

# LEHMANBROWN

雷博國際會計

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May 2007 - Issues 1

China is stock market crazy. Seemingly every new IPO is greeted by investors with such enthusiasm that first-day-of-trading-fortunes have become standard fare in Shanghai and Shenzhen. More generally, the Shanghai composite index rose 130% last year, is up 50% per cent thus far in 2007 and has registered a market value of more than 50 times earnings. With an average of 1 million trading accounts being established every week, this kind of exuberance has well warranted the stern talk and foreboding warnings and from senior state officials, most recently from Zhou Xiaochuan, governor of the People's Bank of China, on understanding asset bubbles and the inherent risks of equity trading. All this excitement, however, gives us pause to again consider the nature and lineage of China's stock market today. What is the nature of the Chinese market? How did it come to be? How is it peculiar? And what fuels it today?

While liberalizing reforms in China have remarkably transformed its formerly centrally planned socialist economy into a vibrant, semi-market oriented engine of growth and possibility, the vast majority of China's domestic enterprises remain state-owned and socialist remnants and inclinations still loom and frustrate progress. China has taken a fancy to calling its special brand of economy, a "socialist market economy" and without discussing the meaning or merits of such a title, suffice it to say that most of the rest of the world—probably reasonably—still officially considers China a non-market economy. Yet this strange amalgam of socialism and capitalism has produced in nearly 20 years one of the most significant and robust stock markets in the world. Just this past week, the daily turnover on the two mainland exchanges exceeded the rest of all the Asian markets (including Japan) combined. Traditional understanding, however, dictates that a stock exchange can be regarded as the incarnation of capitalism and a state-ownership structure is similarly the hallmark of socialism. In China the two seem completely unopposed, if not in harmony.

Sonia M.L. Wong has traced the emergence of China's stock market "to a fall in the central government's revenue in the early 1980s, which necessitated finding new sources of capital to fund [state-owned enterprises]'s capital expenditures." In 1983 the PRC government began to phase out the financing of state-owned enterprises (SOEs) via budgetary allocations and began to have fellow SOE banks shoulder the burden through loans. Municipal governments in the mid-1980s began then to seek additional sources of funding for their local SOEs and began to issue shares of a few collectively owned enterprises to domestic individuals. It is here that we first see the emergence of private



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增值税

"Zeng Zhi Shui"

(Value Added Tax)

ownership and its attendant “challenge to both state ownership and monopolistic control over financial intermediation” by providing an alternative to perennially unattractive SOE bank deposit rates. In 1990 the State Council regulated that share issuance would be limited only to SOEs and collectively owned enterprises were forbidden to issue shares, in this way retaining exclusive control over invested funds. While at first share quantities were squeezed tightly both in an effort to limit the scope of their experiment and to ease the competitive element with respect to SOE banks, by the late 1990s most all restrictive regulations were relaxed and the IPO quota system was abolished in 2001.

The maturation of the Chinese stock market is story of a well crafted scheme to equity finance mostly fundamentally flawed remnant SOEs whose constituent social burdens demand enterprise perpetuation. In a economic regime entirely void capital markets, where the population is left to either sit on their cash as inflation devalues it or deposit in banks at rates outstripped by inflation, financial options and alternatives are, to say the least, in demand. And indeed, as China’ s population has gradually reaped the benefits of her remarkable economic progress, the stock market has surged. What, however, is the nature of this growth?

A good deal of the reasoning behind listing SOEs is an unveiled hope that at the will of market forces, an ailing remnant enterprise will somehow adapt, remodel and qualify itself as a legitimate, profitable business, worthy of perpetuation and investment. This line of logic, however, entirely fails to account for the continued nature of government ownership. Issuing shares of a SOE in no way serves to disperse proprietary interest or negate ownership responsibilities, if anything, share issuance provides new variable elements that further confuse and pressurize social stability exigencies, with respect to “investor” and “invested” interests. Considerations of this kind compel the government to bail out and prop up their foundering SOEs through subsidies, preferential tax treatment or asset injections. In addition, the government will continue to employ SOEs to serve a political function as well “such as providing excessive employment, extending aid to other SOEs, achieving a regional development strategy, and so forth.”

