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DISCUSSION PAPER 03.04

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Abstract

This paper reviews the history of the development of the Chinese stock market, analyses the market scale and structure, and sheds light on the prospects of the market. The development of the stock market can be classified into four stages, namely, the early stage of stock market development (1983-1991), the transition of the regulatory system (1992-1996), the Red Chips craze and the deflation (1997-1999), and WTO entry and state share reduction (2000-present). We argue that the current structure of China's stock market is unbalanced and that this has important repercussions on the performance of listed companies and the further development of the stock market. Solving the problem with the poor liquidity of non-tradable shares is a particularly urgent task. As China is expected to maintain its current economic growth momentum, the prospects are that the Chinese stock market will continue to expand in the coming decade.

The Chinese Stock Market: Development and Prospect

Since the Shanghai securities exchange (SSE) was established in December 1990, the Chinese stock market has developed rapidly and in a manner significantly different from the stock markets in the West. In many aspects, the development of the Chinese stock market has been very successful. Although initially the equity markets were used largely as a tool for enterprise reform, today they are no longer experimental and have become a vital part of the national economy. Nevertheless, the Chinese share markets have been and continue to be prone to distortion and it is therefore not surprising that the markets still face substantial and varied challenges and problems.

Recently researchers have shown increasing interest in the Chinese stock market and they have reported the results of work on a limited number of specific problems.[1] This paper adds to the literature by providing a systematic record of relevant events and their impact on the stock market with the purpose of enabling the readers to understand the history, the present state and the future prospects for the development of the Chinese stock market.

In the next four sections we review the development history of Chinese share markets, both the primary and secondary markets, describing in each section one of the four stages we identify in the development of the market. That is, the early stage of stock market development (1983-1991), the transition of the regulatory system (1992-1996), the Red Chips craze and deflation (1997-1999), and WTO entry and state share reduction (2000-present). We then go on in Section 5 to analyze the current features of the two exchanges and the problems they now face. Section 6 discusses the prospects of China's stock markets and, finally, conclusion is set out in section 7.

[1]For recent works, for example, see Chui and Kwok (1998) on cross-autocorrelation between A and B shares, Ang and Ma (1999) on transparency in Chinese stocks, Ma (2000) on informational efficiency of Chinese share markets, Chen, Lee and Rui (2001) on foreign ownership restrictions and market segmentation, Groenewold, Tang and Wu (2001) on the efficiency of Chinese stock market, and Groenewold, Tang and Wu (2002) on the dynamic interrelationships between the greater China share markets.

1 The Establishment of the Share Market in China

The Chinese share market can be traced back over 130 years to the late Qing Dynasty when the Shanghai Stock Exchange was first set up in 1869 by foreign firms. Then in 1918 the Beijing Securities Exchange, the first Chinese-operated stock exchange, was established. Since the stock market was basically oriented towards the agriculture and family operation, it never played an important role in the economy. After the establishment of the People's Republic of China in 1949 the two stock exchanges were closed as they were regarded as places for speculation, a capitalist phenomenon inconsistent with the communist ideology of the new government. Hence, the stock market disappeared in China for about 30 years (Liu, 1992). In 1978 the Chinese government began a process of economic reform which included, importantly, the opening up of the economy to the rest of the world. As reform and opening progressed, concomitant changes have also taken place in China's financial system. In this section, we describe the initial stage of the development of the market and distinguish three episodes which led up to the formal establishment of the Chinese stock market – the spontaneous development of share-like securities in the 1980s, the share fever of the late 1980s and the formal setting-up of the two Chinese securities exchanges.

Spontaneous development of share-like securities (1983-1988)

The resurrection of the share market in China began in the Township and Village Enterprises (TVEs) of the southern coastal provinces in the early 1980s. Under the influence of the openness and reform policies, villages began establishing TVEs. Since capital requirements for these new enterprises were more than a single family or even a village could meet, experimentation began with a "co-operative shareholding" structure.[2] Such experiments proved successful in raising capital and soon were quite common, becoming known as the "shareholding co-operative" system.[3]

[2] After nearly a decade of experimentation, the Ministry of Agriculture promulgated "the provisional regulations on farmer shareholding cooperative enterprises" on 12 February 1990 in *Jinrong Falu Fagui Quanshu*, Vol, 3, pp.2826-30 (cited by Walter and Howie, 2001, p.226). Generally speaking, in the TVEs, farmers or villagers held the non-tradable share certificates and allocated the dividends according to the respective proportion of the shares they held at the end of each year.

[3] The "shareholding co-operative" enterprises in a manner were similar to shareholding companies. In general, some small state-owned, collective and private enterprises were merged. The employees jointly operated the business and allocated the profits according to their work hours and the proportions of the shares they held. More details can be found in Li (1998, p.53).

In 1983 a Shenzhen TVE named the Baoan County Joint Investment Company became the first Chinese enterprise to issue share certificates to the public after the establishment of the People's Republic of China (PRC). In July 1984 the Beijing Tianqiao Department Store was the first state-owned enterprise (SOE) restructured as a company limited by shares and in November of the same year the Shanghai Feile Acoustics Company issued irredeemable shares to the public. These early transactions were unregulated and represented the tip of a development that was gathering momentum. The enactment of 'the decision on the reform of the economic system' in October 1984 greatly promoted the broad development of shareholding co-operative and individual (private) enterprises (Gao, 1991). The shenzhen government in 1986 was first to standardize procedures relating to the restructuring of enterprises into shareholding companies.[4] From 1984 to 1989, lots of shareholding companies were set up all over the country and issued 3.8 billion yuan worth of shares. Of these, 70-80 percent of the shares came from conversion of existing state assets, and relatively little new capital was raised by issuance of stocks. Moreover, most of the stocks were issued to related companies or employees in the companies and less than two percent were public issues to general investors. In Shanghai, for example, by 1990 there were 1,250 non-public offerings to only 11 public offerings (Lan, 1997).

The late 1980s was obviously a period of spontaneous fundraising through the issuance of wide variety of non-standardized shares. At first, individual investors weren't interested. They didn't understand that shares could appreciate (or depreciate) in line with the given issuer's economic performance or even simply as a result of supply and demand (Walter and Howie, 2001). To entice individual investors, the companies had to pay dividends at fixed rates in excess of the bank deposit rate, and some companies even promised to refund shareholders on demand. So initially shares bore a strong

[4] Shenzhen Municipal Government, "Provisional regulations on the pilot program for the transformation of state-owned enterprises into shareholding companies", 15 Oct 1986, *Jinrong falu fagui quashu*, Vol.3, pp.2815-18 (cited by Walter and Howie, 2001, p.25). The provision defined the restructuring of a SOE into a shareholding companies as follows: "…transforming the net asset value of a SOE into shares representing the state's equity ownership; then transferring a portion of the state's ownership to other enterprises and individuals or taking in new shares from the state, other enterprises or individuals; then transforming the original enterprises into a company limited by shares in which the state, other enterprises and individuals participate in the shareholding; and then transforming the original enterprises into a company limited by shares in which the state, other enterprises and individuals participate in the shareholding".

resemblance to debt securities. Investors tended to hold rather than trade securities. However, from the mid 1980s equity issuance became increasingly frequent and shares began to change hands through non-market channels. In August 1986 Shenyang became the first city to initiate formal over-the-counter (OTC) trading followed by Shanghai in September of the same year. Then the Shenzhen government in October approved the formal establishment of OTC trading at various financial institutions. By the end of the 1988 there were nine financial institutions conducting OTC trading, eleven business services across the city of Shenzhen, and one institution providing share registry services. In Shanghai some of Trust and Investment companies were allowed to establish OTC trading operation with a primary focus on treasury bonds in April 1988. In the coming twelve months eight trading counters were established with central government supervision. Yet only eight Shanghai companies' shares were traded on the Shanghai OTC market. So almost from the outset Shanghai took on the nature of a central government sponsored market for debt securities, while Shenzhen was the more informal and undisciplined equity market (Walter and Howie, 2001).

Share fever (1989-1990)

"Share fever" came from the Shenzhen Development Bank, China's first financial institution limited by shares, which announced a dividend based on its 1988 results in March 1989. This announcement marked a major turning point in the Chinese share markets. The bank was exceptionally generous to its investors awarding them a cash dividend of 7 yuan per share (amounting to 35% cash dividend ratio), a two-for-one stock dividend, and one-for-one stock split. Investors who bought the bank's shares in 1988 for about 20 yuan per share now enjoyed a profit several times their original investment. Just before 4 June 1989 the price of the bank's shares soared in OTC trading from a year-end price of 40 yuan to 120 yuan and ended the year at 90 yuan.[5] Throughout the summer of 1990 prices for the publicly traded Shenzhen companies continued to rise rapidly and the ensuing "share fever" saw funds pouring in from all across China. While the "share fever" was centered on Shenzhen, it gradually extended to Shanghai.

[5] See Walter and Howie, 2001, *To Get Rich is Glorious,* pp.29-30.

Since only a very limited number of shares were available on the market, prices rose very quickly at this early stage and the share market became wild and speculative. Historical data show that by the end of 1990 total securities were valued at over 200 billion yuan. Of these, stocks accounted for only 4.5 billion yuan or 1.9% of the total while state bonds were 47%, enterprise bonds 13%, and CDs 16% (SSB, various issues). Lan (1997) reported that during this period some shares traded at 10 times, 20 times, 50 times, and even 106 times their face value.

