3
Past and Future Equity Market Activity

The potential of China's equity markets is "huge," says Laura Cha Shih May-lung of the China Securities Regulatory Commission.[1] There's no question that the vice-chairwoman of the nation's stock watchdog is right.

And so is Nicholas Lardy. In his testimony before the U.S.-China Commission on December 6 of last year the Brookings scholar said: "China really is fundamentally different from many other emerging markets in that its domestic savings are more than sufficient to finance all of its investment." Therefore, it should be a simple matter for the equity markets in Shanghai and Shenzhen to put those savings to good use. That is, after all, what stock markets are supposed to do.

As Cha suggests, tomorrow the country's bourses may work. Today, however, they don't: the stock markets of the People's Republic are inefficient, corrupt, and endanger social stability. They are, in a word, failing. The country's current reliance on foreign direct investment is a reflection of its failure to put domestic savings to good use. In short, the great FDI inflows are a testimonial to the weakness of China's equity markets.

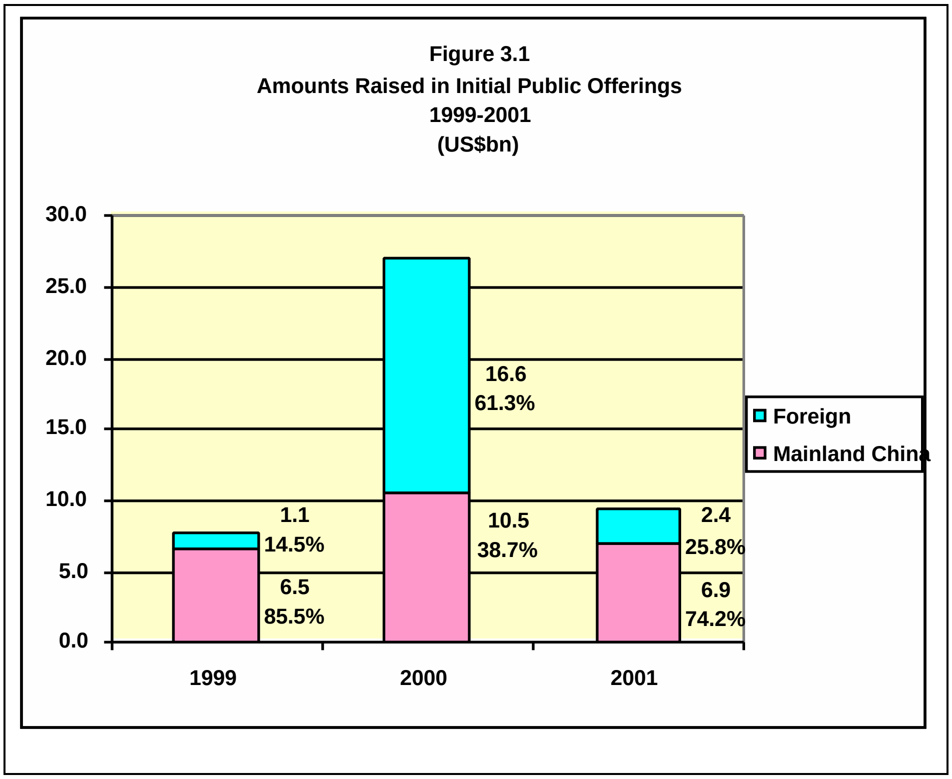
The truth is in the numbers, the numbers showing where the money is coming from. During the preceding three calendar years, Chinese companies raised an average of US$8.0 billion in the domestic equity markets in initial public offerings. The average masks significant year-to-year changes, however. In 1999 Chinese companies raised US$6.5 billion in these stock markets. In 2000 that number increased to US$10.5 billion. Last year, however, the amount fell by 34.3 percent to US$6.9 billion.

To put these numbers in perspective, Chinese companies raised US$1.1 billion on foreign exchanges in 1999 in initial public offerings, US$16.6 billion in 2000, and US$2.4 billion in 2001.

