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July 20, 1999

To: Members of the Executive Board

From: The Acting Secretary

Subject: **People's Republic of China—Selected Issues**

The corrected table of contents of SM/99/167, Supplement 1 (7/9/99) is reissued together with Boxes VII.I, VII.2, and VII.3, which were inadvertently omitted. For the convenience of Executive Directors, also attached are the last four pages of the paper, which are renumbered as pages 161–164.

New and corrected pages are attached.

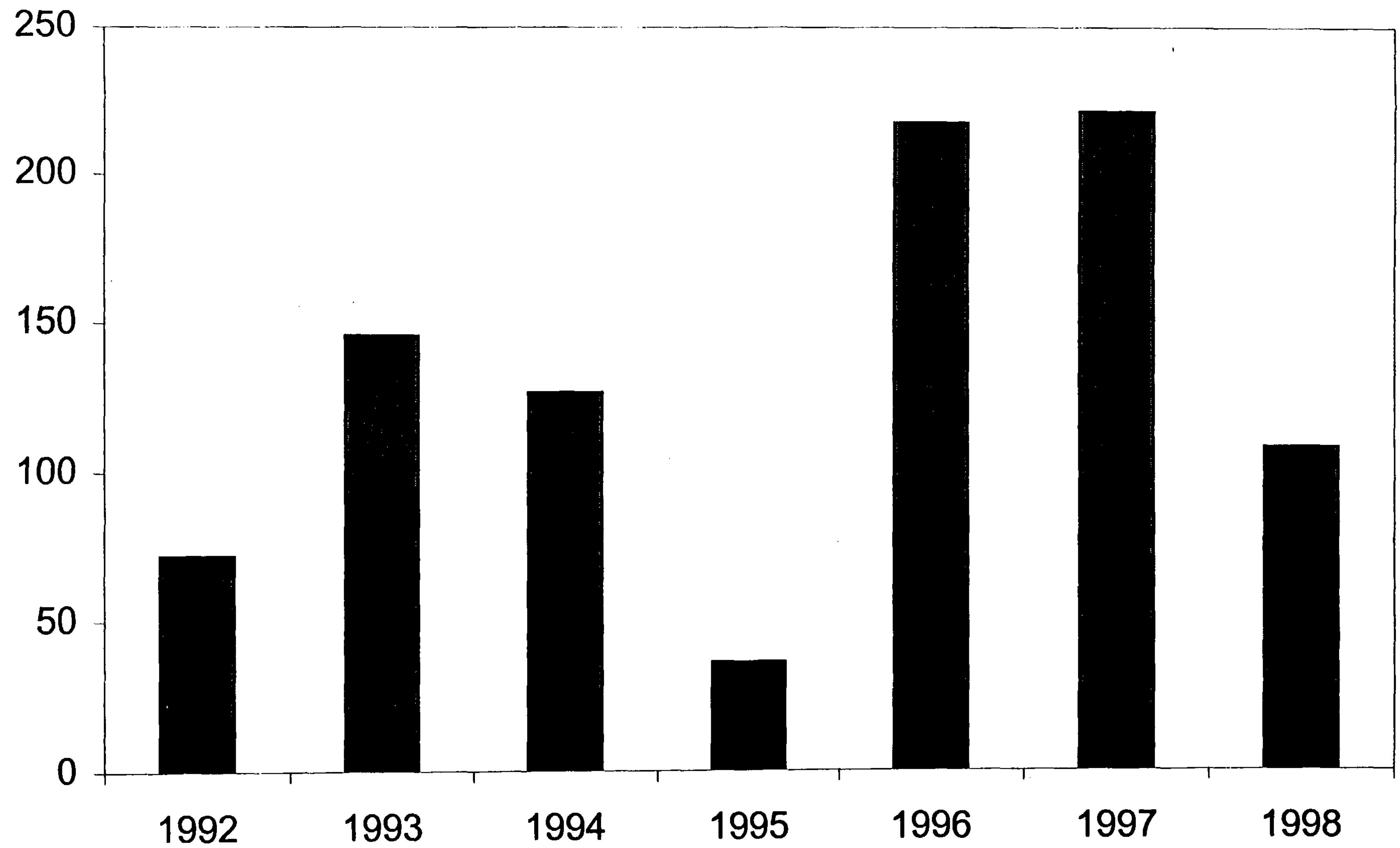
Att: (1)

Other Distribution:
Department Heads

Contents Page

Contents Page

China: Number of IPOs on the Domestic Stock Market, 1992-98



Source: China Securities Regulatory Commission.

