must account for at least 25 percent of the total shares. If the issuance with share capital is over RMB 400 million (US$ 48 million), the proportion of public issuance can be reduced to a floor of 15 percent.

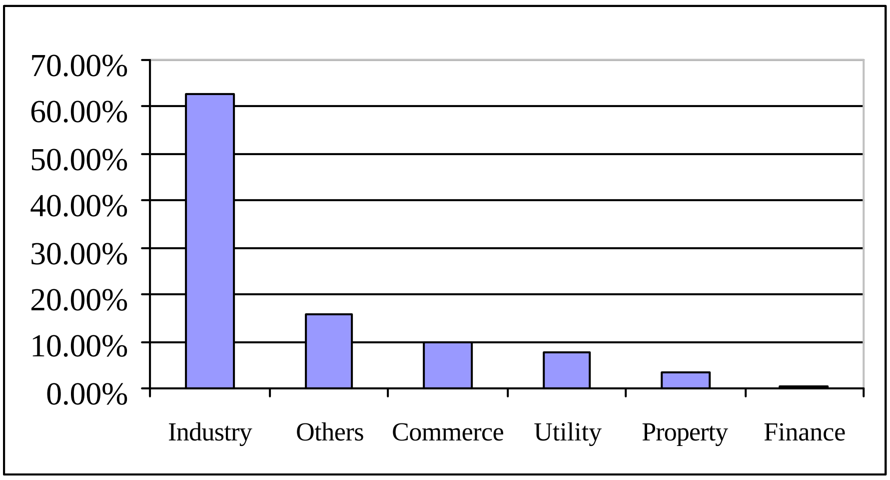
Since 1993, the government encouraged major state-owned enterprises to be listed on the exchanges. In an effort to carry out national industrial policies and reallocate productive factors more efficiently among industries and enterprises through the stock markets, the policy of issuance of new stock began to incline to the strategically important industries and the large-, and medium-sized state-owned enterprises. In 1999, Zhou Zhengqing, the chairman of China Securities Regulatory Commission, also promised the high-tech companies with strong growth prospects will have top priority in upcoming listing. [6] Figure 2-4 shows that the categorical structure of listed companies changed from mainly focusing on real estate, commerce

[6] See Semkow (1999).

to raw materials, petrochemicals, information technology and other pillar industries, such as automobile and electronics. For example, “Shanghai Automobile” and “Yiqi car” have raised more than RMB 2 billion by initial public offerings in A share market. Recall that A share, denominated in the Chinese currency, RMB, subscribed for and traded in RMB by domestic investors. China wants to develop these sectors not only to modernize its industries, but also to create new economic growth sources.

A large number of listed companies have reached the head of their industries by stock issuing, stock splitting, and merger and acquisition activities. The stock market brought forth the emergence of China’s conglomerates that will be able to compete with foreign multi-national corporations. For instance, at the time when Sichuan Changhong was established in mid 1980s, its total assets were less than RMB 0.2 million (US$ 25,000). After the transformation of its structure into a shareholding company listed on the exchange in 1992, Sichuan Changhong’s asset-liability ratio changed rapidly. By the end of 1997, it had raised RMB 2.9 billion (US$ 350 million) and had produced 4.8 million TV-sets in 1996 only.

<Figure 2-4> Structure of Categorical Industry of Listed Companies, 1998



Source: Securities Times, December 18, 1998.

Statistics shows that state-owned enterprises have operated in a far more efficient and profitable manner following the change of enterprises' structures. From 1993-1996, the average asset profitability ratio of listed companies was 6.85 percent, and that of other state-owned enterprises was 1.97 percent. Average labor productivity of listed industrial companies was 42.6 thousand yuan/per person, but that of non-listing state-owned enterprises was only 16.4 thousand yuan/per person.[7]

Securities Companies

Before establishments of Shanghai Stock Exchange and Shenzhen Stock Exchange, the Chinese securities companies mainly engaged in the trading of various kinds of bonds. Since 1991, with the development of stock markets, the numbers of securities companies grew quickly and focused their businesses on almost all the areas traditionally reserved for investment banks. Stock issuing and trading have been the main part of securities companies business.

Securities companies developed very fast during the period of 1991-1996. At that time, People's Bank of China, Ministry of Finance and the Specialized Banks established their own securities departments one after another. In October 1992, in accordance with the boom of China's stock market, the Chinese government established three major securities companies, Huaxia, Guotai, and Nanfang in Beijing, Shanghai, and Shenzhen, respectively. The securities companies that are backed by banks gradually consolidated their dominating role in securities underwriting and other securities businesses. The number of securities companies increased from 44 at the end of 1990 to 87 by October 1992, and business related to stocks grew fast in terms of business on bonds.

[7] See Zhou Zhengqing (1998).

The competition among the securities companies became fiercer and fiercer due to the limit of listed shares and excessive numbers of securities trading agencies. Some securities companies began to involved in speculation of trading of shares or futures on the markets in order to survive. The over speculation and high risk in the China's stock market forced the government to adjust and regulate securities companies since the middle of 1996. Securities companies were separated from the central bank in order to assure the supervisory independence of People's Bank of China. 47 companies have been separated from branches of People's Bank of China since then. From October 1996, 763 securities agencies were separated from other financial institutions, such as commercial banks and insurance companies, by means of rescinding licenses, transferal or merger.

In November 1997, State Council determined that China Securities Regulatory Commission took charge of the supervision of both securities companies and the securities market, instead of People's Bank of China. All of these measures paved the way for the sound development of China's securities companies.

A surge of mergers and acquisitions (M&As) of the securities companies has emerged since 1996. At first, M&As happened as a result of the separation of the securities industry from the banking system and readjustment of the composition of securities companies, such as market entry permission and reorganization of the securities companies. M&As also grew as the securities companies expanded the size of their equity capitals, or merged and restructured the bankrupted securities companies.

The distribution of the securities companies geographically is corresponding to the demand of the market. Only a small number of securities companies are located in northwestern and southwestern parts of China consistent with the small number of listed companies there. However, in developed regions, such as Shanghai, Guangdong and Jiangsu, the securities companies are not only evident in concentration geographically, but also much bigger in terms of capital size as well as have strong impacts on primary and secondary markets. Table 2-5 shows the distributive situation of the securities companies.

As for the size of assets, the average asset of 96 securities companies was RMB 1.66 billion (US$ 200 million) in 1996. 20 percent of the securities companies owned 80 percent of the total assets, around RMB 128 billion (US$ 14.4 billion). The average asset of these major securities companies was about RMB 5 billion (US$ 600 million). Table 2-6 indicates the total assets of top 20 securities companies. In 1997, 46 securities companies of more than 100 competent underwriters undertook the underwriting of shares for 131 listed companies, of which, 15 underwriters occupied 74 percent share in the market.[8]

During the short period of China's stock market development, the number of securities companies and their trading agencies increased at a rapid pace. But Because of the small size of the capital, many of securities companies have been weak in resis-

<Table 2-5> Distribution of the Securities Branches

	Number of Securities Branches	Percentage (%)
Shanghai	586	20.1
Guangdong	416	14.26
Liaoning	179	6.1
Jiangsu	158	5.4
Sichuang	154	5.3
Zhejiang	150	5.14
Beijing	149	5.11
Hubei	130	4.46
Shandong	109	3.7
Tianjing	93	3.2
Total	2124	72.8

Source: China Securities Newspaper, April 1, 1998.

[8] See Choices Facing the 21st Century (1999).

ting the risks in the stock market. And also due to the overlapping business lines among the securities companies as well as the imbalance of market shares, resulted in the serious pressures of the long-term buyer's market. It can be predicted that a new surge of M&As among China's securities companies will emerge in the near future. Meanwhile, compared to the well-known investment banks in the world, the size of the capital of China's securities companies is pitifully small. For instance, in 1997, the total asset of Merrill Lynch Inc. was US$ 292.819 billion. At the same time, the total assets of all the 90 domestic securities companies were only around RMB 200 billion (US$ 24.4 billion).[9] The new surge of M&As will also happen due to fiercer competition caused by immigration of foreign investment banks after China joins the WTO and GATS.

Investors

As table 2-7 shows, the number of investors has increased at an amazing speed in China. From 1992-1998, the number of investors increased by a factor of 18. However, contrasted with the mature stock markets, the proportion of institutional investors in China is quite small according to table 2-8. In particular, the investment

<Table 2-6> Total Assets of the Top 20 Securities Companies, 1998 (RMB billion)

Position	Name	T- Assets	Position	Name	T- Assets
1	Junan	17.56	11	Jiangsu	4.81
2	Shenwang	16.73	12	Guoxin	4.54
3	Nanfang	15.53	13	Zhongxin	4.12
4	Huaxia	11.06	14	Guangdong	4.06
5	Haitong	10.27	15	Dapeng	4.03
6	Guangfa	6.91	16	Shandong	4.0
7	Anshan	6.5	17	Guangda	3.12
8	Shanghai	5.68	18	Zhaoyin	3.0
9	Lianhe	5.43	19	Beijing	2.52
10	Guotai	5.1	20	Hubei	2.45

Source: Securities Industry, July 1998.

[9] See Tian Baoliang (2000).

funds, which have already played an important role in the mature market, are extremely small in China. The majority of investors are individual investors.

The fluctuation of China's stock markets to date, while attributable to a number of factors, can be viewed as a function of their continued small size and consequent vulnerability to manipulation. On the one hand, companies listed on the exchange were subject to government approval. Because very limited stocks were available on the market, the P/E ratios of quite a few stocks could be as high as over 500 or even above 1000. On the other hand, as the individual investors are poorly informed and have little understanding of the stock fundamentals, they would bid up the prices of the stocks that were in scare supply. Many people perceived that the government would not allow the price to go down and it would go up and up. Investing in stocks seemed to be a low-risk and high-return option for many investors without realizing the inherent risks.

Since 1980s, the increase in institutional investors represented by pension funds, insurance funds and mutual funds was rapid in western countries' stock markets. Statistics showed that the total assets of institutional investors in the countries of the

<Table 2-7> Increase in the Number of Investors, 1992-1998 (Million)

	1992	1993	1994	1995	1996	1997	1998
Number	2.1665	7.7766	10.5898	12.4247	23.0723	33.3333	39.107

Source: Choices Facing the 21st Century, China's Securities Industry Association, 1999.

