

# **Moving Forward in Reforming China's Capital Market**

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China's long march to membership in the WTO (World Trade Organization) is finally over. Some 20 years after the People's Republic launched its reform and open door policy, membership in the WTO will integrate the Chinese economy more closely with the worldwide economy. At the same time, Chinese enterprises will be forced to compete under global standards.

This challenge has raised a number of concerns—ranging from the competitiveness of Chinese companies to social stability during this period of transition from a state-planned to market economy. This article discusses several problems affecting China's capital market, which essentially includes no mechanism for efficiently allocating capital. As this is a prerequisite for a free market economy, this deficiency could slow the progress of other reform plans now under way.

Since 2000, however, China has been moving forward towards solving various problems in its capital market. As a well-functioning capital market will strengthen China's industries and enterprises, the time will soon come when Japanese companies can no longer afford to ignore the capital market of China when raising and placing funds.

## I Increasing Importance of the Capital Market

In keeping with its new status as the host country of the 2008 Olympic games and as a member of the World Trade Organization, China is stepping up efforts to open its market to foreign investors. China's economy functions as what might be called a manufacturing base for the world. In addition, it also has a gigantic domestic market. Accordingly, its fusion with the world economy will speed up the integration of the global economy. While emerging Chinese power may be a menace to the world economy, it is actually quite a challenge for China to open its markets to the rest of the world. After the country joins the WTO, Chinese enterprises will be forced to compete under global standards, and the results of this exposure will determine whether China will be able to move on to the next stage in the transition to a free market economy.

At the same time, China is still suffering from the lingering effects of its state-planned economy. In terms of macro-level financing, for instance, no efficient capital allocation mechanism exists. The enormous pool of household savings is the primary source for the huge capital demands to establish infrastructure and provide the capital investment required by companies in preparing the equipment and facilities needed for global competition. As seen in the latest flow of funds table in 1999 (see Table 1), the main source of capital clearly flows from households with surplus savings to enterprises and government, which lack sufficient funds due to excessive investment.

It is also clear that indirect financing accounts for a high percentage of capital needs. Among the funds raised by enterprises (i.e., the total of bank loans, equity and direct investment), bank borrowing occupies nearly 70 percent of the total. Moreover, it is worth noting that financial institutions have purchased nearly 45 percent of outstanding government bond issues. However, banks have been suffering from bad loans made to inefficient state-owned enterprises, and much of this problem still remains to be solved. These bad

loans—coupled with poor risk assessment capabilities—have forced banks to take extra precautions when extending credit. Although some improvement in this area has been seen recently, private enterprises with high productivity still face difficulties in obtaining bank credit. Of equal concern, adequate funding is not available to high tech industries, despite the potential of this sector as a leading industry in the future.

As for micro-level financing, state-owned commercial banks, state-owned enterprises and (regional) governments have amassed mountains of bad debt under a corrupt indirect financing system that lacked any semblance of corporate governance functions.

China's capital market has become the focus of attention as a means to solve these problems. A capital market that includes the mechanisms for efficient capital allocation, as well as good corporate governance, will strengthen industries and individual companies by weeding out the under-performers. In other words, the country's capital market has a crucial role in determining China's success in a globally competitive environment.

The following factors can also be cited as reasons for reforming China's capital market. First of all, the stock market is expected to solve various problems that remain as debilitating vestiges of the era of the state-planned economy, i.e., bad debts as well as shortages in social security funding. Regulators have enacted a framework to revitalize enterprises in financial trouble by converting their bad debts into equity. Moreover, they have introduced a new program in which the funds raised by privatizing state-owned enterprises will be used to fill the coffers of the social security system.

Second, China is using the government bond market to boost the economy over the short term. As already mentioned, the enormous sums in bank deposits are not efficiently leveraged. Therefore, the government has been revitalizing the flow of capital over the past four years by issuing government bonds as a means to stimulate the economy.

Third, the government bond market is essential to implement economic policies following the expected liberalization of capital. After joining the WTO, China

**Table 1. Flow of Funds Accounts in China (For 1999)**

(Unit: 100 Million Yuan)

	Households		Corporations (non-financial)		Government		Financial Institutions		Foreign Investment	
	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources
<b>Net Savings (Uses/Sources)</b>	10,898		-6,419		-2,190		-991		-1,298	
<b>Deposits</b>	7,281		5,053		919		-788	13,399	-122	-1,061
<b>Loans</b>		1,316		9,140		265	11,018	-33	-45	284
<b>Bonds</b>	1,616			102	8	2,776	2,928	1,318		
<b>Government bonds</b>	1,531				8	2,776	1,237			
<b>Stock</b>	875			926					51	
<b>Direct foreign investment</b>			147	3,208					3,208	147

Notes: (1) As only major items are included, totals per department and item may not correspond; and (2) 1 yuan = approximately 15 yen.