"Share Fever", as the period was characterized, produced a strong reaction from the State Council (Walter and Howie, 2001). Many measures were taken to cool the markets, including daily price movement limits, increased transaction taxes, and ownership-transfer stamp duties. In May 1990 the State Council announced restrictions on the share market experiment, including its limitation to the state sector (SOEs) and the designation of Shenzhen and Shanghai as the only officially recognized OTC markets. These measures led to a market collapse in late 1990.

Establishment of two securities exchanges (1990-1991)

The introduction of OTC trading in Shenzhen and Shanghai was followed by a formal decision to proceed with the establishment of the Shanghai and Shenzhen security exchanges. The intention was to provide a formal venue for security trading in two administrative areas well under the control of the central government. Eventually the Shanghai securities exchange (SSE) was opened on 19 December 1990 and the Shenzhen securities exchange (SZSE) shortly after in February 1991.[6] Both exchanges were heavily promoted by their local municipal governments and had the approval of the nominal regulator, the People's Bank of China (PBOC). Elsewhere in the country OTC trading continued, particularly in Shengyang, Wuhan and Tianjin, each of which had sought to establish a recognized exchange but was not successful. With their establishment both exchanges shared an organizational structure similar to a non-profit organization run by members (securities firms and securities agencies) through a general meeting that elects a standing executive committee or council. The council is

[6] At the beginning, SSE and SZSE are called Shanghai securities exchange and Shenzhen securities exchange, see *Jinrong falu fagui Quanshu,* August 1990 and January 1991, Vol.3, pp.2746-58 (cited by Walter Howie, 2001, p.232). Later the fact that Shanghai securities exchange on unilaterally changed its English name to the 'Shanghai Stock Exchange' is an indication of its effort at establishing an independent identity. Later Shenzhen followed this practice.

headed by a director with a separate general manager appointed by the executive council to act as the legal representative for the exchange. In addition, a supervisory committee responsible to the members' general meeting was also established. Both exchanges were subject to the supervision of their respective local PBOC branches.[7]

The openings of Shanghai and Shenzhen stock exchanges were extremely important historical events. They marked the official foundation of the Chinese stock market even though the scale of the market was quite small (11 listed companies with a total value of 500 million yuan in Shanghai and 5 listed companies with a total face value of 270 million yuan in Shenzhen) (Lan, 1997).

From the early stages of the establishment of China's two exchanges two main types of shares have been traded: A shares and B shares. In this dual market, A shares are common stock issued by mainland Chinese companies, priced and traded in Chinese Renminbi (RMB), listed in either of the two exchanges, and bought and sold by domestic investors only. The A share market was launched in 1990. On the other hand, B shares are issued by mainland Chinese companies, listed in either of two exchanges, carry a face value denominated in RMB but are traded in foreign currencies (US dollars for Shanghai and HK dollars in Shenzhen) and bought and sold exclusively by foreigners. The B share market was launched in 1992. However, due to the continuously thin trading and small capitalization of the B stock market, B shares have been made available for trading by domestic investors since February 2001. Besides the A and B shares, there are several other types: H shares have been issued by Chinese companies since 1993 and traded on the Hong Kong stock exchange (in terms of HK dollars); N shares are American Depository Receipts (ADRs) and are issued by Chinese companies and traded on the New York stock exchange in terms of US dollars; and S shares are floated by Chinese companies and traded on the Singapore stock exchange in terms of Singapore dollars. However, the relative importance of the final two types of shares is small in terms of their capitalization and turnover.

[7] In Shanghai the council director is nominated by the council and followed by PBOC Shanghai branch approval. Its general manager, deputy general manager and supervisory committee director are all nominated by PBOC Shanghai Branch and approved by PBOC headquarter in Beijing. Shenzhen seems more independent. There the council director, general manager and the supervisory committee nominated by their council subject to PBOC Shenzhen Branch approval (Walters and Howie, 2001, pp.76-77).

2 Transition of the Regulatory System (1992-1996)

The exchanges having been formally established, the time now arrived for the development of a regulatory structure within which the stock market could operate efficiently and in a manner consistent with the overall economic policy of the Chinese government. The process of development during 1992-1996 can be divided into two overlapping episodes: the first culminating in the establishment of the State Council Securities Committee (SCSC) and the Chinese Securities Regulatory Commission (CSRC) with the eventual domination of the latter, and the second concerning with the role of the banks in the stock trading.

Establishment of the SCSC and CSRC (1992-1994)

In early 1992 Deng Xiaoping undertook a historical trip to the southern province of Guangdong where his support to the shareholding system triggered an explosion of share-trading activity both domestically and internationally. In the meantime, the Chinese economy recorded a rate of growth in real GDP of 12.8% in 1992, 13.4% in 1993 and 11.8% in 1994. However, this fast growth was accompanied by high rates of inflation, which peaked at 21.7 per cent at the end of 1994 (SSB, various issues).[8] Those positive developments dramatically boosted trading in the two stock exchanges. The SSE composite index peaked at 1558.98 on 16 February 1993 compared to its base value of 100 in December 1990; the SZSE composite index was 359.44 on 22 February 1993 compared to its base value of 100 in April 1991 (Table 1).[9]

Prior to 1992 the market was quite small, and relatively unregulated. Though extensive regulations were drafted in 1989, they were never implemented.[10] However, after

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[8] This figure is based on the retail price index. The rate is 24.1% if the CPI is used.

[9] The SSE composite index is a weighted index of the share prices of all listed companies on the Shanghai exchange. Its base value is 100 points in December 1990. The SZSE composite index has a similar structure but with a base date of April 1991.

[10] Such draft regulations include "Provisional measures on the experiment with the shareholding system by enterprise", "Regulations on shareholding companies", "Regulations on limited liability companies" and the PBOC drafts including "Provisional measures for the administration of the issuance and trading of shares". These drafts were then submitted to the State Council for review and approval. But, due to the Tiananmen incidence in June 1989, these measures were not taken up again until after Deng Xiaoping's trip (Walter and Howie, 2001, p.95).

Table 1 Historic Data of SSE Index (19 December, 1990 – 31 December, 2002) and SZSE Index (3 April, 1991 – 31 December, 2002)

(SSE Base = 100 on 19 December,1990; SZSE Base = 100 on 3 April, 1991)

Year	Open		High		Date		Low		Date		Close	
	SSE	SZSE	SSE	SZSE	SSE	SZSE	SSE	SZSE	SSE	SZSE	SSE	SZSE
1990	96.05	n.a.	127.61	n.a.	12/31	n.a.	95.70	n.a.	12/19	n.a.	127.61	n.a.
1991	127.61	100.00	292.75	110.37	12/31	12/31	104.96	45.98	05/17	09/20	292.75	110.37
1992	293.74	110.53	1429.01	312.21	05/26	05/26	292.76	107.08	01/02	01/16	780.39	241.21
1993	773.89	251.63	1558.98	359.44	02/16	02/22	750.46	236.52	12/20	12/29	833.80	238.27
1994	837.70	233.13	1052.94	242.65	09/13	07/29	325.89	96.56	07/29	07/29	647.87	140.63
1995	737.72	139.88	926.41	169.66	05/22	05/22	524.43	112.63	02/07	12/28	555.29	113.25
1996	550.26	110.15	1258.69	473.02	12/11	12/11	512.83	105.34	01/19	01/22	917.02	327.46
1997	914.06	334.13	1510.18	518.13	05/12	05/12	870.80	305.81	02/20	01/06	1194.10	381.29
1998	1200.95	389.70	1422.95	439.28	06/04	06/01	1043.02	317.10	08/18	08/18	1146.70	343.85
1999	1144.89	336.56	1756.18	525.14	06/30	06/29	1047.83	310.65	05/17	05/18	1366.58	402.18
2000	1368.69	414.69	2125.72	654.37	11/23	11/23	1361.21	414.69	01/04	01/04	2073.48	635.73
2001	2077.08	644.66	2245.44	664.85	06/14	06/13	1514.86	439.36	10/22	10/22	1645.97	475.94
2002	1643.49	470.76	1789.89	512.38	06/25	06/24	1357.76	371.79	12/31	01/22	1357.65	388.76

Notes: n.a.- not available.

Source: Datastream.