Analysts speculate that the increase in amounts raised in 2000 was attributable to equity offerings that, but for the Asian financial crisis, would have reached the markets in the immediately preceding years.[2] This effect is especially noticeable in the foreign offerings.

All these figures are dwarfed by the approximately US$157 billion in new loans extended by Chinese banks in 2001.[3]

Domestic and foreign initial offerings, illustrated in Figure 3.1, are derived from a table found in Appendix 4.



source: China Securities and Futures Statistical Yearbook (various years)
websites of various stock exchanges
Bloomberg

The statistics show China's increasing dependence on foreign markets. In 1999 14.5 percent of its funds from initial public offerings were raised in foreign markets. The corresponding percentage in 2000 was 61.1 percent. In 2001 the number was 26.7 percent.

Figure 3.2 shows the amounts raised in equity markets in the United States.

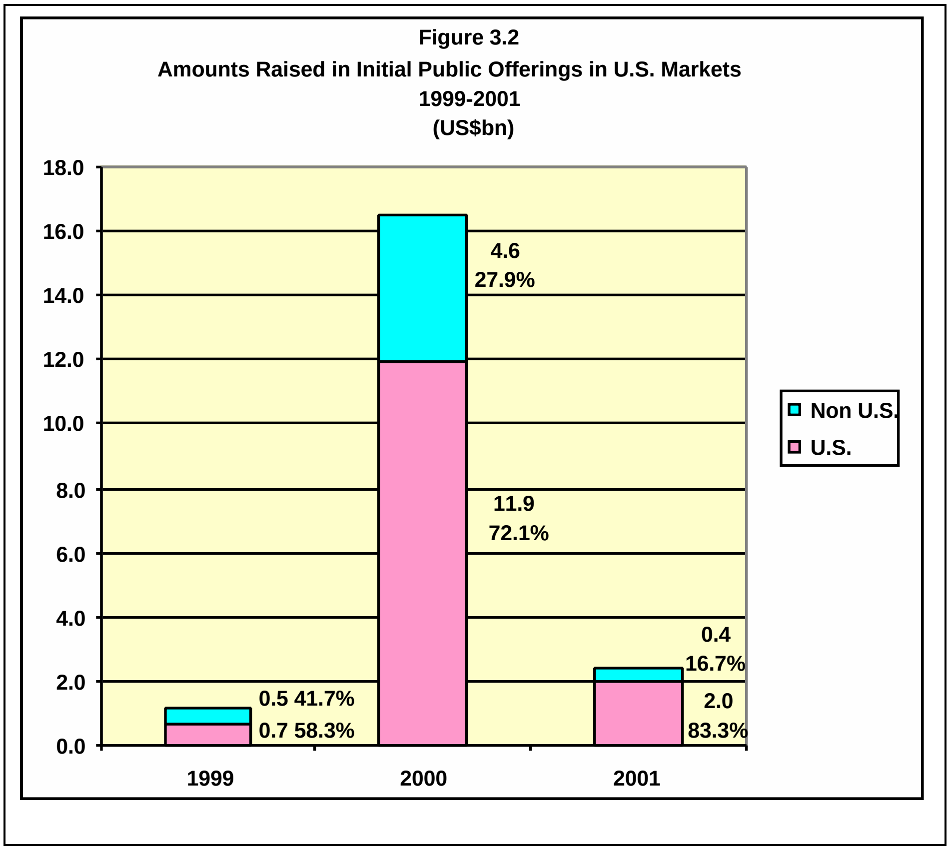


Figure 3.2
Amounts Raised in Initial Public Offerings in U.S. Markets
1999-2001
(US$bn)

source: China Securities and Futures Statistical Yearbook (various years)
websites of various stock exchanges
Bloomberg

Foreign markets are becoming more important than the domestic ones. Because the People's Republic has more than enough capital for its own needs, we have to ask: What is wrong?