Source: *The People's Bank of China Quarterly Statistical Bulletin*.

will liberalize its capital account at some point. Some devices to ensure a flexible monetary policy are crucial so that capital flows from abroad will not affect domestic monetary policy. A sound and highly liquid government bond market is essential in enabling the central bank to conduct smooth open market operations.

Despite the great potential for China's capital market, there is still much room for improvement at this point. The market is fragmented and partially illiquid, thus generating considerable speculative investment. Some of the listed companies and investors have questionable qualifications, and massive infractions of the law and the inadequate disclosure of information create more problems. Nonetheless, we need not be overly pessimistic, as the good news is that regulators are currently targeting these problems for rapid action aimed at their resolution.

The next chapter will discuss the recent state of affairs and movements towards improvements in the stock market (i.e., opening the market to foreign investors, the reduction of state-owned shareholding, listing and delisting procedures, and the creation of a second board), the bond market, institutional investors, and regulations and supervision.

## II Accelerating Stock Market Reforms

### 1 Opening the Stock Market to Foreign Investors

As of July 2001, China's total market capitalization (including A and B shares) was approximately 4.6 trillion yuan, competing with the Hong Kong stock market of almost the same size for the rank of the second largest stock market in Asia. However, only some 40

percent of the shares included in this figure are actually subject to trading. The market suffers from low liquidity due to the distinction between tradable and non-tradable shares (for details, refer to the following chapter).

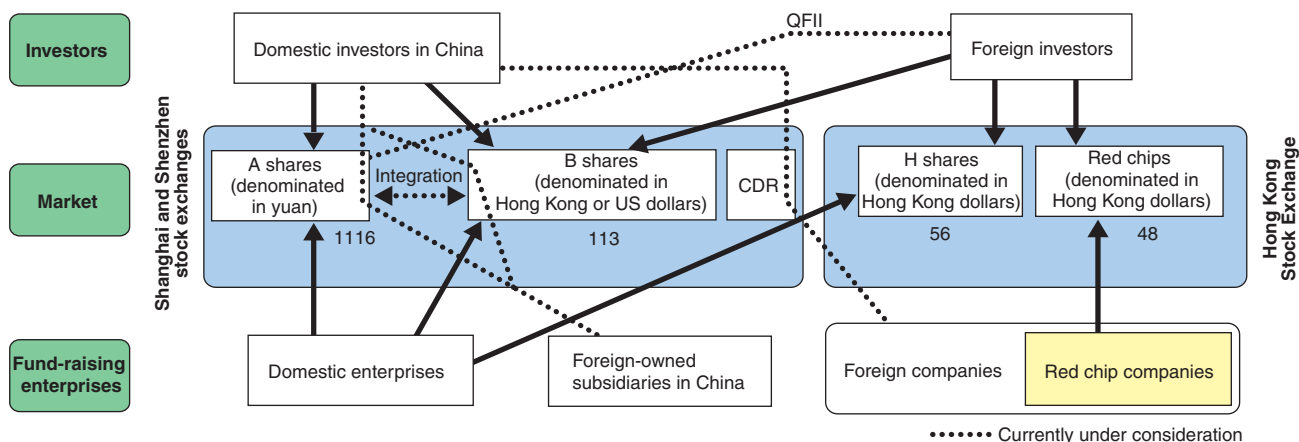
Additionally, as presented in Figure 1, even tradable shares are classified by investor, issuer, or currency, such as A shares (denominated in yuan and issued in China), B shares (denominated in foreign currency and issued in China; although originally sold exclusively to foreign investors, they were made available to domestic individual investors in February 2001), and H shares (denominated in Hong Kong dollars and issued in Hong Kong; targeted at foreign investors). Such market fragmentation contributes to the highly speculative tenor of the market and needs to be corrected.

In this section, I would like to discuss the following three important issues in light of the consolidation of these different types of shares and the inevitable opening of the market to foreign investors: (1) merging A and B shares; (2) permitting foreign investors to invest in the domestic market; and (3) permitting foreign companies (and foreign-owned subsidiaries in China) to raise funds in the domestic market.

#### (1) Merging A and B shares

There is a significant difference in size between the A- and B-share markets. As of the end of July 2001, 1116 companies are listed on the A-share market, with a total market capitalization of some 4.5 trillion yuan (approximately 30 percent of the shares are traded), while 113 companies are listed on the B share market, representing a market capitalization of 121.3 billion yuan (approximately 90 percent of the shares are traded). While the A-share market has a far higher trading volume, B shares are considered to represent more appropriate pricing levels.

