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Strategies for the development of an effective Chinese stock market

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University of Wollongong

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Strategies for the Development of an Effective Chinese Stock Market

A thesis submitted in fulfilment of the requirements for the award of the degree

Doctor of Philosophy

From

UNIVERSITY OF WOLLONGONG

By

Tianshu Liu

BS in Industrial Foreign Trade (China)

School of Accounting and Finance

2004
Declaration

I hereby declare that this thesis has never previously been submitted for any other degree and is the result of my own independent research.

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Tianshu Liu
I would like to thank my supervisor, Professor Michael Gaffikin of School of Accounting and Finance at the University of Wollongong, for his continued interest, support and advice throughout the research and writing of this thesis, and for his effort and constructive supervision he has provided. I am especially grateful for his patience and encouragement during the entire PhD program. Without his support, the study could not have been completed.

I owe a very large debt to my parents. They shared with me many moments of frustration, disappointment, and rejoicing. Although they are already more than sixty years old, they went to Beijing library to collect the current statistical data, collected the recent information relative to the Chinese stock market and other stock markets which were published in newspapers, and continued my survey concerning the status of middle and small investors when I was in Australia.

In addition, I would like to express my gratitude to my friends, my colleagues and all those who, in one-way or another, kindly assisted me both in my research and the preparation of this thesis.
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Abstract

It is clear from stock markets in western countries that a share holding system is a necessary prerequisite. However, the development of a stock market affects not only that share holding system but is connected to a country's macro-economy and its entire society. In fact, the stock market once formed has its own functions and momentum. When this momentum matches the development speed and scale of the substantive economy, it will promote the development of that economy. Once it deviates from the normal momentum too much, it will likely cause an economic crisis. The stock market is a double edged sword: to what extent should it be left to promote economic development yet be restrained from leading to the production of an economic bubble is a very important research question.

The economic reforms that took China from a centrally-planned economy to a market economy necessitated a share holding system and stock market on the basis of western economic models. This also required a change to the administration mechanism of state-owned enterprises, reform of the banking management system and the establishment of a complete financial system. To now, China's stock market has had little more than a ten year history yet has developed at a very rapid speed; it has expanded the financial channels for enterprises and promoted enterprise reform. But, because China is in the process of transition, the administration and management methods that have been applied to the stock market, have resulted in a series of institutional problems. These institutional problems, along with some immaturity (inexperience) of investors, the lack of an effective surveillance system for the Chinese government, the incomplete construction of a legal
framework and so on, have restricted the further development of China’s stock market. The Chinese secondary stock market shows not only the common characteristics of an emerging market but also has some special characteristics.

This thesis focuses on the special and developing problems facing the Chinese stock market through a method of comparative analysis and testing of investors, surveillance institutions, and listed companies. It is found that there are several infrastructural problems that policymakers will have to resolve in order to make the Chinese stock market comparable to the sophisticated stock markets in some developed economies. Added to these problems are international pressures as the global economy develops. The study concludes with some strategic suggestions that policymakers might consider if they are to make the Chinese stock market one of the leading markets in the new world order.
CHAPTER 1
INTRODUCTION

1.1 Background

Since the early contributions of Gurley and Shaw (1955, 1960, 1967), McKinnon (1973) and Shaw (1973), the relationship between financial development and economic growth has become an important issue. Numerous studies have dealt with this relationship from different aspects at both theoretical and empirical levels.

Garcia and Liu have indicated the importance of the relationship:

The broadest division of a financial system is between financial intermediaries (banks, insurance companies, and pension funds) and markets (bond and stock markets). A large part of an economy’s savings is intermediated towards productive investments through financial intermediaries and markets. Since the rate of capital accumulation is a fundamental determinant of long-term growth, an efficient financial system is essential for an economy. (Garcia and Liu, 1999, p.29).

And,

The main reason why an efficient financial system is essential to an economy is that there are substantial information and transactions costs in the real world. Asymmetric information creates adverse selection and moral hazards, and high transactions costs impose inefficiencies. By specializing in collecting information, evaluating projects, sharing risks, and providing liquidity, an efficient financial system increases financial
savings, and improves their allocations across investments. Consequently, financial intermediation increases capital productivity, and promotes economic growth. (Garcia and Liu, 1999, pp.31-32).

Through three main channels, financial intermediaries and markets may affect economic growth. First, a developing financial system increases saving rates. By using economies of scale and expertise, financial intermediaries and markets are able to provide a relatively higher yield for savers, and therefore stimulate savings. Many studies such as McKinnon (1973) and Shaw (1973) show that financial deepening improves not only productivity of capital but also the savings rate and results in investment increase and economic growth.

Second, the financial intermediaries and markets perform the essential economic function of increasing the funneling of funds from lenders to borrowers by reducing information and transactions costs. Gurley and Shaw (1955, 1960 and 1967) emphasize the importance of financial intermediation in channeling savings to investment (Garcia and Liu, 1999).

Third, the financial system improves the allocation of resources. Recent research strongly argues that financial development promotes an efficient allocation of investment, thus enhancing economic growth through various mechanisms. Again, Garcia and Liu, summaries the position well under five points:

1. pooling of funds, that is, making large investments projects possible and lending cheaper;
2. diversifying risk, that is, reducing productivity and default risks by holding diversified portfolios;
(3) liquidity management, that is, providing liquidity to investment projects;
(4) screening, that is, gathering and evaluating information on projects to channel funds to the most profitable ones; and
(5) monitoring, that is, disciplining borrowers' performance to make sure they fulfill their commitments. A well functioning financial system improves resource allocation through these mechanisms (Garcia and Liu, 1999, pp.32-33).

The relationship can also work in the other direction according to Gurley and Shaw (1967) and Goldsmith (1969). In other words, economic growth can also promote financial development.

A more recent commentator, Stephen Green, has also indicated the importance of an efficient stock market to an emerging economy. His arguments can be summarized in four points, viz;
1 it facilitates investment in industry;
2 if it reflects supply and demand it can improve the efficiency with which capital is allocated;
3 it can play a major role in managing private assets and providing pensions and other forms of long-term private asset management; and
4 it can provide an important vehicle for attracting foreign investment to a capital-hungry developing economy. (Green 2004. pp. 9-10)
At present, there is no unified standard that can classify financial systems in practice. In developed countries, according to the roles of the market or financial intermediaries, financial systems are divided into bank-dominated systems or market-dominated systems (Allen and Gale, 1995, 2000). This classification has two extremes: the German financial system and the United States financial system. In the German financial system, several large banks play a dominant role and the role of the financial market is not as important as that of the banks. At the other extreme is the United States financial system in which the financial market is very strong and plays a dominant role. The bank system is weaker in comparison. Between these two extremes, there are some other systems such as those of Japan and France. In Japan and France, the bank system dominated in the past, however their financial systems are rapidly changing in recent years and the financial markets have become more and more important.

Early research emphasized the role of the banking sector in economic growth. The bank-dominated system is thought to be vital in the earlier stages of financial development until firms have attained a favourable reputation (Diamond, 1991). Furthermore, Nuti, (1992) recommends “a German or Japanese type of financial system where financial markets are dominated by banks. In these systems, banks act as insiders by controlling and monitoring firms, with bank managers sitting on boards of corporations and sometimes even acting as chairpersons of the board. The argument is further supported by the fact that there have been only three hostile takeovers in Germany since the Second World War and none in Japan” (Choi and Doukas, 1998, p.11). It is also supported by the fact that where there is dispersed ownership of stock markets it is difficult for firms to be monitored effectively, especially in the early stages of financial development. Thus, it is likely that “The costs
associated with the establishment of the stock market would outweigh the benefits” (Choi and Doukas, 1998, p.8).

However, the bank-dominated system is also controversial. Nuti (1992) also admits that the main criticisms are short-termism and monopolistic practices of banks. Another argument against the establishment of the bank-dominated system at an early stage is that the development of the stock exchange may lag behind for an extended period, partly because banks enjoy formidable political power and are reluctant to dilute their strong influence over the financial sector. This bank bias can be observed in a majority of financial systems around the world. This bank bias is influenced by a combination of economic and political factors.

On the other hand, recent research has begun to focus on the linkages between the stock markets and economic development. New theoretical results show how stock market development might boost long-run economic growth, and new empirical evidence supports this view. For example, Demirguc-Kunt and Levine (1996a), Singh (1997), Levine and Zervos (1996), and Levine and Zervos (1998) (and, as suggested by Green, 2004, alluded to above) find that stock market development plays an important role in predicting future economic growth. A study conducted by Levine and Zervos (1996) finds a positive link between stock market development and economic growth. This research does not obtain a clear relationship between size or volatility and economic growth. However, it was found that there is a strong positive link between market liquidity and growth. This finding points to the negative role of large shareholders in the market that results in the non-dilution of shares. One policy implication is to grant incentives to small shareholders to own equity.
This will, therefore, add to a well-functioning secondary market through an increase in liquidity.

Some of the problems facing an emerging economy in developing their financial markets are indicated by Choi and Doukas who state that: “Emerging market finance has not been a well-defined area of research and is often viewed as a subfield of the international finance literature. Although these markets are imperfect, they have gained growing attention from academics and practitioners over the recent past because of the substantial benefits foreseen by investing and/or operating in these markets in the long run. A primary characteristic of an emerging market is domestic rigidity and international segmentation based on elements of market imperfections both across and within countries. The main factors that keep them partially segmented from the international capital markets are political and exchange-rate uncertainty. These market imperfections, however, preserve potentially superior risk-return trade-offs that will continue to attract international capital in the emerging markets” (Choi and Doukas, 1998, p. 3).

Transition economies are dramatically different from developed economies in terms of the “stages of financial development”. The typical stages for developed economies are characterized by a relatively strong emphasis on retained earnings, debt finance, and equity finance. However, in transition economies all forms of financing are equally undeveloped and have to be developed accordingly. As transition economies are establishing and reforming their financial systems, it is critical that they learn from experience, and avoid the pitfalls of the systems of developed nations. In fact, most transition economies are
unique in the sense that they are not following the typical stages of financial development. These economies are also facing tight budgets and spending limits.

Once again, Choi and Doukas have summed this up succinctly when they state that, Numerous issues need to be considered when selecting the choice of financial reform. Some of the issues relate to the nature of the initial conditions prevailing in the country in question and include the nature of corporate ownership structure, the speed of privatization, shareholder concentration, property rights, bankruptcy laws, disclosure requirements, bank deposit insurance, state credit guarantees, wealth allocation, the expected profits of firms, the degree of openness of the country, the degree of reputation established by firms through monitoring, and the nature of regulations. However, in the case of the newly formed financial sectors of transforming economies, some factors such as shareholder concentration, property rights, and the degree of reputation established by firms are expected to attain greater significance once the economies have been completely liberalized and the legal systems are firmly in place” (Choi and Doukas, 1998, p. 7)

And, Transition economies ought to be treated differently for three related reasons. First, massive privatization in these economies at the initial stages makes effective control and monitoring of firms critical, which can best be handled by established institutions such as banks or investment companies. Second, large stock exchanges can be very expensive to set up
and operate. Third, lack of liquidity and high volatility at the early stage can lead to market outflow of funds and an erosion of confidence in the financial system that may be irreversible for a long time” (Choi and Doukas, 1998, p. 8).

China is one of the most important representatives of transition countries. Chinese economic reform refers to the program of economic changes in China that were started in 1978 by Deng Xiaoping. The goal of Chinese economic reform was to restructure and replace the command economy which had been instituted as a result of Maoism and to develop the Chinese economy and improve the standard of living. The challenge of economic reform was to simultaneously resolve problems of command economies in addition to the problems of developing economies.

The first part of Chinese economic reform involved implementing the contract responsibility system in agriculture by which farmers were able to retain surplus over individual plots of land rather than farming for the collective. This was followed by the establishment of township and village enterprises which were industries owned by townships and villages. These initiatives immediately increased the standard of living for most of the Chinese population and generated support for later more difficult reforms.

The second phase of reform occurred in the 1980s and was aimed at creating market institutions and converting the economy from an administratively driven command economy to a price driven market economy, of which state-owned enterprise reform is an important part. Fundamental to the reform is the separation of ownership and management, along the lines of western forms of corporate governance, and to reform banking systems.
and build up a perfect financial system as well, while small enterprise could be shut down, privatized, or become limited liability corporations. The largest and most promising state-owned enterprises that met certain standards were reconstructed as joint-stock companies.

Before economic reform in China, no internal financial system existed. The capital for reproduction and reproduction expansion mainly relied on that granted by the government. In early 1980, profit remittance was replaced by tax and caused some state-owned enterprise to have retained earnings. In 1988, finance from internal sources was 29.6% (China Fiscal Statistics, 1989). Enterprise financial patterns gradually transited from government grants into bank loans. However, quite a large percentage of loss-maker state-owned enterprises could not obtain a loan from a bank. On the other hand, because of the lag in the reform of state-owned enterprises, bad debts were created in banks. Compared with other financial approaches, equity finance has a comparative advantage at this stage. Under these conditions, the stock market was introduced to make up the fund shortage of the state-owned enterprises. With its development, the stock market has continued to play a more and more important role in the Chinese economy. It raises capital from privatizations to make up for the weakness of the country's revenue collection system. In addition, because China has a rapidly aging population which will require the development of pension funds in order to finance retirement, the pension fund will need a big capital market. Moreover, the growth of the stock market could help China’s private sector to expand more rapidly and bolster employment at a time when many state enterprises are shedding labour. How to develop the stock market has become a very important research subject in the process of the further development of the Chinese economy. Many researchers such as "Institutional Changes and Impacts on the Evolution of Chinese Stock
Market" (Hu Jizhi, 1999), and, “Chinese Capital Market in the Transitional Process” (Li Yang, 1999) have analyzed the history and evolutionary process of the Chinese stock market and made suggestions. However the majority of researchers have only focused on the Chinese stock market, few researchers use the current data to discover the character and problems through making full comparison with international stock markets. This thesis will contribute to the vast literature and provide some systematical understanding of the Chinese stock market.

1.2 Research Aim and Methodology

The purpose of this thesis is to explore the problems that exist in the Chinese stock market and make corresponding suggestions for its further development. While many tables and statistics will be employed in presenting the arguments of the thesis the methodology can best be described as qualitative. It does not aim to develop a quantitative model nor test any of the dominant models used to analyses stock markets in developed economies. As the Chinese stock market is still in its early development stages many of these models are inappropriate as there are very significant structural differences. Thus, it is not possible to employ the research methods employed in the vast range of “capital market studies” (of developed economies) found in much of the finance literature as the significant variables either do not exist or differ too greatly in size and potential importance.

The use of a qualitative research in no way diminishes the significance of the research and there exists a vast body of literature supporting it (Denzin and Lincoln’s Handbook of Qualitative Research, 2 ed, 2000 is an excellent example). Specifically, the research method used in this study has been described by Neuman (2000, p.37) as “historical-
comparative research". This research examines the development of the Chinese stock market with a view to developing some policy suggestions for its refinement and further development in a global economic environment. By examining the stock market’s history it is possible to discern elements which have proved problematic and which possibly continue to inhibit development. Being aware of these will enable the formulation of realistic policy guidelines. This study aims to suggest how such guidelines can be developed especially those related to surveillance, greater investor education, an effective legal structure and the less desirable aspects of internationalization in a global economic environment.

1.3 Structure of the Thesis

Chapter 1 introduces the research background, research purpose, methodology, and contribution and structure of the thesis. Chapter 2 and Chapter 3 survey the emergence and development of the shareholding system and stock market in western countries and in China. Chapter 2 briefly introduces the emergence and development of the shareholding system and stock market in western countries and assesses the contribution to the development of western economies from theoretical and practical points of view. Chapter 3 focuses on the history of the Chinese stock market and shareholding system. This chapter first introduces the early development of the stock market and shareholding system and development characteristics. Then, this chapter introduces the enterprise reforms and the state-owned enterprise reform that were undertaken to make possible the emergence of the stock market.

Chapters 4 to 9 trace the development characteristics of the stock market and questions are analyzed in respect of the capital structure of listed companies, investor structures,
surveillance, trading structures and investor behaviour points of view through internal-comparison and comparison with developed or emerging stock markets.

Chapter 10 discusses the internationalization of the Chinese stock market. And chapter 11 briefly reviews the development process and summaries the problems of the Chinese stock market and makes corresponding suggestions.

The joint-stock company emerged in China at the end of the Ming dynasty and the early period of the Qing dynasty. The real development of the early joint-stock company and the stock market occurred with the "Westernization Movement". The reason for this emergence was to promote the development of the Chinese economy so as to resist aggression. The development pace of the early stock market was slow and efficiency of the stock market was very low. Secondary markets did not perform their resource reallocation function but were only used to absorb "hot" money. It left a deep and negative impression on the Chinese people. The stock market was also described as a place full of the stinking smell of money and wickedness and as "a paradise of speculation" or "senior bedlam". Investing in the stock market is just like playing a terrible kind of game, "The big fish eats the small fish".

After China began to carry out economic system reforms, the shareholding system first was adopted by Chinese village enterprises. Because of the approval of the Chinese leader, Deng Xiaoping, the scope of the shareholding system was expanded further. Because of the advantages of the stock markets and the requirements of share trading, the Shanghai and Shenzhen stock markets were established in 1990 and 1991 respectively. The pace of
development within the stock market was very rapid. This development can be seen in the changing numbers of listed companies, the change in the total market capitalization and in the change of the type of investors. Although the pace of development was very rapid, the structural development level has been quite low. Raising funds changed the capital structure of listed companies and improved the performance of listed companies. The stock market changed the concept of investment for the investor and his/her understanding of the stock market. However, many problems exist in the stock market. These problems involve the structure and the institutions and also are interrelated to the immaturity of investors and regulators. The essential structural problem is related to share structure, share trading structure, trading structure and the pattern of investors. In view of these problems which exist in the Chinese stock market, strategies are suggested that relate to:

1) Strengthening corporate governance.
2) Trading state-owned shares and legal entity shares.
3) Changing the investor structure.
4) Establishing a multi-level trading structure.
5) Perfecting the legal system.
6) Strengthening information disclosure.
7) The role of the effective government surveillance of the stock market.
8) Strengthening investor education.
9) Combing the A share stock market and the B share stock market, when the price of A share and B share are relatively rational.
1.4 Conclusion

This chapter first reviews the literature concerning the development and current trends in the financial systems in developed countries. Then, the old financial system in China is introduced and the reemergence and reasons for the Chinese stock market and its impact on the Chinese economy are analyzed. In addition, this chapter expounds the research aim and methodology adopted in this thesis and introduces the structure of the thesis.
CHAPTER 2

THE JOINT-STOCK COMPANY, THE STOCK MARKET AND THEIR RELATIONSHIP WITH ECONOMIC DEVELOPMENT IN WESTERN COUNTRIES

2.1 Introduction

The joint-stock company is a form of business organization and management. It serves many functions in modern societies and has changed dramatically over its history (see Gaffikin et al, 2004 chapter 1). It is a prerequisite and the necessary foundation for a stock market to emerge and develop. The joint-stock company pools capital through the issuance of shares in the primary stock market which are then reallocated in a secondary stock market. This chapter will focus on the relationship between the joint-stock company, the stock market and economic development.

2.2 The Joint-stock Company and Economic Development

2.2.1 Basic elements of the joint-stock company

The key features of the joint-stock company are well known and can be simply stated as following:

1) Liability of shareholders is limited.

2) Ownership rights are separated from management rights, that is, the manager is separated from the investor.

3) Shares can be traded freely.
These features enable the joint-stock company to achieve advantages over other business organization forms.

2.2.2 Advantages of the joint-stock company

The joint-stock company pools the capital of numerous individual shareholders, thus diversifying the risk of each shareholder. In other words, the joint-stock company subdivides this capital into identical units. Hence, the joint-stock company can accumulate more scattered capital much more extensively and comprehensively. Substantial capital affords a possibility for the joint-stock company to invest in some relatively big projects.

On the other hand, the shareholders obtain the shares, which makes them the capital providers. Correspondingly, their profit is partly protected by law. The shareholder of a limited liability company takes limited liability. Even if the company goes into bankruptcy, the limited liability ensures their forfeit is only their initial investment. In addition, the shareholder can "exit" through selling their shares in the secondary market. The total capital amount financed through issuing shares does not increase or decrease with the change of shareholders. The capital can be used forever.

In addition, an option system for managers and a holding system for employees form long-term and sustained incentive mechanisms for managers and employees.

2.2.3 Emergence and development

The joint-stock company emerged when the social economy developed to a certain level. As a form of capital organization, its history can be traced back to the commercial
company, which was established in the form of shareholding during the Roman Empire period. The real commercial company came into being in Genoa of Italy in the middle ages (Thomson J.W., 1961, Gaffikin et al, 2004).

With the evolution of capitalism, the improvement of science and technology, completion of the industrial revolution, improvement in production socialization and sustained development of a commercial economy, a share holding system and the joint-stock company quickly became a dominant economic organization and enterprise organization form in the transition process of non-monopoly capitalism into monopoly capitalism. From the 17th to 19th centuries, a modern shareholding system became a popular organization form, first in the banking and communication industries. The emergence of the joint-stock company in banking was in the 17th century. In 1694, the Bank of England was established with a shareholding system and is the oldest central bank among capitalist countries. At the end of the 19th century, nearly all banks were established within a shareholding system. Over the period 1760 to 1830, a canal, which was 46650 kilometers long, was built in the United Kingdom. At that time, such a gigantic project could not have been completed if a shareholding system had not been introduced. In the middle of the 18th century, many roads and canals were built in the United States as well. The capital was mainly raised through the form of the joint-stock company. In the 19th century, the United States and United Kingdom began to build railways. In 1828, the United States began to build its railways. The total length of railway was 2808 kilometers in 1842 (Jin Jiandong, 1992). In 1825, the first railway was built in the United Kingdom. In 1870, the United kingdom had built up its railway transportation network over the whole country. The total length of railway network that was built was 13562 kilometers. The rapid development of railway
construction benefited from the strong capital pooling ability of the joint-stock company. Karl Marx has made a vivid comment on that: "If it must wait until capital accumulation is enough to build a railway, I’m afraid that there would be no railway up to today. However, the shareholding system conducted it in a twinkling of an eye" (Karl Marx, 1975, p. 688)

Over the period from the later 19th to early 20th century, the joint-stock company became the main organization form of state-owned companies in Europe and the United States. In 1862, there were 165 stock joint companies in United Kingdom. In 1880, the number of registered joint-stock companies had been up to 15,000. In the economic history of the United Kingdom, the joint-stock company played a very important role. It enabled the United Kingdom to become the strongest economy at that time. In the same period, in the United States, a share holding system was introduced into many industries as well, for example, textile, flour, canned meat, agricultural machinery manufacture, armament manufacture and so on. In 1914, the number of established factories in the United States was 275,000 and people employed by joint-stock companies accounted for more than 80% of the total employees. In 1904, the joint-stock company accounted for 23.6% of the total entities in the United States. In 1939, the ratio increased to 51.7%. In 1947, it increased to 69%. In 1962, it was 78% (Lei Xiaoyang, 1996).

A shareholding system was also introduced into Japan, as a then new capitalist country. It was first imported into Japanese banking from the United Kingdom and the United States in 1870. Then, this system was adopted by the insurance industry as well as other industries. After the Second World War, with the rapid development of social productivity and the sustained expenditure of markets in the world, a shareholding system and joint-
stock company were adopted by different industries and became an important impetus for promoting productivity and economic development in many countries. In the United States, compared with other business organizations, despite the number of joint-stock companies being very small, this enterprise organization form played an important role in its economic development. In the United States, monopoly capital occupied an important place. Despite the proportion of middle or small-sized companies being more than 95%, the company which played a decisive role in social economy and politics was the large-sized joint-stock company which accounted for less than 5% of companies. For instance, in 1980, the largest companies only accounted for 0.003% of the total number of enterprises in the United States. But their sales income accounted for 23.1% of total sales income. Income of the largest jointed companies accounted for 26.9%. Total assets accounted for 15.5%. The proportion of employees was 21.3% (Chu Yushen and Sun Pinjun, 1990). In 1955 Japan, a latter developed country, began to enter into its rapid development stage. Japanese investment in civil equipment grew very rapidly. Through issuing shares, the joint-stock company provides substantial funds. At present, the joint-stock company has become their dominant enterprise form. The shares held by legal entities increased from 30% in the prewar period to 70% at present" (Zuo Zhonghai, 1993) of which, banks, as legal entities, are the main shareholders. But, the shareholders of banks are life insurance companies which are legal entities but non-joint-stock companies. Therefore, an interlocking system was formed in Japan. The special holding system starts from life issuance companies. Life issuance companies hold the shares of banks. Banks hold the shares of joint-stock companies.
Similar situations have developed in other countries (such as Australia) as the joint stock company has assumed a more and more important role in developed economic societies.

2.3 The Stock Market and Economic Development

2.3.1 The stock markets and the joint-stock company

Historically, market economy development experiences the following process: commercialization of product economy, monetization of commodity economy, creditization of money economy, and securitization of credit economy. The securitization rate of one country reflects the general level of marketized resource allocation in these countries and this ratio has become an important index to reveal the development level of these countries.

The stock market emerges when the commodity economy has developed to a certain stage. The stock market arises from the development of the joint-stock company. The joint-stock company is a prerequisite and foundation for stock market emergence. The stock market plays an important role in perfecting the joint-stock company. If there is no stock market, it is impossible to issue and trade shares, public shares in particular. The stock market also provides an external surveillance mechanism for enterprises to develop rapidly.

In a primary market, the stock market plays its primary and fundamental function of pooling funds. A public company can pool scattered funds through a primary market for large-scale investment. On the other hand, it provides an investment channel for the investors who have surplus money as well. From the public company's point of view, they pool capital to improve its financial structure. From the shareholder point of view, the public company provides a chance for a shareholder to obtain high returns. From both of
points of view, capital is intermediated towards the public company through the stock market.

In the secondary market, a stock market plays a capital reallocation function. This is also an important function of a stock market. It provides an external surveillance mechanism for public companies. These functions can be reflected in the following aspects.

1) Self-expansion mechanism

The multiplier effect of the share price in a secondary market is going to attract more investors into the secondary market. This effect plays a very positive role for the development of the secondary stock market. The public company, with a good performance and growth potential in the future, can expand the company through rights offerings or share dividends. Thus the stock market is effectively used to carry out capital management.

2) Self-incentive and self-restriction mechanism

An incentive mechanism of the stock market exists from the fact that the share price trend of a public company is related to its performance. Other things being equal, good performance of a public company creates a good public image, which produces an opportunity to issue new shares. The restriction mechanism of a stock market is mainly shown by the shareholders expressing their negative opinion through “voting by their feet” to demonstrate their concern with a company’s bad performance. If the share price has been very low and there is no evidence to show that their performance will be improved, the company will face a take-over risk, or even face being delisted from the market.
Because a share is a certification of an ownership right, the trade in shares achieves the transfer of ownership rights among the property owners. The joint-stock company is a kind of contract reorganization form, which is achieved through transferring ownership rights. Therefore, the operation of a stock market has an inherent property right transfer function, that is, share trading is of benefit for the decomposition, fluidity, transformation and reorganization of the enterprise's property right. Thus, the capital, as a kind of relative scarce economic resource, will flow into the highly efficient production factors.

The pooling of funds and capital reallocation are the main functions of the stock market. In addition, as part of an important state economic system, the stock market also has some other functions.

1) Reflection function.

In developed countries, the stock market becomes a barometer of the state of the economy. The stock market reflects the status of the macro-economy and the micro-economy, government policy and so on. Additionally, the development and maturity status of the stock market will reflect the percentage of marketing and centralization of social capital.

2) The function of risk diversification

From a capital demand point of view, the stock market provides not only a highly efficient financial channel, but also a convenient approach to diversifying social risk. From an investor point of view, according to their capacity for risk, they can diversify and transfer risk through establishing a portfolio in stock market.
2.3.2 Economic development and the stock market

With regard to the linkage between the development of the stock market and economic growth, the experts’ views are divergent. Some experts document that there is a positive relationship between the stock market and economic growth (Levine and Zervos, 1998; Atje and Jovanovic, 1993). But, some of experts argue that there is no clear linkage between the development of a stock market and economic growth. The stock market functions of diversifying or sharing the risk and providing the liquidity of capital reduce the motivation for people’s saving, thereby impacting on economic growth (Harris, 1997). In a developed country, indeed, the stock market helps to explain the increase of GDP per capita. However, in a developing country, because the size of the stock market normally is small, therefore its impact on economic growth is very weak.

Despite the views on the impact of the stock market on economic growth being different, the stock market has become a barometer of the economy in developed countries. According to the practices in different countries, promoting and hindering the impact of the stock market on an economy through price fluctuations is more and more remarkable.

Jianjiang Liu and Huaide Liu in their paper, “The Contribution of Economic Growth to Stock Market-US Case Study” (2000), analyzed the role of the stock market in the economic growth of USA. They argued that since the middle of the 19th century, a high record of the main indices in the United States, such as Dow Jones, S&P500, Nasdaq, was changed successively and these indices kept a strong upward trend over a long period. Sustained boom in the stock market not only injected energy into the economy of the
The stock market impacts on the economy through the following mechanisms.

1) The stock market promotes economic growth through stimulating consumption which increases the investment multiplier. A wealth effect refers to price increase of financial assets which results in wealth growth of the owners, thus creating consumption increase effect. Ordinarily, a ratio of long-term marginal propensity to consume (MPC) is regarded as constant. The short-term MPC could change because of the following factors, for example, disposable income, interest rate, economic situation and the stock market situation. However, in practice, the long-term marginal propensity is a variable rather than a constant. For instance, in the early 1990s, the MPC of the United States was in the range of 0.9 to 0.97 but during the period over the end of 1940s to the early of 1950s, MPC was in the range of 0.8 to 0.9 (Stiglitz, 1997). Since the 1990s, because the rate of unemployment rate was kept low, a large amount of disposal income existed and a "wealth effect" was increased by the stock market in particular. Mark M. Zndi (Liu Jianjiang, Liu Huaide, 2000) demonstrates wealth effect impacts on the expenditure of a shareholder. If the wealth of a shareholder increases US$100, the shareholder increases his/her expenditure, US$4; if the wealth of a shareholder decreases US$100, the shareholder decreases his/her expenditure.
US$7. All these greatly stimulated the consumption desires of American society, thereby increasing the total demand and MPC. The consumption multiplier of the American economy was enlarged.

Milton Friedman (1957) stated that in some periods the income of a consumer was the sum of the temporary income and the enduring income. In some periods, the consumption of a consumer is equal to the temporary consumption plus enduring consumption. Between temporary consumption and enduring consumption, there is no fixed ratio. Between temporary consumption and temporary income, a fixed ratio maybe exists. Only between stable consumption and income, there exits a fixed ratio. Although stock income was still regarded as temporary income, an anomaly has appeared. Since the 1990s, in the United States, the stock market maintained a steady upward trend. Since 1995, the average annual increase range of the Dow Jones index is over 24%. Not only did public companies pay high dividends to shareholders, but also the stock market directly resulted in a wealth growth of shareholders. All of these play a exemplary role and impel shareholders to hold stock. In the United States, 48% of families directly hold stock or indirectly hold stock through holding the shares of funds. The ratio of share wealth in their total family’s wealth is bigger and bigger (As can be noted in Table 2.2). Affected by these factors, in a consumer’s physiology, stock income tends to be regarded as enduring income rather than temporary income, thus enhancing the certainty of expectation for the future economic development. Its results are as follows: 1) The sustained increase of consumer confidence index. For instance, in 1999, the consumer confidence index rose from 137.7 in May to 141.4 in December. 2) Consumption expenditure increases and MPC shows a growth trend. Some research shows that, impacted by the boom in the stock market, the MPC was in the
range of 0.97-0.98 by the end of 1990s. According to the equation of Keynes, $\frac{1}{1 - MPC}$, the multiplier is about in the range of 30 to 50. Certainly, if the following factors are considered, such as tax rates, import and export changes and politics, the multiplier will decrease a little bit.

According to expert estimations, an increase of $US1 American stock wealth will lead to a 4 cent consumption expenditure increase. In 1998, the GDP in the United States was US$8,680 billion. Individual consumption was US$5,930 billion and accounted for 68.26% of GDP. Residential consumption increase pace was around 5.7% pa. The pace reached a peak over the past 14 years. In 1998, stock wealth of American families increased by 20% and has been up to US$10,770 billion. In 1999, it was about US$13,500 billion. Wealth increases resulted in extra expenditure and played a promoting role to economic growth through the multiplier effect.

Moreover, the sustained boom in the stock market increased consumer's expectation for future income and enabled consumers to be willing to accept the situation, and led to expenditure being over income and a need for their savings or consumption credit to make up the gap. Hence, American consumption credit grew very fast. At the end of 1998, consumption credit was US$1,299.2 billion. It accounted for about 18.2% of individual income. In September 1998, the saving rate of an American family was -0.2%. This was the first time it had been negative and was the lowest point since 1959 as well. The main reason was an increase in consumption credit. According to the Federal Reserve statistics, in September 1998, consumption credit increased US$8.4 billion and kept a sustained
increase during the last ten months. Since 1999, the saving rate of American families fell further. In July 1999, it reached -1.4%.

\[
Y = GNP = C + S = C + I
\]

Figure 2.1 Wealth Effect and Multiplier Effect

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<td>Rate of Stock Income in Family Wealth</td>
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<td>12</td>
<td>28</td>
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Therefore, it can be seen that the boom in the stock market increases the stock wealth of American families and stimulates their extra consumption expenditure. Family
consumption credit is also affected and there has been a corresponding increase. According to estimation, the contribution of the stock market to economic growth is over 1% per year.

Assume the consumption function is: \( C = a + bY \).

C: Consumption
a: Original consumption.
b: MPC.
Y: National income or the total GNP

Assume: Government expenditure and government income and input and output are out of consideration.

\[
\text{GNP} = \text{consumption} + \text{investment} = \text{consumption} + \text{saving}
\]

(Below follows the same means)

\( C_0 \): Original consumption line, which is determined by MPC (b).

\( C_1 \): Consumption line, which is determined by \((b + \Delta b)\) after MPC is changed by the stock effect. It is noted by broken line.

I: New investment

\( C_0 + I \): New consumption line when new investment is added.

\( C_1 + I \): New consumption line when new investment is added.

\( O_1, O_2, Q_3, Q_0 \): GNP

Because of the stock market effect, the original b is changed as \((b + \Delta b)\). From figure 2.1, relative change of income and output Y can be found. In figure 2.1, a small change is made to the multiplier model of Keynes. \( C_0 \) is the original consumption line determined by MPC.
(b). $C_1$ is the consumption line determined by $(b + \Delta b)$ after MPC is changed by the stock effect. It is noted by broken line. The latter one has a greater slope than the original consumption line. With the increase of MPC, the investment multiplier increases correspondently as well ($1/(1 - b) < 1/[1 - (b + \Delta b)]$). From figure 2.1, it can be seen that even though no new investment is added, when the original consumption line $C_0$ is changed as new consumption line $C_1$, GNP, which is determined by $C_0$ and $C_1$, will move from $Q_0$ to $Q_1$. Assume I is added investment. $C_0 + I$ and $C_1 + I$ separately note the different expenditure lines after the equal amount of investment is added. \[(Q_3 - Q_0)/I > (Q_2 - Q_0)/I\]. The difference is $Q_3 - Q_2$.

2) The second mechanism that impacts on the economic growth is carried out through steadying the fluctuations of the economic cycle.

a) A booming stock market creates three steady mechanisms to cushion the fluctuation of economic cycle.

While economic development of one country loses its equilibrium, it will impact on the economic cycle through consumption or investment and so on. It shows as demand expansion and it will result in demand pull type of inflation. Or it shows as demand shortage and results in deflation. However, three mechanisms of the stock market play their role to steady the macro-economy. First, the stock market steadies the total demand through impacting on total supply. Particularly, when money supply increases, the stock market can attract is additional money into the stock market, thus quickening the transformation of savings into investment and reducing the inflation pressure while money supply and income increases. Second, the stock market attracts the money for consumption to be
invested in the stock market thereby reducing the investment pressure on money issuing. Third, pooling idle capital into production capital reduces the pressure of deflation. If the idle capital comes from consumption funds, when the capital is invested in the production field, the total supply does not take any corresponding change, however the capital in the investment field has increased, thereby reaching the aim of restraining deflation and promoting economic development.

