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Crouching bull, hidden bear

The Chinese equities markets in fat years and lean years

Ted Rule

When I last visited the Chinese stock exchanges two years ago, they were in dire straits (Rule 2005). The market indices had been in decline since 2001. In May 2005, the Shanghai Index stood at 1,060—less than half of its 2001 peak of 2,245. During 2005, the Shenzhen and Shanghai exchanges were two of the three worst performing exchanges in the world, with year-on-year declines of 11.7 per cent and 8.3 per cent respectively. Only the Tehran Stock Exchange performed worse (World Federation of Exchanges 2007a). In terms of market capitalisation, the once great Shanghai Exchange had slumped to nineteenth in the world, similar in size to Singapore but significantly smaller than the Mumbai and National Stock Exchanges of India (World Federation of Exchanges 2007a). Key price–earnings ratios had declined from their peak of 37.7X in 2001 to 16.3X in 2005 (World Federation of Exchanges 2007a). As Chinese companies made up an ever-greater proportion of the Hong Kong board, such declines in price–earnings ratios started to influence the less volatile Hong Kong ratios. Hong Kong price–earnings ratios fell from a high of 19X in 2003 to 15.6X in 2005 (World Federation of Exchanges 2007a).

Even though the Chinese economy continued to be the fastest growing major economy in the world and the world's largest recipient of foreign direct investment (FDI), the role of the Shanghai and Shenzhen markets in mobilising new capital declined drastically. This was due partly to a ban on new initial public offerings (IPOs). But it seems doubtful whether market conditions were conducive to successful IPOs even if they had been permitted. At US$3.6 billion raised, Shanghai ranked twenty-fourth among world exchanges in terms of capital raised. This was a little more than Tel Aviv, less than Oslo, Athens or Tehran and significantly less than the Indian exchanges, which raised US$19 billion between them. Shenzhen raised a mere US$351 million in new capital in 2005 and not a single cent was raised in secondary issues. Only Colombo, Budapest and Ljubljana exchanges performed worse. Turnover in Shanghai and Shenzhen declined by 26 per cent and 20.6 per cent respectively in the already disappointing 2004 figures (World Federation of Exchanges 2007b).

This was not a happy picture. Indeed, the mood around regulators and other government bodies associated with the markets was growing increasingly frantic. Too many ordinary people had lost too much money speculating on stocks and the spectre of social unrest loomed. In May 2005, there was a series of meetings around the country to discuss measures to stimulate the markets. It was hoped that these measures would return a northerly aspect to the figures and, hopefully, a smile to the faces of the tens of millions of retail investors. Measures proposed even included an extraordinary suggestion that the government should establish a fund to stimulate the market.[1]

Hong Kong gathers strength

Meanwhile, outside the closed shop of the two domestic markets, life went on as normal. The economy was growing at 10 per cent per annum, there was an enormous demand for expansion and other capital and it was being met from the markets. Hong Kong, however, was the market supplying this demand. In 2005, the previous mould of international capital raising was broken and Hong Kong started to come into its own as China's capital gateway to the world and one of the world's leading exchanges.

In 2005, three of the five largest IPOs in the world were of Chinese companies on the Hong Kong exchange (Table 13.1).

Despite the weakness in the Chinese domestic markets and the slump in IPO and secondary raising activity, China dominated Asian IPO activity in 2005. More than half of the US$41 billion raised in Asian IPOs was raised by Chinese companies. This was almost four times the amount raised by Japanese companies and 10 times the amount raised by Indian companies (Table 13.2).

Partly as a result of all this Chinese activity, Hong Kong became the fourth largest capital-raising exchange in the world after New York, London and Toronto (Toronto was boosted by the boom in minerals raisings resulting from Chinese demand for resources). Professionals commented, 'This marks a new era, not just for China but for the global capital markets in general. By listing in Hong Kong and selling tranches of shares to qualified investors in the US and Europe, Chinese companies have sidestepped traditional assumptions that the only way for large corporations to gain access to global capital pools was to complete a full US listing' (Ernst and Young 2006a).

Thus the problem did not lie with the Chinese economy. The economy was fine. It did not mean that there was a limited demand for capital, nor did it mean that foreign suppliers of capital were not interested in Chinese paper. The enormous success of Hong Kong-based Chinese IPOs at the nadir of the domestic markets gave the lie to that proposition. The problem lay within the Shanghai and Shenzhen markets themselves.

The long decline

It is appropriate at this juncture to restate the reasons I enumerated in my previous paper (Rule 2005) for the decline of the domestic markets. Essentially, there were three reasons.