Deng's positive comments in early 1992, all provisional measures and other regulations were poured forth, including the Standard Opinion and the Corporate Law.[11] These imposed a standard framework on shareholding companies and the shares offered to investors. Yet, and not surprisingly given the nature of the Chinese political system, the regulations were imbued with the spirit of state planning, state control and state interest. For example, the Standard Opinion permits a company to issue both common and preferred shares. Meanwhile it also defines a number of different types of shares such as state shares, legal person shares, individual shares and foreign capital shares. These different classes of shares reflect the ownership characteristics of the assets contributed by the promoters of or investors in the new company. According to the Standard Opinion and the Corporate Law, state shares refer to shares held by governmental agencies or authorized institutions on behalf of the state. It includes: (a) the shares converted from the net assets of SOEs which have been transformed into joint shareholding companies; (b) the shares initially issued by companies and purchased by governmental department; and (c) the shares initially issued by companies and purchased by the investment companies, assets management companies, and economic entity companies authorized to invest on the behalf of the state. State shares are not allowed to trade on an open market. Legal person shares refer to shares of a joint stock company owned by another company or institution with a legal person status. There are four types of owners for legal person shares, namely, state-owned, collective enterprise, private enterprise, foreign invested enterprise and institutional legal person shares. The transfer and trading of legal person shares are also restricted. Individual shares, with an official recognized nickname of A share, refer to shares that may only be owned by Chinese citizens. A shares have the full function born by classic stock, and it can be freely traded and transferred in domestic markets. Foreign capital shares include B shares and overseas-listed shares (H shares, N shares, S shares and so on).[12]

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[11] The Standard Opinion, implemented in May 1992, was aiming at standardizing the procedures of creating shareholding companies. For SOEs there were two principal ways to be restructured into companies: the promoter method and the fundraising method. The Corporate Law was signed into effect in July 1994. It was a formal law to standardize the organization and behaviors of limited liability and companies limited by shares.

[12] See the paper entitled "Different Types of Shares in China's Stock Market", Http://www.cninfo.com.cn.

The many different classes of share have their origin in the doctrine of Chinese ownership of productive assets. Prior to economic reform begun, the ownership structure of an enterprise either took the form of state-ownership or collective-ownership (collective assets owned by employees). The state had discretionary power to set the price of all products produced by state-owned enterprises regardless of the size of supply and demand, as well as the allocation and transfer of assets among state-owned enterprises. The collectively owned firms could set the price based on the market mechanism. The state could not interfere in their financial affairs such as profit allocation and employment of workers.

Under the system of the public ownership, all assets belong to the State on behalf of the people. Following the emergence of the shareholding system, however, Policy makers are concerned about the trading of state shares and legal person shares: it may erode the state's position of majority shareholding in state-owned enterprises. They were afraid that the trading of state shares and legal person shares would undermine the state's holding of its assets with the result of the loss of their dominant position in the national economy. So the Provisional Measures on the Regulation of State-owned Shares Issued by Companies Limited by Shares was enacted in 1994. According to this law the predominance of the socialist public ownership system would be preserved in the shareholding system by maintaining the controlling position of the state-owned share rights. Here the state-owned shares include state shares and state-owned legal person shares. During the period of the conversion of enterprises into shareholding companies, this policy resulted in the necessary dominant positions for state shares and the secondary position for state-owned legal personal shares, with individual shares to occupy a third, non-controlling, and minority position. Having thus created a hierarchy in the primary market for shares of the state, legal person, and individuals respectively, the government designed a peculiar secondary market aimed at maintaining in the secondary market the same hierarchy of classes of shares created in the primary market. As a result, the trading of state shares is banned, the trading of state-owned legal person shares is confined within the scope of state-owned enterprises, and members of the Chinese public may trade individual shares among themselves.[13]

[13] See the paper entitled "Reasons for the Introduction of State Shares and Legal Person Shares", Http://www.cninfo.com.cn.

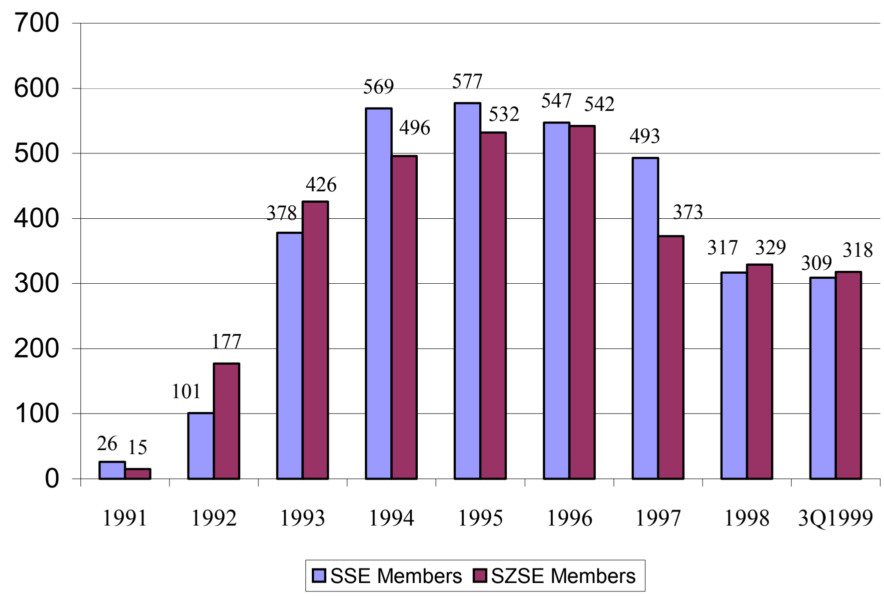
As can be expected, such an artificially segmented capital market has resulted in poor liquidity and produced artificial, differentiated prices for various types of shares of the same issuer. With the rapid growth of stock markets, restriction on trading state and legal person shares has had various adverse effects. For instance, the value of state assets cannot be increased; the enterprise' assets cannot be optimized and restructured and the advantages of a shareholding economy cannot be realized to its fullest extent. The enormous amount of non-tradable shares limits the function of stock markets as a mechanism to evaluate the management performance of listed companies and poses a serious threat to the secondary market. The problems of state shares have been recognized as a continuing headache for the Chinese government and will be further discussed in Section 5.

Another issue that has became a serious concern to the Chinese government relates to the role of the People's Bank of China (PBOC) in the securities market. Before October 1992 the PBOC was not a real central bank and was responsible for all aspects of the regulation and administration of China's financial system. The evolution of the PBOC is as follows: (1) During 1949-1979 the PBOC was the only financial institution whose branches were located in every province and municipality of the country and provided all kinds of financial services including deposits, loans, foreign exchange, insurance and so on. (2) From 1980 to 1985 the PBOC was gradually transformed to play the role of the central bank and several state-owned commercial banks were set up such as Bank of China, Agricultural Bank of China, China Construction Bank and Industrial and Commercial Bank of China.[14] But they were owned by the State and PBOC was their actual owner and regulator. (3) During 1986-1992 the PBOC exercised comprehensive regulatory as well as administrative jurisdiction over the financial sector, broadly defined to include the traditional financial sector, insurance sector, and securities.[15] The PBOC further delegated certain regulatory and legislative powers to its provincial and municipal PBOC branches for the regulation of the securities market. As a result, the PBOC, other state-owned banks, the Ministry of Finance and local finance departments were permitted to establish their securities agencies and indirectly

[14] The four state-owned banks became state-owned commercial banks only after the enactment of the Commercial Bank Law in 1995.

participate in the securities market. Figure 1 shows that the SSE members increased from 101 to 577 while SZSE members from 177 to 532 during 1992-1995.

Thus, the PBOC was both the regulator of and an active participant in (and beneficiary of) the securities market. Not surprisingly by the early 1990s speculation and violation of regulations were rife because of the PBOC official corruption. Policy makers realized that the PBOC as an institution was unsuitable as market regulator.



Source: Fact Book of SSE and SZSE (cited by Walter and Howie, 2001, p. 81).

Figure 1 Historical Data on Members in SSE and SZSE (1991-3Q1999)

As a result, the Chinese Securities Regulatory Commission (CSRC) and the State Council Securities Committee (SCSC) were set up in October 1992. The SCSC, similar to the Equity Market Office, was a ministry-level government organization and was authorized by the State Council to enforce securities laws. It was the immediate superior of the CSRC during the period October 1992 – mid 1998. The CSRC was a quasi- government, vice-ministry entity and was designed to be the implementing apparatus for the SCSC. The CSRC was responsible for drafting various regulatory measures, overseeing and supervising entities involved in the securities business, compiling the requisite statistics and market analysis to advise the SCSC on policy

[15] The PBOC was not to become a normal central bank until after the enactment of the PBOC Law in

matters. It eventually became the dominant regulatory body. Its accretion of power has domestically gone through three stages: (1) the establishment and consolidation of authority over the securities and future markets during 1992-1993, (2) the CSRC's full control over the two exchanges in 1996, and (3) in mid 1998 the SCSC was dissolved and the CSRC became a full ministry-level organization empowered by the 1999 Securities Law.

The Role of the Banks (1994-1996)

The securities firms, the principal players in Chinese share markets, initially originated from the major banks, local government Finance departments and Trust and Investment Corporations.[16] Before the establishment of both exchanges, the securities firms mainly engaged in the trading of various kinds of bonds. Since 1991, with the development of stock market, securities firms developed very quickly and focused their businesses on stock underwriting and trading. The number of securities firms increased from 44 at the end of 1990 to 87 by October 1992. Naturally, the competition among the securities firms became fiercer and fiercer due to the limit of listed shares and excessive numbers of securities trading agencies. Some securities firms began to be involved in speculation or trading of futures on the markets in order to survive. The over speculation and high risk in the Chinese share market forced the government to adjust and regulate securities firms. In December 1993, the State Council made a decision to separate the banks from the securities industry and industrial enterprises. Although the State Council permitted banks and industrial enterprises to invest in financial institutions including securities firms, it prohibited securities firms from investing in any sector but the securities industry. The government's effort has been to create a Glass-Steagall-like segregation between securities industries and banking.[17]

The first step in this process was the separation of the PBOC branches from all economic entities including securities firms. Then in 1994 the PBOC prohibited the Ministry of Finance and local government finance departments from involvement in

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1995.

