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## The Chinese Stock Market Picks Up Thanks to Reform

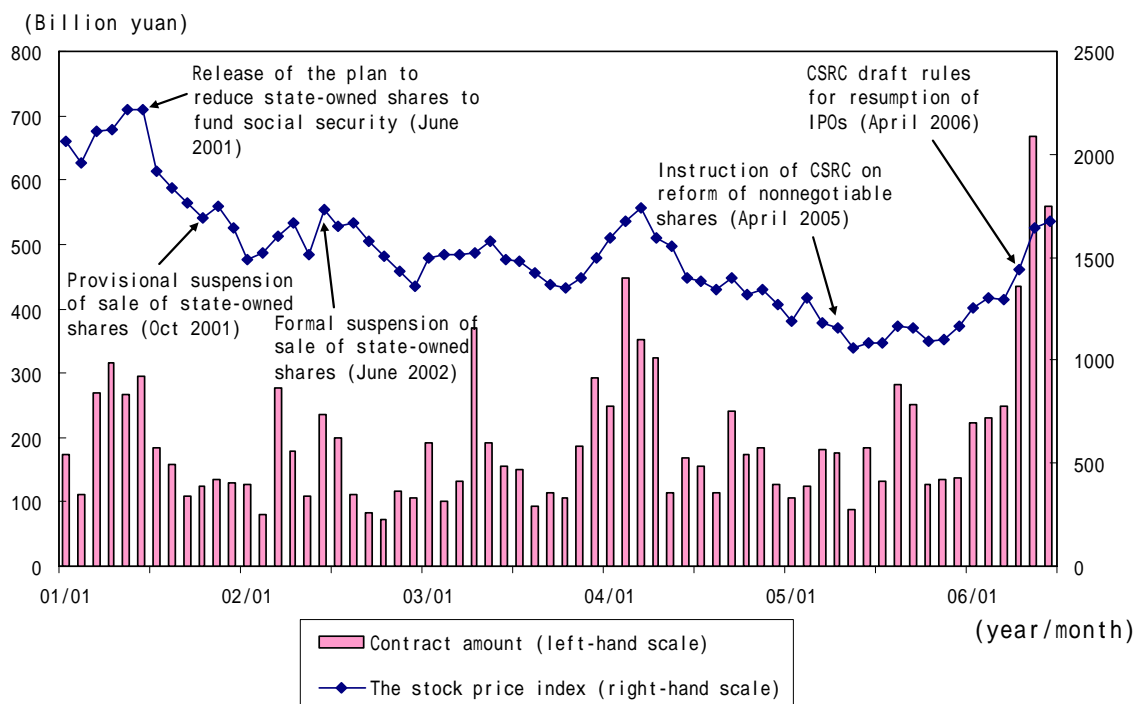
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The Chinese stock market is moving in a sound direction thanks to progress in reform on nonnegotiable shares. The reform has encouraged companies to list group companies as a whole, and stimulated the resumption of mergers and acquisitions (M&As) through the stock market. However, for the market to function properly, market principles must be thoroughly enforced, including the shakeout of inefficient businesses.

### Progress on Nonnegotiable Share Reform Brings Back IPOs

Nonnegotiable shares are a product of China's unique system, under which the state or state-owned enterprises put their share holding out of trading in the market, so that the central government's control on state-enterprises will be maintained. As of the end of 2004, nonnegotiable shares accounted for 64 percent of all issued shares.

**Chart: Trends of the Shanghai Stock Price Index**



Source: Compiled from the Web site of the Shanghai Stock Exchange.