<Table 2-8> Structure of Investors, 1998 (Million)

	Shanghai	Shenzhen	Total
Institution	0.0626	0.0932	0.1558
Individual	19.9271	19.0241	38.9519
Total	19.9897	19.1173	39.107

Source: www.csrc.gov.cn, *1999.*

Organization for Economic Cooperation and Development (OECD) increased from US$ 32,000 billion in 1981 to US$ 243,000 billion in 1995. At the same time the total market value for shares in the world market was US$ 180,000. The institutional investors played the main role in the stock markets at the time when their assets increased to an astonishing level. In the United States, institutional investors owned more than 50 percent of all shares, which accounted for three-quarters of total turnover on the New York Stock Exchange.

In China, the number of institutional investors is very small. Besides unsophisticated individual investors, the mature and sophisticated institutional investors have not developed. In November 1997, China Securities Regulatory Commission promulgated the new Provisional Regulations on Securities Investment Funds. Fourteen funds have since been established under the Regulations, raising a total of RMB 32 billion (US$ 3.9 billion) by the end of 1999. Of the 14 funds, the first 10 were each capitalized with RMB 2 billion (US$ 244 million), accounting for 0.25 percent of the total market value of RMB 800 billion (US$ 97.6 billion) in A share market.[10] By October 1996 it was reported that China had 75 officially approved funds of which 22 were listed. The largest was the Tianjin fund only with RMB 580 million (US$ 70.7 million), while the smallest one only 10 million (US$ 1.2 million). Compared to 1,473 funds authorized for sale in Hong Kong at the end of 1997 (with a total net asset value of approximately HK$ 1,000 billion), the potential for developing the investment fund industry in China is immense.

The Provisional Regulations on Securities Investment Funds have established relatively clear and concise rules governing the establishment and operation of investment funds and, to a large extent. It has provided a framework within which

[10] See Millward and Qiao (1999).

participants' rights are clearly defined, albeit under the overall supervisory and discretionary control of China Securities Regulatory Commission.

Lack of sophisticated institutional and individual investors in China illustrates the rampant speculative behaviors on the markets. Firstly, there is a high transfer rate in stock trading, which is much higher than that of mature markets. Secondly, the manipulation of the stock markets happens quite often. Some institutional investors or individual "big accounts" (Dahu) control stock prices by taking advantage of their big amount of capital and information. In many cases, this kind of behavior is usually under some kind of agreement, or even supported by the listed companies.

Regulatory Framework

China Securities Regulatory Commission

At the beginning of the establishment of Chinese stock markets, due to the lack of regulation and supervision, China's stock markets were driven primarily by rumor and speculation. Legislation on securities came under the jurisdiction of a number of ministries and commissions under the State Council. There was not only an overlapping of legislative power, but also a lack of demarcation of the administrative and supervisory functions at different levels and in different departments. Because of multiple regulators, there exists high transaction costs and low efficiency.

In October 1992, the establishment of State Council Securities Commission and China Securities Regulatory Commission marked the formation of this regulatory body. The State Council Securities Commission is the state authority responsible for exercising centralized market regulation. The China Securities Regulatory Commission is its executive arm responsible for conducting supervision and regulation of the securities markets in accordance with the law.

The State Council Securities Commission and China Securities Regulatory Commission gradually monopolized their administration over the markets year by year. However, they shared their regulatory powers initially with People's Bank of China and several competent government agencies. The large number of regulators made for high transaction costs for companies seeking listing. In November 1998, the state held the National Finance Conference and decided to reform and reorganize the national securities regulatory mechanism. The central securities authority will supervise local securities regulatory departments directly. Organizations engaging in securities businesses that were formerly supervised by People's Bank of China were put under the centralized supervision of China Securities Regulatory Commission.

In April 1998, pursuant to the State Council Reform Plan, the State council Securities Commission and the China Securities Regulatory Commission were merged to form one ministry rank unit directly under the State Council. Both the power and the functions of the China Securities Regulatory Commission have been strengthened following the reform. A centralized securities supervisory system was thus established.

China Securities Regulatory Commission had gradually been accumulating power in the years leading up to the law's passage, and the new Securities Law further strengthens its position. The Law formally grants China Securities Regulatory Commission many of the powers it is already exercising, but for which it previously lacked a clear legal basis. As a result, China Securities Regulatory Commission now enjoys legislative, administrative, supervisory, regulatory, investigative and disciplinary powers in the securities sector, subject to only a few restrictions.

Legislation Related to the Stock Markets

For years, in an effort to regulate China' s stock market, the fundamental system of regulation of the stock market has gradually taken shape. The legislation of stock markets in China went into a new stage after the establishments of State Council Securities Commission and China Securities Regulatory Commission. Since 1993, the state promulgated a series of regulations and measures.

In April 1993, the State Council issued the first important regulation of China' s stock market – Provisional Regulations concerning Stock Issuance and Trading. The regulation provided formal nation-wide standards for stock transactions in China. It addresses such matters as stock issues and trading, takeovers, custody, clearance and registration of shares, information disclosure, inspection and penalties, and dispute resolution. The newly amended Criminal Law in 1997 added to provisions on securities crime and its penalties, which ended the history of a lack of a systematic criminal measures to safeguard the stock market in China.

On July 1 1994, the Company Law of PRC became effective. This is the first law that regulated corporations and listed companies as well as shares issues. The Company Law organizes the basic corporate framework in which shares and bonds may be issued and transferred. For instance, the Company Law indicates which forms of company may issue shares and bonds to the public, the internal corporate procedures to be completed to approve such issues, how registered and bearer shares and bonds are transferred, under what circumstances shares may listed and traded on stock exchanges.

The landmark Provisional Regulations on the Administration of Qualifications of Domestic and Foreign Securities Institutions Dealing in Foreign Investment Shares became effective on December 1, 1996. The regulations aim to standardize the qualifications of domestic and foreign securities institutions, such as brokerages and underwriters, that deal in foreign investment shares listed on the Chinese market and domestic securities institutions that deal in foreign investment share listed outside China.

The Provisional Regulations Banning Entrance into the Securities Industry was promulgated in March 1997. The Regulations outline various securities violations for professionals working in the securities industry. China Securities Regulatory Commission may determine that directors and other senior management of listed companies, securities institutions, settlement and clearing institutions, as well as professionals, etc, will be banned from the securities industry in the case of contravention of the regulations.

At present, more than 250 sets of measures and regulations relating to stock markets have been laid down. A basic regulatory framework on China's stock market has already been formed. In July 1 1999, the long-awaited Securities Law of the PRC came into effect. It is the first comprehensive national law on securities in China.

Securities Law

The Securities Law is intended to provide a framework for rationalizing the great many extant, narrower rules, measures and regulations that touch on securities matters, which apply to the issue and trading of shares, corporate bonds and other securities. (Excluding Hong Kong) Shares of companies reserved for foreign investment, like B shares and H shares, are governed by measures made by the State Council.

Various restrictions are placed on the kinds of individuals and funds that may enter the market. Most stringently, officers and employees of stock exchanges, securities companies, and securities regulatory authorities may not engage in share trading, whether directly or indirectly. Bank funds may not enter the market. Many kinds of activities are outlawed. Brokers may not lend stocks to their customers. State-owned enterprises may not engage in share " speculation", and so on.

In an effort to counter the speculation and volatility in China's stock market, the Securities Law imposes more discipline on, and clearly defines the liabilities of, all market participants, including listed companies, underwriters, brokers dealers, and law and accounting firms. But it is the securities companies that are being forced to change the most, in ways that will have a deep and lasting impact on the development of the market.

Securities companies will be divided into comprehensive and brokerage securities companies. Those in the first category may offer a full range of services, from brokerage and trading on their own accounts, to underwriting new issues. Those in the second category can only act as brokers for their clients. To qualify as a comprehensive securities company, a company must have a minimum capitalization of RMB 500 million (US$ 60 million). Among more than 90 securities companies presently, only about 16 larger companies will be able to satisfy this requirement according to appendix 2. It is also understood that some smaller companies do not even have a large enough capital to qualify as brokers. The order to change has been signaled, and restructuring, merger, recapitalization and closure of securities companies will be anticipated.

Trust companies must be separated from banks, insurance companies and securities companies, and as such may no longer engage in securities business. It is estimated that almost all of the trust and investment companies in existence, numbering more than 240, are engaged in securities business, which accounts for about 60 percent of their turnover. After July 1999 if these companies are to stay in the securities business, they must either convert or merge with other companies into securities companies, or spin off their securities operations as separate securities companies, or take other appropriate actions.

The Securities Law attaches severe liabilities, which set forth detailed penalties for different kinds of violations. Chapter 11 of Securities Law contains 36 sections on the details of administrative punishment for violations of Securities Law, including the forfeiture of unlawful income, fines, and business license revocation. Seventeen of those sections impose criminal liability, which is unusual for a commercial law.

In short, consistent with the central government's open stance on these matters, the Securities Law embraces as its goals the standards of advanced securities markets around the world, namely, that a securities market should be open, accessible and fair. Subsumed under this cardinal principle is the requirement that market participants' act voluntarily, honestly and for good consideration; the exhortation that laws be observed; and the prohibition of deception, insider dealing and market manipulation. The impact this new law will have on the market should not be underestimated.

Conclusion

The birth of the two stock exchanges was a milestone in the history of China's securities industry. It not only promoted the development of the securities industry, but also had a significant impact on both social and economic advances. It accelerated the further reform of economic system, especially in the field of experimentation in shareholding and modern enterprise systems, and played a very important role in the formation of China's fully-fledged capital market.

China's stock markets have grown very rapidly since its inception. It has emerged from virtually nonexistence to become a major segment of the country's financial sector and also grew from small to large and from a regional market to a national market. The numbers of listed companies, intermediaries and investors increased rapidly. A relatively sound stock market system especially regulatory and supervisory system has been built.

However, China's stock market is still in a very primitive stage of development. The size of markets is far smaller than that of other emerging markets, let alone mature markets. In 1995, the ratio of stock market capitalization to GDP was 95.5 percent in the United States, 83.5 percent in Japan and 121.7 percent in Britain, respectively. The ratio was also very high in many emerging markets. It was 259.4 percent in Malaysia, 194.8 percent in Singapore, 46.4 percent in South Korea, respectively, but in China, only 5.96 percent in 1995.[11]

China's stock market that initiated from the socialist system is characterized by the transition from a planned economy to a market economy and imprinted many elements of the planned economy. Lots of problems and issues, left over by history, remain to be solved. For example, the non-tradable state and legal person shares, the segmentation of A and B shares and standardized operation of listed companies and securities companies. The next section of this paper will discuss these issues in greater depth.

[11] See Zhou Zhengqing (1998).

