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[CHINA'S STOCK MARKET]

China is currently well ahead of other similar emerging markets in terms of age. It had a tremendous growth, but this growth has been very uneven.

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Introduction

China experienced tremendous change, from centrally planned economy in the middle of twentieth century to more market orientated economy since eighties. Currently, it is one of most significant participants in the global economy. Chinese emerging stock market experienced a tremendous growth and development, since its two main stock exchanges – Shanghai Stock Exchange and Shenzen Stock Exchange - were established in 1990. Still, it is still believed that the development is on early stages. It is true, that number of listed companies at both of stock exchanges grew up more than 100 times since 1990, and total market capitalization is far more than 500 billion USD, but still there is also another side. Researchers of China stock market point out many negative things, including for instance incomplete corporate-governance structure, significant structural defects of the market, inadequate regulatory capacity and wild market manipulators. Fixing up these things is critical condition of further long-term economic development of market.

The Chinese market has a number of unique, idiosyncratic features including for example "different shares issued to enterprises, state, individual shareholders, who have different purchasing costs and circulation regulation"[1], strict segmentation of market for domestic and foreign investors. Other features include high transfer rates, high values for P/E indicators, finally relatively high risk. The quality and level of education of investors is also not yet high enough, also the maturity of regulatory system is not really can be really doubted.

In my project I will try to analyze the situation on Chinese stock market. This paper starts with short overview of situation and conditions, then it comes to overview of two main stock exchanges existing in China. Separation of market will be very important issue presented in that context. The very important part of my work is analysis of idiosyncratic and specific issues connected to stock market, its failures and shortcomings, which don't let it be fully competitive and developed. I will also try to compare Chinese market to other, selected emerging markets.

[1] China Stock Market, http://wwww.chinaorbit.com/china-economy/chinas-stock-market.html

Market overview

Chinese stock market experienced tremendous growth since 1990, although the growth has been uneven and irregular. Thus, this market still remains in rather early stage of development. Furthermore, Chinese companies are not operating on high level of profitability, providing rather poor earnings, and low dividend yields.

Chinese stock market actually consists of several sub-markets, with limited access and ability to buy stock and shares. Class A shares are (with rare exceptions) restricted only to domestic investors. They are listed either on Shanghai or Shenzen exchange, and they are denominated in not freely exchangeable Renminbi (abbr. RMB). Foreign investors can trade "B" class shares, but these shares don't carry ownership rights in a company.

Jianguo Chen (2007) points out, that "looking at the share structure wise, approximately one-third is publicly traded, one-third is state-owned and another one third is privately owned and untradeable shares". Issues connected to failures in structure of market will be presented later.

Before 2005 China didn't experienced boom, that was present on other stock markets. The reasons were different, but what should be primarily pointed out is, that Chinese currency was pegged to USD, and not many firms were interested in listing B-class shares, which could be only bought by foreigners (market for A-class shares were restricted to domestic investors). When this strict regulations were partially liberalized, China experienced tremendous boom – in next year Shanghai Composite Index went up by 130%, and Shenzhen Composite Index even more – by 197%.

Stock Exchanges

There are two stock exchanges in China: Shanghai Stock Exchange and Shenzhen Stock Exchange. Both were established in the beginning on 90. Generally, Shanghai Exchange is dominated by larger-cap companies, while in Shenzhen small joint-ventures and export-oriented company are listed. Both exchanges are supervised by Chinese Securities Regulatory Committee (CRSC), that supervises new stock listing and daily trading activities.

Shanghai Stock Exchange

Shanghai Stock Exchange was established in November 1990, and started operations in December 1990 as "non-profit institution based on a membership"[2]. Shanghai Stock Exchange perform numbers of functions:

- It provides facilities of trading securities
- It formulates business rules
- It accepts and arranges for listings
- It performs supervision of market, regulations and information

The exchange occupies large trading floor (more than 3600 square meters), making it the largest Exchange in Asia-Pacific region.

