Chapter 5 Going Public: Privatization of Large State-Owned Enterprises via Stock Market

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Going Public: Privatization of Large State-owned Enterprises via Stock Market

Introduction

Privatization of state-owned and collective enterprises in China, which began with small and medium enterprises, has spread to relatively large enterprises since the latter half of the 1990s. Outright privatization of large state-owned enterprises, however, has been an exception rather than the norm. Privatization of large enterprises is rather apt to follow the two-stage formula: (1) reorganization of an enterprise into a joint stock company and its listing on a stock exchange; and then (2) gradual reduction of the state's equity share in that company. As a result of corporate reform since the latter half of the 1990s, quite a few large state-owned enterprises have already cleared the first stage of becoming joint stock companies and getting listed on the stock exchanges. The second stage of the reduction of the state's equity share in these enterprises finally got around to the implementation phase in 2001 as an officially sanctioned policy. But this stage has encountered a variety of constraints, including stock price declines and the lack of competent entities capable of corporate governance, making it likely that it will be considerable time before the second stage makes significant headway.

This chapter focuses on privatization through stock markets as a way toward privatization of large enterprises as the final stage of privatization of state-owned enterprises.

5.1 From Exchange Listing to Sale of State-owned Equity Shares

5.1.1 Stock Markets as Venues for Corporate Reform

As reviewed in Chapter 2, privatization of small and medium enterprises has been carried out through the conversion to employee-owned enterprises or the buyout by a small number of parties, such as managers of enterprises being privatized and outside enterprises. As the procurement of funds necessary for acquisitions become more readily available through bank loans or informal financings, enterprises with relatively large size are now being privatized through similar methods.

However, as the size of enterprises grows larger, it becomes more difficult to privatize them by turning them employee-owned or through the buyout by a small number of parties such as enterprise managers and outside enterprises. Thus, the stock markets, which realize the ownership of capital by a large number of investors by breaking up an enterprise's stock into negotiable shares, is expected to play the most important role in privatization of large enterprises holding massive assets.

Listings of Stocks of State-Owned Enterprises

China's stock markets entered the stage of full-blown development in the latter half of the 1990s (see Table 1). When the stock price indices reached their apexes in May 2001, the total market capitalization exceeded 5 trillion RMB (approximately US $600 billion),temporarily overtaking the Hong Kong stock market as the second largest market in Asia after the Tokyo Stock Exchange.

Shares are divided into negotiable shares and nonnegotiable shares. Negotiable shares, which are allowed to be freely traded on the stock exchanges, are again divided into three types: RMB-quoted A-shares, B-shares denominated in foreign currencies, and H-shares listed on overseas stock exchanges. On the other hand, state shares held by the government (*guojia gu*) and legal per-

Table 1 Composition of Stocks Issued by Companies Listed on Shanghai and Shenzhen Stock Markets

(%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Listed companies	51	180	290	322	529	744	851	949	1,088	1,160
Total capitalization (100 milion RMB)	n.a.	3,531	3,691	3,474	9,842	17,529	19,506	26,471	48,091	43,522
Negotiable share	31.9	28.8	32.9	41.3	35.2	34.6	34.0	35.2	36.6	36.6
A-share	15.4	16.8	20.9	21.0	21.9	23.0	24.1	26.9	29.0	25.7
B-share	16.5	6.4	6.1	6.7	6.4	6.4	5.4	4.3	4.2	3.1
H-share	0.0	5.7	6.0	7.7	6.9	5.2	4.5	3.9	3.5	6.4
Nonnegotiable share	68.1	71.2	67.1	64.6	64.8	65.4	66.0	64.8	63.3	65.3
State share	44.6	48.1	42.7	38.9	37.7	35.4	34.3	31.6	37.1	46.2
Legal persons' share	22.1	21.3	23.1	24.5	24.9	26.7	28.2	29.6	24.9	18.3
Others	1.5	1.7	1.3	1.2	2.2	3.3	3.4	3.6	1.3	0.8
Grand Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Souce : *Zhongguo Shangshi Gongsi Jiben Fenxi 2000* and China Securities Regulatory Committee Website.

son shares held by enterprises (*faren gu*) are not allowed to be distributed freely. The majority of legal person shares are assumed to be state-owned legal person shares held by state-owned enterprises. State shares and state-owned legal person shares are collectively called state-owned shares (*guoyou gu*).

The original purpose of banning the circulation of state shares and legal person shares was to maintain the ratio of state-owned shares in listed enterprises. The ratio of state shares declined from the early part of the 1990s toward the late 1990s, but the ratio of legal person shares actually increased, limiting the decline in the ratio of nonnegotiable shares small. Of the legal person shares, the ratio of state-owned legal person shares is not precisely known but roughly estimated at about 60%. It is likely that the combined ratio of state shares and state-owned legal person shares has only shown a minimal drop despite the rapid development of the stock markets.