- The markets had been overpriced and were due for a serious correction. At the peak in 2001, Shanghai average price–earnings ratios were 37.7X and Shenzhen's were averaging 39.8X—the same ratio as applied in Tokyo in 1990 close to the peak of the Japanese bubble.[2] This overpricing was ascribed variously to market immaturity and lack of a large institutional sector.
- There was too much money chasing too little product. This was because of a regulatory system that rationed IPO slots and took listing decisions out of the hands of underwriters and others who took the actual IPO risk. A 2000 decision partly resolved this problem by giving more weight in deciding who should go to IPO to the people who took the underwriting risk. This put further downward pressure on prices.
- The market was seriously spooked by a 2001 decision to experiment

Table 13.1 **Leading international IPOs, 2005**

	Domicile	Industry	Proceeds (US$ billion)	Primary exchange
China Construction Bank	China	Banks	9.2	Hong Kong
Electricité de France	France	Power	8.2	Euronext
Gaz de France	France	Power	4.2	Euronext
China Shenhua Energy	China	Mining	3.3	Hong Kong
Bank of Communications	China	Banks	2.2	Hong Kong

Source: Ernst and Young, 2006a. *Accelerating Growth—Global IPO Trends 2006*, Ernst and Young.

Table 13.2 **IPO activity in Asia, 2005** (capital raised by nationality of firm)

Domicile	Total capital raised (US$ million)	Number of IPOs
China	24,263	114
Japan	6,231	157
South Korea	2,903	83
India	2,283	53
Malaysia	1,406	83
Kazakhstan	1,362	2
Thailand	721	37
Singapore	505	33
Other	1,524	69
Total	41,199	631

Source: Ernst and Young, 2006a. *Accelerating Growth—Global IPO Trends 2006*, Ernst and Young.

with selling down state-owned shares. The two-thirds of Chinese-listed company shares owned by the state in one form or another were non-tradable and would never come to market. On 12 June 2001, a modest proposal was implemented that would see a limited sell-down of state shares. Under the proposal, new IPOs of state-owned enterprises would sell down a block of 10 per cent of existing state shares with the proceeds going to the Social Security Fund. No existing listed company was affected. This scared the market and marked the beginning of the decline. The market was afraid of enormous amounts of state paper flooding the board and leading to a collapse in value.

In April 2005, the China Securities Regulatory Commission (CSRC) announced the 'experimental' conversion of the non-tradable shares of three listed companies to tradability, and in June a further 42 companies joined the 'experiment'. This marked the nadir of the domestic markets.

This, possibly coincidentally, marked the bottom of the Chinese bear market. Four years of decline were replaced by a boom, which continues today. The markets remain spritely and extremely volatile, subject to violent movements on whim, rumour and occasional manipulation. Although the domestic markets are back, Hong Kong has strengthened its position as the 'big brother' of the Chinese equities market.

But there are signs of a growing maturity. Lots of ordinary people were hurt badly during the bear market and are no longer so eager to believe in their own invincibility or to rely on their own judgement. This has led to the growth of a fledgling institutional sector—especially in the area of mutual funds—a concept that Chinese retail investors have adopted with characteristic gusto. And, for a brief moment in March 2007, even mighty Wall Street trembled momentarily in response to sentiment on the east bank of the Whangpoo River and on the Shanghai Bund.[3]

Before looking at the boom, however, let us examine some of the factors that helped put a bottom on the bear market. These were the resolution for the time being of the non-tradable share issue, growth of mutual funds and the introduction of sophisticated hedging instruments to help manage risk.

Administrative measures

The key administrative measure adopted to revive the Chinese share markets was the reform of the state shareholding system. This is usually referred to as the non-tradable share reform. This reform did not mean the complete privatisation of state-held shares, although this is what was feared most by shareholders. Not even all state shares were held directly by the state. Many 'state' shares were held by incorporated bodies, which, as registered businesses, had 'legal-person' status. This artificially created some of the benefits of share ownership, even though the ultimate owner was still the state. Directly held state shares were also held at different levels of government, and were 'owned' and managed by different levels of State Assets Supervision and Management Commissions. Centrally held shares were managed by the Central Commission, provincially held shares were managed by the Provincial Commissions and so on. Some owners of non-tradable shares were private individuals and even foreigners. The Chinese Companies Law locked up the shares of sponsor organisations.

When the non-tradable share issue first came to public notice in 2001, the occasion that brought it to the fore was a proposal to prop up the State Pension Fund and the State Social Security Fund by a small sell-down of state shares and the allocation of 10 per cent of the state's holdings in future IPOs to those funds. Using state share holdings to capitalise the Social Security Funds remains a subject of active debate today (*The People's Daily* 2006a), however, the objective of the reform was never mass privatisation and a sudden dumping of state shares on the market.