In the end of 2004, there were 875 companies listed on Shanghai Stock Exchange, from which 825 were A-shares, and 54 were B-shares. A-shares are priced in Renminbi, and B shares are prices in USD. Originally, trading in A shares was totally restricted to domestic investors, and only B class shares were available to both domestic and foreign investors. Since 2002, foreign investors are allowed to trade in A shares under restrictions of Qualified Foreign Institutional Investor system. There are plans to merge two types of stocks in future. Changes of prices of individual stock in daily trading are limited to maximum 10%, this border is two times lower in case of Special Treatment stocks.

Apart of stocks, there are other securities tradable on this exchange, like T-bonds, corporate bonds, convertible corporate bonds and funds.

Trading system is modern and paperless, computer systems tracks operations and match the orders according to the principle of price and time precedence. This efficient system allow to handle more than 10 000 operations each second, with daily maximum capacity of 28 million trades and 60 million transactions daily.

All A & B class shares on Shanghai Exchange Stock are indexed by SSE Composite Index. Below is value of SSE Composite Index in history:

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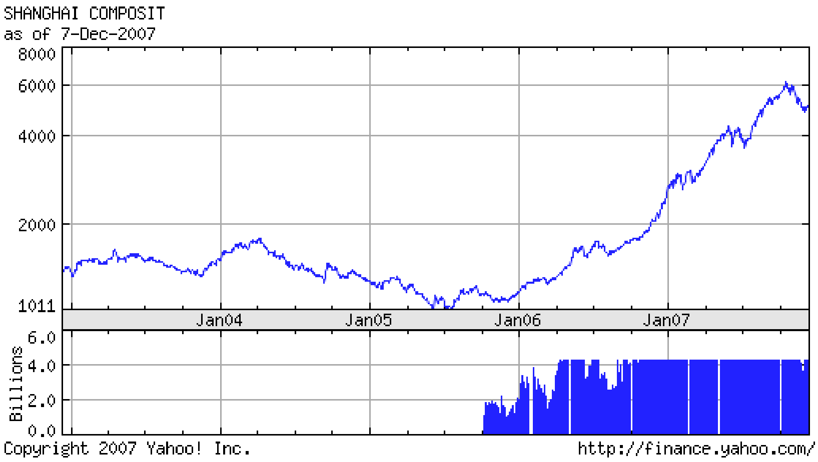
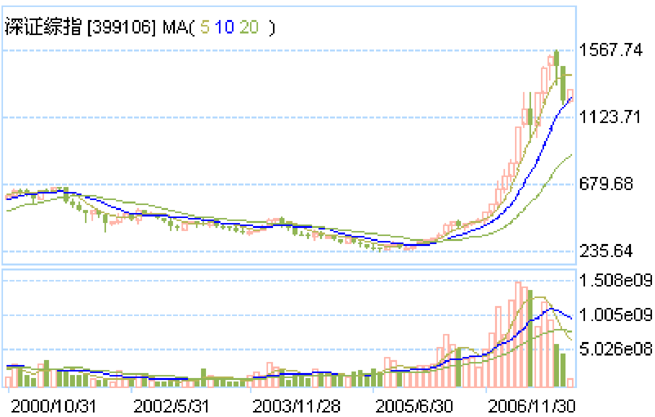
[2] http://www.chinaknowledge.com/financial/shanghai-stock-exchange.aspx



Shenzhen Stock Exchange

The second mutualized national stock exchange in China is The Shenzhen Stock Exchange (SZSE). SZSE includes more than 500 companies, and market is participated by 35 million registered investors and 177 exchange members. Since 1990, Shenzhen Stock Exchange has grown tremendously, achieving market capitalization of 1 trillion RMB (122 billion USD). On average, around 600 000 deals are performed daily, their total value exceeds 807 000 000 USD. Buying and selling orders are matched by automated system according to price-time priority. Trading volumes have been robust.