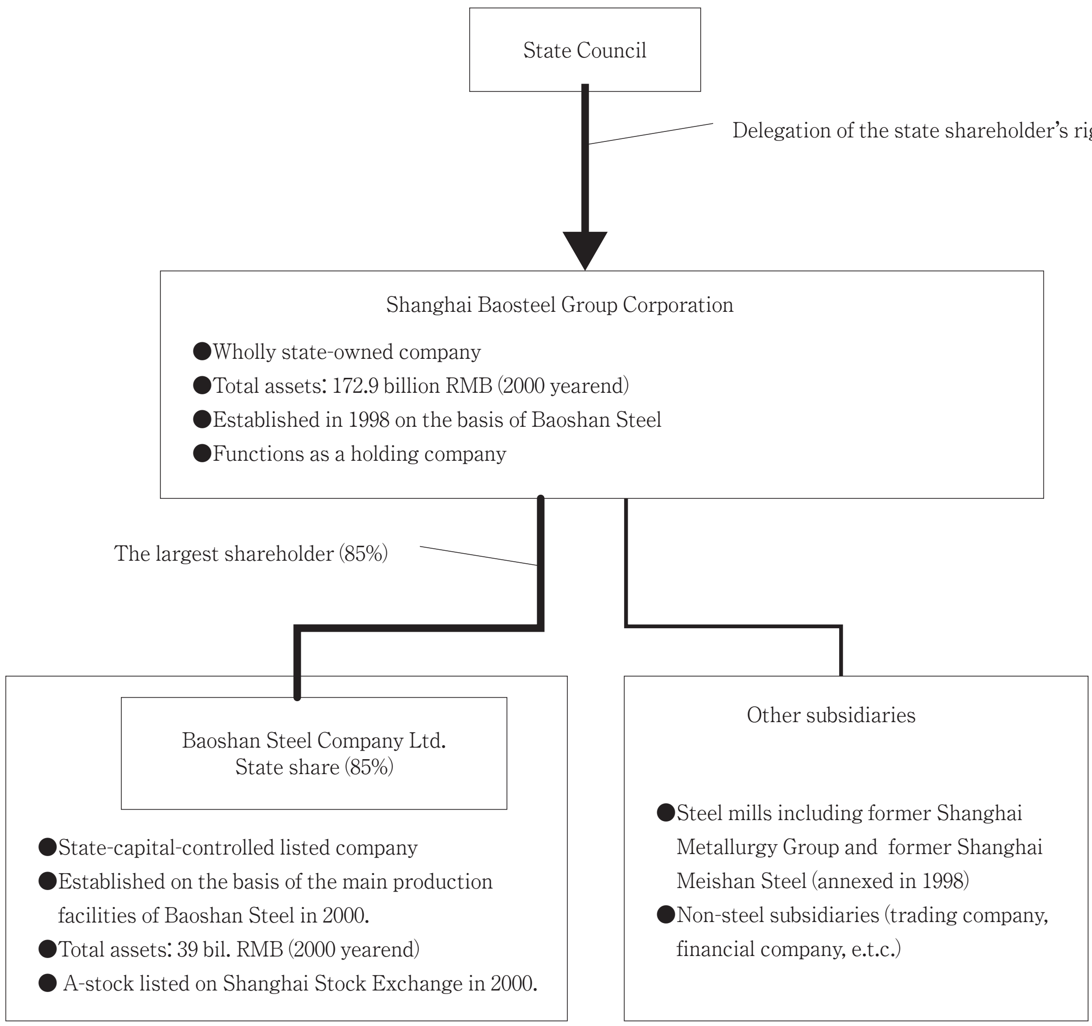
Significance and Limitations of Separation-Type Listings

When a state-owned enterprise is reorganized into a joint stock company for its listing on the stock market, it is usually the case that performing assets are taken over by a newly created joint stock company while the parent enterprise continues to exist as a type of a holding company. This method may be tentatively labeled as "separation-type listing".

A good example of separation-type listing is Baoshan Steel (Baosteel), which went public in 2000 as the biggest domestic market listing of state-owned enterprises at that time. Baoshan Steel has restructured most of its production facilities as assets of the listed enterprise (see Figure 1), and the parent group corporation (*jituan gongsi*), through the delegation by the State Council, exercises its authority as the owner of state shares that account for 85% of shares of the listed enterprises. Baoshan Steel Company Ltd., the listed enterprise, is only about 20% of the group corporation in size in terms of total assets. But since most other subsidiaries of the group corporation are either in the red or have only small profits, the group corporation's profit level (pretax profit in 2000) stood at only 3.5 billion RMB, about 900 million RMB less than the listed enterprise.

In China, where most of large state-owned enterprises are burdened with excessive facilities or redundant labor, it is true that the separation-type listing is a realistic approach. From the standpoint of reform of the corporate management system, however, there are obvious limitations on the sepa-

Figure 1 Stock Listing of State-owned Enterprise: Case of Baoshan Steel



Source: Annual reports (2000 issue) of Shanghai Baosteel Group Corporation and Baoshan Steel Company Ltd.

ration-type listing. The Baoshan Steel example may be a case of extremity with the very high ratio of 85% for state shares. Yet, in general, the ratio of state shares or state-owned shares in listed state-owned enterprises reaches as high as several dozen percent. As a consequence, parent enterprises remain in a position to exercise effective control over the management of listed enterprises as the largest shareholders dwarfing other shareholders. It also means that the administrative authorities that oversee parent enterprises can also intervene in management of listed enterprises through parent enterprises that remain as the top shareholders. As the scale of the stock market grew, the frequency of incidents also increased where parent enterprises, and the administrative authorities that pull the strings from behind, obtained improper benefits from listed enterprises by taking advantage of the privileged position as the top shareholders(See Chapter 4).