PART III ISSUES FACING CHINA' S STOCK MARKET

Introduction

The origin and early development of China' s stock market are different from practices of western countries. From very beginning China' s stock market is hedged under the central planning system that is doomed to be an abnormal. The emergence of the stock market in China was the result of top down transformation of China' s economic system. To some extent, the public ownership and a non-market economy usually do not provide the conditions necessary for the development of a truly functional stock market.

After the birth of new China, the state adopted the centralized planned system for socialist construction for more than 30 years, but the result was not satisfactory. Since the end of 1970s, the government launched economic reforms and tried to promote socialist productivity by experimenting with various development models. It has been proved that the shareholding system is an effective approach to promote both socialist economic reform and development, especially the reform of state-owned enterprises.

The shareholding system grew exceptionally fast as soon as China adopted transitional economy. Due to the inexperience of policymakers many rules and regulations are lagging behind to ensure the growth and supervision of shareholding firms and stock markets. Therefore, it is inevitable that many of the problems were not solved at that time.

State Shares and Legal Person Shares

Reasons for Introduction of State Shares and Legal Person Shares

As of the middle of 1980s, the reform of the Chinese economy stepped into a transitional period between two economic systems. Before 1992, the planned economy was in a dominating position and the market economy grew in a rather limited scale. The historical problems left over within the stock markets mainly originated from the period before 1992.

During the period of economic transition, economic operation still followed the traditional planning management model. The stock system was a totally new field for Chinese policy-makers. They were accustomed to taking the issues of state shares and legal person shares into account only from the viewpoint of the planned economy. The government deregulated the management of the traditional planned economy slowly and gradually allowed the market mechanisms to work. It was difficult for the government to legislate appropriately in matters concerning the stock markets, as they had no prior experience of such capitalist systems.

Prior to the economic reform, the system of unitary ownership of enterprises had been in existence for decades. The ownership structure of an enterprise either took the form of state-ownership or collective-ownership. Under the centralized planning economy, the state had discretionary power to set the price of all products that were produced by state-owned enterprises regardless of the size of supply and demand, as well as the allocation and transference of assets among state-owned enterprises. The collectively owned firms, however, could set the price based on the principle of exchanges of equivalent. The state could not interfere in their financial affairs, such as profit allocation and employment of workers. Under this system, the standards of price setting were different between state-owned enterprises and collectively owned firms. If two forms of ownership existed within one enterprise, it would lead to two results - either the state encroaching on collective assets or the collective encroaching on the state's assets. The segregation of different forms of ownership seemed to be reasonable under the planned economy system. But meanwhile, the people were shackled with the ideologies of the traditional ownership. Following the emerging of the shareholding system, there was concern regarding the trading of state shares and legal person shares within the policy making circle: it may erode the state's position of majority shareholding in state-owned enterprises. They were afraid that trading of state/legal person shares would damage the state's holding of its assets with the result of losing their dominant position in national economy.

On the other hand, during the period of shareholding experiments, the largest shareholder was usually the line ministry that was in charge of this enterprise. Under the planned economy, the line ministry and local bureaus took charge of the management of state assets that fell within their jurisdiction to the limits of their authority. The state assets that were controlled by one department were difficult to be transferred to the other departments. This system resulted in a departmental system and of management style of state assets. After the emergence of shareholding enterprises, the departmental system was almost broken down mainly due to the existence of cross-shareholdings among enterprises as legal person shares. If the state and legal person shares are allowed to be traded in the secondary market, it will become difficult to control the shares that the authorities owned before. It also means that the power of the authorities could be laid aside. The authorities responsible for the management of state assets were surely set against the trading of state/legal person shares. In 1992, the State Economic System Reform Committee proclaimed the regulations concerning companies limited by shares and limited liability companies, which clearly divided the companies shares into three forms: state shares, legal person shares and individual shares. Thus, the departmental system of ownership could be maintained as long as restriction on the trading of state/legal person shares was observed and such assets were not allowed to flow out to other departments or individuals.

With the rapid growth of stock markets, restriction on trading state/legal person shares has showed lots of disadvantages. For instance, the value of state assets cannot be increased; the enterprises' assets cannot be optimized and restructured and the advantages of shareholding economy cannot be realized to its fullest extent. The tremendous amount of untradable shares limits the function of stock markets as a mechanism to evaluate the management performance of listed companies and poses a serious threat on the secondary market, which made the government unable to solve this problem in time.

Restrictive elements on Trading of State Shares and Legal Person Shares

At present, the total amount of untradable shares is almost 2 times as current tradable shares in the market, of which the state shares accounted for 34.25 percent of total shares in 1998 according to table 3-1. In addition, the data on December 30, 1997 shows that a total of the market capitalization of tradable A shares was RMB 478.497 billion, while total market capitalization of untradable A shares was RMB 1221.383 billion on that day, which was 2.55 times of tradable A shares.[12] The impacts on the stock markets will be tremendously serious if such a huge amount of shares are listed on the exchanges. It may lead to a crash of the market to a large extent because of limited market capacity and vulnerable investors. From the policy-

[12] See Jin Dehuan (1998).

makers points of view, it must take time to nurture the rational investors, especially individual investors. In addition, even if the state/legal person shares could be traded in secondary market, such huge amount shares might form the power to manipulate the market. This will not only shake the vulnerable China's stock markets, and undermine the stock market development, but probably also cause serious social unease.

As common shares, state shares and legal person shares should enjoy the same rights and profits, as the individual shares should. However, individual investors lack the equal rights compared to state and enterprises holders because of unequal purchasing prices. In general, if the state shareholder purchases the shares at their face value, say, one yuan per share, the legal persons can only buy at 3.5 yuan per share. But the individual investors are supposed to buy their shares at the fixed price of at least six times or even more than ten times the stock face value. If the government allows the state/legal person shares to enter into the market without reasonable compensation for the individual shareholders, it is not only be unfair to the latter but also detrimental to stock market development. Moreover, when listed companies split their shares, the state usually doesn't have enough capitals to buy these splitting shares, and has to transfer the ownership to other legal persons or individuals. If things continue in this way, the percentage of state equity will decrease rapidly over the years. Once the state/legal person shares are allowed to be listed on the market, the problem could become more complex and serious. Therefore, an efficient state assets management and operation mechanism will guarantee the trading of state/legal

<Table 3-1> State Shares of the Listed Companies (Billion)

	1992	1993	1994	1995	1996	1997	1998
State shares	2.85	19.022	29.647	32.867	42.301	61.228	86.551
Total shares	6.887	38.773	68.454	84.842	121.945	194.267	252.679
Percentage	41.38	49.11	43.31	38.74	35.42	31.52	34.25

Source: China Securities Newspaper, May 10, 1999.

person shares on the market and ensure the same rights will be enjoyed among the individuals, state and enterprises shareholders. The most important thing is to safeguard the value of state assets to be maintained and added.

Another important restrictive element on trading of state/legal person shares is the lack of a favorable environment such as mature investors, stable capital inflow, and a perfect legal system.

Due to the deep-rooted ideologies formed under the central planning system and the high risk in stock markets, many people would rather put their cash in banks than invest in stocks. Right now, deposits and cash mainly composed the financial assets of urban residents in China. Table 3-2 shows that the composition of financial assets in China. So, how to change the concept of depositors is quite important for trading state/legal person shares. In addition, although the basic principles on the stock markets are fairness, openness and justice, due to the heavy influences of planned economy, the competent security authorities always administered stock markets with lots of government intervention. The management of stock markets was usually done through administrative means rather than laws.

<Table 3-2> Composition of Financial Assets in China, 1978-1995 (RMB Billion)

	1978	1986	1991	1995
1.A total of financial assets	321.75	1596.82	4640.40	12726.58
2.Percentage of non-banking financial assets to the total(%)	0.40	2.80	6.60	10.10
3.The total financial assets of enterprises and residents	152.75	748.16	2131.46	7463.40
4.Percentage of deposits and cash to the total financial assets of enterprises and residents (%)	99.02	91.00	87.12	89.86
5.Percentage of non-banking financial assets to the total financial assets of enterprises and residents (%)	0.98	6.00	12.58	17.11
6.In which (5), % of stock market value to non-banking financial assets	0.00	0.00	1.86	6.93

Source: Wang, Liya, Present Situations of China's Capital Market, 1997.

Analysis of Trading Models for State Shares and Legal Person Shares

To regularize and internationalize China's stock market, the problem of trading state/legal person shares on the markets must be addressed first. But obviously, under the present condition, it is impossible to raise a huge amount of money to make all the state shares and legal person shares listed on the markets. Almost RMB1000 billion (US$ 122 billion) or 1500 billion (US$ 182.9 billion) are required to be injected in the markets in order to activate state/legal person shares based on their market values. Some people proposed that issuance of new stocks should be suspended for two or three years so as to ensure the problem solving of trading of state/legal person shares. This suggestion might be beneficial for trading of state/legal person shares on the markets, but the suspension of issuing new stocks could not only slow down state-owned enterprises' reform inevitably, but also affect the pace of entire economic reform adversely.

Evidently, it is unrealistic to make a package plan for trading of state/legal person shares on the markets instantly. But it is feasible to experiment various trading models on state/legal person shares according to different situations and conditions that will pave the way to eradicate the problem eventually in the foreseeable future. The trading models involved the following:

Changing part of state or legal person shares into preferred shares. Compared to common shares, the preferred shares enjoy two "priorities": one is priority of reaping dividends. Namely, earnings of the company will be distributed to preferred shareholders earlier than common share holders. In general, the rate of earnings on preferred shareholders' equity is higher than that of common shares. The other one is priority of residual claimant. Namely, whenever the company restructures or bankrupts, preferred shareholders have precedence to claim an indemnity. Because of these features, when a company issues the preferred shares, it usually attracts a number of investors; especially those who want to reap the regular earnings. If a part of state/legal person shares could be changed into preferred shares, it could kill two birds with one stone. Firstly, changing the structure of ownership in order to solve the problems of concentration of powers in a few hands. Secondly, alleviating the stress of trading state/legal person shares on the markets. According to international practice, preferred shares can be traded on the markets. The purpose of most shareholders holding preferred shares, however, is mainly for the relative stable long-term earnings rather than speculative profits by transferring shares often on the markets.

Issuing convertible bonds. The state or listed companies could issue a special convertible bond. Investors who purchase the convertible bonds could convert the bonds into shares according to the prior agreement of the time limit and price setting. During the agreed convertible period, however, if the share price becomes higher than convertible price as agreed, investors could convert the bonds they hold into shares. A part of state/legal person shares can be traded through this way on the markets finally.