Since nonnegotiable shares are not priced, the central government tends to grow indifferent to the financial conditions of enterprises, in which it has control. At times, the government has led state-owned enterprises to make unnecessary capital increases to siphon off funds thus raised, which has had deleterious effects on corporate governance. In June 2001, the government announced its plan to sell shares it held (nonnegotiable shares) to fund social security. However, the subsequent sharp fall in share prices caused by the fear of deterioration in the demand-and-supply balance of shares forced the government to give up its plan (Chart)

Having learned from this experience, the government, in April 2005, announced a new reform policy, which takes into consideration the rights of holders of traded shares, who bear the risk of decline in share prices when nonnegotiable shares are put on the market. As an experiment, the government selected four companies to implement the new policy, which introduced the concept of “compensation” to be paid by holders of nonnegotiable shares to holders of traded shares for the former to acquire the “rights to trade.” The specifics of how such compensation is to be paid are to be determined by the enterprises in question at an extraordinary shareholders’ meeting, and are subject to approval by at least two-thirds of all shareholders and at least two-thirds of holders of traded shares. At the same time, the government decided that nonnegotiable shares are not to be traded during the 12 months after the implementation of the reform. Even after the 12-month period, shareholders who hold 5 percent or more of shares in an enterprise are limited in terms of the number of shares they may sell at one time, since their share sales must be made in several phases. They are also subject to other conditions.

As a result of these measures, by July 2006, more than 1,000 listed firms, or 80 percent of all listed companies in terms of the number of companies and market capitalization, had adopted resolutions for the reform of nonnegotiable shares. However, the new measures apply only to A shares (which are yuan-denominated) listed in mainland China. B shares, which are foreign currency-denominated shares also listed in mainland China, and H shares (which are Hong Kong dollar-denominated shares listed in Hong Kong) are not subject to “compensation.” As a result, foreign investors are complaining since the new measures fail to address the problem of equal shareholder rights.

The reform of nonnegotiable shares has normalized corporate fund raising through the stock market. Initial public offering (IPO), which had been suspended in order to give priority to the reform, was resumed in June 2006 at the stock exchanges in Shanghai and Shenzhen. In April 2006, the China Securities Regulatory Commission (CSRC) had announced rules for IPOs and capital increases. With regard to capital increases, the CSRC stipulated that the issuing prices of shares in a capital increase may not fall below the market

prices immediately before the new issue, and it also set standards for the distribution of profits to shareholders, thereby demonstrating its stance on investor protection.

While economic development in China is fueled by private enterprises, these enterprises have a strong demand for funds. The resumption of IPOs has expanded the scope of fund-raising tools for these enterprises, and this is expected to reduce the pressure (of fund provision) on state-owned commercial banks, which are saddled with enormous non-performing loans.

### *Corporate Governance and Disclosure Sought*

A more important change is that, as it has become possible to sell the shares of state-owned enterprises in the market, major corporations, including Anshan Iron and Steel (Group) Company and TCL, have been taking steps to list their corporate groups as a whole. In China, it was common practice to list only well-performing divisions of an enterprise, raise funds through a capital increase and siphon the funds to poorly performing divisions. However, since shares held by the government (which is a large shareholder) can now be sold, an increasing number of enterprises are actively disclosing financial information on the entire corporate group to investors and are trying to improve management of the group as a whole. If such steps are adopted by more companies, non-transparent fund raising and inside trading will decline, generating more trust on the part of investors.

With the increased liquidity of shares, there are signs of M&As through the stock market. Baoshan Iron and Steel (Group) Corporation, the largest steel maker in China, has been buying up shares of Handan Steel, a middle-ranking firm, and the parent of the latter has begun defensive purchases. When M&As pick up, efficient allocation of resources will be realized through the stock market.

For the Chinese stock market to function properly, however, there remain many tasks to be tackled, including improvement of the “quality” of listed companies. In China, up to 2000, local governments de facto chose the companies to be listed in accordance with the quota set by the central government. As a result, local governments chose the companies which were important to them in terms of employment and tax revenues, even if the financial conditions of such firms were poor. When these companies made losses, local governments gave them financial support in order to maintain their listing. In 2000, the regional allocation system was replaced by a system, under which quotas for the number of underwritings were allocated to securities companies. In 2004, this quota system was replaced by yet another system, under which securities companies, which recommend companies to be newly listed, are held responsible for information disclosure, etc. However, the number of enterprises which have listed since 2000 is relatively small at approximately 30 percent of all listed companies.

The reform of nonnegotiable shares is expected to heighten awareness of share prices among big shareholders and improve corporate governance. However, for this to take place, it is essential that poorly performing companies be shaken out of the market and information disclosure improved.

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