China's hybrid capital markets

China's capital markets have taken off since their emergence in the early 1990s. But they are losing steam because China's experimental system, a hybrid of market forces operating within a planned economy, is at odds with itself. If its capital markets are to thrive, China will need to complete its macroeconomic housecleaning, intervene less in its securities markets, and regulate more effectively.

China's fast-growing economy has sparked an almost insatiable demand for capital, driving Beijing to permit the rapid opening and building of its capital markets. Since they emerged in the early 1990s China's capital markets have grown dramatically, outstripping longer-established emerging markets. By June 1996 market capitalization in China, at $72.5 billion, was approaching the ranks of mid-size markets such as Chile ($72.7 billion), Indonesia ($79.2 billion), and the Philippines ($80.0 billion). For its size, however, China remains behind most major emerging economies, implying that its capital markets have much room for further growth (figure 1). New international equity issues by Chinese firms were close to $1 billion in the first half of 1996 alone, and new overseas bond issues amounted to $1.7 billion. Both figures exceeded the total for all of 1995.

Distortions in development

Despite rapid growth, China's capital markets are still struggling to perform their fundamental functions: increasing the efficiency of resource allocation, aiding the pricing of risks and returns, and providing a vehicle for risk management. Why? The development of China's capital markets is constrained by the framework of the aggregate credit plan (which assigns quotas for primary issues of debt and equity securities) and state investment plans. In addition, the economy still retains other basic pillars of a nonmarket regime: interest rate controls, a risk-free environment for state enterprises, and a banking system that lends largely on the basis of the credit plan and that is unaccustomed to managing interest rate risks, liquidity, or asset liability.

The Chinese government still views the country's capital markets essentially as a vehicle for resource mobilization. A large portion of bond issues is still distributed through quota allocations and are nontradable. The value added of well-functioning capital markets lies in their ability not only to act as a primary vehicle of resource mobilization but also to effectively channel—flexibly and at short notice—large volumes of market savings among alternative uses, thereby spurring economic modernization and industrial growth.

The domestic bond market

The Chinese bond market has grown considerably since 1994, when the government agreed to restrictions on financing its deficit through central bank borrowings and had to rely instead on recourse to the bond market. But the bond market is still in transition.
Figure 1. Market capitalization in selected developing countries, June 1996

<table>
<thead>
<tr>
<th>Country</th>
<th>Billions of U.S. dollars</th>
<th>Market cap/GDP (percent)</th>
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<tbody>
<tr>
<td>Saudi</td>
<td>200</td>
<td>120</td>
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<tr>
<td>Korea</td>
<td>150</td>
<td>100</td>
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<td>India</td>
<td>100</td>
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<td>Thailand</td>
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<tr>
<td>Mexico</td>
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<td>20</td>
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<td>Southeast Asia</td>
<td>20&lt;/br&gt; ASEAN</td>
<td>10</td>
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Source: IFC, Emerging Markets Database. GDP figures based on IMF data.

Bond issuance is viewed mainly as an alternative revenue mobilizing system and an extension of the budgetary process in that it offers additional financing options under the credit plan. Coupon rates are set on the basis of the administratively determined deposit rate and do not reflect secondary market yields. Since the default risk of state enterprises is considered to be relatively low, bond pricing does not adequately reflect risk differentials. In these circumstances the link between bond market activity and underlying real sector developments is constrained, and the bond market cannot act as an efficient allocation mechanism for capital or as a pricing mechanism for risk.

**Equity markets**

China’s equity markets evolved more rapidly than the government had anticipated, as enterprises sought new ways to raise capital. Government regulation of capital market activities therefore evolved after the fact. Officially, equity markets are regarded as a controlled experiment. The government has retained a high degree of control over the listing of new enterprises, which is done as part of the credit plan. It also closely monitors the authorization of new exchanges and the degree and direction of growth permitted to the fledgling market.

The primary aim of listing firms is to raise capital for investment. The portion of shares listed is typically small, since 75–80 percent of shares remain in state hands. The extent to which shareholders can influence corporate governance is correspondingly limited. Using the stock market as a mechanism for merger or takeover threats is rare, and the sale of government shares to private shareholders is still not permitted.

**Recommendations**

What should be done? Beijing must first decide whether it is prepared to release the constraints on its capital markets. Interest rates need to be freed to serve as a pricing mechanism. Credit and investment plans must play a smaller role in capital allocation. Banks need to be transformed into institutions whose lending is based on evaluations of risk and creditworthiness, rather than on credit plan quotas. And state enterprises must be forced to face the real risks and returns of the marketplace—through a binding budget constraint.

The sequencing of reforms is also important. Abandoning the credit plan before indirect instruments of monetary control are in place or decontrolling all interest rates at once could result in economic chaos. Several steps must be taken before interest rates are deregulated and the credit plan is cut back:

- The government must coordinate its monetary and fiscal policies more smoothly.
- Commercial bank lending must be insulated from government policies so that banks are exposed to market-based financial management. At the same time banks must begin acquiring the capacity to manage interest rate risk and to remedy the current mismatch between their assets and liabilities.
- Deregulation of interest rates could then begin with short-term and money market rates. The first step would be to establish a better-defined short-term benchmark interest rate and interest rate term structure.
- Recommendations for freeing up capital markets fall into five broad areas: the primary market, the secondary market, institutional investors, foreign investment, and the regulatory framework.