Compared to treasury bonds, the interest of convertible bonds could be much lower. State could not only raise funds immediately by issuing convertible bonds, but also postpone the timing of trading of state/legal person shares on the markets. Meanwhile, the convertible bond itself is one kind of tradable securities and can be listed on the exchanges.

Establishment of specialized investment funds. The specialized investment fund was established to purchase state/legal person shares, especially state shares. The investment funds could be sponsored by state owned non-financial institution and also could be raised from the public. The minimum proportion of the funds, which must be invested in trading of state/legal person shares, should be no less than 55 percent.

State or listed companies could transfer all or parts of their shares to the specialized investment fund with reasonable prices. These transferred shares could be frozen for a certain period, say 3-5 years before they are traded on the markets. The setup of investment funds that are particularly used to transact state/legal person shares could not only produce a cushion effect for market fluctuation resulted from trading of state/legal person shares, but also make stock markets develop stably and soundly. Furthermore, as the state-owned institutional investors, the specialized investment fund will have a capability and responsibility to adjust the market when it comes into distorted volatility.

Changing state/legal person shares into employee shares or B shares and American Depositary Receipts (ADRs). For the legal person shares, it may be more suitable to be transferred to the company' s employees. In order to regulate operation of employee shares, a specialized institution is suggested to be set up for taking charge of management of employee ownership inside an enterprise. In-service employees cannot withdraw or trade the shares. Employees can transfer employee shares only when they retire or leave for other company.

In China, employee shares can be traded on the markets after a certain period of restriction pursuant to relevant regulations. But because the much lower purchase price of the employee shares in comparison with the issuance price to the public, in order to get premiums between the primary market and secondary market, a number of employees sold the shares they held immediately when these share were allowed to be traded. To some extent, the nature of employee shares has already been changed into "beneficial shares", contrary to the initial purpose of issuance of employee shares. Therefore, certain restrictions on transaction of employee shares are necessary in the case of transferring of legal person shares to employee shares. Appendix 3 indicates that the U.S. Employee Stock Ownership Plan, which ties employee's pension with the firms' long-term performance, is also a useful scheme to correct the short-term behavior of the Chinese worker shareholders.

As for selling a part of state/legal person shares to foreigners, it means to transfer parts of state/legal person shares into B shares or ADRs. Companies, which have issued B shares, could expand the size of issuance. Those that never issued B shares could transfer state/legal person shares to B shares directly. At present, there are only a few Chinese enterprises' shares to be traded on American markets in the form of ADRs. If this suggestion can be taken into account, more and more listed companies will be put into overseas markets rapidly.

Currently more than 10 models for trading state/legal person shares exist in academic circles. However, each model has its limitations. For example, in the case of changing state/legal person shares into convertible bonds, it needs experienced investment banks as intermediaries. Even though approximately 90 securities companies played the role of investment banks in China, they cannot compare in terms of all the aspects with foreign competitors. As for transferring state/legal person shares into B shares or ADRs, there are much more problems with it. Firstly, parts of state or legal person ownership will be changed to foreigners' ownership; it may impair the development of national industry. Secondly, the state authorities have still no final decision to justify the existence of B shares market in the long run.

As discussed above, due to the historical reasons, the issue of state/legal person shares is quite complex, involving both investors' interests and prospects of stock markets as well as the pace of economic reform. Trading of state/legal person shares on the markets should be implemented carefully with regard to their sizes, categories and structures of ownership, and so forth. It should adopt various trading channels in response to different situations of listed companies so that problems can be solved in piecemeal with a result of healthy development of China' s stock market.

A Shares and B Shares

Since the stock market emerged in China in the middle of 1980s, Chinese shareholding companies have issued different stocks to different shareholders. A shares are for Chinese citizens to buy with Renminbi. They account for the majority of all issued shares and almost every shareholding company have A shares. Starting in early 1992, another category of shares, B shares, which are also called " renminbi special shares" was introduced exclusively for foreign investors, and which are priced in RMB, purchased with US dollars (SHSE) and HK dollars (SZSE) through selected Chinese and foreign stockbrokers. The principal of B shares must be foreign exchange, and the companies that issued B shares should pay the shareholders dividends with foreign exchange converted from RMB profit at the current market exchange rate. In theory, B share holders have the same right and bear the same obligations as A share holders.

By the end of July 1999, there were totally 108 B share issuers. Most of companies that issued B shares have issued A shares, too. The A shares and B shares are not substitutable, which means B shares are not convertible to A shares. According to the Company Law, each share of different categories is supposed to have the same right and equal share of the profit and property of the company, but the segregation of stock transactions in a segmented market causes the stock prices to vary considerably. A study showed that daily price discount for the B shares listed on

Shanghai Stock Exchange is 65.62 percent, compared to 48.71 percent for B shares trading on Shenzhen Stock Exchange in terms of A shares.[13]

Compared to the over-speculative A share market, the B share market has been quite inactive and stable, the reasons are probably as follows: a) The requirement of foreign status for B share investors makes domestic investors unable to enter B share market directly. b) The non-convertibility of B shares to A shares and strict segregation between the A share market and the B share market mean that foreign investors have little opportunity to control the listed companies because the majority of shares are A shares. And also state and legal person are usually the leading shareholders. This makes some potential huge investors, like multi-national corporations, lack interest in the B shares market. c) The comparative lack of transparency of the management of listed companies means foreign investors have difficulty in evaluating the value of their shares. As a result the average price and P/E ratio of B shares is much lower than that of A shares, in contrast with the rising A share indices, the B share indices in Shanghai and Shenzhen have kept a flat or even downward trend according to table 3-3.

<Table 3-3> Trading Price of A Share and B Share in the Same Company, December 30, 1996 (Unit: yuan/per share)

	A share	B share	B share converted to RMB	Multiplier
Zhenkong	4.7	0.19	1.58	2.97
Erfang	4.3	0.17	1.41	3.05
Dazhong	16.48	0.83	6.88	2.40
Yongsheng	8.46	0.30	2.49	3.47
Zhongqian	9.93	0.45	3.73	2.66
Zhongfang	4.46	0.17	1.41	3.16
Jiaodai	7.17	0.24	1.99	3.60
Lujian	9.44	0.30	2.49	3.80
Luntai	10.10	0.44	3.65	2.77
Bingxiang	13.22	0.54	4.48	2.95

Source: Shanghai Securities Newspaper, Dec 31, 1996.

[13] See Charkravarty, Sarkar and Wu (1998).

In fact, the purposes of establishment of B share market were to raise foreign capitals, to learn operating experiences from mature stock markets as well as promoting internationalization of China's stock market. At the beginning, in order to prevent foreign capital from flowing into A share market, resulting in turmoil of China's stock market, both segmentation of investors and issuing model was set up artificially. On the one hand, the segmentation of markets was a double sword to protect currently infant China's stock market, and was in the interest of supervision of stock markets by authorities. But on the other hand, segmented markets between A shares and B shares also constrained the stock market development and hampered the circulation of stocks as well as capital financing. Therefore, to standardize the markets along common practice in most other markets in the world, it is necessary to unify the different types of shares and set up an integrated stock market sooner and later.

Merging of A shares and B shares will be a tendency of development of China's stock market. But considering the big price gap between A shares and B shares, tremendous untradable A shares, in which most of them are state shares and legal person share as well as incomplete convertibility of RMB, the process might be difficult and time-consuming. The problem should be handled with great care. Merger of A share market and B share market through market behaviors of diversified market players will be an important aspect that accelerate the problem solving smoothly.

To Set up Sino-Foreign Joint Investment Funds

At the beginning of experiment of merging of A shares and B shares, the contract closed-end investment fund may fit for current situations of A/B shares markets. The joint investment funds must register in China. Registered capital must be no less than US$ 100 million. For the contribution, Chinese party should hold the majority share of capital, for example, 51 percent to 49 percent. The funds must be mainly invested in A share and B share markets. In order to avoid the stock price fluctuation, the proportion of the investment fund, which is invested in the same stock, may not be more than 5 percent. The activities of purchase or selling of joint investment funds in the same stock on two markets can reduce the price gap between A shares and B shares, and promote the merging of A and B shares. From any perspective, if foreign investments are lured to the A share market in the form of closed-end Sino-foreign joint investment fund, not only it is less risky, it can greatly promote the development of stock market.

To Nurture Domestic Institutional Investors

If some competent domestic institutional investors say, 3-5 institutional investors are allowed to invest in B share market, it will be beneficial to both institutional investors and markets development. Firstly, it could precipitate the circulation of B shares and also animate the B share market. Secondly, it could reduce the risks for investors themselves due to the low P/E ratio of B shares in terms of A shares. Finally, it could enhance domestic institutional investors' capability of management and operation in stock markets in order to facilitate the formation of a unified stock market.

To Open B Share Market to Domestic Investors

In September 1996, due to the rampant speculative behaviors in B share markets, the Chinese authorities required that securities registration companies cleared up B share accounts in order to keep the stability of B share market. Since then, domestic institutions and individuals have been subjecting to rigorous restrictions on trading B shares. With the increase of foreign exchange reserve, however, the deposits of foreign currencies registered by domestic residents have hit a high of 40 billion US dollars. The foreign currency cash in hands has reached tens of billions of US dollars by the end of 1998.[14] If parts of them can be channeled into the stock market, the circulation of B shares may be further improved so as to meet the demand of long-term development of the markets. Moreover, if B share markets is dominated only by foreign investors, the implementation of supervision for Chinese securities authorities will become harder and harder. In addition, issuance mode of B shares mainly adopted the practice of private placement, and these raised funds mainly concentrated on medium-, and long-term investment, resulting in inactivity of B share markets for a quite long time.

It is worth noting that renminbi have not realized its convertibility under the capital account. The process to achieve the goal of a fully convertibility of yuan is time-consuming. However, an incompletely convertible yuan does not illustrate that any trial on merging of A shares and B shares could not be performed. In order to pave the way of unifying the China's stock markets, the state needs to formulate new policies for solving this problem, such as, to arrange the special foreign exchange quota; the inflow and outflow of foreign exchange are freely within this quota. Another method is to draw up the specific measure for settlement of exchange on foreign investment and profit, or to open the hedging business for foreigners who intend to invest in A/B share markets, and so on.

[14] See Global Sources: China (1999).