[16] There are two categories of securities firm: (1) comprehensive secuities firms; and (2) brokerage firms.The two are subject to different regulations and receive different licenses. The former must have a minimum of 500 million yuan in capital to run brokerage and proprietary trading business.The latter needs only 50 million yuan to run brokerge business only.

[17] Wheelock, David C. , 1994, "Glass-Steagall Act", *New Palgrave Dictionary Money and Finance,* Vol. 2, Mocmillan, London, pp.243-244.

ownership of securities firms. The State Council also prohibited the major commercial banks from owning trust and investment corporations which, in turn, usually either owned a securities firm or had their own internal securities department. The Laws of PBOC and the Laws of Commercial Banks enacted in mid 1995 confirmed this segregation, as did the Securities Law enacted on 1 July 1999. The resulting disappearance of bank members from both securities exchanges and the consequent withdrawal of enormous sums of funds from the share market led directly to the share market stagnation during early 1994 to April 1996 (Figures 2 and 3). This market downturn was exacerbated by the anti-inflation measures which were put into place in mid-1994. It is interesting that one of the anti-inflation measures was a virtual halt to the approval of new equity listings both domestically and internationally. The policy to control inflation was successful since by the end of 1995 inflation rate clearly fell and in early 1996 it declined to below 5 percent while GDP growth maintained a rate about 10 percent. The effect on stock prices was even more dramatic – the stock price indices bottomed with the SSE Composite index down to 325.89 on 29 July 1994 from1558.98 eighteen months ago and the SZSE Composite Index falling to 96.56 from a previous high of 359.44. Thereafter the Chinese stock market experienced more than two years stagnation (Table1 and Figures 2 and 3).

Source: Datastream.

Figure 2: Shanghai Composite Index (1990 - 2002)

Source: Datastream.

Figure 3: Shenzhen Composite Index (1991 - 2002)

3 Red Chips Craze and Deflation (1997-1999)

With the regulatory framework in place, the Chinese market experienced fluctuations which are not uncommon to stock markets. In this section we look at the brief "Red Chips Craze" associated with the handover of Hong Kong in mid-1997 and the subsequent deflation and stable market until the end of the century.

"Black Monday" and the Red Chips craze (Late 1996-1997)

In April 1996 the stock market began to recover and prices rose strongly so that by mid-December of that year the average stock price had risen by 120 percent in Shanghai and by over 300 percent in Shenzhen. On 11 December 1996 the Shanghai index reached a high of 1258.69 and the Shenzhen index was up to 473.02, the highest in three years with the daily turnover of 37.4 billion yuan (Table 1). But 16 December 1996 was "Black Monday" for the Chinese stock market due to the disclosure of illicit speculation by the Shenzhen Development Bank. The government took strict measures to punish the offenders as well as to ease the overheating of the market. Consequently prices fell dramatically in the exchanges – both A share indexes fell by approximately 40% in a little more than a week after which the market was subdued for some time, with the Shanghai index at around 1000 and Shenzhen index 350 (Figures 2 and 3).

The lull was short-lived, however, since the "Red Chip Craze" in the Hong Kong market terminated the stagnation. Red chips are stocks listed on the Hong Kong Stock Exchange for companies with significant interests in mainland China.[18] As the Hong Kong handover of July 1997 approached, trading in the Red Chip stocks became increasingly frenzied. In 1997 alone there were 16 initial public offerings (IPOs) of such companies including the largest China IPO, China Telecom. This clearly spilled over into the Shanghai and Shenzhen exchanges both of which experienced a sustained upturn in prices for about a year although there was some downward correction in the weeks leading up to the handover on 1 July 1997.

Deflation and the quiet markets (1998-1999)

At about the time of the Hong Kong handover, however, the market fell and then lapsed into quiet trading. This was a function of two factors. First in 1998 it became apparent that China was drifting into a deflationary period with continual decline of the CPI and a rising unemployment rate. Second, China was not wholly immune from the Asian financial crisis after its outbreak in 1997. China's export growth shrank drastically and growth in committed foreign direct investment turned negative for the first time since the early 1990s. This uncertain economic environment also affected Chinese domestic and international new equity issues. In 1998 there was a total of 106 issues (only three of which were B share issues) domestically and two internationally compared to approximately 200 in the previous two years (323 listed companies in 1995, 530 in 1996 and 745 in 1997). The first half of 1999 saw only 39 A-share issues, no B-share issues and one issue of H shares.

Despite this, a rally began on 19 May 1999 which pushed share prices up nearly 40 per cent in a little over a month. This recovery followed a number of stimulatory measures issued one after another. They included allowing state-owned enterprises and up to five per cent of the assets of 25 insurance companies to enter the securities market, the implementation of a tax on interest earnings from savings accounts and an expansion of brokerage capitalization. On 15 June the government joined the party by writing the

[18] A Red chip company should have at least a 35% shareholding directly held by either: a) mainland entities which are defined to include state-owned organizations, provincial or municipal authorities in mainland China; or b) listed or privately owned Hong Kong companies which are controlled by mainland entities. Moreover, the company should have at least a 12-month trading record after having satisfied above criteria (Walter and Howie, 2001, pp. 164-165).

famous *People's Daily* editorial proclaiming, in preparation for the 50th anniversary of the PRC, that the upturn reflected a fundamental improvement in the overall economy. Besides, the Securities Law also took effect on 1 July 1999, which pushed up market sentiment.[19] The Shanghai market promptly shot upward by 600 points (from the 1999 opening index of 1144.89 to a 1999 high of 1756.18 on 30 June) before falling back once again. Activity in the Shenzhen market exhibited similar characteristics over the same period (Table 1).

4 WTO Entry and State Share Reduction (2000- present)

.From 2000 onwards, the Chinese Stock market has experienced a continuing rectification and standardization. The major episodes include China's WTO entry and the debate about state share ownership.

WTO entry and bull markets (2000-mid 2001)

The late 1990s appeared to be a turning point of the Chinese economy. Exports increased and deflationary pressures were reduced. Most large and medium-sized state enterprises were showing signs of recovery, and retail prices were beginning to pick up. Most of all, China and US reached their trade agreement on China's WTO entry on 16 November 1999. All these developments created a sound basis for a medium- to long-term rally in the stock market, especially for the shares that are likely to benefit from China's WTO entry such as textiles, clothing, and high-tech industries. In fact, in early 2000 the stock markets rebounded strongly and maintained bullish trading on expectations of more market-boosting policies and sound economic growth in 2000. The price of A shares soared by more than 50 percent on the Shanghai exchange and by more than 60% on the Shenzhen exchange in the first eight months of 2000. Later in 2000 several stimulatory measures, such as the establishment of a venture capital market in both stock exchanges and the entry of pension funds into the stock market, were taken by the government and caused further surges in China's stock market. In brief, during 2000 the securities markets expanded rapidly with market capitalization increasing from 2647.117 to 4809.094 billion yuan and both exchanges' indices rising strongly (SSE composite index from 1366.58 to 2073.48, SZSE composite index from 402.18 to 635.73) (Table 1).

[19] The Securities Law is intended to provide a framework for rationalizing the great many extant, narrow rules, measures and regulations that touch on securities matters, which apply to the issue and trading of shares, corporate bonds and other securities.

At the start of the new millennium the upturn continued in China's stock market due to investor confidence even though international securities markets fell. On 19 February 2001, the government allowed domestic investors into the B-share market, Thus up to US$75 billion of household savings (deposited in foreign currencies) was made available for stock investment.[20] Since then, greatly increased liquidity has sent B-share prices surging. By April 2001 the SSE B share index was up by 130 per cent and the SZSE B index soared 205 per cent. B shares trading and investor sentiment pushed the whole market steadily upward to reach its highest point of 2245.43 in Shanghai on 14 June 2001 and 664.85 in Shenzhen on 13 June (Table 1).

State shares reduction and the market recession (July 2001- present)

This strong share-price growth was reversed, however, when the government announced its intention to solve the non-tradable share problem by means of state share reduction from 2001. According to the statistical report of the Shenzhen Securities Information Company, by the end of 30 June 2001 there were 1121 listed companies with total non-tradable shares of 259.324 billion, which represents 67.76% of total issued shares. Of these, state-owned shares accounted for 178.606 billion, or 42.23% of total (Table 2). The government planned to complete the sale of state shares over a five-year period with a total of 251.51 billion yuan to be unloaded (Li, 2002). But the state share reduction is considered by investors to be a force driving the market toward a further decline. Most investors felt that the state shares should not be sold at market prices since they generally far exceed net asset values. Following the start of the reduction in July 2001, prices on the Shanghai stock market plummeted to about 1645 points in December 2001 from its peak of 2245.43 in June. The index hit a low of 1514.86 points on 22 October. Over the same period the Shenzhen composite index sank to 439.36 points on 22 October from a high of 664.85 on 13 June (Table 1). Influenced by the collapse of the A share market, the B share market also witnessed a sharp downward adjustment after an extraordinary month-long rally, dropping from its peak of 220 points in mid-year to 160 points by the end of 2001 in the Shanghai market.