The objective of the non-tradable share reform was the further extension of the benefits of the shareholding system to state-owned listed companies. Because their shares were non-tradable, state-owned companies were unable to enjoy two of the benefits of the shareholding system: they could not cash out their holdings and apply the proceeds to other purposes, and they were immune from takeover pressure. This reduced the influence of minority opinion on business decisions. Some state-owned companies had quite varied registers of legal-person owners and state owners at different levels. Since these shares were non-tradable, however, the legal-person owners were unable to cash out in the event of poor share performance or a takeover offer. This meant that sometimes quite small controlling interests could afford to ignore the interests of large minority shareholders. Share price performance was clearly an issue for listed companies that wished to maintain access to the capital markets, but there was never that sinking realisation that the market might decide that its interests were better served by having a different person looking after its investment.

Chairman Shang Fulin and his colleagues at the CSRC undertook the delicate task of introducing an essential reform, which the market was very afraid of. The delicacy of the task was compounded by its timing. The market had been declining for four years and the index was at less than half of its peak.

Fear and greed

Fear

Chairman Shang is an interesting character. He has never been considered one of the intellectual or policy powerhouses of the Chinese financial system, but he was often the man whom Zhu Rongji called on to fix unfixable problems in the financial system. His first navigation of shark-infested waters was in 1994 when he resolved the issue of triangular debt between state-owned enterprises—an issue that had threatened to paralyse the whole payments system. In 2000, he was made Governor of the Agricultural Bank, which was still the weakest of the state-owned banks. There he made and carried through several of the most difficult decisions, including closing 3,000 branches and laying off 50,000 staff.

Shang understood that in dealing with shareholders it was necessary to deal simultaneously with the conflicting emotions of fear and greed. On 27 June 2005, Shang addressed the issue of fear. He announced that the aim of the reform was not to sell out all non-tradable shares on the market but to eliminate the trading right differential. ‘Making all shares tradable doesn’t mean selling out all shares,’ he commented (ChinaPaper Online 2007). Any sales of state shares would have to be approved by the State Assets Supervision and Management Commission. There would be guidelines specifying the amount of shares that should remain in state hands at any time and also lock-ups. He was commenting on the ‘Notice regarding the issue of experimenting with reforms to the split-share structure of listed companies’ (CSRC 2004). Under this notice, the method of making shares tradable was to be decided by the company itself. The method had to be approved by not only a full EGM, but two-thirds of attending tradable shareholders. Flotation of the shares on the market was forbidden in the first year of reform and limited to 5 per cent of outstanding shares in the second year.

A further decision also expanded the pool of capital available for buying shares held by the public. It was decided that state-owned enterprises could expand their holdings in companies by buying shares held by the public. This put the public and the state on an equal footing and gave the public a potentially large buyer. The basic rationale appears to have been to allow controlling shareholders to buy in the market, thus holding up market prices in case small shareholders began dumping stock after the reforms.

The issue of foreign shareholders holding non-tradable shares in listed companies was also addressed. On 7 November, it was announced jointly by the CSRC and the Ministry of Commerce that foreign strategic investors would be able to enter Chinese companies by buying previously untradable 'A' shares from state and other sources. 'A' shares had previously been available to foreigners only via Qualified Foreign Institutional Investors (QFIIs). This was subject to various lock-up arrangements but potentially significantly widened and deepened the market (Ministry of Commerce 2007). Foreign stakes of more than 25 per cent would attract normal Sino–foreign joint-venture privileges.

Greed

This successfully addressed the fear issue. The issue of greed was addressed by simply throwing large amounts of money at public shareholders. Each reforming company was to compensate tradable shareholders for potential losses that might be incurred in the reform process. Each company was to make its own decisions on the quantum and form of compensation, subject to approval by the CSRC. Compensation took the form of cash, bonus shares and other measures. Many of these compensation schemes were extremely generous to minority shareholders, especially in the early stages. A couple of examples demonstrate this. One of the first companies to float its non-tradable shares, Sany Heavy Industries, offered three free shares plus 8 yuan in cash for every state share sold (*South China Morning Post* 2001). Jiangxi Changli Automobile Spring offered 3.5 shares for every state share floated; Zhuhai Huafa Industrial offered three shares for every state share floated; and Aeolus Tyre Company Limited offered holders of its non-tradable shares 4.2 shares for every 10 owned (Forbes.com 2007a). Generally speaking, between two and five shares' compensation was offered for each state share floated.