Performances of Listed Companies

Listed Companies Are not Genuine Shareholding Companies

In China, most of listed companies initiated from state-owned enterprises. The state-owned enterprises transformed their structures according to the requirements of shareholding system, but the operation mode and management mechanism of many state-owned enterprises are still in line with the planned economy model. Namely, the corporate structure and operation mechanism has not been modernized in terms of the requirements of company limited by shares or modern enterprise system. These companies could not be called shareholding companies in their real sense.

One of the main goals of China's shareholding system reform is to clarify property rights and delineate the roles of the state and of the enterprises. In theory, the shareholding company should be an economic entity with clear ownership's rights, whose activities on production and operation should only focus on maximizing shareholders' profit and guaranteeing shareholders' rights.

The state-owned enterprises, however, are not endowed with the above characteristics. Their property rights are usually ambiguous because the government or other agencies exercise the roles of both shareholder and administrator. In China, listed companies were set up through administrative procedures under the government approval and checking rather than formed through market requirements. As a consequence, listed companies are characterized by both equivocal shareholder and the poorly defined ownership. Equivocal shareholder means that who can represent the state as state shareholder is not clear, namely, who can shoulder the rights and obligations of state ownership is not clear. The poorly defined ownership means that shareholders' rights cannot be protected on the one hand, what kind of rights and obligations individual shareholders can enjoy is not definite on the other hand. At the same time, the lack of ownership representation in the state-owned enterprises leads to various moral hazard problems, such as managers and workers pursuing their own interests at the expense of the state. Although the introduction of individual shareholders is through public listing, it has not been resulting in a clear separation of ownership and management due to the existence of the huge state shareholders. In many of listed companies, the board members are almost identical to the members of the executive officers. This is regarded as a norm rather than exception. Relatively few outside monitors can exercise strong discipline on these companies. Managers of listed companies usually make decisions that promote their own interest but that damage the interest of individual shareholders. In practice, the directors of board of the listed company are only responsible for the government rather than its shareholders.

In addition, the lack of clear definition of the ownership of listed companies undermines corporate governance because it leaves the issue of who is able to be monitoring the boards of directors and managers of the company. Meanwhile, the operation of the listed companies remains subject to quite extensive administrative control and intervention from various levels of government, causing serious incentive problems that reduces the companies' efforts in enhancing performance. It seems difficult to achieve the goal of a completed separation of the administrative, regulatory and social functions from the commercial functions of enterprises.

Listed Companies Deviate from Standards

Most of the listed companies are more interested in raising funds and making profits through splitting more new stocks in the form of premium placement to original shareholders than in improving their management and lowering operational cost. They invest with raised funds into the fields that not related to their major business without the agreement of shareholders. Some of the listed companies engaged in speculative behaviors in stock markets, and a few even manipulate their own stocks in the markets, resulting in high fluctuation of stock prices and high operation risk of the company itself. Moreover, the listed companies that lack transparency and enough information disclosure are far away from reaching international practice. From 1993-1998, the cases that China Securities Regulatory Commission investigated and prosecuted amounted to 118, of which 91 related to securities contravention and crime. Penalties for 25 listed companies that violated relevant regulations and law included fines, confiscation of profits and suspension of listing.

Low Efficiency of Listed Companies

Because listed companies are not genuine shareholding companies, they are not able to operate according to the principles of standard shareholding companies in practice. Managers of listed companies do not have incentives to improve their management to maximize the profit of shareholders. According to the report of 1998, the income of listed companies averaged 0.24 yuan per share, while 73 listed companies, or 7.12 percent of the total, operated at a loss.[15] For the lower profit level in comparison with the very high stock price, even the dividends of well-performing companies could hardly meet the expectation of their shareholders. It is worth worrying that annual rate of return of listed companies decreased over years according to table 3-4. It is extremely urgent to improve the quality of listed companies and perfect the internal management system, strictly separate the administration and

[15] See global sources (1999).

enterprise management functions, standardize the corporate decision-making procedure and strengthen the responsibility of directors.

Measures for Standardizing Behaviors of Listed Companies

To improve operation and management mechanism

The key of China's stock market development lies in fundamental changes of the operation mechanism of listed companies and also lies in enforcement of standardized management in accordance with principles of shareholding system. Under the current conditions, operation and management mechanism of listed companies has to be readjusted and regulated rigidly.

In the case of state holding, it requires to clearly define the ownership right of state assets. Without a clarified right of state ownership, we can hardly talk about transformation of state-owned enterprises' operation mechanism. To solve this problem, the administrative appointment system of managers of listed companies has to be abolished. The boards of directors and managers should be selected by shareholders in an open forum. In addition, the right of individual shareholders must be guaranteed by law. Individual shareholders should possess the power to select members of the boards, and to have the opportunity to be a member of the boards.

The tremendous untradable state/legal person shares are also the barriers on changing the operation mechanism of listed companies into that of the genuine shareholding companies. At present, almost 65 percent state/legal person shares are

<Table 3-4> Changes in Profit or Loss of Listed Companies, 1993-1999 (Unit: yuan)

	1993	1994	1995	1996	1997	1998	1999
Earning per share	0.35	0.32	0.25	0.23	0.25	0.24	0.10
Loss per share		0.13	0.20	0.37	0.53	0.49	0.21
Ratio of Loss-incurred companies to the total (%)		0.68	5.26	5.85	5.53	7.12	9.52

Source: Securities Research, Jan 1999.

untradable ones, therefore the rest 35 percent tradable shares can not bind operation behaviors of listed companies. For individual shareholders, they rarely joined the shareholders meeting, and they do not even have much information about the listed company they held shares. Therefore, a fundamental factor to bind the behaviors of listed companies on the markets is the issue of tradability of total shares. Likewise, speculations can also be reduced on the fully tradable stock markets. For trading the state/legal person shares, we have already discussed in the previous section.

To enhance transparency and improve information disclosure

China's accounting reforms have been largely responsive to enterprises' reform. By the end of 1998, eight specific accounting standards were promulgated in China in a bid to make listed companies more transparent. In early 1998, China's Ministry of Finance proclaimed a Revised Accounting System for shareholding companies, which governs the preparation of financial statements for listed companies, especially for companies listing overseas (H shares and B shares). The Revised Accounting System set out for various types of provisions, such as doubtful debt provisions, provisions for realizable values of inventory and shot-term investments, and provisions for permanent diminution in value of long-term investment. The new requirements narrow the profit gap between China statutory accounts and International/Hong Kong financial statements. This improves the creditability of China's statutory financial statements and helps to lift the corporate image of B share and H share companies.

A share companies, on the other hand, are not required to prepare International/Hong Kong financial statement, and traditionally, make virtually no provisions. Actually, allowing rather than requiring A share companies to make provisions gives them the opportunity to build up their provisions gradually, and hence avoid a fatal hit on their balance sheets in a single year.

Apart from the requirements for making provisions, the Revised Accounting System also introduces a vast number of new or revised accounting treatments that bring the accounting practices of China's listed companies very close to international practice. Moreover, the disclosure requirements introduced by the Revised Accounting System are very comprehensive, and match the disclosure requirements in many countries, which are continuing to improve the transparency of listed companies.

However, as analyzed above, the problem of the lack of transparency for listed companies is mainly because of the lack of efficient management of supervision by authorities resulted from the lack of the professional and independent auditing. As a result, the application of the detailed accounting standards may not be able to generate financial statements with "a true and fair view". On the one hand, information disclosure of listed companies is neither comprehensive nor in time; on the other hand, the listed companies disclosed information or financial statements usually inaccurate in order to earn manipulation and speculative profit. Therefore, rigid enforcement of the accounting rules and strengthening judiciary power are the keys to solve this problem.

To change ownership structure and strengthen corporate governance

The strengthened corporate governance is essential to improve the performances of listed companies. It includes that improvement of operation and management mechanism, and diversification of the ownership, and also equipment of a proper institutional framework of checking and balance.

Ownership structure significantly affects the performance of listed companies. It directly addresses the question of how corporate governance mechanism can be changed and whether outside investors' interests can be better protected by law. In China, a typical listed company has a mixed ownership structure with three predominant groups of shareholders: state shares, legal person shares, and individual shares – each holding approximately 30 percent of total outstanding shares. The composition of the boards of directors and the supervisory committee, however, is not proportional to the ownership. It is striking to see that individual shareholders have no more than 0.3 percent of the seats on average, even though they possess approximately one third of the total outstanding shares. The state is over represented on the board: 50 percent of positions are filled by government officials. Likewise, the composition of the supervisory committee is also characterized by an extremely low presence of individual shareholders, approximately 0.5 percent for Shenzhen Stock Exchange listed companies and zero for the sample companies listed on Shanghai Stock Exchange.[16]

It seems clear that both the state and legal person rely on their control over the board to influence corporate policies and to protect their interests. The vast majority of individual investors are small shareholders and their interests are not protected. Individual shareholders are in a disadvantageous position because of the lack of proxy voting procedures. Almost no individual shareholders are on the board of directors or on the supervisory committee.

Therefore, increasing outside participation by appointing non-state representatives to the companies' boards of directors is very important. Board members who are selected from different regions and have diverse backgrounds are also the keys. The internal incentive structure of listed companies must be reformed by diversifying the state ownership and by introducing other forms of large shareholders, like institutional investors. Compared to the individual investors, the large institutional investors will be less likely to behave as a free rider. They have the incentive and the power to

[16] See Xu and Wang (1999).

monitor and control the behavior of the management and have played a significant role in corporate governance.

Conclusion

The shareholding system is the fundamental of stock markets development. In China, the shareholding system initiated from socialist country was determined by the historical conditions at that time. All these issues we talked about in this section were left over by history and happened under a special background – the transition from planned economy to market economy. The untradability of state/legal person shares and the completely segmented markets of A shares and B shares make China's stock market a peculiar one. To standardize the behaviors of listed companies along with the common practice in most other markets in the world, we have to clarify the role that state plays as an owner within the territory of management and supervision in listed companies. Therefore, the issues of trading of state/legal person shares; merging of A shares and B shares and standardizing behaviors of listed companies are quite complex and controversial in current China, and it is challenging too.

In 1995, as an extension of shareholding experiment, the government started the experiment with the "modern enterprise system". The shareholding system is the major composition of experiment for modern enterprise system. However, the function of shareholding system has been not shown fully. The main reason is because many preconditions for its efficient functioning have not been satisfied or even absent. The most important condition for it is a clear defined ownership and corporate governance structure. Consistent with this system, the corporatized state-owned enterprises are required to set up boards of directors that represent the interests of the owners, and a well-designed mechanism that ensures the board members protecting the interests of the owners indeed. However, due to the property right and share ownership structure in China, the incentive and binding system are not able to be set up completely, resulting in inherent drawbacks within Chinese shareholding system. And it also results in a tremendous amount of untradable state shares and legal person shares, a segmentation of stock markets and the poor performances of listed companies, and so forth.