Figure 1. Summary of China's Stock Market (As of the End of July 2001)



Notes: (1) Eighty-nine corporations issue both A shares and B shares, and 22 issue both A shares and H shares; (2) CDR = China Depository Receipt; (3) QFII = Qualified Foreign Institutional Investor; (4) the number of red chips matches the number of companies listed on the main board (as of the end of August, 2001); (5) domestic foreign-aid subsidiaries in China: Share-holding Corporations Ltd. with Foreign Investment  
Source: Compiled by NRI from CSRC (China Securities Regulatory Commission) data and Hong Kong Stock Exchange reports.

Since 2000, the prices of B shares have been rising in anticipation of their being integrated with A shares. The comment by one regulator suggesting this possibility fueled the widely held notion that the obvious next step would be to abolish B shares. Another step toward merging A and B shares came in February 2001, when individual domestic investors with legal foreign currency accounts were permitted to own B shares.

As of September 2001, about six months after this approval, the price differences between the A- and B-share markets for the same stocks fell to two times, compared with three to five times in February (see Figure 2). During this same period, prices for B shares have been rising, narrowing the spread with the overpriced A shares. Some foreign investors seem to have taken advantage of this chance to sell their own B shares.

At this point, opening the B-share market to domestic investors does not appear to have normalized the situation. In order to create a healthy market, it is presumably more important to create an environment in which foreign investors can purchase shares without undue anxiety, as will be discussed in Chapter V.

## (2) Investments in the domestic market by foreign investors

Once B shares are integrated with A shares, foreign investors will be able to invest in China's domestic market. This new phase gives rise to concerns over how foreign capital inflows and outflows will affect the domestic market. The recent Asian financial crisis is still fresh in everybody's memory, and one solution under consideration is to establish a stockholding system for foreigners that is similar to the QFII (Qualified

Foreign Institutional Investor) category adopted by Taiwan and some other countries, in which foreign institutional investors who satisfy certain conditions are approved by the authorities. In Taiwan, capital inflows and outflows are strictly regulated, including a cap for the amount of investment per foreign investor, and all transactions are closely monitored. Thanks to this oversight, Taiwan suffered comparatively little turmoil during the Asian currency crisis. The QFII program is expected to function in China's market without the need to make drastic changes in its current capital regulations.

## (3) Fund raising inside China by foreign companies or foreign-owned subsidiaries in China

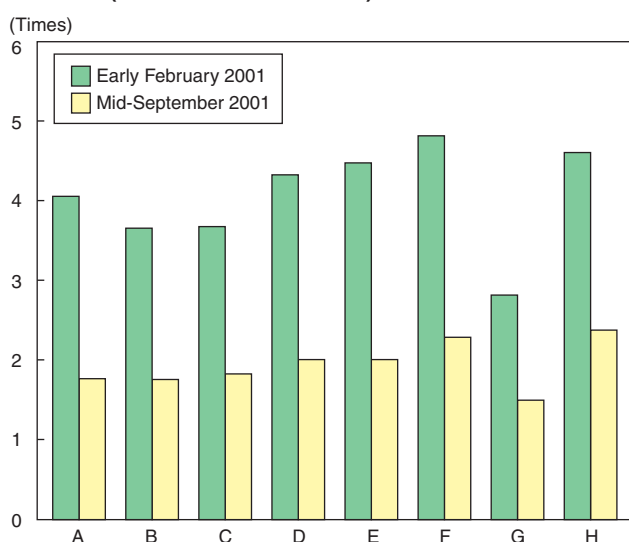
As for fund raising by foreign companies or foreign-owned subsidiaries in China, the following possibilities are under consideration (see Figure 1): (1) listing foreign-owned subsidiaries on the A-share market; and (2) issuing CDRs (China Depository Receipts, i.e., substitute securities issued in China in the amount of the original shares held abroad) by companies listed on foreign stock markets, including red chip companies (Chinese companies incorporated and listed in Hong Kong).

First, the foreign-owned subsidiaries in China will be allowed to apply for listing on the A-share market in the near future, provided that they retain at least 10-percent foreign ownership and request approval from the authorities.

Next, if the CDR format is permitted, domestic investors will be able to invest in red chip companies, which are basically top-flight Chinese companies that are currently excluded from their investment options. Additionally, since the companies listed on overseas stock markets have higher standards with respect to various fundamentals, they are expected to enhance the quality of the domestic market. And a benefit for foreign companies as issuers is that they can raise funds at relatively low cost, since A shares trade at a high PER (price earnings ratio).

