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# Introduction

By James E. Shapiro

While China's capital market is one which has accurately been lauded as one of enormous growth and even more impressive and exciting potential, there are still key issues which have consistently presented challenges throughout the development of China's financial markets. This introduction sheds light onto some of these challenges and provides a broad overview for the exciting and fascinating issues this book will further explore in its coverage of China's capital market.

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China's capital markets have indisputably come a long way since the re-opening of China's equity markets in the early 1990s. At the end of 1992, the first calendar year during which the Shenzhen and Shanghai exchanges were fully operational, a total of 54 companies were listed in the A-share market and 18 in the B-share market, with a combined market capitalization of RMB105 billion (USD12.7 billion), or a miniscule 3.9% of China's 1992 GDP<sup>1</sup>. As of August 15, 2007, the number of listed companies stood at 1,473 with a combined market capitalization of RMB7.1 trillion (USD939 billion).

While this growth has been extraordinary in absolute terms, and the build-up of the basic regulatory and physical infrastructure of modern equity markets has been impressive, China's capital markets still have a long way to go before they reach their full potential. They still fall short of meeting the myriad needs of Chinese companies, as well as Chinese and international investors.

This book provides an up-to-date overview of China's capital markets – a constant necessity in China's rapidly evolving environment. The contributors provide a variety of perspectives and a wealth of up-to-date information on the current on-the-ground reality in China. I have no doubt that corporate executives and capital market professionals will both find it a useful reference book.

My instructions in providing an introduction were to take a very broad overview of the last 20 years of capital market development in China and identify key achievements and continuing challenges.

In my view, there are three central concerns that have pre-occupied practitioners and policy-makers during the emerging decades of the Chinese capital market:

- 1) The desire to create deep and broad capital markets that can lessen the economy's reliance on the banking system.
- 2) The desire to balance the speed of development of the capital markets with stability of the markets, which has been viewed as essential to sustaining continued political support for

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1 Privatizing China, Walter & Howie, 2003; China Bureau of Statistics, *China Statistical Year Book 2004*

general economic reform.

- 3) The desire to create domestic financial market institutions – exchanges, broker-dealers, investment banks – that are capable of competing with global financial institutions.

## Reducing the Economy's Reliance on the Banking System

Early on in the process of economic reform, Chinese policy-makers recognized that establishing well-functioning capital markets would boost economic growth by helping growing companies raise equity capital and by improving the allocation of capital. It was also recognized that a transition to an economy using the capital markets to fund growth and allocate capital would take many years. The vast amount of capital available for investment in China in the 1990s – and even today – is allocated by the banking system.

McKinsey Global Institute reckons that in 2006 banks intermediate approximately 75% of capital in the economy<sup>2</sup>.

And within the banking system, the big four state banks – Bank of China, China Construction Bank, Bank of Communication, Agricultural Bank of China – still account for over 50% of all bank loans made in China<sup>3</sup>. This high-degree of centralization, not surprisingly, can lead to inefficiencies. And while it has helped to fuel China's impressive economic performance over the years, it is also increasingly apparent that it will serve the economy less well going forward, as economic decision-making becomes further decentralized and as the economy grows exponentially more complex.

Because large State-owned enterprises (SOEs) have had the easiest access to the funds of the Big Four, smaller enterprises, especially private-sector entities have been relatively starved of investment funding. And yet these smaller companies are often the fastest growing and most innovative entities.

From a policy perspective this inefficiency was the result of a calculated trade-off: while it was detrimental to economic growth to deprive smaller firms of funds, it was believed to be essential to continue to fund losses in SOEs, providing a cushion to allow some SOEs to reform, while the least inefficient were shut down, producing significant employment losses.

## Maintaining Stability of the Markets

While maintaining macroeconomic stability (and cushioning workers from massive layoffs) has been a key requirement of those managing the transition from a State-bank dominated financial system to one with a greater role for capital markets, maintaining the stability of the nascent capital markets has been equally important.