In a market economy, in terms of the IS-LM model, the prerequisite of steadying the macro-economy is that the development of an entity economy should be in accordance with the development of the monetary economy. When the stock market does not intervene or has little impact on economic movement, the monetary system operates as bank credit leverage. Because the effect of the money multiplier has a time lag and the banking credit only provides a certain amount of money, it cannot meet the requirement of rapid development of an entity economy system in respect of the amount and structure of the money supply and it is easy to form an inflation gap or deflation gap. However, the steady mechanism of the stock market makes the operation of this capital such as stocks or bonds, closes the gap very well. For example, when deflation seriously threatens economic operations, the economic system produces the “thirst” for money. At this time, when total money supply is certain, bonds or stocks can sufficiently absorb idle capital and optimize the structure of money, thus reducing the negative effect on economic growth of deflation.
b) Through promoting the optimum allocation of resources, the stock market accelerates the transition of the economic structure, thus increasing the potential GNP.

A key problem for the stock market to overcome is the information asymmetry between manager and investor. An efficient market motivates the insider to disclose the real information to outsiders and make full use of the information to improve resource allocation in order to promote economic growth (Zhang Weiyong, 1998). The stock market creates a fair market. It leads capital to flow into highly efficient industries and enterprises. The operation of an entity economy reflects capital flows into the industry which accords with future economic development. The stock market optimizes capital allocation through adjusting two aspects to achieve, current capital and added capital. Optimizing current capital is carried out through the following ways:

I) Because different investors have different investment strategies for different types of companies, it changes the flow direction of capital and results in different companies having different PEs (price:earnings ratios). For instance, in the stock market of the United States, a PE of traditional iron stock is around 10 times, but the average PE of high technology stock is more than 60 times.

II) Through merger and acquisition to carry out capital allocation.

Through the stock market, enterprises with good experiences will merge or consolidate or take over those with bad experiences. Vital enterprises will merge or consolidate or take over the less vital enterprises.
The function of the stock market to allocate new investment in advance is achieved through venture capital and Nasdaq. In 1999, new added venture capital was US$36 billion. Compared with the previous year, it increased 87%. In Nasdaq, its market value in 1980 was about US$90 billion; Its market value in 1998 was about US$2600 billion; Its market value in 1999 was US$5200 billion. From 1994 to 1998, an average of the largest companies per year listed on Nasdaq. In 1999, new listed network companies reached 309 and created a network miracle. Through Nasdaq, capital entered into high-technology companies and indicated a new development trend.

The function of the stock market to allocate capital in advance can be reflected through the index of Nasdaq. In 1998, its increase range was 39.6%. In 1999, its increase range was 85.58%. It was much higher than that of the corresponding Dow Jones: 16.1% and 25.25%. Nasdaq provided a financial channel for high-technology companies and an exiting approach for venture capital as well. Nasdaq made a great contribution to the development of high-technology of the United States.

The booming stock market also stimulates the investment desires of enterprises. Enterprises can finance capital from the booming stock market at relatively lower cost in order to expend production scales further or merge and acquire through the stock market. Low financial cost already reduces the production cost of companies and relatively increases the earning of companies. Accordingly, it promotes the further boom of the stock market.
Figure 2.2 explains the process. After new investment $I$ is added, original consumption $C_0$ moves to the $C_0 + I$ parallelly and cross with the $45^\circ$ line at $A_2$. Therefore, original potential GNP is $Q_2$. The booming stock market changes MPC. The consumption line $C_0$ is changed to $C_1$. After new investment is added, it moves to $C_1 + I$ parallelly and cross with the $45^\circ$ line at $A_3$, thus increasing GDP to $Q_3$. It is original potential GNP after a "stock market effect" is created. After the capital allocation function is enhanced, $C_1 + I$ is close to $C^*$ and determines the output as $Q_4$. It is called dynamic GNP. Therefore, the contribution of the stock market to economic growth is represented as $Q_4 - Q_2$. The sustained boom in the stock market optimizes capital allocation and promotes the transition of the old economic structure into a new economic structure. It expends the potential GNP of a country. As a result, since 1990, the United States entered into a "new economy" age.

3) The stock market also can have some negative effects on the development of the economy. Since the emergence of the stock market, the real economy and the stock market affect each other. When the stock market keeps an appropriate development pace with the real economy, it will promote the development of the real economy. Once the stock market deviates from the real economy too far, an economic crisis will possibly take place.

Through optimizing capital allocation, the stock market causes a change in potential GNP. However, capital optimum allocation such as advanced resource optimum allocation is restricted by science and technology. If the stock market is over expanded, it will result in the over-expansion of total demand. But within a certain time, the stock market cannot
increase potential growth of GNP through technology improvement. Therefore the gap between supply and demand will emerge. The output, which is needed, is bigger than $Q_4$ in the figure 2.2. The deviation from the real economy will be further and further. In addition, the deviation will result in the emergence of a bubble in the stock market.

From the consumption demand point of view, a sustained rise in the stock market will result in the increase of expected enduring income. Residents will increase current consumption, even though they make use of credit to purchase houses, vehicles and so on. For example, the scale of American consumption credit expanded rapidly and the debt rate of the American family was strikingly high. At the end of July 1997, the balance of debt had been up to US$1,225.1 billion (not including loans through mortgaging houses) and accounted for 91% of income after tax payments. The expansion trend of residential consumption stimulated the production investment desires of companies. The social economy was in a situation of over-demand.

From the money demand point of view, a boom in the stock market creates a good effect. It attracts more investors to into the stock market and more companies to finance through the stock market. Credit is excessively used. Excessive credit will increase financial risk and break the information symmetry of the stock market. To some extent, it restricts the stock markets to perform its source allocation function. If the total money credit produced by the stock market and bank is bigger than the corresponding total demand of the real economy, a "bubble" also will be created. When the stock market intermediates capital from savings into investment, it is inevitable that it will create a "crowding out effect" on the
productivity investment. Some capital which should be invested in the production field is invested in stock market and the change increases the bubble in economy.

If the creation speed of a bubble is very slow, the gap between demand and supply will produce inflation. If inflation emerges, consumers will decrease their demand, but demand is still higher than the original consumption level. The government will formulate contraction monetary policies so as to reduce the supply of money and then to reduce monetary credit of banks. At the same time, the government will increase interest rates in order to decrease the amount of funds, which flow into stock market. A bubble could be cleared up by a gentler approach.
If the pressure accumulated in a bubble of the stock market is excessively high, despite the fact that the government formulates a whole set of policies, these policies will produce very few effects on the bubble. Some factors such as international speculators will have the opportunity to affect the economy of these countries and impel the inner mechanisms of the stock markets to release the pressure suddenly. This is a "financial storm" (financial crisis). A financial storm will result in the following results: prices on the stock market, foreign exchange market and futures market steeply fall; moveable property and real estate will depreciate. In the stock market, the public companies which have produced fraudulent reports or conducted other fraudulent behaviour or have management problems will go into bankruptcy. Financial crises will result in enormous property losses and produce an economic disaster for a society. Depression of the stock market will create an effect which
is negative to the wealth effect and rapidly result in economic recession through the multiplier effect. Moreover, a depression of the stock market reduces people’s expectation for enduring income and increases the uncertainty of future economic development. People’s consumption habits possibly maintain the level of consumption expenditure or cause that consumption expenditure to decrease only a little. These changes possibly do not affect the absolute value of social consumption, however it will decrease the increase of social consumption. Through the accelerator, GNP of the whole country will decrease. This also explains why real output of a country normally decreases after financial crises take place.

Figure 2.3 is shaped on the basis of figure 2.1. Because of the sustained decrease of share prices, short-term MPC will decrease. The original consumption line $C_0$ is changed to the new consumption $C^1$. The initial output $Q_0$ will change to $Q^1$. The decrease of output is $Q_0 - Q^1$. After investment increases the amount of $I$, because MPC has already changed, the new consumption investment line is $C^1 + I$. It determines the output should be $Q^2$. $Q_2 - Q^2$ is the decrease caused by the falling down of stock market.

Summarizing the above, the impact of the stock market on economic growth is mainly reflected in the following aspects: a boom in the stock market results in the wealth increase of shareholders, thus stimulating demand efficiently. High returns on the stock market accelerate the transformation of capital from savings into investment and leads to a boom in stock market; through optimizing the current capital and new added capital, the potential
GNP of one country is expanded. Over activity in a stock market will create economic bubbles and produce a negative impact on economic growth.

2.4 Conclusion

As an advanced pattern of business organization and management, the joint-stock company plays an important role not only in the process of non-monopoly capitalism into monopoly capitalism, but also in the process of modern economic development. Although in the early period, the stock market arises from the requirements of the joint-stock company, however with the development of the stock market, it becomes a premise of perfecting the joint-stock company. When this movement keeps a reasonable developing pace with that of the real economy, it will promote the development of the economy. Once it deviates from the normal movement orbit too far, it will cause an economic crisis. This has already been proved in the history of the joint-stock company and the stock market in Western countries. The stock market is a double bladed arrow. The next chapter focuses on the emergence and reemergence of the Chinese joint-stock company and the stock market and their development.
CHAPTER 3

JOINT-STOCK COMPANY, STOCK MARKET AND ITS DEVELOPMENT IN CHINA

3.1 Introduction

An analysis of investment theory and the development of the joint-stock company and the stock markets in western countries reveal that both are related to capitalism. Therefore, the history of a capitalist economy is just a history of the joint-stock company development.

Unlike western countries, the main emergence and re-emergence and development of the Chinese joint-stock company and the stock market are fundamentally not under capitalist economic conditions. A review of the history of both the joint stock company and stock markets in China will help highlight some of the current problems in the Chinese stock market.

3.2 Early Joint-stock Companies and the Stock Market

3.2.1 Early Joint-stock companies

With the development of a commodity economy in China, the joint-stock company gradually emerged. The joint-stock company first appeared in Chinese financial industry (Zheng Zhenlong, 2000).

From the end of Ming dynasty to the early part of the Qing dynasty, commercial trade was very active. When businessmen undertook business, they carried with them small amounts of silver. If the amount was very large, it was necessary to employ bodyguards to convey...
the silver. However, bodyguards were not a very efficient protection approach. There were frequent cases in which silver was robbed thereby restricting the development of trade. Therefore, an institution which dealt with remittance was needed.

According to the Shanxi Piaohao history (1990), Shanxi province had been a commercial centre in the Ming and Qing dynasties. The amount of trade was very large and trade occurred frequently in each year, therefore the requirement for remittance was very strong. In order to satisfy its requirement for remittance, the “Piaohao” (negotiation bank), which dealt with remittance, emerged. The first “Piaohao” emerged around 1821-1842 in Shangxi province. A representative example is “RiShenghang” which was established by two brothers. Because of the demand for its services, its business extended over a large area.

According to the records of the Shanxi Piaohao history, “Rishengchang” established 24 branches in other Chinese provinces. They even established branches in Russia and Korea. With the rapid development in the size of the Piaohao came an increased demand by it for capital. In order to overcome this problem of a shortage of capital, on one hand, Piaohao endeavored to attract savings. On the other hand, it raised capital through issuing shares to the public. This was the rudimentary stage of the Chinese joint-stock company. Although the “Piaohao” was only the very first stage of joint-stock company development in China, its operation was regulated very well. Property rights and management rights were separated strictly. However the development of a joint-stock company in China was very slow (Zheng Zhenlong, 2000).

The real development of Chinese joint-stock companies started with the opium war which occurred in 1840. Foreign military power forced China to open her doors. The old Chinese
economic structure was a small-sized agricultural and handicraft economy and could not withstand the commercial shock of foreign capitalism. These shocks impelled many Chinese enterprises to be closed. At the same time, foreign businessmen began to establish their joint-stock companies in China. In the Chinese capital market, the first shares were issued by a foreign joint-stock company. The foreign joint-stock company first issued shares and bonds through their banks. With the increase of foreign joint-stock companies in China, a capitalist production and management method, and shareholding system were introduced into China and were accepted by the Chinese.

Chinese enterprises first issued shares in the “Westernization Movement”. The aim of the “Westernization Movement” was to make China strong so as to resist invasion. An important feature of the “Westernization Movement” in the period between the 1860s to 1890s was the establishment of a military industry, especially to arm the Chinese navy with modern weapons. Zeng Guofan, Zuo Zhongtang and Li Hongzhang were the main people engaged in this movement. Under these government officers’ surveillance, a Chinese early joint-stock company was established and did so in accordance with the western model. However military products could not be put on the market at that time, therefore the further development of these joint-stock companies was determined by the amount of appropriation by government rather than by their performance. The military industry did not lead to a boom in the Chinese economy, therefore they tried to find another way to enrich China. They began to engage in establishing joint-stock companies which dealt with products other than military products (Zheng Zhenlong, 2000). Then, many joint-stock companies were established mainly through two approaches. The first approach was to raise funds from Chinese businessmen but under government surveillance. The second
approach was to raise funds from Chinese businessmen and the government under government surveillance (Zheng Zhenlong, 2000). Through the shareholding system form, Chinese joint-stock companies could pool funds on a large scale. The establishment of these joint-stock companies indicated the real beginning of early Chinese joint-stock company development. The Steamboat Merchant Bureau, established in 1872, and the Kaiping Mining Bureau, established in 1876, were two very representative joint-stock companies. Although these joint-stock companies followed the western model, because bureaucrats held the controlling rights in these joint-stock companies, different shareholders were not granted different rights, the fundamental function of joint-stock companies could not be performed completely. Finally, these companies were soon closed due to their poor performance.

In the same period, some private industrial and commercial enterprises gradually developed and became the main body of a Chinese shareholding system economy, such as the Fachang Machinery Factory established in 1866 (Zheng Zhenlong, 2000).

From the Sino-Japanese war of 1894 to 1898 to the early period of the “Republic of China age”, Chinese commodity economy capitalism further developed. The amount of private capital was more than that of bureaucracy capital and played a dominant role. Issuing shares had become the main approach of private companies to raise funds (Zheng Zhenlong, 2000).

The following age is the Northern government period (1912-1927). “During the period of Northern government age, the development of joint-stock company experienced two
development stages” (Zheng Zhenlong, p.117, 2000). The first stage was the period from 1912 to 1920. The development was very steady in this period. The triumph of the Xinhai revolution reduced the impact of federalism in China and changed the Chinese traditional concepts. More Chinese people began to invest in industry and mining factories. In addition to some businessmen and compradors, more warlords and old officers invested in Chinese joint-stock companies. The following stage from 1921 to 1927, the pace of development of the joint-stock company was very slow. Despite that the number of factories continually increased. The increased number was not as big as before and profits of the factories tended to decline. Some factories made big losses and even had to be closed. Consecutive wars were one reason that contributed to this consequence. Additionally, after the First World War, some advanced countries staged a comeback and dumped their products on Chinese markets. All this considerably impacted on the production of Chinese private industry (Zheng Zhenlong, 2000).

From 1928 to 1937, China was controlled under the governance of the Kuomintang government. The development of private industry was complicated. During the early period after the Kuomintang government was established, despite China not being united, the social situation was steadier than that under the governance of the Northern government. “Four big families took over the enterprises owned by the Northern government and the Northern warlord before and controlled the Chinese financial industry” (Zheng Zhenlong, p.119. 2000). “Because four big families did not begin to intervene in private industry at the beginning, there were not so many obstacles to hinder the development of capitalism” (Zheng Zhenlong, p.119. 2000). However after 1930, affected by world economic depression, Chinese economic development stagnated as well. After 1931, the number of
newly registered factories and their equity capital amount clearly showed a declining trend. “As one pattern of business organization form, the development of joint-stock company followed the same trend of Chinese economic development and gradually slipped into depression” (Zheng Zhenlong, p.119. 2000).

“After the War of Resistance against Japan occurred, because four big families monopolized Chinese enterprise, the regional economy under the Kuomintang governance was depressed” (Zheng Zhenlong, p.119. 2000). Over the period 1937 to 1939, the size of newly established joint-stock companies had been relatively large. But, after 1940, the size of newly established joint-stock company enterprises was gradually smaller. Quite a number of private enterprises were merged by the four big families (Zheng Zhenlong, 2000).

After the end of the War of Resistance against Japan, population and capital flowed to the cities along the seashore. Lots of construction was under way. The industries located in the areas which were occupied by Japanese troop before continued to develop. Some new enterprises were established. “According to the statistics of the Economic Department concerning business opening, in the second half of 1945, there were 273 joint-stock companies which opened business. In 1946, the number was 1992. In 1947, the number jumped to 9285” (Tan Jihong, p. 1461, 1948).

However, part of these was joint-stock companies were established through reopening old ones or the merging of some older ones. After 1948, with the gradual expansion of territory controlled by the communist party, the industrial economic status under the Nanjing
government control completely came into recession. The funds flowed from the northern part to the southern part. Enterprises established in Shanghai were very popular. According to the statistics, at the end of 1947, there were 10,877 enterprises in Shanghai. At the end of 1948, the number increased to 12,570 (Chinese Industrial Institution, 1949).

In 1949, because the Communist party destroyed the Kumindang government, lots of funds flowed overseas from the mainland to Hong Kong and Taiwan. The Shanghai economy was depressed. In contrast, after the triumph of the War of Resistance against Japan, economic development in the area controlled by the communist party grew rapidly. However state-owned enterprises tended to be dominant, the joint-stock company playing a weaker and weaker role in Chinese economic development and then completely disappeared (Zhen Zhenlong, 2000).

3.2.2 Early stock market

1) Foreign stock market in China

From the time the first stock was issued by a foreign company in China at the end of Qing Dynasty before the “Westernization Movement”, the trading of shares occurred. The trading of shares had emerged in Shanghai and other provinces. However, trading occurred only among foreign businessmen and was not widespread.

Similar to the establishment of the joint-stock company, European and Japan businessman first established their exchanges in Shanghai. In 1891, foreign businessman established the Shanghai shareholding Gongsuo (exchange), especially dealing with foreign shares. In 1905, the Qing government reorganized it as Shanghai Zhongye Gongsuo through
transformation. It was also called the Shanghai Security Exchange. This exchange was one which was established according to the Western model. Its capital was obtained by subscription of its members. In 1937, the War of Resistance against Japan took place. Because the Kuomintang military force could not withstand the aggression of Japanese military forces, they retreated in defeat again and again. In November 1937, Kuomintang troops withdrew from Shanghai completely. Japanese troops occupied the other parts of Shanghai outside of the concession. Because the Japanese did not proclaim war on the United States, United Kingdom and France, the US, UK and France continuously controlled their concessions in Shanghai. Concessions could be metaphorized into an "Isolated Island" surrounded by sea. The status lasted for four years until the Pacific war occurred in December 1941. In Chinese history, this period was called the "Isolated Island" age. During the period of the "Isolated Island" age, foreign organizations and Chinese organizations continuously did their business. The difference was that lots of Chinese capital flowed in. Part of this money became "hot money". This "hot money" was first invested in foreign shares. In 1941, the Pacific war occurred; Shanghai was completely occupied by Japanese troops. Shanghai Zhongye Gongsu was compelled to be closed.

The Japanese had attempted to establish the Quyinsuo (Exchange) twice (Zheng Zhenlong, 2000). The first time, they cooperated with the United States and Chinese businessmen and attempted to register in the United States, however it was unsuccessful in the end. The Japanese tried for the second time in 1918 and were finally successful. The variety of trade of the Japanese exchange included securities and commodities such as cotton. Their aim of establishing the Quyinsuo was to control the Shanghai market. After the Quyinsuo opened its business, because it was at the time that the Chinese rejected Japanese products on
Chinese markets, the business of the Quyinsuo was very depressed in the second half of that year. Despite little progress being made in the latter part of this year, this situation did not last for long. Additionally, because Chinese exchanges were established one after another at the same time, the competition among exchanges was very competitive. Its trade did not recover. On 20 January 1925, it closed and the Quyinsuo disappeared from Shanghai.

2) Chinese stock market

In the Westernization movement period, the Steamboat Merchant Bureau issued the first Chinese stock after which trading in Chinese shares occurred. From a decentralized market to a central market, Chinese share trading experienced the following processes.

a) Chahui period (1895-1914) ("Chahui" refers to a pattern of gathering. Here, it is used to describe the situation in which people drank tea and traded in shares at the tea building). In 1911, brokers emerged in Shanghai, however most of them did this job on the side. Their main businesses were to deal with tea, antiques, furs, or old-style Chinese private banks. Because they usually gathered together at tea building of HuiFang located at the corner of Shanghai Yuzhou Lu Daxinjie; the meeting was also called “chahui”. Generally, these brokers drank tea as well as exchanged information with each other in the morning. Some trades were done through an oral contract form. In addition, some businessman brought their shares to the tea party and attempted to sell to others. These trades were spot transactions. Prices were made through negotiation between the two parties. In the afternoon, they visited their clients or banks so as to find more business. With the increase in volume, some businessmen who were specialized in dealing in trading stock emerged.
b) Consortia period (1914-1920)

With the increase in issued shares, trading was gradually increased. The desire for establishing an exchange became stronger and stronger. In the autumn of 1914, the Agriculture and Commercial Department approved the Shanghai Stock Commercial Consortia to be established. At that time, only 13 members registered. The trading variety was more than 20. However the difference from before was that at the location of the Consortia, a fixed place was provided for people to trade shares and equipments for trading was improved. In addition, the Consortia designed a timetable for trading and provided daily market information as well. However the gathering form, which communicated information to the parties or made a deal in the process of drinking tea was still retained.

c) Exchange period (1920-1949)

With the increase in share trading, the development of a private industrial and commercial industry and the monopoly of foreigners to exchange stimulated the strong desire for the Chinese to establish Chinese exchanges.

In 1918, the Beijing Security Exchange was established and followed the model of the western joint-stock company markets.

In Shanghai, Sun Zhongshan and a famous businessman - Yu Qiajin - proposed to establish a Shanghai exchange joint-stock company in 1916. They submitted their application to the Beijing Agriculture and Commercial Department. They attempted to trade in a variety of goods such as securities, gold and silver, flowers, and furs on stock market. However, the Beijing Agriculture and Commercial Department thought an exchange could not deal with
securities and commodities at the same time and rejected their application. In March 1919, they sent a telegraph to the Northern government and applied again. In this telegraph, they stated the difficulty in establishing the exchange and the necessity of trading securities and commodities at the same time on one exchange. In July 1920, the Northern government approved their application for establishing a Security and Commodity exchange and trade variety could include commodities as well as securities. The establishment of the Shanghai Security and Commodity Exchange followed the model of the Japanese Quyinsuo and invited Japanese advisers ("Case file on Shanghai exchange", "Bank Weekly Newspaper" No. 47). On 1 July 1920, the Shanghai Security and Commodity Exchange formally opened their business.

In Shanghai, another group of businessmen applied to establish another exchange, called the Shanghai Hushang Exchange. Because trade variety was unique, the Beijing Agricultural and Commercial Department quickly approved its application and opened business on 20 May, 1921 (Zhang Yifan, Pan Wenan, 1937, p.53). The Shanghai Hushang Exchange was established on the foundation of the Shanghai stock commercial consortia.

In addition to the Beijing and Shanghai exchanges, there were some other exchanges to be established in other cities after 1930, such as the Tianjing Siming Exchange, the Qingdao Commodity Exchange and the Hankou Northern China Exchange. Their sizes and trading volume were smaller in comparison with those of the Shanghai and Beijing exchanges. The establishment and development of exchanges forced the decentralized unregulated trading to enter a stage of central trading and promoted the development of a shareholding system.
economy. However because the capacity of government surveillance was very weak, speculation was very rife.

The establishment of the Shanghai Security Commodity Exchange, the Beijing Security Exchange and the Shanghai Huashang Security Exchange one after another indicates stock trading was centralized.

3) Evolution of the Chinese Security Exchange

After the Shanghai Stock Commercial Consortia was established, the development of the stock market was greatly improved. After security exchanges opened their business, they made high profits and attracted many investors. During the half year after its establishment on 1 July, 1920, the Shanghai Security and Commodity Exchange achieved a trading volume of more than 0.5million RMB (edited by Shanghai branch, People's Bank of China, 1978).

Because of the high profits, people in different industries attempted to establish security exchange and commodity exchanges. ... "Since May 1921, the number of newly established exchange increased very quickly. In September, the number already reached more than 70. In November, there were another 38 new exchanges"... (edited by Shanghai Bank Academy, pp.149-151, 1948). According to the "Shen newspaper" which reported that at the time, people seemed crazy. As long as an exchange is established, they left no stone unturned to buy stock. It seemed that holding stocks implied that they would obtain wealth. In the early stages, exchanges only served as a medium between listed companies and charged commissions as service fees. However shortly after, in order to get more
capital gain, exchanges began to trade the shares on exchanges of each other. Finally, they dealt in shares of the exchanges. Exchanges and trust companies colluded to drive up the prices so as to obtain high capital gains. Some exchanges had no capital when they were established; however, they declared they owned capital. When exchanges opened their business, they sold shares which had no real property backing and became “milliners” in a short time.

In December, the Chinese New Year was going to come. Almost all banks and the “Qianzhuang” restricted their credit, therefore speculators lost the channel to loans and a shortage of capital emerged. The “hot” market was immediately “cooled” off. The number of exchanges which could continue to operate was very few. Yany Yinfu has described the situation at that time as: “The information that the exchange was closed could be heard every day. The exchanges which could survive after the Chinese new year only accounted 1/10 or 2/10” (Yang Yinfu, p.134). After this storm, only some exchanges survived, including the Shanghai Security Commodity Exchange, the Shanghai Gold Industry Exchange, the Shanghai Exchange of Chinese Mechanic Flower and the Shanghai Corn and Seedcake. This was “Tempest of the Bourses”. A deep reason that caused the “Tempest of the Bourses” to occur was that the establishment of exchanges that did not accord with the development of the commodity economy. Exchanges promoted commodity trading and circulation of capital. To some extent, exchanges met the requirement of economic development of that age; their development deviated from objective requirements. In 1920, the variety of stock and commodity, which could be traded in exchange, was limited. Moreover, it was in an industrial crises period. The economy was in a slump. It was obvious that the supply of exchanges was in excess of demand.
In addition, the checking and surveillance by government of exchanges and trust companies was unsuccessful. Among the newly established trust companies, the majority did not comply with the establishment requirements of financial institutions. This phenomenon also emerged in the establishment of exchanges. Very few exchanges were established according to law.

Because the bubble which created the "Tempest of the Bourses" was broken finally, it created a serious, strong negative impact on different industry development and resulted in very many companies going into bankruptcy. In addition, it also created serious social problems, such as an increase of unemployment and a decrease in people's living standards. The most negative result was that it caused people to lose confidence in the stock market. Many Chinese withdrew their investment from the stock market and the stock market did not recover for long time from this setback. Despite some big companies still being listed on exchanges, the volume of trading was very small. At the same time, with the rapid expansion of bond trading, bonds replaced stocks as the dominant trade variety on exchanges. This situation was sustained after the occurrence of the War of Resistance against Japan.

1) Before the War of Resistance against Japan occurred

In 1929, the Kuomintang government promulgated the "Exchange Law". This law stipulated that in one province, only one exchange was permitted to be established. Moreover, it also stipulated that exchanges could only deal with securities or commodities. Shanghai security and commodity exchange dealt with securities as well as commodities and had the same business scope as that of the Shanghai Huashang security exchange.
therefore its existence was illegal. Its security department was merged into the Shanghai Huashang security exchange. It was completely merged with the Shanghai Huashang security exchange in 1933. Before the merger, the Shanghai Huashang security exchange had been booming. In 1927, volume was 239.84 million yuan. In 1928, it increased by more than 50% in comparison with that of the last year. The volume in 1929 was three times as much as that in 1928. After the Shanghai security commodity exchange was merged with it, its volume arrived at 4771.595 million yuan in 1934 (Zhang Yifan, p.80, 1937). The boom status sustained until the occurrence of the War of Resistance Against Japan. After 13 August, 1937, Japanese troops occupied all the places outside of the concession in Shanghai. The Shanghai Huashang security exchange was compelled to be closed.

2) In the War of Resistance against Japan age (1937-1945)

After the War of Resistance against Japan occurred, because Kuomintang troops retreated in defeat, the reputation of the treasury bond decreased, the market was slack. The trading of bonds slumped. Compared with this, the status of trading in shares recovered again. There were three main reasons for this. First, there was a great decrease in the reputation of treasury bonds issued by the Kuomintang. This resulted in the trading in bonds becoming inactive. The second reason was the existence of "hot" money in the Shanghai concession. At that time, the concession was still under control of the USA, the UK and the French. Therefore, Chinese and foreign banks located in the concession could continue their businesses. Many rich people took refuge in the concession. Massive capital accumulated in the concession. Third, in order to plunder more material for its military demands, the Japanese issued enormous military bonds without any guarantee and the status restricted
commodity circulation, thus causing commodity prices to soar. Industry and the commercial economy could not continue to develop. Storing goods became a good approach to achieve high return. Shares as a kind of certification of property rights, could keep accord with the commodity prices, therefore trading in shares was active again. “Hot” money was first invested in foreign shares.

Around 1940, the trading in Chinese shares became gradually active. Because enormous capital flowed into the concession from outside and was invested in factories, the number of issued share increased greatly. In addition, the temporary government at that time prohibited any trade with regard to treasury bonds, foreign shares, gold and silver and cotton. Enormous “hot” money had to turn to Chinese shares and resulted in a boom in the trading of Chinese shares. In order to satisfy trading requirements, the “Chinese Stock Promotion Committee” was established in 1941. The aim of establishing the committee was to promote the trading of stock, to facilitate investor involvement and to encourage production. During the “Isolated Island” age, the “Chinese stock promotion Committee” and the “Shanghai Zhongye gongsu” dealt with the trading of Chinese and foreign shares. The organization form of “Chinese Stock Promotion Committee” was looser than that of the exchange. The committee provided convenient services for its member. The service embraced stock recommendations, market price reports and other matters with regard to share trading. The trade variety, in which the committee dealt, was limited in the scope to shares, which had previously been listed on the Huashang security exchange. In December 1941, Japanese troops completely occupied Shanghai. The committee was compelled to close. The “Chinese Stock Promotion Committee” filled in the period in which there was no Chinese exchange and played an important role in recovering and promoting the
development of the joint-stock company during the "Isolated Island" period. There was no exchange in Shanghai at that time, however the trading of shares did not stop. The trading was carried out on the black market because of the requirements for trading. Many businessmen established stock companies to deal with the trading of shares. The number of stock companies proliferated. Because there was no unified market, the trading of shares was carried out in different stock companies and there was no price ceiling to restrict the price falling within a range. A result was that at the same time, the market prices in different stock companies were quite different. Speculation was very popular and speculation pulled market prices up very fast. On 29 September 1943, the Shanghai Huanshang security exchange reopened so as to satisfy the requirements of share trading under the order of the temporary government. The Shanghai Huashang security exchange closed on 18 August, 1945 after the War of Resistance against Japan was over.

The War of Resistance against Japan war was over. Share trading did not stop due to the close of the Shanghai Huanshang security exchange as it was carried out on the black market. The trading of shares was again disorderly. The Kuomintang government found it was quite hard to cancel stock trading completely, therefore they attempted to control the stock trading through establishing a centralized market. The Kuomintang government appointed Du Yusheng to deal with it. On 16 September, 1946, the Shanghai Security Exchange formally opened its business. At the beginning, all trading was spot. The market was not active. After a series of measurements were carried out, the market was going to boom and the share prices went up rapidly. On 19 August 1948, the Kuomintang government carried out a new financial policy, then the exchange was closed. In February
1949, the exchange reopened, however it closed again within two months of its reopening because of the defeat of the Kuomintang troops.

In addition to the exchange mentioned above, there was another exchange, the Beijing Security Exchange. Its trade variety was treasury. In order to make up its fiscal deficit, the northern government issued enormous bills at high interest rate. The treasury bill issue greatly stimulated the financial development in Beijing and resulted in the emergence of the Beijing Security Exchange. In 1918, the Beijing Security Exchange was established, this exchange followed the form of the western joint-stock company model. At that time, trading on Beijing Security Exchange was very active. However, because treasury bills lacked an industrial foundation to support them, the major investment behaviour was speculation. The development of a Beijing financial industry and evolution of the Beijing Exchange was closely linked with the fate of Beiyang government. Until 1928, the Kuomintang government moved to Nanjing and created an impact on the Beijing exchange. The media at that time reported: “Year statistics showed in the first six months, there were less than two months to open for business. In the second six months, it was lucky that no market stop occurred and there was little income.

4) Development characteristics

Following Zheng Zhenlong (2000) the development characteristics of the Chinese stock market can be summarised as following:
a) Development pace is very slow

With the development of a commodity economy, the requirement for establishing the joint-stock company emerged. However, after nearly one hundred years, the Chinese stock market did not develop to be a mature market. If we trace back to the very early stage of the joint-stock company, the Chinese were involved in joint-stock companies first through holding the shares of foreign joint-stock companies in China. Then the holding rate increased rapidly. The first Chinese shares issued by a Chinese joint-stock company were in the westernization movement. With the development of the private joint-stock company and private capital, shares issued and trading gradually increased. However, because the issue approach adopted at that time was very under developed, it restricted the development of a stock market. It was not until 1920 that the first Chinese stock exchange emerged in China. In addition, the regulation of a secondary market was very weak, and finally caused the “Tempest of the Bourses”. The “Tempest of the Bourses” resulted in a plunge in the stock market and caused people to lose their confidence to invest in the stock market for a long time. It was not until 1940 that the stock market recovered. However because of the corruption in the Kuomintang government, inflation was very serious. Activity was not maintained for long and the stock market declined again. The political and economic status at the time had a strong impact on the development of the Chinese stock market. Development pace was very slow.

b) Development is uneven

The development of the stock market was very uneven. In different areas, the development level of the stock market was very different. The development of the stock market in Shanghai was advanced. The first stock exchange, the Shanghai share Gongsuo, that was
specially engaged in trading foreign shares, was established in 1891. In 1905, it was reconstructed as the Shanghai Security Exchange by the Qing dynasty government. Later, Chinese exchanges were established gradually. From the stock exchange development in other provinces, it is evident that the stock exchanges in Shanghai lasted longer than those in other provinces and their size was larger than others as well.

c) Development of the stock market showed a distinct colonial character. The development of the Chinese joint-stock company was strongly influenced by foreign capitalism. Share issues and stock exchange development in China, both were first undertaken by foreigners. Then, the Chinese joint-stock companies issued shares and a Chinese stock exchange was established. The first stock exchange (Shanghai Zhongye Gongsuo) in China was established by foreigners. The Japanese Quyinsuo was also established before the Chinese Huashang stock exchange. Foreign stock exchanges in China undertook the whole business process with regard to the share issue and trading of securities in foreign companies in China.

d) The development of the stock market is not in accordance with that of industrial markets. Speculation was very popular in stock markets.

The linkage between industrial development and early Chinese stock market development was not close. Non-industrial developmental factors played a dominant role in the development of the early Chinese stock market. An important reason was that finance through issuing shares did not become an important financial approach at that time. The main source of industrial capital accumulation came from the following: 1) Tax. It was the main capital source of early state-owned industry. 2) High land rent. It was the main
capital source for big bureaucrats and landlords wanting to establish a joint-stock company.  

3) Profit. It was capital accumulation of big businessmen through being possessed of surplus product and some part of necessary products of small producers without payment. It was achieved through buying at a lower price and selling at a higher price from small producers.  

4) Commission. It is a kind of monetary wealth of comprador (Comprador refers to a Chinese businessman who did business with foreign businessman or represented a Chinese businessman to do business with a foreign businessman) to get through depending on foreign businessmen power.  

5) Funds from Chinese from overseas. This capital refers to the investment by overseas Chinese in the United States or Japan.

Issuing shares was not the main capital source of Chinese industry. Therefore, the linkage between the stock market and industrial development was loose. The ups and downs of share prices could not reflect the real economic development trend and company performance. “Hot” money determined the movement trend of share prices. Several tempests occurred in the stock market and the boom and slump of the stock market was caused by the entry and withdrawal of “hot” money.

