

CHINA'S STOCK MARKET: A MARRIAGE OF CAPITALISM AND SOCIALISM

Sonia M. L. Wong

The rise of China's stock market during the 1990s was nothing short of breathtaking. For more than 30 years after 1949, China was a centrally planned economy in which virtually all enterprises were state owned or collectively owned. Investments were centrally planned and funded by government fiscal grants as well as by loans from the state-owned monobank system as dictated by the government's central credit plan.

In the late 1980s, as part of enterprise reforms that took place during China's gradual transition to a market economy, local governments in China started experimenting with selling shares of collectively owned enterprises directly to domestic individuals in order to raise equity capital. Curbed trading of enterprise shares soon began and was quickly followed by over-the-counter (OTC) trading in more organized but still informal exchanges. In 1991, two stock exchanges, one created by the Shanghai municipal government and the other by the Shenzhen municipal government, were launched, with the central government's formal approval. Between 1992 and 2003, the market raised a total of 796.79 billion yuan of equity capital. At the end of 2003, China's stock market had 1,287 listed enterprises and more than 70 million investor accounts (CSRC 2004).

Table 1 summarizes the growth of the Chinese stock market since

Cato Journal, Vol. 26, No. 3 (Fall 2006). Copyright © Cato Institute. All rights reserved.

Sonia M. L. Wong is an Assistant Professor in the Department of Finance and Insurance at Lingnan University, and a Research Fellow of the Hong Kong Institute of Economics and Business Strategy at the University of Hong Kong. This article was supported by the Hong Kong Research Grants Council (RGC) Competitive Earmarked Research Grant Awards 2004–2005 (LU7236/04H). The author thanks the Council for its support. She also acknowledges Li Wei, who shared valuable insights on the functioning of China's stock market within the context of financial repression when the author visited the University of Virginia's Batten Institute at the Darden Graduate School of Business as a Batten Fellow, and Zhang Xuan, who provided excellent research assistance.

TABLE 1
OVERVIEW OF CHINA'S STOCK MARKET: 1992-2003

Year	No. of Listed Enterprises (A, B-Share)	Total Amount of Capital Raised (RMB Billion)	Number of Investor Accounts (Millions)	Market Capitalization (RMB Billion)		Market Capitalization to GDP (%)		Trading Volume	Domestic Raised Capital to Amount of Loan of Bank (%)
				Total Market	Negotiable	Total Market	Negotiable		
1992	53	9.41	2.17	104.81	—	3.93	—	68.13	—
1993	182	31.45	7.78	353.10	86.16	10.20	2.39	266.70	4.96
1994	291	13.81	10.59	369.06	96.89	7.89	2.06	812.76	1.91
1995	323	11.89	12.94	347.43	93.82	5.94	1.60	403.65	1.27
1996	530	34.15	24.22	984.24	286.70	14.50	4.22	2,133.22	3.20
1997	745	93.38	34.80	1,752.92	520.44	23.44	6.96	3,072.18	8.72
1998	851	80.36	42.60	1,950.56	574.56	31.82	7.22	2,354.43	6.99
1999	949	89.74	48.11	2,647.12	821.40	31.82	9.87	3,131.96	8.27
2000	1,088	154.10	61.55	4,809.09	1,608.75	53.79	17.99	6,082.67	11.55
2001	1,160	118.21	69.66	4,352.22	1,446.32	45.37	15.08	3,830.52	9.50
2002	1,224	77.98	72.02	3,832.91	1,248.46	37.43	12.19	2,799.05	4.11
2003	1,287	82.31	73.44	4,245.77	1,317.85	36.68	11.29	3,211.53	2.97

SOURCE: *China Securities and Futures Statistical Yearbook*, various years.

its inception. The market experienced tremendous growth with total (negotiable) market capitalization increasing from 353.1 (86.16) billion yuan at the end of 1993 to 4,245.77 (1,317.85) billion yuan at the end of 2003.¹ Along with the growth in market capitalization, the market also enjoyed a high level of liquidity, with trading volume increasing from 68.13 billion yuan in 1992 to 6,082.67 billion yuan in 2000. The two exchanges now boast a modern infrastructure with a computerized automated trading system, a high-speed nationwide satellite communications system backed by digital data networks, a paperless depository, and an efficient clearing and settlement system.² In about a decade, China built a respectable stock market from scratch.

Stock market development in China took off in the early 1990s, roughly at the same time as it did in other transitional economies (Pistor, Raiser, and Gelfer 2000). But China's stock market is performing better than the markets of most other transitional economies, when comparisons are made using standard measures of stock market performance, including the number of listed firms, market capitalization, liquidity, and fundraising capacity (Pistor and Xu 2005: 191).³ By the end of 2000, while many stock markets in transitional economies were plagued by low market capitalization and low liquidity, China's total stock market capitalization had swelled to more than US\$507 billion. That made China's stock market capitalization the second largest in Asia, after Japan's.

China's stock market had three unique features that made its rapid development unique and interesting. First, the government used it largely as a fundraising vehicle for funding state-owned enterprises

¹A typical listed firm in China has two types of shares. The first type includes shares issued to state-owned entities that are not allowed to be traded on China's two stock exchanges. The second type includes freely tradable shares issued to private individual investors. Total market capitalization refers to the market value of all shares issued by China's listed firms. Negotiable market capitalization refers to the market value of all shares issued to private individual investors.

²The computerized automated trading system of the Shanghai Stock Exchange can process as many as 10,000 transactions per second, and the satellite communication system is backed by a digital data communication network. The exchange's clearing system also leads the Asian Pacific region in realizing a paperless depository and highly efficient clearing and settlement system.

³Caution should be exerted when using these indicators to assess stock market development in transitional economies. For example, the number of listed firms is affected by the privatization methods of a transitional economy. The Czech Republic, for instance, requires all firms that have completed the mass privatization program to list on the Prague stock exchange. See Pistor and Xu (2005).

(SOEs).⁴ As a result, most listed enterprises were state controlled, with only one-third of the enterprises' equity capital sold to private shareholders during initial public offerings (IPOs). The other two-thirds of the equity capital raised was held either by state asset management agencies or by SOEs themselves. In an effort to prevent the loss of state control over listed enterprises, the government forbade trading of state-owned shares on China's two exchanges, and the shares could be transferred only after approval from state asset management authorities had been obtained, which made these shares effectively nontradable. The transfer of state-owned shares to private shareholders was rare in the 1990s. At the end of the 1990s, more than 90 percent of the enterprises listed on China's two stock exchanges remained state controlled, with state-owned entities as their controlling shareholders. The rapidity of the development of China's stock market seems to suggest that a stock market (which is regarded as the incarnation of capitalism) can coexist with state ownership (which is regarded as the defining institution of socialism) and does not necessarily require the presence of private enterprise.

Second, China's stock market developed under a repressed financial regime. Financial repression was created through a combination of capital controls on international capital flows and administrative measures imposed by the central government to dampen potential competition among different financial assets (e.g., bank deposits, enterprise stocks, enterprise bonds, and various kinds of government bonds) within the domestic financial sector.⁵ While the capital controls helped to prevent capital from flowing out of the country, the competition-mitigating administrative controls sought to avoid the driving up of returns on various financial assets and thus to allow the government to maintain a source of cheap capital for financing SOEs' investments (Li 1994; Li 2001; Gordon and Li 2003).

Financial repression, which generates artificially low returns on financial assets, inevitably creates excessive demand for valuable financial resources and hence results in nonprice rationing of those

⁴Unlike other transitional economies, China has adopted a gradual reform approach. Instead of privatizing SOEs at the beginning of the transition, China's SOE reforms before the mid-1990s concentrated on adopting a new enterprise governance structure that expanded enterprise autonomy and incentives. Although massive privatization of small SOEs has taken place spontaneously in various localities under the policy of "focusing on large firms, and letting small firms go [*zhuada fangxiao*]" since the mid-1990s, privatization of large SOEs as a reform option was sanctioned only in 1997 at the 15th Party Congress.

⁵Specific examples of the major components are entry restrictions of new banks and nonbank financial institutions, interest rate controls, quotas for the amount of share issuance, and restrictions on the issuance of enterprise bonds.

financial resources to preferred claimants (McKinnon 1973; Shaw 1973). Financial repression is therefore a disguised form of investment planning. In theory, this form of investment planning was to be gradually phased out with the emergence of a stock market that provided a forum for direct transactions between investors and fund seekers. However, China's central government imposed a host of administrative controls aimed at preserving its monopoly over the uses of funds long after the emergence of the stock market, thus grafting the socialistic investment planning institution onto the stock market. Such a unique institutional structure is intriguing for studies on financial repression as well as the functioning of stock markets. Furthermore, the traditional economics literature generally views financial repression as an obstacle that limits financial market development, because, under a repressive financial regime, holders of financial assets are not rewarded for real growth in their portfolios (McKinnon 1973; Shaw 1973). The rapid growth of China's stock market during its first decade seems to offer an interesting alternative case study.