In sum, establishment of the genuine shareholding company consistent with the requirements of the modern enterprise system is the key to develop a fully-fledged stock market. It is predicted that various problems hindering stock markets from growing along the international practice will be solved within 10-15 years. The further reform of economic system, including the property right reform, will pave the way for formation of a unified and integrated China's stock market in the foreseeable future.

PART IV PROCESS AND PROSPECTS OF INTERNATIONALIZATION OF CHINA'S STOCK MARKET

Introduction

Since the mid 1980s, to follow the tide of globalization the securitized financing has come into play in the international markets. As an emerging stock market, China has been growing in an astonishing pace. But to match the perfect standard of international stock markets particularly in terms of the degree of securitization, China's stock market is still in its infant stage.

Internationalization is not only a must for the development of China's stock market, but also a need for opening up of Chinese economy to adopt international practice. Attempts to narrow the gap between China's stock market and other well-established stock markets have been going on since the very beginning of China's stock markets establishment, which produced multiple effects and laid a foundation for further internationalization of China's stock market. The issuance of B shares, H shares, N shares and ADRs has attracted a considerable number of foreign investors and thereby have contributed a great deal to the internationalization of China's stock market.

By the end of June 1999, there were 107 B shares with a total capitalization of RMB 20.718 billion (US$ 2.53 billion) on the market. 43 overseas listed companies have raised more than US$ ten billion by April 1998. Of 43 companies, 31 were listed in Hong Kong, eight were dual listed in Hong Kong and US, two dual listed in Hong Kong and London, one was solely listed in US and one solely in Singapore.[17]

[17] See Introduction to Overseas Listings (1999).

B Share Market and Overseas Listings

February 21, 1992, the listing of Zhenkong B share on Shanghai Stock Exchange raised the curtain of Chinese enterprises financing overseas. The basic requirements for the issuance of B shares are that the stock companies must be profitable for at least two consecutive years; they possess sufficient foreign exchange revenues to pay dividends and cash bonuses; and they provided financial statements and earning forecasts for three consecutive years. The issuance of B shares was the first step of internationalization of China's stock market. Since then, a number of listed companies started to issue B shares. With sustained growth of Chinese economy, the size of B share market expanded gradually. It attracted the overseas investors to China's stock market. The system of transaction and settlement for B shares has been greatly improved. Lots of foreign security brokers were involved in the underwriting and transaction of B shares. By August 1997, there were 107 B share special seats of brokers in Shanghai Stock Exchange and Shenzhen Stock Exchange altogether, of which, 28 foreign investment banks possessed their own seats in Shanghai Stock Exchange only.

Apart from the substantial development of B share market, the volatility and stagnation of B share market were also the main concerns of policy-makers. In retrospect of B shares on secondary markets, B share index increased between 75 and 100 percent in 1993. From September 1994, B share index declined sharply and remained sluggish for almost two years. The index soared during 1996; however, much of the activity has been attributed to illegal speculation by Chinese investors.

At the beginning, there is quite an enthusiastic initial response to the introduction of B shares, and the demand for B shares is high. But due to lack of the uniform guidelines, this enthusiasm has soon turned sour which led the price to plummet.

Other reasons include nonstandard accounting practices, a shortage of information on listed companies, a lack of appliance to publish annual reports. Since 1996, the State Council promulgated a series of regulations on B share issuance and underwriting. China Securities Regulatory Commission gradually perfected pre-selection rules, examination and approval standards, and supervision regulations while striving to improve the quality of listed B share companies, and also expanded B share market size. This shows Chinese government's determination to continue to develop actively and steadfastly the B share market.

Compared to B share market, overseas listings showed more transparent and standardized information disclosure and also they are less volatile than B shares and therefore offer better returns. They are more successful for their reputation and stock turnover.

Even as China proceeds with a multi-market approach, Hong Kong is emerging increasingly as a favored venue for overseas offerings – H shares.

At the end of 1993, the first two H shares "Qingdao Pijiu" and "Shanghai Shihua" were listed on Hong Kong stock market. Most listed companies in Hong Kong stock market are large restructured state-owned enterprises, more than 70 percent of which are related to pillar industries that have strategic importance, such as steel-making, telecommunication, automobile industries. On August 8, 1994, the Hong Kong Stock Exchange announced officially Hang Seng Chinese Enterprise Index, which showed that H shares, backed by Chinese enterprises, have won the recognition of Hong Kong investment circle and foreign investors.

The Hong Kong listed H shares paved the way for their later issuance in New York stock market. In July 1993, Zhongguo Shihua became the first H share that was listed on New York Stock Exchange in the form of ADR. Shandong Huaneng, as the first N share listed on NYSE directly, issued 23.374 million ADRs with the raised capital of US$ 333.1 million in 1997.

Given the future potential of China's overseas shares, a series of policy measures were undertaken by China Securities Regulatory Commission to promote standardized operation of overseas listed companies, for example, the Circular on Further Strengthening the Management of Stock Issuance and Listing Outside Territory (1997). In 1998, China Securities Regulatory Commission and State Economic and Trade Commission have issued Measures on Promoting Standardized Operations and In-depth Reform of Overseas Listed Companies. The key of the Measures is to raise requirements for overseas listed companies with regard to standardized operation by increasing transparency and deepening restructuring. Most of the overseas listed companies have operated within the boundaries of law and observed information disclosure requirements. Some companies have embarked upon a path of continuous growth through overseas listing. Success in international markets will require that the better companies be chosen for overseas listing. There is no doubt that the Chinese government will stick to its policy of raising funds through international capital markets, with an effort of increasing the degree of internationalization of China's stock market.

Openness of China's Stock Market and Foreign Participation

China is opening its stock markets step by step to foreign financial institutions, and official statements have affirmed "national treatment" as the eventual objective for financial liberalization. To date, foreign institutions have made modest inroads into the securities sector.

Foreign securities companies in China have a low operational status. They (investment banks) cannot establish branches or subsidiaries, and entry into China's stock market must be through joint venture only. With the exception of the China International Capital Corporation, foreign securities companies operate through representative offices. The number of foreign representative offices has increased slowly from 40 at the end of 1994 to 58 at the end of 1997.

The foreign securities companies are limited to B shares transaction and subject to government approval to underwriting and they are prohibited from introducing new domestic financial products. These offshore securities companies mostly operate as special members on Shanghai Stock Exchange and Shenzhen Stock Exchange or in the number of limited cases through agency relationships with local securities companies operating on Shanghai Stock Exchange and Shenzhen Stock Exchange.

On November 15, 1996, China Securities Regulatory Commission specified a new framework for the overseas securities companies in B share market with the promulgation of the Administration of Qualifications of Domestic and Foreign Securities Trading Institutions for Engagement in Foreign Investment Shares Business Tentative Provisions (B Share Provisions). These measures require foreign securities companies to apply to the China Securities Regulatory Commission for a qualification certificate. The foreign securities companies which are licensed to do securities business in their parent companies' place of domicile must meet a number of threshold criteria, including having RMB 50 million (US$ 6 million) and RMB 120 million (US$ 14.6 million) in net assets for trading and underwriting foreign investment shares. At the end of 1998, there were about 40 foreign securities companies trading B shares on Shanghai Stock Exchange compared to about 50 domestic companies, and 15 on Shenzhen Stock Exchange compared to 60 domestic companies.[18]

Morgan Stanley, as the major foreign shareholder in the newly established China International Capital Corporation, which established in June 1995 with a capital of US$100 million, may get an inside track on opportunities to participate in non-B share activities, including pilot projects for the Sino-foreign investment funds. During the WTO negotiations, both the EU and the US representatives wanted foreign securities companies to be able to broker and underwrite domestic A shares.

In short, foreign securities companies in China currently occupy an exceptionally peripheral role in domestic markets, with a limited and restricted market share of business activity. Yet these foreign institutions play an important role in bringing modern financial business practices to China and they are awaiting further liberalization and internationalization of China' s stock market.

As for foreign investors, foreign fund managers are not permitted to manage domestic investment funds. In an effort to open up the fund management industry and raise professional standards, a draft national regulation, tentatively entitled Administrative Measures for Sino-Foreign Joint Venture Funds (the JV Fund Regulations), is expected to be enacted in the near future. The Regulations are expected to permit the formation of Chinese-foreign joint venture fund investment companies. A committee set up in May 1999 has started drafting the JV Fund Regulations. China Securities Regulatory Commission has indicated that the Regulations will provide the framework for foreign investors to set up joint venture fund management companies with Chinese investors.

[18] See Semkow (1999).

Comparisons with Other Stock Markets in the World

Market Size

Compared with stock markets of other countries, especially emerging markets, the size of China's stock market is too small to allocate resources effectively. Its slow pace of growth could not keep pace with the demand of economic development in terms of the small function the stock markets played in entire national economy. The table 4-1 and table 4-2 indicate that the big gap between China and other well-known markets in terms of the listed company size and growth rate of market size.

In addition, the ratio of securitization is a major index for measuring stock market function and development level in national economy of a country. In general, the securitization ratio is the ratio of total market capitalization of securities to GDP. The higher the securitization ratio, the more important the role of stock markets in the national economy of a country. By the end of 1994, the total market capitalization of the United States stock market was around US$ 4500 billion, and US$ 3500 billion in

<Table 4-1> Comparison of the Size of the Listed Companies,1994 (US$ Billion)

	Average market capitalization	Market capitalization / GDP (%)	Average size of listed companies	Negotiable market capitalization / deposit (%)
Western stock markets (US, UK, Germany, France)	1803.4	74.65	0.92	n.a.
Asian stock markets (Singapore, S. Korea Taiwan, Hong Kong)	211	91.20 (1990)	0.53	25
China's stock market	55.3	7.92	0.15	3.5

Source: Securities Markets Guide, Apr 1996.

<Table 4-2> Comparison of the Growth Rate of Market Size (%)

1990-1994	Korea	Singapore	Hong Kong	Malaysia	Thailand	Philippine	China
Average growth rate of total capital	15	30	34	42	52	70	4

Source: Shanghai Securities Newspaper, Apr 14, 1996.

Japan, but only US$ 44 billion in China.[19] Table 4-3 shows a comparison of the ratio of total market capitalization to GDP between China and other countries.