3.3 Post Revolution Period

After the People’s Republic of China was founded, the stock exchanges established before its foundation experienced the following process: restricted development stage, utilized stage, reconstruction stage and cancellation stage.
<table>
<thead>
<tr>
<th>Year</th>
<th>Chinese stock market</th>
<th>Beijing</th>
<th>Foreign stock market in China</th>
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<td></td>
<td></td>
</tr>
<tr>
<td>1891</td>
<td></td>
<td></td>
<td>Shanghai Joint-stock Gongsu was established</td>
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<tr>
<td>1905</td>
<td></td>
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<td>Shanghai Joint-stock Gongsu was reconstructed as Shanghai Zhongye Gongsu</td>
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<tr>
<td>1914</td>
<td>Shanghai Stock Commercial Consortia</td>
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<td>1918</td>
<td></td>
<td>Beijing Security Exchange was established</td>
<td>Quyinsuo was established</td>
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<td>1920</td>
<td>Shanghai Security and Commodity Exchange was established</td>
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<tr>
<td>1921</td>
<td>Shanghai Huashang Security Exchange</td>
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<td>1925</td>
<td></td>
<td></td>
<td>Closed</td>
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<tr>
<td>1933</td>
<td>Shanghai Security and Commodity Exchange was merged with Shanghai Huashang Security Exchange</td>
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<tr>
<td>1937</td>
<td>Shanghai Huashang Security Exchange was closed by Japanese</td>
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<tr>
<td>1939</td>
<td></td>
<td></td>
<td>Closed</td>
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<tr>
<td>1940</td>
<td>Shanghai Promoting Committee was established</td>
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<tr>
<td>1941</td>
<td>Shanghai Promoting Committee was closed</td>
<td></td>
<td>Closed</td>
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<tr>
<td>1946</td>
<td>Shanghai Security Exchange was established by Kuomintang government.</td>
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</tbody>
</table>

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In the early period after the foundation of People's Republic of China, the Chinese financial market was in disarray. Commodity prices soared and soaring prices caused speculation in gold, silver, foreign currency and security was popular. "Hot" money flooded the market and threatened the stability of the market. In light of the statutes at that time, the Chinese government took a series of measures. One of these measures was to utilize and reconstruct the stock market. On 1 June 1949, the Tianjing stock market was established on the foundations of the original Tianjing stock market. This was the first stock exchange after the foundation of People's Republic of China. For a similar reason, the Beijing stock exchange opened on 1 February 1950. The establishment of Tianjing and Beijing stock exchanges made a contribution to the recovery and steady growth of the Chinese economy and promoted social institution transition. After March 1950, with the improvement of the Chinese economic position, revenues and expenditure of the Chinese government were nearly balanced, and inflation was controlled. Share prices and commodity prices kept steady. In July 1952 the Tianjing stock exchange closed. On 21 February 1952, Beijing stock market was closed.

3.4 Modern Chinese Joint-stock Company

1) Emergence and Development

One reason for the emergence of joint-stock company was to raise funds and the re-emergence of the joint-stock company in China was for the same reason. However the difference was that it was not only for pooling funds from individuals in order to satisfy the requirement of production, but also for meeting the requirements of economic system reform. The emergence and development of the modern Chinese joint-stock company experienced the following stages:
a) Seed stage (1978-1984)

Chinese economic system reform first began in villages. The key to village reform was to bring the enthusiasm of peasants into play and to improve productivity through carrying out associated production and contract responsibilities. With the gradual improvement of productivity, superfluous labour and some peasants who were specialized in producing commodities emerged. However, production materials, funds, labour and technology were owned by different families. A form that organized fund, labour, production material and technology efficiently was needed. Some village enterprises were established as joint-stock companies. These enterprises became the early joint-stock companies since the establishment of People’s Republic of China. Because the form promoted the production of the village, the Chinese government promulgated a series of policies in order to promote the further development of a shareholding system in villages. In April 1984, at the meeting, “city economic system reform”, because of the good performance of joint-stock companies in villages, it was proposed that joint-stock companies should be established as collective enterprises and small-sized state-owned enterprises. Collective and small-sized state-owned enterprises located in the city began to carry out joint-stock company reform.

At this stage, materials such as land, houses, equipment, technology and labour rather than currency were invested in the joint-stock company. Dividends were paid according to the number of shares, which the shareholder held. Despite these companies not being regarded as real joint-stock companies, it was this early form of Chinese modern joint-stock company in China under the socialism system that was a breakthrough for the enterprise system reform process.
The new economic phenomenon attracted the attention of Chinese researchers and resulted in a series of disputes. These disputes mainly focused on the essence, function, application range of the joint-stock company and the essence of dividends.

The first dispute focus was on whether the joint-stock company could exist in a socialist economy. As regards this question, the views of major researches were similar. They thought the emergence of joint-stock company was the necessary result of economic development, therefore the joint-stock company should not be regarded as a special organization form which only capitalism had. It could be applied under a socialist system.

However there was a minority of researchers who put forward their arguments, focusing on the question of whether state-owned enterprises should transit into joint-stock companies. These researchers thought that establishing some restricted mechanisms on state-owned companies might be a better choice than their transiting into joint-stock companies. They proposed: 1) If government played a dominant role in joint-stock companies, government would become a big shareholder. There was no difference from before when management was conducted through administrative command. Therefore, they thought there was no necessity to convert to joint-stock companies. 2) If government was not the biggest shareholder, the enterprise is going to be under “out of control” status, thus resulting in the increase of short-term investment or production behaviour. 3) Conflicting interests that existed among central, local and other departments before will directly impact on joint-stock companies (Fan Maofa, 1986).
The second dispute was with regard to the essence of joint-stock company in a socialist country; there existed two major viewpoints. The first view thought that establishing joint-stock companies was a transition from public ownership to private ownership. The reason was that if shareholders held shares, it means that they own the property rights of production material. Therefore, in the joint-stock company, production material was owned by individuals. The ownership structure did not satisfy the definition of socialist public-ownership. If the shareholding system was adopted by private enterprises, it was not a new thing. However if the shareholding system was adopted by collective enterprise, it was going to change a collective enterprise into a joint-stock company; if the shareholding system was adopted by state-owned enterprise, it meant individuals were permitted into state-owned enterprises and these individuals had the strong motivation to maximize their benefit from these enterprises. This kind of change would make ownership of state-owned enterprise change from a public-ownership company to a private company (Ma bin, 1986). From this viewpoint a stock exchange was deemed not only unnecessary but was counter-revolutionary. Such institutions were not consistent with the dominant political ideology.

Another view held that the shareholding system did not change public-ownership of enterprises. The explanation was, in practice, that what was of importance was not the capital amount which is owned by government but rather the proportion which could be dominated by the government. Through a shareholding system, state-owned enterprises could raise more capital. Therefore, a joint-stock company promoted public-ownership economy development rather than weakened its development (Li Yining, 1986). Another explanation was that under the condition that government and collective ownership enterprises owned the majority of the total issued shares of listed companies, the joint-stock
company diversified the ownership structure however it did not change the features of public-ownership. State-owned enterprises issued shares to the public. Capital of state-owned enterprises would include the capital of other enterprises and individuals. Therefore, the unique ownership structure such as state-ownership or collective-ownership was changed to a combination of ownership structures. (Guan Mengjue, 1987)

The third dispute concerned application scope; on just which enterprises should transit into a shareholding system, there existed different views. The first view thought most state-owned companies could not carry out a shareholding system. The reason is that these enterprises do not satisfy the requirements of a joint-stock company. The second view thought the joint-stock company was not suitable for small or middle-sized enterprises. Large-sized enterprises were suitable, because they need substantial capital. Depending on share issues, it would be quite hard to raise all the necessary capital. The third view held that state-owned enterprises should not convert to a shareholding system, however a shareholding system could be applied in collective or private enterprises. The reason is that a shareholding system could accelerate the speed of capital accumulation and improve the efficiency of enterprise management. From a theoretical point of view, it was held that a socialist system had more advantages than that of a capitalist system. The fourth view was that a shareholding system could be experimented with in only some regions and some enterprises. The reason is that the outside environment does not provide enough conditions for state-owned enterprise to carry out shareholding system reform, such as development of a commodity economy, the establishment and further perfection of the capital market. Therefore, a shareholding system was only to be experimented with in some regions and in some enterprises (Zheng Zhenlong, 2000).
b) Start-up stage (1984-1986)

Since October, 1984, the central committee of the Chinese communist party promulgated "Decisions on economic system reform". The focus of economic reform was moved from village to city. The experiment with joint-stock companies was undertaken in large or middle-sized state-owned enterprises.

From 1984 to 1986, a few large or middle-sized state-owned enterprises in Beijing, Guangzhou and Shanghai began to carry out joint-stock company reform. After economic reforms moved to this stage, understanding of investment in joint-stock companies was already more extensive than before.

In July, 1984, a state-owned company, Qianmen Department Store, was merged with Beijing Tianqiao Department Store Company and became Beijing Tianqiao Department Store Ltd. Beijing Tianqiao Department Store Ltd issued shares worth 3 million RMB. Investors could withdraw their money after three years (This is not real stock, however because of Chinese misunderstanding of shares at that time, it was regarded as stock). At the same year, after it was approved by the Shanghai Branch of People’s Bank, collective enterprise, the Shanghai Feile Acoustics entity was transformed into Shanghai Feile Acoustics Company through issuing shares to its employees and the public. It raised more than 0.5 billion yuan. The Shanghai Feile Acoustics Company did not promise to pay back initial investment and interest, thus it was regarded as the first real joint-stock company in modern China. Then, the Shanghai Yanzhong Industrial Company was reconstructed as the Shanghai Yanzhong Industrial Co. Ltd in 1985.
The real experiment in which state-owned enterprises were transferred into joint-stock companies started in Guangzhou. The government began to separate ownership from management rights. Its basic approach was to convert state assets into shares and issue some shares to employees and public. In addition, a directorate was established in these companies. Then, Shenyang, Chongqing, Wuhan gradually established joint-stock companies as well. During this period, the joint-stock company mainly was used in collective enterprises and small-sized state-owned enterprises.

The joint-stock company was a pattern of modern business organization. Its requirement for inside and outside conditions is more than that of other business organizations. However because many conditions were not mature, there was much confusion surrounding the process of joint-stock company experimentation. For instance, joint-stock companies promised shareholders could withdraw their initial investment at any time and would pay certain dividends to shareholders. Pooling of funds was their main aim. The relative mechanism of the joint-stock company did not work in these joint-stock companies.

c) Development stage (1987-1989)

Before 1987, the experimentation with the joint-stock company was carried out mainly in collective-enterprises and small-sized state-owned enterprises. The pace of establishing joint-stock companies in large-sized state-owned enterprise was very slow. In December of 1986, the State Department drew attention to some large-sized state-owned enterprises which satisfied the establishment requirements and which could carry out the experiment of a shareholding system. In 1986, eight large-sized state-owned enterprises in Shanghai first prepared for the experiment of a joint-stock company. However for some reason, only the establishment of Shanghai Vacuum Co. Ltd. Inc. was approved. Shanghai Vacuum Co.
Ltd. Inc issued over 400 million shares to the public in January 1987 and became the first large and medium-sized enterprise to carry out a shareholding system experiment in Shanghai. The change strongly impacted on other enterprises in Shanghai as well as enterprises in other provinces and enterprises in other provinces or cities followed the approach. Joint-stock companies were established in Shandong, Zhejiang, Hubei, Sichuan, Guangdong, Liaoning, even Guangxi, Yunnan and so on one after another. The number of joint-stock companies increased rapidly and that the industries and patterns in which joint-stock companies lay were more and more extensive. It included not only large-sized and small-sized enterprises but also state-owned enterprises and collective enterprises. It included industrial enterprises, transportation enterprises, and financial enterprises but also business enterprises. The joint-stock company broke through the old association production model and created a new model.

Comparing the status at this stage with that before, there had been an improvement in the regulation of shareholding system enterprises. Because of a lack of necessary knowledge and practical experience, registration and surveillance were imperfect. Many problems appeared at this stage. These problems resulted in the government taking relative measures to keep the healthy development of the shareholding system in China. These measures cooled off "the hot joint-stock company" (Zheng Zhenlong, 2000).

d) Adjustment and regulation stage (1989-1990)

Since the latter part of 1989, for political reasons and government adjustment to the overheated economy, some enterprises which had "experimented" with the shareholding system were required to "exit the experiment" in order to avoid political risk. Except for the joint-
stock companies in Shanghai and Shenzhen provinces, which remained and increased their experience, the experiment of a shareholding system in other provinces basically stopped. In theory, some criticisms of the shareholding system gradually increased. Some researchers argued that carrying out the shareholding system in China meant to carry out privatization. Marketization means to develop capitalism. In December 1990, the Seventh Plenary Session of the 13th Central Committee of the Chinese Communist Party approved suggestions on the national economy and ten year planning of social development as well as the eighth five-year plan. These suggestions proposed bond and stock issues should be gradually increased and that the government should enhance management of these issues. In some cities, stock exchanges should be established and regulated. Under these positive policies, the development of a shareholding system was sustained.

With the whole social political economy being steady, the stock market began to heat up. In March, 1990, the stock market was hot in Shenzhen and the share prices increased very rapidly. The hot Shenzhen stock market stimulated the development of the Shanghai stock market. It indicated that the adjustment stage was already finished and the new stage (under the regulation premise) started.

e) Continuous development stage (since 1991)

After several years of practice with a shareholding system, the shareholding system showed its strong development potential. Since the latter part of 1991, the shareholding system further developed. In the fourth quarter of 1991, nine joint-stock companies were established in Shanghai. In Shenzhen, eleven joint-stock companies were established. Moreover, some joint-stock companies in Shenzhen and Shanghai issued B shares.
During this stage, through exploring theories and summarizing practical experiences, the
law and requirements of the shareholding system development had already been
understood gradually. The understanding of the existence of a shareholding system had a
big impact, particularly in the speeches made by Chinese leader, Deng Xiaoping when he
inspected the northern part of China and his other speeches on furthering reform and the
experiment with the shareholding system and stock market in 1992. These led to Chinese
enthusiasm about economic reforms and the shareholding system reforms. These speeches
demonstrated the government's views in which the shareholding system was not the sole
prerogative of capitalism as it could exist in socialist countries as well. These speeches
confirmed that the shareholding system was a form of effective business organization under
the conditions of market economy and socialization production.

At this stage, the government began to regulate the establishment of the joint-stock
company. The government promulgated a series of documents concerning the shareholding
system, such as “Experiment approach on joint-stock company” promulgated by the State
Reform Commission, the State Development Planning Commission, the Ministry of
Finance, the People's Bank of China and the State Department jointly, “Regulation
suggestion on Joint-stock company” promulgated by the State Reform Commission. In
December 1993, the standing committee of the NPC promulgated “Cooperation Law of
People's Republic of China”. It greatly improved the regulation of the Chinese joint-stock
company and provided a sound basis for the regulated development of the joint-stock
company.
The Chinese Communist Party 15th Central Committee confirmed the existence of ownership structure and proclaimed that the ownership structure in China included state-ownership, collective ownership but also the joint-stock company. In addition, in this meeting, president, Jiang Zeming indicated the shareholding system was a form of modern business organization. It was beneficial to achieve the separation of ownership rights from management rights and improve the efficiency of capital operations. The shareholding system was able to be adopted by capitalism. It was also able to be adopted by socialism. Under the strong support of the government, the shareholding system continues to develop in China.

2) The reform of state-owned enterprise

In China, public-ownership enterprise includes state-owned enterprise and collective enterprises. From table 3.2, it is evident that all industrial enterprises were in public-ownership enterprises and retail, commercial and restaurant services accounted for 85.8% of the whole number of collective enterprise in 1978. Compared with that of collective enterprises, the number of state-owned enterprise is smaller. However, table 3.3 shows that industrial production by state-owned enterprises accounted for 78% of the whole country in 1978. State-owned entities played a very important role in 1978.

Therefore, the reform of state-owned enterprise became a key to Chinese economic system reform. It experienced the following development stages:
a) Increasing enterprise autonomy

This experiment of increasing enterprise autonomy was carried out in Oct. 1978. Increasing enterprise autonomy as to strengthen enterprise’s vitality was the aim of city economic reform. At this stage, reform mainly focused on adjusting profit allocation relationship between enterprise and government. Adjustment measures included the expansion of decision-making scope and a tax rate reduction and profit retention in order to enhance the autonomy of enterprises and the accountability of directors.

Table 3.2 Ownership Structure of Chinese Enterprise (1978)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number (10,000)</th>
<th>Rate</th>
<th>Retail, commercial and restaurant service Industry</th>
<th>Number (10,000)</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>8.37</td>
<td>24%</td>
<td>10.3</td>
<td>8.2%</td>
<td></td>
</tr>
<tr>
<td>Collective</td>
<td>26.47</td>
<td>76%</td>
<td>97.4</td>
<td>77.6%</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>17.8</td>
<td></td>
<td>125.5</td>
<td>14.2%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>38.84</td>
<td>100%</td>
<td>125.5</td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Beijing Weekly Newspaper (1987)

Increasing enterprise autonomy changed the accountability status as directors had not understood market demand, nor were concerned about the sales volume and profit and loss. It accelerated the change in enterprise managers’ management concepts, improved the technology progress and increased the quality of products. Enterprises improved their economic benefits. However, because there were no auxiliary measures to be taken and decision-making powers were held by different levels of government departments, the enterprise system reforms did not achieve a complete breakthrough.
b) Economic responsibility system

Economic responsibility system referred to a pattern of a comprehensive administration system. The aim of this system was to increase economic benefits under government planning, through establishing corresponding relationships among responsibilities, rights and benefits and relatively rational benefit relationships among state, enterprise and employees.

The measures allowed enterprises to retain profit surpluses after they had satisfied their profit contract. To a certain extent, it reached the aim of increasing economic benefits and bringing competitive factors into play. However, on the other hand, it also caused the problem that the funds collected by government were less than before.

c) Profit remittances replaced by income tax.

Profit remittances were replaced by income tax and the government first levied income tax at 55%. Enterprises retained some proportion of the rest after income tax was paid. Enterprises also should remit the rest of their profits according to a fixed rate, quota contract or adjustment tax.

In the second stage, profit remittance was completely replaced by income tax.

The aim of this approach was to create a competitive environment for enterprises, improved accountability of director and mobilized every positive factor of employers into play. However, in practice, this approach did not really improve the accountability of directors.
Table 3.3 Industrial Productions by Ownership of Enterprises

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>78.0</td>
<td>56.1</td>
<td>30.7</td>
</tr>
<tr>
<td>Collective</td>
<td>22.0</td>
<td>35.7</td>
<td>43.2</td>
</tr>
<tr>
<td>Private/Individual</td>
<td>0</td>
<td>4.8</td>
<td>12.5</td>
</tr>
<tr>
<td>Joint Venture/Foreign</td>
<td>0</td>
<td>3.4</td>
<td>13.6</td>
</tr>
</tbody>
</table>

Source: China Statistical Publishing House

d) Contract responsibility system

In 1988, the Chinese government promulgated "Temporal Regulation Concerning Contract and Management Responsibility System of Stated-owned Enterprise" which resulted in a contract responsibility system being adopted by state-owned enterprises. In 1988, 78% of industry enterprises (which was calculated in the government budget) carried out the contract responsibility system; 95% of large or medium-sized industry enterprises adopted the contract responsibility system. At the same time, different kinds of reforms were carried out in the enterprises in different provinces due to different industry and enterprise characteristics. These reforms included a leasing system, a shareholding system, an asset management responsibility system and so on. Through carrying out the contract responsibility system, the responsibilities and rights relationship between government and enterprises were clarified to a certain extent. The contract responsibility system played a positive role in the development of large and medium-sized enterprises. However, the shortcoming of the contract responsibility system was that it resulted in managers of enterprises focusing on short-term profits of enterprises rather than the long-term development of them.
e) Modern enterprise system

The aim of the modern enterprise system was to establish a modern enterprise system which had clear property rights, clarified responsibilities and rights and separated management from property rights according to the requirement of a socialist market economy system. The aim is to transit state-owned enterprises into enterprises, which were independent legal entities and took part in market competitive behaviour.

3) Development characteristics

Zheng Zhenlong (2000) summarizes the development characteristics of the modern Chinese joint-stock company as follows:

a) Natural emergence

The emergence of a shareholding system in China was not the result of central government and local government command. It was to satisfy the basic demand for economic development. The emergence of a shareholding system reflected the reform requirements to reform production and management approaches and business organization forms. Because there was not a similar example to follow in economic history, the Chinese designed the shareholding system themselves. Therefore, this variety of shareholding system was unique. The emergence of the shareholding system reflected the law of the economy; it had a strong vitality; it was inevitable to occur at an early stage; it satisfied the inner requirements of economic development.
b) The development of the shareholding system is very unsteady.

The emergence and development of the shareholding system in China had as its objective necessity. However for economic and politic reasons, the development of the shareholding system was unsteady.

For instance in 1984, investment and consumption showed an upward trend at the same time. Some evidence implied that the Chinese government would implement tied policies. In order to avoid fund shortages, many enterprises began to raise funds through issuing shares. However in the later part of 1989, for political reasons, the shareholding system was placed in abeyance. Not only did many enterprises attempt to give up their planning for transition into joint-stock companies, but also some joint-stock enterprises planned to give up the experiments. At the end of 1991, the reform of the shareholding system was revived. The reason was that Chinese policy makers unified their views on a shareholding system and government leaders also made up some policies to support it, both the number of listed companies increased and the variety of issued shares increased.

c) Public ownership is the Chinese main ownership form of joint-stock company.

Although the ownership structure of the Chinese joint-stock company was not as unique as before, the government was the dominating owner. The difference from the development of shareholding systems in other countries was the feature of a public ownership system, which was fully taken into account when the ownership structures were designed; in the design of the equity structure, a public system was full incorporated. In some joint-stock companies which were reconstructed on the basis of a collective enterprise, the rate of state ownership decreased, but it still dominated the company.
4) Reform of state-owned enterprise results in the emergence possibility of a stock market

The key to state-owned enterprise reform is to innovate with the system and management structure of Chinese enterprises. A stock market builds up a linkage between savings and enterprises. Through developing direct finance, an investor structure is diversified and property rights are varied. The emergence of the stock market promotes the reform of state-owned enterprise and indicates the reform direction of state-owned enterprise.

The gradual reform model mobilizes the enthusiasm of enterprises and employees into play through adjusting the profit allocation structure and changing the income allocation structure among government, enterprises and residents. The reform model resulted in the change to the social capital accumulation structure and formed a substantial decentralized savings potential and provided the subjective possibility for the emergence of a stock market.

Increasing autonomy and permitting enterprise to retain profit resulted in capital flowing into the enterprise and individuals from government. The Chinese economic reform process was accompanied by high and steady growth of national savings. From table 3.4, it can be seen that in 1978, residential savings accounted for 23% of total savings; enterprises accounted for 34% of total savings; government accounted for 43% of total savings; in 1988, the three rates were 62%, 30% and 7% respectively. The residential savings rate increased greatly. Compared with the increase in residential savings, the government savings rate rapidly decreased. The enterprise saving rate decreased a little. In 1995, the residential savings rate continued to go up to 70%. However, the government savings rate fell down to 5%; enterprise savings percentage decreased to 25%.
Table 3.4 The Change in Chinese Savings Structure

<table>
<thead>
<tr>
<th>Domestic Source %</th>
<th>Saving Source</th>
<th>1978</th>
<th>1988</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td></td>
<td>43</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Enterprise</td>
<td></td>
<td>34</td>
<td>30</td>
<td>25</td>
</tr>
<tr>
<td>Chinese Resident</td>
<td></td>
<td>23</td>
<td>62</td>
<td>70</td>
</tr>
</tbody>
</table>


On the other hand, the structure of national income also changed. Table 3.5 shows increasing autonomy and permitting enterprise to retain capital resulted in the rate of government income in national income to decrease from 23.5% in 1978 to 12% in 1995. But the rate of family savings increased from 64.4% in 1978 to 77.5% in 1988.

In addition, the replacement of the state budget grant by bank loans changed the financial distribution of enterprises. Fixed capital and current assets of enterprises basically were obtained from banks. The rate of residential savings in the national production value increased from 6% in 1978 to 46% in 1991. At the same time, in the total budget and funds for fixed assets and current assets lent from banks, the rate of bank loans increased from 39% in 1978 to 73% in 1997. From 1981 to 1990, the rate of domestic bank loans in fixed asset loans increased from 13% to about 20%. The rate of bank loans in current assets accounted for above 80% of current assets (Cao Fengzhi, 1998).

Because banks did not carry out reform, the monopoly of the state bank resulted in the high debt rate of enterprises and the existence of substantial bad debts. Abundance of residential savings created the possibility of the stock market emergence. The high debt rate of
enterprises and substantial bad bank debts existed at the same time, and created the necessity for enterprises to seek new financial channels.

Table 3.5 Final Allocation Structure of National Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>23.50</td>
<td>11.70</td>
<td>12.00</td>
</tr>
<tr>
<td>Enterprise</td>
<td>12.10</td>
<td>10.80</td>
<td>10.00</td>
</tr>
<tr>
<td>Family</td>
<td>64.40</td>
<td>77.50</td>
<td>78.00</td>
</tr>
</tbody>
</table>


5) Stock market and state-owned enterprise reform

a) The impact of the stock market on the property right structure of state-owned enterprises

Diversifying property rights is one of functions of joint-stock companies. Through the stock market, on the one hand, new capital has an opportunity to be invested in state-owned enterprises; on the other hand, property rights of state-owned enterprises can be transferred to other investors through trading in a secondary market.

In the stock market, trading in shares implies that the owners' right to shares is transferred. The aims for investors are to obtain profit or take over enterprises. Through the stock market, property rights of state-owned enterprises can be clarified. The direct interruption of the government in enterprise management will lose its subjective basis and rationale. It will be beneficial for enterprises to become a legal entity, which can make decisions, balance their losses and profits and develop by themselves.
b) Stock market and financial channel

Direct finance means the final capital user directly raises capital from the initial owner.

1) The stock market as one of the direct financial channels can provide a new financial channel for Chinese enterprises and change the status of this unique financial channel. Prior to financial reform, transformation of residential savings into investments was mainly achieved through bank and fiscal appropriation in China. Under this financial system, a bank had to take all risk on one hand. On the other hand, low efficiency of the bank resulted in a waste of resources. Increasing the rate of direct finance can weaken the dependence of enterprises on bank loans and reduce the risk of the bank. Direct finance is benefit for the enterprise as well as the bank.

2) Direct finance is of benefit for enterprises to enable them to improve their capital structure.

3) Promoting cooperative governance of joint-stock companies

The stock market is an information market. Share prices reflect all basic information pertaining to listed companies such as earnings, the ability of managers, asset increases. Investors depend on company information to make investment strategies. If the joint-stock companies regard the stock market as their long-term steady financial channel, they are willing to provide accurate information. Information should be the basis for evaluating and supervising the performance of the enterprise’s manager. The approach to oversight of a listed company can be divided into the following kinds, outside surveillance, option contracts on the basis of stock prices and direct interruption by shareholders. Outside surveillance and option contracts are apparently dependant on the fundamentals of stock
prices. The third approach is on the basis of evaluation of the company’s performance as well. In short, the stock market creates a surveillance and evaluation mechanism for the performance of managers.

The liquidation facility of stock markets plays a role for enterprises to change management mechanisms. The liquidation function of the stock market gives a shareholder the right to sell their shares when they are dissatisfied with the performance of a listed company. If the liquidation function of stock market is restricted, the pressure placed on managers will be very weak. Therefore, liquidation in the stock market promotes cooperate governance of joint-stock companies.

4) The impact of the stock market on allocation and reallocation of enterprise capital
Allocation and reallocation of resources is an intrinsic adjustment mechanism of the stock market. In the process of state-owned enterprise reform, the stock market promoted state-owned enterprises to achieve optimum structures. Resource reallocation refers to adjustments to enterprise organization structure through changing property right between different enterprises. In practice, reallocation is achieved through mergers, acquisitions, takeovers or bankruptcy. It changes and optimizes property right structures and capital structures. Reallocation perfects enterprise’s governance, increases enterprise capital, rationalizes the debt rate and reduces production costs. Reallocation is a kind of mechanism and approach in order to optimize allocation. The function of an enterprise is to establish an optimum portfolio for capital, labour, technology, and management in order to obtain the highest economic benefit. In a modern market economy, the production technology condition is continuously changed. The demands of the market also
continuously change. Because of the inside motivation of pursuing capital maximization and outside compulsory power of market competition, enterprises always sustain to reorganize production factors in order to be the same with market environmental change.

The stock market breaks the allocation structure of an administration institution. On the one hand, Chinese enterprises have opportunities to obtain new capital assets through the stock market so as to reduce the pressure emerging in the transition. On the other hand, through the stock market, an enterprise can hold some shares of other companies or take over other enterprises, thus utilizing the assets efficiently through merger, acquisition or take-over.

3.5 Conclusion

The joint-stock company emerged and developed in the environment of modern capitalist development. It is a kind of enterprise organization form, which is suitable to the modern market economy, and it is evident in practice that it is a strong, vital element in capitalist society. With the development of the joint-stock company, the stock market is established so as to satisfy the requirements of the public company to issue shares and exchange their shares. Compared with the development of joint-stock companies and stock markets in western countries, China fell behind these countries nearly 300 years ago. In China, the word, “security”, was cited from Japan. Shares and the stock market emerged at the end of the Qing Dynasty. Its development was very abnormal and has a strong semi-feudal and semi-colonial character. No matter, the joint-stock company or the stock exchange, both were issued or were established by foreign businessmen. Later, it was followed by Chinese businessmen. The function of a stock market was only to absorb individual funds. The function of resource allocation had not been performed. Because of weak surveillance and
consecutive wars, stock markets became the paradise for speculation and the place where a dynasty plunders the property of other Chinese. In addition, this chapter also analyzed the reemergence of and reasons for the joint-stock company and the stock market in China. Chapter four will analyze the development status of the Chinese stock market.
4.1 Introduction

In 1978, the joint-stock company re-emerged in China. Then in 1990 & 1991 the Shanghai and Shenzhen stock exchanges were successively established. The stock market, as a new financial channel, promoted the development of the Chinese economy. In this chapter, internal-comparisons and a comparison between the Chinese stock market and other stock markets will be made in order to see the pace of development and the gap between the Chinese stock market and other markets.

4.2 Emergence and Development before the Establishment of the Chinese Stock Exchange

In December 1984, Feile Acoustic Ltd issued shares to the public. Raising funds through the issuing of shares gradually became an important financial approach for Chinese companies. Over the period 1984-1986, the government did not establish a market for investors to trade shares. Trading was done in a decentralized form. Because of such problems as the black market, the Chinese government began to regulate the behaviour of investors through the enactment of regulations and the establishment of stock exchanges. During the regulation process, the Chinese government first established over-the-counter trading and this was followed by the Shenzheng stock market and the Shanghai stock market being established. The establishment of these two stock markets indicated that trade behaviour had stepped up from a decentralized stage into a centralized stage. In his book,
“Institutional Changes and Impacts on the Evolution of Chinese Stock Market”, Hu Jizhi divided the development of the Chinese stock market into three stages and analyzed the evolution process:

1) Early stage (1984-1986)

After Feile Acoustic Ltd issued shares to the public, the shareholders proposed a requirement of trading shares with the Chinese government and some shareholders spontaneously traded their shares with each other. Complying with the requirement, the Shanghai branch of the People’s Bank of China formulated some corresponding regulations. The regulations stipulated that shareholders themselves had to seek out the people who were willing to buy their shares and they settled some procedures within the institution which initially issued the shares on behalf of joint-stock companies. The price was equal to face value plus the short-term interest rate. The trade approach was definitely very inconvenient and the cost was very high and caused the emergence of brokers. These brokers collected information from both sides and charged money for this service. This status lasted for two years.

2) Over-the-counter stage (1986-1989)

At the end of the two years, local government began to regulate the trade behaviour of investors and established over-the-counter trading in order to meet the requirements of liquidity. On 26 September 1986, with the approval of the Shanghai branch of the People’s Bank of China, the first institution, Jingan Xintuo (Jingan Trust Company), which dealt with the trading of shares, was established. However the stipulation on price was not cancelled. Price was equal to face value plus the expected dividend. Because of the price limitation, trading was not active.
Because of the different attitudes between the Shanghaiee and the Shenzhenee towards the stock market, the trade status of the Shenzhen and the Shanghai stock markets was quite different. The stock market crisis, which occurred before 1949, remained fresh in the Shanghaiee's memory and therefore the majority of the Shanghaiees showed an indifference towards these changes. The share prices on the Shanghai stock market only fluctuated within a small range. If the Jingan index designed by the Shanghai trust company was used to measure the fluctuations at that time and the index of 2 November 1987 was considered as a base, the index only reached 115 in January, 1988 and later receded. At the end of 1988, despite there being a rebound, it then plummeted to the lowest point of 83 in November, 1989.

Compared with the development of the Shanghai stock market and despite the development of the Shenzhen stock market being late, the positive attitude of Shenzhen government towards the stock market and the stock of the Shenzhen government enabled its development to be faster than that of the Shanghai stock market. In May 1987, the Shenzhen Development Bank first issued ordinary shares to the public. In order to adapt the development of the stock market as had been approved by the general bank of the People's Bank of China, twelve financial institutions jointly established the first security company, "Shenzhen Economic Special Zone Security Company". In April 1988, this company began to act as an agent to trade shares of the Shenzhen Development Bank, and with the positive attitude of the Shenzheng government towards stock and the stock market and the high dividend payment by the Shenzhen Development Bank in particular, the trading on the Shenzhen stock market was more active than that on the Shanghai stock market.
With the development of the stock market, the government eliminated the price limitations of over-the-counter trading. The information segmentation at different over-the-counter centres, caused the prices of the same shares to differ within various security institutions, thus creating arbitrage opportunities for speculators. Table 4.1 shows the price differences of the same shares at different over-the-counter centres.

In addition, because the number of over-the-counter trades was considerable, the trading approach adopted by over-the-counter sales was less underdeveloped and in particular, the demand for shares outstripped the supply. The black market exited at this period.

3) Later period of over-the-counter stage

In the Shenzhen stock market, the high returns of the Shenzhen Development Bank left a deep impression on the Chinese. In March 1990, the Shenzhen Development Bank split their shares. One share was split into 20. In addition, they paid share dividends to shareholders according to the share number after the split. Payment detail showed that shareholders with two shares were paid another one as a share dividend. At the same time, 218,179 shares were offered to the old shareholders at 71.2 RMB per share as a rights offer. Such a high dividend payment attracted substantial capital to flow in. In March 1990, the Shenzhen stock market began to “heat up”.

In order to avoid share prices rising too rapidly, the Shenzhen government promulgated a bulletin. The bulletin announced that trading had to be done through the security of intermediate institutions and they cancelled old regulations, which had permitted trading to occur outside of security companies and they settled procedures within security companies.
On 30 May, 1990, in order to restrict trading on the black market, the Shenzhen branch of the People's Bank of China promulgated "Contemporary Regulations on the Current Over-the-counter Trade in Shenzhen", stipulating that trade had to be done through holding efficient identification and 10% was stipulated as the price fluctuation range. After these policies were announced, the stock market did not cool off. On the contrary, share prices sustained a rise. On 18 June, 1990, the Shenzhen branch of the People's Bank of China changed the price fluctuation range to 5%. The market price continued to climb at a lower speed. On 26 June 1990, the fluctuation range was changed to 1% of the ceiling price and 5% of the floor price.

Price limitation measures made it difficult for large shareholders to get a high capital gain. Therefore, large shareholders who obtained a high return in Shenzhen sold their shares and brought their money to buy shares in Shanghai in May and June, 1990. It greatly stimulated the Shanghai stock market. In addition, the State Department approved the establishment of the Shanghai stock exchange. This dispelled the doubt of the Shanghai residents towards this new event as did the wealth effect created on the Shenzhen stock market. "The great increase in the share price on the Shanghai stock market was influenced by the entry of the enormous investments from Shenzhen" (Zhang Shuguang, 1996, pp. 37-38). The rapid increase in the share price on the Shanghai stock market and trading in the black market attracted the attention of the Shanghai government. Similar to the Shenzhen government, the Shanghai government took some corresponding measures as well. On 3 August 1990, the Shanghai branch of the People's Bank of China sent notification to all financial institutions, which were dealing with the over-the-counter trade aiming to restrict the rapid increase of share prices as well as to stop trade on the black market. However, because demand was more
than supply, these limitation measures did not slacken the increased speed of fluctuations in share prices. For instance, after the price fluctuation range was stipulated, the share price rose at the speed of 1% each day and the trend of the share price showed that it would continue to increase. Who was willing to sell the "cornucopia" to others? The aim of limiting price is to stop the up or down trend of share prices. However, in practice, these policies did not create these effects but rather aggravated the up or down trend. The result was that the supply-demand mechanism, the competition mechanism and the risk mechanism lost their function and protracted the period of price increases and also extend the total increase range of price. In addition, after the implementation of the price fluctuation limitation, investors could not buy shares through the normal channels. Some people who wanted to be rich had no choice but to take a high risk through the black market in order to buy. These management measures did not stop trade on the black market but on the contrary made it become more active. The Table 4.2 shows the share prices of several stocks on the black market and reflects the trade status of the black market at this period. The Shenzhen government then sent out notification entitled "Enhancing stock market management and cancelling illegal trade outside of the stock market" and the black market began to slump.