Third, China's stock market was developed under a weak legal framework that offered shareholders little protection. On the widely used indicators for shareholder rights protection developed by La Porta et al. (1998), China scored 3, compared with the average score of 3.61 for all other transitional economies (Pistor and Xu 2005: 191).⁶ The actual protection for shareholders in China, however, is lower than what the index suggests because of the weak legal enforcement in China (Tenev and Zhang 2002; Allen, Qian, and Qian 2005; Pistor and Xu 2005). The development of China's stock market therefore presents a puzzling case for economists and financial analysts who hold that legal shareholder protection is a prerequisite for the development of a functioning capital market (Shleifer and Vishny 1997; La Porta et al. 1997, 1998; Pistor and Xu 2005).

This article attempts to explain how China was able to develop a large, active, and technologically advanced stock market in the 1990s while maintaining its salient socialistic institutions of state ownership and monopolistic control over financial intermediation, and offering shareholders only weak legal protection. I argue that the marriage of socialism and capitalism took place when China's poorly regulated stock market was becoming a venue whereby local governments and SOEs issued shares to capture economic rents created by financial repression, and traders bought and sold shares based on speculative

⁶The maximum score for shareholder rights is 5. The scores for the United States and Hong Kong are 5 and 4, respectively (see La Porta et al. 1998).

motives rather than investment value. I show how the development of China's stock market in the 1990s was in fact driven primarily by these rent-seeking and speculative activities rather than by value-driven transactions between investors and fund seekers.

In the early 2000s, China's central government introduced a series of reform measures for privatizing listed enterprises, removing restrictive barriers in the financial sector, and improving legal protection for shareholders. Those measures are all consistent with the standard prescriptions for fostering the development of a well-functioning stock market. However, they have met with little enthusiasm and have triggered a bear market. The composite index of the Shanghai Stock Exchange slid from around 2,250 points in mid-2001 to around 1,300 points in December 2004, a plunge of 42 percent. In January 2005, the central government decided to slash the stamp tax by half, reducing it to 0.1 percent in an apparent attempt to boost the falling stock market. The stock market, however, remained weak. As recently as March 2006, the composite index was still hovering around 1,300. I conclude this article with a discussion of the impacts of recent reforms as well as the likely evolution of China's stock market in the future.

Institutional Development of China's Stock Market

The origin of China's stock market can be traced to a fall in the central government's revenues in the early 1980s, which necessitated finding new sources of capital to fund SOEs' capital expenditures. Since the introduction of economic reforms in 1978, the central government's revenues declined steadily relative to gross domestic product (GDP), falling from 31.2 percent in 1978 to 15.8 percent in 1989.⁷ Mired in a deficit of 17.06 billion yuan (about 5 percent of national income) in 1979, the government did not achieve a small surplus until 1985.⁸

During this period, private household savings surged, with deposits

⁷Several factors, including falling profit margins in SOEs owing to competition from nonstate firms and the inexperience of the tax authority to monitor nonstate firms, contributed to the decline in central government revenue. The decline in reported revenue is also consistent with the economic and fiscal decentralization that took place in the 1980s (Gordon and Li 2003).

⁸With budget deficits relative to GDP reaching record highs in 1979 and 1980, the central government could initially count on seigniorage, which resulted from the increases in cash issued by the central bank, as a source of revenue. In anticipation of continued budget deficits, the Ministry of Finance resumed the issuance of treasury bonds in 1981 in order to raise funds to finance SOEs' capital expenditures.

in state-owned banks increasing from 21.06 billion yuan in 1978 to 121.47 billion yuan in 1984.⁹ In July 1983, the government started to fund most of the SOEs' capital expenditures with bank loans rather than via free budgetary allocations. Bank lending to industrial enterprises for capital construction investment jumped from a mere fraction of the total capital investment in 1979 to about 80 percent in 1985. The central government's shift from budgetary to bank financing of SOEs represented only a switch from financing SOEs with direct taxes to financing them with implicit taxes (quasi-fiscal revenue) collected from bank deposits (Gordon and Li 2003). Under a financially repressed regime, the government had been able to set the deposit interest rate lower than the foreign borrowing cost that it faced, thus adding an implicit tax rate onto the returns to savers from their deposits. The difference between the foreign borrowing cost and the domestic interest rate (i.e., the implicit tax rate on domestic savings) was at least 6 percent during the period 1978–84 (Gordon and Li 2003).¹⁰

In the mid-1980s, after having taken over control and cash flow rights of the vast majority of small- and medium-sized SOEs in the early 1980s, local governments wanted access to alternative sources of investment funds in addition to fiscal grants and bank loans (Xia, Lin, and Grub 1992). Some local governments spontaneously started to sell the shares of a few collectively owned enterprises to domestic individuals. However, selling shares directly to individuals represented a challenge to both state ownership and monopolistic control over financial intermediation.¹¹ The issuance of shares to individuals

⁹The following factors contributed to this increase. First, starting with the agricultural sector, the central government endorsed a breakup of the communes and a return to traditional household farming, which resulted in a substantial increase in income among farming households. Second, in the industrial sector, local governments and SOEs experimented with providing monetary incentives to both factory directors and workers, which resulted in a substantial increase in income among urban households. Owing to the existence of capital controls as well as administrative measures that created obstacles to direct private investment, most household savings were deposited in state-owned banks, thus providing the government with a sizable stock of loanable funds.

¹⁰There are two other sources of implicit taxes that the government collected from the financial sector. The first is seigniorage income resulting from the difference in the cost of printing money and the face value of that money. According to Hofman (1998), the implicit tax revenue from seigniorage in China was 1.3 percent of GDP between 1986 and 1994. The second source is the issuance of treasury bonds. In the early 1980s, the returns on treasury bonds were lower than the interest rates on bank deposits. As a result, the purchase of bonds was subject to an implicit tax rate that was higher than the rates levied on bank deposits (Bowles and White 1993).

¹¹In early 1990, Zhu Rongji stated that there are four political objections to the emergence of the stock market in China. First, SOEs issuing shares and debt might lead to

inherently creates private ownership, which is perceived as one of the defining features of capitalism. The emergence of enterprise shares also creates potential competition for bank deposits because enterprises now have the option of seeking direct financing, and domestic households can invest their savings in the stock market rather than deposit them in state-owned banks. This poses a threat to the government's monopolistic control over financial intermediation and implicit tax benefits. The challenge becomes more pronounced when stocks become more liquid with the emergence of secondary markets in which more funds are drawn from the banking system into share trading.¹²

Despite these potential risks, the central government saw that a functioning stock market could facilitate the mobilization of private savings to finance SOEs and to diversify investment risks otherwise concentrated in the state-owned banking system. The government also sought to use corporatization to restructure SOEs in the hope of improving their performance by subjecting them to the disciplinary forces of the stock market. In other words, the government wanted to free ride private shareholders' monitoring of SOEs via the stock market. The government, therefore, had conflicting views about the emergence of the stock market. The government decided to allow it to develop but only if state ownership and monopolistic control over the financial sector remained dominant.

To avoid being criticized for endorsing capitalism and privatizing state assets, the local governments that had spontaneously initiated share issuance took a cautious approach by limiting the scope of their experiments to collectively owned enterprises and no SOEs. Shortly, the government realized that such a strategy in effect had diverted the low-cost capital away from SOEs to collectively owned enterprises. In May 1990, the State Council issued a regulation that restricted share issuance to SOEs and no collectively owned enterprises. In this way, the government reserved the stock market as a fundraising vehicle for SOEs only, thereby maintaining monopolization over the uses of funds even after the stock market had emerged.

In May 1992, the State Council issued another regulation that

privatization. Second, selling shares or fixed income securities to individuals might reduce bank deposits and harm the banking system. Third, trading of shares might lead to speculation and social instability. And fourth, opening a stock exchange might lead to the emergence of a new class of capitalists (Walter and Howie 2003).