Table 2 Summary for State Shares in SSE and SZSE (30 June 2001)

[20] China Daily, 25 April 2001, "B Share Pushes Stock Market Slightly Higher".

Items	SSE	SZSE	Total
No. of listed companies(1000)	507	621	1121
No. of total capital (billion)	164.004	230.359	394.363
No. of non-tradable (billion)	102.761	156.563	259.324 (67.76%)
state-owned shares	70.438	108.168	178.606 (42.23%)
Domestic legal person shares	18.949	32.563	51.512 (13.06%)
Other legal person shares	9.807	11.597	21.404 (5.43%)
Total market capitalization (billion yuan)	2199.288	3163.770	5363.058
Negotiable market capitalization (billion yuan)	835.475	1053.315	1888.790

Notes: Here state-owned shares include state shares and state-owned legal person shares. Yuan is the Chinese currency unit. In 2002, US$1=8.27 Yuan approximately.

Sources: Shenzhen securities Information Company, http://www.cninfo.com.cn.

Besides the implementation of state share reduction, other measures introduced in 2001, including the introduction of rigid supervision measures and tougher rules to delist debt-ridden firms, also sparked market fears, which reinforced the bearish performance in the second half of the year. The market bounced back slightly, however, as the state share reduction program was suspended on 23 October 2001. In order to further shore up investor confidence in the market, the Minister of Finance announced a stamp duty cut from 0.4% to 0.2% on 16 November. The upward trend continued in the following months. Expecting the market to remain firm in 2002, on 12 May, the CRCS announced that the state share reduction scheme would be resumed in a new form, designed to replenish China's under-funded social welfare system. As a result, investor confidence collapsed again and the market price fell quickly.

However, the central government soon moved to suspend once again the controversial state share reduction scheme – it is argued that the complicated plan would requir lengthy study before regulators could devise a comprehensive plan widely accepted by the markets and that it has other ways to raise money for the social welfare system. This announcement not surprisingly boosted the market and the indices increased by more than their daily limit. The Shenzhen index peaked at 512.38 points on 24 June and the Shanghai index at 1789.89 on the second day (Table 1). A record volume of trade (4851.8061 million yuan) and daily turnover (49.48 billion yuan) for the year were also reported on 24 June 2002. However, the market reversed and the indices moved downward in the second half of 2002. In July the stock price indices still remained at around 1700 in Shanghai and around 500 in Shenzhen. Yet from the beginning of August, SSE composite index fell steeply to the 2002 low of 1357.65 points on 31 December and SZSE composite index lost 123.62 points (from the peak 512.375 in June to 388.755 at the end of the year) (Table 1). Moreover the combined turnover of the two exchanges fell 27% to 2.8 trillion yuan. This is because of poor corporate results, frequent initial public offerings and especially a lack of policy incentives. At present the market sentiment is weak. Some investors are nervous and trying to pull out the market by selling their stocks while waiting for market-boosting steps by the government**.**

5 Achievements and Problems

Market scale: expanding rapidly

The Chinese share markets have achieved impressive progress over the last twelve years. Since their establishment the two exchanges have expanded rapidly in terms of market capitalization, turnover, funds raised and numbers of firms listed. By the end of 2002 China had 1224 listed domestic companies with a total market capitalization of 3832.9 billion yuan, or about 30 per cent of current GDP. The number of stock account holders reached to 68.8408 million (Table 3). From 1991 to 2002 total raised capital through share offerings amounted to 872.236 billion yuan of which A share accounted for 670.677 billion yuan. International investors contributed the remainder with US$4.959 billion for B shares, US$20.425 for H shares and other markets contributing 8.85 billion yuan.[21] This clearly underscores the relatively importance of China’s domestic markets to corporatization.

[21] Data came from Http://www.csrc.com.cn.

Table 3 Trading Summary for Shanghai and Shenzhen Exchanges, 1990 – 2002

Years	Listed Companies (A or B)	Market Capitalization [a] (100 million yuan)	Stock Turnover (100 million yuan)	Total Investors [b] (10,000)	Market Capital/GDP (%)
1990	8	12	n.a.	n.a.	0.06
1991	14	109	46.08 [c]	11.00	0.56
1992	53	1048	323.85 [c]	111.23	4.38
1993	183	3522	3627	423.51	11.22
1994	291	3691	8182	574.89	8.43
1995	323	3474	4036	685.20	6.02
1996	530	9842	21332	1207.87	14.52
1997	745	17529	30722	3387.19	23.44
1998	851	19506	23544	3910.70	24.52
1999	949	26471	31320	4481.97	32.26
2000	1088	48091	60827	5801.13	53.79
2001	1160	43522	38305	6650.41	45.38
2002	1224	38329	27990	6884.08	n.a

Notes: [a] Market Capitalization is computed as the total number of shares on issue multiplied by their market price; [b] Only for SSE for 1991-1996; [c] Only for SSE.

Sources: SSE and SZSE Fact Books, http://sse.com.cn, http://www.cninfo.com.cn and http://www.csrc.gov.cn

A prominent feature of the market is that the B share market has not expanded as rapidly as the A share market. As Table 4 illustrates, the market for A shares has grown dramatically since 1990. By the end of 2002, there were 361601 million A shares issued on the Shanghai exchange with a market capitalization of 2492.142 billion yuan and more than 33.269 million investors accounts opened for A share. In contrast, the B share market has been considerably smaller ever since B shares were first issued in 1992. By the end of 2000, there were 8507 million B shares issued on the Shanghai exchange with a market capitalization of 33.454 billion yuan and 0.202 million overseas investors accounts. From 19 February 2001, trading in B shares became permissible for Chinese individuals and legal persons with foreign currency accounts. B share market capitalization increased sharply from 33.454 to 65.606 billion yuan in a year as B shares became the investors' favorites and by the end of 2001, the number of B share accounts had increased to 0.9297 million, 4.6 times the number of a year earlier.

Table 4 Comparative Statistical Data for Shanghai A and B Share Markets

Years	Issued volume of B share (million)	Issued volume of A share (million)	Market capitalization of B shares (million yuan)	Market capitalization of A shares (million yuan)	B-share investors Accounts (10,000)	A-share investors Accounts (10,000)
1993	1795	18867	12804	206766	1.02	422.49
1994	3134	38763	11659	248354	1.91	573.00
1995	3465	46360	9195	243371	2.89	682.50
1996	4543	62576	16188	531613	4.93	1203.03
1997	6781	90776	18561	903245	13.93	1706.77
1998	7423	120611	10053	1052538	16.79	1991.61
1999	8147	149868	13975	1444072	18.43	2272.33
2000	8507	194735	33454	2659632	20.21	2943.32
2001	9068	307376	65606	2693451	92.27	3326.93
2002	9253	361601	44230	2492142	n.a.	n.a.

Source: SSE fact books in 2001and market statistic data in the Web Page Http://www.sse.com.cn

To summarize, over the last decade, China's stock market has achieved substantial growth. China now ranks among the top 10 countries in terms of market capitalization. Within Asia, China is ranked second after Japan. China's stock market will continue to grow with market capitalization being excepted double by the end of 2005.[22] However, Future development will be affected by several problems which are addressed in the following sections.

[22] Data from China daily, 1January 2002.

Dominance of Manufacturing Sector in the Share Market

By the end of 2002, 1224 Chinese companies had completed initial public offerings with four broad categories: A shares, B shares, H shares and Red Chips (Table 5).[23] The A-share companies have tended to be small and unfocused with a wide variety of businesses. Typical A-share IPOs have been of the order of $US50 million representing a 25% ownership interest. Disclosure tends to be extremely poor. While the B-share companies are larger and subject to listing requirements similar to overseas listing transactions, ongoing transparency is only marginally better than A share companies. The IPOs tend to be somewhat larger with the largest about $US250 million. The H-share companies are Chinese state-owned enterprises that have gone through major restructuring designed to satisfy the requirements for an international issuance, one leg of which is almost always in Hong Kong. H-share IPOs generally have ranged from $US100 to 600 million. In comparison with the A-share companies, H-share companies represent focused businesses having a strong position in China's domestic economy. These companies have been selected by the government to be listed as part of the overall state enterprise reform effort. The intention is not only to raise foreign funds but also to transform them into modern enterprises that follow international management practices and are allowed to cope with market challenges. The Red Chip companies are Hong Kong registered companies into which Chinese assets have been injected, usually in shares for asset swap. The asset injection comes both prior to and as part of the listing, and might continue thereafter with minority shareholder approval. In general, Red Chip companies are holding companies with typically little specialization in any one industry and, for the most part, are rather poor in terms of management and earnings. Many of them are the result of so-called 'back door" listing in which a non-listed Chinese company acquires a relatively dormant SEHK listed company and then injects mainland assets. They tend to be conglomerates in which the Hong Kong entity is used as a funding vehicle for its Chinese operations or for the further acquisition of Chinese assets.[24]

[23] Most companies issue only A or B shares although some with A shares were permitted to issue B or H shares (Table 5).

[24] See Walter and Howie (2001), "To Get Rich is Glorious ", pp.111-112.