Assets Structure

In China, the increase of the size of financial assets of enterprises mainly depended on the increased expansion of deposits and loans of banks. The indirect financing played a major role in the markets in terms of the direct financing through the various portfolios. Since the economic reform, the proportion of direct financing increased rapidly, especially stock financing, but the stock market development is still very primitive in terms of the small value of stock financing with respect to other financing tools. In comparison with other mature markets, there is a long way to go for China' s stock market. Table 4-4 and table 4-5 show the composition of enterprises

<Table 4-3> Comparison of the Ratio of Total Market Capitalization to GDP (%)

	China	Japan	Britain	S. Korea	Singapore	Hong Kong	Thailand
1992	3.93	68.10	93.00	36.30	300.50	189.40	60.13
1993	10.20	77.80	122.70	42.60	545.80	354.20	68.24
1994	7.92	86.40	123.90	50.90	609.60	229.90	93.58
1995	5.96	72.70	125.30	40.20	479.30	198.20	88.68
1996	14.52	67.50	142.70	28.70	162.80	n.a.	n.a.
1997	23.40	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1998	24.50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Choices Facing the 21st Century, 1999.

<Table 4-4> Composition of Enterprises Financing in China (RMB billion)

	1995		1996		1997		1998	
	Volume	%	Volume	%	Volume	%	Volume	%
Total raised capital	1151.8	100	1345.8	100	1479.5	100	1394.8	100
1. loans from financial institutions	1014	88	1114	82.8	1140	77	1152	82.6
2.direct financing	137.8	12	231.8	17.2	339.5	23	242.8	17.4
a. stock financing	15	1.3	42.5	3.2	128.5	8.7	84	6.0
b. bond financing	21.6	1.9	26.8	2	25	1.7	14.7	1.1
c. commercial bill financing	101.2	8.8	162.5	12	186	12.6	144.1	10.3

Source: Choices facing the 21st Century, 1999.

[19] Choices Facing the 21st Century (1999).

Statistics showed that individual investors accounted for 99.51 percent of total investors by the end of 1997 in China's stock market according to table 4-6. Out of 0.49 percent institutional investors, trust and investment companies, securities companies, or a few securities investment funds composed the majority of institutional investors. The investment funds on the markets mainly were consisted of institutional short-term investment. Compared to the mature markets, the number of China's domestic funds is very small. Table 4-7 shows that the structure of shares held by investors in the United States. Of all the shareholders, institutional investors, especially various funds played an important role in the US stock market.

In November 1999, the Chinese government allowed the insurance companies to get into stock market by buying securities investment funds. The entry into stock market indirectly of the insurers will benefit both the insurers and China's stock market.

Market Operation

<Table 4-5> Capital Composition of the Corporations in Selected Countries (%), 1966-1970

	The U.S.	Britain	France
1. Internal capital	69.4	51.4	65.0
2. External capital	30.6	48.6	35.0
a. Loans	12.4	10.3	27.4
b. Securities issuance	18.2	38.3	7.6
Total	100	100	100

Source: Nurture and Development for China's Capital Market, 1999.

<Table 4-6> Structure of Investors in Shenzhen Stock Exchange (10 Thousand)

	Total	Individual	Percentage(%)	Institution	Percentage(%)
1991	25.69	25.63	99.79	0.06	0.21
1992	105.05	104.91	99.87	0.14	0.13
1993	353.27	352.22	99.70	1.05	0.30
1994	482.99	480.72	99.53	2.27	0.47
1995	555.04	555.90	99.43	3.14	0.57
1996	1089.57	1085.30	99.61	4.27	0.39
1997	1609.78	1601.88	99.51	7.90	0.49

Source: Shenzhen Stock Exchange, Market Statistics Yearbook, 1993-1997.

In China's stock market, the rate of transfer is incredibly high according to table 4-8. On December 12 1996, the daily turnover was 37.4 billion yuan (US$ 4.6 billion) in two stock markets, three times the highest daily turnover of Hong Kong, even though the formers' market capitalization was only one tenth of the latter's.[20] On the New York Stock Exchange, the yearly stock transaction value was below 40 percent of its stock market value in 1995. But in Shanghai and Shenzhen, the stock transaction value was 4.5-9.5 times the stock market value annually in the early 1990s. And later the rate have been between 2 and 3.5 times, which means, on average, every stock could be sold twice or more a year.

In addition, the average P/E ratio in mature markets is between 15 and 20. In China's stock market, the P/E ratio of quite a few stocks could be as high as over 500 in the early 1990s. After stock market collapse, the stock price and P/E ratio lowered considerably. On average, the P/E ratio maintains between 30 and 45 according to

<Table 4-7> Structure of Shareholders of Listed Companies in the US (US$ Billion)

	1989	1990	1991	1992	1993	1994	1995	1996
Market capitalization	3825.9	3524.8	4897.9	5456.8	6280	6263.3	8389.9	10090
Individual	1941.6	1752.9	2675	2906.3	3249.6	3100.4	4166.6	4779.8
Insurance companies	190.5	177.8	245.5	272.8	336.4	386.5	491.9	584.9
Pension funds	609.7	592.5	686.7	822.0	925.2	921.6	1150.3	1345.3
Retirement funds of local government	300.1	293.0	392.4	447.4	533.9	534.9	744.2	948.4
Investment funds	267.6	249.4	330.7	425.1	635.0	741.8	1061.7	1501.8
Others	516.4	459.2	567.6	583.2	559.9	578.1	775.2	929.8

Source: Federal Reserve Board, the U. S., Capital Flow Account, 1989-1996.

<Table 4-8> Comparison of Transfer Rates in Selected Markets

	SHSE	SZSE	NYSE	Tokuyo	Korea	London	Hong Kong	Thailand	Singapore
1992			47	20	133	43	53	15	19
1993	341	213	53	26	187	81	61	133	84
1994	787	472	53	25	174	77	40	63	28
1995	396	180	59	27	105	78	37	40	18
1996	591	902	52	27	91	58	44	30	14
1997	362	466	66	33	146	44	91	50	56

Source: China Securities Industry Association, 1999.

[20] See People's Daily (Dec 16, 1996).

table 4-9. All of these evidences show that China's stock markets characterized by a typical emerging market is far away from reaching the practices of internationalized stock markets.

The Impact of WTO Accession on China's Stock Market

GATS and China's Securities' Sector

China's bid to join the World Trade Organization will fundamentally impact the world economy and will critically affect development of China's stock market. Basic improvements in the efficiency, transparency, and liquidity of China's stock market will follow China's accession to WTO membership. Specially, changes mandated by the WTO's General Agreement on Trade in Services (GATS) through negotiations on the liberalization of financial services sector will significantly influence the development of China's stock markets.

The GATS has three basic principles: it covers all services except those provided in the exercise of governmental authority; secondly, there should be no discrimination in favor of national providers, the national treatment principle. And thirdly, there should be no discrimination between other members of the agreement – the most favored nation (MFN) principle. However, the agreement provides important exceptions to all three of these principles. In the first instance, governments can choose the services in which they make market access and national treatment commitments; and secondly, they can limit the degree of market access and national treatment they provide. They

<Table 4-9> Comparison of the P/E Ratio in Selected Markets

	SHSE	SZSE	NYSE	Tokuyo	Korea	London	Hong Kong	Thailand	Singapore
1992			15.2	36.7	10.2		13.2	16.3	19.5
1993	42.48	42.69	15.2	64.9	15.9	24.4	21.6	26.1	37.3
1994	23.45	10.28	12.7	79.5	19	16.3	10.7	19.5	26.2
1995	15.70	9.46	14	86.5	16.1	15.6	11.4	19.8	24
1996	31.32	35.42	15.7	85.3	18.7	15.5	16.4	13.3	21.5

Source: China Securities Industry Association, 1999.

can also take exceptions even from the MFN obligation, in principle only for ten years, in order to give more favorable treatment to some countries than to the generality.

Exceptions to obligations and specific commitment are allowed by GATS in certain cases. Governments may justify a measure otherwise inconsistent with GATS by showing it is necessary to achieve one of a limited number of special policy objectives. This exception permits a government to take discriminatory or restrictive measures to protect consumers or to ensure the integrity and stability of the financial system.

The new GATS financial services agreement broadly liberalizes securities markets to foreign involvement in the underwriting and broker-dealer activities undertaken by securities companies. Clearance and settlement may also be severely affected by foreign competition on a state’ s securities markets.

There is no doubt that Chinese government has to make greater efforts to open its financial service sector in order to access to WTO and GATS. Restrictions on foreign participation in stock markets will be removed gradually after China enters the WTO. One thing is clear: China will have to pick up the pace of reform to meet WTO requirements by providing full market access, national treatment, and a timetable for implementing specific measures to deregulate and open the financial sector.

Opening up China’ s Stock Market Gradually

Pursuant to GATS that does not require a fixed timetable for opening the financial market and liberalization of financial sectors, GATS allows its members to take discriminatory or restrictive measures to protect consumers and depositors or to ensure the integrity and stability of the financial system. Therefore, opening China’ s stock market should be implemented step by step in light of the lessons and experiences of other emerging markets, and combined with the current practices of China' stock markets. The opening up of China's stock market should follow the stages of:

The first stage (2000 – 2005): Foreign participants will be allowed to enter the markets in dealing or underwriting stock business with certain conditions. Obviously, with the entry of foreign securities intermediaries into China's market as a result of liberalization of stock market, Chinese securities companies will have little capacity to compete with foreign counterparts due to their small sizes of assets or relatively lower quality on financial services. Therefore, the relaxation of restriction on foreign financial institution's entry into China's stock market must be limited and done gradually so as to protect the China's infant securities service industry. But meanwhile, the strength of the introduction of foreign intermediaries is also significant. It can enhance the development of domestic securities companies through market discipline or free competition, promoting the improvement of service quality and expansion of service scope.

In addition, more Sino-foreign joint capital corporations or joint investment funds will be allowed to involve in domestic share trading. A share market is expected to partly open at that time in order to attract more foreign direct investments. It will be useful to merge A and B share market as early as possible and to improve the transparency and corporate governance of listed companies.

The second stage (2006-2010): In this stage, the stock market size, market operation, market supervision and legal system will match the international practices to a large extent. With the increased stability and reduced risk degree for the stock markets, restrictions on foreign participation will be greatly relaxed. Foreign investment banks and institutional investors will increasingly enter into the domestic market. Moreover, investment in foreign securities' markets by domestic individuals and institutions will be allowed with specified conditions. Hopefully, the problems of trading state and legal person shares and merger of A and B shares can be solved to a large degree during this period. The goal of a unified market will be achieved fundamentally, and pave the way for opening China's stock market completely.