¹²The first OTC trading market was formally opened in Shanghai by the Shanghai Trust and Investment Company and the Industrial and the Commercial Bank of China in December 1986. OTC markets then quickly spread to other major cities (Walter and Howie 2003; Green 2004a).

categorized the shares of a shareholding enterprise into three types: (1) state and legal person shares, which are owned either directly or indirectly by the state and which cannot be traded freely on the stock exchanges but can be transferred only with administrative approval; (2) A-shares, which are yuan-denominated and are available for trading by domestic private shareholders on the stock exchanges; and (3) B-shares, which are available for trading by foreign investors in foreign currencies on the stock exchanges. This regulation effectively institutionalized a unique feature of China's stock market—the creation of three distinct markets for the stocks of a listed enterprise, namely, the one-way transfer market for state-owned shares, the A-shares market for domestic private shareholders, and the B-shares market for foreign investors.

In addition to establishing regulations aimed at maintaining the dominance of state ownership, China's government adopted measures to control the supply of and the demand for shares in the market. The most important control devices on the supply side were administrative controls aimed at controlling the amount of shares available to domestic shareholders. From 1993 to 1998, the government imposed an explicit annual quota on the total amount of capital that could be raised through IPOs issuance. Similarly, regulations were imposed to restrict the amount of post-IPO issuance, including both secondary and rights offerings. The restrictions on the supply of shares served two purposes. First, these restrictions limited the size of the stock market and thus limited potential competition between enterprise shares and other financial assets. Second, the restrictions tended to inflate share prices and thus reduce their returns. In this way, the restrictions effectively increased the implicit tax rates levied on stock ownership and thus made stock ownership less appealing (Gordon and Li 2003).

Measures to control demand for stocks included regulations imposed to restrict the sources of funds that could be invested in the stock market. First, domestic individuals were prohibited from owning and trading in B-shares, which were issued only to foreign investors, and, conversely, foreign investors were prohibited from owning and trading in A-shares, which were issued only to domestic individuals. This measure enabled the government to access funds from foreign investments while maintaining control over both domestic and foreign capital. Second, domestic individuals and institutions were prohibited from using bank loans to invest in the stock market in order to control the amount of funds that could be diverted from the banking sector to the stock market. Third, financial institutions and major institutional investors such as insurance funds and pension

funds were not permitted to buy shares and could only invest in government bonds and bank deposits. From May 1997 to September 1999, all SOEs and listed enterprises were prohibited from buying any shares, even with funds from their own operations.

The supply and demand controls that the government imposed on the stock market until the late 1990s were aimed at restricting its size and growth. The restrictive strategy was perhaps due in part to the central leaders' lack of experience with operating a stock market within the construct of a socialist economy and also to opposition from the banking sector, which had exercised nearly complete monopolization over the uses of funds before the emergence of the stock market.¹³ The government generally favored the banking system over the stock market as the primary vehicle of financial intermediation, and domestic funds were channeled mainly to the banking sector instead of the stock market.

In the mid-1990s, state-owned banks, which had been primarily responsible for providing loans to SOEs for more than 10 years, had a rate of nonperforming loans that was as high as 40 percent (Wong and Wong 2001). Subsequently, in 1997, the government decided to make greater use of the stock market as an alternative fundraising vehicle for SOEs to allow state-owned banks some room for restructuring. Pursuant to these strategic decisions, nearly all the restrictive regulations that had been imposed on both the supply of and the demand for stocks were relaxed, step by step. Of the supply controls, the quota system on IPO issuance was the first to be relaxed in 1999 and eventually abolished in 2001, while the requirements for post-IPO issuance were also made less restrictive after 1999. On the demand side, domestic individuals were permitted to buy B-shares starting in February 2001, and the A-share market was opened to foreign investors under the scheme of Qualified Foreign Institutional Investors in 2002. Starting in February 2000, some selected securities enterprises were also allowed to borrow funds from banks with their shares as collateral. This marked the first step toward allowing bank credits to enter the stock market. Beginning in September 1999,

¹³The experimental approach of the central leaders can be revealed by the remark of Deng Xiaoping: "Are securities and the stock market good or bad? Do they entail any dangers? Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out. If, after one or two years of experimentation, they prove feasible, we can expand them. Otherwise, we can put a stop to them and be done with it. We can expand them all at once or gradually, totally, or partially. What is there to be afraid of? So long as we keep this attitude, everything will be all right, and we shall not make any major mistakes" (Editorial Committee for Party Literature, Central Committee of the Communist Party of China 1994: 361).

institutional investors, including SOEs, listed enterprises, investment funds, insurance funds, and pension funds were gradually permitted to invest in the stock market either directly or indirectly through investment vehicles such as investment funds.

Relaxing the restrictions on the demand for shares was intended not only to accommodate the increase in the supply of IPO and post-IPO issuance but also to support the government's plan of reducing the state ownership stake in listed enterprises (Naughton 2002a, 2002b). In early 2001, the central government decided to sell its ownership of the listed enterprises to raise funds to replenish the newly established National Social Security Fund (NSSF). As the state stock reduction program would significantly increase the supply of shares in the A-share market, the government paved the way for allowing more funds to enter the stock market. However, when the State Council issued a detailed plan of selling state shares in June 2001, the market responded with a dramatic downturn spurred by fear that the market would be flooded with these shares.¹⁴ On October 22, the government was forced to announce a suspension of the sell-off and in June 2002 finally decided to scrap the program altogether. Nonetheless, an alternative state share reduction program had been operating quietly in the off-exchange one-to-one transfer market since 1996. From 1996 to the end of 2002, about 200 to 250 listed firms experienced a change in the largest shareholders from state to private entities (Green 2004b). This kind of state share reduction did not affect the supply of shares in the A-share market because the shares acquired by large private shareholders remained nontradable.

In tandem with removing regulatory barriers and reducing government ownership stakes, the China Securities Regulatory Commission (CSRC) introduced a series of measures aimed at improving corporate governance and legal protection for shareholders in the 2000s. Early in the year, CSRC declared 2001 the "year of market supervision" and commenced a series of investigations into irregularities and illegitimate activities in the stock market, including illicit use of bank funds for stock speculation, market manipulation, and earning falsification by listed enterprises. CSRC also introduced a series of rules and regulations aimed at improving listed firms' corporate governance, including the requirement that firms must have at least two independent directors on or before June 30, 2002, and that at least

¹⁴The specific plan is as follows: when SOEs (including enterprises listed overseas) launched IPOs or issued additional stocks in the secondary market, they were to sell state stocks at up to 10 percent of the total value of the offering to replenish the NSSF.

one-third of the board members must be independent directors on or before June 30, 2003.

In terms of legal protection for shareholders, the most important development was a judicial interpretation issued by the Supreme People's Court in January 2001, which stated that fraudulent accounting cases could be pursued in courts by civilians if CSRC had already punished the listed enterprises involved or if criminal proceedings had already taken place. This document introduced for the first time civil threats to China's listed enterprises. In January 2003, the Supreme People's Court issued another judicial interpretation that further clarified ways to define losses suffered by shareholders and to calculate related civil compensation. The interpretation also enabled shareholders to launch collective civil suits in which a number of plaintiffs could gather to sue a listed enterprise through a few representatives, giving the shareholders a more powerful voice in these cases. The provision of such a legal framework led to a substantial increase in the number of civil cases brought against listed enterprises. In 2002 alone, various local courts in China accepted about 900 such cases (Li, Song, and Wong 2004). Although most of the lawsuits against firms remain in the courts and have not yet entered handling procedures, shareholders in China have finally been given legal means to protect their interests.

The Stock Market As a Rent-Seeking Avenue

The growth and the liquidity of a stock market depend essentially on the demand for and the supply of funds. This section explains the growth of China's stock market from the point of view of the demand for equity financing. Unlike open market economies where equity financing involves the exchange of control and cash flow rights over assets for a certain amount of capital that is determined by market valuation, China's stock market has at least three institutional peculiarities that provided additional rents to be captured through equity financing and thus create special incentive to issue shares and raise funds from the market. First, China's stock market operated in a financially repressed regime in which enterprises faced artificially low capital costs (McKinnon 1973; Shaw 1973). As argued by Gordon and Li (2003), raising funds from China's stock market has been equivalent to the central government implicitly allocating taxes. As a result, local governments and enterprises have a strong incentive for equity financing in order to capture the economic rents created by such financial repression.

Second, state ownership itself is associated with a greater tendency toward equity financing. Unlike private owners, state owners are not real owners but are rather bureaucrats who are unable to capture directly and entirely the cash flows that can be derived from state assets (Shleifer and Vishny 1997). The absence of or at least the incomplete cash flow rights for state owners implies that their valuation of a given asset tends to be lower than that of private owners who enjoy both control and cash flow rights (Li and Wong 2004). The lower valuation assigned by state owners in turn implies that they are more willing, when compared with private owners, to sell a given asset for a given price. Therefore, the incomplete property rights of state ownership create a special incentive for equity financing.