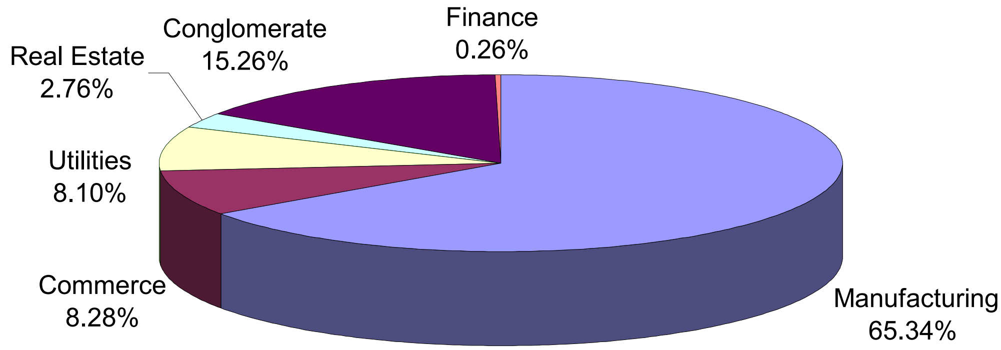
Table 5 Summary of Listed Companies by Shares Categories (except Red Chips)

Years	A or B	B total	H total	A only	B only	H only	A & B	A & H
1998	851	106	43	727	26	25	80	18
1999	949	108	46	822	26	27	82	19
2000	1088	114	52	955	28	33	86	19
2001	1160	112	60	1023	24	35	88	25
2002	1224	111	75	1085	24	46	87	29

Sources: http://www.csrc.gov.cn.

In the early days Chinese share markets were created to assist SOE reform. As a result, Most of the listed companies, both international and domestic, are transformed SOEs. At first, these SOEs listed their stocks on the domestic stock market. But China's stock market is not effective mature in regulating listed firms and protecting investors' interests so that many transformed SOEs regarded the market as a mere financing tool and have failed to carry out anticipated reforms. In order to overcome their inefficiency and inability to operate at a profit, selected Chinese companies have been permitted to list on overseas exchanges with the selection partly based on the importance of certain sectors to the state plan. So it is not surprising that the largest number of candidates for international listing comes from the infrastructure industry (largely highways and ports) and then power (and power equipment), followed by transportation, petrochemicals and chemicals, and steel.

Figure 4 demonstrates the distribution of listed companies in China for 2001 and shows that by far the listed Chinese companies are dominated by manufacturing ones. However, since mid-1999 there has been a change in the composition of new listings following a shift in government policy. Until 1998, the government's industrial policy emphasized the development of basic industries, energy and agriculture. Since mid-1999 China's policy has gradually changed to foster the development of knowledge-based high-tech industry. Therefore, it has been easier for high-tech companies than for others to secure government permissions to list on the exchanges. As a result, hi-tech industry listing has increased and the restriction on financial institutions to go public has gradually relaxed. There are now more than five shareholding banks.



Source: http://www.csrc.gov.cn

Figure 4 Sectoral Representation of Listed Companies in 2001

These changes will be helpful in improving industry structure and enhancing international competitiveness as listing decisions become increasingly driven by economic rather than political considerations.

If we also consider the geographic distribution of listed companies, we see a large gap between the representation of companies from coastal and interior regions. As Table 6 indicates, 13 of China's 32 provinces occupy the top ten spots in the two stock exchanges and they account for roughly 65% of all listings. Moreover, eight of these are coastal provinces and cities which have contributed to 42.41 percent of the total in SSE and 44.98 percent in SZSE, while these eight provinces represent less than one third of the total provincial-level regions and about 25 per cent of the population. This type of geographic distribution is also found for H shares and reflects the unbalanced development of the Chinese regions despite the long-term policy to narrow the gap between the coastal and interior regions.[25]

In summary, China has permitted more than 1224 enterprises to enter the share market, domestic or international. The selection of these companies for listing reflects a policy of screening for favored sectors and an economic screening for being allowed to raise capital

[25] China's regional development policy is to first develop the coastal regions of eastern China. For example, the eastern coastal regions were the first to be opened up, receiving preferential treatment in attracting foreign capital and technology, foreign trade, and so on. In recent years more emphasis has been placed on the development of western regions to narrow the gap of the eastern and western regions.

internationally. Since the number of successful international issuers has been few, the original sector policy grip has been relaxed so that enterprises from nearly all but the most sensitive industries can now seek an international listing.[26] Domestically there is an almost endless supply of potential issuers from the state-owned sector. Recently the non-state or private sector has been permitted to issue shares. At the National People's Congress held in March 1999, China's Constitution was revised to give the non-state sectors the same legal recognition as the state sector by providing some bank financing as well as opening the capital markets to the non-state sector. Perhaps the addition of such companies is the only way that domestic exchanges can offer a fully diversified equity product to their investors as the mature equity markets do.

Table 6 Top Provinces of Incorporation of Shanghai and Shenzhen A & B Companies (December 2001)

Shanghai			Shenzhen		
Provinces	No. of companies	% total	Provinces	No. of companies	% total
Shanghai	130	20.12	Guangdong	118	23.18
Zhejiang	43	6.66	Sichuan	30	7.86
Jiangsu	41	6.65	Liaoling	28	5.50
Beijing	41	6.65	Hubei	28	5.50
Shandong	34	5.26	Shandong	27	5.30
Liaoning	31	4.80	Hunan	25	4.91
Hubei	30	4.64	Beijing	23	4.52
Sichuan	28	4.33	Jiangsu	22	4.32
Fujian	24	3.72	Fujian	18	3.54
Heilongjiang	22	3.41	Hainan	16	3.14
Sub-total	424	66.24	Sub-total	335	65.82
Others	222	33.76	Others	174	34.18
Total	646	100.00	Total	509	100.00

Sources: SSE Fact Book, 2001 and the web pages http://www.sse.com.cn and http://www.szse.com.cn.

[26] The selection of the sectors and listing companies is an extremely complex process in China. According to "the trial measures on the shareholding system", 15 May, 1992, in CSRC. Art.1,"Circular on certain issues relating to share issuance", 26 December, 1996, it begins with the State Planning Commission's financing plan for state enterprises in accordance with the national industry policy, then the CSRC allocates the listing quotas after a decision taken by the State Council. The success of an enterprise in obtaining a listing quota, particularly H shares, depends to a large extent on its owner, whether a local government, a provincial government or the central government. Generally the central and provincial enterprises are favored. Finally the selected companies receive listing approval from CSRC (Walter and Howie, 2001, pp. 112-129 for further details).

Equity structure: poor liquidity and the problem of state shares

As mentioned previously, China is renowned for its extravagant variety of shares, eg., A, B, H, N shares and Red Chips. Other ones include state shares, legal person shares, overseas legal person shares, social legal person shares, internal person (employee) shares and so on.[27] According to the market principles, a stock market should be "open, fair, and just" while the stock should be characterized by the "same rights, same interests, and same obligations for the same stock". But, in Chinese share markets, differentiated types of shares were conferred different sets of rights, interests, and obligations. For example, state shares and legal person shares cannot be traded. Only individual shares, which make up one third of all shares issued, can be freely sold. At present approximately 70% of domestically issued stock is frozen in the form of state and legal person shares, which results in an unreasonable equity structure and severe non-liquidity. This point is illustrated well by Table 7, which shows the composition of shares listed on the Shanghai exchange in October 2000.

This equity structure, which is overwhelmingly concentrated in state shares and legal person shares, arguably has some adverse consequences. On the one hand, the agents of state enterprises (the managers) actually control the listed companies due to the lack of real ownership (nominal state ownership) and have become the big shareholders due to the large proportion of state shares. This coincidence of ownership and management not only leads to internal control and the invalidity of corporate governance mechanisms, but also infringes on the interest of small and medium shareholders. Big shareholders can easily misappropriate the funds of a listed company and subvert the interests of small-medium shareholder. The Shanjiu Medicine incident, where big shareholders withdrew 95% of the net assets of the firm, shocked the whole securities market.[28] On the other hand, relatively few tradable shares on the markets have stimulated speculation on the secondary markets. China adopted administrative pricing from the start in contrast to market pricing in mature markets. A-share pricing, for all

[27] Since 1996 Chinese share types have been divided into promoter shares (including state-owned shares, domestic legal person, foreign legal person share and so on), social legal person shares, employee shares, preferred and other shares. Legal person shares are created when a company uses state assets to invest in a company limited by shares. Overseas legal person shares represent the investment by properly authorized overseas Chinese state-owned enterprises. Social legal person shares represent investment by third party legal persons in the public offering of a company. Internal shares represent investment by internal staff or employees.

[28] Data from the web page http://www.sse.com.cn.

intents and purposes, was based on a formula which applied a 15 times P/E ratio to the average of the company's past three years profits, that is, the offer price equals to the taxed profits multiplied by 15.

