

**China's Securities Market Development:
Lessons from Hong Kong and Other Asian Markets**

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Achievements of China's securities market

In a little more than a decade's time, China was able to develop a full-fledge stock market with modern direct financing mechanism to compete and supplement the dominant indirect financing function of the banking system. This is clearly a great achievement few had expected a decade ago. The development of stock markets has clearly helped to improve the capital structure of Chinese enterprises by reducing their debt-equity ratio. This is important for both enterprise and banking reforms in China.

Funds raised from IPOs in China's two stock markets are now larger than those raised in Japan. In 2001, Chinese enterprises raised about two times more capital from Shanghai and Shenzhen markets than from Hong Kong market. Since early 2001 the combined market capitalisation of Shanghai and Shenzhen have also grown larger than the market cap of Hong Kong, becoming the largest in Asia-ex-Japan.

Today more than 60 million Chinese shareholders are investing in more than 1000 listed Chinese companies. China's market capitalisation is also rising to about 50% of GDP, catching up with those in Korea and Japan.

As the scale of stock markets in China increases, their infrastructure also catches up quickly. Shanghai and Shenzhen stock markets have already achieved script-less transaction, well ahead of Hong Kong.

In the last few years, we have also seen clear improvement in the area of market regulation not only by CSRC but also by other government agencies and also with critical help from the public media.

Some of your may point out that the performance of the stock market index in China has been disappointing during the last few years. We need to take this into perspectives by taking a longer horizon and by comparing with other markets in the region.

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Stock Market Performance in Asia

	Stock Market Indices		% change	
	end Jun 97	end Dec 02	in local currency	in USD
Shanghai A	1,307	1,419	8.6	8.8
Shenzhen A	449	410	-8.8	-8.6
India	1,192	1,094	-8.3	-31.6
Korea	745	628	-15.8	-37.2
Hong Kong	15,197	9,321	-38.7	-39.1
Singapore	1,921	1,341	-30.2	-42.4
Japan	20,605	8,579	-58.4	-59.8
Malaysia	1,077	646	-40.0	-60.1
Taiwan	9,030	4,452	-50.7	-60.4
Thailand	527	356	-32.4	-61.3
Philippines	2,809	1,018	-63.7	-82.2
Indonesia	725	425	-41.4	-84.1

In fact, as shown in the above table, if we compare the performance of the stock markets in Asia between June 1997 and December 2002, on average, only China's shareholders have some gains, while all investors in other Asian markets lost from 30% to 85% of their value in stocks. This I believe is a statistical picture much closer to that of the real economy in the region.

Delineation and enforcement of property rights critical to securities market

Before going into details, I would like to emphasize that the core issue about financial market development in China is the delineation and enforcement of property rights.

Financial markets are derivatives of the real economy. The trading of securities is a derivative of the exchange of property rights over real assets. Well functioning financial markets rely not only on clear property rights and effective enforcement of contracts with regards to the financial instruments but also critically depend on delineation and enforcement of property rights over underlying real assets. No matter how advanced the securities market institutions and regulations are, a fake title or a fake certificate about a piece of the land or other assets would destroy all the value in a listed company, when discovered.

Securities market is at the top of the pyramid of a market economy in terms of the requirement on clear property rights and effective enforcement because of its nature of direct and immediate financing. Investors are given no collateral in their financing of listed companies. They have no time to observe and then intervene in the behaviour of the listed companies after buying the stocks. They gain or lose immediately following the actions not only in the financial market but also in any activities of the listed companies and of any other parties providing services to the listed companies.

The temptation to cheat is so big since the gains or losses could be so huge and so quick. This is where you need the best police and most clear and transparent rules. This is where clear and enforceable property rights matter the most.

Consumers can examine the products before purchasing. Employers and employees do work together and know each other over time. Homebuyers know the location, the design, and the physical conditions of the real estate. Banks hold collateral on their loans and inspect their clients. However, investors in the securities markets invest

entirely on their trust in the property rights, as delineated and enforced by the existing system of the economy.