The third stage (After 2010): At that time, the socialist market economic system will be established. China's economy will also integrate completely with the world economy. The stock market will be relatively mature and well developed in comparison with other stock markets even with developed countries. Under the fully convertible Renminbi, the foreign capital and foreign financial institutions can enter into domestic market directly, and foreign companies can be listed on China's stock market. It is expected that highly internationalized China's stock market will emerge and comply fully with all the requirements of GATS. China's stock market will become an important component of the world's stock markets.

The process of opening up of China's stock market is only a tentative and theoretical idea. The implementation of the proposed scheme could be complex and difficult in practice. But anyway, in the process of gaining full access to GATS, increased competition in securities sector will lead to increased development of China's stock market and finally reach the goal of a highly liberalized and internationalized stock market in China.

Conclusion

In China, the lower degree of internationalization of stock markets resulted mainly from the less developed financial industry and also due to the restraints of many structural factors. Strict restrictions imposed on financial sector limited the scope of the business activities of foreign financial institutions in China' s stock market. The incomplete convertibility of Renminbi makes an additional obstacle for foreign investors to invest in China' s domestic markets. Moreover, in the field of regulation, supervision, accounting system and property assessment, China' s stock market is still far from the practices of mature international markets.

The development of the stock market is a potentially fundamental factor for China' s long-term economic growth. The tendency of internationalization of China' s stock market will accelerate the economic growth and integrate domestic economy with the rest of the world. However, the Asian financial crises of 1997-1998 demonstrated that such liberalization and integration could impose potential danger if the process is not meticulous planned and managed with great care. Therefore, the implementation of deregulation and liberalization of China' s stock market must base on adequate and in-depth reform of financial sector and macroeconomic preconditions. In a more hurry, one should take more time, as an old proverb says.

CONCLUSION

China's stock markets developed at an amazing pace and received the astonishing accomplishments in past ten years since the establishment of two stock exchanges and it is beginning to take shape now. It started from scratch to become a major component of the nation's economy. In 1996, the objective of developing securities market was written into the national Ninth Five-year Plan and Long- term Program for 2010.

In an effort to meet the international standard, the government sets up the high technological infrastructure for stock issuing and trading, and perfects a unified stock market regulation and supervision system gradually. It is estimated that the raised capital through the stock market was more than RMB 400 billion (US$ 48.8 billion) by now. The stock market expands the channels of financing and investment greatly both for enterprises and individuals and it also increases the productivity and efficiency of state-owned enterprises. It has been one of the most positive effects for industrial structure readjustment and production factor reallocation.

Although the achievements of China's stock market attracted worldwide attention, the market characterized by an infant and emerging market is still at its primitive stage. Lots of problems remained to be solved; some of them left over by history are inherent inside the economic system such as the non-tradability of state shares and legal person shares, the segmentation of A share market and B share market and the low quality of listed company. The degree of internationalization of China's stock market is far away from reaching the international practices. The process of making China's stock market to meet the international standard completely will be difficult and time-consuming.

Development of institutional investors will be a key to improve China's stock market. Out of institutional investors, various funds such as the pension fund, insurance fund or a variety of investment funds will be the active players in the stock market with the relaxation of regulations on entry into the markets.

The expansion of market capacity is one of the preconditions for stock market development. To nurture investment awareness and confidence of the investors so as to stimulate market demand is the decisive force in developing stock market steadily. By now, the total of the household savings is around RMB 5.9 trillion (US$ 720 Billion).[21] It illustrates that there exists the huge potential for expanding capacity of the stock markets in line with the economic reform and economic growth.

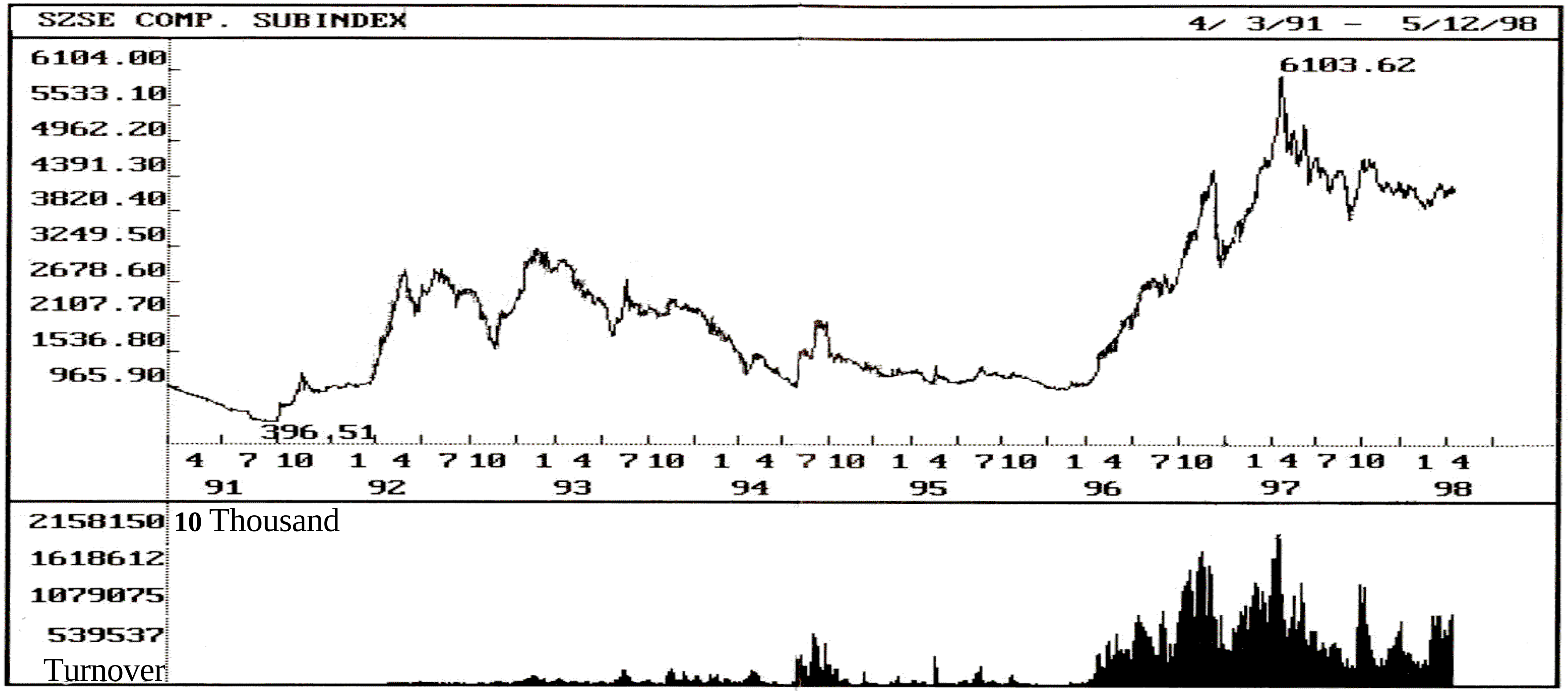
In order to gain full access to WTO and GATS, opening up of China's securities sector is only the matter of time. Therefore, the government must take the vigorous action to build up the market environment and to nurture the players and investor in the market.

China's stock market has a long way to go in order to adopt the practice of other mature stock markets. The coming 15 years will be the critical time period for China's stock market development. In the fields of issuance system, operation mechanism, merger and acquisition activities, regulation and supervision framework as well as internationalization, China's stock market will have made considerable progress. A unification of different types of shares and a unified stock market will be formed in the foreseeable future.

[21] See Shimizu (1999).

APPENDIX 1

The Process of China' s Stock Market Development



Source: Hu, Jizhi, The Evolution of China Stock Market & Its Institution, 1999.

APPENDIX 2

Paid-in Capital and Total Assets in Top 23 Securities Companies
(RMB Billion) (1998)

	Securities Companies	Capital	Securities Companies	T-Assets
1	ShenyinWanguo	1.33	Junan Securities	17.56
2	Nanfang Securities	1.0	ShenyinWanguo	16.73
3	Guotai Securities	1.0	Nanfang Securities	15.53
4	Huaxia Securities	1.0	Huaxia Securities	11.06
5	Haitong Securities	1.0	Haitong Securities	10.27
6	Dongfang Securities	1.0	Guangfa Securities	6.91
7	Lianhe Securities	1.0	Anshan Securities	6.5
8	Beijing Securities	0.85	Shanghai Securities	5.68
9	Guangfa Securities	0.8	Lianhe Securities	5.43
10	Guoxin Securities	0.8	Guotai Securities	5.1
11	Zhaoyin Securities	0.8	Jiangsu Securities	4.81
12	Junan Securities	0.7	Shandong Securities	4.72
13	Shandong Securities	0.508	Guoxin Securities	4.54
14	Dapeng Securities	0.5	Zhongxin Securities	4.12
15	Guangda Securities	0.5	Guangdong Securities	4.06
16	Shanghai Securities	0.5	Dapeng Securities	4.03
17	Zhejiang Securities	0.45	Guangda Securities	3.98
18	Jiangsu Securities	0.404	Pingan Securities	3.42
19	Anshan Securities	0.32	Xingye Securities	3.26
20	Zhongxin Securities	0.3	Liaoning Securities	3.24
21	Hunan Securities	0.2351	Zhuhai Securities	3.15
22	Liaoning Securities	0.22	Zhaoyin Securities	2.98
23	Tequ Securities	0.20568	Changcheng Securities	2.72
Total		15.413		149.8
% of total		78%		76.70%

Source: China Securities Industry Association, 1999.

APPENDIX 3

Employee Stock Ownership Plans

By the end of 1980s, over 11,000 U.S. firms have instituted Employee Stock Ownership Plans (ESOPs). Formally, these are employee pension plans, and in many cases they have replaced more standard plans. Under an ESOP, the company acquires an amount of its own stock that it places in trust in the plan. Each year the individual employees are allocated some of these shares, which the ESOP then holds until they retire or leave the firm. In the first half of 1989, U.S. corporations acquired over $19 billion of their stock to establish new ESOPs, and in some cases the employees actually acquire the whole company through the ESOP.

ESOPs are claimed to have good incentive effects. By making employees into owners, (particularly long-term owners), ESOPs are supposed to tie the employees' interests more closely to the firm's success and motivate them better. For example, Avis, the employee-owner car rental company, advertises that its employee cares about the firm's future and so will give customers better service.

Source: China's Economic Reform in the 1990s, 1997.

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