Table 7 Shanghai Stock Exchange Capitalization Structure (31 October 2000)

Shares	Total Issued Value (10,000 yuan)	%	Total Market Capitalization [a] (10,000 yuan)	%
1. Promoter shares	10649127.26	55.923	137997205.30	59.437
State shares	7733724.85	40.613	99020791.51	42.650
Domestic legal person shares	2710784.94	14.236	35762037.29	15.403
Overseas legal person shares	204617.47	1.075	3214376.45	1.384
2. Social legal person shares	1107367.45	5.815	16061679.64	6.918
3. Internal shares	117950.13	0.619	1798103.00	0.774
4. Preferred shares or other	112581.33	0.591	1684174.69	0.725
5. Pay fund	66772.61	0.351	1245948.39	0.537
Total non-tradable	**12053798.78**	**63.300**	**158787111**	**68.392**
1. A shares	5182799.48	27.217	70787684.36	30.489
2. B shares	850713.77	4.467	2598540.36	1.119
3. H shares	955112.80	5.016	0	0
Total tradable	**6988626.05**	**36.70**	**73386224.72**	**31.608**
Total	19042424.83	100.00	232173335.7	100.00

Notes: [a] Market capitalization is the total number of shares including a value for non-tradable shares on issue multiplied by their market price.

Source: SSE Fact Book, 2001, http://www.sse.com.cn

Recently Chinese practice has changed significantly.[29] This has been driven by a problem with the P/E approach. Firstly, reliance on past performance is obviously no guarantee of future performance. For example, earnings may have declined from a high

[29] P/E (Price-earning ratio) is the price per share divided by the company's earning per share. In the early 1990s the average P/E ratio at issuance was 9-13 times and decided by CSRC. During 1995-Febrary 1999 the offering price was set at taxed profits multiplied by average P/E ratio (14.5-20 times). After the pricing reform in March 1999 the offer price was based on additional factors such as the industry prospects, the company's performance, the P/E ratio in secondary market and so on. During 2000-2001 higher P/E ratios were observed: 29.9-31 times in Shanghai and 31.72 times in Shenzhen.

to a low level during the three-year period, assuming that the company was encountering difficulties. Secondly, a common multiplier of 15 treat for all companies equally, but companies are not equal. In comparison with the average P/Es and turnover rates in the United States and other share markets, A-share markets have higher P/E ratios and higher turnover rates. Table 8 shows that A shares are traded at a P/E ratio of 40-50 times and turnover ratios of 300-500. Whereas New York shares generally have a P/E ratio of 15- 22 times; most B shares, H shares and red chips are traded at a P/E ratio of 10-30. In Hong Kong and New York exchanges the turnover ratios are below 100. This provides evidence of the highly speculative nature of Chinese stock market. With the distorted equity market, stock prices are easily manipulated by the market makers and the P/E ratios fluctuated relatively widely and quickly. As a result, financial reports do not reflect company's fundamental performance and prospects. Although China's secondary markets are quite active and constantly expanding, they have not yet been used as an instrument to value companies efficiently. On the contrary, the government has often manipulated the share price and the market trend by floating new policy ideas and issuing new regulations.

Recently the government appears to have decided to solve the problem of non-tradable shares by reducing state shares in a bid to optimize equity structure, eliminate the system deficiency of state ownership and further develop the share market. According to the original design in the early 1990s, the non-tradable shares were to be temporarily withheld from circulation. Thus they would be released for trading at some point in the future. Actually in late 1999, state shares reduction was proceeding in two minority state-controlled companies: Beijing Zhongguancun science-Tech and Guangdong kelon. The process ran into two problems: how to price the non-tradable shares and when to open for trading. In August 1999 Zhongguancun announced a one for one rights offer for A shares holders priced at the original IPO level of 5.78 yuan. Obviously given the secondary market price at the time of 30 yuan, the rights issue was a guaranteed money winner for any current A share investors. Not unexpectedly, the closing price of the share prior to ex-rights rose to 33.80 yuan. The next morning the Shenzhen exchange announced the new price, a weighted averaged price of 26.02 yuan

Table 8 Comparison of Turnover Ratios and P/E Ratios among Shanghai, Shenzhen, Hong Kong, and New York Markets

Years	Shanghai			Shenzhen			Hong Kong				New York	
	Turnover Ratio(%)	P/E Ratio(%)		Turnover Ratio(%)	P/E Ratio(%)		Turnover Ratio(%)	P/E Ratio(%)			Turnover Ratio(%)	P/E (S&P) Ratio(%)
		A shares	B shares		A shares	B shares		HSI	H shares	Red Chips		
1992	--	72.65	17.4	--	57.52	35.56	53.00	--	--	--	44.00	22.7
1993	341.0	42.48	--	213	44.21	20.11	61.00	--	--	--	53.00	23.4
1994	787.0	29.67	9.94	472	10.67	7.02	55.00	--	11.61	--	53.00	18.2
1995	396.0	16.32	8.00	180	9.80	6.01	38.00	--	10.05	--	59.00	18.5
1996	591.0	32.65	14.04	902	38.88	14.07	41.00	--	10.85	--	62.00	20.6
1997	326.0	43.43	11.99	466	42.66	10.67	90.92	12.29	14.84	--	65.71	23.9
1998	297.0	34.38	6.04	283	32.31	5.71	61.95	12.36	7.11	10.44	69.88	27.2
1999	315.6	38.13	10.05	299	37.56	10.38	50.60	27.89	--	--	74.62	31.3
2000	360.4	59.14	25.23	509[a]	58.75	13.06	62.99	12.74	--	--	82.40	25.2
2001	449.1[a]	37.59	43.39	483[a]	40.76	25.30	--	15.06	6.26	18.57	--	31.1
2002	--	34.50	30.16	--	38.22	17.51	--	--	--	--	--	--

Notes: The method of calculation for the share turnover rates for Shanghai and Shenzhen was as follows: turnover ratio = total number of shares trade in the year/total number of shares in circulation at the end of the year. The P/E ratio is calculated by taking the market price of a share and dividing it by the company's earning per share at the end of year.

[a] turnover ratio = Total number of shares traded in the year / the average number of circulated shares at the end of this year and last year. --Not available.

Sources: Turnover ratios for 1992 - 2000 from Chen and Shih (2002, p.39); Shanghai and Shenzhen P/E ratios for 1992-1998 from Walter and Howie (2001, p.68) and Almanac of China's Finance and Banking in 2002; New York P/E ratios from http://.nyse.com and HIS P/E ratios from http://www.hkex.com.hk/.

per share, reflecting the dilution caused by the rights issue.[30] Unfortunately, the market that morning opened at 23.42 for the Zhongguancu shares, down by the 10% mandated daily trading limit, and the next day the shares traded down again by the 10% limit to 21.08 yuan. By the third day the shares closed at 19.01 yuan, down almost 44% from the pre-rights share price. The market reaction reflects investor expectations of much lower pricing. Some thought the post-rights price should reflect only the tradable A shares in the company's capital base and not the non-tradable legal person shares. So the price per share should be 19.79 yuan.[31] Apparently retail investors don't attribute any value to non-tradable shares. The case of Zhongguancun suggests that successfully reducing the proportion of state shares will come at the cost of a significant decrease in secondary market values and the overall market capitalization of the companies involved (Walter and Howie, 2001).

When the shares became tradable and what prices they are traded at are still serious unresolved issue, such uncertainty has increased investor's pessimistic mood about the future of China's stock market. Recently at a China business conference, a senior government figure suggested that the value of state and legal personal shares is approximately 20-25% of the market price of A shares trading on the secondary markets.[32] So it is important for any state share reduction scheme to consider the element of investor psychology including that of the state itself. To maintain market stability, a good scheme has to involve as a first step a substantial reworking of the current market relationship between the state and investors. If the non-tradable shares were sold at the current market price without any compensation for existing investors, any attempt to resolve the market liquidity problem would incur strong resistance by investors and hence create market instability. However, on 4 November 2002 the

[30] In Beijing Zhongguancun there were 300 millions legal person shares and 187 million A shares. The calculation was summarized as adding the total market capitalization of the company (A shares and legal person shares) to the funds raised through the rights offering and dividing by the new total number of shares as follows. $[(187+300)\times 33.8 + (187 \times 5.78)] / (187+300+187) = 26.025$ yuan (Walter and Howie, 2001, p. 57).

[31] The calculation is $[(187\times 33.8) + (187\times 5.78)] / (187+187) = 19.79$ yuan (Walter and Howie, 2001, p. 58).

[32] An approximation of this 20-25% valuation can be arrived at by assuming that only the market capitalization of trade shares is real as shown in the example below:
Share market capitalization = US$200 billion. If a total of 100 billion shares have been issued, then the implied price per share = US$2 per share. If 30% of share are freely tradable A shares they have a value of US$60 billion. If all issued shares are floated on the market the price is US$0.6 per share. So, if all non-tradable shares were listed, their value is roughly 30% of the current market price. The value 30% is roughly close to the official's estimate (Walter and Howie, 2001, p. 59).

circular that allows listed companies to sell non-tradable shares to foreigners by public tender was announced by China's securities regulator, the Finance Ministry and the State Economic Trade Commission.[33] For the government, the sales of these state shares and legal person shares is crucial to improving corporate transparency and raising money for social welfare funding. For the existing investors, once the non-tradable shares flow into the market, the overall price of the shares will most likely be driven down by the enlarged supply, thus making it impossible for them to recover their investment. Such worries explained much of the lackadaisical trading and the falling index in the A-share markets in late 2002.