**Improve the primary market**

The first and most critical area for attention is the primary market for bonds and equities. First,
the government needs to allow securities to be issued if companies and their underwriters choose to take the risk of going to the market, and the issuer must be permitted to set the prices. The role of credit rating agencies in issue and pricing decisions should be expanded. Quotas in securities issues should be phased out.

Next, the government must assess its own short- and long-term financing requirements and its cash flows. Until 1996 virtually all debt was issued in the first few months of each year. For its term financing requirements the government should announce its issue calendar for the year, thereby improving its own liquidity management and that of wholesale buyers. This announcement will also further the development of benchmark yields. Government and institutional liquidity management would also be promoted by regular issues of short-term debt and by central bank issues of short-term paper, as required. If an auction process is difficult to adopt on a large scale, the coupon at issue should be related to current secondary market yields rather than to deposit rates.

Electronic registration and title transfer should be adopted as the standard for wholesale issues, and the issue period should be progressively shortened. The government could then gradually expand the recently introduced auction system, auctioning part of its bills and selling the rest noncompetitively at the auction or average bid price. A savings bond issue should be designed for retail investors, available on demand at any time of the year. This issue would spread retail sales over the year. The primary bond market needs a strong, wholesale investor base, which will permit shortening the offer period and facilitate the eventual adoption of an auction system. Efforts should be made to gauge wholesale investors' demands for bonds and preferences in maturities, and bonds should then be targeted to this group.

To improve primary equities markets, the decision to issue new equities should reside with the risk-bearing enterprise, subject to compliance with rules established by the exchanges and the central regulatory authority. When a new issue is launched, share allotment among potential buyers in cases of excess demand should be decided by the price auction system with which China has begun to experiment. The current "firm commitment" underwriting system should be gradually abandoned in favor of systems that permit risk sharing between enterprises and their underwriters, such as "best effort" or auction methods. The selection of underwriters should be left to issuing enterprises, and underwriters should be allowed to bid competitively for terms. The length of time from the initial offer to the opening of trade should be reduced, and the bunching of new issues should be avoided.

Reduce secondary market volatility
The second area for action is the trading of securities, or the operation of secondary markets. In the bond market the problem of poor liquidity requires greater standardization of bond instruments, targeting of issues toward wholesale investors, and more even spacing of issues throughout the year according to a preannounced schedule. Constraints on the operation of the money market also must be addressed. The government is establishing a centralized depository for all government bond issues, a response to the regional segmentation in bond markets.

The key problem in the secondary market for equities is high volatility. Many of the measures recommended to strengthen the primary market will also ease this problem. In addition, daily price limits should be reintroduced, a capital gains or turnover tax should be levied on share trading to reduce speculation, and better regulations on disclosure should be imposed. New guidelines for press responsibility, an emphasis on the payment of cash dividends, and regulations preventing front-running and market manipulation could also help. Most important, the government must be more alert to the effects of its announcements, which can send markets soaring or plunging.

As in bond markets, regional market segmentation is another limitation. Dual listings on recognized exchanges and the opening of new trading centers would encourage competition between the exchanges and increase liquidity in the medium term. The new central regulatory authority, China Securities Regulatory Commission (CSRC), will eventually be able to supervise regional exchanges, but it first must establish its own regional offices.

Encourage institutional investors
The development of an institutional investor base requires attention to both the uses and
sources of investment funds. To achieve greater flexibility in the uses of funds, the government should encourage the spread of contractual savings institutions (the new insurance law is a step forward) and spur competition in the insurance industry by separating the subsidiaries of the People's Insurance Company of China from the parent. To augment the sources of funds, the government should introduce a multipillared, (at least) partially funded social insurance and pension system, allow housing funds to offer more attractive returns, and clarify the regulatory framework for mutual funds.

Promote foreign investment
To facilitate the orderly flows of foreign investment in its securities markets, China must encourage foreign portfolio equity investment and reduce fiscal incentives favoring foreign direct investment. It should continue to broaden overseas listings and encourage dual listings (with Hong Kong, for example) to ensure adequate liquidity. The distinction between A and B shares (A shares are sold exclusively to domestic investors and B shares to overseas investors), which generates pricing distortions, should be replaced by less discriminatory safeguards against volatility in capital flows (figure 2). Restrictions against foreign participation in the domestic debt securities market should remain, however, until the domestic bond market is stronger.

Coordinate regulation
Supervision of capital markets must be better integrated. A first step is to transfer all central oversight responsibilities for securities brokers, dealers, and underwriters from the central bank to the CSRC. Right now the central bank supervises licensing and financial soundness and the CSRC supervises trading. The recent decision to give the CSRC regulatory jurisdiction over regional trading is a step in the right direction, away from the overlapping regulatory regimes of central and local authorities. The regulatory framework must deal clearly with all types of securities market participants—from securities dealers and intermediaries to institutional investors. The authorities should continue the process begun by the recently promulgated Commercial Banking Law to clearly separate bank and nonbank activities.

In sum, China’s capital markets are evolving rapidly. But old habits need to be shed and regulations overhauled if capital markets are to fuel the growth of China’s industries and infrastructure.

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Further reading


This DEConote was prepared by Anjali Kumar, Kwang Jun, and Leilynne Lau in the International Economics Department of the World Bank. DEConotes transmit key development trends to Bank Group managers and staff. They are drawn from the work of individual Bank researchers and do not necessarily represent the views of the World Bank and its member countries—and therefore should not be attributed to the World Bank or its affiliates. DEConotes are produced by the Research Advisory Staff. We welcome your questions and comments; please e-mail them to the authors or to Evelyn Alfaro, RAD.

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