Warrants were offered for the first time as part of this compensation package. They were warmly welcomed by investors and quickly became an integral part of the market mix. Indeed, market wisdom was that when a company completed its reform, share prices immediately went up.

It is hard to look at the skill with which these very fundamental reforms were carried out without some feeling of admiration. Far from causing a market collapse, the reforms sparked off the boom that continues today. After the first three experimental conversions in April 2005, there came 42 firms in June 2005. Many of these were newly listed firms from the Shenzhen small and medium enterprise (SME) board. The logic appears to have been that many of them already had substantial private participation and they would thus require less change in their structures.

Then the reform started in earnest. Each week, two or three companies would announce their reform plans. By late November 2006, Qi Bin, the research director of the CSRC, could report that 90 per cent of listed firms had resolved their non-tradable share issues. This was spread across 1,161 companies representing 96 per cent of the market capital of the Shanghai and Shenzhen listed companies. One hundred and thirty companies had still not complied with the CSRC's requirements but most of these had either 'huge losses' or had their shares used as collateral or frozen by the courts. Qi encouraged them to use mergers and acquisitions to solve their problems. After all, bringing the pressure of the threat of takeover to bear on majority shareholders had been one of the original objectives of the reform (*The People's Daily* 2006c).

At the same time, the CSRC felt strong enough to start attacking some of the abuses that the previous system had found difficult to control. At a meeting in Changsha in October 2006, the CSRC announced that it would prosecute controlling shareholders of listed companies who had applied listed company funds to their own use. This had been made a criminal offence only in June 2006, reportedly after personal intervention by Premier Wen Jiabao. Between then and the end of September 2006, 309 companies had recovered 20.4 billion yuan from controlling shareholders and 15 executives had been arrested or prosecuted for misappropriation of funds (*The People's Daily* 2006b). The CSRC also felt comfortable enough to reopen the issue that had originally been the occasion for the decline of the market in 2001, namely the possibility of transferring state-owned shares to the pension and social security funds. At the end of September 2006, it was reported that the government was once again studying the possibility of transferring 10 per cent of state shares in listed companies to the National Pension Fund and the National Social Security Fund.

New trading products

As the markets progressed through 2006, it quickly became clear that a new style of Chinese market was starting to emerge from the chaotic slump of the previous five years. The exuberance and volatility remained but there was a new sophistication. This could be seen most clearly in the emergence of new trading products and in the growth of investment institutions, particularly retail mutual funds.

Warrants became a fundamental part of the tradable share reform and spread from there to the general market. A warrant is an instrument that gives the holder an option to buy or sell a share at a fixed price—often at a discount to market price—within a given period. There is no obligation to exercise the option, which simply falls away if not exercised. It is used mostly as a hedging instrument, but it can rise and fall rapidly in price depending on whether the exercise price is higher or lower than the current market price of the underlying share. Because of this volatility, it is a popular investment with the less risk-averse end of the investor spectrum. This end of the spectrum is well represented in the Chinese markets.

The tradable share reform concentrated its approach to compensation originally on issuing cash and new shares to tradable shareholders as compensation for a potential fall in share price. The fact that share prices did not fall after the first couple of reform experiments, however, coupled with a mid 2005 decision to allow the creation of covered warrants, opened a new avenue of compensation. Soon the issue of warrants by reforming companies became the normal path to compensate existing shareholders. As the market reversed its decline, the gearing effect of warrants in a bull market suddenly became apparent to even the most amateur investors. From a trickle in mid 2005, Shanghai boomed to become the world's third largest issuer and trader of covered warrants in 2006, after the Deutsche Börse and Hong Kong (World Federation of Exchanges 2007c).

It was a similar story with mutual funds. It had long been an ambition of the intellectuals behind the Chinese markets—particularly former reform commission chairman Liu Hongru—to avoid the casino-like behaviour associated with retail investing and to support the development of institutions. History teaches us, however, that institutions that invest on behalf of individuals grow up only when individuals feel that they are unable to get the full benefits of their investments by themselves, and turn to professionals.