In August 2001, the CSRC (China Securities Regulatory Commission) released its findings on CDRs to be issued by companies listed on overseas stock markets, and the relevant authorities (including the State Council) currently appear to be considering its implementation. Although details have not been disclosed, it is reported that they positively evaluated CDRs in expectations of improving market quality. It is more likely, however, that they will add a provision to block capital outflows by prohibiting foreign CDR issuers from transferring the raised funds abroad. Overseas transfers will be permitted only for profits from businesses that are carried out with the funds raised. Top-notch companies listed on the Hong Kong market—especially red chip companies—are expected to be the first issuers of such CDRs.

**Figure 2. Price Comparison of Selected Stocks (A Shares and B Shares)**



Notes: (A) Chongqing Changan Automobile Co., Ltd.; (B) Jiangling Motors Co., Ltd.; (C) Shanghai Yaohua Pilkington Glass Co., Ltd.; (D) Shanghai Dajiang (Group) Stock Co., Ltd.; (E) Shanghai Automation Instrumentation Co., Ltd.; (F) Hero (Group) Co., Ltd.; (G) Shanghai Shangling Electric Appliances Co., Ltd.; (H) Shanghai Diesel Engine Co., Ltd.  
Source: Nomura Research Institute.

#### (4) Conditions for a real liberalization of capital

As seen in the examples of the planning for the QFII and CDR systems, the Chinese authorities have been taking cautious steps in opening the country's stock markets to foreign investors. Even if they decide to introduce the QFII scheme, it will take at least another year. Similarly, China probably needs at least five more years until it achieves real capital liberalization because of the great amount of preparatory work required.

First of all, instead of adopting a de facto fixed exchange rate system, China currently maintains total control over its monetary policy in a closed capital market. Based on the comments of financial regulators, it would appear that they are aiming at a gradual shift from the current quasi-fixed exchange rate to a floating exchange rate by permitting an ever-wider range of fluctuations for the yuan on a step-by-step basis as they proceed with the capital liberalization plan. In the end, they wish to achieve the same sort of system adopted by developed nations, whereby monetary policies are controlled under a floating exchange rate and the capital market is liberalized.

During that process, the following questions should be asked. Are the domestic financial markets such as the government bond market adequate in terms of size and liquidity? Can the People's Bank of China (China's central bank) conduct open market operations promptly? (Refer to Chapter III.) In other words, if it becomes too easy for the domestic financial markets to rely on excessive capital inflows from abroad, will the central bank be ready to absorb liquidity to offset this impact? We need to allow some time before China's central bank learns its new role and actually gets ready to act.

Second, in order to realize a well-functioning monetary system that exerts indirect macro-economic control, China needs to further liberalize its interest rate policy. However, the bad loan problems currently plaguing banks are forcing the authorities to take extra cautious steps towards a complete liberalization of interest rates. This supports the prognosis that it will take some time before China actually establishes a system comparable to those of the advanced economies.

## 2 Enhancing Liquidity by Reducing State-Owned Shareholding and Making Up Shortages in National Social Security Funding

In terms of liquidity, stocks in China can be classified into four categories by the type of shareholder: state shares (government-owned), corporate entity shares (mainly owned by state-owned enterprises), employee-owned shares, and general public shares. Among them, only general public shares, accounting for 40 percent of the total, are listed and traded (moreover, these listed shares are divided into A, B and H shares).

State shareholdings account for nearly 40 percent of the total number of shares—a figure that rises to over 50 percent if corporate entity shares owned by state enterprises are included. Therefore, the government has introduced a plan to release such state-owned shares (the total of state shares and corporate entity shares owned by state enterprises) for open trading in order to enhance market liquidity.

At the same time, planners envision that added benefits can be secured if the proceeds from such transactions are diverted to make up the shortages in social security funding. Although there is a wide range of projections concerning the potential magnitude of social security deficits, the figure for old-age pensions alone is expected to reach 3 trillion yuan in the year 2025. By coincidence, the current total value of non-tradable shares is about 3 trillion yuan as of the end of July 2001. Essentially, the paper figures are the same.

Releasing state-owned shares means privatization. At the 4th Plenum of the 15th CPC Central Committee, the ideological obstacles to this plan to reduce state-owned shares were watered down. Although the State Council avoided using the word “privatization,” members agreed to promote the privatization of state-owned enterprises regardless of size, provided that they are not included in certain types of industries, such as military-related companies. They further agreed to enhance the competitiveness of such companies.

In June 2001, draft measures for downsizing state-owned shareholding to make up the social security shortfalls were announced. These provisions include the following: (1) in the event any company (including those listed on overseas stock markets) in which the state holds shares carries out an IPO or issues new shares, the government will sell off a portion of its holdings in such company equal to 10 percent of the total new financing raised by the company; (2) the proceeds of this sell-off of state-owned shares will be assigned to the Council of National Social Security Funds; and (3) the price of such shares will be determined by the stock market in principle. After implementing these provisional measures described above, more than ten companies sold state-owned shares during IPOs (as of the end of September 2001).