Last but not least, weak legal protection for shareholders also offered enterprises a special premium for equity financing. As argued by Shleifer and Wolfenzon (2002), a lower level of legal protection for investors tends to be associated with a greater demand for equity financing, because controlling shareholders are more likely to be able to expropriate minority shareholders and outside investors. In China, many controlling shareholders treated listed enterprises as cash cows from which they can benefit at the expense of minority shareholders. Documented abuses by controlling shareholders include obtaining soft loans from listed firms; using listed firms as guarantors to borrow money from banks; and buying and selling goods, services, and assets at unfair prices (Tenev and Zhang 2002; World Bank 1997). Green (2004a) further argues that legal protection for shareholders in China improved little in the 1990s because the regulators were under political interference for the local governments that wanted to maintain a low level of legal protection for the average shareholders to allow listed SOEs to reap the benefits of expropriations created by a weak legal framework.

Given the excessive demand for equity financing, China's government attempted to control the aggregate amount of share issuance through a quota system on IPOs and a set of stringent requirements for post-IPO issuance. However, those controls were ineffective. Furthermore, the limited supply actually generated additional economic rents and thus strong incentive for local governments and listed enterprises to increase the number of shares they issued while encouraging the central government to prevent others from issuing. China's stock market then became a rent-seeking venue where local governments and enterprises sought to issue shares to capture the economic rents.

Rent Seeking through IPO Issuance

In the mid-1980s, when direct equity financing first emerged, it spread quickly across the country. In 1986, the State Council extended regulatory authority over the emerging stock market to the People's Bank of China (PBOC), which immediately exerted control over the total amount of funds that could be raised by enterprises by requiring local governments to obtain approval from the bank's headquarters in Beijing before authorizing any share issuances.¹⁵ During the period 1986–88, PBOC was unable to exercise effective control over the number of shares issued across the country, and the total number significantly exceeded the quotas it had set (Green 2004a). In 1989, share issuance contracted sharply because of the tightening of political control after Tiananmen and the implementation of the monetary retrenchment program. Share issuance picked up in early 1990. By the end of 1990, some 4.2 billion yuan worth of shares had been issued throughout the country (Green 2004a).

A new round of massive issuance was triggered by Deng Xiaoping's public endorsement of the adoption of a stock market as part of his vision of a socialist market economy that he made known during his famous Southern China tour in early 1992. There are no reliable statistics for how many stocks were actually issued, but it is certain that the value of the shares issued far exceeded the PBOC's quota of 4 billion yuan for 1992. While one source claimed that the total issuance was worth 27.7 billion yuan, another more conservative estimate suggested that 10 billion yuan worth of shares had been issued across the country (Green 2004a). Such massive overissuance raised concerns about the effectiveness of PBOC's control over the newly emerged stock market.

In October 1992, China established CSRC as a watchdog over the stock market after a riot broke out on August 10 of that year in Shenzhen, when roughly a million eager investors became suspicious that corrupt officials had diverted the application forms of a hot IPO. Shortly after its establishment, CSRC created an explicit quota system to strengthen control over share issuance. Under the quota system, the total value of A-share issuance for each year was determined on a national level by the State Planning Commission (SPC). CSRC would divide this amount among provinces and ministries that then selected their preferred SOEs for listing accordingly. In this way, the quota system not only exercised control over the supply of shares but

¹⁵Since local governments had a strong influence over senior appointments at local PBOC branches, the central government could not rely on them to enforce share issuance quotas.

also allowed local governments to maintain investment planning through their ultimate control over the SOEs that could go for listing.

In theory, the quota system should have been straightforward, with little room for manipulation. In reality, the value of shares issued far exceeded the amount specified by the quota, which suggests manipulation or ineffective control over the listing process. Table 2 shows the initial, revised quota and the value of shares actually raised during the period 1993–98. In 1993, when the system was first introduced, the planned value of new shares to be issued was 5 billion yuan, but the total value of shares actually issued by various local governments reached about 19.4 billion yuan. The flooding of the market with new shares eventually led to a crash in mid-1994. The central government had to abolish the 5.5 million yuan quota in July 1994. In December 1996, the government, in order to tame a bull market that was increasingly drawing funds from the banking sector, upwardly revised the issuance quota from 5.5 billion to 10 billion yuan. When this failed to reverse the trend, the quota was again raised to 15 billion yuan in March 1997 and then to 30 billion yuan. The actual amount of capital raised in 1997 was still more than double the revised quota amount. From 1993 to 1998, the total initial (revised) quota amount was 56 (81) billion yuan. The actual amount of capital raised was 216.1 billion yuan, which is 3.86 (2.76) times the initial (revised) quota.

TABLE 2
THE A-SHARE ISSUANCE QUOTA: 1993–99
(RMB BILLION)

Year	Initial Quota	Revised Quota	Actual Capital Raised through A-Share IPOs
1993	5.0	5.5	19.4
1994	5.5	No issuance	5.0
1995	None	5.5	2.3
1996	5.5	10.0	22.4
1997	10.0	15, then 30	65.5
1998	30.0		44.3
1999	Formal quota system abolished		57.3

SOURCE: Green (2004a: 164).

Beginning in 1998, the government terminated the quota system and attempted to list as many enterprises as the market permitted. During the period 1998–2001, a total of 235 enterprises were listed,

with the amount of capital raised grossing at 171.93 billion yuan, which is 1.44 times more than the cumulative amount of capital raised from 1992 to 1997. The ratio of capital raised through the stock market to bank loans increased from 6.77 percent in 1998 to 11.23 percent in 2000, indicating the relative increase in the importance of the stock market as a source for financing SOEs (see Table 1). The ratio, however, started to decline after 2001 as a result of weak market conditions that significantly limited new stock issuance.

Rent Seeking through Post-IPO Issuance

Much as it had restricted IPO issuance, China's central government also controlled the amount of post-IPO issuance to limit the supply of shares in the market. There are two ways of issuing new shares post-IPO. The first is through secondary offerings, which involves issuing additional new shares to new shareholders. The second is through rights offerings, which involves issuing new shares to existing shareholders. Secondary offerings were prohibited by CSRC from 1993 to 1998 because they lead to a dilution in state shareholding and therefore to erosion of state control over listed enterprises. Rights offerings, on the other hand, were allowed because they do not change the relative shareholding if shareholders fully subscribe to the shares that they are allocated. However, many state shareholders in China's listed enterprises voluntarily gave up their allocated shares. Table 3 summarizes China's shareholders' subscription rates, defined as the ratio of the new shares to which shareholders actually subscribed to the number of shares allocated to them from 1994 to 2003. While the A-shareholders tended to fully subscribe to their allocated shares, state shareholders on average subscribed to only about 30 percent of the shares allocated to them.¹⁶ Owing to under-subscription, the percentage of state-owned shares declined by about 4.5 percent after each rights offering. The dilution of state shareholders resulted in the privatization of many of China's listed enterprises (Li and Wong 2004).

The central government became aware of such a privatization implication as early as 1994, as revealed by two urgent notices that the State Asset Administration Bureau issued in April and December.

¹⁶Domestic investors tend to fully subscribe to the shares allocated to them because rights offerings tend to be priced at 65 percent of the current market prices. Under-subscription of shares by state shareholders is parallel to selling their shares to other shareholders at discounted prices. Given that state shareholders tend to have a lower valuation on their ownership, the discounted prices may still be above the valuation of state shareholders.

TABLE 3
SUBSCRIPTION RATES OF STATE AND LEGAL PERSONS SHAREHOLDERS

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of rights offerings and legal person shares)	6.00	68.00	48.00	117.00	153.00	121.00	181.00	84.00	20.00	25.00
Subscription rate (state and legal person shares)	0.21	0.40	0.43	0.43	0.42	0.28	0.13	0.05	0.05	0.02
Subscription rate (A-shares) ^a	1.08	1.45	1.10	0.99	1.00	1.01	1.00	1.01	1.00	1.00
Percentage change after rights offerings (state and legal person)	-5.12	-6.29	-4.84	-4.62	-3.10	-3.49	-4.61	-5.21	-5.63	-5.80

^aThe subscription rates of A-shareholders were higher than 100 percent during 1994-96 because employees who were holding nontradable employee shares listed the shares that they obtained from rights offerings on the A-share market. This practice has been strictly prohibited by the government since 1997.

SOURCE: Shanghai Wind Information Co., Ltd. (WIND).