This is what has happened in China. Ordinary investors had watched the value of their holdings dwindle by half in the period 2000–05 and were suddenly prepared to put their business in professional hands. Foreign participation was a key stimulus for the development of mutual funds. Bloomberg reported that the arrival in Shanghai of Franklin Templeton in 2003 was one of the first foreign-invested fund management businesses (International Herald Tribune 2006). It was followed rapidly by international firms such as ING's Asia Pacific Investment Management Unit, Deutsche Bank, Credit Suisse, Société Générale and Australia's Colonial First State. During 2006, mutual funds raised an astonishing 387 billion yuan for investment in the share markets (International Herald Tribune 2006). The peak of the mutual fund madness seemed to come on 7 December 2007, when Beijing-based Harvest Fund Management—19.9 per cent owned by Deutsche Bank—raised 40 billion yuan in a single day (Forbes.com 2007b). This prompted the CSRC to put a 10 billion yuan per day limit on fund raising in the hope of controlling funds rushing into the market. The top performer for 2006 was reported to be Invesco's Great Wall Domestic Demand Fund, which returned 182 per cent for the year (International Herald Tribune 2006). Interestingly, although it is difficult to confirm from published data, the general view among the investing community is that Shenzhen is a major beneficiary of this development, with some informants estimating that up to 40 per cent of funds are managed out of this southern city.

Thus, from the ashes of the bear market a new market was born. It was still recognisably Chinese, speculative and retail based, but it had a new sophistication, new products and new institutions.

The boom

The measures that the CSRC took to reform and stimulate the markets were extremely successful. The four-year bear market had turned around into 2006's greatest boom and the CSRC was inclined to take the credit for this.

On 26 April 2007, the Shanghai Index stood at 3,783. This was a 283 per cent increase from its lowest point of just under 1,000 in early June 2005 (China Exchanges Web 2007). At the end of March 2007, the Shanghai Index had grown by 161.2 per cent from March 2006 and the Shenzhen Index had increased by 55.3 per cent in the same period. These were the two highest increases in the world. Only Lima Stock Exchange had grown faster (World Federation of Exchanges 2007d). At the end of 2006, the Shanghai market cap had grown by 220.8 per cent from the end of 2005—the highest increase in the world—to US$917,507 billion, which made it the fourteenth largest market in the world as measured by market cap. In the same period, the Shenzhen market cap had grown by 97.1 per cent—the third highest increase in the world for the period—to US$227,947 billion. Together, at US$1,145,454 billion, they constituted the twelfth largest market in the world in terms of market cap, ahead of the

Australian Stock Exchange. When Hong Kong's market cap is added into the mix, at US$1,714,953 billion, they constitute the sixth largest market in the world (World Federation of Exchanges 2007e).

The frantic activity of the first quarter of 2007 further emphasised the coming role of the Chinese markets. By the end of March 2007, Shanghai's market cap had increased by a massive 314 per cent on the same period in 2006, to US$1,297,387 billion, which made it by itself the tenth largest market in the world. In the same period, Shenzhen's market cap grew by 182 per cent. Shanghai and Shenzhen together, at US$1,656,275 billion, were the ninth largest market in the world, and with Hong Kong, at US$3,390,392 billion, the sixth largest in the world (World Federation of Exchanges 2007f).

Market turnover figures are the indicators that best give a feeling for the wild and unrestrained nature of the activity on the Chinese markets during the boom. Looking at the numbers for the end of 2006, an increase in market turnover of 209.4 per cent in Shanghai and 174 per cent in Shenzhen on the same period in 2005 seems impressive. Shanghai is still only fifteenth in the world and Shenzhen only nineteenth (World Federation of Exchanges 2007g), but trading volume for January to March 2007 in Shanghai was an almost unbelievable 640.2 per cent higher than in the same period in 2006, and Shenzhen was up 529.4 per cent for the same period. It seemed that everybody was beginning to get that feeling of omnipotence and infallibility that drives human behaviour during serious booms. At US$652 billion, Shanghai by itself had the seventh highest trading volume in the world. Shenzhen, at US$339 billion, was tenth in the world, with a higher trading volume than Hong Kong (US$327 billion) (World Federation of Exchanges 2007h). Together, Shanghai and Shenzhen, in US dollar terms, represented the fifth largest market in the world during this period.

We should not take these boom-time figures as indicators of the long or medium term future of the domestic markets. The figures are extremely volatile and, in the medium term, almost certainly unsustainable. Current price–earnings ratios are in the high 30s—already back to close parity with Tokyo's at the peak of its bubble—and a correction, probably a serious one, is not very far away. This correction, when it comes, will probably once again push the Chinese markets back into the second league of international markets for a period.

If we are looking to the longer term, however, the most interesting figures for the period 2006–07 are those for funds raised. Here we see yet more evidence of a strong underlying demand by very large companies for access to world capital markets for very large sums of money. The recapitalisation of the Chinese banks gave Hong Kong the world's largest ever IPO (the International

Commercial Bank of China IPO of October 2006) during the period under review. It drew the attention of international capital providers to the Chinese markets seriously for the first time. This was evidenced when, for the first time since the 1930s, volatility on the Shanghai market was cited by observers as the cause of a serious hiccup on Wall Street. The Chinese markets could be due for some serious pain, but they aren't about to go away.