Since October 2001, however, this plan to reduce the quantity of state-owned shares has been temporarily suspended in response to complaints by various market participants that launching the scheme caused a sharp decline in stock prices. However, the program is expected to be resumed after the means of downsizing state-owned shareholdings is adjusted.

## 3 Improving Listing and Delisting Procedures

The gradual improvements that have been made in China's stock markets have reached the point that market mechanisms have started to function. With respect

to listing procedures, the following three areas deserve attention. (1) One negative holdover from the days of the state-planned economy was the quota system, which allocated to local governments a certain number of the shares to be issued. This created a number of problems, especially during the experimental stage in the 1990s, when local governments listed financially troubled state-owned enterprises (most of which were not qualified for listing) in order to raise capital. (2) Overly optimistic expectations among investors for price run-ups after listing, as well as the actual record of inflated prices, raised a number of concerns. (3) Stock exchanges did not delist shares issued by enterprises with poor performances. Because investors expected that the government would bail them out in the end, a peculiar situation was created in which such stocks actually became popular among speculative investors.

It is noteworthy that recent trends have addressed some of these problems. First, a recommendation system has been introduced to replace the old quota system. It would appear that this new system has already taken de facto effect, as local governments must have surely used up the final quota allocated in 1997 amounting to 30 billion yuan. Under this recommendation system, a candidate for listing needs to obtain a recommendation from a securities firm (its main consignee), which submits a guidance report to the CSRC. Following this, the Verification Committee on Stock Issuance (consisting of professionals including some members of the CSRC, the stock exchange and securities firms) investigates the company and makes a final decision on its listing.

Second, listing prices in the past were set at relatively low levels to meet the requirement of maintaining PERs below 15—which, in turn, fueled the expectations of post-listing price increases. Currently, however, a transition to market-driven pricing is under way. Indeed, the price of Sinopec shares has declined even after recording Chinese largest initial listing in 2001. This phenomenon bears watching, as extraordinary price hikes following listing were previously the norm and attracted a huge number of speculative investors. The market should actually welcome price declines like this, as they suggest a more rational pricing mechanism is taking root.

Third, a lottery system is used to decide which investors may purchase stocks to be listed. As investors become eligible for the lottery only after remitting the money, those anticipating price increases often borrowed money from a bank to enter the lottery and bet on the chance of making profits by selling the stock. At the end of 2000, however, the People's Bank of China started to intervene in this type of bank lending (refer to Chapter V). The advance payment system for the lottery was originally developed to prevent defaulting on the payment afterwards. As a result, however, the substantial

funds collected by the listing company during the three-day period between the advance payment deadline and the lottery could be invested at the interest rate applicable for savings accounts with a maturity of one year.

Fourth, stock exchanges have started to delist companies with poor performance records. While Chinese Corporate Law provided for withdrawing the listing of enterprises that record losses for three consecutive years, there had been no cases under this provision until April 2001, when the Shanghai Stock Exchange delisted a company with losses for four consecutive years. As of the end of September 2001, there have been two delisting cases in total. Such delisted stocks are expected to trade in the future on the planned over-the-counter (OTC) market.

#### 4 Delay in Creating China's Second Board

There is a plan to create a second board in Shenzhen for start-up companies, providing a new market that is equivalent to the NASDAQ in the US and the GEM (growth enterprise market) in Hong Kong. This idea was developed on the grounds that it would be preferable for ventures such as high-tech companies (seen to be important players in economic development) to use a capital market specializing in start-ups, rather than relying on bank loans to raise capital.

The CSRC announced its draft regulations covering this second board in September 2000. Compared with the main boards in Shanghai and Shenzhen, listing requirements are lower, and wider daily price fluctuations are permitted. While the initial announcement led to expectations that this new market would open during the first half of 2001, it continues to be tied up in delays as of September 2001. Part of the problem relates to various technical steps that had to be cleared, including amendments to China's Corporate Law. But the main reason for the delay is the cautious approach adopted by the CSRC following the plunge in stock prices on the NASDAQ market. Hence, the actual launch of China's second board market ultimately comes down to a political decision regarding the appropriate timing, as all preparations are now completed. With this delay, another pending plan to merge the Shenzhen and Shanghai markets and create a single exchange in Shanghai will be postponed for the time being.