The notices urged state shareholders of listed enterprises to safeguard state interests in rights offerings and to approve rights offerings only when state shareholders had enough capital to subscribe to them. Nevertheless, state shareholders continued to approve rights offerings and to give up their rights on the grounds that the funds raised through the rights offerings were needed for listed enterprises' investment purposes but that they themselves did not have sufficient capital to subscribe to the shares. To create additional hurdles for rights offerings, CSRC continuously raised the bar on profitability requirements. The first regulation, which was promulgated in December 1993, required listed enterprises to show a record of positive profitability for the previous two years and to have at least a one-year interval between two offerings. The requirements for rights offerings were made more stringent in 1994, when it was determined that a listed enterprise could apply for rights offerings only if it could prove that it had a record of positive profitability for the past three years, with a higher than 10 percent three-year average return on equity (ROE). In 1996, CSRC again tightened the requirements by requiring a listed enterprise to provide an ROE track record of no less than 10 percent in *each* of the past three years.

The increasingly strict requirements imposed by CSRC had limited success in restraining the amount of funds raised through rights offerings. In 1995, the total amount of funds raised through rights offerings was 6.28 billion yuan, which was nearly three times the total amount of funds raised through IPOs that year. In 1996, the year in which CSRC's new requirement that a listed enterprise show a record of ROE of no less than 10 percent in each of the past three years became effective, the percentage of listed enterprises with ROE on a 10–11 percent interval significantly increased, rising from only 9 percent in 1995 to 19 percent and 29 percent in 1996 and 1997, respectively (see Table 4). Although we cannot substantiate this with data, the percentage increase in the number of firms reporting ROE on a 10–11 percent strongly suggests that earnings were manipulated to meet the new requirements. Instead of reducing the amount of funds raised through rights offerings, the total amount of funds actually raised increased substantially, rising from 6.989 billion yuan in 1996 to 33.496 billion yuan in 1998, which is 81.88 percent of the amount of funds raised through IPOs (see Table 5).

In 1998, the government decided to allow secondary offerings on an experimental basis for some selected enterprises, and it finally permitted them for all enterprises in 2000. In 1999, the requirements on rights offerings were also relaxed, and the ROE requirement was reduced from 10 percent to 6 percent for each of the past three years.

TABLE 4
DISTRIBUTION OF RETURN ON EQUITY (ROE) OF CHINA'S LISTED ENTERPRISES, 1992-2003

Year	No. of Listed Enterprises	No. of Listed Enterprises with ROE between 10% and 20%	No. of Listed Enterprises with ROE between 6% and 7%	Percentage of Listed Enterprises with ROE between 10% and 20%	Percentage of Listed Enterprises with ROE between 6% and 7%
1992	52	0	0	0	0
1993	176	2	0	1.14	0
1994	283	26	12	9.19	4.24
1995	307	27	13	8.79	4.23
1996	510	97	7	19.02	1.37
1997	715	206	12	28.81	1.68
1998	821	184	37	22.41	4.51
1999	918	131	93	14.27	10.13
2000	1,054	82	138	7.78	13.09
2001	1,132	44	132	3.89	11.66
2002	1,188	61	157	5.13	13.22
2003	1,263	58	127	4.59	10.06

SOURCE: China Stock Market & Accounting Research Database, provided by GTA Information Technology Company, Ltd.

TABLE 5
 FUNDRAISING ACTIVITIES OF CHINA'S STOCK MARKET, 1992-2003
 (RMB BILLION)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total capital raised	9.41	37.55	32.68	15.03	42.51	129.38	84.15	94.46	210.32	125.23	96.18	135.78
A-shares	5.00	27.64	9.98	8.55	29.43	82.59	77.80	89.36	152.70	118.21	77.98	81.96
Initial public offerings (IPOs)	5.00	19.48	4.96	2.27	22.45	65.51	40.91	49.79	81.24	53.43	51.70	45.35
Secondary offerings (SEOs)							3.05	5.98	16.67	21.72	16.47	11.07
Rights offerings		8.16	5.02	6.28	6.99	17.09	33.50	32.10	51.95	43.06	5.66	7.48
Convertible bonds							0.35	1.50	2.85	0	4.15	18.06
Ratio of SEOs to IPOs (%)							7.45	12.00	20.52	40.65	31.86	24.40
Ratio of rights offerings to IPOs (%)		41.87	101.09	277.03	31.14	26.08	81.88	64.47	63.94	80.60	10.95	16.49
Ratio of convertible bonds to IPOs (%)							0.86	3.01	3.51	0	8.03	39.82

SOURCE: *China Securities and Futures Statistical Yearbook*.

After CSRC changed the profitability requirement, the percentage of listed enterprises with ROE on a 6–7 percent interval increased significantly, rising from 4.51 percent in 1998 to 10.13 percent in 1999 and to 13.09 percent in 2000. The amount of funds raised through both rights and secondary offerings in 2000 increased to 51.946 billion yuan and 21.721 billion yuan, respectively, with the total value of post-IPO issuance exceeding the amount of IPO issuance (see Table 5).

Sources of China's Stock Market Growth

Out of their desire to raise funds from the stock market, local governments and listed enterprises have circumvented restrictions on the supply of shares and significantly increased the number of shares in the market. To examine the role of rent-seeking activities in driving the growth of China's stock market, I divided the growth in the market capitalization of China's A-share market into two sources. The first is extensive growth, which is caused by the increase in the supply of shares through IPO and post-IPO issuance. The second is intensive growth, which is due to the increase in the value of the old shares. The results are presented in Table 6.

Judging from the data, the growth of China's stock market was driven primarily by extensive expansion. In 1993, for example, the market capitalization of the A-share market increased by 46.569 billion yuan. The year-end market values of IPOs and post-IPOs issued in that year were 33.05 billion yuan and 8.471 billion yuan, respectively, which contributed to nearly 90 percent of the growth in market capitalization in that year. In 1994, the amount of growth in market capitalization was 12.82 billion yuan, but the total year-end market value of IPOs and post-IPOs issued in that year reached 26.89 billion yuan, which accounted for 209 percent of the growth in market capitalization. During 1992–2003, the market capitalization of the A-share market grew at an annual rate of 87.65 percent. The average percentage changes of tradable market capitalization contributed by IPO and post-IPO issuance were 45.16 and 23.63 percent, respectively. That is, extensive growth contributed to 73.03 percent of the growth of China's A-share stock market over the 11-year period.

The Stock Market as a Casino

We have shown that the supply of new shares was the main driver of the expansion of China's stock market in the 1990s. Underlying such expansion must have been a demand for new shares. In order to ensure sufficient demand for IPO issuance, CRSC limited IPO prices

TABLE 6
 SOURCES OF CHINA'S STOCK MARKET GROWTH, 1992-2003
 (RMB BILLION)

Year	Total Market Capitalization	Market Capitalization of A-share Market	Amount of Change in Market Capitalization of A-share Market	Year-End Market Value of IPO Issuance	Year-End Market Value of Post-IPO Issuance
1992	97.30	20.11	15.79	6.50	4.56
1993	336.29	66.68	46.57	33.05	8.47
1994	353.24	79.51	12.82	18.98	7.91
1995	333.58	79.02	-0.49	4.73	4.29
1996	952.88	249.78	170.76	63.92	9.60
1997	1,718.65	480.45	230.67	125.11	26.45
1998	1,933.18	550.83	70.38	67.21	25.99
1999	2,636.58	788.03	237.20	83.91	41.07
2000	4,600.64	1,515.05	727.03	129.16	110.85
2001	4,257.78	1,330.64	-184.42	83.29	92.97
2002	3,759.06	1,160.74	-169.90	65.94	51.94
2003	4,131.60	1,195.73	34.99	67.15	20.06

Year	Amount of Intensive Growth	Changes in Tradable Market Capitalization		Changes in Tradable Market Capitalization		Changes in Tradable Market Capitalization	
		Capitalization (%)	IPO Issuance (%)	Contributed by IPO Issuance (%)	Contributed by Post-IPO Issuance (%)	Contributed by IPO Issuance (%)	Contributed by Post-IPO Issuance (%)
1992	4.73	365.12	150.31	105.46	109.35		
1993	5.04	231.52	164.33	42.11	25.08		
1994	-14.06	19.23	28.46	11.86	-21.09		
1995	-9.51	-0.62	5.95	5.39	-11.96		
1996	97.25	216.11	80.90	12.14	123.07		
1997	79.11	92.35	50.09	10.59	31.67		
1998	-22.82	14.65	13.99	5.41	-4.75		
1999	112.22	43.06	15.23	7.46	20.37		
2000	487.02	92.26	16.39	14.07	61.80		
2001	-360.67	-12.17	5.50	6.14	-23.81		
2002	-287.78	-12.77	4.96	3.90	-21.63		
2003	-52.23	3.01	5.79	1.73	-4.50		
Average		87.65	45.16	18.85	23.63		

NOTE: Market capitalizations are calculated based on firm-level data provided by the China Stock Market & Accounting Research Databases, which excluded listed enterprises that issued only B-shares as well as listed firms in the finance industry.