Moves toward Liquidation of State-owned Shares

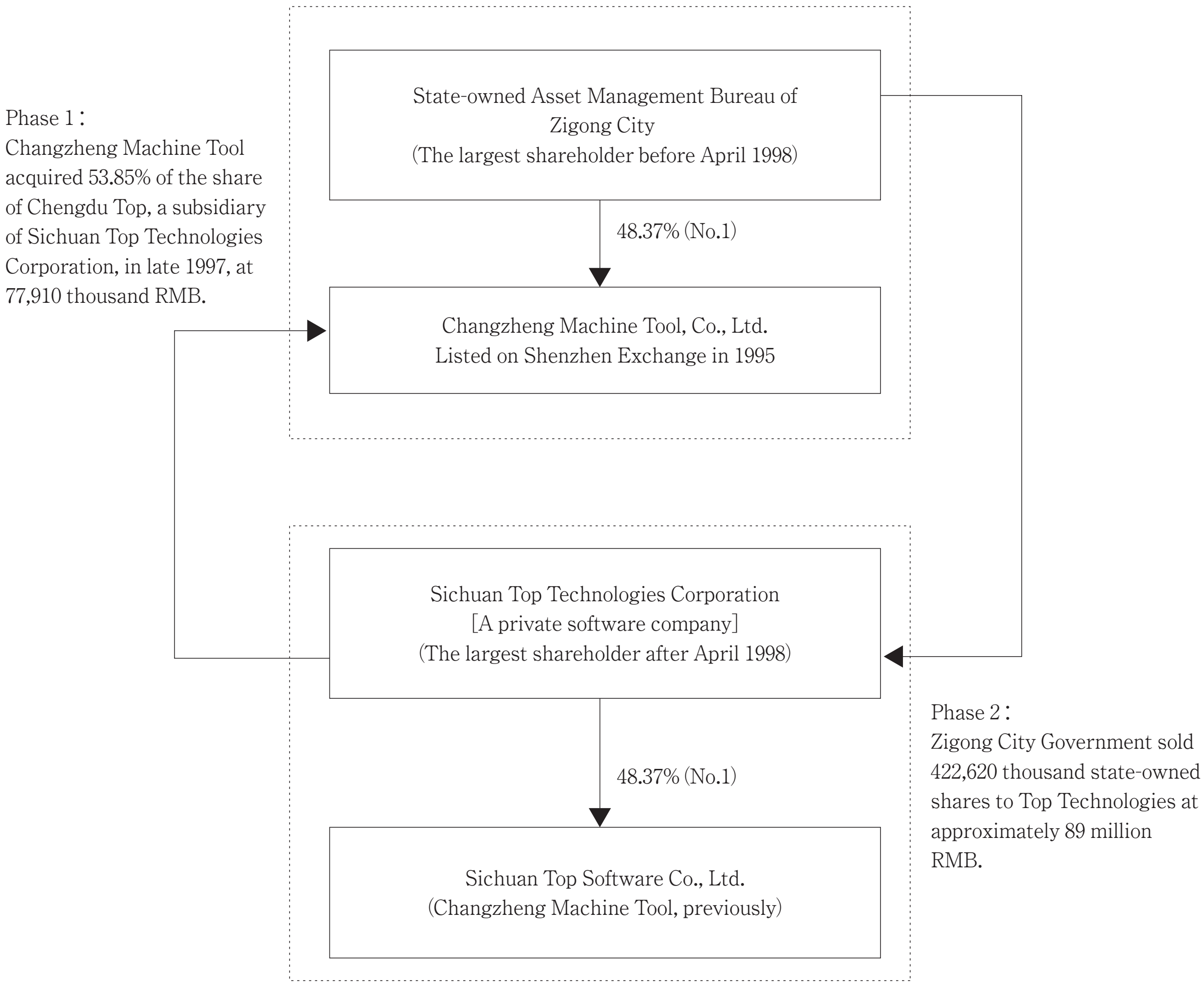
In seeking the development of the stock markets, the policymaking authorities previously tended to give priority only to the stock markets' aspect as the channel of fund-raising for large state-owned enterprises. Reform of the management system of state-owned enterprises in association with the stock market listing was emphasized as the key principle, but the slogan lacked substance, and this led to the frequent occurrences of abuses by parent enterprises.

The stock market, that are void of sound corporate governance cannot grow out of the "pit of gambling." Market instability would undermine investor confidence, and could eventually destroy the fund-raising function of the stock markets. In this context, the awareness of the need to establish sound corporate governance at listed enterprises grew stronger in China from the late 1900s to 2000, and the idea of the phased liquidation of state-owned shares emerged in this process.