Since September 2002, the Initial Public Offering in Shenzhen Stock Exchange has been suspended. Chinese government as the Chinese government considered merging two exchanges into a single one in Shanghai, and then launch a Nasdaq-style second board aimed at technology companies in Shenzhen. Stocks traded in SZSE are indexed by SZSE Composite Index.



Chinese Stock Market as an emerging market

Both of Shanghai and Shenzen exchanges are relatively young (established in 1990). Until 1999 there were no laws for regulation of securities. After all, it is not surprising, that China still demonstrates many features, that are typical for emerging market. These features are observable not only in Initial Public Offerings, but also on the secondary stock market. Sheldon Gao (2002) mentions five different characteristics:

Number of classes

There are plenty of different classes of shares in China, some of them have limited access to either foreign or domestic investors. Apart from A and B class (A restricted to domestic, B to foreign investors) there are also other classes available to global investors. In this context we have to mention H,N,L or S class shares, listed respectively in Honk Kong, New York, London and Singapore, and denominated in hard currencies. Many of China's blue-chips are listed only on overseas exchanges, restricted only to foreign investors. This issue generates structural drawbacks of China's stock market. Take for example such company as China Mobile - it is operating only in China mainland - their customers, suppliers, producers and employers are there, but none of them can invest in it.

Strict regulation of IPO

Chinese government strictly regulates initial public offerings. Normally, it is desirable to have supervision over fairness of operations, but in China it is even more complicated. Size, allocation and development of stock market in china are fully under control of state. It controls the quota for new listings that can be issued each year, even selects qualified issuers based on sector allocation. Furthermore, before 2001 it had even right to determine, where stocks will be listed. Surprisingly, no company in Chine is allowed to list shares, having less than three years of continuous profits. What is the effect is easily predictable – only few from listed companies are young enterprises with potential dynamics. Entrepreneurial ventures are not favored, which is pointed by critics[3].

[3] Sheldon Gao, "Dow Jones Indexes: China Stock Market in a global perspective", Dow Jones & Company, Inc, September 2002

Size gap

A consequence of overseas listing of China's blue chips and other large companies is, that small-cap stocks are dominant on the market, and there is a large gap between relative share in the exchange, comparing to other countries. Sheldon (2007) reminds, that according to Dow Jones Emerging Market Index (consisting of South Korea, Taiwan, Malaysia, Indonesia, Philippines, Thailand, South Africa, Mexico, Brazil, Chile, Colombia and Venezuela with 95% coverage) the cutoff line between large and mid-cap and respectively between mid-cap and small-cap are 1.2 billion dollars and 210 million dollars. This division applied to China tells, that there is only one large-cap stock company, which is Shenzen Development Bank. Not more than 150 companies can be described as mid-cap stocks , and the rest (more than a thousand) are small-cap stock companies. Taking into account there are 500 billion shares outstanding, with total market value of 500 billion dollars, this gives average price per share about 1 dollar, and that is really low price comparing to $34 and $23 at NYSE and Nasdaq.

Market Concentration Measured by % of Stocks (%)						
% of stocks	**5%**	**10%**	**15%**	**20%**	**25%**	**#of composite**
USA	58,4	70,9	77,7	82,5	85,9	1676
Global	58,6	71,1	78,3	83,1	86,6	4865
Emerging markets	44,7	58,6	67,2	73,7	78,6	823
China	**18,1**	**28,9**	**36,4**	**43,1**	**51,8**	**549**

Source: "Dow Jones Indexes: China Stock Market in a global perspective", Dow Jones & Company, Inc, September 2002

Dominance of retail investors

Stock market in china is dominated by retail investors. Holdings of institutions in China are not more than 20% of total market share – comparing to 40% in U.S.A, U.K or Japan. Moreover, holdings of foreign investors in China are not exceeding 2.5%, while in developed markets of U.S.A and Japan they own respectively 11% and 19%.