The Shanghai stock exchange and the Shenzhen stock exchange separately and formally opened business on 19 December 1990 and 1 December 1990. The establishment of the two exchanges closed down decentralized trade and initiated central trading. The change improved market efficiency and stopped the black market.
4.3 Development of the Stock Market

4.3.1 Internal-comparison.

Since the Chinese stock markets were established in 1990, they have accumulated more than ten years of history. During this period, the two stock markets have expanded, and gradually developed from local markets into nationwide markets and they now play a continually important role in the Chinese economy. This development and their current status can be seen by making a comparison with other stock markets and financial channels:

1) The number of listed companies.

Figure 4.1 shows that, in 1990, the number of listed companies was 10. In 2002, the number of listed companies had increased to 1224. The number of listed companies in 2002 was nearly 122 times more than in 1990. Its annual average increase over this period was 10.

2) The market capitalization.

In figure 4.2, the market capitalization in 1990 was 3000 million RMB. At the end of 2002, it increased to 3832912 million RMB. The market capitalization in 2002 was 1278 times more than that in 1990. The annual average increase over time was 106.5.

3) The number of issued shares.

In figure 4.3, in 1990, the number of issued shares was 261 million. At the end of 2002, the number of issued shares was 546,299 million. The number in 2002 increased by 2093 times from that in 1990. The annual average increase over time was 174.
4) The proportion of GDP in trade volume and total market capitalization.

The proportion of total market capitalization in GDP was a very important index with which to measure the level of securitization. In Table 4.3, the proportion of market capitalization in GDP in 1993 was 10.22%. In 2002, market capitalization accounted for 37.89% of GDP. The proportion of trade volume in GDP also increased from 2.49% in 1993 to 27.67% in 1999. The two indexes show that the impact of the stock market on the Chinese economy was becoming stronger and stronger.

4.3.2 Comparison with other financial channels.

Table 4.4 shows that the rate of equity finance in the total financial amount increased very rapidly. At the end of 1995, the rate of share capitalization in the total financial amount was 36.92%. At the end of 2000, the rate was up to 68.4%. Compared with other financial alternatives, it can be seen that the financial ability of equity was stronger than previously. However, at the end of 2001, the rate of equity finance decreased to 1.01%. Although the amount of equity finance increased, it did not make a significant difference.

4.3.3 Comparison with other stock markets.

In comparison with other stock markets, the development pace and gap between the Chinese stock market and other stock markets is apparent. The London stock exchange, the New York stock exchange, the Tokyo stock exchange, and other developed stock markets in Asia such as the Australian stock exchange, the Hong Kong stock exchange and the Singapore stock exchange, along with some emerging stock markets in Asia and some stock markets in transition countries are selected as examples.
First of all, the rates of increases of listed companies from 1993 to 2001 are compared. From Table 4.5, the average rates of increase of the HK stock exchange and the Singapore and Australia stock exchanges are higher than those of the New York stock exchange, the London stock exchange and the Tokyo stock exchange. Compared with the average annual rate of increase of 1.62% on the Tokyo stock exchange, 0.29% on the New York stock exchange, 2.78% on the London stock exchange, 3.34% on the Australian stock exchange, 9.49% on the Hong Kong stock exchange and 11.2% on the Singapore stock exchange, the average rate of increase of listed companies in China is 52.67%. The average rate of increase of listed companies on the Chinese stock exchanges is much higher than that of other developed stock exchanges. All rates of increase of listed companies on Chinese stock exchanges are positive and rapid increases occurred in 1993, 1994, 1996 and 1997. The average rate of increase of listed companies on Chinese stock exchanges was also much higher than that on the main emerging stock markets. It can be seen from Table 4.5 that among the main emerging stock markets, the highest average rate of increase of listed companies was the Taiwan stock market. The average rate of increase was 10.25%. The rate of increase was much lower than that of the lowest rate of increase on the Chinese stock market. Compared with the stock exchanges in transition countries, only the average rate of increase in Romania is higher than that on the Chinese stock market.

From table 4.9, it can also be seen that the number of listed companies on the Chinese stock market is bigger in comparison with those on other main emerging stock markets except for the number of listed companies in India and Korea. The number of listed companies on the Chinese stock market is also bigger than that on the Hong Kong and Singapore stock exchanges. The number of listed companies on stock markets in majority transition
countries is smaller than those on the Chinese stock market. In addition, the average size of listed companies on the Chinese stock market was bigger than that in all transitional countries, emerging stock markets except for the Taiwan stock market and the Australian stock market.

In regard to the rate of increase of the total market capitalization, the development pace of the Chinese stock market was also very rapid. From Table 4.6, it can be seen that from 1993 to 2001, the average rate of increase of total market capitalization of the main emerging stock markets in Asia was 18.32%. The highest average rate of increase of the total market capitalization of emerging stock markets in Asia was that of Korea, 33.30%. From Table 4.6, the average rate of increase in the total market capitalization of the main developed stock markets was only 14.44% during the same period. The average rates of increase in the total capitalization on the HK stock market and the Singapore stock market was 21.16% and 23.14%. Compared with these average rates of increase, the average rate of increase of the Chinese stock market was much higher at 55.44%. The average rates of increase in market capitalization of stock markets in transition countries were much higher than those on the Chinese stock market. This was mainly caused by the rapid increase on the Russian and Romanian stock markets.

Although the development of the Chinese stock market was very rapid, there existed a big gap between it, emerging stock markets and other developed stock markets. This gap reflects the following aspects: 1) The total market capitalization 2) The rate of total market capitalization in GDP. 3) The number of listed companies and the average size of listed companies. From the above analysis, it can be seen that the increased speed of the total
market capitalization of the Chinese stock market was faster than that of the New York stock exchange, the Tokyo stock exchange, the London stock exchange and the Australian stock exchange. However, the absolute market capitalization of the Chinese stock market is much smaller than that of the New York stock exchange, the Tokyo stock exchange and the London stock exchange. The absolute market capitalization of the Chinese stock market at the end of 2001 was only 23.27% of the Tokyo stock market, 3.79% of the New York stock market and 23.63% of the London stock exchange.

The rate of the total market capitalization in GDP will now be analyzed. The rate shows the impact of stock market development on the economy of a country. Generally, if the rate is high, it indicates the securitization rate of a country is high and implies that the stock market has had a strong impact on the economy of the country. From table 4.8, it can be seen that the securitization rate of China was lower than that of the main developing countries, but that it was close to that of Japan in 2000. Among emerging stock markets, the securitization rate of Malaysia in 2000 was the highest. The average securitization rate of Malaysia from 1993 to 2000 was 209.20%. The average securitization rate from 1993 to 2000 and securitization rate in 2000 of Taiwan was also higher than that of China. Compared with that of transition countries, the securitization rate of China was much higher in 2000. The transition country, which had the highest securitization rate, was Russia, 30.34%. The securitization rate of China increased from 4.37% in 1993 to 53.80% in 2000.

The gap can also be reflected in the number of listed companies and the average size of listed companies. From table 4.9, it can be seen that there are fewer listed companies on the
Chinese stock market than on the Tokyo, London, New York and Australian stock exchanges. At the end of 2001, the number of listed companies on the Tokyo stock exchange was up to 2471. The number of listed companies on the New York stock exchange was up to 6355. The number of listed companies on the London stock exchange was 1923. The number of listed companies on the Australian stock exchange was 1334. But the total number of listed companies on the Shanghai and Shenzhen exchanges was 1160. In 2001, the average size of listed companies on the Chinese stock market was 451.7 US$ Million. It was smaller than 590.6 US$ Million and 501.1 US$ Million of the average size of listed companies in the Hong Kong and Taiwan regions. The average size of listed companies on the Chinese stock market was only 49.57% of the average size of Japanese companies, 39.17% of average size of UK companies and 20.79% of the average size of US companies.

4.4 Conclusion

In this chapter, the early development just before the re-emergence of the Chinese stock exchange is first introduced. Then, features of its later development are indicated by internal-comparison and comparison with other stock markets and other financial channels.

Through the analysis, it can be seen that the development pace of the Chinese stock market has been very fast, but the development level is still very low. The next chapter will further analyze the development status of the Chinese stock market from the investor point of view.
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SDB: Shenzhen Development Bank

WK: Wanke Company

JT: Jintian Company

AD: Anda Company
Table 4.1 Price Gap in Shanghai Over-the-counter on 28 December, 1989 (Unit: RMB)

<table>
<thead>
<tr>
<th></th>
<th>Vacuum Electricity Co.</th>
<th>Feile Acoustics Ltd.</th>
<th>Yanzhong</th>
<th>Feile Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jingan Trust</td>
<td>101.10</td>
<td>50.50</td>
<td>50.80</td>
<td>101.80</td>
</tr>
<tr>
<td>Hongkou Trust</td>
<td>98.80</td>
<td>49.80</td>
<td>50.00</td>
<td>99.50</td>
</tr>
<tr>
<td>Difference</td>
<td>2.30</td>
<td>0.7</td>
<td>0.8</td>
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Table 4.7 The Proportion of Market Capitalization in GDP (2001)

<table>
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<th>US</th>
<th>UK</th>
<th>Japan</th>
<th>Australia</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Proportion of</td>
<td>137.21%</td>
<td>155.70%</td>
<td>54.37%</td>
<td>101.51%</td>
<td>53.80%</td>
</tr>
<tr>
<td>Market Capitalization</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>in GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>21.67%</td>
<td>15.50%</td>
<td>19.83%</td>
<td>30.34%</td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Russia</td>
<td></td>
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Table 4.3 The Proportion of Market Capitalization in GDP and the Proportion of Trade Volume in GDP (%)

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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportion of market capitalization in GDP</td>
<td>10.22</td>
<td>7.91</td>
<td>6.04</td>
<td>14.72</td>
<td>23.97</td>
<td>25.00</td>
<td>32.26</td>
<td>30.00</td>
<td>45.75</td>
<td>37.89</td>
</tr>
<tr>
<td>Proportion of trade volume in GDP</td>
<td>2.49</td>
<td>2.08</td>
<td>1.63</td>
<td>4.29</td>
<td>7.11</td>
<td>7.36</td>
<td>10.01</td>
<td>68.97</td>
<td>40.27</td>
<td>27.67</td>
</tr>
</tbody>
</table>

Source: China Statistic Year Book and CSRC
Note: It is the result of calculation on the basis of data

Table 4.9 Size and Number Comparison of Listed Companies on Developed Stock Markets, Emerging stock markets and Stock markets in Transition Countries (2001) (Unit: US$ Million)

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>UK</th>
<th>Japan</th>
<th>Australia</th>
<th>HK</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Size</td>
<td>2173.2</td>
<td>1153.1</td>
<td>911.3</td>
<td>280.6</td>
<td>590.6</td>
<td>304</td>
</tr>
<tr>
<td>Number</td>
<td>6355</td>
<td>1923</td>
<td>2471</td>
<td>1334</td>
<td>857</td>
<td>386</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Region</th>
<th>China</th>
<th>Korea</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Indonesia</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Size</td>
<td>501.1</td>
<td>156.2</td>
<td>148.2</td>
<td>80.9</td>
<td>72.8</td>
<td>19.1</td>
</tr>
<tr>
<td>Number</td>
<td>584</td>
<td>1409</td>
<td>809</td>
<td>449</td>
<td>316</td>
<td>5795</td>
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<table>
<thead>
<tr>
<th>Russia</th>
<th>Hungary</th>
<th>Poland</th>
<th>Czech Re.</th>
<th>Romania</th>
</tr>
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<tbody>
<tr>
<td>Average Size</td>
<td>322.9</td>
<td>113.1</td>
<td>99.3</td>
<td>0.4</td>
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<td>Number</td>
<td>236</td>
<td>230</td>
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### Table 4.4 Comparisons of Different Financial Channels

<table>
<thead>
<tr>
<th></th>
<th>1995 Capitalization (100 million)</th>
<th>1995 Rate%</th>
<th>2000 Capitalization (100 million)</th>
<th>2000 Rate%</th>
<th>2001 Capitalization (100 million)</th>
<th>2001 Rate%</th>
<th>2002 Capitalization (100 million)</th>
<th>2002 Rate%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury</td>
<td>3300.30</td>
<td>36.81</td>
<td>13674.00</td>
<td>19.71</td>
<td>4884.00</td>
<td>163.34%</td>
<td>5934.00</td>
<td>62.79</td>
</tr>
<tr>
<td>Financial Bond</td>
<td>1708.49</td>
<td>19.06</td>
<td>7383.28</td>
<td>10.64</td>
<td>2590.00</td>
<td>33.64%</td>
<td>3075.00</td>
<td>32.54</td>
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<tr>
<td>Enterprise Bond</td>
<td>646.61</td>
<td>7.21</td>
<td>861.63</td>
<td>1.24</td>
<td>147.00</td>
<td>1.91%</td>
<td>325.00</td>
<td>3.44</td>
</tr>
<tr>
<td>A share</td>
<td>3310.57</td>
<td>36.92</td>
<td>47455.75</td>
<td>68.4</td>
<td>77.62</td>
<td>1.01%</td>
<td>117.15</td>
<td>1.24</td>
</tr>
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</table>


### Table 4.8 Securitization Comparisons among Emerging Stock Markets

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<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
<th>Av.</th>
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</thead>
<tbody>
<tr>
<td>Taiwan</td>
<td>47.67%</td>
<td>87.68%</td>
<td>102.62%</td>
<td>71.94%</td>
<td>100.47%</td>
<td>101.60%</td>
<td>99.76%</td>
<td>130.61%</td>
<td>79.85%</td>
<td>91.36%</td>
</tr>
<tr>
<td>India</td>
<td>24.69%</td>
<td>35.05%</td>
<td>38.58%</td>
<td>20.06%</td>
<td>30.87%</td>
<td>24.46%</td>
<td>41.46%</td>
<td>32.40%</td>
<td>32.51%</td>
<td>30.90%</td>
</tr>
<tr>
<td>Korea</td>
<td>34.14%</td>
<td>40.33%</td>
<td>47.64%</td>
<td>37.19%</td>
<td>26.69%</td>
<td>8.79%</td>
<td>35.73%</td>
<td>75.98%</td>
<td>32.51%</td>
<td>37.67%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>161.22%</td>
<td>343.30%</td>
<td>274.85%</td>
<td>255.02%</td>
<td>304.59%</td>
<td>93.42%</td>
<td>135.96%</td>
<td>184.02%</td>
<td>130.42%</td>
<td>209.20%</td>
</tr>
<tr>
<td>Thailand</td>
<td>52.27%</td>
<td>104.23%</td>
<td>91.07%</td>
<td>84.17%</td>
<td>55.02%</td>
<td>15.79%</td>
<td>31.35%</td>
<td>47.82%</td>
<td>24.14%</td>
<td>56.21%</td>
</tr>
<tr>
<td>China</td>
<td>4.37%</td>
<td>9.40%</td>
<td>8.02%</td>
<td>6.01%</td>
<td>13.93%</td>
<td>22.97%</td>
<td>24.12%</td>
<td>33.36%</td>
<td>53.80%</td>
<td>19.55%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>8.65%</td>
<td>20.86%</td>
<td>26.71%</td>
<td>32.94%</td>
<td>40.03%</td>
<td>13.49%</td>
<td>23.48%</td>
<td>45.35%</td>
<td>17.51%</td>
<td>25.45%</td>
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</table>

Table 4.5 Comparison of Increase Speed of Listed Companies among Developed Stock Exchanges, Emerging Stock Exchanges and Stock Markets in Transition Countries

<table>
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<tr>
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<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
<th>2001</th>
<th>Av.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>1.75%</td>
<td>2.32%</td>
<td>2.63%</td>
<td>3.14%</td>
<td>2.27%</td>
<td>1.21%</td>
<td>2.24%</td>
<td>3.68%</td>
<td>-3.51%</td>
<td>1.62%</td>
</tr>
<tr>
<td>UK</td>
<td>-12.17%</td>
<td>25.76%</td>
<td>0.39%</td>
<td>17.08%</td>
<td>-15.91%</td>
<td>17.25%</td>
<td>-18.93%</td>
<td>-2.11%</td>
<td>1.00%</td>
<td>2.78%</td>
</tr>
<tr>
<td>US</td>
<td>8.17%</td>
<td>6.16%</td>
<td>-0.27%</td>
<td>10.53%</td>
<td>4.39%</td>
<td>-4.53%</td>
<td>-9.46%</td>
<td>-1.67%</td>
<td>-15.54%</td>
<td>0.29%</td>
</tr>
<tr>
<td>Australia</td>
<td>3.88%</td>
<td>10.84%</td>
<td>-0.68%</td>
<td>1.02%</td>
<td>-2.61%</td>
<td>0.26%</td>
<td>4.73%</td>
<td>9.29%</td>
<td>0.30%</td>
<td>3.34%</td>
</tr>
<tr>
<td>HK Region</td>
<td>16.58%</td>
<td>17.56%</td>
<td>-2.08%</td>
<td>8.30%</td>
<td>19.61%</td>
<td>3.28%</td>
<td>3.46%</td>
<td>8.65%</td>
<td>10.01%</td>
<td>9.49%</td>
</tr>
<tr>
<td>Singapore</td>
<td>9.20%</td>
<td>34.83%</td>
<td>-11.67%</td>
<td>5.19%</td>
<td>35.87%</td>
<td>5.94%</td>
<td>10.59%</td>
<td>17.75%</td>
<td>-7.66%</td>
<td>11.12%</td>
</tr>
<tr>
<td>Average</td>
<td>4.77%</td>
<td>7.68%</td>
<td>4.20%</td>
<td>8.56%</td>
<td>5.18%</td>
<td>3.24%</td>
<td>6.38%</td>
<td>5.85%</td>
<td>8.43%</td>
<td>4.77%</td>
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</table>

<table>
<thead>
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<th>Country</th>
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<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
<th>2001</th>
<th>Av.</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>251.92%</td>
<td>59.02%</td>
<td>11.00%</td>
<td>67.18%</td>
<td>37.59%</td>
<td>14.80%</td>
<td>11.37%</td>
<td>14.32%</td>
<td>6.81%</td>
<td>52.67%</td>
</tr>
<tr>
<td>Korea</td>
<td>0.73%</td>
<td>0.87%</td>
<td>3.15%</td>
<td>5.41%</td>
<td>2.11%</td>
<td>-3.61%</td>
<td>-3.08%</td>
<td>80.41%</td>
<td>7.72%</td>
<td>9.40%</td>
</tr>
<tr>
<td>Taiwan Region</td>
<td>11.33%</td>
<td>9.82%</td>
<td>10.86%</td>
<td>10.09%</td>
<td>5.76%</td>
<td>8.17%</td>
<td>5.72%</td>
<td>14.94%</td>
<td>9.98%</td>
<td>10.25%</td>
</tr>
<tr>
<td>Thailand</td>
<td>13.77%</td>
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<td>6.94%</td>
<td>9.13%</td>
<td>-5.07%</td>
<td>-3.02%</td>
<td>-6.22%</td>
<td>-2.81%</td>
<td>17.85%</td>
<td>4.27%</td>
</tr>
<tr>
<td>India</td>
<td>3.98%</td>
<td>2.94%</td>
<td>14.07%</td>
<td>10.21%</td>
<td>-33.60%</td>
<td>0.29%</td>
<td>0.05%</td>
<td>1.26%</td>
<td>-2.40%</td>
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</tr>
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<td>3.95%</td>
<td>2.85%</td>
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<td>1.76%</td>
<td>9.83%</td>
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<td>1.71%</td>
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<td>72.29%</td>
<td>38.46%</td>
<td>11.62%</td>
<td>1.81%</td>
<td>2.22%</td>
<td>33.93%</td>
</tr>
<tr>
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<td>5.00%</td>
<td>7.14%</td>
<td>8.89%</td>
<td>12.24%</td>
<td>20.00%</td>
<td>-9.09%</td>
<td>-5.00%</td>
<td>10.38%</td>
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<td>1.25%</td>
<td>4.64%</td>
<td>-7.47%</td>
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<td>16.68%</td>
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</tr>
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<td>-82.62%</td>
<td>-5.43%</td>
<td>-37.17%</td>
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<td>-28.24%</td>
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Table 4.6 Comparison of Market Capitalization among Developed Stock Markets, Emerging Stock Markets and Transition Stock Markets

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<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
<th>2001</th>
<th>Av.</th>
</tr>
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<tbody>
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<td>Japan</td>
<td>25.04%</td>
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<td>-1.42%</td>
<td>-15.77%</td>
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<td>12.59%</td>
<td>82.19%</td>
<td>-30.56%</td>
<td>-28.68%</td>
<td>4.35%</td>
</tr>
<tr>
<td>UK</td>
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<td>5.09%</td>
<td>16.32%</td>
<td>23.62%</td>
<td>14.71%</td>
<td>18.94%</td>
<td>23.54%</td>
<td>-12.15%</td>
<td>-13.96%</td>
<td>11.15%</td>
</tr>
<tr>
<td>US</td>
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<td>35.34%</td>
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<td>18.95%</td>
<td>23.67%</td>
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<td>-8.57%</td>
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</tr>
<tr>
<td>Australia</td>
<td>41.64%</td>
<td>6.83%</td>
<td>12.04%</td>
<td>27.23%</td>
<td>-5.19%</td>
<td>11.21%</td>
<td>30.01%</td>
<td>-12.83%</td>
<td>0.40%</td>
<td>12.37%</td>
</tr>
<tr>
<td>HK</td>
<td>123.84%</td>
<td>-30.04%</td>
<td>12.69%</td>
<td>47.97%</td>
<td>-8.02%</td>
<td>-16.92%</td>
<td>77.37%</td>
<td>2.34%</td>
<td>-18.81%</td>
<td>21.16%</td>
</tr>
<tr>
<td>Singapore</td>
<td>171.91%</td>
<td>1.34%</td>
<td>10.03%</td>
<td>1.49%</td>
<td>-29.22%</td>
<td>-11.14%</td>
<td>110.02%</td>
<td>-22.97%</td>
<td>-23.22%</td>
<td>23.14%</td>
</tr>
<tr>
<td>Average</td>
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<td>7.28%</td>
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<td>170.49%</td>
<td>81.41%</td>
<td>12.09%</td>
<td>42.96%</td>
<td>75.68%</td>
<td>-9.82%</td>
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<th>2000</th>
<th>2001</th>
<th>Av.</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>122.22%</td>
<td>7.28%</td>
<td>-3.37%</td>
<td>170.49%</td>
<td>81.41%</td>
<td>12.09%</td>
<td>42.96%</td>
<td>75.68%</td>
<td>-9.82%</td>
<td>55.44%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>93.03%</td>
<td>26.70%</td>
<td>-24.31%</td>
<td>6.15%</td>
<td>5.19%</td>
<td>-9.66%</td>
<td>44.60%</td>
<td>-34.15%</td>
<td>18.18%</td>
<td>13.97%</td>
</tr>
<tr>
<td>India</td>
<td>50.46%</td>
<td>30.15%</td>
<td>-25.00%</td>
<td>-3.61%</td>
<td>4.78%</td>
<td>-18.12%</td>
<td>75.50%</td>
<td>-19.79%</td>
<td>-25.44%</td>
<td>7.66%</td>
</tr>
<tr>
<td>Korea</td>
<td>29.76%</td>
<td>37.55%</td>
<td>-5.12%</td>
<td>-23.71%</td>
<td>-69.83%</td>
<td>173.62%</td>
<td>169.20%</td>
<td>-51.82%</td>
<td>40.03%</td>
<td>33.30%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>134.38%</td>
<td>-9.56%</td>
<td>11.77%</td>
<td>37.92%</td>
<td>-69.53%</td>
<td>5.27%</td>
<td>47.57%</td>
<td>-19.60%</td>
<td>2.63%</td>
<td>15.65%</td>
</tr>
<tr>
<td>Thailand</td>
<td>124.02%</td>
<td>74.00%</td>
<td>7.63%</td>
<td>-29.45%</td>
<td>-76.42%</td>
<td>48.28%</td>
<td>67.22%</td>
<td>-49.48%</td>
<td>23.23%</td>
<td>21.00%</td>
</tr>
<tr>
<td>Average</td>
<td>18.32%</td>
<td>124.02%</td>
<td>74.00%</td>
<td>7.63%</td>
<td>-29.45%</td>
<td>-76.42%</td>
<td>48.28%</td>
<td>67.22%</td>
<td>-49.48%</td>
<td>23.23%</td>
</tr>
</tbody>
</table>

| Russia | 10405.30% | 134.70% | 244.36% | -83.93% | 250.54% | -46.10% | 95.77% | 1571.52% | 18.32% | 1571.52% |
| Poland | 49.30% | 83.83% | 44.64% | 68.61% | 44.55% | 5.75% | -16.82% | 39.98% | 1571.52% |
| Hungary | 49.56% | 119.79% | 183.99% | -6.32% | 16.32% | -26.33% | -13.76% | -17.19% | 17.19% | 17.19% |
| Romania | 92.31% | -43% | 1000.00% | 62.04% | -14.08% | 22.45% | 98.69% | 174.06% | 17.19% | 174.06% |
| Czech | 163.79% | 15.40% | -29.27% | -5.80% | -2.07% | -6.73% | -15.19% | 17.19% | 174.06% | 174.06% |

Figure 4.1 The Number of Listed Company

2) 1994-2002 China Statistic Year Book 2003

Figure 4.2 Total Market Capitalization (unit: 100 million RMB)

Source: 1) 1990-1993 Shenzhen Stock Market Statistic Year Book and Shanghai Stock Market Statistic Year Book
2) Chinese Statistic Year Book 2003
Figure 4.3 The Number of Issued Share (Unit: million)

2) Chinese Statistic Year Book 2003

Figure 4.4 the Rate of Trade Volume in GDP and the Rate of Total Market Capitalization in GDP

Note: This graph is drawn according to table 4.3.
Figure 4.5 Comparison of increase Speed of Listed Companies between Developed Stock Markets and the Chinese Stock Market

Note: This graph is drawn according to table 4.5

Figure 4.6 Comparison of Increase Speed of Listed Company between Emerging Stock markets and Chinese Stock Market

Note: This graph is drawn according to table 4.5
Figure 4.7 Comparison of Increase Speed of Listed Companies between the Stock Market in Transition Countries and the Chinese Stock Market

Note: This graph is drawn according to table 4.5.

Figure 4.9 Market Capitalization Comparison between Emerging Stock Markets and the Chinese Stock Market

Note: This graph is drawn according to table 4.6.
Figure 4.8 Market Capitalization of Developed Stock Markets and the Chinese Stock Market

Note: This graph is drawn according to table 4.6

Figure 4.10 Market Capitalization between Transition Countries and the Chinese Stock Market

Note: This graph is drawn according to table 4.6
CHAPTER 5
INVESTOR COMPARISON

5.1 Introduction
Participants in the secondary stock market include surveillance institutions, listed companies and investors. According to their investment aims, investors can be classified into three further groups. The first group refers to people whose investment aim is to control listed companies or to take over listed companies. The second group refers to people whose investment aim is to obtain dividends. The third group refers to people whose investment aim is to obtain a capital gain. In light of these different attributes, investors can be classified as individual investors, institutional investors, legal investors and public institutions, such as governments.

In this chapter, the impact of different investors on stock markets will first be analyzed and then the investor structure of other stock markets will be used as a comparison.

5.2 The relationship between investors and the stock market
5.2.1 Individuals
The individual investor is an important investment group. Generally, individual investors are further classified. However in China, according to the investment amount of investors, individual investors are classified into small investors, middle investors and large investors. Security companies provide special services such as special rooms, computers, trading lines, information and dealers for the larger investors. Conditions provided for middle investors are not so good as those provided for the larger investors, but are better than those
provided for small investors. There is no unified standard to classify individual investors. At different times, in different provinces and in different security companies, classification standards differ. Focusing on this, I have investigated the classification statuses in Beijing. In 1997, investors whose investment amount was more than 1,000,000 RMB were treated as big investors. The investors whose investment amount was within 300,000-1,000,000 RMB were treated as middle investors. Then, the government gradually strengthened surveillance on the stock market, thus making capital gain not as easy to procure as before. However the return from investing in industrial enterprises and in bond markets was low. Despite the fact that the return on investing in the futures market was high, the risk was also very high and therefore, the classification standard continued to improve. In 2000, investors whose investment amounts were more than 2,000,000 RMB were treated as large investors. Investors whose investment amounts were within 500,000-2,000,000 RMB were regarded as middle investors. There was no law to support the classification approach. It was mainly the result of strong competition. In order to attract larger investors, security companies provided different services. Although the media frequently criticized the unfair service, in order to attract larger investors, security companies did not attempt to change their status. Security companies knew that bad service did not result in small investors leaving the stock market. The things which attracted them were the high returns of the stock market. The existence of unfair service indicated that the Chinese stock market was still a buyers-market.

When investors make their investment decisions, they take into account factors such as the return and safety and liquidation of assets. However because of the difference in history, culture, social systems, financial systems, market structure, investor structure and
government policy, the people's investment concept is also different. For instance, before economic reform, China adopted a central-economy. Theoretically, there was no necessity for the existence of the stock market. On the other hand, the capital market was regarded as the product of capitalism. All capital markets were closed. "Pursuing to get more money" was regarded as a bad idea. The Chinese had no alternative but to save their balances with the banks. With economic reform going further, the "investment concept" of the Chinese was changed. The number of investors in the Shenzhen stock market reflects this change. From table 5.1, it can be seen that in China the speed of individual investors increased very fast. Before 1990, all investors in Shenzhen were local individual investors and the number was small. After 1992, non-local individual investors began to invest in the Shenzhen stock market. By the end of 2001, the account number had increased from 1.06 thousand in 1990 to 3149.76 thousand in 2001. Because nearly all of the investors opened accounts at the Shenzhen and Shanghai Stock Exchanges, the number of investors approximates half of the number of accounts.

Despite the increase in individual investors in China being very fast, investigation reports in 1997 and 2002 show their status was not good.

In 2002, the research institution of the Shenzhen stock exchange published a report concerning Chinese individual investors in A share stock markets. The sample of this search focuses on individual investors in six cities, namely Shenzhen, Shanghai, Beijing, Chongqing, Changsha and Fuzhou. According to investment amounts, individual investors are divided into three groups; the small investor, middle investor and large investor. The rates of small investors, middle investors and large investors in total samples are 60%:
35%: 5% respectively. The ages of investors who were investigated ranged from 16 to 83 years. The average age was 43.01. Research results were:

1) Fundamental statuses of investors

a) The age of investors

The investors whose ages were mainly in the range from 25 to 55 accounted for 77.59%. Retirees whose ages were over 55 accounted for 16.96%.

b) The period of accessing the A stock market

The average period was 5.4 years, of which the investors who opened an account before 1996 accounted for 36.9%; the investors who opened an account after 2000 accounted for 21.86%.

c) Educational status

The investors who had completed senior and middle school education accounted for 43.81%. The investors who had completed primary school education accounted for 12.04%.

d) Occupational status

The research discovered that the major investors engaged in the following occupations: institution officer, labourer, researcher, teacher and journalist, labourer who works in the commercial field, and private owner. If the investment scale which was less 50,000 RMB was defined as a small scale investment and the investment scale which was more than 500,000 RMB was defined as a large scale investment, it could be seen that the investment scale of labourers, including the people who worked in the commercial industry, those who
were unemployed and those who had no occupation, was smaller than that of private owners or journalists.

e) Income and investment

The annual income of the sample investor is generally not high; 55.63% of the investors' annual income was below 20,000 RMB. This investigation shows that their average leverage was 23.46 (leverage = mean of investment scale/mean of annual income). Higher leverage reduced their ability for undertaking further risks and aggravated social unease. Stock and mutual funds were their main investment subjects, accounting for 60.67% of their total investment. Their second investment choice was to save money in banks or to hold cash. The rates of investing in treasury bills, insurance and enterprise bonds were very low. Among these survey samples, stock investment accounts were around 50% of their average family assets.

Investor behaviour

a) Investment motivation.

This investigation showed that the main aim for 78.6% of individual investors was to invest in the stock market in order to obtain capital gains through buying and selling of shares. Only 11.7% of the individual investors’ aim was for a dividend; 38.0% of investors invested in the stock market because they had idle money and regarded the stock market as a long-term investment place. The rate of investors who engaged in “stir-frying” shares for others and themselves plus the rate of investors who were unemployed and attempted to make money through “stir-frying” was 22%.
b) Stock investment knowledge.

Many investors had no formal investment training. They gained knowledge and collected information concerning the stock market mainly from good friends, stock experts and newspapers or magazines. When they made investment decisions, they mainly depended on the recommendations of good friends or on rumour. These investors accounted for 51.5%. Concerning their investment strategy, over 20% of individual investors did almost no investment analysis. They depended on their feelings in order to select stock.

c) Investment risk.

The survey showed that risk consciousness of Chinese investors was very strong. More than 90% of investors knew that the risk of investing in the stock market was very high. The majority thought the investment risk was caused by changes in the Chinese government’s policies and non-regulation of the stock market such as the existence of price manipulation or false information provided by listed companies. Concerning the ability of undertaking a risk, 45.9% of individual investors thought their ability for taking a risk was very low; 42.9% thought their ability for taking a risk was quite common.

d) Investment concept.

Investigation showed that 54.6% of investors practised middle-term investment. Middle-term investment meant that the investment term was from three months to twelve months. Concerning the stock choice, major investors preferred the stocks where share prices were not too high or low. The companies which issued a small number of shares and some indexes to be used to measure the performances of these companies were good. Investors who had bought the shares issued by the companies which were in the process of special
treatment (ST) or the companies which were in the process of particular transfer (PT) amounted to 61.4%. They thought these shares were going to give them opportunities for speculation and 23.6% of investors still held these shares. Nearly half of the investors had never bought closed-funds. About 19.0% of investors held mutual funds. Their aims for buying the shares were for dividends and net value. Few people considered the ability of fund managers and the regulations of mutual fund companies. These people accounted for less than 7%. Investors who held two to five shares at the same time amounted to 70%. Concerning the average holding period, 70% of investors held one share for less than six months. The short-term investment behaviour is very clear. Concerning the trading frequency of each year, 42.5% of investors bought or sold their shares more than 13 times per year and 90% of investors did so more than three times per year. Concerning the relationship between share price fluctuations and share investment behaviour, more than 90% of investors sold their shares when the rise of the share price was 30%; 80% of investors sold their shares when the fall in share prices was less than 20%. When the current share prices were far lower than their buying prices, the majority of investors decided to hold the shares until the share prices rebounded to their buying prices.

e) Investment behaviour.

Investors normally obtained information through two channels, the newspaper and TV programs. Investors who obtained information through these two channels accounted for 78.3% of all investors. The investors who obtained information through the Internet accounted for 8.8% only.
f) Company information.

The survey showed that investors do not care about the availability of information of listed companies very much. The main reasons were the following: 1) They thought the information was unbelievable. These people accounted for 41.4%. 2) They thought the information was already known by “Zhuang jia”. It was of no use. These people accounted for 31.3%.

g) Investment returns status.

Generally, investors were divided into three groups. The first group obtained a return. The second group did not make a loss or a gain. The third group lost their money. The percentage between the three groups was 22%: 34%: 44%.

Rational individual investors make their investment decisions according to their forecasts on the return, safety and liquidation of financial assets and their current asset distribution status. They normally select an appropriate time to buy or sell their shares. Many less rational or irrational individual investors only follow other investors or only believe the advice of security companies and the analysis of stock analyzers. However, no matter how they think as individual investors, if they invest in the stock market, their aims are the same, that is, to obtain a return through the stock market. Thus, the aim of major investors is not to join cooperative governance of the listed companies but rather to obtain a return, especially a capital gain. This is the reason why an individual investor is regarded as an unsteady factor for the stock market. However, different forecasts of individual investors in respect of the movement of the stock market results in rational share prices and promotes the liquidity of shares.
5.2.2 Institutional investors

Institutional investors refer to special organizations, which pool the money of investors who cannot directly manage their investment or have difficulty in analyzing the movement of share prices or other securities and invest these pooled funds in capital markets. Their investment aims are also for returns. In developed countries such as the United States and the United Kingdom, the institutional investors mainly refer to charity organizations, individual trust companies, pension funds or superanuation funds. In China, all investors excluding individual investors who invest in tradeable shares are called institutional investors.

The investment aims of institutional investors have been stated when trustees sign contracts with fund companies. If institutional investors reach their aims, more investors will be attracted to join in. Therefore, institutional investors can expand their businesses further and obtain more commission.