5.1.2 Privatization through Sale of State-owned Shares

State-owned shares (state shares and state-owned legal person shares) are not currently allowed to be traded freely on the stock markets, but can be sold in negotiated transactions with the approval of authorities. Since it was not easy for private enterprises to obtain official approval for their exchange listings, some private enterprises opted for the indirect listing through the method called "shell buying," which is the buyout of already listed state-owned enterprises with deteriorating business performance. Since the substantial easing of political constraints on business

Figure 2 Buyout of Changzheng Machine Tool by Top Group



Source: Based on interviews to Top Group executives (September 1999) and related articles activities of private-sector enterprises after the 14th Congress of the CPC, there was the gradual increase in the buyout of listed state-owned enterprises by private enterprises for the purpose of shell buying.

Increase in "Shell Buying"

A typical example of shell buying is the buyout of Changzheng Machine Tool Company Ltd. by private software firm Top Software (see Figure 2). Changzheng Machine Tool was a state-owned enterprise under the aegis of Zigong City, Sichuan Province, which went public on the stock market in 1995. But its business performance deteriorated rapidly after the exchange listing, with after-tax profit in 1997 plunging to one million RMB, less than one-tenth of the pre-listing level. In 1998, major private software firm Top Software, also based in Sichuan Province, purchased all the state shares held by Zigong City for the 48.4% equity stake in Changzheng Machine Tool, changed the corporate name into Sichuan Top Software Company Ltd., and then switched its main business to software development.

The sharp increase in the acquisition of listed enterprises since 1997 is clearly noticeable. But it is difficult to have a true figure of shell buying cases because there is no statistics available on the buyout of listed state-owned enterprises by private-sector enterprises. An estimate based on the transfers of state shares put at about 40 the number of cases that can be assumed to be the buyout of listed state-owned enterprises by private enterprises in the period between January 1999 and mid-September 20001. This estimate does not include the purchases of state-owned legal person shares. The sale of legal person shares has been made very frequently in recent years. Therefore, if the purchases of state-owned legal person shares are included, it is highly likely that the number of the acquisitions of listed state-owned enterprises by private enterprises increased to exceed the above-mentioned number substantially.

Moves toward the buyout of listed state-owned enterprises by private enterprises are important as a step toward market mechanism-based privatization of large enterprises. However, despite the rapid development of private enterprises, they have limitations on their funding abilities and a majority of acquisition targets are middle-standing and smaller enterprises with deteriorating business perfor-

Table 2 Trends towards Divestiture of State-owned Shares

1997	/Sep.	The 15th Party Congress declared "Strategic adjustment of the state economy" as an official party line
1999		A few listed companies announced plans to buyback and liquidate their own state-owned shares
	/Sep.	The fourth Plenum of the 15th Central Committee of the CPC confirmed "Strategic adjustment of the state economy" and referred officially to promoting the divestiture of state-owned shares for the first time
	/Nov.	China Securities Regulatory Commission announces a plan to divestiture a part of state-owned shares in ten selected listed companies on a trial basis.
		National Bureau of Statistics published a report on exit from non-strategic industries and concentration on strategic industries of state capital.
	/Dec.	Partial divestiture of state shares in China Jialing Motor Company Ltd. and Guizhou Tires Company Ltd. was implemented
		A senior official of Ministry of Finance referred to a phased plan of reducing state share in listed companies.
2001	/Jun.	The State Council issued "Provisional Rules for Management of Fund-raising for Social Security through the Sale of State-owned Shares."
	/Jun.-	Stock prices sharply plummeted, erasing out around 30 percent of total capitalization by October in the year.
	/Oct.	China Securities Regulatory Commission suspended divestiture of state shares in the domestic market based on "Provisional Rules."
2002	/Jun.	The State Council declared that it permanently abandoned the divestiture policy of state shares in the domestic stock market.

Source: Compiled by the author.

mance. In order to push ahead with privatization of large enterprises by making use of the stock markets' function of concentration of scattered capital, it is necessary to systematically carry out the sale of state-owned shares to general investors on the stock markets. The sale of state-owned shares on the markets began to take a concrete shape in 2000 (see Table 2).

5.1.3 Launch of a Policy for Sale of State-owned Shares

As discussed in previous chapters, the 15th Congress of the CPC in 1997 marked the first tilt of the party leadership's policy toward privatization of state-owned enterprises. But the party leadership still held on to a cautious stance on institutional reform of the ownership of large enterprises, which would touch the very basis of the socialist economic system. What prodded the party leadership to decide in favor of the promotion of the sale of state-owned shares on the market was the need to respond to the looming risk of a fiscal crisis.

Risk of Pension Liabilities

Since 1997, the central government has been developing the social security system, centering on pensions, as a part of reform of state-owned enterprises. The core of the pension system reform was the shift from the pay-as-you-go system to the funded system. In the transitional period, the need arise for ensuring benefits to retirees who have not sufficiently funded their own pension plans under the pre-reform pay-as-you-go system. In the Northeastern region, where the ratio of retirees to workers in service is high and the economy was languishing, regional pension funds already began to fall short of resources around 1997. The central government began to cover the shortfalls in 1998, with these compensation expenditures swelling rapidly from a little over 2 billion RMB in 1998 to 10 billion RMB in 1999 and further to 30 billion RMB in 2000.[2] In 2001, the central government's expenditure to cover the pension funding shortfalls reached 34.2 billion RMB, or about 17% of the year's total pension benefits amounting to about 205.0 billion RMB.[3]

The shortage of pension funds in the transition from the pay-as-you-go financing to the funded system is generally called the government's "hidden liabilities." Estimates of the size of the "hidden liabilities" vary due to different assumptions, but they are generally believed to amount to 2 trillion to 3 trillion RMB.[4] At present, pension-related expenditures account for a relatively small share of the central government's expenditure, but the potential risk of a fiscal crisis cannot be neglected considering that China is expected to experience a very rapid aging of the population even by global standards over the coming 20 years.[5] The rapid expansion of issuance of deficit-covering government bonds since China introduced a policy for domestic demand expansion through public investment further created concerns over a possible fiscal crisis in the future.