Securities markets can easily go wrong when any part of the long chain of activities necessary for the delineation and enforcement of property rights is broken. The delineation and enforcement of property rights in the securities markets involve not only financial regulators but also an array of other regulators, service providers, and stakeholders, such as accountants, lawyers, judges, police, investors, and the government. This is why even the most advanced securities market, the U.S. market, could go wrong, and repeatedly in history.

Hong Kong as the World's freest market economy has developed one of the most advanced property rights system. Most physical and financial assets have clearly documented titles and certificates. The market through free and open transactions also assesses their value systematically and continuously with little intervention from the government. The transactions are well documented and taxed at a low tax rate in order to get the protection and enforcement by the legal system. World-class international companies in finance, accounting, and law are available for providing services on the delineation and enforcement of property rights under a modern and western-style legal system, a strong police force as well as arguably the World's best anti-corruption force, ICAC (Independent Commission Against Corruption). This is a system any developing economies, including Mainland, would dream to have. This system of property rights is behind Hong Kong's success in becoming Asia's leading international financial market.

But, like the U.S., Hong Kong's securities market could also go wrong even under a well-established system of property rights. In the case of Hong Kong, the weakest links are usually in the cross-border delineation and enforcement of property rights. Most of Hong Kong's listed companies are incorporated overseas. Many of them are Mainland companies, including the recent waves of Minying firms. This creates challenges for protection and enforcement of property rights and contracts. The strength of the property rights system depends on the weakest links in the long chain of activities for the delineation and enforcement of property rights. This is why even Hong Kong and the U.S. need to work hard in improving its property rights systems (or sometimes referred fashionably but narrowly as corporate governance).

There are many challenges facing China's securities market development. These challenges can be organized around the four functions of the securities market: resource allocation, price discovery, corporate governance, and risk management.

Resource allocation

The challenge for China's stock market development is huge in terms of its scale and its role in resource allocation. China's banking sector assets/GDP ratio is as high as 160%, more than three times of the stock markets capitalisation. At the present, a large portion of the bank deposits, perhaps as much as 20% to 30% of China's GDP, has difficulties in finding productive investment. It means that if the stock markets could do better than the banking system in intermediating savings and investment, the scale of stock market could increase for another 20% to 30% of GDP or several hundred billion US dollars in the near future.

Clearly there are ample domestic savings to support the expansion of the stock markets in China. The real challenge to the stock markets development in China is the same as that to the banking system: how to channel savings efficiently to the most profitable and productive enterprises and projects. Effective intermediation of savings and investment through the stock markets depends on the markets' capability in facilitating efficient and reliable price discovery, corporate governance, and risk management.

Price discovery

The Chinese government is still having significant influences on the stock markets. Given China's history of central-planning and state control on the economy, this is no surprise. Some of these government influences may distort the pricing function of the stock markets. This is common for emerging markets. The price distortions could exist even in the mature stock markets due to problems in policy, openness, and macro economic conditions.

The issue is that as China continues to open its economy under the WTO requirement and as the stock market participants becoming mature and sophisticated, it is likely that the investors and enterprises would increasingly benchmark the pricing function of China's stock markets with those of other international markets. Given this future trend of development, the existing price distortions may become major barriers for further development of China's stock markets. The key price distortions may include the following as pointed out by many scholars including my colleague Professor Frank Song in one of his papers:

- Distortion to IPO process and prices due to tight control on the number, price and timing of IPOs by the government on the one hand, and large demand on listing by enterprises and on subscription to IPO by investors, on the other hand;
- Distortion to markets and stock prices due to large amount of non-tradable shares (as high as two thirds of the total), by the State and other state-controlled institutional shareholders;
- Distortion to market structure and overall stock prices due to restriction or tight control on listing of private and foreign invested enterprises;
- Distortion to markets and stock prices due to shortage of professionally managed and properly regulated investment funds on the one hand, and active participation of hardly regulated and highly speculative trust companies, finance companies, and enterprises on the other hand;
- Distortion to markets and stock prices due to lack of short-selling mechanisms and derivatives products.
- Lack of transparent merger and acquisition transactions conducted through the stock markets, due to existence, fragmentation and different treatments to

different shareholder types and concentration of state ownership in listed companies.