SOURCE: China Stock Market & Accounting Research Databases, provided by GTA Information Technology Company, Ltd.

to P/E ratios of about 13–15.¹⁷ As shares in the secondary market were usually traded at PEs of 40–50, share prices tended to rocket on the first day of trading. This produced a huge demand for IPO shares, which were allocated through various lottery systems. During 1992–2003, the average first-day return for IPO issuance was 257.97 percent, and the average allocation rate for IPO shares was only 1.21 percent. That is, the new shares were oversubscribed 82.6 times, on average (see Table 7).

TABLE 7
FIRST-DAY RETURNS AND ALLOCATION RATES OF CHINA'S
INITIAL PUBLIC OFFERINGS, 1992–2003

Year	No. of Enterprises on IPO	First-Day Returns (%)	Allocation Rates (%)
1992	39	413.42	—
1993	123	520.06	—
1994	110	165.59	1.87
1995	24	609.40	0.25
1996	203	306.37	3.16
1997	206	272.54	1.97
1998	106	319.87	0.65
1999	98	114.26	0.75
2000	137	150.82	0.47
2001	79	169.71	0.55
2002	71	148.63	0.16
2003	67	72.03	0.13
Average		257.97	1.21

SOURCES: Data on allocation rates are obtained from Genius Information Company, Ltd. Stock market price data come from the China Stock Market & Accounting Research Database provided by GTA Information Technology Company, Ltd.

The instant riches created in the IPO primary market, however, do not explain the high liquidity in the secondary market. We still need to address the question of how and why active trading occurred on China's stock exchanges. Our major argument is that trading activities were unlikely to be driven by investment behaviors because the

¹⁷The restriction on IPO prices was also relaxed in January 1999, although a price ceiling of a P/E ratio of 20 was reimposed in 2002.

shares of the listed enterprises had low investment value. Rather, trading activities were likely the result of speculative behaviors that were induced by the market's unique institutional arrangements.

Low Investment Value of China's Listed Enterprises

Many studies have documented the poor performance of China's listed enterprises (Sun and Tong 2003; Wang, Xu, and Zhu 2004). As shown in Table 8, the ratio of pretax operating profit to total asset declined from 7.34 percent in 1993 to 2.7 percent in 2003, while the ratio of pretax total profit to total asset declined from 8.56 percent in 1993 to 3.39 percent in 2003. Similarly, the percentage of listed enterprises incurring negative operating (pretax total) profits increased substantially from 1.7 (0.57) percent in 1993 to 20.43 (12.59) percent in 2003. The total amount of operating profits achieved by the listed enterprises have continued to decline since 1998, although the GDP of China's overall economy maintained an annual growth rate of about 8 percent during this period.

Different reasons have been offered to explain the poor performance of listed enterprises, including the negative impacts of enduring state ownership (Xu and Wang 1999), political control by local party committees (Wong, Opper, and Hu 2004; Chang and Wong 2004), and ineffective corporate governance (Tenev and Zhang 2002). A more fundamental cause may simply have been the local governments' lack of incentive to be more selective about the quality of the enterprises chosen for listing, given the existence of a huge demand for IPO rights. As the same amount of funds could be raised with no additional risk, there was no reason for local governments to give up part of their control over and cash flow rights of good-quality SOEs. Instead, the rational decision for local governments was to list poor-rather than good-quality SOEs.

Despite the low profitability of China's listed enterprises, their shares had been trading at a P/E ratio of around 40–50, thus offering an extremely low dividend yield to shareholders. Table 9 summarizes the cash dividends payout percentage, the cash dividend payout ratio, and the dividend yield for China's listed enterprises, as well as the interest rates for saving deposits in China during 1992–2003. On average, 50.7 percent of China's listed enterprises issued cash dividends. The average cash dividends payout ratio was 35.75 percent. Neither the payout percentage nor the payout ratios were considered low; in fact they are comparable with those of other stock markets. However, owing to the low level of profitability and high market prices, the dividend yields have been extremely low, ranging from 0.5

TABLE 8
 PROFITABILITY OF CHINA'S LISTED ENTERPRISES, 1992-2003

Year	Ratio of Operating Profits to Total Assets (%)	Ratio of Pretax Total Profits to Total Assets (%)	Percentage of Enterprises with Negative Operating Profits	Percentage of Enterprises with Negative Pretax Total Profits	Changes in Operating Profits (%)	Changes in Pretax Total Profits (%)
1992	4.98	6.62	5.77	3.85	147.15	237.26
1993	7.34	8.56	1.70	0.57	64.11	87.42
1994	5.63	7.56	4.24	0.71	-2.95	21.20
1995	3.76	5.43	14.66	5.21	-18.28	-18.88
1996	4.59	6.84	15.29	6.67	-15.42	0.65
1997	5.61	7.34	12.31	5.87	11.36	11.78
1998	5.26	6.80	17.78	10.35	-1.22	3.08
1999	4.63	6.11	17.32	9.04	-8.42	-3.31
2000	4.13	5.25	16.13	9.49	-0.39	3.98
2001	3.10	3.95	19.79	13.87	-16.02	-16.34
2002	2.92	3.47	20.03	14.14	-2.76	-4.07
2003	2.70	3.39	20.43	12.59	-0.30	3.39
Average	3.96	5.18	17.00	10.07	-4.96	0.01

SOURCE: China Stock Market & Accounting Research Database, provided by GTA Information Technology Company, Ltd.

percent in 2000 to 3.4 percent in 1995. During 1992–2003, the average dividend yield was 0.85 percent, which was lower than the saving deposits' average interest rate of 1.78 percent, indicating that stocks of China's listed enterprises have had extremely low long-term investment value.

TABLE 9
INVESTMENT VALUE OF CHINA'S LISTED ENTERPRISES,
1992–2003

Year	No. of Listed Enterprises	Percentage of Enterprises Distributing Cash Dividends	Dividend Payout Ratio (%)	Dividend Yield (%)	Saving Rate (One Year) (%)
1992	52	55.80	45.60	0.60	1.80
1993	176	29.00	9.50	0.30	2.54
1994	283	69.30	46.70	2.50	3.15
1995	307	80.80	130.60	3.40	3.15
1996	510	41.20	36.90	0.80	2.62
1997	715	54.30	38.50	1.00	1.91
1998	821	32.30	23.40	0.60	1.58
1999	918	35.70	26.80	0.60	1.18
2000	1,054	60.40	34.20	0.50	0.99
2001	1,132	61.00	32.20	0.60	0.99
2002	1,188	52.10	29.90	0.80	0.74
2003	1,263	48.70	33.40	0.80	0.72
Average		50.70	35.75	0.85	1.78

SOURCE: China Stock Market & Accounting Research Database, provided by GTA Information Technology Company, Ltd.

A Casino for Speculators

Given the low investment value of the shares of China's listed enterprises, trading activities were more likely to be driven by speculative rather than investment motives. Black (1986) shows that, without speculative ("noise") trading, very little trading occurs in individual assets. The most commonly used indicator for the degree of speculation in a stock market is the average turnover rate, defined as the total annual trading value divided by the average market capitalization. Table 10 shows that China's stock market has been characterized by an extremely high turnover rate, and this indicates the

TABLE 10
 TURNOVER RATES OF MAJOR STOCK EXCHANGES, 1994–2003
 (PERCENT)

Stock Exchange	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
Shanghai	1,135	529	913	702	454	471	493	269	214	251	543
Shenzhen	583	255	1,350	817	407	424	509	228	198	214	499
New York	53	59	52	66	70	75	88	87	95	90	74
Tokyo	25	27	27	33	34	49	59	60	68	83	47
London	77	78	58	44	47	57	69	84	97	107	72
Hong Kong	40	37	44	91	62	51	61	44	40	52	52
Singapore	28	18	14	56	64	75	59	59	54	74	50

SOURCES: *China Securities and Futures Statistical Yearbook* (2003); Web site of the World Federation of Exchange (www.world-exchanges.org).

existence of substantial speculative trading. In 1996, the average turnover rate at the Shenzhen Stock Exchange reached 1,350 percent. In other words, each share changed hands about 13 times in that year. During 1992–2003, the average turnover rate was 543 percent for the Shanghai Stock Exchange and 498 percent for the Shenzhen Stock Exchange. These rates were about 10 times higher than the turnover rates of other major stock markets in the world.