The essential problem is that the Communist Party, having authorized the markets in the era of Deng Xiaoping in the early 1990s, has failed to back crucial reforms during Jiang Zemin's tenure. Incomplete development has left the exchanges in disarray, and Beijing seems to be paralyzed, unable to do what every observer agrees must be done.

There are a few explanations for this generally deplorable state of affairs. First, state-owned enterprises are powerful in China's politicized economy and there is virtually no accountability to shareholders. Left to their own devices, managers of these businesses do what they want to: grossly waste resources in a variety of ways. In the past, the state was the victim of this behavior. Now, China's small retail investors are also losers.

And these investors do, in fact, lose due to blatant fraud.[4] In one of worst cases, the major shareholders of Sanjiu Medical Pharmaceutical Ltd. misappropriated US$303 million, almost all the assets of the company.[5] In the eyes of too many managers of listed companies, outside shareholders are there to be fleeced.

Second, the stability of the financial system of the nation could be undermined if the markets worked too well. The country's banks are in poor shape, as discussed in Appendix 2. Insolvent, these financial institutions are kept afloat by a stream of new deposits from the nation's small savers. If the domestic markets were really attractive, ordinary Chinese citizens might cash out their deposits to buy stock and reduce the flow of new liquidity that keeps these institutions going. That would be great for the equity markets but could be disastrous for the nation as a whole. It is true that, from time-to-time, technocrats try to coax a little of the money out of the banks and into the stock markets. Yet at the first sign of trouble, the whole process is quickly reversed: Beijing's first instinct is to protect these sickly financial institutions, the lynchpin of the economy.

Third, the CSRC seems to be a captive of the industry it is supposed to regulate--the government watchdog just watches all the problems and barks only when prompted. As a consequence, the exchanges of Shanghai and Shenzhen are infested, plagued by market manipulation, insider trading, accounting fraud, outright theft, and a dozen other corrupt practices. The markets are even worse than casinos. "Even casinos have rules and you cannot look at other people's cards," said Wu Jinglian, one of the leading Mainland economists, in early 2001.[6] Wu caught some flak in Beijing for that colorful statement, but nobody seriously questioned the accuracy of his assessment.

Today, in a sign that things are getting better, everyone seems to be aware of the problems in the markets. It is common, perhaps fashionable, for people in Beijing to complain. Deputies at the recently-concluded National People's Congress meeting criticized the CSRC for the mess in the markets as did members of the advisory Chinese Peoples' Political and Consultative Conference. In the words of the official Xinhua News Agency, the CSRC "should be responsible for the listing of unqualified companies, the falsification of financial statements by listed companies, joint trading of listed companies with their controlling shareholders, excessive speculation and insider manipulation."[7] But bad practices in the Chinese markets are like the weather: everyone complains but no one really does anything.

Central government regulators rail against the situation, of course. Yet considering all of the misdeeds that occur, extremely few miscreants are punished. Historically, Beijing has tolerated a certain amount of corrupt practices in the markets so as to obtain the political support of the wealthy.[8] Belatedly, the CSRC has tried to reduce the tide of market misdeeds, but only because it has had to. Financial system risk increased dramatically in 2001 because bank funds were finding their way into the markets through securities companies, which were losing money due to mismanagement and corruption. The losses are reputed to have been huge, thereby dramatically increasing the risk of systemic failure.[9] The CSRC finally forced illegal money out of the markets to the tune of US$18.1 billion according to an estimate from

Shenyin Wanguo Securities.

The markets did not react well to the crackdown, and the CSRC subsequently backed off enforcing rules according to observers.[10] Moreover, the CSRC has also lost enthusiasm for implementing important reforms as well. Perhaps the most visible retreat occurred this March when the CSRC decided not to impose tough accounting regulations. Instead, it issued a "dramatically watered-down version" of provisional rules issued in December,[11] the last month in the CSRC's "year of market supervision." Zhu Rongji can call accounting fraud "a malignant tumour,"[12] but he either cannot or will not do much to cut it out.

