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The Chinese Stock Market: Pitfalls of a Policy-driven Market

by

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The Chinese Stock Market: The Pitfalls of a Policy-driven Market¹

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The stock exchanges in Shanghai and Shenzhen have been established only eleven years ago. But at the end of the year 2000, total market capitalization already amounted to 580 billion US\$. In 2001, a slide of share prices reduced this to 525 billion. But this is still larger than the market capitalization of the Hong Kong or Taiwan stock markets.

Much more interesting than these naked numbers are the rules of the game that we find behind the often misleading façade of statistics. That's why I am going to deal with the political and economic context of stock market regulation. This paper is based mainly on Chinese written and interview sources since there has not been a lot of research in the West on this topic by now.

Since its initiation, the Chinese stock market has manifested particular rules of the game which are clearly different from stock markets in the conventional understanding. The political leadership has laid down a course of regulation that is oriented

- towards supporting state-owned enterprises and
- towards promoting quick market growth at the expense of consistent regulatory standards.

In China, we face a regulatory style that is heavily influenced by Leninist political habits. This sounds a bit antiquated in the year 2002. But what do I mean by that? By **Leninist institutions** of political control I mean the pervasive presence and elaborated hierarchy of Party organs in state, military, economic and social organizations, the rigid rules of „cadre“ surveillance and recruitment, methods of extra-judicial disciplinary supervision, politically motivated selective disinformation

¹ This essay is based on several studies that have been published by the author in German. For detailed references, Chinese sources etc. see China Analysis No. 3 and No.4 (www.chinapolitik.de).

(propaganda) through official media etc. In short, all the hierarchical instruments of control that draw upon Lenin's conception of a monocratic, centralized party-state.

More specifically, the Chinese stock market can be characterized as a **policy-driven market**. What is a policy-driven market?

- A market in which political calculations, policy missions and administrative interference are more important than the dynamics of market competition for determining price fluctuations.
- A segmented market in which certain shares (they are called "state-owned shares" and "legal person shares" in China) are excluded from trading so as to perpetuate state control.
- A market that is a battlefield for the most powerful political and economic actors who try to benefit from their control over state assets.

My analysis focuses on the tension between stock markets as a "new" non-socialist economic institution on the one hand and the "old" Leninist institutions that are still characteristic of the Chinese state on the other hand. My guiding question is:

How strong and effective is the Chinese state in terms of regulatory capacity? Is it possible to establish sound institutions of stock market regulation, that are conducive to market growth and competition, with Leninist means of political and administrative control?

These issues appear to be of special importance in the light of recent financial crises. Ineffective regulatory institutions in emerging capital markets proved to be major factors that contributed to the vulnerability of individual economies.

I will demonstrate that key deficiencies of the regulatory framework in China can be traced to the political economy of China's transition from socialism. These deficiencies leave a lot of room for opportunistic insider behaviour which inevitably destabilizes the stock market. A reversal of these tendencies will not be achieved unless the degree of depoliticization increases significantly.

1 Why is the regulation of capital markets crucially important in China?

Major functions of the banking and securities system in emerging markets such as China are

- to mobilize national savings by offering safe and diversified investment opportunities,
- to transfer capital to productive usage,

- to provide capital access to small and medium-sized enterprises,
- to provide access to international capital markets and
- to make financial services accessible to all economically active segments of society.

Building modern capital markets does not only require robust organizational and technical capacities as well as the strict enforcement of regulatory mechanisms. Institution-building also involves time-consuming learning processes and behavioral amendments of both, regulators and market participants.

With regard to financial regulation, the Chinese state has to carry a heavy socialist heritage. In conventional socialist planned economies, national financial systems just provided a passive instrument. Socialist banks had to steer financial resources into those sectors of the national economy that had been selected according to political criteria, not according to market demands. That is why in China the establishment of a capital market and securities trading was subject to intensive ideological and political controversies.