At the fourth Plenum of the 15th Central Committee of the CPC in September 1999, the decision was taken to reaffirm the policy for "strategic adjustment of the state economy" adopted at the 15th Party Congress in 1997, and specified areas over which the state should control more clearly than before (Column 1). At the same time, on listed enterprises, the decision said the "proportion of ordinary negotiable shares should be raised appropriately, and several state-controlled listed enterprises that are highly rated and have high growth potential should be chosen for the sale of state-owned shares in these enterprises in an appropriate manner provided that state control over them is maintained," officially announcing the policy for the sale of state-owned shares for the first time. Following this decision, the State Council kicked off the policy for the sale of state-owned shares for the immediate purpose of raising funds to cover the shortfall in social security funds.

Launch of Trial Sale of State-Owned Shares

In November 1999, right after the decision at the fourth Plenum of the 15th Central Committee, the China Securities Regulatory Commission designated a total of 10 listed state-owned enterprises with the state ownership of 60 to 70% for the first trial of the sale of state-owned shares on the market. Of the 10 enterprises, the partial sale of state-owned shares in China Jialing Motor Company Ltd. and Guizhou Tires Company Ltd. were implemented at the end of 1999.

Since the state-owned shares in these two enterprises were priced close to market prices despite their lackluster business performance, the sale was not well received by the market, leaving about 20% of the planned sale amounts unsold.[6] Share prices of these two enterprises surged briefly at the time of the decision on the share sale, but plunged after the actual sale on the market, deepening market participants' wariness about the policy for the sale of state-owned shares. Because of this development, the sale of state-owned shares in the remaining eight enterprises, initially planned for 2000, was virtually suspended, and a review was launched within the government and the China Securities Regulatory Commission on the method of the sale of state-owned shares.

Despite the disappointing result of the first trial, the government policy to push ahead with the sale of state-owned shares was strengthened, rather than weakened. In December 1999, senior officials of the Ministry of Finance unveiled for the first time the goal of reducing the ratio of state ownership (the ratio of broadly defined state-owned shares, including legal person shares) of listed enterprises in non-priority industry sectors from 62% to 51% in the first stage of the policy for the sale of state-owned shares.[7] Then, in September 2000, it was reported the goal in the second stage would seek to lower the ratio of state-owned equity shares to 30%.[8]

Following the review of the method of the sale that took a year and a half, the State Council on in June 2001 finally issued a notice on the "provisional rules for management of fund-raising for social security through the sale of state-owned shares." The rules stipulated that when state-owned enterprises reorganized into joint stock companies publicly offer new shares or increase capital, they are required to sell at market prices state-owned shares equivalent to 10% of the amount of funds to be raised through the offering of new shares or capital increase. Further, under the new rules, the proceeds from the sale of state-owned shares are paid into the National Social Security Fund, established in 2000 for the purpose of covering the shortfalls of social security funds by the central government.

Setback in the Policy for the Public Sale of State-owned Shares

The Chinese government reportedly intended to raise some 20 billion RMB by the sale of state-owned shares under the "provisional rules," releasing state-owned shares in

Column 1

Description of “industries and areas where the state economy should keep control” in Resolution of Fourth Plenary Session of the Fifteenth Central Committee of the CPC (Excerpt)