Box VII.1. The Origins of China's Shareholding System

The emergence of the shareholding system

The initial impetus for shareholding reform originated in the rural sector. To alleviate capital shortages in the villages, the central government in 1979 allowed brigades to withdraw accumulation funds to form joint-stock enterprises. In 1983, capital and labor were both deemed "legitimate bases" for distributing returns in cooperative production units. This resulted in a rapid expansion of joint-stock township and village enterprises (TVEs), and in 1984 it became official policy to encourage farmers to invest in various kinds of enterprises. In the same year, the concept of "socialist joint-stock" ownership also emerged, and the country's first shareholding company, the Beijing Tianqiao Department Store Company, was established. The following year, the Fushan First Radio Factory in Guangzhou became the first industrial shareholding enterprise in China. This was followed by the selection of a small number of SOEs in Beijing, Shanghai, and Guangzhou as experimental units of the shareholding system.

In December 1986, the reformist leader Zhao Ziyang ordered the expansion of the shareholding system experiment. He explained to delegates at the 13th Party Congress the following October that since China was still at an "initial stage of socialism", other forms of ownership should supplement the dominant public sector. Specifically, the shareholding system was recognized as "a form of organizing assets of socialist enterprises", and hence the experiment "could continue". Further, official support was given in the 1988 Report of the 3rd Plenum of the 13th Central Committee, which defended the shareholding system as not being privatization but rather a means to rationalize property rights relations.

The favorable political environment led to an expansion of the scale of the shareholding system experiment. In March 1988, there were some 6,000 enterprises with shareholding characteristics. They fell under four major categories of enterprises issuing shares to employees, other legal persons (i.e., enterprises or institutions), the public, or enterprises owned by workers on the basis of the capital they had contributed. Shareholding enterprises came under the first three categories. In 1988, there were about 3,800 such enterprises. Enterprises in the first two categories were known as private placement enterprises, as the shares were privately issued to specific employees and/or legal persons. The third category were known as public placement enterprises, while those in the fourth category were a mixture of shareholding enterprises and cooperatives, and as such were called cooperative shareholding cooperative enterprises, distinct from shareholding enterprises.

The early attempts at developing a shareholding system, which was a spontaneous process, took place in the absence of a legal framework. The experiment was attempted mainly by small-sized collective enterprises. Shares were issued primarily to raise capital rather than to establish a new form of corporate governance. Most of the shares received guaranteed interest plus dividends. They could be redeemed when mature, and investors bore little risk. As such, the shares were more like bonds in nature, and only a small handful were traded over-the-counter in Shanghai, Shenyang, Wuhan, and Chongqing.

Later setbacks

The recognition in 1987-88 of the shareholding system as an official reform experiment was misinterpreted by some as a signal for national promotion. Capital shortages also caused many enterprises to switch to the shareholding system as a means to raise funds. As a result, shareholding expanded rapidly in early 1989. However, the contract responsibility system was still the mainstream reform scheme at the time, and the State Council issued a Notice reminding enterprises that shareholding system reform should focus on consolidating existing shareholding enterprises rather than establishing new experimental units. The Notice added that the reform was intended to improve overall enterprise efficiency, rather than just to raise funds and distribute returns; that the leading role of state ownership should be retained; and that the value of state assets should be protected.