Institutional investors pool funds from investors. A large scale of investments can create a scale effect and institutional investors can diversify investment risks through establishing portfolios. In fund companies, experts are employed to manage funds. They acquire specialized knowledge. In addition to the above advantages, institutional investors have the ability to collect substantial information and take high risks. They analyze stock market information before they make an investment decision. Therefore, compared with individual investors, the behaviour of institutional investors should be more rational and institutional investors should be a factor that will steady stock markets.
However, from a new institutional economics point of view, in order to analyze the motivation of human behaviour there has to be two considerations. On the one hand, human beings seek to maximize their own welfare. On the other hand, they seek to maximize non-welfare. These considerations will result in the emergence of innovation. In addition, the rationality of individuals is limited. This is mainly because of the following aspects. First, the environment is very complex. Second, the estimation ability and understanding ability of individuals is limited. Third, human behaviour tends to be opportunistic, that is, human behaviour tends to play to score and make profits for themselves. In immature stock markets, the trend of opportunism is more serious. In addition, although experts manage funds, the ability of controlling the complicated environment is limited. Therefore, institutional investors do not play a steadying function in the stock market. Under many situations, institutional investors do not steady the stock market but rather aggravate the fluctuations of the stock market, particularly the immature stock market.

Herding behaviour refers to institutional investors who follow each other in and out of the same shares at the same time. Froot, Scarfstein and Stein (1992) point out that institutional investors are quite homogeneous. They normally pay attention to the same market information, use similar models, information processing technology, portfolio approaches or hedge investment strategies. Institutional investors possibly have the same reactions to the same information, as for example, earnings. Their investment behaviour shows herding phenomena. Fund holders sign contracts with fund managers and the performances of trustees are associated with benchmarks. Therefore in order not to fall behind other managers or to be lower than the market index, fund managers normally deduce and follow the investment behaviour of other fund managers. When “herding” emerges, many
institutional investors will buy or sell the same shares at the same time. The balance between buyer and seller will create unequilibrium and this unequilibrium will result in fluctuations of share prices and the destruction of the steady market.

On the other hand, Lakonishok, Shleifer and Vishny (1992) argue that the herding behaviour of institutional investors might not result in an unsteady market. If institutional investors collect more information for evaluating share values than individual investors do, all institutional investors will buy the underpriced shares. The herding behaviour offsets the irrational behaviour of individual investors and accelerates the formation of equilibrium share prices. Because herding behaviour is the rapid reactions of institutional investors to the same information, the trading behaviour of institutional investors quickens the absorbing speed of share prices to information. This behaviour promotes the efficiency of the market. Therefore, the herding behaviour of institutional investors is not enough to be considered as an unsteading factor of the stock market.

Feedback trading strategy theory means to buy or sell shares on the basis of historical records. Positive feedback means to buy the shares which historical records show have an ascending trend and to sell the shares which historical records show have a descending trend. Negative feedback strategy is to sell the shares which historical records show have an ascending trend and buy the shares which historical records show have a descending trend.

Efficient market theory holds that the current share price already completely reflects all relevant information, and therefore any feedback trading strategy is irrational. It will result in the deviation of share prices from their value and aggregate the fluctuation of share
prices (De Long 1990; Poterba & Summer 1990). However, some researchers argue that in practice, the market needs time to "digest" information and react, and therefore new information can be reflected in the share price after a period. Under this situation, feedback strategy possibly is rational (Lakonishok, Shleifer and Vishny 1992). Other researchers argue that different patterns of institutional investors will use different diversification strategies. The negative and positive strategies will offset each other; therefore the trade behaviour of institutional investors might not be a factor to cause the fluctuation in share prices.

From a corporate governance point of view, fund managers keep a relatively close relationship with the shareholders of a fund, but however, they keep a loose relationship with listed companies, although they hold the shares issued by the listed companies. Institutional investors affect listed companies mainly through buying or selling their issued shares.

In the United States, there are substantial institutional investors who hold the shares of listed companies. These institutional investors are very sensitive to the decrease of share prices caused by the performance of listed companies. In order to maximize the profit of trustees and beneficiaries, since 1980, institutional investors are not only enthusiastic in obtaining profit through short-term investment but are also involved in the corporate governance of listed companies. For instance, in the 1990s, institutional investors pushed the GM, IBM to improve their management through reorganizing their assets. Therefore on the one hand, institutional investors are dissonant with listed companies; on the other hand, they co-operate with listed companies. Through promoting the corporate governance of
listed companies, institutional investors reduce the possibility of price fluctuations, thus steadying the stock market.

In practice, some cases indicate institutional investors did not steady the stock market. In 1993, in the Hong Kong stock market, investor structure shows that institutional investors accounted for 54.71%, while individual investors accounted for 42%. However at the end of 1993, overseas funds such as J.P. Morgan, Solomon in the USA, and the Swiss bank created a surge of dangerous waves on the Hong Kong stock market.

Table 5.4 Shareholder Statistics in the U.S. and Japanese stock markets (Unit: %)

<table>
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<tr>
<th></th>
<th>U.S.</th>
<th>Japan</th>
</tr>
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<tbody>
<tr>
<td>Institutional</td>
<td>45.1</td>
<td>45.8</td>
</tr>
<tr>
<td>Individual</td>
<td>47.4</td>
<td>46.1</td>
</tr>
<tr>
<td>Foreign</td>
<td>6.9</td>
<td>7.4</td>
</tr>
<tr>
<td>Other</td>
<td>0.6</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Statistic Report, Tokyo Stock Exchange Year Book 2002

Another example is the investment behaviour of the Baoding fund in 1994. Table 5.2 reflects how the Wanguo security company adjusted their portfolios during the period of 28 Feb., 1994 to 30 Sept., 1994. From February 1993 to July 1994, the Shanghai index fell from 1532 to 332. The Shenzhen index fell to around 90. Major individual and institutional investors lost money according to the current prices at that time. The Baoding closed-fund lost money as well. However at the end of June, the proportion of shares in their portfolio increased up to 45.92%. They sold all bonds that they had held before and the amount of
held cash gradually decreased. This implied that fund managers had forecast that share prices were going to reach the bottom of the share price, and therefore fund managers thought they should invest in stock markets at that time. In August 1994, SRC promulgated a series of policies. These policies included a policy on issuing new shares and three policies on steadying stock markets. These policies enabled the index of the stock market to spring back to 1052. Because measures which were related to these policies had not been taken, later in September, the stock index began to fall down again. The Baoding fund made a correct forecast concerning the movement of shares and gained a large capital gain. However the rapid access and exit accelerated the fluctuations of the stock market. Funds did not play their steadying function as people had expected.

From the above analysis, it can be seen that institutional investors might not be a steadying factor on the fluctuations of stock markets. However compared with individual investors, the amount of funds, information selection ability, or the evaluation ability of the market, cannot match institutional investors who have more advantages. Investment efficiency of institutional investors is higher than that of individuals. If there are some corresponding regulations to regulate this behaviour, the high percentage of institutional investors will enliven the stock market and rationalize the processes of the market prices.

5.2.3 Others

Because China is in the process of transition, the role of the government on the stock market is very special. The Chinese government holds more than 60% of issued shares, and therefore it is the largest shareholder. It determines the development direction of Chinese enterprises, personnel arrangements and dividend payments. The Chinese government is
not only a participator in the game, but also the constitutor and judge of the game. Therefore, the influence of the Chinese government is stronger than that of other governments. Here, foreign investor refers to the foreigner who invests in the B share market.

5.3 A comparison of the investment structure and holding structure

The following tables will make comparisons concerning the investor structure of different stock markets.

Investor structure is an important indicator to measure the development of a stock market. Table 5.3 shows that in China, the number of institutional investors was 31.33 thousand and the number of individual investors was 64.61 million in 2001. The proportion of the institutional investors in the total is still very low on the Chinese stock market: only 0.48%. Table 5.3 also indicates that compared with the rate in 1995, the rate of institutional investors has increased; however the change is minimal. Basically, the average rate of institutional investors is around 0.41%.

Compared with the stock markets in Japan and the United States, the rate of institutional investors on the Chinese stock market is too low. In the United States, the rate of institutional investors is much higher than that on the Chinese stock market. Institutional investors accounted for 49.6% in 2000. The average number of institutional investors in total is 46.56% from 1996 to 2000. In Japan, the rate of institutional investors in total is also much higher than that of China. The average number of institutional investors in total is 40.46% from 1996 to 2000. However, the rate of individual investors in total shows a
decline. In Japan and the United States, the variety of institutional investors is large. However, the variety of institutional investors is very small in China. The main institutional investors are the mutual funds.

5.4 Conclusion

Individuals are the major investors on the stock market. The behaviour of different investors creates different impacts on the stock market. This chapter classifies different investors and analyzes their impact on the stock market from theoretical and practical aspects. In addition, the investor structures of different stock markets are compared. As investment objectives, the status of listed companies impacts on the long-term development of the stock market. Chapter six will focus on the capital structure of listed companies.
### Table 5.1 Account Number of Individual Investors in A-share Shenzhen Stock Market (Unit: ten thousand)

<table>
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<th></th>
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<th>91</th>
<th>92</th>
<th>93</th>
<th>94</th>
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<th>98</th>
<th>99</th>
<th>2000</th>
<th>2001</th>
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<tbody>
<tr>
<td>Total</td>
<td>1.06</td>
<td>25.63</td>
<td>104.91</td>
<td>352.22</td>
<td>480.72</td>
<td>551.90</td>
<td>1085.30</td>
<td>1601.88</td>
<td>1892.47</td>
<td>2178.81</td>
<td>2816.47</td>
<td>3149.76</td>
</tr>
<tr>
<td>Local</td>
<td>1.06</td>
<td>25.63</td>
<td>82.99</td>
<td>152.30</td>
<td>165.28</td>
<td>173.57</td>
<td>198.52</td>
<td>212.01</td>
<td>218.77</td>
<td>227.44</td>
<td>242.04</td>
<td>245.02</td>
</tr>
<tr>
<td>Non-local</td>
<td>0.00</td>
<td>0.00</td>
<td>21.92</td>
<td>199.92</td>
<td>315.45</td>
<td>378.33</td>
<td>886.78</td>
<td>1389.86</td>
<td>1673.70</td>
<td>1951.37</td>
<td>2574.43</td>
<td>2904.74</td>
</tr>
</tbody>
</table>

Source: Collected from Shenzhen Statistics Year Book 2001

### Table 5.3 Investor Structure Statistics in the Chinese A-share Stock Market (Unit: 0.01million)

<table>
<thead>
<tr>
<th></th>
<th>95</th>
<th>96</th>
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<th>98</th>
<th>99</th>
<th>2000</th>
<th>2001</th>
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<tbody>
<tr>
<td>Individual</td>
<td>1231.90</td>
<td>2285.30</td>
<td>3304.07</td>
<td>2078.52</td>
<td>4443.48</td>
<td>5747.67</td>
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<td>Institution</td>
<td>5.64</td>
<td>7.57</td>
<td>12.49</td>
<td>14.18</td>
<td>18.28</td>
<td>26.04</td>
<td>31.33</td>
</tr>
<tr>
<td>Total</td>
<td>1240.24</td>
<td>2297.45</td>
<td>3323.09</td>
<td>3900.50</td>
<td>4470.64</td>
<td>5788.23</td>
<td>6585.07</td>
</tr>
<tr>
<td>Rate of Institutional Investor in Total</td>
<td>0.45%</td>
<td>0.33%</td>
<td>0.38%</td>
<td>0.36%</td>
<td>0.41%</td>
<td>0.45%</td>
<td>0.48%</td>
</tr>
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</table>

Source: Shanghai Statistic Year Book 2002, Shenzhen Stock Exchange Year Book 2001
Table 5.2  Portfolio Change of Baoding Fund Managed by Wanguo Security Company

<table>
<thead>
<tr>
<th>Index</th>
<th>Stock</th>
<th>Bond</th>
<th>Company</th>
<th>Money Fund</th>
<th>Others</th>
<th>NPV(RMB)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rate</td>
<td>Change Rate</td>
<td>Rate</td>
<td>Change Rate</td>
<td>Rate</td>
<td>Change Rate</td>
</tr>
<tr>
<td>94.2.28</td>
<td>35.62</td>
<td>-</td>
<td>6.63</td>
<td>-</td>
<td>2.48</td>
<td>-</td>
</tr>
<tr>
<td>94.3.31</td>
<td>33.35</td>
<td>-8.37</td>
<td>3.62</td>
<td>-94.50</td>
<td>2.44</td>
<td>1.61</td>
</tr>
<tr>
<td>94.4.30</td>
<td>39.47</td>
<td>18.35</td>
<td>3.35</td>
<td>-7.46</td>
<td>2.50</td>
<td>2.46</td>
</tr>
<tr>
<td>94.5.31</td>
<td>32.49</td>
<td>-17.68</td>
<td>3.46</td>
<td>3.28</td>
<td>2.74</td>
<td>9.60</td>
</tr>
<tr>
<td>94.6.30</td>
<td>45.92</td>
<td>41.34</td>
<td>0.00</td>
<td>-100.00</td>
<td>3.02</td>
<td>10.22</td>
</tr>
<tr>
<td>94.7.30</td>
<td>24.54</td>
<td>-46.56</td>
<td>3.52</td>
<td>-</td>
<td>21.02</td>
<td>596.03</td>
</tr>
<tr>
<td>94.8.31</td>
<td>42.58</td>
<td>73.51</td>
<td>7.50</td>
<td>113.07</td>
<td>17.73</td>
<td>-15.65</td>
</tr>
<tr>
<td>94.9.30</td>
<td>4.77</td>
<td>-88.80</td>
<td>9.79</td>
<td>30.53</td>
<td>21.95</td>
<td>23.80</td>
</tr>
<tr>
<td>Average</td>
<td>32.34</td>
<td>-</td>
<td>4.73</td>
<td>-</td>
<td>9.23</td>
<td>-</td>
</tr>
</tbody>
</table>

6.1 Introduction

Listed companies issue shares to the public. The status of listed companies is one important factor which influences the share price. This chapter will discuss the financial structure of companies listed on the Chinese stock market and their changing status.

6.2 Equity Finance

Financial structure refers to the rate of debt to total assets. There are two channels for companies to finance, viz internal and external. Internal finance mainly refers to situations where companies obtain funds through retained earnings and discounts. External finance includes direct finance and indirect finance. Direct finance mainly refers to finance through the issuing of bonds or shares. Indirect finance mainly refers to procuring a loan from a bank.

6.2.1 Financial theory

Modigliani and Miller (1958, 1961) proposed their corporate financial theory (MM) which documented that, in a perfect capital market, under no transaction costs and income tax assumptions, the value of one company is not relevant to its financial structure and dividend payments.
However, if the capital market does not satisfy the assumption, the financial structure is relevant to the value of the corporation. The company must seek an appropriate rate in order to minimize the cost of finance.

At the end of the 1980s, C. Mayer published his papers. He proposed that in developed countries, earnings retained are the main capital source. Bank loans rank second. The rate of equity is normally small. This is Mayer’s puzzle and is called pecking order theory. This theory puts forward a strong challenge to traditional financial theory. Some recent work by F&F has thrown some doubt on this theory.

Some later financial theories such as agent cost theory and transaction cost theory have arisen. These theories mainly analyze the impact of financial structures on the corporation’s value under an imperfect market assumption.

6.2.2 The feature of equity finance

Issuing ordinary shares is different to issuing bonds. Listed companies have no liability to repay the outstanding balance at the end of an agreed period or an agreed rate of interest to shareholders at a specific interval and so reducing the debt pressure of companies. Listed companies can pay a dividend to shareholders in the light of their profit. Accordingly, because the risk of investing in ordinary shares is higher than that of investing in bonds, the required return of an ordinary shareholder is higher than that of a bondholder. In addition, interest is paid before income tax. However the dividend is paid after income tax payment. Hence, the cost of equity finance is higher than that of debt finance.
Because of the nature of equity finance, it will be of benefit for companies who have had a fund shortage problem. From this point of view, equity finance strengthens the ability of companies to withstand operational risk. It is very important for companies, which are in the early stages of producing some new products or pushing new products into the market, or where operational risks are particularly high.

6.2.3 Suitable application scope of equity finance

Listing on the stock market is suitable for large-sized companies. What follows will analyze the reasons. Different sizes of business organizations normally adopt different organizational forms. Generally, a small-sized business organization chooses a limited liability company as the business organizational form akin to the Australian propriety company; a large-sized business organization chooses the public company as its business organizational form. Some large-sized companies choose to list on the stock market. In Japan, the percentage of large-sized companies selecting limited liability as their organization form is higher than that of small-sized companies. For example, among the companies which own less than 10 million yen, the percentage of these who selected the joint-stock company as their organizational form was 59%; however among the companies which own the capital of more than 1 billion yen, the percentage of the companies which selected the joint-stock company as their organizational form was 98%. In the United States, although the percentage of businesses selecting the joint-stock company as their organizational form was only 16%, the assets and sales volume accounted for 85% and 89% of the all joint-stock companies separately (Chen Jiague, 1996).
<table>
<thead>
<tr>
<th>Company</th>
<th>Debt Ratio</th>
<th>Main Business Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMB</td>
<td>42.1%</td>
<td>PC, PC processor, Equipment, Government System, Maintained Service and Other Information technology</td>
</tr>
<tr>
<td>AT&amp;T</td>
<td>48.9%</td>
<td>Computer, Software, Communication, Telephone service, switchboard and software, Government System, Credit care, Electronic product, Lease, Investment, Research and Development</td>
</tr>
<tr>
<td>Xerox</td>
<td>65.5%</td>
<td>Server, Workstation, Equipment, Copy machine, Painting technology, Financial service, Capital venture, hospital and etc.</td>
</tr>
<tr>
<td>Average</td>
<td>52.2%</td>
<td></td>
</tr>
<tr>
<td>Unisys</td>
<td>62.0%</td>
<td>Master Board, Server, Workstation, Equipment, Communication processor, System software, Disk system</td>
</tr>
<tr>
<td>Apple</td>
<td>7.8%</td>
<td>PC, Software, Printing machine and other equipment</td>
</tr>
<tr>
<td>Sun</td>
<td>26.2%</td>
<td>Server, Workstation, Software</td>
</tr>
<tr>
<td>Digital</td>
<td>2.2%</td>
<td>PC, Software, Equipment, Computer service</td>
</tr>
<tr>
<td>Average</td>
<td>24.6%</td>
<td></td>
</tr>
<tr>
<td>Compaq</td>
<td>3.7%</td>
<td>Notebook, PC, System software</td>
</tr>
<tr>
<td>Seagate</td>
<td>35.9%</td>
<td>Floppy disk driver</td>
</tr>
<tr>
<td>Microsoft</td>
<td>1.4%</td>
<td>Software and other (CD-Rom, Mouse and Publication)</td>
</tr>
<tr>
<td>Average</td>
<td>13.7%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Hoover's Handbook of American Business 1993

Compared with other organizational forms, listed companies have more advantages. The advantages are taken from the features of equity finance. Capital structure of listed companies which produce high-technology products in developed countries can prove this. The debt ratio of these listed companies is ordinarily lower than that of companies in other industries. The companies whose business risk is low and whose cash flow is relatively steady rarely raise funds through equity. For instance, in the United States, the debt ratios of companies in the retail industry and multi-service industry are normally higher than that of companies in high-technology industries. The average debt ratio of the ten biggest companies in different industries in the United States are as follows: 1) Industry is 50.8%.
2) Retail is 57.8%. 3) Multi-business segmentation is 56.2% (Gary Hoover, Alta Campbell, and Patrick J. Spain, 1993). 4) Computer is 29.6%.

From the business segmentation point of view, if the companies have relatively centralized business segmentations and the market is unique, they will need more equity capital than those whose products have a multi-market. Table 6.1 shows the business segmentation, product distribution and debt ratio of ten big companies before 1991. These companies produce computer software and relevant products. It can be seen that companies whose businesses are diversified are IBM, AT&T and Xerox. Debt ratios are high; the average is 52.2%. Where business segmentation is simple their production mainly focuses on one product, for example, Compaq, Seagate, Microsoft have very low debt ratios. Although the debt ratio of Seagate is high, the overall average is 13.7%. In this latter group, compared with the companies whose businesses are relatively diversified, production focuses on several products, as for example, Digital, Unisys, Apple, and Sun. Their debt ratios are within a big range. Although the debt ration of Unisys is high, the average debt ratio is 24.6%.

For companies, financial structure choice is an important content of company strategy and is one of the very important research projects in the corporate finance field as well.

6.3 Financial status in developed countries

6.3.1 Finance pattern

In order to analyze the financial pattern and financial structure in developed countries, eight have been selected as examples. The conclusions are as follows:
1) Internal finance is the main source

Table 6.2 shows that internal finance is the main source of funds. The internal financial ratio ranges from the lowest rate, 60.6% in France, to the highest rate, and 97.3% in the UK. The average is 79.63%.

Table: 6.2 Unweighted Average Gross Financing of Non-financial Enterprises in Developed Countries (1970-1989)

<table>
<thead>
<tr>
<th>Source/Category</th>
<th>US</th>
<th>UK</th>
<th>Japan</th>
<th>France</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal</td>
<td>91.3</td>
<td>97.3</td>
<td>69.3</td>
<td>60.6</td>
<td>79.63</td>
</tr>
<tr>
<td>Bank finance</td>
<td>16.6</td>
<td>19.5</td>
<td>30.5</td>
<td>40.6</td>
<td>26.8</td>
</tr>
<tr>
<td>Bonds</td>
<td>17.1</td>
<td>3.5</td>
<td>4.7</td>
<td>1.3</td>
<td>6.33</td>
</tr>
<tr>
<td>New Equity</td>
<td>-8.8</td>
<td>-10.4</td>
<td>3.7</td>
<td>6</td>
<td>-2.38</td>
</tr>
<tr>
<td>Trade Credit</td>
<td>-3.7</td>
<td>-1.4</td>
<td>-8.1</td>
<td>-2.8</td>
<td>-4.00</td>
</tr>
<tr>
<td>Capital Transfers</td>
<td>4.9</td>
<td>2.5</td>
<td>1.9</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>4.9</td>
<td>-2.9</td>
<td>-0.1</td>
<td>-6.5</td>
<td>-1.15</td>
</tr>
<tr>
<td>Statistical Adjustment</td>
<td>-8.7</td>
<td>-8</td>
<td>0</td>
<td>2.5</td>
<td>-4.73</td>
</tr>
</tbody>
</table>

Source: Bertero (1994) and Corbett and Jenkinson (1996)

2) In external finance, getting a loan from the bank is the main focus.

From table 6.2, it can also been seen that the average rate of loans from bank accounts is 26.10% of the total financial amount and accounts for 33.66% of external finance.

3) Equity finance shows a down tendency.

The average proportion of new equity finance in the total finance is 2.38%. The highest percentage is Japan, with 3.7%; the lowest is UK, with 10.4% from 1970 to 1989.
If the financial history of the United States is analyzed, it can be seen that the rate of equity finance in total finance tends to decline. Table 6.3 shows the rate falls from 19% in the 1930s to 5% in the 1940s–1950s, to 2% in the 1970s.

In the early industrialization process of these developed countries, the stock market was considered to be their main financial channel. In their middle and later industrialization process, with the expansion of company size and maturity of business, the companies tend to finance through retained earning.

6.3.2 Financial structure

Table 6.4 lists the corporate capital structure of developed countries in 1992. The average debt rate of these countries is 70.2%.

6.4 Financial status in developing countries

6.4.1 Finance pattern

Table 6.5 lists the financial patterns of four developing countries. These data reflect the features of financial structures within these developing countries.
Table 6.4 Capital Structures in Developed Countries 1992

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>UK</th>
<th>Japan</th>
<th>USA</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term Debt/Equity</td>
<td>1.417</td>
<td>0.387</td>
<td>0.938</td>
<td>1.054</td>
<td>0.949</td>
</tr>
<tr>
<td>Total Debt/Total Asset</td>
<td>0.783</td>
<td>0.597</td>
<td>0.787</td>
<td>0.642</td>
<td>0.702</td>
</tr>
</tbody>
</table>


1) The proportion of external finance is higher than that of internal finance. Debt finance is the main financial source.

In the four developing courtiers, the average proportion of equity finance is 17.88%. The average proportion of debt finance is 61.68%. Debt finance is the main financial channel of these countries.

2) Variances reflect the different financial choices of these developing countries. The differences are caused by different economic development levels and the social factors of these countries.

6.4.2 Financial structure

Table 6.6 lists the data concerning capital structure in nine developing companies. The average long-term debt ratio of the four countries is 0.45%. The average short-term debt ratio is 0.42%.
### Table: 6.5 Financial Patterns of Developing Countries (1992-1996) (Unit: %)

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Korea Rep.</th>
<th>Average</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retentions</td>
<td>23.1</td>
<td>25.3</td>
<td>13.3</td>
<td>5.7</td>
<td>16.85</td>
<td>9.08</td>
</tr>
<tr>
<td>External Finance</td>
<td>76.9</td>
<td>74.7</td>
<td>86.7</td>
<td>94.3</td>
<td>83.15</td>
<td>9.08</td>
</tr>
<tr>
<td>Shares</td>
<td>31.2</td>
<td>14.6</td>
<td>9.6</td>
<td>16.1</td>
<td>17.88</td>
<td>9.31</td>
</tr>
<tr>
<td>Debt Finance</td>
<td>43.3</td>
<td>51</td>
<td>70.8</td>
<td>81.6</td>
<td>61.68</td>
<td>17.62</td>
</tr>
</tbody>
</table>

Source: Ajit Singh, Alaka Singh and Bruce Weisse, “Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in emerging Markets”, www.wifo.ac.at

### 6.5 Financial status in China

#### 6.5.1 Finance pattern

Before economic reform, there was no internal and external finance in China. The funds for production, expansion and enterprise operation mainly depended on government appropriation. Since 1980, profit remittance imposed on enterprise has been replaced by income tax. Some state-owned enterprises with good performance have had some retained earnings. With further economic reform, the finance patterns of Chinese enterprises have changed from dependence on state appropriation to dependence on loans from banks to equity finance.

In order to analyze the financial status of Chinese enterprise, an indicator such as an asset debt ratio, capital profit rate and fund profit rate are selected as examples. According to the statistics of various Chinese enterprises, the results are shown in table 6.7.
Table: 6.6 Capital Structures of Developing Countries (1980-1997) (%)  

<table>
<thead>
<tr>
<th>Year</th>
<th>India</th>
<th>Korea Rep.</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term Debt/equity</td>
<td>0.29</td>
<td>0.52</td>
<td>0.49</td>
<td>0.39</td>
<td>0.42</td>
</tr>
<tr>
<td>Long-term Debt/equity</td>
<td>0.38</td>
<td>0.41</td>
<td>0.53</td>
<td>0.48</td>
<td>0.45</td>
</tr>
</tbody>
</table>

Source: Sumit Agarwal and Hamid Mohtadi, “Financial Markets and the Financial Choice of Firms: Evidence from Developing Countries”

The debt status of Chinese enterprises can be summarized as follows:

1) The asset debt ratio has an upward trend. Since Chinese reform, the asset debt ratio of Chinese enterprises still tends to increase. The asset debt ratio of state-owned enterprises in 1980 was 18.7% (Wu Xiaoling, 1996). At the end of 1994, the debt ratio had already increased to 80.5% (Investigation result done by State Assets Management Bureau).

Table 6.7 Debt Ratio of Chinese Enterprises (%)  

<table>
<thead>
<tr>
<th>Year</th>
<th>SOE</th>
<th>Collective enterprise</th>
<th>Joint-stock company</th>
<th>Foreign company</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>96</td>
<td>64.94</td>
<td>49.67</td>
<td>36.87</td>
<td>43.26</td>
<td>48.69</td>
</tr>
<tr>
<td>97</td>
<td>66.64</td>
<td>44.51</td>
<td>36.83</td>
<td>27.92</td>
<td>43.98</td>
</tr>
<tr>
<td>98</td>
<td>63.99</td>
<td>37.07</td>
<td>34.50</td>
<td>29.49</td>
<td>41.27</td>
</tr>
<tr>
<td>99</td>
<td>57.80</td>
<td>33.24</td>
<td>32.14</td>
<td>25.79</td>
<td>37.24</td>
</tr>
<tr>
<td>2000</td>
<td>56.42</td>
<td>31.63</td>
<td>28.94</td>
<td>25.13</td>
<td>35.53</td>
</tr>
<tr>
<td>2001</td>
<td>51.26</td>
<td>28.64</td>
<td>30.34</td>
<td>22.60</td>
<td>33.21</td>
</tr>
</tbody>
</table>

Source: Collected from Chinese Statistic Year Book

2) From table 6.7, it can be seen that the debt ratios of state-owned enterprises and collective enterprises are higher than those of other kinds of enterprise. The debt ratios of collective enterprises are lower than that of state-owned enterprises.
Table: 6.8  Financial Structure of Chinese Enterprise since 1990-1995  
(Unit: billion RMB)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>27.318</td>
<td>429.509</td>
<td>573.218</td>
<td>729.384</td>
<td>810.566</td>
<td></td>
</tr>
<tr>
<td><strong>Internal</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Finance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discount</td>
<td>-</td>
<td>94.637</td>
<td>115.052</td>
<td>150.876</td>
<td>207.938</td>
<td>260.313</td>
</tr>
<tr>
<td>Retained</td>
<td>14.253</td>
<td>21.576</td>
<td>27.695</td>
<td>48.343</td>
<td>46.632</td>
<td>42.63</td>
</tr>
<tr>
<td><strong>Finance/Total</strong></td>
<td>52.17%</td>
<td>27.06%</td>
<td>24.90%</td>
<td>27.31%</td>
<td>31.41%</td>
<td></td>
</tr>
<tr>
<td><strong>External</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Finance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan</td>
<td>-</td>
<td>287.8</td>
<td>357.1</td>
<td>484.6</td>
<td>514.1</td>
<td>779.1</td>
</tr>
<tr>
<td>Bond</td>
<td>12.637</td>
<td>24.996</td>
<td>68.371</td>
<td>23.584</td>
<td>36.175</td>
<td>21.615</td>
</tr>
<tr>
<td>Stock</td>
<td>0.428</td>
<td>0.500</td>
<td>5.00</td>
<td>21.981</td>
<td>5.721</td>
<td>-</td>
</tr>
<tr>
<td><strong>Finance/Total</strong></td>
<td>46.26%</td>
<td>72.94%</td>
<td>75.10%</td>
<td>72.69%</td>
<td>68.56%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Chinese Financial Year Book 1996 and Chinese Fiscal Year Book 1996

6.5.2 **Finance structure**

The financial structure of Chinese state-owned enterprises includes retained earnings, discounts, loans, bond issues and share issues. From table 6.8, it can be seen that the features of the financial pattern are those from after 1990, and the rate of internal finance shows a decrease. The ratio decreases from 52.17% in 1990 to 31.41% in 1994. The ratio of external finance shows an increase. It increases from 46.26% in 1990 to 68.56% in 1994. In external finance, loans are the main source. Although the amount of equity finance shows an increasing trend, the amount is still very small in comparison with the amount of loans.
6.5.3 Listed Company

1) Share type and structure

During different periods, the issued types of listed companies are different. Before March 1992, there were mainly three types of shares, state-owned shares, legal entity shares and public shares. Public share are only issued for Chinese residents. They are also called A shares. After March 1992, shares designed only for foreigners emerged. They are called B shares so as to distinguish them from A shares. According to Chinese government stipulations, only public shares and B shares can be traded on the Shanghai and Shenzhen stock markets. Public shares and B shares are also called tradeable shares. State-owned shares and legal entity shares cannot be traded in the two stock markets. In order to distinguish from tradeable shares, state-owned shares and legal entity shares are also called untradeable shares. The structure of issued shares in China is:

The variety of shares can be divided into tradeable shares and untradeable shares.

a) Tradeable shares include A shares, B shares, H shares, N shares and L shares.

A shares are held by the Chinese public. They are denominated and payable in renminbi and listed in China.

B shares are denominated in renminbi. They are payable in foreign currency, listed in China, but designated for foreign investors.

H shares: These are shares floated and listed on the Hongkong stock exchange.

N shares: These are shares floated and listed on the New York Stock Exchange.

L shares: These are Chinese companies listed on the London Stock Exchange.
b) Untradeable shares include state-owned shares, state-owned legal entity shares, promoter legal entity shares, social legal entity shares and foreign legal entity shares.

From table 6.9, it can be seen that the number of tradeable shares is very low in comparison with the number of untradeable shares. A low rate of tradeable shares results in the movement of the A shares market being able to not reflect the total market value of listed companies completely and correctly. In other words, the price index movement sends false signals to the investors. All of these shares are ordinary shares.

Table 6.9 Shares Type of Listed Companies in the Shanghai Stock market (Unit: 100 million RMB)

<table>
<thead>
<tr>
<th>Year</th>
<th>State-owned</th>
<th>Legal Entity</th>
<th>Public</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>617.28</td>
<td>132.24</td>
<td>443.24</td>
<td>117.57</td>
</tr>
<tr>
<td>1998</td>
<td>1429.33</td>
<td>152.34</td>
<td>608.03</td>
<td>133.96</td>
</tr>
<tr>
<td>1999</td>
<td>1745.78</td>
<td>189.54</td>
<td>812.89</td>
<td>141.92</td>
</tr>
<tr>
<td>2000</td>
<td>2165.40</td>
<td>241.21</td>
<td>1078.17</td>
<td>151.57</td>
</tr>
<tr>
<td>2001</td>
<td>3121.10</td>
<td>245.25</td>
<td>1318.13</td>
<td>163.09</td>
</tr>
<tr>
<td>2002</td>
<td>3493.36</td>
<td>299.70</td>
<td>1509.08</td>
<td>167.61</td>
</tr>
</tbody>
</table>

Source: China Statistic Year Book

2) Industry structure

From table 6-10, it can be seen that the industry structures of listed companies on the Shenzhen and Shanghai stock markets are similar. If the industry structure is analyzed, it can be seen that manufacturing as a "sunset" industry accounts for 62.5% of the total number. The operational risk of the wholesale and retail industry is lower than that of the high-technology industry. The wholesale and retail industry should adopt debt to finance...
more than equity to finance. However, the rate of the wholesale and retail industry in total is 9.7%. In contrast with this rate, the communication and electric industry accounts for only 5%. In addition, there are only 7 financial companies listed on the stock market, accounting for 0.6% of the total. No matter whether it is the absolute number or percentage, it is far lower than that of other countries.

3) Regional structure
At the end of 1992, the majority of the listed companies were located in Shanghai and Shenzhen. After 1993, the listed companies located in other provinces were gradually listed on the two stock markets. After February, 1995 when Tibet Pearl, located in the Tibet autonomous region, was listed, all provinces had listed companies. Table 6.11 and table 6.12 show that the distribution of listed companies tends to be even. Table 6.11, shows that in 1995, the eastern region of China accounted for 13.5%, however 71.08% of listed companies came from this area. In order to promote the development of the central and western regions’ economies, the Chinese government promulgated a series of policies. One of the policies is to let more enterprises located in the central and western regions be listed on the stock market. Therefore, it can be seen that the number in these regions increased from 28.92% in 1995 to 40.11% in 2002. There was a 19.78% gap between the rates of listed companies of the eastern region and the central and western regions of China.

4) Status of a Listed Company
The return on net assets, earnings per share and the number of listed companies are three important indicators with which to analyze the status of a listed company. What follow will analyze the status of listed companies from these three aspects.
Table 6.11 Productivity and Region Distribution of listed Companies (1995)

<table>
<thead>
<tr>
<th></th>
<th>Eastern Region of China</th>
<th>Central and Western Region of China</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Absolute value</td>
<td>%</td>
</tr>
<tr>
<td>Population (100million)</td>
<td>4.56</td>
<td>41.24</td>
</tr>
<tr>
<td>Area (10 square kilometer)</td>
<td>129.00</td>
<td>13.50</td>
</tr>
<tr>
<td>GDP (100 million)</td>
<td>33967.65</td>
<td>58.57</td>
</tr>
<tr>
<td>Number of Listed Company</td>
<td>236.00</td>
<td>71.08</td>
</tr>
</tbody>
</table>

2) GDP: China Year Statistic 1996  
3) Listed company: China Security and Futures Statistic 1996

a) The average return on net assets tends to decrease gradually.