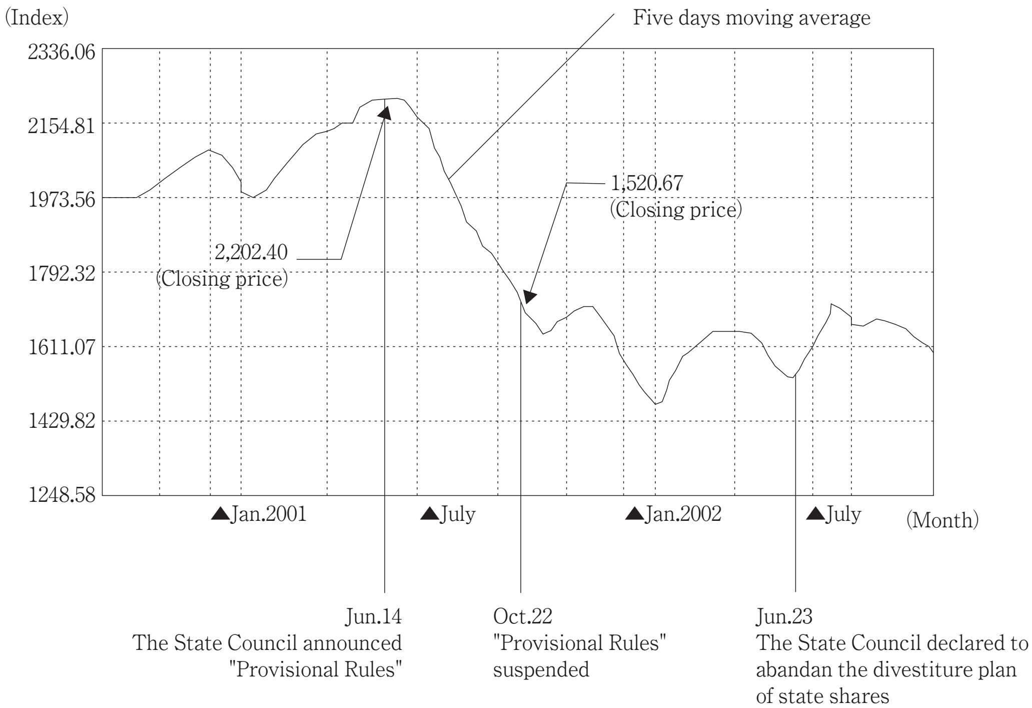
Industries and area where the state economy should keep control in principle are as follows: industries that concern national security, natural monopoly industries, industries that supply important public goods, and important enterprises affiliated with core industries and high-technology. In other industries and areas…development of the non-public economies including individual or private enterprises should be encouraged and directed on the premise of maintaining the principle of the dominant status of the public economies.

about 10 enterprises, including Sinopec Co., the largest-ever initial public offering in China. But the market was far more cautious than the government anticipated toward the sales of state-owned shares. The stock markets, which hovered around record levels by May, started steep declines about the time of the announcement of the provisional rules (Figure 3). The markets' decline widened to over 30% by October, forcing the China Securities Regulatory Commission to declare the suspension of the sale of state-owned shares under the provisional rules on October 22. It appears the amount of funds raised by the sale of state-owned shares before the suspension was only about 10% of the planned amount. The substantial shrinkage of nearly one trillion RMB in the total market capitalization whipped up investor panic over the government's policy for the sale of state-owned shares.

In promoting the sale of state-owned shares, the government paid its greatest attention to a potential impact on the stock market. The government limited the sale of state-owned shares to just 10% of the amount planned to be raised by new share issuance or capital increase with the intention of mitigating the impact on the stock market by making the sale gradual. Despite these careful considerations on the part of the government, the stock market responded with a dramatic fall to force the suspension of the sale policy. All this came as a great shock to the government. The government and the China Securities Regulatory Commission subsequently adopted an unprecedented measure to publicly solicit ideas and schemes for the sale of state-owned shares via the Internet, and considered proposals submitted.

The decision the government made after a little over six months of consideration was far more drastic than expected. In June 2002, the government declared that except

Figure 3 Trends of Shanghai Stock Exchange Index (May 14, 2001 and afterwards)



Note: The spacing between scales on the horizontal axis are not equally wide since they correspond to actual numbers of trading days.
Source: Compiled by the author based on http://www.stockstar.com/.

for initial public offerings on overseas markets, provisions of the "provisional rules" for the release of state-owned shares on the stock markets will be suspended permanently and that new provisions will not be formulated.

The attempt at the sale of state-owned on the stock market ended in the rejection by the stock markets themseives. The government's decision to permanently suspend the provisions of the "provisional rules" for the sale of state-owned shares rules out the release of state-owned shares on the domestic market, but does not at all mean the withdrawal of a policy to reduce the ratio of state-owned shares. The government's decision says that state-owned shares will still be released in stages as necessary to raise cash by selling them to so-called "strategic investors." As such "strategic investors," the government apparently has in mind private-sector enterprises and foreign-affiliated enterprises as well as institutional investors at home and abroad.

5.2 Constraining Factors for Privatization of Listed Enterprises

5.2.1 Macro Aspects-Household Savings for Buying State-Owned Shares

The party policy shift in the latter half of the 1990s effectively relaxed political constraints substantially on privatization of listed and other large enterprises. As indicated by the successive failures in 1999 and 2001 of the policy for the public sale of state-owned shares, the most immediate difficulty in privatization of listed enterprises in China is the highly technical problem of how to facilitate the sale of state-owned shares by avoiding giving a big impact on the stock market that has now grown to be one of the largest in China. Constraining factors for privatization of listed enterprises are examined below from both the macro and micro aspects.

Scale of Sale of State-Owned Shares and the Stock Market's Fund-Raising Capacity

Of the total number of shares currently outstanding, the broadly defined state-owned shares (state shares and state-owned legal person shares) are estimated to account for 60% (see Table 1). On the basis of the total market capitalization as of the end of 2001, the broadly defined state-owned shares are wroth approximately 2.6 trillion RMB. Based on the policy goals of reducing the state-owned equity share to 51% in the first stage and to 30% in the second state, the capitalization of state-owned shares to be sold would amount to around 430 billion RMB in the first stage and to 860 billion RMB in the second stage, for a combined sum of around 1.3 trillion RMB. On the other hand, the scale of funds that can be raised through the stock market is experientially assumed to be about 15% of the total value of negotiable shares (about 250 billion RMB in 2001).[9] Given annual fund-raising needs of 100 billion to 200 billion RMB in recent years and assuming that these regular fund requirements are satisfied on the market first, the stock market has room to absorb only several dozen billion RMB worth of state-owned shares in a year. This means that it would take over 10 years to complete the second stage of the sale of state-owned shares. In this context, it is essential to devise measurers to expand the stock market's fund-raising capacity in order to facilitate the sale of state-owned shares.