In recent years the market forces and regulatory reforms have been working more and more effectively in reducing the above distortions to the markets and stock prices. In last few years the quality of markets in Shanghai and Shenzhen improved significantly and the stock prices became more rational on the whole. In particular, the markets have been able to punish and discipline quickly and forcefully the exposed market manipulations and improper behaviour by the listed companies.

Corporate governance

The quality of markets depends ultimately on the quality of listed companies and other market participants. The stock markets are certainly useful in providing pressures for listed companies to improve their corporate governance. The regulatory authorities in China have done a lot in promoting good corporate governance by establishing rules and guidelines similar to the OECD standards. These efforts are certainly helpful.

But given the above distortions to the pricing function of the stock markets, it is difficult for the market discipline to play its full role on corporate governance. In my own view, the key is still in the delineation and enforcement of property rights and incentives. As I have suggested in many occasions, the government could own stocks of large enterprises up to a certain limit, say below 20% or 30%, but have to give up its absolute control on the enterprises so that the market forces could really guide and check their behaviour.

Given the prevalence of majority state ownership and state control of the listed companies, major state banks, and major state-owned securities brokerage houses, there are serious conflicts of interest not only in making policies but also in the enforcement of property rights, laws and regulatory rules. The traditional paternalistic role of the State for the investing public makes it even more difficult for the Chinese government to detach itself from the conflicts of interest among different groups.

Risk management

The pricing and corporate governance problems in China's stock markets are typical of all emerging markets. These emerging market problems represent systematic and structural risks to domestic investors, as they could not deal with these risks through diversification within the domestic markets. China could reduce these risks in a number of ways:

- Reducing pricing distortions and improving corporate governance are the only way to reduce systematic and structural risks in the long run. This has been increasingly recognized as an on-going task for policy-makers and market participants.
- Listing more quality private and foreign invested companies would help to reduce the systematic and structural risks. This is happening slowly in China. I

have pointed out in many occasions before that the listing of good private and foreign invested companies is less about giving them access to capital. For many really good companies, they may not need the capital. It is more about building the reputation of China's stock markets and giving investors more quality companies to choose from. With globalisation, quality companies now have access to overseas markets for listing and all stock exchanges in the world are competing to get them listed in their own markets. This competition is creating pressures for all stock markets to improve their quality.

- Another market-oriented way to deal with systematic or structural risks in domestic markets is to allow investors to diversify their investment into foreign markets. This is a common practice for investors in the developed markets such as in the U.S. and Hong Kong. It is also the principle behind holding and managing foreign exchange reserves with foreign assets (to hedge against the risks of declining export income).

The experiences of Hong Kong and Japan may be useful in illustrating the last point. The fact that the investors in Hong Kong can easily diversify their investment into any international markets leads to my believe that the long-term systemic and structural risks of stock markets in Hong Kong is relatively low and limited. The price-earning ratios of companies listed in Hong Kong are not high compared to those in New York and London. The investors in Hong Kong apparently are able to benchmark their pricing of Hong Kong listed stocks on international standards. Indeed, as the quality of stock markets in China improves, investors in Hong Kong can easily switch their investment into China markets.

Another useful example on diversifying domestic risks is Japan. Since 1989, the annual net outward investment in securities markets by the Japanese has fluctuated in the range of 5 trillion to 12.5 trillion yen or US\$ 40 to 100 billion (at 125yen/dollar). Partly as a result of this diversification strategy, Japan is now a huge creditor to the rest of the world with external assets of more than 360 trillion yen or US\$ 3.9 trillion (at 125 yen/dollar), which is close to one year's GDP in Japan. These huge external assets would certainly help Japan to deal with its domestic and structural risks that have led to a stagnation of growth for more than 10 years and a government debt/GDP ratio of more than 140%.

