

# **Despite Government Controls, Optimism for the Future of the Chinese Stock Market**

By William R. Dodson

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David Hale sees great promise in China's equity markets. Hale is the Global Chief Economist for the Zurich Financial Services Group and its investment affiliates. He advises the group's domestic and global fund management operations on economic conditions and public policy issues. He is a member of the Academic Advisory Board of the Federal Reserve Bank of Chicago and the Hong Kong Monetary Authority as well as a variety of government and private sector economic policy research groups in Washington, Tokyo and Bonn.

Hale was careful to not overstate the capitalizations of the Chinese stock market and various industries. For instance, though the Chinese stock market appears to have a value of US\$500 billion [amount?], the real value is US\$200 billion after analysts account for the Chinese government's investment in State-Owned Enterprises (SOEs), which make up some 95% of shares listed on Chinese bourses. Chinese private companies have had tremendous success raising billions of dollars in capital through stock markets in Hong Kong, New York and Singapore.

The Chinese government is implementing regulatory changes to increase the transparency and credibility of the China's stock markets. Chinese companies will eventually be listed on Chinese exchanges with shares offered to global investors. Currently, China has China-only shares called A-shares; and B-shares that are supposed to be for global investors. However, foreign traders do not trade much in B-shares, due to the relatively low-quality of the offerings as primarily Chinese SOEs looking for additional investment. However, the Chinese government in 2001 opened B-shares at a 90% discount to average Chinese citizens, who now own about 30% of the stocks.

China will gradually open up its stock market to foreign investment by creating a parallel system of trading shares, the same way India and Taiwan had during the 1990s [year?]. Entrepreneurs in China have especially been looking forward to de-regulated exchanges since the crash of the NASDAQ pre-empted the entry of a technology exchange in China. Now, most bank loans from the four largest banks in China (also state-owned) go to other SOEs. Entrepreneurs are starved for capital as a result. Still, those same banks have loans that total 100% of China's GDP, with 40% of outstanding debt bad.

Mutual funds are a growth industry, currently valued at US\$12.4 billion. With one of the highest retail savings rates in the world, Chinese consumers have invested heavily in fund portfolios.

The change in Chinese political leadership has put activities for the stock market restructuring on hold. Still, Hale believes that economic pressures will soon force the CSRC – the China Securities Regulatory Commission – to continue liberalizing the exchanges.

As yet, there is no institutional trading of Chinese shares. Instead, China has 60-80 million retail investors, "many of whom were math teachers", Hale said, "when the Shanghai exchange opened in 1991."

Pension funds should give market capitalization a boost when the government has rationalized retirement savings. The prospect of "supporting 400 million elderly pensioners

in the next ten years has put a great deal of pressure on the government" to develop pension plans, collection vehicles and distribution channels.

Hale did not believe the Chinese would develop conglomerates the same way the Japanese and South Korean governments did. Now, foreign companies can buy SOEs and companies with bad loans. The Japanese and South Korean governments closed their economies to outside investment early on in their development. Instead, Hale foresees the Chinese developing a hybrid model that supports government nationalization of some industries with a mix of Foreign Direct Investment (FDI).

Chinese society does risk instability from a rising unemployment rate: fifty million employees have lost their jobs in SOEs. The risk of social unrest is real, though the government is concerned that a concerted populist opposition party that opposes economic reforms would create more stress on the economy. Hale's belief is that a single party will control Chinese society until the society has enough members of an affluent class that will force its government to change, much as has already happened in Taiwan and South Korea.

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