Political changes in 1989 caused a further setback to the spread of shareholding in China. According to the limited statistics available (there are no official statistics kept), by the end of 1989 there were some 3,800 shareholding units in the country, which was about the same as the previous year. It was the intention of the current conservative leadership to restrict the shareholding system reform to inter-enterprise investment (i.e., the second category noted above), as this involved no sale of state assets to private individuals. In 1990, the State Council issued a document allowing further experimentation with the second shareholding category, but freezing enterprises in the first and third categories. The idea of shareholding reform still appeared in the Party's proposal for the 8th Five Year Plan, but the theme was restricted to the second category option.

New momentum

The momentum for enlarging the target of share issues from legal persons and employees to the general public nevertheless proved to be unstoppable. Accordingly, the Shanghai stock exchange was opened in December 1990 and the Shenzhen exchange in mid-1991, which provided official markets for the trading of shares. The impetus for revamping the shareholder system along these lines gained additional momentum after Deng Xiaoping called for further reform during his high profile Southern Tour in January 1992, and the basic precept of share issuance has not been seriously challenged ever since.

Box VII.2. State Ownership in China's Listed Companies

Through mid–1993, the state maintained strict controls to preserve its majority ownership status in listed companies, mandating that its stake—represented by "state" shares—must exceed 51 percent of all shares issued. However, in a circular issued in August 1993 by the National Administration of State Property (NASP), a distinction was made between "absolute state-holding enterprises" and "relative state-holding enterprises". In the circular, the NASP mandated that the state's share in an absolute state-holding enterprise must exceed 51 percent, while that in a relative state-holding enterprise could range between 35 percent and 51 percent. The distinction between these two classes of enterprises disappeared entirely in the 1994 Company Law, which simply mandated that the state maintain a minimum share of 35 percent.

Thus, in theory at least, the state was no longer required to hold more than 35 percent ownership of any listed company. It can be argued, however, that if legal person shares—which are owned by SOEs and other state institutions—are taken into account, the state would still hold a controlling stake in virtually all listed companies. In 1993–94, such shares accounted for about 45 percent of the total market capitalization, and according to official statistics there has been only a gradual increase—from about one-quarter in the early 1990s to about one-third presently—in the relative proportion of individual shares in the total A–market capitalization of listed companies on the Shenzhen and Shanghai exchanges.

But given the devolution of managerial responsibilities in SOEs and the lack of cohesion among the various legal person shareholders, it would seem that there has nevertheless been a meaningful reduction in the state's control over listed companies. In addition, the degree of non-negotiability of state and legal person shares, an additional safeguard against a dilution of state ownership, has also been reduced. Since mid–1993, there have been increasing reports of state shares being converted into legal person shares, and a widespread black market has developed in the latter that has been tolerated if not officially sanctioned by the regulatory authorities.

More recently, there are signs that the transfer of legal person shares is being encouraged in certain cases. For example, in December 1998, four private companies were permitted to purchase legal-person shares and assume majority control of loss-making state enterprises. In each case the purchasing firms pledged not to sell or transfer their stakes for at least three years, which was reported to be the key factor in obtaining regulatory approval for the sales. Overall, these developments have facilitated at least some reduction in state ownership and control of listed enterprises.

Box VII.3. The Puzzling Behavior of Chinese Share Prices

John Fernald and John H. Rogers in a recent paper ("Puzzles in the Chinese Stock Market", US Federal Reserve *International Finance Discussion Paper* No. 619, August 1998) reported the results of an empirical investigation into the behavior of Chinese share prices. They found that the "law of one price" failed dramatically in China's highly segmented stock market, with domestic investors paying roughly four times more than foreign investors for virtually identical shares issued by the same company.

In the absence of arbitrage, plausible differences—4 percentage points as of early 1998, and even lower before the Asian crisis—were found in expected returns by foreign and domestic investors to explain the generally much higher level and volatility of domestic share prices. The apparent low expected returns by Chinese investors was attributed primarily to the lack of alternative investments, given the underdeveloped domestic financial markets and the presence of capital controls that make it very difficult for domestic residents to invest overseas. The main alternative is bank deposits, which historically have paid interest rates below world levels. The authors also conjectured that Chinese investors might have a low equity premium, because stocks offer one of the few opportunities available to residents to diversify their investments.