2 From decentralized markets to centralized market supervision

The expansion of securities markets in China is a fascinating story. In the beginning, securities trading was a spontaneous, local and unregulated affair in several southern cities. Local governments supported those activities since it brought them new sorts of taxes and gave state-owned companies a new channel for raising capital. But the central political leadership remained skeptical and tolerated these local markets only hesitatingly and on an experimental basis. Only after Deng Xiaoping's famous "Southern Tour" in 1992, fundamental ideological controversies began to subside. It took another five years until the 15th Congress of the Chinese Communist Party in 1997 made the statement: "Joint stock companies can be used in capitalist systems as well as in socialist systems."

In retrospect, we can distinguish three main stages of stock market development:

- In the *early stage* before 1992, securities trading flourished on local markets and there was no effective and unified regulation.
- During the *second stage* from 1993 to 1997, national regulatory institutions were gradually established but centralized supervision was undone by rivalries between local and central, old and new state organs that claimed to be the main regulator of this lucrative business.
- The *third stage* began in 1997 against the background of a series of domestic financial scandals

and under the shadow of the Asian Financial Crisis. At this time, political support for reorganizing and strengthening financial supervision intensified. Zhu Rongji who became prime minister in 1998 perceived the financial system as the vulnerable backbone of the entire economy. “Financial security” (*jinrong anquan*) moved to the center of political attention. A new “vertical leadership structure” and a centralisation of financial market supervision were initiated. This trend of centralization has been further strengthened in the last few years.

3 Political market supervision: The Communist Party’s Financial Work Committee

How did the political leadership eventually accomplish the renovation of regulatory institutions? One key feature of the reforms in China’s financial sector since 1997 has almost completely been ignored by Western studies: These reforms would not have been possible without Communist Party control. Why do I say this? The reforms were based on the creation of a Central Financial Work Committee (*Zhongyang jinrong gongwei*) directly under the Communist Party’s Central Committee which in turn installed new party organs and a centralized party hierarchy in the three major areas of the financial system (banking, securities and insurance). Even many people specializing in observing the Chinese banking and securities sector do not know that this Central Financial Work Committee exists or what it does. But the creation of the Central Financial Work Committee was the key precondition for the successive centralization of financial supervision.

[Chart 1 (at the back of the paper):

Political and administrative supervision of the Chinese securities market]

This establishment of a "vertical leadership structure" fully reflects the Leninist logic of control over personnel and organization. Actually, the essential reform steps in China’s securities regulation were implemented with classical Leninist instruments ranging from the personnel power of the Communist Party central leadership to the establishment of a centralized hierarchy of party organs in the financial sector. The establishment of a vertical leadership structure of Communist Party organs took place ahead of the establishment of the state supervisory organs.

The most important task of the Central Financial Work Committee is the recruitment and surveillance of leading personnel in key regulatory bodies and financial firms. In the name of the committee several comprehensive personnel reshuffles were carried out in recent years. The Central Finan-

cial Work Committee does not enjoy formal decision-making authority with regard to financial regulation. Yet, reality is different: There is a lot of evidence that the Central Financial Work Committee regularly sets broad policy objectives for banking, securities and insurance supervision, and thus constitutes a key operational, while secretive player in China's financial market. It is evident that this kind of institutional set-up can hardly be conducive to a depoliticised, rules-based and market-oriented style of stock market regulation.

4 Administrative monitoring: The China Securities Regulatory Commission (CSRC)

Under the political supervision of the Central Financial Work Committee, the China Securities Regulatory Commission (CSRC) has been given the task of day-to-day monitoring of markets and market participants. We have here a relationship between a Communist Party principal and an administrative agent, that is the CSRC. In 1998, the CSRC was granted the equivalent rank of a ministry with extensive authorities. Supervisory rights over brokerage houses which were previously supervised by the central bank, were transferred to the CSRC. Both stock exchanges in Shanghai and Shenzhen, including their leading personnel and their clearing and settlement organs, were placed under the authority of the CSRC. The strengthening of national securities supervision was legally formalized with the promulgation of China's first securities law, which became effective in July 1999. The CSRC has repeatedly demonstrated its power in cases of market misconduct by removing managers of brokerage houses and investment funds from their positions and imposing penalties on a number of financial firms.