The establishment of stock markets – one of the more potent symbols of capitalism in the world – has not always been warmly received in all corners of the Chinese leadership. Some have embraced

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2 "Putting China's Capital to Work", *Far Eastern Economic Review*, Farrell and Susan Lund, May1, 2006

3 "Efficiency and Stability in China", *Chicago GSB*, Anil Kashyap, March 2007

the markets as effective tools of privatization, wealth creation, risk management and economic development in general. But others have been concerned that markets – unlike the banking system – are much harder to control. Stock markets – where prices are determined by the interactions of judgements of many individual buyers and sellers – are always prone to bouts of euphoria and panic. In emerging markets, typically dominated by the more emotional judgements of retail – rather than institutional – investors, these tendencies are often even more pronounced.

Rapid swings in valuation in the market pose political risks as well. As more and more small investors have been drawn into the stock market and have opened brokerage accounts, there has been increasing pressure among regulators to manage the market to make certain that big price declines do not wipe out small speculators and lead to a political backlash against further development of the markets.

Attempts to manage the market – both on the upside and downside – to try to insulate investors from volatility and risk, have been an important feature of Chinese capital market development in recent years. These attempts may have been essential given the political constraints in the last decade or so. But this pre-occupation has also slowed down the market's development. In times of market weakness, there was a tendency to restrain new issues coming to the market – a crude attempt to reduce (or not increase) supply and prop up prices. It could be argued, however, that the real weakness in the Chinese market in its long 1998-2005 period of stagnation, was the shortage of quality companies. Restrictions on domestic listings during these years drove many of the most attractive Chinese companies to overseas markets. Only when the new listings tap was opened and new companies started to list did we see renewed interest in the market from investors.

Today's market is characterized by high valuation and a fair amount of volatility. Now policy-makers are concerned about restraining the rise in valuations so that a severe correction will not precipitate widespread losses among the less sophisticated retail investors and derail support for further development of the market. To some extent Chinese attempts to protect retail investors from volatility and market declines have been successful. But they have come at a cost. Artificially restraining the ability of domestic firms to list has delayed the development of robust, liquid and meaningful markets that play a real role in the economy's allocation of risk and capital.

### **The Role of Foreign Expertise in the Development of the Domestic Financial Markets**

A third pre-occupation of Chinese financial market policy-makers has been the desire to build domestic financial institutions to ensure that the key institutions supporting the Chinese capital markets are not unduly dominated by foreign participants.

Of course, it was recognized early on that expertise in operating the basic machinery of the capital markets – the exchanges, firms and regulatory bodies – would have to come from countries with experience in these areas, rather than home-grown technical talent. And much of the early leadership in all these institutions was naturally foreign-trained, foreign educated and with extensive foreign experience.

But the reluctance to allow greater direct participation by foreign firms has, at least in my opinion, significantly retarded the development of the markets. When foreign firms operate locally, they

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hire and train local talent that then acquires the skills and standards of global firms. This talent pool is then available to local firms and institutions.

Delaying and severely restricting the participation of foreign firms in Chinese capital market activities has essentially slowed down the transfer of capital market skills from foreign firms to domestic firms. It has not stopped it. Much of this skill transfer continues to take place – but it happens in New York, London, Tokyo, Singapore and Hong Kong, where Chinese citizens have found employment opportunities with global firms. It would happen faster if those same firms were allowed to operate more freely, across more of the spectrum of financial market activities, in China.

Greater foreign participation in the domestic capital market will not only accelerate the transfer of skills to domestic firms, it will also more immediately enhance the functioning and efficiency of the market itself. For example, if restrictions on foreign participation through the QFII quotas were relaxed, liquidity would be enhanced and greater diversity of the investor base would likely lead to more efficient pricing of many securities.

The various chapters in this volume will shed new light on all three of these themes. The Chinese capital markets are an exciting work in progress. They have come an extraordinary distance in the last two decades and it is certain that the pace of their development will only accelerate in the future as global competitive pressures continue to raise the bar. Companies and policy-makers expect more and better from capital markets with every passing year. China's markets are unlikely to disappoint.



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