In addition, a panel of 57 Chinese companies that had issued both domestic and foreign shares was examined, and several variables associated with cross-company differences in the relative price paid by foreigners and in price-earnings (P/E) ratios were identified. Foreigners paid lower prices relative to domestic residents for small firms and for those with a higher state ownership share. But these lower prices did not reflect lower levels of foreign prices. Indeed, both foreign and Chinese residents tended to pay higher prices—as measured by P/E ratios—for small, export-oriented, high-dividend paying firms with larger state ownership. These results are consistent with small firms and those with high state ownership having high expected growth rates. Since Chinese investors discounted future earnings at a lower (expected) rate, they were thought to have valued future dividends proportionately more highly than foreign investors.

However, several anomalies remained. Most notably, no explanation was found for why Chinese investors in Shanghai paid less in 1994 and 1995 for companies that had also listed foreign shares in Hong Kong SAR. They also failed to explain the broader issue of the failure of arbitrage, given such large price differentials. As already noted, despite legal barriers, domestic investors can fairly easily purchase foreign shares (both in Hong Kong SAR and in the domestic B–share market). Arbitrage has failed in markets in other parts of the world because of the risk that such mispricing might persist, causing arbitragers to lose money in the short run. But in the Chinese case, domestic residents investing in foreign person shares would, at a minimum, earn much higher dividends, providing them some compensation for the risk that foreign shares would under perform in the short run. However, though legal barriers have been porous, the authors concluded that the risk that market regulators might crackdown in the future—indeed, the intensification of foreign exchange controls in mid–1998 is often cited as a contributing factor to the downturn in the B–share market—was enough to offset the sizeable differences in expected returns.

The Legal Basis of Domestic Share Issuance

1. Public shares are governed by the Company Law and the Provisional Regulations on Stock Issuance and Exchange. The Company Law defines two types of companies: those "limited by shares" and "limited liability companies". The fundamental difference between the two is that the Law imposes higher capital requirements on companies limited by shares and in addition allows them to trade shares publicly. Not all such companies are automatically qualified to issue public shares, and must meet other eligibility criteria prescribed in the Company Law.

2. Under the Company Law, a company limited by shares can issue shares using one of two methods: the promoter's subscription method, in which the promoters purchase all the shares the company is to issue; and the public flotation method, in which only a portion of the total share issue is purchased by the promoters, and the remainder is made available to the public for subscription. Public shares can therefore only be made available by this latter method, and by companies meeting all the conditions (e.g., in regard to profitability, minimum capital, etc.) set out in the relevant legislation. They can only be traded among members of the public, and the trading market of public shares is segregated from the trading market for other types of shares. Moreover, individual members of the public can be penalized for holding more than 0.5 percent of the total number of shares outstanding of the common stock of a company limited by shares, as the law provides the issuer the legal right—subject to the CSRC's approval on a case-by-case basis—to purchase the excess shares from individuals at either the initial purchase price or the current secondary market price, whichever is lower.

3. Employee shares were initially governed by the Regulations on Employee Shares Issued by a Company Limited by Shares Adopting a Targeted Flotation Method. Employee (as well as legal person) shares are issued through what is called the targeted flotation method, aimed at distributing shares to the issuer's employees only, and not to members of the public at large. The employee pool is defined to include both current and retired employees. Such employee-shareholders were not issued share certificates, but rather their share ownership was recorded in their company's share rights book, which they had no legal right of access to.[1] Employee shares were also not publicly traded, but could be assigned to other employees within the same company after three years. Even upon death or departure from the company, the employee-shareholder (or his estate) had to assign his shares to fellow employees or back to the company, at a uniform price fixed as a fraction of the company's net capital. Following the promulgation of the Urgent Circular on Putting an End to the Non-Standard Distribution of Employee Shares in March 1993, employee shares could be traded

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[1]Under these Regulations, employees in fact had no legal right to know the number of shares they held or the value of their portfolio. Such information could only be obtained from the securities institution designated as the mandatory depository for their employer's shares upon death or departure from the company.

freely like public shares after they had been held for six months. Employee shares issued before this date continued to be subject to the original trading and other restrictions noted above.

