Perspective of China Stock Market under Global Financial Uncertainty

By: Yao Yao, Master of International Business 2002

Norwegian School of Economics, Norway

1. Introduction

2002 features the end of a 20-year long bull market and prolonged economic uncertainty. Global financial market was hard hit by '9.11' and numerous scandals of US listed companies. Suddenly, the capital market fell into a serious depression and uncertainty. New Economy bubbles broke completely and investors lost confidence. Countless 'clever' investment bankers and IT professional just got laid off.

However, in the Far- East, China opened its stock market to the world after accession to WTO in 2001. The Asia crisis in late 1997 did not influence China's A share market in the same way as in other Asian markets. The main reason may be the inconvertibility of RMB and China's solid USD reserve. B shares and H shares were somewhat affected due to the withdrawal of foreign investors. Surprisingly, terrorist attacks on NY the 11. September 2001 did not have the same effect on Chinese stocks compared to world financial markets. The Dow Jones Industrial Index and The NASDAQ Composite often reflect the world economics but fail in the case of China market.

Then,how about the perspective of China's emerging market under global uncertainty? Are there opportunities to international investors? How to enter this market? I will answer the questions above in the following, with special concerns to joint venture.

2. Stock Market Profile

Currently, China stock market capitalization is around USD 622 billion, roughly 60% of China's GDP in 2001.The market is a rather young and undeveloped one, only 12 years old. To understand the market better, let us look back to its history.

. Stock exchanges reappeared in 1990s to raise capital for problematic state owned companies, as a new funding channel besides the state owned banks. Currently, China has two stock exchanges, namely Shang Hai Exchange and Shen Zhen Exchange. There were around 1160 domestically listed companies and 55 overseas listed companies by the year 2001.

The stock market used to be highly speculative and government manipulated. The market turnover velocity was 500% in 2001 and over 1000% in 1996. As a comparison, in 2001, the figure in NYSE was only 88% and the figure for NASDAQ was around 384%. Government policy was the dominant factor to china stock market and directly triggered Bull market (1996 and 1998). As to mutual fund, China has 55 mutual funds now with a capitalization around USD 10 billion. It is relatively small compared with the USD 900 billion residents' deposit and most mutual funds are poorly managed.

How about the regulation system? China Securities Regulatory Commission (CSRC) is the capital market watchdog. Most CSRC officials previous worked at Wall Street, with PhD degree from top USA universities. People's Bank of China (PBOC) is central bank and responsible for commercial banking business. CIRC, China Insurance Regulatory Commission is in change of insurance related business.

The market is divided into different parts. One is **A share market** including ordinary common shares issued to individual nationals, denominated in RMB .the A-share market dominates the equity market of the PRC in terms of both size and activity. Another market is **B-share market,** denominated in RMB, but traded in either US dollars (in Shanghai) or Hong Kong dollars (in

Shen Zhen). B share market only opened to foreigners in the past but now restrictions to nationals abolished. The phase-out of previous restrictions made B-shared market the most profitable one in 2001, from a global view. B-share index tripled within 4 months. Other markets include **H-Shares** that are listed in Hong Kong and **N-Shares** that are American depository receipts (**ADRs)** listed in New York. By 2001, totally 55 Chinese companies were listed on overseas exchanges.

3.Problems and Opportunities

There was not a complete and concise law about China stock market until 1999. Thus corruption, insider trading and market manipulation were prevalent in stock market. Besides, two thirds of all the shares are non-tradable state or legal shares, As a result, China government has demanding power to most listed companies and investors' interests cannot be protected. Most listed companies are inefficient and problematic. China investors began to lose interests towards the market and the index dropped sharply in reaction to the proposed release of state shares.

To recover investors' confidence and to meet the demands of WTO rules, CSRC cracked down on lots of problems like market manipulation, insider trading, and illegal loans for stock market speculation and stock investment by listed companies. Furthermore, now CSRC requires double audits (by PRC CPAs and international 'Big 5" CPAs) for companies listing and making secondary offerings.

How about the opportunities for international investors after China's accession to WTO? I list some of them as follows.

a. For the first time, foreign investors can enter the partially opened China market. Mainland fund management companies, securities companies and banks have been actively seeking foreign partners. Most recently, Alliance Group (Germany) has been the first approved one and ING Group may be the next one. As to investment banking business, BNP Paribas (France) may be the first one to set up a JV.

b. Most listed companies in China used to be traditional business firms. Recently, Chinese government has approved lots of financial institutes and hi-technology companies, as well as infrastructure companies to list both domestically and overseas. The structure of listed companies will change soon. Recently, China Telecom employed Morgan Stanley to be its leading underwriter in global IPO.

c. China government is trying to change the function of current two stock exchanges. Shanghai exchange will be positioned as China's New York Stock Exchange (main board) while Shen Zhen exchange will act as China's NASDAQ --growth or secondary market.

d. China securities market is an immature one without lots of financial instruments such as option, interest swaps, commodity futures, financial futures and derivatives. Government is researching the advanced tools while most local securities firms are inexperienced.