The boom in capital raising and the dominant role of Hong Kong

The 2005 mega-listings of Chinese banks were the precursors of the revolution in international fund raising, which the world witnessed with a mixture of bemusement and—on the part of New York—mild panic during 2006. The domestic exchanges were players in terms of cash raised but they continued to suffer from the suspicion in the international markets that they weren't quite kosher and that their regulatory standards were not up to scratch. And even if international investors had wanted to play in the domestic markets—there was plenty of evidence that they were too scared to do so—currency and other regulatory considerations meant that their ability to do so was severely circumscribed. Once again, the great beneficiary was Hong Kong.

Hong Kong was the primary market for international offerings by major Chinese banks during 2006. The requirement of Chinese banks for capital to bring them into conformity with the Basel rules was enormous and, in the judgement of their boards, could be satisfied only by access to international markets. There was also a consideration of prestige. International institutional investors brought respectability. The threat of greater scrutiny by the world market was also thought to be a disincentive to the dodgy practices—legal and illegal—that had characterised the performances of Chinese banks to date. This was their third refinancing in a decade and nobody was keen to dip into the state coffers for a fourth round.

Thus in 2006, three massive Chinese bank IPOs were launched from Hong Kong. On 1 June 2007, the Bank of China listed on the Hong Kong exchange, raising US$11.1 billion. On 22 September, Shenzhen-based China Merchants Bank listed, raising US$2.7 billion. On 27 October, the International Commercial Bank of China (ICBC) listed, after raising a massive US$21.9 billion in a simultaneous Hong Kong–Shanghai listing. The Hong Kong H-share listing raised US$16 billion while the Shanghai A-share listing raised US$5 billion (ICBC 2007). This was the largest ever IPO, eclipsing NTT DoCoMo's US$18.4 billion listing in 1998 (CBC News 2007). The Shanghai A-share listing alone ranked as the world's fourth largest IPO of the year (Ernst and Young 2006b).

This pushed Hong Kong to the position of the world's second largest stock exchange in terms of capital raising, eclipsing even Wall Street. In 2006, London raised US$55.8 billion, Hong Kong raised US$43 billion, while New York raised US$37.1 billion (World Federation of Exchanges). Of Hong Kong's US$43 billion, US$37.5 billion was raised in IPOs of H-share or red-chip companies (Hong Kong Exchanges and Clearing Limited 2007).

One country, two systems: Hong Kong Exchange's dependence on Chinese business

I have commented previously on just how dependent the Hong Kong Exchange has become on Chinese business and how much it has become the world gateway for China's capital raising, but it is worthwhile revisiting how this tendency has progressed in the two years since I last addressed this issue.

In 2006, 'H' shares and red chips accounted for 47.68 per cent of Hong Kong's total market capitalisation (28.13 per cent in 2004; 26.88 per cent in 2000) and 56.39 per cent of total market turnover (45.58 per cent in 2004; 29.34 per cent in 2000). At 14 out of 38, the number of Chinese constituents of the Hang Seng Index remained fairly stable. A couple of Chinese companies—such as Denway Motors and Lenovo—had been deleted from the index, however, the addition of the heavyweight Chinese banks meant that the weighting of Chinese companies in the index increased significantly. Against this it should be noted that the free-float factor assigned to H-share companies by Hang Seng Services was relatively low. The Bank of China's free-float factor is as low as 30 per cent, and the Construction Bank's is a mere 15 per cent (HSI Services Limited 2007). Nonetheless, these are massive enterprises and, when China sneezes, the Hong Kong Stock Exchange gets a severe flu.

A new scale of deal comes to Hong Kong: can the deals keep flowing?

The flotation of the big banks was obviously the key factor in Hong Kong's rise to near domination of the world's capital-raising markets. But how sustainable is Hong Kong's new prominence in international equity markets in the near to medium term?

The entry of China into the Hong Kong market has fundamentally changed the scale of deals in that market and brought Hong Kong a new respectability in world markets. An interesting manifestation of this is the total disappearance of the small British merchant banks such as Wardleys, Standard Chartered Asia and Schroeders, which dominated the market in the 1980s and early 1990s, and their replacement with Wall Street heavyweights such as Goldman Sachs.[4]

Since the early 1990s, China has consistently supplied the Hong Kong market with a stream of deals that were much bigger than anything Hong Kong had seen before.