4. Domestically-issued foreign person shares are governed by the State Council's Regulations on Foreign Person Shares Issued by Companies Limited by Shares and Listed Domestically and subsequent Implementation Rules. According to these regulations, such shares are issued by a company limited by shares, using public flotation to "foreign persons", who comprise:

- foreign natural and legal persons and other foreign entities;
- Chinese natural and legal persons and other Chinese entities who reside in Hong Kong SAR, Macau, or Taiwan Province of China;
- Chinese citizens who are lawful residents of foreign countries; and
- any other investor designated by the State Council Securities Office (SCSC).

5. Any company limited by shares may issue both Chinese public shares and domestically-listed foreign person shares. While the Company Law provides for the "same rights and same obligations for domestically-listed foreign person shares as for Chinese domestic shares belonging to the same stock", other regulations and statutes allow for differential treatment. For example, under the Company Law, at least 12 months must elapse between issues of Chinese public shares by the same issuer, whereas under the Regulations on Domestically-Listed Foreign Person Shares, there is no such waiting period between share issues. In addition, domestic shares issued to promoters may not be transferred for three years from the time of corporatization, whereas the relevant regulations for foreign person shares contain no such restrictions. In addition, whereas a Chinese individual holding more than 0.5 percent of a total public share issue is subject to penalty, there are no such sanctions on foreign persons.

6. That said, the minimum capital requirements for a company to float foreign person shares, at Y 150 million, is considerably higher than that for domestic public shares (Y 10 million). In addition, there are no specific rules governing disputes among holders of foreign person shares, whereas disputes among all other categories of market participants are covered by specific legislation. Finally, to ensure, as the Chinese saying goes, that "the well water does not invade the river", trading of Chinese public shares is strictly confined to Chinese citizens residing on the mainland, while trading of domestically-listed foreign person shares is strictly limited to "foreign persons" as defined above.[2]

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[2]Domestic resident are nevertheless reported to own a substantial amount of B–shares. Market analysts estimate this could be as high as 40 percent of shares issued, and that domestic residents could account for as much as 60–80 of current daily market turnover. The intensification of foreign exchange controls in mid–1998 is often cited as a contributing factor to the decline in the B–share market. In addition, there are reports of illegal foreign investment, albeit in much smaller proportions, in the A–share market.

The Main Features of the STAQ and Net Systems

1. **STAQ system.** The STAQ system was launched in July 1992 to provide the legal person enterprises that had been converted into stock corporations with a market to trade state-owned legal person shares on a trial basis, as well as treasury bonds. The STAQ system is operated as a membership organization, with class A and class B members; the former have direct trading access rights, while the latter can access the system only through the former. In contrast to the Shanghai and Shenzhen exchanges, the STAQ system operates in a dealer market environment with compulsory participation of a market maker in every trade. However, there is no concept of "market orders" on the STAQ system: all orders must either be "priced orders" or "limit orders".

2. **NET system.** The NET system was developed, and is operated and managed by the China Securities Trading System (CSTS) Co. Ltd. The CSTS, in turn, is jointly owned by the PBC, the Industrial and Commercial Bank of China, the China Construction Bank, the Bank of Communications, the People's Insurance Company of China, and three large national securities companies owned by the various state commercial banks. The PBC, while being a stockholder, also controls the board of directors and senior management of the CSTS, and is the market regulator.

3. The NET system went into operation in 1993 to trade state-owned legal person shares and treasury bonds using the PBC's existing VSAT satellite network. Unlike the STAQ system, the NET system operates in an auction market environment without a specialist or market-maker system. Further, in contrast with the Shanghai and Shenzhen exchanges, which provide a continuous auction market using three trading mechanisms for retail trades and one mechanism for block trade, the NET system provides a call auction market through an automated execution system. As on the STAQ system, transfers of legal person shares are only allowed between legal person entities, and all orders must either be priced or limit orders.

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