### III Improving the Government Bond Market

Currently, China's government bond market is playing an important role in channeling the pool of domestic savings to various economic activities. Since the lion's share of individual savings is kept in banks and is not efficiently utilized, government bonds have played a

major role in providing financing for many economic activities.

Over the past four years (1998–2001), government bonds totaling 510 billion yuan were issued to boost the economy. According to the Finance Department, government bonds issued during 1998–2000 in the total amount of 360 billion yuan funded national projects worth approximately 1.5 trillion yuan, a sum that includes increased bank lending following the bond issuance. Also, about 60 percent of the above amount has been spent on projects designed to develop the western region of the country, thereby contributing to implementing the national agenda aimed at the large-scale development of that area. Beyond this, in order to control the macro-level economy, the central bank needs a government bond market to enable the smooth exercise of open market operations.

Despite all these benefits and the potential of the Chinese government bond market, it still faces several issues that call for improvement. First, there are two kinds of government bonds: (1) certificate-type government bonds, which are similar to certificates of deposit and issued to individual investors; and (2) registry-type government bonds issued to members of the interbank market (to be explained below). Although the latter electronic registry is more efficient and desirable, certificate-type government bonds are still maintained for political reasons—namely, pressure from agents dealing in such certificates.

Second, since June 1997 the market itself has been split into two parts: the interbank market (for members including financial institutions such as commercial banks) and exchange markets (for individuals and local non-financial entities).

And third, the market lacks the periodic injection of new issues on a regular basis and offering diverse maturity dates, both of which are prerequisites for a mature market.

Fortunately, these problems are being resolved on a gradual basis. In 1999 and 2000, issues of registry bonds accounted for most of the new offerings, reflecting the intentions of the financial authorities to expand the interbank market (registry system) for better open market operations.

There has also been a movement to consolidate the interbank and exchange markets by narrowing the distinctions in terms of bond types and market participants. In September 1999, for example, registry-type government bonds were issued simultaneously in both markets. And since 1998, financial institutions other than banks have been approved for membership in the interbank market. Moreover, bonds are now offered with a greater variety in terms of maturity dates. For instance, 15- and 20-year government bonds were issued in 2001, in addition to the one-year government bonds issued in 2000 (see Figure 3).

## IV Nurturing Institutional Investors

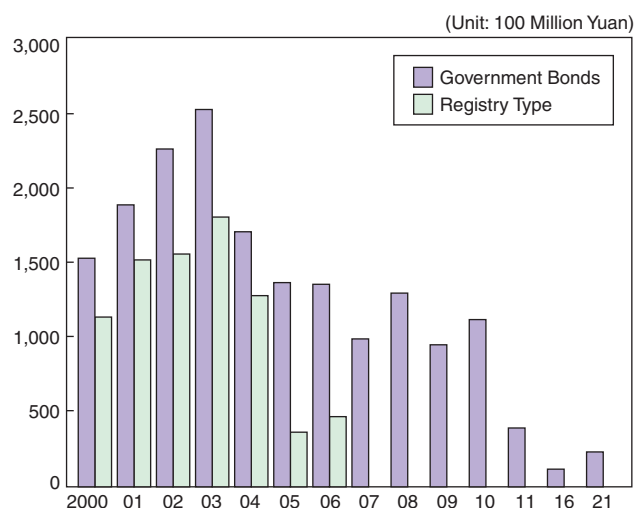
As the lack of truly professional investors promotes speculative investments, it is crucial to foster more institutional investors and develop stability in the market. The following is recommended for that purpose: (1) lifting the ban on open-end investment funds; (2) encouraging insurance companies and social security funds to enter the market, as can often be seen in advanced economies; and (3) clearing up the gray zone in terms of the laws covering private placement funds.

### 1 Lifting the Ban on Open-End Investment Funds

In September 2001, the first open-end funds in China (Hua'an Fund Management and Southern Fund Management) were approved and made available to investors. Prior to this, the only investment funds permitted in China were closed-end funds, which prohibited repayment before maturity (by 2000, China had 10 fund management companies [four additional companies joined in 2001] managing the operations of 33 funds). Open-end funds will improve the convenience of investors, who may purchase now and request redemption at any time in the future. The open-end fund market is expected to grow gradually with more funds to be established and approved.

On the other hand, fund management companies require a higher level of know-how to manage and sell open-end funds as compared to closed-end funds. At this point, many of these firms are trying to acquire know-how through some sort of assistance and/or cooperation agreements with foreign fund management companies. This applies not only to the first two open-end funds, but also to eight of the 10 fund management

**Figure 3. Government Bond Maturities**



Source: Compiled by NRI from *The People's Bank of China Quarterly Statistical Bulletin* and other materials.

companies mentioned above. Such a learning process will enhance their abilities and professionalism as institutional investors.