What is characteristic of financial systems all over the world, also applies to China: The circle of leading securities regulators is small: In China, just about 180 persons constitute the core of the leading elite of the Central Financial Work Committee, the China Securities Regulatory Commission, and the Shanghai and Shenzhen stock exchanges. This group of persons regularly meets on the occasion of high-level conferences. Most of the leading cadres are in their mid-age (about 40 to 55 years old), have common roots in the formative period of China's stock markets in the late eighties and early nineties and have working experience in leading positions of banks, brokerage houses or investment funds.

5 Conflicting policy missions

In spite of the centralization of regulatory organizations, financial supervision in China remains fragmented and ineffective. What is the reason for that? I will try to illustrate the dilemma by focusing on conflicting policy missions that the political principal (the Central Financial Work Committee that represents the Communist Party's leadership) demands from its key administrative agent, the CSRC.

In effect, the Chinese political leadership tries to square the circle in its efforts at capital market development:

- On the one hand, the political center seeks to gain credibility in the construction of securities markets by establishing formally strong regulatory organizations.
- On the other hand, the political center is eager to maintain political control over the regulatory organizations by means of Communist Party supervision.

This Janus-faced style of political supervision and politically biased regulation opens the door for typical deficiencies in capital market regulation. Obviously, the effectiveness of China's stock market regulation is weakened by conflicting policy missions assigned to the CSRC.

Chart 2: Conflicting Policy Missions in China's stock market

	Policy Missions	Conflicts
(1) General economic policy mission	<ul style="list-style-type: none"> ▪ Preferential capital access for state-owned enterprises. ▪ Increasing the value of state assets. 	with (3)
(2) Additional economic policy mission (since 1998)	<ul style="list-style-type: none"> ▪ Promoting consumers' and producers' trust in economic growth through higher share prices. 	with (3)
(3) Official regulatory mission	<ul style="list-style-type: none"> ▪ Establishing level playing field in the market. ▪ Protecting investors. ▪ Fighting market manipulation. 	with (1) (2) (4)
(4) Inofficial regulatory mission	<ul style="list-style-type: none"> ▪ Restricting negative information about enterprises and market development. ▪ Thereby preventing devaluation of state assets. 	with (2) (3)

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(1) The dominant policy mission assigned by the political leadership to the CSRC is to provide state-owned enterprises (state-owned enterprises) with preferential access to financial resources and to protect the value of state assets (that is: state shares). At this point, the political content of the Chinese stock market manifests itself very clearly. This fundamental economic policy has far-reaching consequences. Increases of state-owned shares' prices enjoy priority over the establish-

ment and consistent enforcement of market-preserving rules. Zhou Zhengqing, China's chief securities regulator from 1995 to 1999, explicitly stated the political principle that in a socialist system "securities markets have to serve the state-owned enterprises" and not the share-holders. However, recently there were some indications of a changing attitude. The current CSRC chairman, Zhou Xiaochuan, holds the opinion that the CSRC must change its style of regulation and distance itself from the still prevailing "structures of the planned economy". As he put it, the regulator is supposed to become a neutral "referee" in the securities market.

(2) But since 1998, the CSRC was actually assigned an additional economic policy mission which focuses on supporting the business cycle: promoting the trust of enterprises and consumers in the national economy through soaring share prices which should in turn raise the propensity to invest and to consume. With regard to the first two policy missions, the stock-market is supposed to serve as a channel to transfer private capital into the hands of state-controlled economic entities. Obviously, the effect of such policy missions is lax market supervision, which might even tolerate insider trading and market manipulations as long as these illegal activities contribute to the growth of the national stock market.

(3) No doubt, the two general economic policy missions undermine the official regulatory objective of the CSRC, which calls for control of market manipulations and the establishment of rules-based market competition.