Shift of Household Asset Allocation from Savings to Stock Investment

From the macroeconomic point of view, there are conditions in place to make it possible for the stock market to expand its fund-raising capacity. First and foremost, there are household savings that go well over 7 trillion RMB (Figure 4). While the annual increase in household savings narrowed steadily until 2000 after peaking out in 1996, the balance of savings kept growing by nearly 500 billion RMB or more each year. According to the 1999 estimate by the People's Bank of China, of the total financial assets held by Chinese households amounting to 8,167.4 billion RMB, deposit assets accounted for 5,962.2 billion RMB, or a little over 70% (Table 3). On the other hand, the share of stock certificates and other stock-related assets was merely 6%.

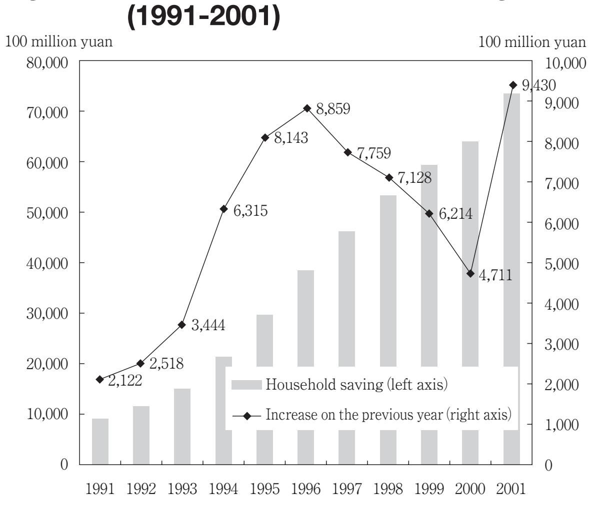
Since around 2000, general interest in stock investment has been on the rise as stock prices have come out of the long period of stagnation. A survey on urban households' attitudes on savings conducted by the People's Bank of China in the first quarter of 2001, the ratio of households that regard equity shares as a major element of financial assets rose to 12.0% from 6.8% in the fourth quarter of 1999, almost doubling in just over a year. The number of stock investment accounts increased by 8.5 million in 2001 alone to total 66.5 million.

Given the currently low ratio of stock assets to total household financial assets, it is quite likely that households will increase stock holdings going forward. The key to increased stock investment by households is how to lower risks associated with stock investment.[10] The Chinese stock market remains highly speculative. The turnover ratio (turnover/year-end balance of negotiable shares) is around 500%, 10 to 15 times as high as the matured stock markets in Europe, the United States and Japan. The average holding period for a given stock is less than two months. Investment risk is evidently very high for ordinary investors. Based on one sampling survey, over 80% of small and medium investors incurred investment losses despite the sharp rises in the stock price index in recent years (though over 70% of them were profitable in 2000). Unless this high-risk market environment is rectified, households cannot be expected to make a further shift from savings to stock investment in the allocation of financial assets.

Fundamentally, the speculative nature of the Chinese stock market stems in part from instability of management at listed enterprises. Many of Chinese enterprises seem unable to stably maintain the good business performance seen at the time of their listings. Accounts rigging still remains the serious problem, making it considerably difficult to reasonably forecast earnings performances of listed enterprises. Against these backgrounds, investors tend to focus on short-term margin earnings rather than on long-term investment gains. Investors' orientation toward short-term gains helps increase market volatility, and consequently further reinforces the speculative aspect of the stock market.

In order to help increase the stock mar-

Figure 4 Growth of Household Savings (1991-2001)



Source: *Almaniac of Chinese Finance and Banking* and *Quaterly Statistical Report of the People's Bank of China* (2002-1).

Table 3 Composition of Household Financial Assets (as of 1999 year end)

	Amount	Share
	(100 million RMB)	(%)
Total financial assets held by households	81,674	100.0
Deposit	59,622	73.0
Cash	5,717	7.0
Bonds	9,802	12.0
Share of stock certificates and other stock-related assets	4,900	6.0
Insurance assets	1,633	2.0

Source: http://www.dtjww.gov.cn/dtjw/guoneiwaixw/002.htm. Original data is based on an estimation made by the People's Bank of China based on household survey.
Note: Since the original figure in the item of "Bonds" was obviously incorrect (89,840), it is deducted by subtracting other assets from the total.

ket's stability, it is necessary to foster investors who are capable of effectively monitoring management of listed enterprises. From this standpoint, the regulatory authorities have been making strong efforts in recent years to foster institutional investors.

5.2.2 Micro Aspects: Institutional Investors as Agents of Corporate Governance

China's stock market has so far been dominated by small individual investors. Generally speaking, however, these individual investors are incapable of effective monitoring of management of listed enterprises. In order to strengthen the corporate governance function of the stock market and reduce stock investment risks, it is important to shift the weight from small investments by individual investors to institutional investors with monitoring capabilities.