As one of China's post-WTO commitments, foreign participation in the fund management market will be permitted through joint-venture vehicles. Foreign-owned companies are hoping that the current cooperative relationship will lead to a partner status for such joint-venture businesses.

## 2 Market Entry by Insurance Companies and Social Security Funds

Insurance companies and social security funds are now assuming more importance in the stock market. The Chinese insurance market is expanding, and a legal framework for social security funds has been established.

In the past, insurance companies were allowed to make investments only via bank deposits and bonds. New provisions adopted in October 1999, however, allowed them to invest up to 5 percent of their total asset value in investment funds. Since then, the limits have gradually been lifted, reaching 15 percent for top-ranked companies at this point. With the total assets in the industry worth approximately 300 billion yuan in paper value, some 20 billion to 30 billion yuan could be flowing into the stock market via investment funds.

While it is true that the recently introduced open-end funds will increase investment options, insurance companies are demanding funds that are exclusively designed for their business. In fact, some insurance companies and fund management firms have signed agreements to meet such requests, and are waiting for final approval from the government. Moreover, there are those who advocate allowing insurance companies to invest in the stock market directly, without going through fund management companies.

Next, China's social security funds had been invested only in bank deposits (20%) and government bonds (80%). However, after the announcement of the plan to reduce state shareholdings in 2001 (for details, see II.2), part of the national social security funds—namely those raised by the divestiture of state-owned shares—are beginning to be managed by investment management firms both inside and outside of China. In addition, the Chinese government is expected to give its approval for the investment of funds from old-age and corporate pensions into the stock market, as early as 2002.

## 3 Future of Private Placement Funds

Private placement funds have recently been attracting considerable public attention. In actuality, only qualified investment fund management companies are permitted to collect money from investors privately and make investments. But recent research indicates that

private placement funds (also called underground funds) are wide spread despite their illegality, as is investment by securities firms with discretionary powers. These activities cannot be ignored in view of the amounts involved.

Research findings presented in an economic magazine came up with a ballpark estimate for the size of this underground market at around 700 billion yuan. As it has long been assumed on the surface that China's stock market is characterized by an unusually high proportion of individual investors (estimated by some to be as high as 99 percent of all investment accounts), these findings would appear to contradict this general impression by suggesting that an enormous amount of money has actually entered the market via these private placement funds.

Moreover, these illegal private placement funds are hard to detect, as they are carefully set up to appear as individual investors with their own accounts, and to leave no evidence to indicate a connection to another party with discretionary power. In other words, these private placement funds operate in a legal gray zone.

It is also worth noting that the private placement funds vary widely in terms of quality. Some are no more than a cover for illegal transactions including price manipulation based on insider information, while others have excellent fund managers. This complex situation suggests that private placement funds can be used to nurture institutional investors, depending on how they are handled. Therefore, the Investment Fund Law, currently under consideration by the National People's Congress (NPC) is expected to regulate private placement funds by approving certain types of funds, instead of trying to completely outlaw such funds across the board.

As mentioned above, China has been working on cultivating institutional investors, but still needs to improve the infrastructure side of the market. First of all, there is no established stock index like the Dow Jones or Nikkei Average. In order to evaluate the performance of each fund, it is crucial to create a stock index composed of leading enterprises in both the Shanghai and the Shenzhen exchanges. It is also necessary to offer hedge options by creating futures trades based on the stock index. These issues are currently under review by the stock exchanges and other bodies.

## V Tighter Supervision and Control

The highlight of China's stock market in the year 2001 appears to be the issue of tighter control. So far we have examined why stocks are over-priced and why they are not considered to reflect the true value of the issuing enterprises. In addition to these reasons, we need to bear the following in mind: (1) the lack of ade-

quate disclosure of corporate information; and (2) the existence of a host of illegal practices. Since the beginning of 2001, authorities such as the CSRC have started to go after such illegal activities. Although some have blamed this crackdown to a large extent for the fall in stock prices, the authorities do not appear to be easing up on exerting control and promoting fairness in the market.

First of all, the CSRC has tightened regulations to prevent illegal capital outflows to foreign markets. Following the opening of the B-share market to domestic investors, investment capital started to be illegally shifted to Hong Kong on the assumption that domestic investors might soon gain access to H shares. Indeed, even a Hong Kong tour designed for “H-share hunting” was reported around the holidays in May. Since February, some 20 billion to 50 billion Hong Kong dollars (2.6 billion to 6.4 billion US dollars) is considered to have been transferred abroad. In this context, China’s errors and omissions in the balance of payments for the year 2000 amounted to 11.9 billion US dollars.