The banks are the latest indications of this trend. The large size of the bank deals is a response to the specific set of circumstances mentioned above. Are there any other large enterprises waiting in the wings to keep up the stream of deals to allow Hong Kong to maintain this prime position? In the long term, unquestionably; in the short to medium term, possibly. The best potential source of similar deals in the short to medium term lies in the terms of the tradable share reform. Implicit in this reform is the notion of mergers and acquisitions as a method of consolidation of shaky state enterprises and ultimately their privatisation. Privatisation is a fraught word in Chinese politics, but the action already taken in the banking sector recognises that minority shareholders are not simply cash cows to be milked at will but real participants in the decision-making processes of the enterprises. The search on the part of the listing banks for strategic partners makes this clear. So on-market mergers and acquisitions appear to be the coming trend in the domestic markets and particularly in state-owned companies. This is the area where we should look for the future mega-deal flow source for Hong Kong.

If we accept this proposition, the next question is which sector of the Chinese economy is poised to take advantage of this new set of opportunities? In my estimation, the next area for consolidation, financial strengthening and listing for international capital is the iron and steel sector. China is now the world's largest steel maker—producing 419 million tonnes in 2006, or more than one-third of total world production—but its steel companies are small and scattered. In the past couple of years, Chinese economic policymakers have looked with increasing concern at the consolidation of the world steel industry and the on-market merger and acquisition activities of Arcelor and Mittal. They recognise the urgent necessity for consolidation in the Chinese steel industry but have difficulty finding a base company for this consolidation. Local governments are too protective of the vested interests of their own local steel makers to allow this to happen easily. One possible solution being discussed actively in Beijing at the moment is the extension of the tradable share reform to the steel industry, the invitation of strategic partners, the raising of capital on world markets and consolidation through classic on-market mergers and acquisitions.[5] If this comes to pass, as now seems increasingly possible, Hong Kong is sure to have a major role and there are many other state-controlled industries lining up for similar reforms. These deals will probably not be as large as the banks, but they will be very large by any other standards.

So at this stage, Chinese deal flows do not seem to be a problem for the Hong Kong Stock Exchange. The real challenge to Hong Kong's pre-eminent position as China's world capital-raising gateway will come when the renminbi becomes freely tradable and foreign investors are able to put their money directly into Chinese enterprises. At that stage, all three Chinese exchanges suddenly become potential market leaders. It is invidious to make predictions at this stage as to which one will ultimately prevail. Hong Kong supporters point to Hong Kong's reputation as a well-regulated market that international capital can trust, and certainly there is plenty of evidence that that assertion is true. It is equally true, however, that the regulation of domestic markets has improved steadily and impressively in the past seven years to a stage where it is recognisable as being of international standard. Equally, capital is notoriously fickle. Institutional investors often make sheep look like animals of independent judgement and, if there's a buck to be made and all your colleagues are telling you to go to Shanghai ahead of Hong Kong, anything can happen—and surprisingly quickly.

Irrational exuberance? The valuation of the banks

The current boom could well be the source of future problems for Hong Kong. I am not in the business of predicting prices or market levels; I simply make the point that every boom is followed eventually by a bust, in which markets typically lose between 75 and 90 per cent of their boom value. The Japanese boom and bust of the 1980s and 1990s was eerily compliant with this old market saw.[6]

The current Chinese boom shows a lot of similarities with the Japanese boom of the 1980s. Price–equity ratios are hovering about the 40s—just where Japan was when things started to go south. A particularly worrying parallel is the emergence of Chinese banks among the world's largest by market cap. In the late 1980s, any list of the world's largest banks by market cap was dominated by Japanese banks, to the extent that there appeared to be little competition. A subsequent near-collapse of the Japanese banking system demonstrated that this status reflected the enormous amount of cash swishing around in the Japanese economy, not the underlying financial strength of the banks.

Now we see the phenomenon of the ICBC becoming the world's third largest bank by market cap, after Citibank and Bank of America, but ahead of HSBC. Between its listing in October 2006 and early March 2007, the ICBC's share price rose by 43 per cent (Reuters 2007). The ICBC and the other listed Chinese banks were trading at between 2.5 and 2.7 times book value—a significant premium to international banks, which typically trade at approximately 2.1 times book value (*The People's Daily* 2006d).