Growth of Institutional Investors

The presence of institutional investors on the Chinese stock market seems to be expanding rapidly following the government's policy from 1999 to encourage the entry of institutional investors. According to an estimate made by an official of the People's Bank of China in 2001, stock holdings by institutional investors have already accounted for 30% to 40% of the total value of negotiable shares. Of this, about 85% were held by privately subscribed investment funds catering to corporate clients, and around 15% by publicly offered investment funds.[11]

For the moment, however, the rapid growth of institutional investors has not necessarily contributed to greater stability of the stock market yet. Rather, some institutional investors, taking advantage of the relative magnitude of investment funds available to them, even seem to be manipulating stock prices to their advantage. In October 2000, a securities exchange official dropped a bombshell by revealing the prevalence of illicit price manipulation by securities investment funds.[12]

There exists a sort of dilemma between the growth of institutional investors and stabilization of the stock market. As long as investors participating in the stock market prefer high returns by taking high risks, institutional investors entrusted by them cannot help but make speculative investment.

Pension and Insurance Funds

Greater expectations may be placed on pension funds and insurance funds, rather than on ordinary investment funds, as institutional investors who help stabilize the stock market. By nature, these funds can be expected to emphasize investment aimed to realize long-term and stable gains. In addition to the public pension system now being developed in China, private pensions such as supplementary pension schemes by enterprises and savings-type pension plans for individuals are growing. The regulatory authorities have also taken measures to encourage stock market investment by pension and insurance funds, such as the permission for these funds to directly invest in the stock market and the hike in the ratio of stock investment to their total assets.[13]

Conclusion : Prospects for Privatization of Large Enterprises

Since the latter half of the 1990s, the administrative authorities have been promoting the exchange listings of large state-owned enterprises, and in 2001 launched a full-fledged policy to facilitate the sale of state-owned shares on the market. These measures have potential to lead to de facto privatization of large state-owned enterprises in the long run, and in that sense, can be considered as ground-breaking developments in China's economic system reforms.

However, as discussed in this chapter, these policy initiatives have hit the wall of very down-to-earth constraints in the Chinese market stemming from the fact that both the institutional framework of the stock market and effective market players have yet to be fully developed. Steady development of the institutional framework of the stock market is indispensable in order to further facilitate privatization of large enterprises through the stock market. Needless to say, this cannot be done overnight. It will be a considerable time before institutional investors grow up to perform the role of effective monitors of corporate governance on the stock market. All in all, privatization of large enterprises in China is expected to prove a long and gradual process.

(Ken-ichi IMAI)

Notes:

1. Based on data provided by China Securities Online, a Web site on listed enterprises, we assumed a case where state shares have been purchased by a presumed private-sector enterprise.
2. For the pension system reform and the problem of "hidden liabilities," a good reference is Zhao Xiaojian and Zhu Xiaochao, "Zhongguo yanglao zhidu zhuangi," *Caijing,* June 19, 2001.
3. The Ministry of Labor and Social Welfare website
4. The 1997 estimate by the World Bank put the size of "hidden liabilities" at 46~69% of GDP. The estimate by the State Council's Office of Economic System Reform in 2000 put the amount of the liabilities at up to 12 trillion RMB (Zhao Xiaojian and Zhu Xiaochao, cited above)
5. The World Bank estimates that the ratio of the elderly to China's total population would reach 10.8% in 2020, almost double the 1995 level (World Bank, *China 2020: Development Challenges in the New Century,* Washington, D.C., the World Bank, Chapter 4, 1997).
6. The sale of state-owned shares reduced the state-owned equity ratio from 74.76% to 53.7% in China Jialing Motor and from 57.7% to 51.0% in Guizhou Tires.
7. Based on the remarks by Zhu Zhigang, Assistance to the Minister of Finance, quoted by sina.com (http://finance.sina.com.cn/stock/marketMsg/1999-12-07/14369.html)
8. Based on sina.com (http://finance.sina.com.cn/2000-09-16/12528.html)
9. Gu Ji et. al, "Guoyougu jianchi de guanjian," (Property Right Trading Center of Jiangsu Province, http://www.jscq/com.cn/)
10. In Japan, the weight of risk assets (mainly stocks) in household financial assets slipped far below 10% since the latter half of the 1990s as stock investment became highly risky following the bursting of the bubble. However, during the high growth period when the stock price indexes sustained an upward trend in general, the ratio of risk assets was much higher at 20-30% (Shinobu Nakagawa and Tomoko Katagiri, "Behaviors of Japanese Households in Choosing Financial Assets - Why Japanese Households Are Negative on Risk Asset Investment?," *Bank of Japan Research Papers,* November 1999).
11. Xia Bin, "Report on Private Funds in China," *Caijing,* July 6, 2001.
12. Ping Hu and Li Qing, "Jijin heimo: Guanyu jijin xingwei de yanjiu baogao jiexi," *Caijing,* October 19,2000
13. The entry by foreign financial institutions also seems beneficial in enhancing the corporate governance function of the stock market. Though China has basically taken a cautious attitude on the opening of the capital market to foreign concerns since the Asian economic crisis, it has taken steps to gradually allow foreign financial institutions into the Chinese stock market.