Few Institutional Investors

Investors are normally categorized as either professional (institutional), or retail. Retail investors are individuals investing their own funds, as opposed to institutional investors, a category representing a variety of entities using institutional, that is, other people's funds to invest. In the past decade, the vast majority of market participants in China were individuals with the securities houses added in to stir the soup. In the 1990s the government sought to build a base of so-called 'institutional investors' who, presumably by holding shares for long-term gains, would bring greater stability to the markets. As a result, market participants have become somewhat more diverse. Yet the fact is that retail investors accounted for 99.54% of total accounts at the end of 2001.

Current institutional investors are represented by the proprietary trading departments of securities firms and various other non-bank financial institutions such as trust and investment companies, securities investment funds, and insurance companies. Corporate investors also trade in the markets from time to time when regulations permit. Despite double-digit annual growth for years, the institutional accounts at the two exchanges still amount to a small percentage of total accounts as shown in Table 9.

The two exchanges have nearly equal numbers of accounts, approximately 33 million in SZSE and 35 million in SSE. Without question there is considerable overlap. A

[33] Data come from http://www1.chinadaily.com.com,cn , China daily, 5 November 2002.

Table 9 Summary of Investor Accounts (SSE, December 2001)

Individuals (10,000)	A share investors (10,000)	%	B share investors (10,000)	%	Institutional investor (million)	%
3429.6	3326.93	97.09%	92.97	2.71%	15.87	0.46%

Source: SSE Fact Book, 2001, http://www.sse.com.cn.

survey conducted by SZSE shows the overlapped proportion is about 91.29% of the total accounts. Perhaps in total there were only 33.6-34 million A-share individuals with share accounts across China at the end of 2001 or 26 individuals out of 1000 people.[34] They represent citizens living predominantly in China's developed and wealthy coastal provinces. In the Shanghai Market, Shanghai investors hold nearly 14.36% of the total A-share accounts. After Shanghai, Guangdong is the second with more than 9.62% followed by Jiangsu at 9.45%, Sichuan at 6.89%, and Shandong at 6.23%. The regional character is slightly different for the Shenzhen market where Guangdong accounts for 18.94%, followed by Jiangsu at 8.54%, Shanghai at 8.5%, and Sichuan at 7.61% (Table 10). Overall, the top ten provinces' account holders in both markets account for over 70% of all accounts and the same provinces comprise the top ten for each market. This is not surprising since these ten provinces or cities are among the most prosperous in China, representing nearly 25% of China's population and half of the country's GDP.

The previous discussion has dealt with the current investor base for China's A share market. Obviously, the investor base for overseas listed Chinese shares and B shares is significantly different. Before February 2001 only offshore individuals and economic entities were permitted to trade them. Due to the lack of transparency and liquidity on this small B-share market, few foreign institutional investors would trade in the market. Since holding B shares became permissible for domestic investors in 2001, retail investors, especially the domestic individuals, have increased more rapidly than institutional investors. Table 11 illustrates the structure of B share investors for the Shenzhen exchange.

[34] Based on a 2001 survey by the Shenzhen securities exchange of individual investors in China's stock market. See http://www.cninfo.com.cn or http://www.sse.com.cn
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Table 10 Regional Composition of A Share Accounts (31 Dec. 2001)

Top ten	SSE Accounts	SZSE Accounts	SSE (%)	SZSE (%)	All (%)
Shanghai	4 790545	2 690 784	14.36	8.50	22.86
Guangdong	3 210 992	7 005 144	9.62	22.13	31.78
Beijing	1 469 822	1 436 130	4.41	4.54	8.95
Jiangsu	3 154 461	2 701 746	9.45	8.54	17.99
Zhejiang	1 685 040	1 419 603	5.05	4.49	9.54
Shangdong	2 078 552	1 624 304	6.23	5.13	11.36
Sichuan	2 299 340	2 407 476	6.89	7.61	14.50
Liaoning	2 057 398	1 565 435	6.17	4.95	11.12
Hubei	1 131 604	1 338 423	3.39	4.23	7.62
Fujian	1 116 683	1 014 215	3.35	3.20	6.55
Sub-total	22 994 237	23 203 260	68.92	73.32	
Total	33 366 961	31 652 183	100.00	100.00	

Notes: Sub-total - top ten provinces in terms of the number of the accounts; % = every province's accounts/total accounts. % All = % SSE + % SZSE.

Source: SSE and SZSE market statistics, http://sse.com.cn and http://cninfo.com.cn.

In short, the current investor structure seems less mature than that of international markets, where investment funds, pension funds and insurance companies have become the major participants. For example, institutional investors trade 80% of the total turnovers in New York Securities Exchange. Since the enactment of investment fund rules in 1997, the Chinese government has moved to encourage funds as a vehicle to broaden market participation. In addition, insurance companies were permitted to invest in shares indirectly in October 1999 and securities firms have gained access to the first level inter-bank market and to use shares as collateral for loans. China's participation in the WTO may also hasten this process since the government has agreed to permit foreign involvement in A-share markets through joint ventures in the asset management industry. As noted previously, the social insurance fund will also participate in the purchase of non-tradable shares during the process of state shares reduction. All these efforts to broaden the market participants are to change the composition of the investors and will transform China's share market the current emerging market status to one of the major players in the world in the coming decade.

Table 11 Ownership of Shenzhen B Share Accounts by Country (October 2001)

Country or area	Accounts	% of total	Individuals	Institutions
China mainland	436215	81.379	435994	215
Hong Kong	76580	14.286	73866	2548
USA	5432	1.013	3030	214
Macao	3559	0.663	3539	18
Taiwan	2742	0.511	273	9
Canada	1833	0.341	1502	12
Australia	1649	0.307	1417	66
United Kingdom	1314	0.245	427	261
Singapore	930	0.173	733	106
Japan	768	0.143	593	34
New Zealand	544	0.101	533	1
Others	4414	0.840	2791	596
Total	535980	100	527157	4080

Notes: % of total = the accounts opened by each country in China/total accounts of Shenzhen exchange.

Sources: SZSE market statistic data, http://www.cninfo.com.cn.

6 Prospects

In recent years, a lot of changes have taken place in China's securities market. According to the analysis presented above and taking into account the current situations in China and abroad, over the next decade the Chinese stock market will play an increasingly important role in the Chinese economy as well as in Asian and international markets.

First, it is clear that the Chinese stock market will continue to grow rapidly. Estimates by SZSE show that by the end of 2010 China's GDP will have increased from 9,000 billion yuan in 2001 to 20,000 billion yuan, and there will be more than 3,000 listed companies on the market with the total market value of about 14,000-16,000 billion yuan, or 70-80% of GDP.

Second, with China's accession to the WTO its stock market will be more open. According to the 10th Five-Year plan, standardization and development of the stock market has been written into China's medium- and long-term development plans for the first time. Recently Chinese authorities have decided to further open the bourses to foreign investors and build the markets according to the international standards. Besides, foreign companies will be formally allowed to participate in the merger and takeover of domestic listed firms, which is likely to promote large-scale restructuring in some of China's more traditional sectors. And some foreign companies will also be allowed for domestic listing so as to change the mix of listed firms and stimulate market sentiment in China.

Third, China's stock market will become more mature and efficient with the introduction of delisting rules and upgrades of the issuing systems (turning the approval system into a register system). In the meantime different classes of trade markets will be established on the basis of standardization, transparency and impartiality. Market regulations will also be similar to those of international securities markets.

Fourth, the market participants will become more diverse and competitive. Insurance companies, pension funds and social insurance funds will be allowed to participate directly in the market. In addition, there are also likely to be increasing numbers of other institutional investors over the next few years, private funds as well as Sino-foreign open-ended funds. It is predicted that institutional investors will account for up to 30-40% of market trading by the end of 2005.

Fifth, there will be great changes in the capital structure of listed companies. Non-tradable shares will be reduced, while non-state sector enterprises, including private and foreign firms, should be allowed to access the market as long as they meet the publicly available legal criteria. The issues of shareholder interest and the efficiency of listed companies will be solved.

In short, over time, China's stock market will function more effectively as a capital valuation and allocation mechanism. It will be able to absorb large chunks of state shares and to attract significant amounts of new domestic and foreign capital when Renminbi becomes fully convertible. By then China's stock market will probably throw off its emerging status (Walter and Howie, 2001).

7 Conclusion

This paper has reviewed the development history of China's stock market, discussed its scale and structure, and shed some light on its prospects. The market's characteristics reflect the influence of three factors: (1) government policy; (2) investor sentiment about the performance of the Chinese economy and listed compannies, and (3) the deficiency of the market system. Generally speaking, China's stock market is still an emerging market with a structure which is still far distant from a mature market. A major obstacle to the further development of the Chinese share market, undoubtedly, is the poor liqudity – the issue of large numbers of non-tradable shares. Achieving greater liquidity of state shares will help to ensure an appropriate dispersal of equity, strengthen the corporate governance of listed companies and provide an exit route for state capital that conforms to market requirements. Thus how to reduce state shares and solve the problem of state share liquidity is an urgent task for Chinese policy makers and its regulators. In addition, the introduction of a comprehensive legal framework, the creation of an environment of fair and orderly market competition and the establishment of transparent "rules of the game" must play key roles in stock market development. The development of institutional investors and large securities firms will also help to establish a sound structure and effective operation of the market and increase the level of stability by reducing speculation.

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