So companies try to get away with as much as they can. Guangxia (Yinchuan) Industry manufactured almost 95 percent of its earnings reported in 1999 and 2000. This Shenzhen-listed company had the dubious distinction of being outed not by government officials but by journalists at the now-famous *Caijing* magazine.[13] This incident highlights an unwholesome development: pressure for cleaning up the markets is coming from below and is often resisted by those in authority.

And the authorities are dragging their feet, progressing as slowly as they can. Some of the worst offenders are those in charge of the legal system. The Supreme People's Court has come out with rules that say how liability should be apportioned for false financial data. That's good, but the thrust of the new regulations appears to limit liability.[14]

The effort to limit recoveries is no surprise because that court is no friend of the individual investor. In January 2002 the court lifted a temporary ban that it had previously imposed on shareholder suits. Now, investors can go to court, but only if the CSRC first punishes the company in question. In other words, the central government refuses to let shareholders take the initiative and keeps them at the mercy of the fraudsters. Moreover, the Supreme People's Court said that shareholders may only sue for false misrepresentation; they are still prohibited from filing suits for other wrongs, such as insider trading and market manipulation.[15]

It may be no mistake that market manipulators are beyond the reach of shareholders because the biggest manipulator of them all is the central government. If there is one single reason why the domestic markets don't work well, this is it. Experts like Lardy may see the exchanges as mechanisms to efficiently allocate capital, but Beijing created them as a way to sell off chunks of state-owned enterprises. So the central government, in its dual role as regulator and largest market player, delays necessary reforms when they threaten its ability to sell stock of state enterprises to investors.

As a result, the markets are kept at abnormally high levels. Chinese stocks in domestic bourses normally trade at price/earnings ratios well above those of markets outside the Mainland. Chinese stocks trading in nearby Hong Kong, for instance, can be found for ratios under ten[16] while a few miles across the border in Shenzhen the prevailing ratios are five or six time higher on average. Stock prices in China can be more than ten times net asset value, and some high fliers have no net asset value at all. It is a gravity-defying act.

And a dangerous one. Not only is the potential of the markets huge as Laura Cha tells us, so are the risks that they pose to social stability. Beijing's leaders are constantly concerned about falling stock prices, in part because of the fear of angering tens of millions of shareholders.[17] And there is every reason to be concerned. "Their markets are an accident waiting to happen," one broker said referring to the exchanges in Shanghai and Shenzhen. "They're like Nasdaq in 2000 or Japan in the 1980s."[18] A steep fall, and maybe even a small one, could spell trouble: the average investor commits to the markets a sum equal to 23 times his or her annual income.[19]

So far, the central government has restricted the supply of new shares entering the Mainland markets as a means of maintaining prices. In an ideal world, Beijing could keep the markets aloft indefinitely by adopting this tactic. In the real world, however, technocrats face a tight deadline.

China's social welfare system is almost bankrupt. As mentioned in Appendix 3, Beijing will need to come up with about US$1 trillion, and maybe even more, in the years ahead to make up funding shortfalls. For this purpose Chinese technocrats have devised a general concept that should work: sell more stock of state enterprises. The state still owns a majority of the shares of listed companies, some 70 percent according to state media.[20]

This concept was translated into a State Council plan, announced in June of last year, which essentially required companies selling stock on public markets to sell additional shares equivalent to 10 percent of the original offer size. The proceeds from the additional shares were to be handed over to the national social security fund.[21] The rules applied to both domestic and foreign offerings.