Coexisting exchanges

As mentioned before, there are two major exchanges in China. Shanghai and Shenzen exchanges are similar in size, and they are simultaneously co-existing on the market. Most of developed countries however either have single-exchange, or migrated from multi to single-exchange model. Sheldon mentions here Australia, which used to have

7 exchanges till 1987, Hongkong with four exchanges until 1986. Both of them have one exchange right now.

Multiple-exchange model in China is very unusual and rare then. Surprisingly, stocks listed on these two exchange perform quite differently. They don't have large differences in sector they represent. However, their correlation coefficient is only 0.82, close to correlation between Dow Jones Shanghai and Dow Jones Shenzen indexes. Furthermore, in last year there were significant differences in return at the level of five percentage points.

Comparison of emerging markets in selected countries		
Country	**Number of stocks**	**Total market value**
China	**1131**	**524,3 bil. USD**
Russia	245	62,9 bil. USD
Israel	654	63,2 bil. USD
Poland	228	26,8 bil. USD
Czech	138	9,7 bil. USD
Hungary	58	8,9 bil. USD
Egypt	80	7,1 bil. USD
Slovenia	130	4,0 bil. USD

Source: "Dow Jones Indexes: China Stock Market in a global perspective", Dow Jones & Company, Inc, September 2002

Pyramidal structure of the market

China market lacks true blue-chip stocks with high level of profitability. Instead, market is dominated by large amount of small-cap stocks. This structure is called "a pyramid structure" and it is opposite to funnel structure, that is present in most of developed countries. Sheldon Gao (2007) recalls an example of Nokia company, which represent about 73% of Finland's total market value. In China however, without true blue-chip companies in the A-share market and with the increasing number of listed companies, the aggregate market value accumulates quite slowly, because gradually more and more shares have to compete for a limited amount of money of investors. Comparison of market in developed countries and in China is presented in following table:

Market Concentration Measured by % of Stocks (%)						
% of stocks	5%	10%	15%	20%	25%	#of composite
USA	58,4	70,9	77,7	82,5	85,9	1676
Japan	43,9	58,6	68,3	74,6	79,1	704
United Kingdom	57,3	69,4	76,6	82,0	85,8	328
Canada	36,2	52,7	63,0	71,3	76,8	203
Global	58,6	71,1	78,3	83,1	86,6	4865
Emerging markets	44,7	58,6	67,2	73,7	78,6	823
China	**18,1**	**28,9**	**36,4**	**43,1**	**51,8**	**549**

Source: "Dow Jones Indexes: China Stock Market in a global perspective", Dow Jones & Company, Inc, September 2002

Basically, in China 5% of top-cap stock companies represent only 18.1% of market capitalization, while in USA for example, total market capitalization from 5% of top-cap companies is more than a half. Another measure, but compared to top stock of each exchange is even more showing, that China differs from developed markets. For instance (as previously said) Finnish Nokia's stocks are more than 73% of total Finnish market capitalization. In Netherlands, this is almost 25%, Sweden and Switzerland have 22.8% and 20.3% respectively. In China however, top-cap stock company stands only for 1,8% of total market capitalization.

Speculation

Sheldon Gao (2007) says, that "statistics show that a developed market usually has a lower turnover level than an emerging market, because long-term investing and buy-and-hold strategies are more ingrained in the investing culture". The common way to measure degree of speculation is average stock turnover calculated as total annual trading value, divided by average market capitalization.

Turnover comparison of several stock exchanges								
	NYSE	Tokyo	Toronto	Australia	HK	Singapore	Taiwan	China
2001	87,9	61,3	56,7	65,5	50,2	34,3	159,6	**264,8**
2000	89	60,8	59,4	58,2	63,5	63,5	195,3	**378,1**
1999	72,7	50,7	41,8	47,1	40,5	40,5	237,6	**381,3**
1998	67,4	35	41	47,9	63,9	63,9	261,8	**409,7**
1997	59,6	34,5	33,4	50,6	118,3	118,3	368,5	**590,4**
1996	54,3	28,6	25,5		40,6	40,6	243,4	**744,1**
1995	50,8	23,1	18,9		34,3	34,3	199,6	**430,3**

1994	55,1	25,6	17,3		51,7	51,7	352,5	**838,8**
AVG	67,1	40,0	36,8	53,9	57,9	55,9	252,3	504,7

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

The table above shows, what is the situation on China's stock market compared to developed markets.