From tables 6.13, it can be seen that in 1994, the average return on net assets was nearly 14%. However, in 1995, the average return on net assets was around 11%. In 1996, the average return on net assets was 10%. This was mainly caused by the increase of new listed companies. In 2001, the average return on net assets decreases to 5.56. The main reason was that the Chinese government began to regulate the behaviour of listed companies.

b) Earnings per share showing the decreasing tendency

From table 6.13, in 1993, the average earnings per share were 0.35 RMB. In 1995, the average earnings per share went down to 0.25. In 2000, it fell to 0.108 RMB.
Table 6.10 Industry Structure of Listed Companies in Shenzhen and Shanghai Stock Market (2000)

<table>
<thead>
<tr>
<th>Item</th>
<th>Total</th>
<th>Shanghai (A)</th>
<th>Shenzhen (B)</th>
<th>A/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>1088</td>
<td>572</td>
<td>516</td>
<td>1.11</td>
</tr>
<tr>
<td>Agriculture</td>
<td>27</td>
<td>16</td>
<td>11</td>
<td>1.45</td>
</tr>
<tr>
<td>Mining</td>
<td>14</td>
<td>5</td>
<td>9</td>
<td>0.55</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>664</td>
<td>339</td>
<td>325</td>
<td>1.04</td>
</tr>
<tr>
<td>Food &amp;Beverage</td>
<td>52</td>
<td>26</td>
<td>26</td>
<td>1.00</td>
</tr>
<tr>
<td>Textiles &amp;Apparel</td>
<td>59</td>
<td>33</td>
<td>26</td>
<td>1.27</td>
</tr>
<tr>
<td>Timber &amp;Furnishings</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>2.00</td>
</tr>
<tr>
<td>Paper &amp; Printing</td>
<td>20</td>
<td>12</td>
<td>8</td>
<td>1.50</td>
</tr>
<tr>
<td>Oil &amp; Chemistry</td>
<td>153</td>
<td>76</td>
<td>77</td>
<td>0.99</td>
</tr>
<tr>
<td>Rubber &amp; Plastic</td>
<td>13</td>
<td>6</td>
<td>7</td>
<td>0.86</td>
</tr>
<tr>
<td>Metals &amp; non-metals</td>
<td>110</td>
<td>55</td>
<td>55</td>
<td>1.00</td>
</tr>
<tr>
<td>Machinery</td>
<td>178</td>
<td>89</td>
<td>89</td>
<td>1.00</td>
</tr>
<tr>
<td>Electronics</td>
<td>60</td>
<td>30</td>
<td>30</td>
<td>1.00</td>
</tr>
<tr>
<td>Other Manufacturing</td>
<td>16</td>
<td>10</td>
<td>6</td>
<td>1.67</td>
</tr>
<tr>
<td>Utilities</td>
<td>40</td>
<td>22</td>
<td>18</td>
<td>1.22</td>
</tr>
<tr>
<td>Construction</td>
<td>21</td>
<td>9</td>
<td>12</td>
<td>0.75</td>
</tr>
<tr>
<td>Transportation</td>
<td>42</td>
<td>24</td>
<td>18</td>
<td>1.33</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>106</td>
<td>64</td>
<td>42</td>
<td>1.52</td>
</tr>
<tr>
<td>Financials</td>
<td>7</td>
<td>4</td>
<td>3</td>
<td>1.33</td>
</tr>
<tr>
<td>Real Estate</td>
<td>31</td>
<td>16</td>
<td>15</td>
<td>1.07</td>
</tr>
<tr>
<td>Social Services</td>
<td>51</td>
<td>27</td>
<td>24</td>
<td>1.13</td>
</tr>
<tr>
<td>Media</td>
<td>7</td>
<td>3</td>
<td>4</td>
<td>0.75</td>
</tr>
<tr>
<td>Conglomerates</td>
<td>78</td>
<td>43</td>
<td>35</td>
<td>1.23</td>
</tr>
</tbody>
</table>

Source: China Market Statistic Year Book 2001
Table 6.12 Productivity and Region Distribution of listed Companies (2002)

<table>
<thead>
<tr>
<th></th>
<th>Eastern Region of China</th>
<th>Central and Western Region of China</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Absolute value</td>
<td>%</td>
</tr>
<tr>
<td>Population (100 million)</td>
<td>5.31</td>
<td>41.60</td>
</tr>
<tr>
<td>Area (10 square kilometers)</td>
<td>129.00</td>
<td>13.50</td>
</tr>
<tr>
<td>GDP (100 million)</td>
<td>70744.42</td>
<td>59.94</td>
</tr>
<tr>
<td>Number of Listed Company</td>
<td>733.00</td>
<td>59.89</td>
</tr>
</tbody>
</table>

         2) GDP: China Year Statistic 2003
         3) Listed companies: China Security and Futures Statistic 2003

c) The number of loss listed companies showing an upward trend.

From table 6.13, it can be seen that in 1994, there were only two loss listed companies, accounting for 0.68% of the total listed companies. In 1995, the number of loss listed companies was up to 17. It accounted for 5.26%. Although the percentage of loss listed companies in 1996 and in 1997 was 5.26% and 5.85% respectively, the absolute number continually increased to 31 and 41. The percentage continually rises. At the end of 2002, the number of loss companies was up to 135. They account for 13.5%. Therefore, since 1994, the absolute number of loss companies and relative percentage in the total of listed companies indicates an upward trend.

Before these companies were listed on the Chinese stock markets, the majority of non-business assets (such as schools, hospitals, kindergartens) were separated out. Only capital of high quality was listed on the stock market. Moreover, almost all listed companies excluding several listed companies located in Beijing enjoyed tax advantages. From table...
6.18, it could be surmised that both the ROI and ROA of joint-stock companies and collective enterprises are higher than that of SOEs.

Table: 6.13 Loss Situation of Listed companies

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EPR (RMB)</td>
<td>0.35</td>
<td>0.32</td>
<td>0.25</td>
<td>0.23</td>
<td>0.25</td>
<td>0.247</td>
<td>0.249</td>
<td>0.108</td>
<td>0.137</td>
<td>0.143</td>
</tr>
<tr>
<td>Loss</td>
<td>0.68</td>
<td>5.26</td>
<td>5.85</td>
<td>5.30</td>
<td>7.12</td>
<td>9.52</td>
<td>8.5</td>
<td>13.3</td>
<td>13.5</td>
<td></td>
</tr>
<tr>
<td>Percentage(%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss (million RMB)</td>
<td>32.79</td>
<td>691.83</td>
<td>2074.66</td>
<td>4776.17</td>
<td>14100</td>
<td>9800</td>
<td>13900</td>
<td>30400</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Return on Net Assets (%)</td>
<td>14.00</td>
<td>11.00</td>
<td>10.00</td>
<td>9.69</td>
<td>7.83</td>
<td>8.38</td>
<td>9.03</td>
<td>5.56</td>
<td>5.72</td>
<td></td>
</tr>
<tr>
<td>No. of Loss-maker</td>
<td>2</td>
<td>17</td>
<td>31</td>
<td>41</td>
<td>86</td>
<td>77</td>
<td>96</td>
<td>155</td>
<td>167</td>
<td></td>
</tr>
</tbody>
</table>

2) 2000-2002 Shanghai Security Information Ltd.

6.6 Conclusion

This chapter analyzes the financial patterns and financial structures of developing countries and developed countries. On this basis, the financial pattern and financial structure of Chinese joint-stock companies are analyzed. Analysis shows a transition from state-owned companies to joint-stock companies which improves their business status, but development shows a downward trend. The next chapter will analyze the trading structure of the Chinese stock market.
<table>
<thead>
<tr>
<th>Year</th>
<th>SOE</th>
<th>Collective Enterprise</th>
<th>Joint-stock Company</th>
<th>Foreign Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>96</td>
<td>10.47</td>
<td>16.97</td>
<td>11.92</td>
<td>13.52</td>
</tr>
<tr>
<td>97</td>
<td>9.43</td>
<td>16.72</td>
<td>11.56</td>
<td>13.56</td>
</tr>
<tr>
<td>98</td>
<td>8.60</td>
<td>16.10</td>
<td>17.81</td>
<td>13.01</td>
</tr>
<tr>
<td>99</td>
<td>8.74</td>
<td>21.74</td>
<td>11.41</td>
<td>15.23</td>
</tr>
<tr>
<td>2000</td>
<td>10.39</td>
<td>16.70</td>
<td>16.76</td>
<td>17.16</td>
</tr>
<tr>
<td>2001</td>
<td>10.15</td>
<td>16.04</td>
<td>15.43</td>
<td>17.03</td>
</tr>
<tr>
<td>Average</td>
<td>9.96</td>
<td>17.38</td>
<td>14.15</td>
<td>14.92</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>SOE</th>
<th>Collective Enterprise</th>
<th>Joint-stock Company</th>
<th>Foreign Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>96</td>
<td>4.13</td>
<td>3.88</td>
<td>4.71</td>
<td>4.98</td>
</tr>
<tr>
<td>97</td>
<td>8.96</td>
<td>4.22</td>
<td>1.71</td>
<td>1.87</td>
</tr>
<tr>
<td>98</td>
<td>3.28</td>
<td>7.68</td>
<td>8.81</td>
<td>5.28</td>
</tr>
<tr>
<td>99</td>
<td>3.03</td>
<td>3.92</td>
<td>5.38</td>
<td>6.68</td>
</tr>
<tr>
<td>2000</td>
<td>4.69</td>
<td>7.53</td>
<td>9.58</td>
<td>8.23</td>
</tr>
<tr>
<td>2001</td>
<td>4.43</td>
<td>7.35</td>
<td>8.24</td>
<td>8.17</td>
</tr>
<tr>
<td>Average</td>
<td>4.75</td>
<td>5.76</td>
<td>6.41</td>
<td>5.87</td>
</tr>
</tbody>
</table>

Source: collected from China Statistic Year Book 1994-2002
CHAPTER 7
TRADING STRUCTURE COMPARISON

7.1 Introduction

The stock market includes the stock exchange and the markets which exist outside of the stock exchange. This chapter will focus on analyzing the stock market structure in China on the basis of comparing it with the stock market structures of other developed countries.

7.2 A comparison of trading structure

7.2.1 Trading structure in the United States

Once stocks are issued to the public, investors may trade them among themselves. The purchase and sale of already issued securities takes place in the secondary markets. Because the development levels of stock markets in various countries are different, the structure of stock markets varies considerably from one country to another. Normally in the countries with a developed market financial system, the structure of the stock market includes 1) the stock exchange 2) the over-the-counter market, and 3) direct trading between two parties. The multi-level structure of the stock market satisfies not only the fund-raising requirements of different companies but also the requirements of investors. Different companies can apply to list at different levels of the stock market according to the requirements of the different levels of the stock market. The multi-level structure provides the paths for the different types of companies to enter. A company with a good performance can apply to be listed at a higher level in the stock market. A company whose current operation status is not good can exit or enter into the lower levels of the stock market. The multi-level structure gives companies time and opportunity to improve their
operational status. On the other hand, it provides protection for investors. Additionally, the multi-level structure creates competitive mechanisms through the different levels of the stock market. For instance, the Nasdaq market and regional exchanges posed a stronger competitive challenge to the NYSE. Many large firms that would have been eligible to list their shares on the NYSE chose to list on Nasdaq (Bodie, Kane and Marcus, 1996). In the early 1980s, about 80% of the trades in NYSE-listed shares were executed on the exchange. However, in the 1990s, approximately two-thirds of the trades in stocks listed on the NYSE were actually executed on the NYSE (Bodie, Kane and Marcus, 1996). The multi-level stock market creates competition through the different levels of the stock market. Further, competition promotes different levels of the stock market and so provides good service to the listed companies and investors. The multi-level of the stock market improves the efficiency of the stock market. However, it does not mean that a structure which includes more levels is necessarily a good structure. How to determine the structures of different countries should be on the basis of their concrete conditions, such as if there are enough companies trying to list at different levels of the stock market and if there are enough investors interested in investing at different levels of the stock market. This means that a market structure should be a reasonable structure. Certainly, "reasonable" is a relative concept as "reasonable" or "unreasonable" will change with the development of the economy, the development of the stock market and the change of investment concept of the investor.

"In the United States, there are nine major stock exchanges. Two of these, the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), are national in
The others are regional exchanges, which list firms located in a particular geographic area such as the Boston, Cincinnati, Chicago, Pacific, and Philadelphia Stock Exchanges (Bodie, Kane and Marcus, 1996). The regional exchanges provide a market for the trading of shares of local firms that do not meet the listing requirements of the national exchanges. Regional exchanges also sponsor trading of some firms that are traded on national exchanges. This dual listing enables local brokerage firms to trade in the shares of large firms without needing to purchase membership on the NYSE.

Over-the-counter trading is not undertaken on a formal exchange. There are no membership requirements for trading, nor are there listing requirements for securities. With the development of technology, the over-the-counter Nasdaq market has posed a bigger competitive challenge to the NYSE.

“The third market refers to trading of exchange-listed securities on the OTC market” (Bodie, Kane and Marcus, 1996). This market is mainly for the benefit of large traders. The third market competes with organized exchanges like the NYSE and AMEX by offering better bid and ask prices.

The fourth market refers to direct trading between investors in exchange-listed securities without the benefit of a broker. This market enables institutions to engage in direct trading and therefore save brokerage fees for large institutions. The third and fourth markets as competitors strengthen the stock market in the United States.
7.2.2 Trading structure in Japan

In Japan, the trading structure of the stock market consists of the stock exchange and the over-the-counter facility. Some stock exchanges have established a first board, a second board and a foreign board. Different boards satisfy different requirements of listed companies. According to different listing requirements, different companies are listed on different boards. When listed companies are listed at any level of boards, it does not mean their position is fixed. With the changes of scale and operational status of these listed companies, companies which are listed on the second board can move to the first board. Companies which are listed on the first board can possibly exit that board and list on the second board. The stock exchanges include those of Tokyo, Osaka, Nagoya, Kyoto, Hiroshina, Fukuoda, Niigata and Sapporo, of which Tokyo, Osaka and Nagoya are established with a second board (Tokyo Security Exchange, 1997). In addition, the Tokyo stock exchange has also established a board on which foreign companies can list.

7.2.3 Trading structure in United Kingdom

In the UK, there is no over-the-counter trading (John Black, 1997, p339). The principal stock market in the United Kingdom is the London Stock Exchange (LSE), formally called The International Stock Exchange of the United Kingdom and the Republic of Ireland. The London Stock Exchange runs three markets.

1) The Official List -- this is the largest market. It is intended for large companies, which have substantial public floating and a history of business activity. The market is divided into a domestic section and an international one, on which non-UK stocks are traded.
2) The Unlisted Securities Market (USM) -- This market was established in 1980 to cater for smaller companies, but met with only limited success. It stopped accepting new listings and was closed at the end of 1996.

3) The Alternative Investment Market (AIM) -- This market was set up in June 1995, in a renewed attempt to establish a market for smaller stocks. (A previous effort, the Third Market, flopped in the wake of the 1987 stock market crash, and was finally closed in 1990). Unlike the Official Market, it does not impose any requirements for a minimum trading period or the number of shares to the public.

7.2.4 Trading structure in Australia

Australia was the first fully consolidated equities market in the world. The system is very different to that of USA and UK. From 1871 to 1889, six separate stock exchanges were established in state capitals around Australia. These stock exchanges operated independently of one another until 1937. An association known as the Australian Associated Stock Exchange was formed in 1937. On 1 April 1987, the six separate exchanges formally merged and became one entity-The ASX Limited. Floor trading ceased in 1990 when the new Stock Exchange Automated Screen Trading System (SEATS) was installed. SEATS was based on a similar system known as CATS (Computer Automated Trading System) developed by the Toronto Stock Exchange. Unlike Toronto, Australia succeeded in managing to transfer all their stocks on to the CATS system on the 1 October, 1990. ASX is Australia’s main board.

If a broker receives a very large order from a client, SEATS may not provide sufficient depth for the broker to be able to execute the trade. The Australian Stock Exchange permits
the broker to trade "off-market". An order can be executed off-market if it is worth more than AU$ 1 million. An order can also be executed off-market if it is part of a portfolio of orders from the same client that (i) is worth more than AU$ 5 million, (ii) involves more than 10 stocks and (iii) the order in any stock is worth more than AU$ 200,000.

In 1985, the ASX set up a second board to assist smaller companies (that would not otherwise satisfy the profit or asset admission tests of the main board) get a stock market listing. The market crash in October 1987 led to significant illiquidity for the second board companies, and the second board disappeared in 1992. Later, second boards re-emerged. The Federal Government allocated $1.2 million for the preparation of feasibility studies on the resurrection of the Hobart and Bendigo stock exchanges. $600,000 was also allocated, through the New South Wales government’s Hunter Advantage Fund, to private interests looking to resurrect the Newcastle stock exchange. The Bendigo Stock Exchange brings a new focus to Australia's small and medium sized enterprises and highlights the nation's untapped regional strengths. It is apparently intending to establish an Internet-based business matching service (similar to the ASX Enterprise market), while the Newcastle Stock Exchange will be a traditional stock market aimed at IT and other emerging industry companies.

7.2.5 Trading structure in China

1) Structure of stock market

At present, the trade structure of the Chinese stock market consists of two exchanges, the Shanghai stock exchange and the Shenzhen stock exchange. The Shanghai and Shenzhen stock exchanges are divided into the A share stock market and B share stock market. In addition to the two exchanges, there have been two legal entity trade markets, STAQ and
NET. STAQ was established on 5 December, 1990. NET was established on 28 April, 1993. Because ordinary investors cannot enter into these two markets, trade on the two exchanges is not active. On 9 September, 1999, the SRC closed the two markets.

The Shenzhen and Shanghai stock exchanges follow the same listing standards and regulations. The first, second and third classes of enterprises are separately listed on the two exchanges and there is no cross-listing of A shares on the two exchanges, however companies can cross list A shares on a stock market and B shares on a stock market. A shares and B shares are not convertible to each other. No over-the-counter or second board is provided to small and middle-sized enterprises to raise capital. In contrast with the structure of the UK stock market, the structures of the United States, Japanese stock market and Australian stock market, the market structure of the Chinese stock market is simple. The structure can not completely satisfy the different requirements of listed companies. According to the current situation and the development trend of the Chinese stock market and joint-stock companies, a reasonable market structure should be established.

2) Structure of the share trade

For Chinese listed companies, at different times, the variety of shares is different. Before March, 1992, there were only state-owned shares, legal-entity shares and public shares (A shares). After March 1992, listed companies issued B shares. Tradeable shares included A shares and B shares. Untradeable shares mainly include state-owned shares, sponsor legal entity shares, social legal entity share and foreign legal entity shares. The main reason for the classification is because the stock market is only considered an experimental product at this early stage. Nobody knows the final result of this experiment. In order to avoid the loss
of state-owned assets and to keep the controlling right of listed companies, the surveillance institution makes the stipulation that state-owned and legal entity shares are prohibited from trading.

Among issued shares, some can be traded, but some cannot. This classificational approach is one of the special characteristics of the Chinese stock market. What follows will discuss the effect of these special characteristics of the Chinese stock market.

a) Not aligned with international practice

The classificational approach is not aligned with international practice. Normally, an international habit is formed on the basis of the many successful and failed experiences of different countries. The classification change has an historical reason. Although it has been proved that classification restricts the performance of the corresponding mechanisms of the joint-stock company and becomes a bottleneck to the further development of the Chinese stock market, it has played a certain positive role in the early development of the Chinese shareholding system and stock market.

b) Against the theory of equity finance

Theoretically, the same shares should be granted the same rights. In another words, shareholders of the same shares should have the same decision making rights, dividend payment rights and ownership right of property. However the government is afraid that state-owned enterprises could be taken-over by other individual investors. The same shares are divided into tradeable and untradeable shares. This is contrary to accepted theory which
holds that the same shares have the same rights. At the same time, it is also against the principles of fairness, justice and openness.

c) Against Chinese Company Law.

Chinese company law, definitely stipulates, "Shareholders of the same shares should be granted the same rights".

d) The negative effects on the secondary market

The large percentage of untradeable shares causes a bad effect on the stock market. It gives large investors an opening to manipulate share prices and so disturbs the fairness principle of the stock market under this imperfection in the legal system. The negative effects are as follows:

1) When the comprehensive indexes of the Shanghai and Shenzhen markets are calculated, the number of shares not only includes tradeable shares but also untradeable shares. The proportion of untradeable shares in the total is high. The movement of the indexes not only impacts on tradeable shares, but also on untradeable shares. Obviously, the indexes do not reflect the status of the stock market movements accurately. In addition, some shares are a component of the index. The total number of these shares is very small. Because of the trade structure design of tradeable and untradeable shares, it further decreases the number of shares which are traded on the secondary market. Therefore, the trade structure design makes it easy for some investors to manipulate one or more kinds of shares so as to manipulate the movement of the index. Because the index is one of the very important indicators for investors to judge the movement trend of the stock market, a manipulated
index will possibly result in investors making false investment strategies. Obviously, the trade structure design disturbs the fairness principle of the market.

2) Because classification reduces the number of shares which are traded on the secondary stock market, it increases the probability of large investors manipulating the price of these shares.

3) Market segmentation

The reason for the designing of B share stocks is similar to that of share classification. Emerging countries are “thirsty” for foreign capital on one hand, but are also afraid of the detrimental effects caused by foreign capital, especially when their legal system has not been fully established and the laws are imperfect, and the surveillance ability and level are less developed. Therefore, these countries normally absorb foreign capital, and they take some measures to avoid the negative effects of internalizing their stock markets at the same time. Because the Chinese capital account has not fully opened and the Chinese government tries to reduce the negative influence of internationalization, a special market for foreign investors has been established. The market structure design overcomes the problem that the RMB cannot be freely exchanged with other foreign currency. In other countries, they normally reduce the negative impact through limiting the holding number or the holding percentage.

B Shares are foreign-invested shares issued domestically by PRC’s companies. B Shares are also known as Renminbi Special Shares. B Shares are issued in the form of registered shares and carry a face value denominated in Renminbi. B Shares are subscribed to and
traded in foreign currencies (B shares listed on the Shanghai stock exchange are purchased with US dollars and B shares listed on the Shanghai stock exchange are purchased with HK dollars) and are listed and traded on securities exchanges in the mainland of China.

**Figure 7.1 The Number of Listed Stock**

![Figure 7.1 The Number of Listed Stock](image)

Source: China Statistics Year Book 2003

**Figure 7.2 Total Issued Capital (unit: billion shares)**

![Figure 7.2 Total Issued Capital](image)

Source: China Statistics Year Book 2003
One year after the establishment of the Shanghai security exchange, on 21 January, 1992, the Shanghai stock market successfully issued B shares, called Vacuum Electronic. This was the first step in the internationalization of the stock market. According to the China statistic year book, at the end of 1993, there were 41 varieties of B shares with a total capitalization of 21.24 billion RMB, of which 22 varieties of the B shares were traded on the Shanghai stock exchange and 19 varieties of B shares were traded on the Shenzhen stock exchange with a total capitalization of 19.05 billion RMB. By the end of 2002, there were 111 varieties of B Share issuers, of which 54 varieties of B shares listed on the Shanghai stock exchange had a total capitalization of 44.28 billion RMB and 57 varieties of B Shares on Shenzhen stock exchange had a total capitalization of 36.02 billion RMB. The B shares are traded in US dollars on the Shanghai stock exchange. The majority of shares concern industry. The total issued capital is 9.2 billion shares. In the Shenzhen
stock exchange, shares are traded in Hong Kong dollars. The total issued capital is 8.7 billion shares. In contrast with the size of the A share stock market whose share variety is 1199, total tradeable market capitalization is 117.19 RMB billion and the total shares number 546.3 billion, while that of the B shares stock market is very small. Figure 7.1, figure 7.2 and figure 7.3 show that until the end of 2002, the number of listed stock on the A share stock market is about eleven times that of the B share stock market. The total issued capital of the B share stock market only accounts for 3.28% of the A share stock market. The tradeable market capitalization of the B share stock market accounts for 6.54% of the A share stock market.

7.3 Conclusion

In this chapter, the trading structure of some developed stock markets has been analyzed and then the special trading and shares structure of the Chinese stock market has been introduced and analyzed and the results caused by these special structures explained. Finally, the development of the B shares stock market and the disequilibrium development between the A shares and B shares stock markets has been analyzed. A reasonable trading structure will promote the efficiency of the stock market. As a determinant factor of whether a stock market is efficient, the share price will be explained and analyzed in the next chapter.
CHAPTER 8
MARKET BEHAVIOUR COMPARISON

8.1 Introduction
This chapter will discuss share price, share pricing process and share price behaviour theory and compare the returns and risks of different stock markets. In addition, speculation and over-speculation will be discussed.

8.2 Share price, share pricing process and share price behaviour theory

8.2.1 Share price and share pricing process
Stock is certification of ownership. It is a type of fictitious capital and has capital features and commodity features. The capital features of shares means that shareholders can get dividends from companies or obtain capital gain through the selling and buying of shares; either can increase the wealth of the shareholder. In addition, stock has a commodity feature, that is stock can be traded on the stock market. Commodity features mean that the stock has value and use value. However the use value of stock is different from that of commodities.

A share price includes the face value, the book value and the market price. The market price is formed in the process of trade. It is the negotiation result of two parties. The movement of the market price results in the loss or profit for investors. The market price is determined by the relationship between supply and demand. The supply and demand relationship is influenced by the following factors:
1) The expected asset value and investment value of companies. The expected asset value refers to the expected net assets of companies. The investment value is used to measure the potentiality of companies.

2) The expectation for a future market price.

3) Psychology.

The following will analyze the factors influencing a market price in the short-term and in the long-term.

Under normal conditions, the demand-supply equilibrium of a commodity is formed at a point or in a range around the point. In the long-term, the equilibrium cannot be lost and the prices of commodities will be relatively steady. However, no matter whether it is long-term or short-term, the equilibrium of the share price is maintained for a much shorter time than that of a common commodity. Therefore, the share price, especially the share price in the short term, has a higher volatility than that of a commodity. The following will analyze the different impacts of long-term and short-term supply-demand on the formation of a share price.

Assuming that the total number of issued shares in the stock market is certain and that the number of buyers is more than that of sellers, the share price will be pushed up. If demand continues to be greater than supply then the share price will increase continuously. Where the site occurs, the share price will go in the opposite direction. When the number of buyers is basically equal to that of sellers, an equilibrium price will emerge and the share price will be fixed at this level. Later, some factors possibly cause the equilibrium to be lost.
When this bid and asks price gradually closes, a new equilibrium will be formed. However the equilibrium will last only for a short term. The share price is always in the process of changing. One reason to explain this is because of the special use value of stock.

In figure 8.1, assume that curve D and S represent separate primary demand and supply curves, $A_1$ is the intersect of curve D with S; $P_1$ represents the equilibrium price. The square, $O P_1 A_1 C_1$, represents the market value of stock. Assume for some reason, the demand for stock increases. The demand curve moves from D to $D'$ as indicated in figure 8.2. At the same time, assume the number of issued shares does not change and the supply curve remains in the same position; the $D'$ will cross with curve S at the point $A_2$. A new equilibrium is established. The square, $O P_2 A_2 C_2$, represents the new market value and $O P_2 A_2 C_2 - O P_1 A_1 C_1$ represents the decrease in the market value.
Enormous and consecutive share prices changes form the movement of the curve of the share price. With the change in demand and supply, the share price increases or decreases around its value.

The above explains the share pricing process under long-term demand and supply equilibrium conditions. However, the impact of short-term supply-demand equilibrium on the share price is more important, because it indicates the supply-demand equilibrium feature of the share price which is different from that of the common commodity. Under normal conditions, the lower the commodity price is, the higher the demand is for the commodity. There are more buyers in the market. On the contrary, the higher the commodity price is, the lower the demand is for the commodity; there are more sellers.
This is the relationship between supply and demand and the commodity price. The relationship between supply and demand and the share price follows the same principle. However, because the share has a special use value and the liquidity speed of the share is faster than the speed of the commodity, the supply and demand curves of the share will be different from that of the commodity. The supply of the share is steadier. The co-efficient of elasticity is small. The demand for shares is affected by the forecast of people on the expected share price, and the demand curve of the share price is also different from that of the commodity.

8.2.2 Factors impacting on price movements

Many factors impact on the movement of the share price. How these factors impact on the stock market is very complicated. At present, although no theory can accurately forecast the movement trend of a share price and completely explain how these relative factors impact on the movement of a share price, many kinds of factors and their relationships are already understood. The main factors impacting on the movement of a share price will now be analyzed.

The factors which impact on the share price include inside and outside factors. Outside factors normally are political, economic, societal and cultural. Outside factors are very important for a listed company, because they impact on its profitability and whether or not a listed company can survive in competition. The main inside factors are:

1) The structure factor. It is relative to the share structure, investor structure and holding structure.

2) Market behaviour. This refers to the aims of the investors.
3) Share supply. This refers to share increases or decreases.

4) System. It refers to the system of market operation, management, surveillance and so on.

5) Technology. This involves the trading approach and technology.

6) Physiology. This refers to how investors affect each other and their confidence with the whole market and shares.

These factors from both inside and outside, impact on the share price. The same factors create a different impact on the share price in different countries and during different periods.

8.2.3 Share price behaviour theory

Share price behaviour theory provides a theory base for investors to make decision. In some Chinese investment analysis books, share price behaviour theory is divided into two schools; the steady fundamental theory school and the air castle theory school. The steady fundamental theory is further divided into two schools; the value school and the risk school. The air castle theory school is also divided into two schools; the technology school and the random walk school. Their representatives are the following:

1) Value group: J.B William, Myron J. Golden

2) Risk Group: Harry Markowitz, William Sharp

3) Technology analysis: Dow, Dettlet

4) Random walk: Fama
1) Steady fundamental theory and air castle theory

Steady fundamental theory documents that the minority of the share price is determined by the psychology of the investor while the majority of the share price is determined by their logical analysis. The adherents think that the psychology factor cannot be sustained to support the ascending trend of share prices for too long and that financial law must impact the soaring prices. In practice, it can be seen that within a long period, the share price fluctuates around its value and over-high market prices will result in an investment risk; unsystematic risk can be avoided through the establishment of an investment portfolio.

The air castle theory argues that logical analysis explains the minority of the share price; the majority of the share price should be explained by the psychology factor. In 1936, Keynes addressed the “Beauty Selection” theory. He documented the shortcomings of the steady foundation theory and pointed out that the true value of a company cannot be measured.

Argument between the steady fundamental theory and the air castle theory has continued until recently. Their arguments focus on determining whether there is a reasonable approach to evaluate the true value of a company.

2) Valuation school and risk school

Markowitz proposes, when investors make their investment strategies, they consider both the returns and the risk and this is why they do not put all their eggs in the one basket. Markowitz also documents this in his investment portfolio theory.
Sharpe shaped his single factor model (CAPM) under Markowitz's supervision. The theory greatly simplified the calculation process of the Markowitz theory. Sharp applies statistical theory in security analysis. He divides risks into two parts, systematic risk and unsystematic risk. The difference between the valuation school and the risk school lies in how they emphasize different variables.

3) Technology analysis and random walk

The contradiction between technology and random walk lies in whether a share price can be forecast according to the historical share price. The technology school thinks every factor that impacts on the share price must influence the behaviour of investors. If the share price rises 10% one day, it can be caused by good news. Secondly, the movement of the share price follows certain laws; the share price has "inertia". It normally keeps its movement direction. Within the stock market, the main body is made up of people. Since they are human, their behaviour must be influenced by psychology. So long as investors experience a positive outcome they will tend to infer that, given similar conditions, a result will be repeated. Investment strategy follows this same principle, once the investment strategies of investors have been successful. Later, if they face similar conditions, they will apply their same investment strategies. If they have experienced failure, they will make new investment strategies. However random walk thinks that the movement of share prices has no regularity and that the movement track is no different from the track of throwing a coin. Fama thinks "noise" exists in the stock market. Despite the fact that the stock market can reflect information through share prices, influenced by other investors, share prices are not normally able to reflect relative accurate information. Fama divides efficient markets into
three types: the strong form market, the semi-strong form market and the weak form market.

3) Financial behaviour theory

Financial behaviour theory was first proposed by Burrell and Bauman in 1951. Financial behaviour theory is established on the basis of social science theory. Their research purpose is to explain and forecast the strategy process of investors in the financial market. Financial behaviour theory explains some anomalies.

8.3 Return and risk

8.3.1 Return and risk

For investors, both the returns and the risks are important considerations when the investor makes an investment decision. For listed companies and the economics of a country, a market with a low risk and a high return will attract more investors and it is easy for such companies to finance and refinance funds, and thus promote the ongoing development of the economy.

The returns of listed companies can be divided into current return and expected returns. Compared with the features of savings, bonds and so on, investing in shares carries the uncertainty of returns. This feature is directly related to the uncertainty of expected profits for listed companies. The risk is completely undertaken by investors themselves.
Investors can obtain returns from dividends. Moreover, in many conditions, getting capital gain is the main approach for an investor to obtain a return, however it needs the investor to make a correct forecast.

1) Expected returns

Expected returns include the dividend increase or decrease and the share price increase or decrease. Expected returns can be expressed as follows:

Expected return = expected dividend + expected capital gain (selling price - buying price)

Normally, the interest rate is regarded as a benchmark to evaluate the returns of stock; therefore the above formula can also be expressed:

Expected return = free rate + expected capital gain or

Expected return = free rate + \( \frac{\text{selling price} - \text{buying price}}{\text{buying price}} \)

An expected capital gain is relative to two factors, viz. risk and growth ability. An expected return is an investor's expectation for a return. An investor must take a risk as to whether the expected return could eventuate or not. An investor takes a high risk only for obtaining the return which is higher than the interest rate. However, this is not enough for some investors. They hope to get a higher return than the return of interest rate plus the premium. This part of the return will come from the growth ability of the company. Under the assumption that a number of shares is certain, if the investor invests in shares with a high growth ability, the earning per share will increase, and therefore the expected return will be:

Expected return = free rate + premium + expected return for growth ability
Risk is normally divided into two types, systematic risk and unsystematic risk. Systematic risk is that which all investors should take. It influences all listed companies whereas unsystematic risk does not influence all listed companies but rather a part of them. Unsystematic risk can be further classified into industry risk, enterprise risk and market risk.

8.3.2 Return and risk comparison

1) Return Comparison

a) Subject:

In China, the comprehensive index of the Shanghai stock exchange and the Shenzhen component index have been selected as this research subject. In selecting Japan and United States, the TOPIX and NY compound indexes are used as research subjects.
b) Period

The period is from 1991 to 2001.

From table 8-1, it can be seen that the average returns of the Shanghai and Shenzhen stock markets are higher than those of NYSE and TOPIX. The average returns of the Shanghai and the Shenzhen stock markets are 27.85% and 30.38% respectively from 1991 to 2001. During the same period, the average returns of the New York stock exchange and the Tokyo stock exchange are 14.39% and 0.14%. The average returns of the Shenzhen exchange are higher than that of the Shanghai exchange. The investors in these different stock markets have also taken different levels of risk. From the table 8-2, it can be seen that the risk of investors in the Shanghai and Shenzhen stock markets is much higher than that of investors in the New York stock exchange and the Tokyo stock exchange. The risk of investing in the Shenzhen stock market is higher than that of investing in the Shanghai stock market.

**Table: 8.2 Risk Comparisons**

<table>
<thead>
<tr>
<th></th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>NYSE</th>
<th>TOPIX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard</td>
<td>62.27</td>
<td>72.50</td>
<td>12.38</td>
<td>24.43</td>
</tr>
<tr>
<td>Variance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>27.84</td>
<td>30.38</td>
<td>14.39</td>
<td>0.14</td>
</tr>
<tr>
<td>Return</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: calculated on the base of table 8-1

**8.4 Speculation**

8.4.1 *Speculation*

When a person commits a certain amount of money with the expectation that it will return a larger amount in the future, this investment behaviour could be called gambling or
speculation or investing. A holding period, the law and rationality are normally regarded as
the main indicators for separating investment from other economic activities.

Table 8.1 Return Comparisons

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>NYSE</th>
<th>TOPIX</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>166.50</td>
<td>120.83</td>
<td>27.12</td>
<td>-0.39</td>
</tr>
<tr>
<td>1993</td>
<td>6.84</td>
<td>-1.22</td>
<td>4.69</td>
<td>-23.02</td>
</tr>
<tr>
<td>1994</td>
<td>-22.30</td>
<td>-40.98</td>
<td>7.86</td>
<td>10.97</td>
</tr>
<tr>
<td>1996</td>
<td>65.10</td>
<td>189.04</td>
<td>31.31</td>
<td>2.09</td>
</tr>
<tr>
<td>1997</td>
<td>30.20</td>
<td>16.48</td>
<td>19.06</td>
<td>-6.06</td>
</tr>
<tr>
<td>1998</td>
<td>-3.97</td>
<td>-9.82</td>
<td>30.31</td>
<td>-19.41</td>
</tr>
<tr>
<td>1999</td>
<td>19.18</td>
<td>16.96</td>
<td>16.55</td>
<td>-6.57</td>
</tr>
<tr>
<td>2000</td>
<td>51.73</td>
<td>56.62</td>
<td>9.15</td>
<td>59.60</td>
</tr>
<tr>
<td>2001</td>
<td>-20.63</td>
<td>-24.65</td>
<td>1.01</td>
<td>-24.96</td>
</tr>
<tr>
<td>Average</td>
<td>27.85</td>
<td>30.38</td>
<td>14.39</td>
<td>0.14</td>
</tr>
</tbody>
</table>

Source: Shenzhen and Shanghai: CSRC
NYSE: New York Stock Exchange
TOPIX: Tokyo Stock Exchange

Gambling differs from speculation and investment in the following aspects. 1) Gambling is
short-lived unlike speculation or an investment. 2) Gambling does not bet on an economic
endeavour: gambling creates an artificial risk in that if people do not gamble, no risk can
emerge. 3) Gambling creates a risk without providing any commensurate expectation of
economic benefit. Gambling could be said to be a type of irrational investment behaviour.