(4) In order to conceal the incompatibility between the economic policy missions on the one hand and the regulatory tasks on the other hand, the CSRC was assigned a fourth – basically informal regulatory objective, that is: to limit the dissemination of negative information on enterprises and markets so as not to threaten the positive development of state enterprise shares. This unofficial working mission is not only backed by the central and provincial governments and respective political leaderships; it is naturally also welcomed by the financially distressed state-owned enterprises and the institutional investors who can both easily exploit information asymmetries for their own advantage.

In short: the regulatory mission is first and foremost dedicated to market growth and only to a much lesser degree to the enforcement of strict regulatory standards. Therefore critics claim, that the core function of the stock market in China lies in "transferring the money of the broad masses into the hands of a minority of power-holders in the state".

In the terms of principal-agent analysis, the Chinese central government is trapped in a dual political and economic role: **As the political principal, the government is directly affected by its own economic policy decisions since it is at the same time the ultimate economic principal of China's state-owned enterprises and thus has a vivid short-term interest in the preservation of asset value.** No wonder, the Chinese government is tempted to sacrifice the long-term interest in market integrity to short-term calculations of preserving and raising the asset value of state-owned corporations.

6 How share prices can be driven up politically

How is it possible in practice to drive share prices up according to political objectives? We witnessed a very good recent example for how this works in May 2002: With the help of the state-owned media, the regulators not only talked up the market but also introduced new rules for initial public offerings that were obviously meant as a market-supporting measure, not as a sound regulatory rule. Every Chinese investor understood that. But in a highly speculative market environment, where you never know how good the companies really are that you invest in, such regulatory interferences are the best opportunity to make a quick buck. And indeed, the share indexes were boosted, at least temporarily, by about 7% through the new regulatory announcement.

One of the most influential Chinese securities regulators in the nineties, Zhou Zhengqing, pointed to a central feature of China's politicized stock market, when he said: *"We need to use the visible and invisible hand simultaneously."* China's securities regulators have been quite successful in shaping market trends by means of ad hoc interference and supported by selective information in the state media. The CSRC played an active role in cooling down massive market speculation in 1997 and in revitalizing the market in 1999. This political influence becomes obvious, when we take a closer look at market trends during selected periods of intensified administrative interference. Changes of regulatory policy in fact seem to have had a decisive influence on index movements. Of course, the politically induced index movements do not pertain and are reversed sooner or later. But on the whole political interference appears capable of producing policy-driven cycles in the market when this was deemed necessary.

In addition to regulatory measures and media campaigns, share prices have also been directly influenced by state-owned securities dealers which acted on instructions by government regulators. A major field of stock market "regulation" in the early nineties consisted of politically directed buy

and sell activities, with the aim of producing politically desired share price movements. A similar phenomenon could be observed in 1999-2000, when the CSRC encouraged brokerages and investment funds to support the market by all possible means. The regulatory authorities apparently even turned a blind eye to massive market manipulations, as long as they contributed to market growth. A strong indicator of this kind of “blind eye policy” is the fact, that the probability of being accused for illegal market manipulations did not increase in recent years though the technical equipment to detect illegal activities with the help of automated data-processing improved significantly in the meantime. Thus, the Chinese stock market remains characterized by institutionalized methods of market manipulation which are subject to interference by regulatory bodies but definitely not subject to severe legal sanctions.

7 Insider control in the Chinese stock market

Let us turn to another important phenomenon that has to do with the regulatory system: insider control in the Chinese stock market. The phenomenon of insider exploitation of semi-liberalized systems is anything but new, as was shown by privatization processes in eastern European economies. But it is astonishing that insider control has been neglected on the research agenda of transitional financial systems. The reason for this neglect might be seen in the wide-spread myth that stock markets are the incarnation of free-wheeling capitalism and are not subject to political interference. This myth is wrong. Securities markets, including Wall Street, belong to the most heavily regulated markets and are subject to a lot of political lobbying in rule-making, rule-enforcement and rule-evasion.

In China, we find a number of market participants and regulators that belong to the informational or even operational market insiders.