The prevalence of speculative activities in China's stock market was due to the three socialist institutional features. The first and most fundamental was the existence of financial repression that limited investment opportunities for domestic savers. While more risk-averse savers may have preferred to keep their savings in domestic banks, savers seeking higher returns were willing to move their funds into riskier assets. It should be noted that the monopolistic controls imposed implicit taxation not only on domestic households but also on state-owned institutions that deposited money in state-owned banks. As a result, the players in China's stock market included not only small private individuals but also state-owned institutions. Unlike private players, these institutions were traded with public funds and were particularly prone to speculative trading because they could divert a part of a large profit while shifting the loss to the public accounts (Naughton 1998). As a result, a large volume of public funds was flowing in and out of the stock market. During late 1996 and early 1997, for example, it was reported that 8 billion yuan in public funds had been diverted from banks into the stock market (Green 2004a).¹⁸

Second, the state-owned nature of the listed enterprises is also a cause for speculation, as there is no definite basis for determining the value of a state-owned asset. Unlike private assets, whose values are determined ultimately by the expected future income stream generated from business operation, the value of state-owned assets is affected by two kinds of government interventions. On the one hand, the government tends to use enterprises that it owns to serve political objectives such as providing excessive employment, extending aid to other SOEs, achieving a regional development strategy, and so forth. These "grabbing hands" distort the value of state-owned assets (Wong, Oppen, and Hu 2004; Chang and Wong 2004). On the other hand, the government also tends to bail out poorly performing SOEs. These "helping hands" artificially prop up asset values. Table 11 reports the amount of subsidies received and the preferential tax

¹⁸One common method for obtaining loans from the banking sector is to utilize the repo market for treasury bonds.

TABLE 11
SUBSIDIES FROM GOVERNMENT IN CHINA'S LISTED
ENTERPRISES, 1992–2003

Year	No. of Listed Enterprises	No. of Listed Enterprises Receiving Subsidies from Government	Percentage of Listed Enterprises Receiving Subsidies from Government	Subsidies as a Percentage of Operating Profits
1992	52	0	0	0
1993	176	1	0.57	29.41
1994	283	23	8.13	21.21
1995	307	70	22.80	14.00
1996	510	112	21.96	12.71
1997	715	150	20.98	11.41
1998	821	405	49.33	22.26
1999	918	510	55.56	17.18
2000	1,054	506	48.01	10.98
2001	1,132	567	50.09	17.11
2002	1,188	631	53.11	13.14
2003	1,263	713	56.45	8.84
Average			43.81	14.17

SOURCE: China Stock Market & Accounting Research Database, provided by GTA Information Technology Company, Ltd.

treatments enjoyed by China's listed enterprises during 1992–2003. On average, about 38.64 percent of listed enterprises received various kinds of subsidies from local governments. Among the recipients, the amount of subsidies obtained was on average equivalent to 14.8 percent of their operating profits. In addition to providing direct subsidies, the government has also propped up poorly performing enterprises by injecting them with good-quality assets or by relieving their debt burdens. The existence of both grabbing and helping hands means that the valuation of a listed enterprise in China is affected not only by the uncertainty originating from business operations but also by the uncertainty created by government interventions. Because local governments have a strong tendency to bail out poorly performing enterprises, anticipation of such aid in itself often becomes the basis for speculative trading (Bai, Liu and Song 2004).

Finally, weak oversight from regulators is also a cause for speculation. Owing to lax regulations, insiders can benefit not only passively

by riding the stock market roller coaster but also actively, creating rises and falls themselves through false information disclosure and market manipulation (Du and Wei 2004).¹⁹ Stories abound of how insiders and big players bought up shares or spread rumors of asset injections or new business plans and subsequently sold the shares at their peak to naïve investors. Nevertheless, it is very difficult to verify or quantify the extent of insider trading because insider trading is, by definition, nontransparent to the average outsider. According to Global Competitiveness Report's insider trading index, which was constructed by Harvard University and the World Economic Forum, China's rating was significantly higher than the ratings of other major stock markets (Du and Wei 2004). Green (2004a) reports that regulators privately admitted that at least 30 percent of shares had been actively manipulated at any point in time. In addition, Walter and Howie (2003) argue that many of the 70 million investor accounts in the early 2000s were illegal "ghost" accounts opened by big players to manipulate share trading.²⁰ They estimate that each active player in China's stock market had on average 500 such illegal accounts, which suggests that a significant proportion of trading in the market was conducted by market manipulators. In January 2001, Wu Jinglian, head of the State Council's Development Research Council, openly condemned China's stock market for being "worse than a casino"—that is, like a casino without rules. Although such a stock market was not an investment venue for investors, it was a paradise for speculators (Walter and Howie 2003).

Recent Reforms and Future Developments

China's central government gave its blessings to the marriage of socialism and capitalism in the mid-1980s because it wanted to create a socialist stock market that could serve as a new fundraising venue as well as a new monitoring device for SOEs. The ultimate objective of the market, in the government's eyes, was to improve SOE performance. Unfortunately, the market became a rent-seeking venue for local governments and SOEs and a casino for speculators.

Following the Asian financial crisis, in August 1997 the State Council decided to put the Shanghai and Shenzhen stock exchanges under

¹⁹Du and Wei (2004) show that an increase in insider trading leads to a rise in market volatility.

²⁰Big players opened these accounts by sending people to the countryside to buy peasants' identity cards in bulk (Walter and Howie 2003).

the direct supervision of CSRC. In September 1998, CSRC was promoted to a ministry rank unit, which was directly under the State Council, and CSRC established 10 regional branches, with the objective of restricting local governments' rent-seeking activities. The central government attempted to introduce institutional changes in three important ways, including reducing state ownership stakes, relaxing restrictive measures on the stock market, and improving listed enterprises' corporate governance and legal protection for shareholders in the early 2000s. But the stock market greeted these seemingly positive developments unenthusiastically, as evidenced by a prolonged slump in both market prices and market liquidity.

The major contributing factors for the slump were the state shares reduction program as well as CSRC's efforts to improve the transparency of the stock market. There are two major reasons that the state shares reduction program led to a decline in market prices and trading activities. First, market prices depend on the equilibrium of supply and demand. The selling of state shares is expected to substantially increase the supply of shares in the market and thereby to dilute the value of existing shares. Second, selling down state ownership stakes may signal the government's reduced willingness to prop up poorly performing enterprises. Anticipation of a weaker helping hand from the government would drive down the value of listed enterprises' shares.

CSRC's efforts to improve corporate governance and legal protection for shareholders led to improvements in board monitoring and in the quality of information disclosure (Li, Song, and Wong 2004), which then limited insider trading and market manipulation, thus restricting on some level speculative activities in the early 2000s. Nevertheless, the stock market has yet to become an attractive investment venue, because its regulations to improve transparency are still inadequate, and listed enterprises' profitability and thus investment values remain low. As a result, the stock market is now neither a casino nor an attractive investment venue. As such, it is attractive neither to speculators nor to investors, and it was inevitable that it would experience a reduction in both prices and liquidity during this transitional period.

Despite the decline in market capitalization and liquidity in the early 2000s, the stock market has embarked on a healthy trend toward becoming a venue for channeling funds to productive projects. On the one hand, there was a gradual increase in the level of dividend yield from 0.5 percent in 2000 to 0.8 percent in 2003. The dividend yields in both 2002 and 2003 exceeded the interest rates on saving deposits, indicating an increase in enterprises' investment value. On the other

hand, there was a decline in the level of turnover from around 500 percent in 2000 to 250 percent in 2003, suggesting a significant reduction in the level of speculative trading in the market.

Looking toward the near future, the government is very likely to continue its three-fronted reforms. It will continue to work toward the goal of state ownership reduction through the transfer of state-owned shares to private shareholders in the off-exchange transfer market, and more non-SOEs will become listed. A notable characteristic of China's stock market in the 2000s is therefore the coexistence of listed enterprises controlled by state entities and those controlled by private shareholders. Although it remains likely that the majority of listed enterprises will be state controlled, the emergence of private listed enterprises provides shareholders with choice and therefore forces state-controlled listed enterprises to be more competitive. Such competition will enable fund suppliers and shareholders to exert disciplinary pressure on the management of both state-controlled and private listed enterprises.

China is also likely to continue along the path of gradual relaxation of administrative controls over the stock market. Domestically, more and more funds, particularly public funds held by state-owned financial institutions such as insurance and pension funds, will also be allowed to invest in the stock market as new sources of demand for shares in order to support the continuous listing of SOEs and the selling off of state-owned shares. Furthermore, it is also likely that the government will give state-owned financial institutions more latitude to invest in the stock market so that they can potentially generate a higher level of returns to alleviate their increasing financial burdens. The significance of the stock market as a source of investment funds, relative to the banking sector, will inevitably rise with the liberalization of the capital market.