In reaction to the June plan, the markets tanked, losing more than 30 percent of their value, some US$181 billion in market capitalization. Eventually, the CSRC suspended the plan to sell off state shares (on October 22, 2001).[22] Markets soared after the CSRC withdrew the plan: stocks immediately hit their maximum 10 percent daily ceilings.[23]

Reversing course solved the problem of sinking prices, but it did nothing to take care of the original problem. But Beijing is nothing if not persistent. Just when technocrats thought that it was safe to reintroduce their plan to sell state shares, local stock speculators proved them wrong. In late January of this year the CSRC announced over a weekend several proposals to unload state-held shares. The following Monday (January 28) saw domestic markets plunge across the board (the indexes fell between 6.3 percent to 8.7 percent on that day).[24] By Tuesday the CSRC was in "damage control mode" and announced that the plan was only "preliminary" and that "a lot of improvement needs to be made through further discussions." Stocks, predictably, went back up on the new announcement.[25]

"The hasty introduction and suspension of the scheme, though both well-intentioned, are indications of the CSRC's inconsistent governance of the market,"[26] wrote *People's Daily*. The Communist Party's paper is correct, of course, but the essential problems are deeper than indecision of Laura Cha and her colleagues.

For one thing, Beijing is finally paying the price for operating wacky markets. "The plan's fatal problem is that it is based on the premise that the market is operating stably," said Wang Yuanhong of the State Information Centre. "But we don't have such a stable market now."[27]

Even if the markets worked in general, the CSRC plan would not have fared will. The technocrats have little, if anything, to show for all the turmoil that they have caused in the markets because they were in denial about one of the fundamental building blocks of economics: the law of supply and demand. These men and women, no matter how much they may think of their own abilities, cannot announce a plan to sell hundreds of billions of shares without causing a severe adjustment in prices.[28]

The CSRC in January did say that it would compensate existing holders of shares for price declines, but it was sketchy on details as to how it would do so.[29] Apparently, the regulators thought that their good word was good enough to keep the markets high. No matter how credible they may be, they ignored simple economics. "No matter how the reduction is carried out, it means [a] big market expansion," said Dong Chen, a China Securities Co. analyst.[30] "The plan fails to find a way to introduce new capital."

As even CSRC officials have learned by now, sales of state shares at market value will take too much liquidity out of the markets. Therefore, they could soften the blow by letting go of new shares below prevailing prices. Selling below market, unfortunately, is not considered an option for two reasons. First, there is a matter of finances. "The state needs cash," says Anthony Neoh, senior advisor to the CSRC.[31] Second, there are politics and ideology: selling at a low price would look like a giveaway of state assets,[32] dynamite in today's China, at least among the senior cadres who care about these things.

Because the good options are not options, the CSRC can only say that its sell-down plan will be implemented gradually.[33] The CSRC's new proposals allowed for sales over a long period, maybe as long as 15 years, and a lock-up period in which the shares could not be sold after they became tradable.[34] That sounds fine on paper, but in practice such a plan means that China's markets would be burdened for a long time.

Even economists working for investment banks do not think much of the plan. Andy Xie of Morgan Stanley says that the lock-up period will not help: traders know that the shares will be coming onto the market in the future. The impact might be delayed, but the outcome will be the same, he believes.[35] "This isn't going to work," says Mou Xudong an analyst at Southern Securities in Shanghai,[36] speaking of the CSRC's January plan.

Today there has only been one concept that might help. There is talk that whatever funds are drawn out of the equity markets can be reinjected by the nation's social security fund, which is now restricted to investment in bank deposits and government bonds. That plan, even if implemented, cannot have much effect because the need to pay pensions is so great--it is unlikely that the state will ever accumulate enough to have a material effect on stock prices.

Now the Chinese markets exist in the worst possible of worlds. On the one hand, China's social welfare system remains "on the verge of bankruptcy."[37] And on the other, China's equity markets are, in the words of analysts, "on the verge of collapse."[38] Investors know that the share sell-down plan is coming, and the uncertainty is making the situation even worse. "It would be very hard for the markets to stage a solid recovery until the final selldown plan is revealed and clarified," says a stock analyst,[39] expressing simple common sense. "I'm depressed," said one investor. "I hope the final decision can be made soon so that we know where the bottom of the market is."[40]

Investors may want to know where that point is, but the central government is not brave enough to find out. Yet Beijing will have to do something. China needs to pay pensions and unemployment benefits to workers. It can turn its back on the problem for a year or maybe even a decade, but at some point it will not be able to defer the problem any longer.[41] The longer the pain is deferred, the worse it will be for everyone concerned.