In June, the CSRC warned domestic securities firms not to assist customers trading in Hong Kong shares, while the SAFE (State Administration of Foreign Exchange) tightened its control over transactions not complying with the Foreign Exchange Law, including counterfeit L/Cs (Letters of Credit). Such tighter controls are considered to have triggered the drop in H-share prices on the Hong Kong market since June. This is a typical example of the recent circumstances in which authorities have strictly enforced regulations to control speculative investments driven by rumors.

Second, price manipulation is another problem. In 2000, a magazine article revealed the illegal transactions carried out by some fund management companies that combined different funds to achieve a higher transaction volume, promoted speculative investments, or manipulated prices by churning huge volumes of the same stock. The CSRC conducted its own investigation following the release of this article and found that eight out of 10 fund management companies had been engaged in illegal transactions, including price manipulation. As a result, those companies were forced to discipline the employees responsible.

Third, funds from banks have been illegally entering the stock market. Since 1997, the authorities have used various measures in an attempt to regulate this type of money flow, as bank loans for investment in the stock market could promote speculative excesses. As a result of strict penalties (even criminal sentences in some cases), the number of such illegal transactions is believed to be subsiding. However, other observers are still concerned about scenarios where investors lie about the reason for bank financing and actually use the money to fund stock market transactions and convert the proceeds to cash. In such cases, investors still can borrow money from banks for speculative investments.

Although it is hard to control such abuses, once the authorities detect any illegal activities they mete out tough punishments to violators. In July 2001, for example, a bank in Shenyang that had channeled 500 million yuan into the stock market via false discount activities faced strict penalties—including permanent expulsion from the financial industry for the person who organized the scheme. Therefore, some people suspect that the drop in stock prices since July was partly caused by the withdrawal of illegal funds from the market.

Fourth, the market still needs to improve the situation related to information disclosure and corporate governance. In August, a case of pre-settlement window-dressing was detected in the Guangxia (Yinchuan) Industry Co, Ltd., despite the firm’s reputation as a leading corporation. Not only was the company penalized, but also the accounting firm involved in the scheme had its license suspended. Around the same time, the improper use of funds and the disclosure of false information were discovered in Sanjiu Medical & Pharmaceutical Co., Ltd., China’s largest domestic pharmaceuticals company. Following these two cases, an accounting firm that had allowed a listed company to disclose false information was suspended from conducting business at the end of August. In September, three more securities firms and three listed companies were penalized for similar problems related to information disclosure. Almost every week, China’s media reports that stricter controls being carried out.

Manipulating corporate information is often caused by the lack of good corporate governance. Some companies have a dominant shareholder who manages the business without recourse to stockholder meetings. In the worst case, such controlling shareholders simply use company funds to line their own pockets. The interests of minority shareholders are ignored in such situations, and information tends to be manipulated. As a means of resolving these problems and fostering good corporate governance, the CSRC recently announced an independent director system for listed companies. All affected companies are required to adopt this system by July 2002.

Under this new program, significant transactions with related parties need to be approved by an external panel of auditors. In addition, such external auditors can publicly announce their opinions on important matters regarding the company in question, as well as solicit proxies from minority shareholders to ensure that their views are voiced to management. However, as some question whether there are sufficient numbers of qualified individuals to fill such posts, it probably will take some time before this system starts functioning smoothly. Nonetheless, it is a first step towards improving corporate governance in many Chinese enterprises.

In addition, class action suits by minority shareholders who suffer financial losses from such illegal corporate conduct will come to play an increasingly

important role. In the previously mentioned case concerning the Guangxia (Yinchuan) Industry Co., Ltd., the punishment visited on the company did not include any requirement to pay compensation to the affected investors. The CSRC appears to be leaning towards advocating a class action suit in this case. Because of its limited numbers of qualified personnel, however, the CSRC is seeking to leverage the possible exposure to class action suits or mandated compensation by urging each economic unit to comply with the relevant legislation on a self-governing basis.

## VI China's Capital Market Targets the Advanced Economy Model

Since Zhou Xiaochuan became chairman of the China Securities Regulatory Commission in April 2000, the reform of China's capital market has been rapidly pro-

gressing. As described above, China has been attempting to rid itself of the baggage remaining from the era of the state-planned economy, while implementing the framework for a free market economy based on the models prevailing in the advanced economies, especially that of the United States. We have to allow some time until such a framework can function well. In a nutshell, China still has quite a ways to go before it completes its reform plans.

Nonetheless, China has reached the point where it cannot revert to the past or halt the globalization of its economy. Therefore, reforms in the capital market—which can leverage other reform plans—are expected to continue to move forward at the current rapid pace. Soon Japanese companies will start to look at China's capital market as a place to raise and invest funds.

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