[Chart 3 (at the back of the paper): Insiders in the Chinese Stock Market]

Distinguishing between informational and operational market insiders makes a lot of sense: Those who know more than informational outsiders (private small investors and presently also foreign banks) are in a position to use their information advantages for profitable stock market transactions. Nothing special about that. But in China, we have big investors that not only know more than others but also actively influence price movements with their massive and coordinated buy and sell activities. The Chinese term for these drivers of the market is *zhuangjia*, that is the “banker” in a gam-

bling game, a term that revealingly stems from the casino language. I have used here a broad definition of *zhuangjia* including illicit investment but also official market players such as brokerage houses and investment funds. Here we find a game of insider collusion and market manipulation that is well known in stock markets all over the world. But in China, the evidence for systematic market manipulation is particularly impressive.

A typical feature of partially liberalized systems is **corruption**. Glaring examples in the context of stock market regulation are the frequent corruption scandals connected to **initial public offerings (IPOs)** in China. The formal IPO procedures are still guided by principles borrowed from the planned economy: there are quantitative quotas, administrative application and approval, and a heavy role of political patrons in pushing for IPOs of their client enterprises. In the course of most IPOs, networks of accomplices are formed which typically include the executive managers of the enterprise wishing to go public, leading party and state cadres of local and central bodies, administrative offices which are involved in the application procedure, local banks, the underwriting securities firm, and the stock exchange where the enterprise will be listed. Frequently the final decision on IPOs is still made by the top political leaders around prime minister Zhu Rongji or even with the participation of Jiang Zemin.

The emergence of **informal networks between the regulators and the regulated in China's securities market** is a direct consequence of a policy-driven market. In order to control and “support“ the market, regulators depend on the cooperation of the „big players“ in the market. Market manipulations is tolerated by the regulatory bodies over quite long periods of time, since it is their policy mission to support market growth by every means. In addition, the informal connections between the regulators and the regulated naturally hamper market supervision. In this view, the “embeddedness” of Chinese regulatory bodies goes far beyond what might be expected from a political system controlled by a Communist Party. The inclusion of regulatory personnel in multilevel insider networks severely weakens the consistency and effectiveness of market supervision. And the existence of these networks undermines the credibility of the CSRC as an even-handed regulatory organ.

Pointing to the close relationship between the regulators and the regulated in China, some Chinese economists recently warned against the emergence of a “financial oligarchy” in China's securities market that is formed by collusive networks. The emergence of an informal “financial oligarchy” corresponds to the general observation that the effectiveness of Leninist means of control is rapidly eroding in China. The organizations of the party state are decomposed by informal political and

economic networks on all hierarchical levels which flexibly adjust to the changing opportunity structures of China's transitional political economy.

In the Chinese securities regulatory system **demonstrations of control and supervision are restricted to times of severe distress**, when the expected costs of “no action” are specifically high. During these times the political leadership and the securities regulatory organs demonstrate a comparatively high supervisory capacity, though only for a short-term period. Backed by the Communist Party's extralegal disciplinary means, the CSRC and the central government are still able to conduct vehement campaigns, for instance in case of severe securities scandals or speculative bubbles which threaten to destabilize the whole economy once they burst. Leninist institutions still provide an effective disciplinary instrument, if the Communist Party's core leaders calls for immediate action. But sanctions against market participants for pursuing illegal activities are generally restricted to personnel reshuffles, minor fines and partial reorganizations: much too narrow and short-lived to change the basic rules of the game.

8 What is driving institutional changes?

Obviously, the Chinese political economy is not a stagnant system. Where do we find the agents of change that will reshape the dynamics of stock market development and the rules of the game in the near future? In this respect, I am quite optimistic, and this is based on the following points:

First: The accelerating entry of **new market participants**, in particular private companies and foreign investment banks and other financial services firms. By now, private Chinese companies have been heavily disadvantaged in their access to stock market capital. But their position has been strengthened in recent years. It is very likely, that the number of initial public offerings of private companies will increase considerably in the next few years. This will probably raise the overall quality of listed companies. But more importantly, the dominance of state-owned listed entities would be constrained and thereby the rules of the game of the policy-driven market would change fundamentally. There would be a chance for switching from a stock market that is oriented towards speculation to a market that is oriented toward investment that goes into productive sectors of the economy.