Until they can figure out a solution, Beijing's technocrats tinker to prop up the domestic markets. Perhaps the most important tinkering in recent years involved the moribund B shares. The Chinese government maintains fractured domestic markets. There are A shares, available only to domestic investors, and B shares, once available only to foreigners. The former are denominated in renminbi and the latter either in U.S. or Hong Kong dollars. Trading in both types of shares takes place in Shanghai and Shenzhen. Chinese enterprises also issue shares in the foreign equity markets of Hong Kong (H shares), New York, Singapore, London, and Berlin.

Last February regulators opened the illiquid and cheaply-valued B share markets to domestic investors with foreign currency. A year after doing so, the reform still has not achieved its primary purpose of attracting big foreign money: "overseas investors are still shying away from this highly volatile and speculative market."[42] Foreign institutions are repelled by the lack of good stocks, small free floats, and dominance of local speculators "stir-frying" (speculating). When foreigners want exposure to Chinese stocks, they invest their funds in the markets outside the Mainland, especially those in Hong Kong.

Of course Beijing should fix small problems, and everyone knows that last year's liberalization of the B share markets was a step in the right direction. Yet major restructuring is more appropriate at this point in time: every analyst agrees that China eventually needs to combine all the separate markets. Technocrats won't do that for years, and maybe even decades, because a complete merger contemplates making the renminbi convertible. So we can understand why the job won't be finished soon.
Yet Beijing is now moving in the wrong direction by effectively creating even more categories of shares. The next major move will be permitting domestic investors to buy shares listed in Hong Kong pursuant to the qualified domestic institutional investor scheme (QDII), which could be put in place as early as July of this year.[43] Moreover, a few foreign companies will get permission to list on domestic markets by selling China Depository Receipts (CDRs), and this will permit

Mainland investors to use renminbi to buy the shares of these companies.[44] These further divisions of the market can only lead to more inefficiency in the allocation of capital--and lead to a further erosion of prices on the A share market.

These steps also show that Beijing's main goal these days is to support the stock price of Chinese enterprises. There is speculation that the stocks in the QDII scheme will be limited to Hong Kong-listed Mainland companies "with the likely result of sending their prices in a straight line up."[45] And in the first batch of CDRs will be the Hong Kong-listed companies that are arms of Mainland enterprises. So expect to see rising prices for China Mobile (Hong Kong), China Resources, Shanghai Industrial Holdings, and Beijing Enterprises.[46]

The CSRC also is working on smaller adjustments to the equity markets, such as the recent deregulation of brokerage commission rates.[47] Such deregulation is a definite improvement, and many analysts see steps such as this as proof that regulators are pushing in the right direction. Although many CSRC officials personally would like to see reform, the motivation for regulatory activity has little to do with improvement of the markets. Brokerage commissions were deregulated to stimulate interest in stock trading.

Stimulating such interest is also behind another "reform": the central government will soon permit banks to make loans to retail investors with stock as collateral. The purpose is to permit the investors to borrow for further stock market investment.[48] Beijing spent the better part of a half decade getting the banks out of the equity markets to prevent the further erosion of credit quality. Now it is pushing the banks back in. Stock prices will benefit, but banks will inevitably create new nonperforming loans.