The difference between speculation and investment is that the holding period for a
speculator is typically shorter than for that of an investor. Speculation is rational behaviour.
Speculation usually involves the purchasing of a saleable asset with the hope that its price
will increase rapidly, in order to provide a quick profit. Speculators try to buy low and sell high. Contrary to 'folklore', profitable speculators actually smooth price fluctuations as they make purchases at low prices and sell at high prices. In practice, sometimes, it is difficult to distinguish between speculation and investment. Under some conditions, investment and speculation can affect each other. Speculation can be divided into legal speculation and illegal speculation and rational speculation and over-speculation. Illegal speculation mainly refers to the behaviour of people who obtain capital gain through inside trading and the manipulation of prices. This behaviour breaks the basic principle of the stock market. Legal speculation is defined as the activity of forecasting the psychology of the market and John Maynard Keynes introduced the speculative motive as the object for securing profit from knowing better than the market in respect of the future. Its positive impacts on the stock market are as follows:

1) Speculation can restrict price manipulation and strengthen competition. In a completely competitive market, no people or organization can manipulate the price. The price completely reflects the relationship between supply and demand. Price, an "invisible hand", guides the behaviour of buyer and seller. However in practice, a completely competitive market is difficult to find. When speculative behaviour influences the stock market, it is difficult for most investors to manipulate the market. For example, when some larger investors attempt to push the share price up through buying enormous numbers of shares, the ascending trend provides an opportunity for speculators who already hold shares bought at a lower price. They will sell their shares so as to obtain their capital gain. This behaviour reduces the ascending speed of share prices or changes its movement trend.
2) Speculation can adjust the relationship between supply and demand and is of benefit so as the market price may reflect the true value of a listed company. In an economic operation, because of the existence of “herding”, in the short-term period, supply and demand is not in equilibrium. However, during the long-term period, the total supply and total demand is in equilibrium. Speculators pay more attention to changes in the economic environment and the performance of listed companies than do other investors. They make investment strategies on the basis of their analysis. The buying or selling of an investor is helpful in the recovery of the equilibrium between demand and supply. In addition, their investment behaviour also accelerates the speed of information transmission and liquidation and promotes market prices to reflect the true value of listed companies.

8.4.2 Over-speculation

Over speculation is different from speculation. It not only counteracts the positive impact of speculation on the stock market but it also results in some negative effects. The main negative effects of over-speculation are as follows: 1) the share price is twisted. Over speculation enables the share price to deviate greatly from its value and provides a false signal to the investor. It greatly decreases the efficiency of resource allocation of the stock market. 2) because of value law, the twisted market price will go back to its value. Normally, the process accompanies a big fluctuation in the share price when a big fluctuation occurs among minor share prices; its negative effect is not strong. The US stock market in 1929 and the Japanese stock market in 1990 both showed the negative impact of over speculation on the economy and on society. Over-speculation that is caused by buyers will result in share prices rising over the long-term. It is impossible for share prices to rise forever. Once a plunge occurs, it would be difficult for share prices to recover to the prior
level. The results of the plunge are that the market would lose its fundamental function and increase the risk for the stock market. Investors will make large losses. A major reason for over-speculation is that it provides an opportunity for some investors to get a high return. The wealth effect lures other investors to invest in the stock market. Over-speculation can alter people's social behaviour and moral standards and create a negative influence on social development. In the emerging stock market, because of the imperfection of laws and the system and the immaturity of an investor, over-speculation can more easily emerge.

There is no unified accepted standard for determining whether a stock market is over-speculating. During different periods, under different conditions, relative to different people, the understanding of over-speculation differs. Normally, there are two approaches to test the speculation of investors. One is to test through sending questionnaires. The other approach is to use statistical data analysis. This chapter adopted a statistical analysis approach. Three indicators, a fluctuation index, PER (price earnings ratios) and turnover rate, are chosen to measure speculation.
Table: 8.3 Fluctuation Index

<table>
<thead>
<tr>
<th>Shanghai Comprehensive Index</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>1429.1</td>
<td>1558.95</td>
<td>1052.94</td>
<td>926.41</td>
<td>1258.69</td>
<td>1510.18</td>
<td>1422.98</td>
<td>1756.18</td>
<td>2125.72</td>
</tr>
<tr>
<td>Low</td>
<td>292.76</td>
<td>750.46</td>
<td>325.89</td>
<td>524.43</td>
<td>512.83</td>
<td>870.18</td>
<td>1043.02</td>
<td>1047.83</td>
<td>1361.21</td>
</tr>
<tr>
<td>Change%</td>
<td>388.1%</td>
<td>107.7%</td>
<td>223.1%</td>
<td>76.7%</td>
<td>145.4%</td>
<td>73.5%</td>
<td>36.4%</td>
<td>67.6%</td>
<td>56.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shenzhen Comprehensive Index</th>
<th>92</th>
<th>93</th>
<th>94</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>312.21</td>
<td>359.44</td>
<td>242.06</td>
<td>169.66</td>
<td>473.02</td>
<td>517.91</td>
<td>441.04</td>
<td>525.14</td>
<td>654.37</td>
</tr>
<tr>
<td>Low</td>
<td>107.08</td>
<td>203.91</td>
<td>96.56</td>
<td>112.63</td>
<td>105.34</td>
<td>305.81</td>
<td>317.10</td>
<td>310.65</td>
<td>414.69</td>
</tr>
<tr>
<td>Change%</td>
<td>191.6%</td>
<td>76.3%</td>
<td>150.7%</td>
<td>50.6%</td>
<td>349.0%</td>
<td>69.4%</td>
<td>39.1%</td>
<td>69.0%</td>
<td>57.8%</td>
</tr>
</tbody>
</table>

Source: Calculated on the base of data in China Market Statistic Year Book 2001
The fluctuation index is one of the most important indicators to measure over-speculation behaviour. From table 8-3, it can be seen that the average year fluctuation rate of the Shenzhen comprehensive index is 117.1%. In 1992, 1994 and 1996, the yearly fluctuation rate is 191.6%, 150.7% and 349.0% respectively. These rates are much higher than that in other years. Yearly fluctuation rates of the Shanghai comprehensive index show the same trend as the average yearly fluctuation rates of the Shenzhen comprehensive index. The average fluctuation rates of the Shanghai comprehensive index are higher than that of the Shenzhen stock market. Its average fluctuation rate is 130.5%. Yearly fluctuation rates in 1992, 1994 and 1996 are much higher than that in other years. From a short term point of view of the fluctuation status, it can be observed that the fluctuation rate of Chinese stock markets is much higher than that of other stock markets. Normally, the daily fluctuation rate of a stock market is higher than 2%. The stock market is regarded to be over-fluctuated. The daily fluctuation rate of the Chinese stock market is much higher than this rate. For instance, the daily fluctuation rate of the Shenzhen comprehensive index was -18.63% on 11 Aug., 1991. On 1 Aug., 1994, the daily fluctuation rate was +31.29% (Hu Jizhi, 1999).

PER is a ratio of share prices to profit after tax. It reflects the time in which the investment can be recouped. It also reflects the relationship between a share price and its value. PER is a very important indicator. It normally is used to measure investment value and the investment risk of a stock market. In developed stock markets, if PER is around 20, the stock market is regarded as normal. Although the PER in emerging stock markets is normally higher than that in developed stock markets, a PER less than 25 or 30 is regarded as normal. From table 8-4, it can be seen that, the average PERs in Shanghai and Shenzhen
were higher than those in other stock markets and were around 34. If PER in different years was analyzed, it can be found the majority of PERs in Shenzhen and Shanghai stock markets are higher than 30. It means over-speculation normally occurred in the two stock markets.

Table: 8.4 PER Comparison in the World

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>New York</th>
<th>Hong Kong</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>42.48</td>
<td>42.69</td>
<td>15.20</td>
<td>21.60</td>
<td>43.8</td>
</tr>
<tr>
<td>1994</td>
<td>23.45</td>
<td>10.28</td>
<td>12.70</td>
<td>10.70</td>
<td>20.7</td>
</tr>
<tr>
<td>1995</td>
<td>15.70</td>
<td>9.46</td>
<td>14.00</td>
<td>11.40</td>
<td>16.1</td>
</tr>
<tr>
<td>1996</td>
<td>31.32</td>
<td>35.42</td>
<td>15.70</td>
<td>16.40</td>
<td>17.3</td>
</tr>
<tr>
<td>1997</td>
<td>41.24</td>
<td>39.86</td>
<td>23.9</td>
<td>12.10</td>
<td>19.7</td>
</tr>
<tr>
<td>1998</td>
<td>32.96</td>
<td>30.59</td>
<td>27.2</td>
<td>10.66</td>
<td>23.1</td>
</tr>
<tr>
<td>1999</td>
<td>38.13</td>
<td>37.56</td>
<td>31.3</td>
<td>26.73</td>
<td>26.9</td>
</tr>
<tr>
<td>2000</td>
<td>58.22</td>
<td>56.03</td>
<td>25.2</td>
<td>12.80</td>
<td>25.7</td>
</tr>
<tr>
<td>2001</td>
<td>37.71</td>
<td>39.79</td>
<td>31.1</td>
<td>12.18</td>
<td>-</td>
</tr>
<tr>
<td>2002</td>
<td>34.43</td>
<td>36.97</td>
<td>-</td>
<td>14.89</td>
<td>-</td>
</tr>
<tr>
<td>Av.</td>
<td>33.56</td>
<td>33.87</td>
<td>21.8</td>
<td>14.95</td>
<td>24.16</td>
</tr>
</tbody>
</table>

Source: China Security Futures Statistic Year Book 2003

Turn-over rate is another important indicator to measure over-speculation. Turn-over rate can be divided into yearly, monthly and daily turn-over rate. Yearly turn-over rate is regarded as an important indicator to judge whether investment behaviour is a long-term or short-term behaviour. Normally, 30% -50% of yearly turn-over rate is regarded as normal. It means shareholders normally hold shares for three or five years. From table 8.5, it can be seen that the average turn-over rates of the Shenzhen and Shanghai stock markets were much higher than those of other developed stock markets. These two stock markets were
also higher than the Taiwan stock market. A high turn-over rate means that the investment
behaviour of the stock market was normally short-term.

<table>
<thead>
<tr>
<th>Year</th>
<th>NYSE</th>
<th>Tokyo</th>
<th>Toronto</th>
<th>Australia</th>
<th>HK</th>
<th>Singapore</th>
<th>Taiwan</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>55.1</td>
<td>25.6</td>
<td>17.3</td>
<td>-</td>
<td>51.7</td>
<td>-</td>
<td>352.5</td>
<td>838.8</td>
</tr>
<tr>
<td>1995</td>
<td>50.8</td>
<td>23.1</td>
<td>18.9</td>
<td>-</td>
<td>34.3</td>
<td>-</td>
<td>199.6</td>
<td>430.3</td>
</tr>
<tr>
<td>1996</td>
<td>54.3</td>
<td>28.6</td>
<td>25.5</td>
<td>-</td>
<td>40.6</td>
<td>-</td>
<td>243.4</td>
<td>744.1</td>
</tr>
<tr>
<td>1997</td>
<td>59.6</td>
<td>34.5</td>
<td>33.4</td>
<td>50.6</td>
<td>118.3</td>
<td>28.8</td>
<td>368.5</td>
<td>590.4</td>
</tr>
<tr>
<td>1998</td>
<td>67.4</td>
<td>35.0</td>
<td>41.0</td>
<td>47.9</td>
<td>63.9</td>
<td>28.3</td>
<td>261.8</td>
<td>409.7</td>
</tr>
<tr>
<td>1999</td>
<td>72.7</td>
<td>50.7</td>
<td>41.8</td>
<td>47.1</td>
<td>40.5</td>
<td>33.8</td>
<td>237.6</td>
<td>381.3</td>
</tr>
<tr>
<td>2000</td>
<td>89.0</td>
<td>60.8</td>
<td>59.4</td>
<td>58.2</td>
<td>63.5</td>
<td>38.8</td>
<td>195.3</td>
<td>378.1</td>
</tr>
<tr>
<td>2001</td>
<td>87.9</td>
<td>61.3</td>
<td>56.7</td>
<td>65.5</td>
<td>50.2</td>
<td>34.3</td>
<td>159.6</td>
<td>264.8</td>
</tr>
<tr>
<td>Average</td>
<td>67.1</td>
<td>40.0</td>
<td>36.7</td>
<td>53.8</td>
<td>57.9</td>
<td>32.8</td>
<td>252.3</td>
<td>504.7</td>
</tr>
</tbody>
</table>

Source: Yearbook of Stock Exchanges, China Statistical Yearbook; Quarterly Statistics, People's Bank of China

8.5 Conclusion

Share prices are a determinant of whether a stock market can function efficiently. The key
to becoming an efficient market is whether share prices accurately reflect the true value of a
joint-stock company. This chapter introduces price formation theory, factors impacting on
share prices and share price analysis theory. Then, a return and risk comparison between
the Chinese stock market and other stock markets is made. Through analysis, it can be seen
that the Chinese stock market is a market with high returns and high risk. Finally, the over-
speculation status of the Chinese stock market is analyzed. The next chapter will expound
on the surveillance system and the status of the Chinese stock market.
9.1 Introduction

An efficient surveillance system is very important for the healthy development of the stock market. This has been proved by the many cases which have already occurred in developed and emerging stock markets, as for example the 1929 stock market crash in the United States and the financial crisis in Asia in the late 1990s. The following discussion will start with an analysis of surveillance theories and a comparison of surveillance systems among developed countries and will then find the problems, which exist in the Chinese surveillance system.

9.2 Surveillance Theory

In the history of Western surveillance, the debate as to whether or not stock market surveillance improves the efficiency of the stock market has continued unabated. The stock market emerged in the freedom-capitalism age. At that time, the two economic theories, "Invisible Hand" (Smith, 1904) and "Supply creates demand" (Say, 1826) were embraced, and therefore surveillance was thought to reduce the efficiency of the stock market rather than improve it. However, the economic depression which occurred between 1929 and 1933 destroyed this myth. The market did not establish equilibrium automatically. The resultant failure produced the emergence of government intervention theory. The representative of this theory is Keynes. This theory gradually occupied a dominant position in the theory field. This theory thought that surveillance would be helpful in the development of the economy. However in the 1970s, because of the failure of the Keynes
theory in practice, a requirement for relaxing restrictions on the stock market and economic globalization was raised.

The theories that are against government intervention are as follows:

1) Efficient market theory.

Richare. A. Posner (1973) proposes the following view: the stock market is a completed competition market. Price is sensitive. Information is rapidly disseminated and reflected in prices. Without government intervention the market can operate efficiently. Therefore, government intervention within the stock market is unnecessary, even harmful.

2) Public choice theory

The representative of this school is G. J. Stigler (1975, 1968). In his book “The Citizen and the State; the Organization of Industry”, he points out that in practice, government surveillance measures are not complete public goods, because in countries that adopt the market economy, government policies only reflect the views of a majority of congressmen. When they formulate policies, they possibly forget their responsibility as spokesmen. Even, their surveillance objectives possibly control them; policies that they have formulated do not protect the interests of the public but rather infringe on their interests.

These theories analyze the reasons why surveillance does not improve the efficiency of a stock market, and they also demonstrate the negative aspects of surveillance on the stock market. However, it is not enough to deny the positive influence of surveillance because one assumption of efficient market theory is perfect competition. However in practice, it is quite hard to find a market to completely satisfy the assumption. The main reason is that
different kinds of asymmetry exist globally and in any one country. In the global context, the asymmetry mainly reflects the following aspects:

a) The economic development levels of different countries differ. Compared with the amount of funds available in a developing country, that available in developed countries is much more. They control the trends in the stock market.

b) The impact of the same game on developing and developed countries is different. In order to attract more funds, to import advanced technologies and to add more competitive mechanisms, developing countries open their markets gradually. However the results of opening markets are different. For developed countries, they have more of an advantage. For developing countries, they have more disadvantages. The different impacts of the Asian financial crisis on developing and developed countries are an example.

c) The development level of developed and emerging stock markets is different. In comparison with a developed stock market, in any of the aspects such as innovation ability, the trading method or accumulated experience, the emerging market is at a disadvantageous position.

d) Even in one country, the stock market is barely able to be completely efficient. The efficient improvement of the stock market depends on the improvement of expert management, size expansion of funds and the percentage increase of institutional investors.

Public choice theory analyzes the influence of stock surveillance on the stock market from its form process. This theory expounds the aim of government surveillance and demonstrates its deviation from public benefit protection. However it is not enough to
completely deny the positive influence of government surveillance. Concerning some questions, the government possibly represents the special interest of some interest groups, even though the government is a public institution. The scope and degree of government intervention should exist at a level of equilibrium. Moreover, once investors find that the policies of government surveillance are inadequate and adverse to their interest, they will take other measures such as by "voting by foot" to exit the market. The decrease in share prices will impel the government to change its surveillance polices until investors can accept them.

9.3 Surveillance Aim and Type

9.3.1 Surveillance aims

Generally, the aims of surveillance are as follows:

1) To maintain the normal operation of the stock market

2) To provide a fair and competitive environment.

3) To protect the interests of investors and small investors in particular.

9.3.2 Surveillance type

Because of the differences in economic systems, economic development levels and history and culture, different countries have adopted different surveillance systems. For instance, some countries have mainly relied on the government to keep surveillance on the stock market, while other countries have relied on self-surveillance institutions to keep order within the stock market. Furthermore, some countries or regions have enacted security laws or security transaction laws to regulate the behaviour of stock issues and stock companies and have stipulated what the relative civil and criminal responsibility would be if the law is
Some countries enact different laws pertaining to different problems that arise. According to the above differences, the system of security management can be divided into the following types:

1) Central surveillance

Central surveillance refers to the fact that the government enacts the law and regulations and establishes a nationwide institution to regulate the stock market. The stock exchange and stock business association do not play a dominant role in surveillance. A typical representative of central surveillance is the United States as are the countries of Japan, Canada, and China and Taiwan.

Some countries establish a specific surveillance institution to be responsible for surveillance, while other countries authorize a department to carry out this function. In regard to this difference, the pattern of a central surveillance model can be classified into three further groupings.

a) The establishment of a special and independent surveillance institution. A typical representative of this is the Securities and Exchange Commission (SEC) in the United States. The SEC is a security surveillance institution, which was established according to the "Security Exchange Act of 1934". Its members are nominated by the President and are appointed with the approval of the senate. The SEC can dependently execute its surveillance right, its standard registration right, and its standard judicial right according to law, however the President, Congress and the federal court have a certain right to oversee its behaviour. The advantage of central surveillance is that the SEC avoids the interference of government administration institutions on surveillance within the stock market.
b) The central bank as a surveillance body.

In this pattern of the surveillance model, a part of the central bank system is authorized to be a stock surveillance institution. Its representative is Brazil. Under this surveillance subtype the central bank has a macro-finance surveillance right. It is convenient to coordinate surveillance on the stock market with other economic strategies and is of benefit in improving the efficiency of supervision.

c) The Ministry of Finance as a surveillance body. The representative countries of this pattern are Japan, Korea and Indonesia. In these countries, the Ministry of Finance keeps surveillance of the operation of the stock market. For instance, the Japanese stock market surveillance institution is the security bureau of Okura. Japanese security transaction law stipulates that a company needs to register at the bureau of Okura before shares can be issued to the public. Disputes are mediated through the security bureau of Okura.

2) Self-surveillance type

The self-surveillance system refers to the situation in which the state normally does not maintain surveillance on the stock market and rarely interferes with the operations of the stock market. Basically, the stock exchange and the stock transaction association ensure surveillance of the operation of the stock market. The representative countries of this surveillance type are the United Kingdom, Singapore, Malaysia and Hong Kong.

A feature of the self-surveillance system is that there is no nationwide stock surveillance institution. A self-surveillance institution has not been granted the right to enact the law, however it can keep surveillance of the market through other approaches. In addition, the
instigation of moral standards is one approach to restrict people's behaviour. The self-surveillance system of the United Kingdom is based on the following three institutions.

a) Security transaction businessmen's association of the United Kingdom. This association regulates the whole security industry of the United Kingdom and keeps surveillance on all members of the association as to whether they are following the stipulations enacted in the "Security Exchange Management Regulation". Moreover, it owns the right to enact the regulations pertaining to security issues and the behaviour of the Security Company.

b) A special organization which deals with mergers and acquisitions of companies in the United Kingdom.

c) The Council of Security Industry of the United Kingdom This was established according to the proposal of the Bank of England in 1978. It is a self-surveillance institution and consists of more than 10 special association representatives. Its main function is to enact and carry out regulations and laws about security trade.

At present, the countries adopting the system are basically member countries of the Commonwealth of Nations. In recent years, some member countries for example, Hong Kong, Singapore, and Malaysia have imported some regulations that are implemented in American security law. The new company law of the United Kingdom of 1987 also follows some sections of the American security law.
Central surveillance and self-surveillance have advantages and disadvantages. The advantage of self-surveillance is that a self-surveillance organization can make a more appropriate impact on the stock market than central-regulation does under some complicated conditions. The main reason is that a self-surveillance organization is more familiar with the actual situation. Therefore, the enacted clauses are more adaptable to the practice. From this point of view, the surveillance efficiency of self-surveillance is higher than that of central-regulation. Self-surveillance is more easily integrated with the daily stock exchange operation, and therefore, it is more effective and its surveillance cost is lower than that of the central-regulation.

A disadvantage of self-surveillance is mainly that it needs a self-surveillance organization with a grasp of professional surveillance knowledge and familiarity with its surveillance objectives. Because self-surveillance performs its functions through market ethics and industry regulation, unfair cases can easily emerge with the performance of surveillance functions. In addition, members of a self-surveillance organization should include representatives that are selected by the surveillance objectives, to avoid the power of the regulated side being stronger than that of the regulating side. Importantly, because self-surveillance is not granted by right of law, it is hard to investigate and set up some cases under some conditions.

3) Combination type

The combination type emphasizes central surveillance as well as self-surveillance. Represented countries include Germany, Italy and Thailand. In these countries, there is one organization which functions as a security committee and a security exchange has been
established. From a legal point of view, the emphasis is more on promoting economic development than on investor protection.

Through analyzing the above three different patterns of surveillance models, it can be seen that self-surveillance can resolve questions in a timely manner and apply special approaches to deal with difficulties. The self-surveillance model can motivate the supervisor to consider the negative effects caused by excessive regulation and to make an effort to reduce the cost of stock operations. However to purely rely on the self-surveillance model makes it easy to weaken the protection for investors and create a negative impact on the steadiness of the security market and capital market. Because the law grants central-surveillance institutions rights, this surveillance type is powerful. Purely depending on the government to keep surveillance will possibly reduce surveillance efficiency and increase the surveillance cost. A combination type of surveillance would therefore be the most appropriate.

9.3.3 Legal system

a) In the United States, the main laws are as followings:

1) The Security Act of 1933 (the Securities Act) deals primarily with new issues of securities. The aim is to protect potential investors in new securities by requiring issuers to register an issue with full disclosure of information.

2) The Securities Exchange Act of 1934 (SEA) extended the disclosure requirements to the secondary market and established the SEC to oversee registration and disclosure requirements.
3) The Maloney Act of 1936 extended the SEC control to the OTC market.

4) The Investment Company Act of 1940 requires investment companies to register with the SEC and provides a regulatory framework within which they must operate.

5) The Investment Advisors Act of 1940 requires individuals or firms who sell advice about investments to register with the SEC.

6) The Securities Investor Protection Act of 1970 established the Securities Investor Protection Corporation to act as an insurance company in protecting investors from brokerage firms that fail.

7) The Securities Act Amendments of 1975 abolished fixed brokerage commissions.

b) In the UK, the main laws are as follows:

1) The Company Law of 1948 and 1967

2) The Anti-fraud Law

3) The Financial Service Act of 1988

These acts are enacted to regulate the behaviour of traders and joint-stock companies and to restrict insider trading.

c) In Japan, the government pays great attention to keeping surveillance on the Japanese stock market through enacting the law. The main laws include the Commercial Code, the Company Law, the Security Trade Law, the Security Investment Trust Law, the Foreign Security Company Law and the Foreign Exchange and Foreign Trade management Law.

d) The ASX market is governed by various rules and regulations including the ASX Business Rules and the Corporations Act. The Australian Securities and Investments Commission (ASIC) is an independent Commonwealth government body established by
the Australian Securities and Investments Commission Act in 1989. It began on 1 January, 1991 as the Australian Securities Commission, to administer the Corporations Law. It replaced the National Companies and Securities Commission (NCSC) and the Corporate Affairs offices of the States and Territories. ASIC administers the following legislation (or relevant parts of it), as well as relevant regulations made under it:

1) Corporations Act 2001
2) Australian Securities and Investments Commission Act 2001
3) Insurance (Agents and Brokers) Act 1984
4) Insurance Contracts Act 1984
5) Superannuation (Resolution of Complaints) Act 1993
6) Superannuation Industry (Supervision) Act 1993
7) Retirement Savings Accounts Act 1997

9.4 The Surveillance History of the Chinese Stock Market

9.4.1 Surveillance Institution

From 1986 to 1992, the People’s Bank of China was a surveillance institution. At that time, the People’s Bank of China took all responsibility for approving the issue of stocks and bonds, keeping surveillance on financial institutions and the finance market, and enacting the relative financial law, policy, rules and regulations. In addition, other departments of the State Department also took part in the surveillance. Because there was no classified regulation concerning responsibility for different departments and there was no institution to unify these policies, different departments made different policies and these policies did
not match each other. Different institutions have similar functions. The surveillance efficiency is very low. In order to enhance surveillance, approved by the State Department, the People’s Bank of China established a stock check and approval office in 1990.

In December 1992, the State Department decided to establish the State Council Securities Commission (SCSC) and the China Securities Regulator Commission (CSRC). SCSC is the State authority which is responsible for exercising centralized market regulation. The CSRC is the SCSC’s executive branch which is responsible for conducting surveillance and regulation of the securities markets in accordance with the law. The scope of the authority of the SCSC and the CSRC gradually expanded with the growth of the securities markets. In April 1998, pursuant to the State Council Reform Plan, the SCSC and the CSRC were merged to form one ministry rank unit directly under the State Council. Both the power and the functions of the CSRC have been strengthened since the reform. A centralized securities supervisory system has thus been established.

9.4.2 Surveillance Law

The following surveillance regulations have emerged over the years.

1) 1998, People’s Republic of China in Security Law
2) 2001, People’s Republic of China in Trust Law
3) Trade behaviour
   a) Temporary Regulations for Share Issue and Trade (May 4, 1993)
   b) Temporary Regulations for Prohibiting Fraudulent Behaviour (August 1993)
   c) Notifications for Prohibiting Manipulating Behaviour, issued by the CSRC (October, 1996)
d) Temporary Regulations for Prohibiting Entering the Security Market (March, 1997)

4) On mergers and acquisitions


6) The Stock Exchanges

a) Temporary Regulation for Exchange (July, 1993)

b) Management Approaches for Exchange (August, 1996)

c) Notification for Strengthening the Management of an Exchange Member (November, 1997)

d) Regulations on listing shares on the Shanghai Stock Exchange (2000)

e) Regulations on Listing Shares on the Shenzhen Stock Exchange (2002)

7) Listed Companies

a) Temporary Regulation on Share Issue and Trade (April, 1993)

b) Measure Detail for Information Disclosure on Share Issues (July, 1993)

c) Notification for Regulating the Behaviour of a Listed Company (July, 1996)

d) Measure for Checking a Listed Company (December, 1996)

e) Content and Form for Information Disclosure of a Listed Company (1) (January, 1997)

f) Regulations for Prohibiting State-owned Enterprise and Listed Companies (May, 1997)

g) Content and Form on Information Disclosure of Listed Companies (3) (June, 1999)


In contrast to the legal system in other countries, and despite the number of laws in China being not small, a complete legal system has not been established. Security law has already been promulgated, but some relevant detailed rules and laws, for instance "Security Trade Law", and "Security Credit Evaluation Law", have not been enacted. Therefore, it shows that maneuverability of these laws and regulations is weak. In addition, the connection
between securities law and other current laws is very loose. For instance there is no
collection between securities law and company law. The legal responsibility stipulated in
securities law is not reflected in the corresponding stipulations of penal law and
administration procedural law. Within the complete legal system, it will be difficult for
surveillance institutions to fulfill their function in practice.

9.4.3 Surveillance status

Generally, a surveillance institution adopts three approaches in order to reach their aims.
The three approaches are: 1) enacting laws 2) promulgating economic policy 3) issuing
administration commands. The United States mainly keeps surveillance on the stock market
through enacting laws. In contrast with the US, Japan mainly issues administration
management regulations to keep surveillance. In China, administration management has
been the main approach to adjust the Chinese economy since 1949. Even though economic
reform has been carried out in China, administrative command is still used to manage
market operations. Compared with the administration management in other countries,
Chinese administration management is stricter, as for instance there are quota systems and
IPO price limitation systems in the primary stock market.

In the stock market, a company applies to issue shares to the public and list on the exchange
and this company must first get a quota. The quota allocation process is as follows: first,
the total issued number of shares in each year, the quota, is determined by the government
and secondly, the quota is allocated to different provinces.

Theoretically, any public company must take responsibility to optimize their profit for the
current shareholders, potential shareholders and the people who have an interest in the

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company. There is also a responsibility for listed companies to disclose information and provide higher returns for shareholders than that of unlisted companies. Listed companies also take the risk of a take-over by other companies. Once a public company cannot repay its debt on time to the creditor, no matter what the current situation of the company, if the creditor does not agree to delay the deadline for repayment, the company will go bankrupt. Therefore, the choice of whether or not to become a public company should be a type of market action. The quota system results in the issuing of shares and is not a market action. Secondly, the quota system basically fixes the total supply of shares during a certain period. The system results in the supply of shares losing elasticity and the share supply is much less than the share demand in the primary stock market. A large amount of capital is available in the primary stock market for buying the shares. Thirdly, the quota system results in the size of listed companies being small. This is because after the local governments gets the quota, they divide the quota further in order to let more enterprises list on the stock exchange. The result is that the size of the major listed companies is small and because of this, there is an increase in the possibility of manipulating the share price by some large investors in the secondary stock market. On the other hand, the quota system causes some large-sized companies to have no chance to issue and list on the exchange. Fourthly, the quota system changes the relationship between supply and demand, and therefore false information is sent to the investor. Normally, the amount of shares issued should be determined by the market. Under the quota system, the function of the market is replaced by administration command.

In a normal stock market, the price of an initial pricing offering (IPO) should be determined by supply and demand on the basis of the true value of the company. For a company, it
certainly hopes the IPO is higher, because a high IPO means the company can finance more capital and it will be beneficial for the further development of the company. For the investors, the lower the share price the better it is. The final price is the bargained result of the listed company and the security contractor company.

The IPO should be determined by the market. However, because the government considers the fluctuation of the share price in the secondary market to be frequent and large, the share prices do not reflect the status of listed companies. The share price in a secondary market should not be considered as a benchmark. In addition, the government also considers that the demand and supply of the primary stock market is disequilibrium and also small investors are immature. In order to protect the interests of investors and avoid the IPO being too high, the government fixes the price of the IPO. This limitation results in a big price difference between the primary stock and the secondary stock market. It also results in a large amount of funds entering into the primary stock market and provides an opportunity for investors with a mass of funds to obtain returns without any risk. Additionally, because the majority of investors in the primary stock market are speculators, the real people who take the risk are the investors in the secondary stock market. Because only a small part of fund raising through the issue of shares is used in production, listed companies find it difficult to make enough profit to support the high returns in the secondary stock market. This limitation creates a negative impact on the steadying of the secondary stock market and on the growth of the listed companies.

The table 9.1 shows that there were seventeen big fluctuations from 1992 to 2002. Because the total number of new shares issued was controlled by the Chinese government during
this period, new share issues should be regarded as an administration intervention behaviour rather than as market behaviour. From the seventeen fluctuations, it can be seen that there were only three fluctuations responsible for the economic adjustment approach. It shows that the main surveillance approach in the secondary stock market is administration intervention.

9.5 Conclusion

In this chapter, different surveillance systems and surveillance approaches of mature stock markets have been examined. At the same time, the advantage and disadvantage of different surveillance systems have been analyzed. On the basis of these theories and the experience of mature stock markets, the current status and problems of the Chinese surveillance system have been revealed. From chapter four to chapter nine, the development and current status of different aspects of the A share stock markets are analyzed. Chapter ten will focus on the internationalization of the Chinese stock market.
### Table 9.1 Large Fluctuations in the Shanghai Stock Market

<table>
<thead>
<tr>
<th>Time</th>
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<th>Range</th>
<th>Reason</th>
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<tr>
<td>1992.5.20-1992.5.25</td>
<td>617-1429</td>
<td>132%</td>
<td>Cancel price ceiling</td>
<td>5 days</td>
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<tr>
<td>1992.5.25-1992.11.17</td>
<td>1429-387</td>
<td>-73%</td>
<td>Issue new shares</td>
<td>6 months</td>
</tr>
<tr>
<td>1992.11.17-1993.2.16</td>
<td>387-1559</td>
<td>303%</td>
<td>Extend stock market</td>
<td>3 months</td>
</tr>
<tr>
<td>1993.2.16-1994.7.29</td>
<td>1559-326</td>
<td>-79%</td>
<td>Issue 5 billion New shares</td>
<td>1.5 months</td>
</tr>
<tr>
<td>1994.7.29-1994.9.13</td>
<td>326-1052</td>
<td>223%</td>
<td>“Four policies&quot;</td>
<td>1.5 months</td>
</tr>
<tr>
<td>1994.9.13-1995.2.07</td>
<td>1052-524</td>
<td>-50%</td>
<td>Issue new shares</td>
<td>5 months</td>
</tr>
<tr>
<td>1995.5.17-1995.5.22</td>
<td>582-926</td>
<td>59%</td>
<td>Stop T-Bill futures trade</td>
<td>5 days</td>
</tr>
<tr>
<td>1995.5.22-1996.1.19</td>
<td>926-512</td>
<td>-45%</td>
<td>Issue 5 billion New shares</td>
<td>9 months</td>
</tr>
<tr>
<td>1996.1.19-1996.12.</td>
<td>512-1257</td>
<td>146%</td>
<td>Reduce interest rate for twice</td>
<td>1 year</td>
</tr>
<tr>
<td>1996.12.11-1996.12.25</td>
<td>1257-856</td>
<td>-32%</td>
<td>“Three policies”</td>
<td>24 days</td>
</tr>
<tr>
<td>1997.5.12-1997.9.23</td>
<td>1467-1104</td>
<td>-24.74%</td>
<td>Prohibit state-owned enterprises and listed companies to “stir fry” shares.</td>
<td>5 months</td>
</tr>
<tr>
<td>1997.9.12-1998.6.1</td>
<td>1243-1411</td>
<td>13.52%</td>
<td>Three main security Newspaper published articles to enhance confidence of investors.</td>
<td>9 months</td>
</tr>
<tr>
<td>1999.12.27-2000.11.22</td>
<td>1355-2032</td>
<td>49.96%</td>
<td>SRC permitted state-owned enterprises; enterprises controlled by state-owned enterprises and listed company to access into secondary stock market.</td>
<td>11 months</td>
</tr>
<tr>
<td>2001.10.23</td>
<td>1572-1728</td>
<td>9.92%</td>
<td>SRC postponed trading state-owned shares.</td>
<td>1 day</td>
</tr>
<tr>
<td>2001.11.15-2001.11.16</td>
<td>1617-1725</td>
<td>6.68%</td>
<td>Reduce 0.2% of stamp tax rate.</td>
<td>1 day</td>
</tr>
<tr>
<td>2002.6.24-2002.6.25</td>
<td>1563-1707</td>
<td>9.21%</td>
<td>Stop trading state-owned shares</td>
<td>1 day</td>
</tr>
</tbody>
</table>

Source: collect and calculated on the base of CSRC and Shanghai Stock Exchange Statistic Year Book (2003)
CHAPTER 10

CHINESE STOCK MARKET INTERNATIONALIZATION

10.1 Introduction

Since China joined the WTO, the Chinese capital market has been gradually opened. How to have done this in light of the risks involved has been an important question.