A very strong impact on the rules of the game can be expected with the advance of international investment banks, brokerages and investment funds in the Chinese capital market. Recently, foreign capital market players have increased their efforts at cooperation with Chinese firms, recruitment of

Chinese personnel and their political lobbying in China considerably. These powerful big players will shake the foundations of the present regulatory system as they have done in other emerging markets before.

My **second** point is the much more active role of the **media** in criticizing market manipulations and deficiencies of market regulation. This is one of the most fascinating features of the Chinese stock market. There is hardly any other field of Chinese politics, where policy discussions are so controversial, critical of the government and sometimes even insulting as in the public opinion around the stock market. It is not rare that the central government and the CSRC are even openly criticized as being politically irresponsible and incapable. Stock market information is still basically under control through big players such as the *Xinhua* finance network. But there are some investigative, semi-private journals such as *Caijing* (Finance and Economy) that have influenced market regulation by their investigative reports. No doubt: public opinion around the stock market is tending towards pluralization and openness, and the internet is contributing a lot to this.

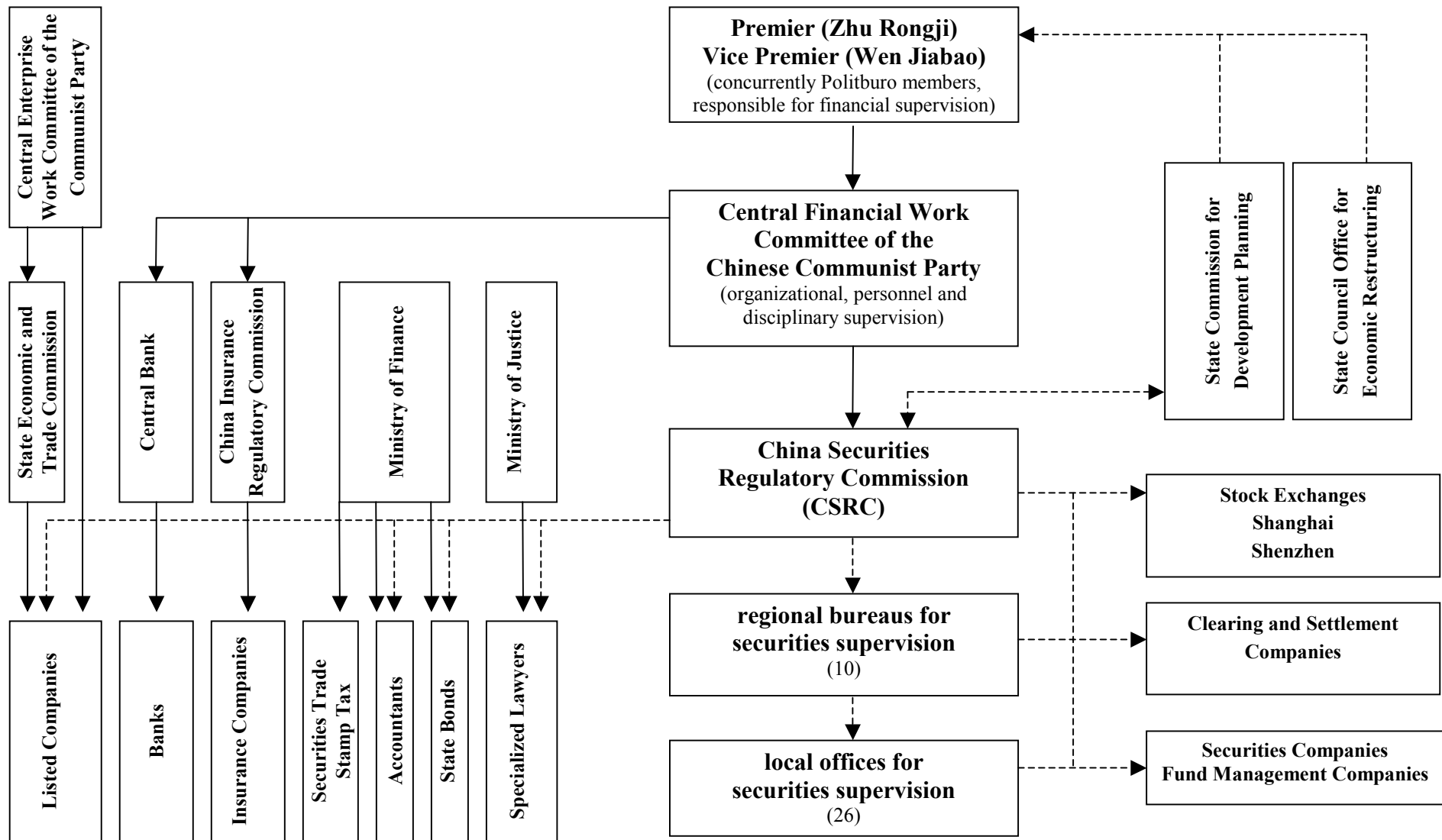
My **third** point is the emergence of **courts** as a new regulatory force. In other capital markets, most prominently in the USA, courts belong to the agents of regulatory change by interpreting market regulations. In China, courts usually aren't independent players. But this begins to change in the realm of the capital market. Since the end of 2000, the CSRC has lost several lawsuits. Dissatisfied shareholders sue listed companies for irregular disclosure. The courts have become much more important in defending the economic rights and the assets of players in the capital market. Lawsuits start to generate pressure to change the rules of the game and to restrict insider manipulations.