Worse, regulators have maintained their policy of avoiding the delisting of bad companies. Only three companies have been thrown off a Mainland exchange so far,[49] and retailer Zhengzhou Baiwen, a shell of a company, has somehow avoided sharing their fate.[50] It is inevitable that it will be delisted, yet it should have gone long ago. Many people think that Baiwen should have had the honor of being the first to be booted off a Chinese bourse. And there are many more Baiwens that regulators choose not to see. "We all know that the Chinese stock market has a lot of very troubled companies that are propped up by helium," says James McGregor, a consultant based in Beijing. "You think Enron is bad? You should see some of the companies here."[51]

The current situation is untenable, at least in the long run. On the one hand, there is no doubt that Beijing can keep stock prices high in the long term. After all, it sets the rules and administers the game. So it mostly gets the desired results. In the future, it can continue to employ all of the old tactics to support the markets such as restricting investment alternatives, leaning on companies to scale back offerings,[52] providing financial and other types of support for listed enterprises, and, when all else fails, talking up the markets. Especially when all else fails, regulators resort to issuing happy thoughts. "The authorities don't want to see the market fall too much, so they released good news to keep investors from becoming even more pessimistic," said an analyst at Pingan Securities in Shenzhen.[53]

On the other hand, all these proven tactics defer the change that must occur if China is to achieve important, and some say critical, goals. There is, after all, no point in having stock markets if they do not allocate capital efficiently and thereby promote economic development. Beijing should listen to some folksy advice that economist Hu Ruyin dispensed in March of this year: "Yesterday I went to the dentist to pull a tooth. That means some short-term pain, but otherwise we would have long-term pain."[54]

And what is the future of the markets? There will not be much progress over the next few years: Beijing, even at this late date, is unwilling to endure pain. What forward movement we will see will come about only because the government will not have a choice. We have to remember that in this period of political transition in Beijing, even economic reforms are being put on hold.

Nick Lardy testified on December 6 that if the central government reforms the domestic markets, Chinese issuers will issue at home. If it cannot, they will have to issue abroad. Because reforms will be slow in coming, we will see a stream of initial public offerings abroad, most of them in Hong Kong[55] but many in the U.S. as well. As Joe Zhang, head of China research at UBS Warburg, said recently: "The fund-raising channels on the mainland are temporarily blocked, so they are coming to Hong Kong."[56]

And there are other reasons why Chinese companies will list outside the Mainland. Jiang Zemin himself is giving an impetus to domestic enterprises to list abroad.[57] His "go outside" theory is being interpreted by local cadres as approval to have their best enterprises sell stock overseas, which is easier than listing on the domestic exchanges. Lardy, in his testimony, supplies the reason why the better companies will have to continue to go offshore for at least the next few years. "Very large issues are not possible on the domestic market," he points out. "The continuing paradox is that a country with the highest rate of savings in the world . . . can't float a share offering of significant size on its domestic market."[58]

As efforts to increase offerings at home fail, the state will seek to increase the flow of stock sales in foreign markets. For example, last Christmas Eve the State Development Planning Commission announced a plan to encourage overseas listings, even hinting that foreigners would be allowed to hold controlling positions in large state enterprises, except for those considered vital to national or economic security.[59] Up to now, the state has permitted foreigners only minority positions in larger state enterprises in public flotations of stock.
And the state will resort to a time-honored technique: talking up the markets. The country's stock markets could start a bull run lasting a decade after a period of adjustment this year, says the prestigious Chinese Academy of Social Sciences.[60] The truth is, the markets are so wacky they could do anything, but going up seems improbable unless more capital is made available. Beijing can lean on its academics or even Laura Cha to say something nice, but this tactic by itself is not going to help investor confidence.

Until the state can get its policies right, we will have to listen to other voices. A professor at Shanghai Fudan University, Xie Baisan, says that China's markets are at a "critical point between life and death."[61] Not everyone would use such stark words, but facts speak for themselves. Last year saw a drop in stock prices, overall market capitalization,[62] and trading volume.[63] And, despite the sky-high multiples that can be found in the home markets, there was an acceleration of the trend of issuing stock offshore. The money knows that something is wrong.

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