It is instructive to compare the quality of the ICBC's loan book with that of its now smaller rival HSBC. At first blush, the ICBC's loan book doesn't look too bad. During 2006, the ICBC saw its non-performing loan ratio decrease to 3.79 per cent for the year, from 4.69 per cent in 2005; however, this was after two major recapitalisations. The corresponding figure for 2004 was 21.16 per cent (*The People's Daily* 2006d). For the September quarter 2006, HSBC declared its non-performing loans to be 6.54 per cent of total assets (Lace Financial 2007). This is a poor figure coming on the heels of HSBC North America's problems with sub-prime loans and, on the face of it, would appear to be significantly worse than the ICBC's figure. The difference is that HSBC has a long track record of fixing problems caused by occasional poor credit decisions and the market usually prices it accordingly. The ICBC, in contrast, has a long record of recapitalisations and dilution of shareholder value. Perhaps it would be more reasonable to compare HSBC's 6.54 per cent with the ICBC's 2004 figure of 21.16 per cent. On this basis, investors' valuations of the ICBC would seem to reflect what Alan Greenspan, referring to another boom, called 'irrational exuberance'.

A coming bear market? Political implications?

Several other measures suggest that the domestic markets seem poised for a severe correction at best. Charting is an inexact science but it often has good predictive effects at the end of bull markets and the beginning of bear markets. Several chartists have pointed out similarities between the Shanghai chart and the NASDAQ chart shortly before the 'Tech wreck' of 2000. This involves a series of retests at the second standard deviation with Shanghai's April–July 2006 retests corresponding with NASDAQ's of June–April 1999 and Shanghai's of November 2006 – January 2007, corresponding with NASDAQ's of August–October 2007. The current (May 2007) Shanghai retest of the second deviation appears to correspond with NASDAQ's final retest of 2000, before it went into deep decline.

Who knows? So far, the market's random walk continues, but if a serious correction comes, the fact that even the institutions have a retail bent in China means that there will be political consequences. Many commentators believe that under Hu Jintao, the Left has taken advantage of his seeming vacillation on his own political stance to further its position. Certainly, in recent months the trickle of articles from sources such as the Chinese Academy of Social Sciences attacking 'neo-liberalism' in economic policy has become a torrent. Particularly during the refinancing of the banks and their subsequent listing, there was a raft of articles, sometimes in leftist publications such as *Utopia* but often in trade publications such as *Zhengzhuan Shichang Zhoukan*, arguing that the banks were being sold off too cheaply.[7] Whether this trend will have sufficient momentum in a securities-crash scenario to push the influence of the Left back into economic policymaking—where it has been weak for more than a decade and a half—is a contentious question. Certainly, the flagship of reform, *Caijing* magazine, felt it necessary on 28 January 2006 to publish a stinging article supporting the achievements of reform and exhorting policymakers not to turn from this path.[8]

In such an eventuality what does the Left have to replace the stock exchanges, other than a set of failed financing mechanisms? Whatever the shortcomings of the exchanges, it is clear that no one wants to go back to the methods of a planned economy. Too many people are involved, too many people make a living out of the exchanges and, at the end of the day, they solve an intractable problem: how to get capital for China's development. To replace this mechanism would require a revolution with unpredictable consequences, which is precisely what New China, with its emphasis on 'harmony', is not about to have.

Notes

1 Notes of discussion between the author and participants in the meeting. The precedents quoted for such action were Alexander Hamilton's support of the market in the panic of 1792 and US President Ronald Reagan's supposed intervention in the market (actually a loosening of liquidity by the Federal Reserve) after the crash of 1987.

2 World Federation of Exchanges 2007a. Note, however, that Japanese price–earnings ratios reached even more absurd levels during the mid 1990s when, it was rumoured, the Japanese government used Postal Savings Bank funds to support the market and avoid a feared meltdown in the banking system. The average price–earnings ratio in Tokyo in 1994 was 79.5X and in 1995 86.5X.

3 This sudden decline of nearly 10 per cent in one day took place just after the Chinese New Year holiday. Many investors were either away on holidays or hurting after the disbursements of the holiday period. It was possibly just a coincidence, but in a market as heavily retail weighted as the Chinese domestic market, such considerations matter.

4 Author's discussions with the Hong Kong Stock Exchange, May 2007.

5 Discussions between the author and economic ministries and commissions, Beijing, June 2006.

6 Note, of course, that the Japanese bust was distorted by the Japanese government's use of the Postal Savings Bank deposits to prop up the market at just above the level where it was estimated that a drop in value of the shareholdings of the banks threatened the integrity of the banking system.

7 For examples of the leftist criticisms of neo-liberalism, see *Guangming Daily* (2004) and *Securities Market Weekly* (2006).

8 Puping (2006). There is speculation that Huang Puping is the pseudonym of the intellectual father of *Caijing* and one of the early sponsors of the stock exchanges, Wang Boming.

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