A **fourth** and important point has to do with **international regulatory competition**. Attracting international capital has become one of the key objectives of economic policy for most governments. By now, China's capital market and the listed state-owned companies were isolated from the competitive pressures of world capital markets. China's entry into the World Trade Organization promises to change all this after a transitional period. As we have learned during the Asian Financial Crisis, to lift capital account controls before a sound regulatory system has been established, is a dangerous strategy. China will face many risks. And many Chinese bankers and brokers expect that the securities market will be among the very last sectors of the Chinese economy that will be opened to international competition. But no doubt: even partial liberalization and the engagement of the international big capital market players will change the rules of the game in China's policy-driven market fundamentally.

My **fifth** point deals with **learning processes** among China's market regulators. In the last two years, we find numerous hints for basic changes in the regulatory ideology and practice. The new leadership of the CSRC has openly distanced itself from the heritage of the planned economy and sees the regulatory systems in the US and in Hong Kong as the model for China. Several experienced securities regulators from Hong Kong have been recruited for leading positions in the CSRC. This is a heavy challenge to the Communist Party's cadre system since the newcomers have no Communist Party background. And the Hong Kong newcomers frankly say that regulating the securities market by means of short-lived „campaigns“ is not conducive to steady and stable market development. If the Hong Kong regulatory style gains ground in China's capital market, the present character of a policy-driven market would be reduced. But whether a “depoliticized” style of regulation can be introduced in the context of China's political economy is highly doubtful and goes far beyond the powers of the CSRC.

This leads to my concluding remark: the possible **political consequences of the expansion of securities markets** in China. Shareholders have a fundamental interest in state protection of their assets and property rights. Actually, in the context of stock market public opinion, demands for responsible, transparent and fair regulation cannot be overheard. Here I see the potential, that demands for the protection of “**economic rights**” will contribute to changes in **the way the government works**. China's present society is driven by an economic ideology and way of life, not by political ideas. In the context of China's stock market, immediate economic interests, not abstract political ideas, have become the starting point for demanding responsible government. Here the study of China's securities markets points to much bigger political and constitutional issues that touch the very heart of China's system of government. That is why studying the Chinese stock market is fascinating not only for economists but is also essential for political scientists.

Chart 1: Political and administrative supervision of the Chinese securities market



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Chart 3: “Insiders” in the Chinese Stock Market