Indeed, China’ s listed enterprises have not experienced much solid financial performance. From 1992 to 2003 the percentage of listed companies with negative operating profits rose from 5.77% to over 20% and “the total amount of operating profits achieved by the listed enterprises have continued to decline since 1998” despite this period seeing an average of 8% annual GDP growth. On the stock market, however, this was a period of tremendous growth. Though there are no especially reliable metrics by which to value an SOE, the Chinese stock market has seemingly altogether detached itself from value-informed investment and instead embraced the market as a speculative venue in which rumors of government asset injections and friendly related-party transactions constitute a frightfully large role in informing market movement.

Regardless, this kind of casino has been an unmitigated success in fulfilling its original aim of raising capital via equity financing. The financial regime from which this market emerged, namely characterized by a government monopoly on financial intermediation though strict repression of financial markets, had so well primed the stock market for a prevalence of interest, if today we see symptoms of a bubble in stark relief, they have been slowly frothing for years. This resulting, slightly diversified, regime of today has therefore been erected on the morally tenuous grounds of self-financing by providing a

## 营业税

"Ying Ye Shui"

*(Business Tax)*

lone financial alternative (void of value and replete in risk) to a population increasingly starved of economic liberty.

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There is speculation from both inside and outside China that further liberalizing the Qualified Domestic Institutional Investor (QDII) quota system that allows wealthy Chinese to invest in foreign markets will simultaneously serve to offset capital inflows, cool domestic equity markets and alleviate pressure on Beijing to appreciate the Yuan. While the reform initiative deserves praise for its further endorsement and augmentation, however modest, of financial liberty in China, its ultimate impact is likely to be minimal.

The Chinese economic regime is designed to amass and monopolize domestic funds, the accrual of which is certainly the source of many of China's most contentious bi- and multilateral trade frictions. China has been and today remains perhaps the hottest emerging market in the world and PRC coffers are indeed brimming (they constitute the richest reserves of foreign exchange in the world). That the financial regime nearly completely restricts an outbound flow of capital precludes two salutary developments that the QDII program serves to moderately facilitate. First, an opportunity for Chinese funds to enter and support foreign markets working thereby to even financial-account imbalances and second, a similar opportunity to dissipate appreciation pressure on the Yuan by allowing it to be exchanged onshore and in greater quantities for currencies of another kind.

While the QDII program has enabled some Chinese investors to send capital abroad (usually to Hong Kong) and in this way begin both to ameliorate financial-account imparities and increase the convertibility of the Yuan, the program's existence seems much more aimed at appeasing the most privileged classes than at rectifying considerations of international trade or financial liberty. Regardless, the program remains tightly controlled and is estimated to account for (including the latest round of reform) a mere \$7bn-\$9bn of outbound investment. The move has also been rightly understood as an effort to deflect funds away from China's vastly overheated equity markets that observers are today nearly unanimous in labeling a bubble.

Chinese investors, however, seem not yet to have lost an appetite to throw the dice in Shanghai or Shenzhen and when coupled with an undervalued, gradually appreciating domestic currency, incentives to ship off RMB are not overwhelming. The scope of QDII liberalization is not great and changes affected will be similarly limited—the most significant amendment allows for greater (though rule laden) access to equity markets. The dollar amount of projected outflow is not significant enough to considerably offset China's massive flow of inbound capital and should have little ultimate impact on her financial-account surpluses or glut of foreign reserves. The stock market, in desperate need of cooling, remains a financial alternative readily available and entirely more accessible to Chinese households than offering up the minimum 300,000RMB to qualify for QDII.

Today, the RMB is far from a convertible currency. Incremental reforms to allow Chinese investors the freedom to roam the globe unencumbered in pursuit of economic opportunity is not only good policy, but should also serve to alleviate appreciation pressure on the Yuan. Though enabling a sizable pool of RMB's convertibility will somewhat serve to balance the currency's massive demand and perhaps even employ some previously untapped foreign exchange reserves, the numbers all remain too small to cause waves. For China's part, however, should these be the initial efforts of fuller, more genuine reform, an approach of gradual and controlled experimentation is probably sensible and stability in this regard should breed greater confidence and further, more substantive change.

### *"Providing an alternative in China"*

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