The opportunities are obviously attractive, especially under a global depression in financial sector. However, Foreign investors should think carefully before their market entry decision. I will discuss the main factors to consider in the following.

4.Market Entry Factors

a. Entry timing.

China's RMB used to be an inconvertible currency and the stock market was strictly restricted. With China's accession to WTO, For the first time foreign financial institutes are allowed to set up joint ventures in china, with a shareholding limit less than 33% from 2002 to 2005 and 49% in the following 3 years.

Considering China’s 622 billion USD securities market and 900 billion bank savings, it seems a good choice to enter this market now. However, even the largest Chinese Investment bank has only a small capital around USD 0.5 billion. Thus foreign partners can invest at most USD 0.165 billion in China now, obviously not attractive to global players. On the other hand, many foreign firms prefer wholly subsidiaries to avoid cultural differences and to hold absolute control power.

I suggest regional foreign investment banks and global mutual fund should enter China soon to specialize in certain services. Global investment banks should wait longer until infrastructure and regulations in China become more favorable. For example, as to a large scale underwriting or IPO project, it makes no difference for Merrill Lynch to use its Hong Kong office or Beijing office to win the project.

For regional investment banks, their comparative advantages and expertise in certain areas must be highly recognized by Chinese government and investors before the ‘Giants’ coming.

While, global asset management fund will lose the market in the long run without current entry. They need local market experiences to adjust the investment methods and be familiar with the local market. The experience of other countries shows that the development of fund/asset management industry is largely driven by the pension reform from a “pay-as-you-go” system to a “paid reserve” system. And pension funds are among the most important institutional investors. Pension reform will likely lead to explosive growth of assets, driving the growth of the fund/asset management industry. China government is trying to drive the pensions enter securities market. Thus it is the right time to enter China’s mutual fund market.

b. Political and economic risk

Surprisingly, the economic growth has been achieved against a backdrop of inadequate legal and regulatory infrastructure and barriers that inhibit market entry and competition. However, Chinese government has promised improve legal and regulatory framework in order to meet several economic development goals.

China government has absolute power and sound control ability over the economy. China leaders have received wide approvals after East Asia Financial Crisis. A solid USD reserve worked a lot in the past. Due to a fast growing economy, China has become the ‘World Factory’ and attracts second largest FDI in the world.

However, there is always a chance for serious economic crisis if Chinese government cannot effectively deal with economic problems like prevalent bad bank loans and inefficiency of state owned companies.

c. Market competition

Competition among domestic securities firms is quite fierce, especially underwriting projects. As to large-scale projects, the competition usually occur between global firms like Goldman Sachs, Merrill lynch and Morgan Stanley. As to mutual fund, the competition is not very fierce for the industry is on a starting stage.

In China, the relationship with government is essential to do business well. Foreign institutes need notice it.

5.Joint Venture

Since joint venture is the only allowed mode of market entry for foreign investors. We will discuss it in detail.

There are five common objectives in a joint venture: **market entry, risk/reward sharing, technology sharing and joint product development, and conforming to government regulations.** Other benefits include **political connections and distribution channel access** that may depend on relationships.

China government allows foreign investor to invest less than 33% in any securities or mutual fund joint venture. Now there is only one joint investment bank in China, namely China International Capital Corporation (CICC).

Local china partners can bring market access and resources. But joint ventures often become problematic due to differences in corporate culture, and share holding rate. Foreign firms should know clear about the following differences between Chinese and westerners. What are the key factors for a joint venture's success? My suggestions are: **Pick the right partner, Establish clear aims from the beginning, Bridge cultural gaps through local people's help, Top management commitment and respect,** and lastly**, Incremental approach works best.**

6.Conclusion

China's accession to WTO partially opens the securities sector to the world. Global stock market is in a serious depression while China's emerging market is just open, with opportunities in mutual fund and investment banking. To make the market more attractive, China government should create better regulatory environment and a more complete market structure, as well as the international convertibility of RMB.

It is the right time for mutual funds and regional investment banks to enter the emerging market. Understanding culture differences and choosing right partner are crucial before China market entry.

Main Reference

'The Stock Exchanges in China'; Author: Dr. Asle Kreutz.