Of course, diversification into overseas markets requires capital account relaxation and greater RMB convertibility, which is a complicated policy development and needs time for careful policy design and implementation and is beyond the scope of this paper.

Lessons from Asia

The post World War II Asia miracle was primarily in trade and manufacturing sectors and was followed by the Asian financial crisis. With China's accession to the WTO, the trade system in Asia will be more robust with low tariffs and non-tariff barriers and rising trade volume. The regional integration of skills and technology is also going smoothly given the rising foreign direct investment into China from the West as well as from Asia.

The bottleneck of economic development in Asia is clearly in the intermediation of its savings and investment. Asia's fragmented financial markets limited its ability to provide basic and normal functions of the capital markets: resource allocation, price discovery, risk management, and corporate governance.

Like in China, about one third of the domestic savings in Asian economies could not find productive uses and have to either sit in the banks or to be lent to the government or to be invested overseas. The extremely low interest rate in Japan clearly encourages investment with low or no return. The fragmentation of the region's stock markets also implies that they have not benefited enough from economies of scale, scope, and integrated high liquidity. The price distortion in the Asian financial markets, such as in Japan, makes it difficult, if not impossible, to use markets as one of the key discipline for corporate governance. The high non-performing loans in Asia's banking system and the fragility of their exchange regimes are still roots for future financial crisis.

Asia, including Japan, has developed strong manufacturing and export sectors during its golden period of growth but largely failed to develop a strong financial sector. The financing of the Asian miracle is largely by foreign direct investment and exports. China needs to draw lessons from this and use the window of opportunities during its high growth period to develop a competitive financial sector. As emphasized in this paper, this requires the development of clear property rights system and effective enforcement of property rights and contracts.

Financial Markets in East Asia: Key Indicators

	World Competitiveness Ranking	World Competitiveness Score	GDP	Productivity per Worker	Index on Quality of Financial Infrastructure	Bank Assets /GDP	Debt Securities /GDP	Equity Market Capitalization /GDP	Foreign Exchange Daily Average Turnover /GDP	OTC Derivatives Daily Average Turnover /GDP
	2002	2002	2001	2001	2000	2001	2001	2001	2001	April 2001
Unit			US\$ billion	US\$		%	%	%	%	%
USA	1	100.0	10,205.6	71,858.3	8.99	62.9	147.5	136.4	2.5	2.8
Singapore	5	81.1	85.6	44,934.3	7.58	243.5	40.5	135.2	118.0	84.7
HKSAR	9	77.8	161.9	52,605.2	7.75	215.3	27.9	312.6	41.4	32.1
Australia	14	74.1	367.2	55,218.2	9.06	262.6	43.6	102.2	14.2	13.8
New Zealand	19	66.5	49.1	43,297.7		187.7	26.9	36.3	8.1	6.9
Taiwan	24	61.3	282.2	52,911.3	7.50	262.3	19.8	103.7	1.4	0.6
Malaysia	26	59.7	87.5	22,273.3	6.55	208.2	93.5	136.0	0.1	1.0
Korea	27	56.8	422.2	39,617.1	6.73	232.9	67.3	46.1	2.4	0.9
Japan	30	54.3	4,143.8	52,779.0	8.67	139.2	153.1	54.6	3.5	3.2
China Mainland	31	52.2	1,159.1	7,375.3		160.0	28.4	45.4	0.0	0.0
Philippines	40	41.5	71.4	10,644.5	4.14	88.5	33.5	29.8	1.4	0.8
Indonesia	47	26.9	130.3	7,285.8	3.52	156.5	2.3	17.6	3.1	0.4

Source: World Competitiveness Yearbook 2002, IMD; Tables in the chapter; FIBV, BIS and websites of the central banks and ministries of finance in the region; Gordon de Brower's paper on "Financial Markets, Institutions and Intergration in East Asia".