

Georgia State University

## ScholarWorks @ Georgia State University

---

International Business Faculty Publications

Institute of International Business

---

2007

### China's Equity Markets: Recent Reforms Encourage Domestic Investors

Penelope B. Prime

*Georgia State University*, pprime@gsu.edu

Yanping Shi

Follow this and additional works at: [https://scholarworks.gsu.edu/intlbus\\_facpub](https://scholarworks.gsu.edu/intlbus_facpub)



Part of the [International Business Commons](#)

---

#### Recommended Citation

"China's Equity Markets: Recent Reforms Encourage Domestic Investors," (with Yanping Shi), *China Currents* 6.2 (Spring 2007).

This Article is brought to you for free and open access by the Institute of International Business at ScholarWorks @ Georgia State University. It has been accepted for inclusion in International Business Faculty Publications by an authorized administrator of ScholarWorks @ Georgia State University. For more information, please contact [scholarworks@gsu.edu](mailto:scholarworks@gsu.edu).

# China's Equity Markets: Recent Reforms Encourage Domestic Investors

April 14, 2007 Yanping Shi 2007: Vol. 6, No. 2, Articles

On 27 February 2007, Chinese equity markets fell almost 9%. Hours later other global markets plunged far and fast, including those in Europe and the U.S. Such a link between China's equity markets and others was unprecedented. Analysis conducted in the aftermath confirmed that capital flows between China and other markets are highly controlled, and therefore were not the main cause of changing stock prices. Subsequent volatility in the Chinese markets has not spilled over to other markets. Nonetheless, global investors are now watching China's markets closely.

The purpose of this article is to provide background on the development of the Chinese equity markets in order to underscore the point that the recent volatility of China's stock values was a result of domestic capital and an array of domestic decisions.

## Some Background

In the early years of reform in the first half of the 1980s, Chinese companies around the country began issuing shares as a way to raise money. The first formal rules for issuing corporate shares were formulated by the Shenzhen government in the mid 1980s. At the national level, the State Council established China's two exchanges, Shanghai and Shenzhen, in the early 1990s, but with mainly state companies initially being listed. Other regional over-the-counter markets and experimental exchanges were closed. The official purpose of the two exchanges was to promote a share-holding system in order to reorganize and improve the performance of state owned enterprises—in other words, this was not initiated as a process of privatization (Walter & Howie, 2003).

The share-holding system categorized shares by their relationship to the state, and only non-state shares could be traded. This particular structure has defined the character and development of the equity markets in China. By 2002, listed, non-tradable stock controlled by the state had decreased to two-thirds of total shares due to sales to the public. However, firms where the controlling share was owned by the state still comprised more than 80% of listed companies, and more than 40% of the firms had one large shareholder controlling 44% or more of the shares, which was almost always a state entity.

## Market Development

Despite the heavy state presence in these markets, as part of the reform effort to create an environment where firms behave in profit-maximizing, cost-minimizing ways, China introduced rules aimed at creating better corporate governance. China passed a series of corporate laws that, among other things, required firms to have boards of directors with at least two independent members. As a result, by the end of 2002, 31% of the listed firms had some independent directors.

Another goal of the current stock-market reform is to convert non-tradable shares into tradable ones. Early on, both the authorities and academics in China began to recognize the disadvantages of having non-tradable shares (Zhang 2006). Attempts to fix this problem of equity division have been tried, but two observations can be made about those previous procedures.

First, political sensitivity led to hesitation to take action that would harm state assets and public ownership at that time. Second, almost every reform arrangement before the latest one ignored the fact that tradable-share investors acquired equities of listed companies in a different way than the state. That is, investors in tradable securities based decisions on stock exchange rules and perceptions of the future value of shares, while the state acquired equity based on the planned economy regime.

As a result, tradable-share investors would vote by selling shares each time a reform with negative consequences for them was put in place. This naturally ended in big drops in the stock exchange index without mergers and acquisitions occurring because of the tradable and non-tradable regime. The biggest drop was about 50%, from about 2200 points in 2001 to 1000 points, in July 2005, in the Shanghai exchange after the last reform experiment. In that reform, referred to as “reducing the state share reform test,” only 17 listed companies participated, accounting for less than 20% of the total, and the experiment lasted only four months. Despite the modest size of the experiment, the resulting market shakeout caused China’s government to rethink how to reform the stock market.

In principle, in order to acquire the right to sell non-tradable shares, a holder (most were state entities and often were also major investors in the listed state-owned enterprises) should compensate the public shareholders in some way determined through bargaining. The reason is that initially when a state-owned company was listed, public investors paid a premium for its shares.

For example, suppose an accounting firm determined that company ABC had assets of 200 units where 100 represented equity and 100 represented debt. Then the 100 units of equity would be divided into 100 shares with face value of 1 Yuan per share, let’s say, and then divided into three parts. The first 51% was issued to a state entity such as a government bureau; a second part (usually 29%) was issued to other state-owned enterprises at face value of 1 Yuan per share; and a third part, 30%, was sold to public investors at a premium price, say 3 Yuan per share on the date the company officially listed.

Due to this initial set-up, later arrangements were going to have to equalize the investment cost of non-tradable shares with tradable ones. In order to protect the public shareholders in this latest round of reforms and avoid either a moribund market or a big crash, the Chinese Securities Regulatory Commission designed a special voting system. Each compensation arrangement had to be passed by the voting system, and if not, the listed company needed to rearrange its compensation. In the end, the compensation arrangement varied company by company.