10.2 The Internationalization of the Chinese Stock Market

10.2.1 Definition of internationalization of the stock market

After the Second World War, the economies of western countries rapidly recovered and developed. National income and domestic savings increased continuously. Capital accumulation and the development of science greatly accelerated the internationalization speed of the stock market in these countries. Since the 1980s, a credit crisis frequently emerged in developing countries. As a result of this, there was skepticism about the credit of international banks. In addition, transitional and developing countries have been normally under the pressure of global competition. The internationalizing of stock markets has been undertaken in order to satisfy the needs of domestic finance within the context of economic globalization and therefore, this has become an increasingly important issue in transitional and developing countries.

The internationalization of the stock market is one part of capital market internationalization. It includes two aspects. The first aspect is market internationalization. Market internationalization refers to foreign investors being allowed to invest in the domestic stock market freely and to domestic investors being allowed to invest in overseas
stock markets as well. Moreover, domestic companies are allowed to list on foreign stock markets and foreign companies are allowed to list on domestic stock markets. The second aspect involves business internationalization. Business internationalization implies two things. First, that a foreign security company is allowed to deal with the purchase and selling of shares in the domestic stock market and the second is that a domestic security company is allowed to deal with the purchase and selling of shares in foreign countries.

10.2.2 The impact of the internationalization of stock markets

Theoretically, the impact of internationalization on stock markets is:

1) Internationalization promotes the development of the stock market and after the entrance of foreign funds, the size of the stock market will be expanded.

With the gradual internationalization of the stock market, new technology, advanced management experience and new financial products get introduced. Internationalization makes the stock market face competition from the external market. Internationalization accelerates the development of the stock market, as for example, ten years ago, few people knew of the Portugese, Greek or Indonesian stock markets and even prior to that, few people paid attention to the stock markets of Poland, Hungary, Colombia or Sri Lanka. However, these emerging stock markets have already shown their development potential and have attracted more and more international investors.

2) Internationalization will adjust the rate of institutional investment

The rate of institutional investment has been an important index to measure whether a stock market is mature or immature. Internationalization will permit more institutional investors to enter into this stock market, thus changing the rate of institutional investors.
3) Internationalization will provide more chances for companies to raise funds. Foreign capital entering into the domestic stock market expands the size of the domestic stock market, adjusts the balance between supply and demand and provides more chances for a listed company to reproduce or expand reproduction.

However in practice, the impact of stock market internationalization on developed stock markets and emerging stock markets is different.

In developed countries such as the USA, the UK and Japan, stock markets were established when their economies developed to a certain level. In addition, their capital account had been established. Therefore, at an early stage, they completely opened their stock markets. The financial systems of these countries are now well developed and are in important positions in the international monetary financial system. A developed country has a strong capacity to control the steadiness of its domestic financial markets and reduce the negative impact of international markets on its economy. The volatility of emerging stock markets has a little impact on financial systems and stock markets of developed countries. Therefore, there is a low risk in internationalizing their stock markets. They are beneficiaries of stock market internationalization.

Compared with the internationalization of developed stock markets, emerging stock markets have had to take three risks while they internalize their stock markets. First, internationalization implies international capital is able to be invested in domestic companies and that this increases the possibility that domestic companies will be controlled through foreign companies holding more shares of these companies. Further, it possibly
results in foreign companies finally taking over domestic companies. Therefore, emerging stock markets normally stipulate a certain holding proportion by international investors within the early process of internationalizing of their stock markets. Secondly, the stock market internationalization possibly accelerates the liquidation of international capital. Short-term international capital in particular possibly causes an attack on the domestic economy. Thirdly, stock market internationalization increases the possible emergence of a bubble in the domestic economy. The Asian financial crisis of the late Twentieth Century is a good example of this.

The definition of a currency crisis is somewhat ambiguous and in general it can be said that it is characterized by continuous or discontinuous movements in foreign reserves that may lead to shifts in the exchange rate regime. The definition of a financial crisis is broader than that of a money crisis, including features such as a run on a bank or a crash in the stock market. The Asian financial crisis occurred on 2 July, 1997 three years after the Mexico financial crisis of 1994. It took place in Thailand first, and then spread to the Philippines, Malaysia, Indonesia and Singapore.

The East Asia crisis of 1997-1999, resulted in part from the fact that bank loans represented about 80% of all enterprise debt in the region, compared to 22% in the US. The dependence upon bank lending produced a corporate sector which was highly vulnerable to changes in the banks' attitude towards risk. In countries such as Korea, the excessive reliance on banks also produced a corporate sector which was remarkably insensitive to profitability as a criteria for success in making investment decisions.
Many studies (for example, McLeod and Garnaut, 1998, Chang, Palma, and Whittaker, 2001, Corsetti, Pensenti and Roubini 1998, Krugman, 1998) have analyzed the basic, emergence and reasons for the Asian financial crisis. These reasons can be summarized as:

1) The economic structure was not reasonable. Their production type was single export.

2) Their currencies were pegged to the $US. When the $US appreciated, exports were reduced.

3) Excessive banking loans. The real estate industry contracted significantly and caused substantial bad debts.

4) The government surveillance approach was very underdeveloped.

5) The rapid movement of “hot money”.

Implications:

1) Internationalization should be in accordance with the current status.

2) There is a strong need for enhancing security surveillance.

10.2.3 *Internationalization models of emerging stock markets*

In contrast, the emergence and development of emerging stock markets have been later than that of developed stock markets. Their economic development levels and development stages are different to those of developed countries and these countries lack experience with risk control. Therefore, the development strategies of internationalization are also different. Emerging stock markets are normally closed within their early development stage (Gutai Junan Securities Co. Ltd, 25 December 2001). With the development of their stock markets, they gradually open up their markets. According to the pace of liberalization, the limited internationalization process of the stock market can be classified into two further
models, viz, radical, limited internationalization and gradual, limited internationalization. They normally adopt three models to internalize their stock markets. These are direct internationalization, limited direct internationalization and indirect internationalization strategies.

Direct internationalization refers to foreign investors being allowed to invest in the domestic stock market directly. Limited direct internationalization refers to foreign investors being allowed to invest in the domestic stock market directly under some strict restrictions such as the investment region, the investment ratio, the institution establishment, the investment process or the holding rate of the listed company. These limiting conditions are gradually reduced. The indirect opening up strategy refers to foreign residents investing in the stock market through investment funds and other forms. Internationalization of the stock markets is related to the capital account. Indirect internationalization is a type of system designed for stock market liberalization while their capital account is not opened. Because currency cannot be exchanged freely, in some countries, foreign currency accounts are separated from the domestic currency accounts or an individual board is established for foreign investors such as a blocked account in Denmark, B shares in the Philippines, the foreign board in Thailand or foreign investors are allowed to invest in domestic stock markets through institutional investors.

In practice, no matter which pattern of the emerging stock market is adopted, they always strictly control the holding proportion of domestic shares by foreign investors in the industries which are related to economic stability. Even though the market is opened completely, this approach can be re-adopted in times of emergency.
No matter which of these approaches is adopted, risks can possibly occur. However the impact on the emerging stock market or developed stock market will be different.

10.3 The Necessity for the Internationalization of the Chinese Stock Market

According to the Oxford Dictionary of Economics, pareto optimality is defined as a situation in which ‘no feasible change can raise anybody’s welfare without lowering that of somebody else.’ This applies to the reallocation of final goods between different users, the reallocation of factors of production to different industries, and changes in the composition of the final goods produced. If resource allocation reaches pareto optimality, under the conditions that the technological level, consumption preference and income allocation are assumed to be equal, the allocation efficiency of resources will be higher than that under other situations. Social economic welfare will be optimized. Pareto optimality can be understood through negatives, as for example, the situation in every country is better than before; the situation in one country is improved; however no one country’s situation has become worse. It means Pareto optimality is not reached. Current resource allocation needs to be adjusted, thus improving the efficiency of resource allocation and increasing economic welfare.

In contrast with other developed countries, China has just begun her economic reform and has high development potentiality. Therefore, adjusting resource allocation improves the total welfare of the whole society. Not only does the return of foreign resources increase, but also the Chinese market obtains the funds that it needs. These funds can be used to improve the level of Chinese technology and solve the “bottle neck” that exists in the industry. Internationalizing the Chinese stock market should be a necessary step realized by
rationally allocating resources. But in practice, although the Chinese and the worldwide economy do not reach equilibrium, it is difficult to achieve pareto optimality. However, the inner motivation of economic development at least requires reaching second-best.

The necessity of stock market internationalization in China is as follows:

1) The high-speed development of the national economy needs substantial funds to accommodate it. Seeking new financial channels becomes a very urgent need for the further development of the Chinese economy.

In a developing country, the source for funds is scarce as being dependent only on domestic sources, is not enough to satisfy the requirements for economic development. There were two main channels for a developing country to obtain funds in the middle of the 1990s. The first channel was a commercial loan. The second channel was direct foreign investment. The costs of these two channels were high and there was the risk of the volatility of the foreign exchange rate. In addition, a loan was at times restricted by the total scale of one country. In comparison with the two channels, raising funds through the issuing of shares or bonds had more advantages. First, it had not been restricted by the loan scale of one country. Secondly, it did not require the borrower to negotiate and survey alternatives and therefore the financial cost was low. Thirdly, it reduced the risk caused by the foreign exchange rate. Moreover, on one hand, it satisfied the long-term demand for direct finance and on the other hand, it reduced the dependence on short-term foreign capital as well.

Since the 1980s, China has become one country with a high rate of development. A high development rate needs substantial funds and therefore fund shortages become an important restricting factor for the Chinese economy to further develop. Pooling international funds
through the issuing of shares is one good approach to overcome the problem of fund shortages.

2) Stock market internationalization will be bound to improve the competitive ability of a Chinese listed company. A Chinese enterprise not only raises an enormous amount of funds through the stock market so as to expand production scale, obtain scale economics efficiency, and reduce production cost, but it also improves price competition ability and regulates its management system. Therefore, stock market internationalization reduces costs for a listed company.

10.4 Current Barriers to Internationalization

10.4.1 Macro-barriers

1) The pace of state-owned enterprise reform will impact on the process of stock market internationalization.

The reform of state-owned enterprises was started more than ten years ago. Although some progress has already been made, it is not very remarkable (Refer to Chapter Six). The main reasons for this is that property rights of state-owned assets are still not clearly defined and the proportion of state-owned shares in total shares is still very high although the rate has shown a downward trend. The lack of clear definition of property rights and the high proportion of state-owned shares have resulted in effective surveillance on managers within the mechanism of the stock market being quite difficult to manage. Managers of state-owned enterprises do not have enough motivation to maximize the assets of shareholders. The lack of clear definition of property rights also results in the surveillance mechanisms of
debt being quite difficult to play out. Bad or good operation statuses of enterprises do not put pressure on these managers.

The reform of state-owned enterprises is the bottleneck for Chinese economic reform and has become the key to Chinese stock market internationalization.

2) Government intervention is an important factor which impacts on the internationalization of the stock market.

In a market economy, economic behaviour is normally regulated through a series of laws and industry regulations. In a central economy, despite there being a series of laws, administrative interaction is often used to regulate economic behaviour. It will also create some barriers.

10.4.2 Micro-barriers

1) Surveillance systems

Although a central surveillance structure has been established, laws which have already been enacted are not perfect, as for example the security law, and a rational and a closed relationship between security law with different laws has not been established.

2) Relative institution

A relative institution refers to an accounting institution, an asset evaluation institution or a legal institution. At present, the behaviour of these institutions has not been regulated. After China internalizes its stock market, the behaviour of these institutions must be regulated and be in accordance with international practice. At present, many problems exist in these institutions. First, the government has established some of these institutions, but they still
follow old administrative approaches. Secondly, they do not follow standards but rather suit the requirement of clients. The quantity or variety of institutions is not enough and these institutions are not comparable.

3) Restriction by accounting system

Because different countries have different cultural, economic, legal and historical cultures, their accounting standards are different. However, the aim of an accounting system is the same. It provides financial information to shareholders and shows the operational status of companies.

In China, accounting standards differ from international accounting standards. This difference causes foreign investors to not completely understand the real status and development prospects of Chinese listed companies.

4) Information disclosure is unregulated

Information cannot be disclosed completely. Non-completeness means that a listed company does not disclose all information according to the requirement of the SRC. For example the operation of some companies is already in a "tight spot" because of "three-angle debts" (More than two enterprises are in debt to each other.). However, no one company reports that the increase of payable amounts is caused by "three-angle debt". Some information disclosures do not completely reflect the real status of the company or they do not report on time. The information disclosed in an annual report and semi-annual report is contradicted. This contradiction normally is reflected in an investment project, earnings forecast and performance.
Table 10.1 Comparison of Amount Issued and Raised Capital between A share, H share and B share

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</tr>
<tr>
<td>A share</td>
<td>42.59</td>
<td>10.97</td>
<td>5.32</td>
<td>38.29</td>
<td>105.65</td>
<td>82.80</td>
<td>83.11</td>
<td>145.68</td>
</tr>
<tr>
<td>H share</td>
<td>40.41</td>
<td>69.89</td>
<td>15.38</td>
<td>31.77</td>
<td>136.88</td>
<td>12.86</td>
<td>23.05</td>
<td>7.10</td>
</tr>
<tr>
<td>B share</td>
<td>12.79</td>
<td>10.40</td>
<td>10.90</td>
<td>16.05</td>
<td>25.10</td>
<td>9.90</td>
<td>1.77</td>
<td>359.25</td>
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<tr>
<td>A share</td>
<td>194.83</td>
<td>49.62</td>
<td>22.68</td>
<td>224.45</td>
<td>655.06</td>
<td>543.05</td>
<td>572.63</td>
<td>1007.41</td>
</tr>
<tr>
<td>H share</td>
<td>60.93</td>
<td>188.73</td>
<td>31.46</td>
<td>83.56</td>
<td>360.00</td>
<td>37.95</td>
<td>47.17</td>
<td>562.21</td>
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<tr>
<td>B share</td>
<td>38.13</td>
<td>38.27</td>
<td>33.35</td>
<td>47.18</td>
<td>80.76</td>
<td>25.55</td>
<td>3.79</td>
<td>13.99</td>
</tr>
</tbody>
</table>

Source: China Statistics Year Book 2001

Note: Exchange rate

- 1993: 1US$=5.80 RMB, 1HK$=0.75 RMB
- 1994: 1US$=8.46 RMB, 1HK$=1.09 RMB
- 1995: 1US$=8.30 RMB, 1HK$=1.07 RMB
- 1996: 1US$=8.30 RMB, 1HK$=1.07 RMB
- 1997: 1US$=8.30 RMB, 1HK$=1.07 RMB
- 1998: 1US$=8.30 RMB, 1HK$=1.07 RMB
- 1999: 1US$=8.28 RMB, 1HK$=1.07 RMB

10.5 Internationalization of the Chinese Stock Market

Internationalization is not only a necessity for the development of China's stock market, but also needed for the opening up of the Chinese economy in order that it may adopt the best of international practice. Chinese stock market internationalization was undertaken mainly through establishing B share stock markets on the mainland and listing Chinese enterprises...
at foreign stock markets such as the New York stock exchange and the Hong Kong stock exchange.

At the end of 1993, the first two H shares “Qingdao Beer Company” and “Shanghai Shihua Company” were listed on the Hong Kong stock market. Most listed companies on the Hong Kong stock market are large restructured state-owned enterprises. In July 1993, Zhongguo Shihua Company became the first H share to be listed on the New York Stock Exchange in the form of ADR. The Shandong Huaneng Power Development Co. LTD, became the first N share to be listed on the NYSE directly. It issued 23.374 million ADRs with the raised capital of US$ 333.1 million in 1997.

In order to avoid the influx of international hot money and raise foreign capital, the Chinese government has established B share stock markets. B share stock markets are exclusively for foreign investors. Chinese citizens can only invest in the A stock market. This is the first step to the internationalization of the stock market. In February, 2000, a Chinese citizen was permitted to open foreign currency accounts and trade in B shares, but the A share stock market does not open to foreign investors until 2003. Few qualified institutional investors have been approved to enter into A share stock markets. The first B share, Vacuum Electronic was issued on 21 January, 1992. Theoretically, B shareholders have the same right and bear the same obligations as A share holders. The B shares are not convertible to A shares. According to the China statistics year book 2001, in 1993, there were 41 companies entitled to list on the B share stock market; by 2000, the number increased to 114. In 1993, there were 6 Chinese companies listed on the Hong Kong stock market and by 2000, the number increased to 52. In light of the data in table 10.1, it can be
seen that until 2000, Chinese companies accumulatively raised 281.02 billion RMB through issuing B shares and 1372.01 billion RMB through issuing H shares. Table 10.1 also shows that in contrast with the other two approaches of raising capital, the average amount of capital raised each year through issuing B shares is the smallest at 35.13 billion RMB per year. The average amount of capital raised each year through issuing A shares is larger than that through the issuing of H shares. The average amount of capital raised each year through the issuing of A shares and H shares is 396.22 billion RMB and 171.50 billion RMB. In addition, table 10.1 also shows that this same approach raised different amounts of capital in different years. For example, in 1994, 1997 and 2000, Chinese enterprises raised much more capital than that in other years through the issuing of H shares, but these enterprises only raised a higher level of capital from B share stock markets in 1997. However, in comparison with the other two capital raising approaches, capital raised from A stock markets showed a sustained increasing trend. These differences are bound up with the Chinese economy, the global economy and Chinese government policies concerning Chinese enterprise reform in particular. On further investigation, it can be seen from table 10.2 that the average size of the B shares stock market of the Shanghai was larger than that of the Shenzhen. In comparison by analyzing the trading volume in 1993, the number of listed stocks, the total issued capital, the tradeable market capitalization and the total market capitalization and the B share stock market of the Shanghai was more active than that of the Shenzhen. However, as development increases these indicators on the Shenzhen stock market are close to those on the Shanghai stock market.

The market segmentation avoids the influx of international hot money. It allows Chinese enterprises to have the opportunity to raise funds from foreign investors and gives
regulators the chance to learn surveillance. However, the special design also results in some negative effects, as for example segmentation of investors and a big price gap between A shares and B shares. The reasons which cause a big price gap between A share prices and B share prices are:

1) different investment psychology between Chinese investors and foreign investors.

2) the non-convertibility of B shares to A shares and strict segregation between the A share market and the B share market so that foreign investors have little opportunity to control the listed companies because the majority of shares are A shares, thus creating the potential of a huge number of investors lacking interest in the B shares market.

3) the comparative lack of transparency in the management of listed companies means foreign investors have difficulty in evaluating the value of their shares.

Big share price gaps between A shares and B shares have also became one of the important problems since the further internationalization of the Chinese stock market.

10.6 Conclusion

This chapter focuses on the internationalization of the Chinese stock market. Internationalization is the development trend of the Chinese stock market. First, this chapter explains the definition of the internationalization of the stock market. Then, the advantages of internationalization are analyzed and the different impact on emerging stock markets and developed countries is introduced. After this, the necessary reasons for the internationalization of the Chinese stock market and current barriers are expounded. In the latter part of this chapter, the history and development of the internationalization of the
Chinese stock market is analyzed. The next chapter will summarize the previous chapters and make strategy suggestions.
Table 10.2 Internationalization Comparison between B shares in the Shanghai and the Shenzhen Stock Market

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai (q)</th>
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<td>22</td>
<td>19</td>
</tr>
<tr>
<td>1994</td>
<td>34</td>
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<table>
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<th>Year</th>
<th>No. of Listed Stock</th>
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<table>
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<th>Year</th>
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<tbody>
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<td>1993</td>
<td>19</td>
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<td>1994</td>
<td>24</td>
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Source: China Statistic Year Book 2001

Note: Exchange rate
1993 1US$=5.80 RMB 1HK$=0.75 RMB 1997 1US$=8.30RMB 1HK$=1.07 RMB
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CHAPTER 11
SUMMARY AND STRATEGY SUGGESTIONS FOR THE CHINESE STOCK MARKET

11.1 Introduction

"Progress is a temporal notion. The claim for progress necessitates comparison over time. Moreover, it requires some acceptable basis for evaluation: on what basis can progress be claimed? Nevertheless, it probably is safe to claim that progress has been the rationale for a considerable part of all human action: what would life be like without the wheel?"

(Gaffikin 1984, p7)

This research has described the development of the contemporary Chinese stock market. The path for such development has not been smooth. There are major inherent structural weaknesses which continue to pose considerable problems for the growth of a modern efficient stock market. This chapter summarises the main features of the development of the stock market and draws attention to the structural problems. It then suggests some possible strategies for overcoming the problems created by the structural and other weaknesses.

11.2 The Checkered Development of the Chinese Stock Market

The stock market and economic theory

There is a marked difference between economic theory and scientific theories. The assumptions from which many economic theories proceed are not easily satisfied. On the other hand the assumptions underlying most scientific theories. Economic theory is used to explain a dynamic environment in which the variables often change. In science conditions
can often be held constant such that replication is possible. Therefore the test results should be the same, no matter who does it or where it is done. But, the ever changing conditions with which economic theorists grapple make theory development difficult. This results in researchers attempting to establish new theory or refine and adapt old theories in order to make them closer to the “real” conditions.

Such is the case with the economic theories that relate to stock market development. These theories (of the shareholding system and the stock market) were originally formed and developed in most western countries. The shareholding system and the stock market greatly promoted the economic development of these countries. Because of this many other countries have gradually adopted the shareholding system and developed stock markets. However, because of the difference in social systems, cultures, economic development and other factors, the application of the two theories brings different results in different countries. For instance, the development of the stock market was very rapid in the United States and now the NYSE and NASDAQ assume important positions in the international financial market. The stock market greatly promoted the development of the American economy. Consequently, the Philippines followed the model of the United States. However, the Philippines stock market has not had a rapid development or become a promising stock market. Through analyzing the case of the Philippines, it can be seen that strict compliance might not be an efficient approach in the promotion of the development of the stock market. The experience of the Philippines indicates that different countries should establish and develop stock markets according to their individual situations. However these differences should not necessarily affect the theory of the stock market. If such differences did change stock market theory, as for example in the special share trade structures of China and Japan,
the “structure” of the stock market would quite likely have a negative effect on the development of the stock market and its impact on social stability.

The development of a Chinese stock market

The joint-stock company emerged in China at the end of the Ming dynasty and in the early period of the Qing dynasty. The real development of the early joint-stock company and the stock market occurred with the “Westernization Movement”. The reason for this emergence was to promote the development of the Chinese economy so as to resist aggression. The development pace of the early stock market was slow and its efficiency was very low. There were reasons for this. Consecutive civil wars and aggression resulted in Chinese enterprises losing a basic environment conducive to investment. Issuing shares at this time was not a main approach in order to raise funds for Chinese enterprises. In addition, the issue approach was less developed and this made the efficiency of the primary stock market low and the development was very slow. In the secondary market, because of an incomplete legal system, the development of the stock market did not keep pace with that of industrial markets and the immaturity of investors, over-speculation, price manipulation and fraud were rife. Under conditions such as the reopening of the Chinese stock market by the Japanese and Kuomintang governments, secondary markets did not perform their resource reallocation function but were only used to absorb “hot” money. Its function of resource allocation was not being performed. The secondary stock market left a deep and negative impression on the Chinese. These negative impressions were described vividly in many movies and novels, as for instance in a saga novel “Ziye” (Midnight) written by Maodong and a drama “Richu” (sunrise) written by Caoyu. In the novel and the drama, the stock market was described as a place where lots of people wore western clothing, put on western
hats and wore golden-framed glasses. They lie to snare and to lure away the money of small or middle-sized investors. The stock market was also described as a place full of the stinking smell of money and wickedness and as “a paradise of speculation” or “senior bedlam”. Investing in the stock market was viewed as just like playing a terrible kind of game, “The big fish eats the small fish”.

After China began to carry out economic system reforms, a shareholding system first was adopted by Chinese village enterprises. The advantages of the shareholding system attracted the attention of Chinese researchers and government. However whether or not a shareholding system can be applied to public-ownership enterprises set off heated disputes in Chinese research fields. Because of the approval of the Chinese leader, Den Xiaoping, the scope of the shareholding system was expanded further. Since then shares were issued and trading already had been made spontaneously by investors. Theoretically, a stock market provides a channel for enterprises to raise substantial funds. After enterprises list on the stock market, managers of these enterprises will be under the surveillance of shareholders, accounting institutions, the stock exchange and so. Listing on the stock market strengthens incentives and restrictions on the managers of listed companies. The stock market promotes cooperate governance. Mergers and acquisitions enable capital to flow to the enterprises with competitive advantage. Because of the advantages of the stock markets and the requirement of share trading, the Shenzhen and Shanghai stock market were established in 1990 and 1991 respectively. The pace of development within the stock market was very rapid and steady. This development can be seen in the changing numbers of listed companies, the change in the total market capitalization and in the change of the type of investors. Although the pace of development was very rapid, the development level
has been quite small. Raising funds changed the capital structure of listed companies and improved the performance of listed companies. The stock market changed what an investment concept is for the investor and his/her understanding of the stock market. However, many problems exist in the stock market and the efficiency of Chinese stock market is still very low. Some of them have become the “bottle neck” in stock market development.

**Structural problems**

First, the Chinese stock market has structural problems. These structural problems relate to the share structure, the share trading structure, the trading structure and the investor structure. The *share trading structure* is unique. When the Chinese government attempted to establish the stock market, they paid attention to avoiding the pitfalls of developed stock markets and emerging stock markets and they designed the stock market according to the existing Chinese economic and social infrastructure. The design aimed to guarantee that state-owned enterprise would be able to raise funds through the stock market, and that but other enterprises would have no possibility of taking over state-owned enterprises. Therefore, a special share structure and share trading structure were designed. This special share structure refers to the state that issued shares are divided into state-owned, legal entity and public shares. The share trading structure was designed so as only public shares could be traded on the secondary stock market. State-owned shares and legal entity shares could not be traded on the same stock market. These special designs were regarded as Chinese in character. This special share trade structure restricts the function of resource reallocation in the secondary stock market. The transition of property rights is a condition within the carrying out of mergers and acquisitions and takeovers. The limiting of the transition of
property right makes the stock market lose the incentive mechanisms. There is no significant difference before enterprises list on the stock market and after enterprises list on the stock market. It also creates a negative impact on corporate governance. Additionally, the high proportion of untradeable shares implies that the number of tradeable shares is small. This small number of issued shares creates space for speculators to speculate. The two special structures become "bottle necks" for further development within the stock market. In addition, the high gap in IPOs between state-owned shares and public shares makes the "bottle neck" more difficult to overcome.

The second structural problem is about investor structure. In contrast with individual investors, the efficiency of institutional investors is higher and investment behaviour is more rational. Institutional investors consist of mutual funds, pension funds, life insurance companies and so on. Although all these are institutional investors, their impact on the stock market is different, because, for instance, aggressive mutual funds and income mutual funds will create different impacts on the steadying of the stock market. The high rate of institutional investors might not be beneficial in steadying the stock market. A high proportion of institutional investors investing long-term will be more beneficial to the stability of the stock market than institutional investors investing short-term. In China, the number and the amount of institutional investors are lower and less than those of individual investors. Therefore, obviously, the rate of institutional investors should increase.

The third structural problem is trading structure. Developed countries normally have a multi-level trade structure. The structure satisfies requirements of different classes of listed companies and provides a chance for some companies to change their listing level. A multi-
level structure provides an opportunity for some companies which have some business operation problems to list at a lower level rather than delisting directly. For the investor, the structure is a type of protection. The structure also provides an opportunity for some companies which have a good business position to list at a higher level on the stock market. A multi-level structure forms competitive mechanisms within different levels of the stock market and promotes the development of different levels. A multi-level of trade structure improves the efficiency of the stock market. In China, the structure of the stock market is very one dimensional. There are only two stock markets in China, the Shenzhen stock exchange and the Shanghai stock exchange and there is no difference between them. There are no over-the-counter or regional stock markets.

Institutional problems

The second problem is an institutional problem. For a long time, there has still existed in China the problem that the market and human behaviour are regulated by intervention or law. This question also exists in the regulation of the stock market. In a centrally regulated developed stock market, the market and human behaviour are regulated by a series of laws. These normally solve the problem through a legal, economic and administrative approach. The administration approach is rarely used to regulate the market and human behaviour. In addition, some related self-surveillance organizations also perform a corresponding regulatory function. The type of Chinese surveillance is central-regulation. Although a series of laws were enacted in China, some laws are imperfect and some behaviour has not been regulated through enacting the law. The connection between different laws has not been formed. A "perfect law" frame has not been established. The self-surveillance system is very weak. Central-regulation is normally achieved through an administrative
intervention approach. Administrative intervention is reflected in the design for share issues and share trading structures; quote limitations of share issues and limitations for the initial price offering and direct intervention of the secondary stock market. The share issue and share trade structure and the quota limitation of share issues and limitations for the initial price offering have played a more negative impact on the development of the stock market. Direct administrative intervention in the secondary stock market restricts the function of the market to adjust prices under many conditions, but it has had a certain positive impact on the development of the stock market because the legal system is imperfect. Direct administrative intervention had the result that share prices have not deviated from the value of shares too much. But with the development of stock market, the impact of direct administrative intervention on stock market will be weaker and weaker.

**Ideological resolution problems**

The third problem is the immaturity of Chinese investors and regulators. Before Chinese economic reform, stock markets and shares were regarded as the products of capitalism. Few Chinese invested in shares in the early period of Chinese economic reform. Because of the wealth effect and the positive attitude of the Chinese government toward stock markets and stocks, more and more Chinese have invested in Chinese stock markets. But the investigation report in 2002 showed that the status of Chinese investors was not good. The annual income of major Chinese investors was low. The investment aim of these investors was for capital gain and average leverage was high. These investors mainly depended on the recommendations of good friends or on rumour. They had no formal investment training. In addition, 45.9% of investors thought their ability for taking a risk were very low. Only 22% of investors obtained a return. It means that major investors are
speculators and invested a high proportion of their income in the stock market. They had less investment knowledge and had low ability for taking a risk. The return of 44% of investors was below zero. The return of 34% of investors was zero. In contrast to Chinese small investors, Chinese institutional investors have more advantages, but the amount of these institutional investors are much less than that of foreign institutional investors of developed countries. Their experience of controlling risk and managing assets is not enough. After they experienced some big fluctuations in Chinese stock markets, Chinese regulators are becoming more and more mature. Although they had accumulated some experience through keeping surveillance on the B share stock market, the experience is not enough to keep surveillance on Chinese stock market after it opens to foreign investors. The immaturity of investors will possibly result in irrational investment behaviour. Irrational investment behaviour will directly impact on the steady state of the stock market. If regulators are not mature, the laws and regulations enacted by them are normally imperfect. Without perfect laws and regulations, the behaviour of participators will not be regulated properly.

Problems created by internationalisation

Internationalization of the Chinese stock market had started when the first B shares were issued on 21 January 1992. The internationalization was mainly undertaken through listing Chinese companies on other stock markets or in the form of ADR and the establishment of a segment market, the B share stock market for foreign investors. Internationalization of the Chinese stock market is still in the early stages. The size and development speed of the B share stock market is smaller and lower than the size and development speed of the A shares stock market. Although the size of the B share stock market is very small, the B
share stock market creates a positive impact on the internationalization of the Chinese stock market. It provides chances for regulators to accumulate management experience and for Chinese companies to raise more funds. But, market segmentation also creates negative impacts. A main negative impact is the big price gap between the A share stock market and the B share stock market. After China joins the WTO, the Chinese stock market must be gradually opened according to WTO's General Agreement on Trade in Services (GATS). Big price gap will become a main "obstacle" to combine the A share and B share stock markets.

11.3 Strategies to Facilitate Stock Market Development in China

In order to become a developed stock market, the Chinese stock market has a long way to go. In view of the problems which exist in the Chinese stock market, the following are suggested strategies:

1) Strengthening corporate governance

As an investment objective, the performance of a listed company is very important. Under a perfect legal system, a listed company with good performance will raise more funds. A listed company with a bad performance will enable an investor to withdraw their investment by "voting with their feet". Under an imperfect legal system, the listed company with a bad performance gives space for speculators to "stir fry". Changing the status of corporate governance is very important for the development of the Chinese stock market.
2) Trading state-owned shares and legal entity shares.

Permitting state-owned shares and legal entity shares to trade on Shanghai and Shenzhen stock market will promote corporate governance of listed companies and recover the function of resource reallocation to perform in the secondary stock market. But it is difficult to do, because there is a big difference between IPO of state-owned shares and legal entity shares and the market price of public shares. The main trading models summarized by Wang Huayu (2000) are as follows:

a. Part of state-owned shares and legal entity shares are changed into preferred shares.

b. Issuing convertible bonds.

c. Establishing specialized investment funds

d. State/legal entity shares are changed into employee shares

Each model has its advantages and disadvantages. Trading models should be chosen according to industry and operational status of listed companies rather than according to the same models.

3) Changing the investor structure.

An investor as the main body of an investment plays a very important role in the stock market. As institutional investors, they have no responsibility to stabilize the stock market. However institutional investors who make a long-term investment do tend to stabilize the stock market. Therefore, increasing the rate of institutional investors who make a long-term investment will be of benefit to the steady development of the stock market.
4) **Establishing a multi-level trade structure.**

Because the functions of the Shenzhen and the Shanghai stock market are the same, the two stock markets should be combined. A second board stock market suggests to be established. With the development of this stock market, a third and fourth stock market should be established.

5) **Perfecting the legal system.**

This includes perfecting the current laws, enacting new laws and rationalizing the connection between different laws. In addition, putting these laws into effect is an important problem.

6) **Strengthening information disclosure.**

Information disclosure is the main source available for investors to evaluate the investment value of a listed company. Strengthening information disclosure protects the interest of shareholders on one hand and also plays the role of promoting cooperate governance of a listed company.

7) **The role of the government in surveillance on the stock market.**

In the past, direct intervention by government created many negative effects. It does not mean that the role of government can be ignored.
8) **Strengthening investor education.**

Because of information asymmetry and their inability of collecting information, small and middle investors are at a disadvantageous position. Therefore, investor education will strengthen the risk consciousness of investors and self-protection consciousness.

9) **Combining the A share stock market and the B share stock market.**

Combining the A share stock market and the B share stock market is a trend. But because of the big price gap between A shares and B shares, combining the A share stock market and the B share stock market is a not rational suggestion within the near future. The Chinese government should strengthen the regulation of the A share stock market and the B share stock market. When the share prices of A share and B share are relatively rational, then the A share stock market and the B share stock market can be combined.

11.4 **Further Research**

The above discussion has indicated that the Chinese stock market is unique in respect of its organization and stage of development. Many empirical research studies have been conducted using data from the Shanghai and Shenzen stock exchanges. However, often such studies have overlooked the individual and unique characteristics of these exchanges. Consequently, the analysis of such data on the basis of models developed for more sophisticated and mature markets is inappropriate. Similarly, emerging markets studies are also often inappropriate as generalizations across the many and varied facets of emerging markets overlook unique variables. This study has attempted to account for many of the unique features associated with the development of the Chinese stock exchange, mostly stemming from the fact that a centrally planned economy is now attempting to adapt to
features of a market economy. Further studies need to be conducted on specific aspects of the Chinese stock market. The financial media does address topical issue (for example, *Business Week*, 3 May 2004 contains a major article on potential problems facing the Chinese economy and addresses the question of efficient securities markets). However, more formal studies need to be carried out that examine the specific problems facing policy makers in respect of bringing the Chinese financial markets to the level of that of more sophisticated economies. Some have been undertaken; as for example Stephen Green's analysis of the need for closer scrutiny of regulatory agencies (Green, 2004) and are to be applauded. However, mere replication of studies and testing of models developed for more advanced securities markets is likely to prove unfruitful for Chinese regulators and policy framers.

11.5 Conclusion

The modern Chinese stock market has grown rapidly since its reemergence in the early 1990s yet there are many problems facing its continued development. The government in framing policies for the development of the stock market has tried to avoid some of the perceived deficiencies of the more sophisticated stock markets of the developed economies. However, it has also had to face the issue of a very significant difference in fundamental political ideology. This is summed up by Green who states:

As China’s government leads the transition away from socialist planning, how does it build the regulatory institutions that it needs to manage the new market economy? (2004, p 1)
In addition, the government now faces the additional problems created by the new global economy. Major changes to information processing and business structures have been needed since China joined the WTO. The global movement has been affected by the push for harmonization of accounting regulations. These also impact on business and financial education as China gears up to meet the challenges of conforming to global expectations.

This study has highlighted many of these difficulties and made some suggestion that may help policy makers construct an efficient stock market in China.
Bibliography:


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