Speculation phenomena is very widespread throughout China's stock market in different kind of investors. Individual investors are fighting for financial survival in a risky investing environment, also institutional investors frequently engage in speculation. Using public money to buy shares is prohibited, but temptation can usually win, and using leaks of information, public clerks can use the knowledge about forth coming privatization, multiplying the value of owned shares. Chinese stock market is not really encouraging long-term investment strategies, its strange features make the construction of traditional business portfolio almost impossible.

Speculation in Chinese stock market provides liquidity and encourages trading activity. The high level of liquidity in China's markets is "accounted for in the construction of the Dow Jones China index series, which uses three-month average prices rather than single-day "snapshot" data."[4]. The cycle of speculation is really significant in China's stock market's movements. The price of single stock is tremendously pushed up, but after becoming large-cap it is abandoned, so as to take profit for investors, in favor of next group of small-cap investors. Pyramid structure of China's stock market is a one of most important causes of market instability, the dominance of small-cap stocks and high levels of market speculation. On the other hand, it simultaneously provides a relatively high level of liquidity.

Low profitability, low dividend yields

Estimations of bubble of China's stock market are different, regarding point of view. It cannot be argued however, that a high level of P/E ratio in China is very disturbing. is a red flag. Indisputably, the higher the trailing P/E is, the lower the future return. High level of independence and isolation (probably due to non-convertible RMB) has resulted in a tremendously big difference between P/E ratios of Chinese companies listed in domestic and overseas markets. Not surprisingly, companies that operate in

[4] "Dow Jones Indexes: China Stock Market in a global perspective", Dow Jones & Company, Inc, September 2002

China, but are listed overseas have normal P/E ratios. High prices of Chinese stock will remain as long, as challengers and competitors don't come into the market.

Interestingly, in developed countries there are higher P/Es for companies, that are operating in such areas as IT, new technology, biotechnology and so. Manufacturing companies have usually lower P/Es. This is because investors are willing to pay more for their future growth potential. In this context it is really interesting to take into account, that many of Chinese companies with high P/Es are manufacturing companies – they are just far behind the global standards regarding profitability. This is probably caused by either low efficiency or poor management. Anyway, high P/Es compared to relatively low P/Bs reveals, that Chinese companies are extremely overvalued. It is however unbelievable by investors, that this trend is going to reverse in next year. It is rather unlikely Chinese state would let this happen before Olympic Beijing in 2008, having the biggest foreign exchange reserves (more than 1.4 billion USD).

Conclusions

China's stock market is emerging market, but in some features it is very different from other emerging markets. The main issue is strong control and supervision by state, and high level of separation and segregation of the stock market. With restriction to foreign capital and specific structure, including strict division to share classes and number of failures of structure, it is very hard to go out of stage of emerging market into developed one. The stock market in China is a pyramid structure, which means there are no typical high-profitable blue-chips. Instead, there is a high market share of small-cap joint ventures, and export oriented companies.

China stock market is highly speculative one, and cycles of speculation are very significant in context of market movements. Speculation is very common, which connected with analysis of pyramidal structure of market gives high level of liquidity, but on the other hands these are reasons, why the market is not stable. Despite tremendous growth of the stock market, Chinese companies are not operating at a high level of profitability, providing poor earnings, and low yield from dividends. This must be changed, if they want to be competitive in global markets. The high P/E ratio of China's (combined with comparison to P/B ratio) gives conclusion, that this market is very seriously overvalued, which may have further effect.

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