Examples of compensation schemes included transferring dividend shares to public investors, transferring dividend shares plus cash, transferring dividend shares plus options, etc.; however, the most common way was for the shareholders of the non-tradable shares to simply turn over some

of their shares to those investors holding tradable shares. The public could sell those shares as soon as they were compensated if they chose, but the non-tradable shareholders were required to wait until they met other requirements. The most common requirement was that they had to wait one year after completing the compensation arrangement before they could sell any shares. In some cases the companies also promised additional compensation, such as not selling their shares unless the price reached a certain level, but these promises were not officially backed or required.

Largely due to the wide implementation of this reform, where investors who held tradable shares were appropriately compensated, starting in 2006 investors returned to the market. According to The New York Times (Yardley 2007), over two and a half million investment accounts were opened that year, and the Shanghai Composite Index increased 130 percent. On February 27, 2007, however, many investors began to sell – some analysts say because of worries that the government might try to slow both overall economic growth as well as valuations in the exchanges.

### **Current State of the Markets**

New research on China's equity markets has focused on how effective reforms have been in shaping the institution. A study by Kato and Long (2006) examines the relationship between firms' performance and the rate of CEO turnover as a gauge of the influence of corporate governance. If a firm is performing poorly, it is expected that the company's leadership would be replaced if corporate governance is sensitive to the company's stakeholders. In the early days of equity-market development in China, with the emphasis on raising capital for state enterprises, this connection certainly would not have existed.

The authors' key performance measure, the rate of return on equity, resulted in several key findings based on data on firm listings between 1998 and 2002. First, the connection between CEO turnover and firm performance was much stronger for privately controlled firms than for state-controlled firms. This implies that equity markets are behaving more like established markets in other countries as more private firms participate. On the other hand, it also suggests that the desired positive effect on state-owned listed firms is less evident. Second, firms with independent boards showed a more sensitive correlation between CEO turnover and firm performance than those without. And third, there was less connection between CEO turnover and performance if the CEO also held a position simultaneously in the controlling shareholding firm. In general the Kato-Long (2006) results support the expectation that more independence for decision-making is better for firm performance.

Another study by Shi (2006) examines how reforms to end the overhang of non-tradable shares by solving the problem of unequal investment costs have affected the value of listed companies. Using the Tobin'Q model, her paper examines 188 listed companies that had finished the first phase of reform by the end of 2005 and addressed the problem of equity division by converting the non-tradable shares into tradable ones. This research tests the relationship between the companies' value and the extent of compensation. The results show that the variation in the value of companies before and after the reform is positively correlated with the protection procedures for the tradable shareholders' compensation.

## **The Next Challenges**

The arrangement of having non-tradable shares in China's stock market led to a series of problems that began with the inception of these markets and put public investors at a disadvantage.

The implications of the Shi (2006) study explain indirectly why the market has accepted the reform procedures this time around. Compared with previous reform procedures, this time China's government recognized that the tradable share investors needed to be compensated for higher investment costs in relation to that of the non-tradable shareholders in order for the reform to be viable. Given this, the goal of China's stock market reform is clear – it is to rearrange the originally misconstrued nature of China's stock market regime to match equity markets in other countries, where the purpose of the markets includes asset pricing and resource allocation as well as the financing function.

The implications of the Kato-Long study (2006) are that corporate governance reforms are working in investors' favor in that governance and firm performance are increasingly linked – at least in private companies.

Despite this documented progress, the recent market volatility means that further reforms to encourage institutional investors (dividend payments, short selling, mutual and index funds, and transparency) are needed. Until these are in place, trading will tend to be driven by the natural volatility of thin markets as well as speculation, rather than fundamentals of companies or the economy (Pettis 2007).

Meanwhile, Chinese equity markets have plenty of room to grow – less than 5 percent of the population owns equities (Balfour & Roberts, 2007) – and investors in China are looking to diversify beyond real estate holdings. Furthermore, loosening of international capital flows is expected to go forward in the future, such as a shift to allow Chinese investors to buy international shares of mutual funds and to allow foreign institutions access to Chinese equities on the two domestic exchanges. To date, however, most foreign investors who own shares in Chinese companies have purchased them through the Hong Kong or New York exchanges. Short-term portfolio flows into and out of China are still highly restricted. Hence, the current volatility of Chinese stocks is due to domestic factors, many of which are driven by reform efforts and investor's expectations about their effect on future share values.

## **References:**

Balfour, Frederik and Dexter Roberts (2007), "Market Mania in China," *Business Week*, 19 March, p.74.

Kato, Takao and Cheryl Long (2006), "CEO turnover, firm performance, and enterprise reform in China: Evidence from micro data," *Journal of Comparative Economics* 34, pp. 796-817.

Pettis, Michael (2007), "Buying into China's Volatility," *Far Eastern Economic Review*, Jan/Feb., [www.feer.com](http://www.feer.com).

Shi, Yanping (2006), "An Analysis of Increasing Companies' Value by Protecting Tradable Share Investors in China's Stock Markets," Working Paper, University of International Business and Economics, Beijing.

Walter, Carl E. and Fraser J.T. Howie (2003). Privatizing China: The Stock Markets and their Role in Corporate Reform. John Wiley & Sons.

Yardley, Jim (2007), "Chinese United by Common Goal: A Hot Stock Tip," The New York Times, 30 January, pp.A1, A10.

Zhang, Ziheng (2006), Panorama of the Reform on the Problem of Equity Division. Beijing: Economic & Management Publishing Houses.