Externally, China has reiterated its commitment to capital market liberalization. The removal of capital controls will provide fund suppliers with an exit option that allows them to exert disciplinary pressure on listed enterprises to improve enterprise performance. But the liberalization process is expected to be a long and gradual one. For one thing, the government will have to deal with resistance from vested interests because financial repression inherently creates a constituency of beneficiaries who benefit from access to low-cost capital and thus do not want it to be stopped (World Bank 1989). For another, it will take time for the government to put in place the necessary preconditions for successful liberalization, such as the restructuring of the state-owned banking system and the establishment of legal and regulatory institutions. Clearly, it is becoming more and

more difficult for the government to enforce existing capital controls as China grows and integrates into the world economy. Part of this liberalization will be spontaneous and will create external competition for funds, which will also increase the costs of funds faced by the government and thus reduce the benefits of maintaining monopolistic control over financial intermediation.

CSRC is also likely to continue its efforts to improve regulations and legal protection for shareholders because of the need to attract additional funds into the stock market. The continuous reduction of state ownership as well as the emergence of more and more private listed enterprises will cut the direct links between local governments and listed enterprises. As a result, CSRC will face less interference and resistance from local governments and will have greater autonomy and an increased capacity to strengthen and enforce its regulations (Green 2004a). Furthermore, as more and more state-owned institutions and investment funds invest in the stock market, the government itself will become a major investor. That trend will motivate the government to engender improvements in the corporate governance of the listed enterprises as well as better legal protection for shareholders (Green 2004a).

Eventually, the socialist institutions of state ownership and monopolistic control will gradually wither away, along with the general trend of privatization and marketization of the whole economy. The process will be lengthy and possibly twisted because the phasing out of state ownership and monopolistic control over financial intermediation will mean the demise of the last two vestiges of socialism. This transition will definitely be confronted with political and ideological oppositions. Moreover, local governments and the vast bodies of vested interests will also be reluctant to give up the economic rents they enjoy under the existing institutional environment.

Conclusion

The success of the central government's reforms of China's stock market will ultimately come down to Beijing's ability to gradually overcome the various oppositions and to establish appropriate market-oriented institutions so that the benefits of a well-functioning stock market can be realized. Those benefits will be a more efficient use of capital by reallocating funds from ailing SOEs to the more profitable nonstate sector, and more domestic and foreign capital flowing into the stock market to fund investments as investors enjoy an ever-increasing range of investment choices and level of legal protection.

The promise of reform suggests that we should maintain a high degree of optimism about the direction, although not the speed, of the stock market's future institutional evolution.

References

- Allen F.; Qian J.; and Qian, M. J. (2005) "Law, Finance, and Economic Growth in China." *Journal of Financial Economics* 77 (1): 57–116.
- Bai, C. E.; Liu, Q.; and Song, F. M. (2004) "Bad News is Good News: Propping and Tunneling Evidence from China." University of Hong Kong, Hong Kong Institute of Economics and Business Strategy Working Paper Series, No. 1094.
- Black, F. (1986) "Noise." *Journal of Finance* 41 (3): 529–43.
- Bowles, P., and White, G. (1993) *The Political Economy of China's Financial Reform*. Boulder, Colo.: Westview Press.
- Chang, E. C., and Wong, S. M. L. (2004) "Political Control and Firm Performance in China's Listed Firms." *Journal of Comparative Economics* 32 (4): 617–36.
- China Securities Regulatory Commission (CSRC), ed. (2004) *China Securities and Futures Statistical Yearbook*. Beijing: Bagai Chubanshe.
- Du, J. L., and Wei, S. J. (2004) "Does Insider Trading Raise Market Volatility?" *Economic Journal* 114 (498): 916–42.
- Editorial Committee for Party Literature, Central Committee of the Communist Party of China (1994) *Selected Works of Deng Xiaoping, Volume III (1982–1992)*. Beijing: Foreign Languages Press
- Gordon, R. H., and Li, W. (2003) "Government as a Discriminating Monopolist in the Financial Market: The Case of China." *Journal of Public Economics* 87 (2): 283–312.
- Green, S. (2004a) *The Development of China's Stockmarket, 1984–2002: Equity Politics and Market Institutions*. London: Routledge.
- _____ (2004b) "The Privatization Two-Step at China's Listed Firms." London School of Economics, Chatham House Asia Program China Project Working Paper No. 3.
- Hofman, B. (1998) "Fiscal Decline and Quasi-Fiscal Response: China's Fiscal Policy and System 1978–1994." In O. Bouin, F. Coricelli, and F. Lemoine (eds.) *Different Paths to a Market Economy: China and European Economies in Transition*. Paris: OECD.
- La Porta, R.; Lopez-de-Silanes, F.; Shleifer, A.; and Vishny, R. W. (1997) "Legal Determinants of External Finance." *Journal of Finance* 52 (3): 1131–50.
- _____ (1998) "Law and Finance." *Journal of Political Economy* 106 (6): 1113–55.
- Li, C. T.; Song, F. M.; and Wong, S. M. L. (2004) "Audit Firm Size Effects in China's Emerging Audit Market." University of Hong Kong, Hong Kong Institute of Economics and Business Strategy Working Paper Series, No. 1114.
- Li, D. D. (2001) "Beating the Trap of Financial Repression in China." *Cato Journal* 21 (1): 77–91.

- Li, K. W. (1994) *Financial Repression and Economic Reform in China*. Westport, Conn.: Praeger.
- Li, W., and Wong, S. M. L. (2004) "Spontaneous Privatization of China's Listed Enterprises." University of Virginia, Darden Graduate School of Business Administration Working Paper.
- McKinnon, R. (1973) *Money and Capital in Economic Development*. Washington: Brookings Institution.
- Naughton, B. (1998) "China's Financial Reform: Achievements and Challenges." BRIE Working Paper 112.
- _____. (2002a) "The Politics of the Stock Market." *China Leadership Monitor* (Summer).
- _____. (2002b) "Selling Down the State Share: Contested Policy, New Rules." *China Leadership Monitor* (Spring).
- Pistor, K., and Xu, C. G. (2005) "Governing Stock Markets in Transition Economies: Lessons from China." *American Law and Economics Review* 7 (1): 184–210.
- Pistor, K.; Raiser, M.; and Gelfer, S. (2000) "Law and Finance in Transition Economies." *The Economics of Transition* 8 (2): 325–68.
- Shaw, E. S. (1973) *Financial Deepening in Economic Development*. New York: Oxford University Press.
- Shleifer, A., and Vishny, R. W. (1997) "A Survey of Corporate Governance." *Journal of Finance* 52 (2): 737–83.
- Shleifer, A., and Wolfenzon, D. (2002) "Investor Protection and Equity Markets." *Journal of Financial Economics* 66 (1): 3–27.
- Sun, Q., and Tong, W. H. S. (2003) "China Share Issue Privatization: the Extent of its Success." *Journal of Financial Economics* 70 (2): 183–222.
- Tenev, S., and Zhang, C. L. (2002) *Corporate Governance and Enterprise Reform in China: Building the Institution of Modern Market*. Washington: World Bank and International Finance Corporation.
- Walter, C., and Howie, F. J. T. (2003) *Privatizing China: the Stock Markets and Their Role in Corporate Reform*. Singapore: Wiley Asia.
- Wang, X. Z.; Xu, L. X. C.; and Zhu, T. (2004) "State-owned Enterprises Going Public: The Case of China." *Economics of Transition* 12 (3): 467–87.
- Wong, S. M. L.; Opper, S.; Hu, R.Y. (2004) "Shareholding Structure, Depoliticization and Enterprise Performance: Lessons from China's Listed Companies." *Economics of Transition* 12 (1): 29–66.
- Wong, R. Y. C. and Wong, S. M. L. (2001) "Competition in China's Domestic Banking Industry." *Cato Journal* 21 (1): 19–41.
- World Bank (1989) *World Development Report 1989*. Washington: World Bank.
- _____. (1997) *China's Management of Enterprise Assets: The State as Shareholder*. Washington: World Bank.
- Xia M.; Lin, J. H.; and Grub, P. D. (1992) *The Re-Emerging Securities Market in China*. Westport, Conn.: Quorum Books.
- Xu, X. N., and Wang, Y. (1999) "Ownership Structure and Corporate Governance in Chinese Stock Companies." *China Economic Review* 10 (1): 75–98.