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China's B-Share Market Reform: Capital Market Liberalization under Imperfect Currency Convertibility

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In February 2001, a major reform took place in China's stock market. Domestic residents have since been allowed to trade B-shares, which formerly were available only to foreign investors. The change is an attempt to liberalize the capital market under imperfect currency convertibility. The primary objective is to achieve more efficient utilization of the growing private foreign exchange savings in the country, rather than to seek unification of the domestic and foreign share markets. This change is consistent with the "easy-to-hard reform sequence," which is a basic characteristic of China's gradualist reform strategy.

KEYWORDS: China; stock market; B-shares; foreign investment; portfolio equity flow

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In February 2001, a major reform took place in China's stock market. Domestic residents have since been allowed to trade B-shares, which formerly were available only to foreign investors. The move was quickly interpreted as a step toward formal merger of the country's domestic and foreign share markets. This article will first introduce the background

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leading to the reform. It will then argue that the change is an attempt to liberalize the capital market under imperfect currency convertibility. The primary objective of this change is to achieve more efficient utilization of the growing private foreign exchange savings in the country, rather than to seek unification of the domestic and foreign share markets. A perhaps unintended consequence has been a transfer of B-shares from the hands of foreign to domestic investors. Such "domestification" of foreign equity capital has upset the B-share market's original function of acquiring equity capital from overseas. This may be consistent with China's present economic priorities, however, given that in China today the problem of inefficient capital utilization is more acute than troubles with capital shortage. The article will conclude by relating the development of the B-share market to the "easy-to-hard reform sequence," which is a basic characteristic of China's gradualist reform strategy.

The Rise and Fall of the B-Share Market

Chinese B-shares are a product of the shareholding system (*gufenzhi* 股份制) reform.[1] Under this system, Chinese state-owned enterprises are converted into shareholding companies, which issue a variety of shares: state shares (*guojia gu* 國家股), "legal person" shares (*faren gu* 法人股), and individual shares (*geren gu* 個人股). State shares are shares held by the state to represent state investment. "Legal person" shares are shares a shareholding enterprise issues to itself, and also shares acquired by other enterprises and institutions using state assets which they have a legal right to dispose. Individual shares are shares issued to workers of the issuing shareholding enterprise, and shares issued to the general public.[2]

[1]China's first shareholding enterprise was established in Beijing in 1984. In 1997, the shareholding system option was officially endorsed as the "mainstream reform program" for Chinese state-owned enterprises. For details of this development, see Ma Shu-Yun, "The Chinese Route to Privatization: The Evolution of the Shareholding System Option," *Asian Survey* 38, no. 4 (April 1998): 379-97.

[2]Xiao Zhuoji, *Zhongguo zhengquan quanshu* (China securities encyclopedia) (Beijing: Shangwu yinshuguan, 1995), 145-46; Yao Chengxi, *Stock Market and Futures Market in the People's Republic of China* (Hong Kong: Oxford University Press, 1998), 9-12, 16-19.

Table 1
Types of Chinese Shares

	Shares that are Nontransferable and Not Publicly Listed		Individual shares (Transferable and Publicly Listed)		
			Place of Listing		
			Shanghai and Shenzhen stock exchanges		Foreign venues such as the Hong Kong, New York, and Singapore stock exchanges
Owner	State	Enterprises	Domestic investors	Foreign investors (and also domestic investors since February 2001)	Foreign investors
				Foreign shares	
Types of Shares	State shares	"Legal person" shares	A-shares	B-shares	H-, N-, and S-shares

Initially, state and "legal person" shares were made nonnegotiable as a safeguard against draining state assets. Only individual shares could be traded at the Shanghai and Shenzhen stock exchanges. Individual shares listed on these two exchanges are known as A-shares and B-shares. A-shares are traded in the Chinese currency, the *yuan*, and are reserved for domestic enterprises and individuals. B-shares are traded in U.S. dollars in Shanghai, and in Hong Kong dollars in Shenzhen. In addition to A- and B-shares, some Chinese enterprises have issued shares in stock exchanges outside the mainland, such as Hong Kong, New York, and Singapore. Shares listed in these venues are known respectively as H-, N-, and S-shares.[3] Despite different names and places of listing, H-, N-, and S-shares are all available only to foreign (including Hong Kong) investors; as such, they are collectively known as foreign shares (*waizi gu* 外資股).[4] Until the February 2001 reform, this restriction on the availability of foreign shares to domestic investors applied also to B-shares. The different types of Chinese shares described above are summarized in table 1.

The issue of B-shares serves a number of purposes. The first is to

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[3] *Yazhou zhoukan* (Asia Week) (Hong Kong), February 26-March 4, 2001, 15.
[4] Xiao, *Zhongguo zhengquan quanshu*, 146-47.

Table 2
China's B-Share Market Statistics

	Number of B-share companies listed	Amount of B-shares issued (million shares)	Capital raised (million US$)	Turnover (daily average)		B-share index (yearly average)	
				Million shares	Million *yuan*	Shanghai	Shenzhen
1992	9	1,075	767	1.86	14.53	78	117
1993	19	1,279	657	6.86	41.30	75	121
1994	24	1,040	452	10.09	49.69	74	112
1995	34	1,090	402	9.79	31.48	55	71
1996	43	1,605	568	28.24	116.15	52	85
1997	51	2,510	973	37.06	178.55	73	140
1998	54	990	308	25.30	52.05	41	75
1999	108	177	46	51.95	114.64	37	75
2000	114	35,925	169	N.A.	N.A.	N.A.	N.A.

Sources: *Zhongguo zhengquan qihuo tongji nianjian* (China securities and futures statistical yearbook) (Beijing: Zhongguo tongji chubanshe, various years); *Zhongguo tongji nianjian 2001* (China statistical yearbook 2001) (Beijing: Zhongguo tongji chubanshe, 2001).

obtain external equity financing. From 1992 to 2000, Chinese enterprises raised a total of US$4.34 billion by issuing B-shares (see table 2). Secondly, the B-share market serves as an instrument for absorbing international financial techniques, as B-share issuers are supposed to prepare financial statements according to international accounting standards. Although A-share issuers are not required to comply with this rule, practices in the B-share market are expected to have spillover effects. Moreover, Chinese securities dealers are given the opportunity to learn from their international counterparts. Finally, by opening only to foreign but not domestic investors (until the change in February 2001), the B-share market served as an effective shelter between the domestic stock market and external shocks (more on this point below).[5]

Shortly after its inception, however, the B-share market went into a state of almost continuous decline. Occasional rallies notwithstanding, the

[5]Huang Yuncheng and Gao Xiaozhen, *Zhongguo zhengquan shichang* (China's securities market) (Wuhan: Hubei renmin chubanshe, 1999), 377-80.

general price trend has been downward, and turnover has been low, making B-shares rather illiquid (see table 2). This has been attributed to a number of factors: vague and unstable government policy; failure of companies to publish financial results in accordance with international requirements; inefficient dissemination of company information; high transaction cost; small size of the market; and competition from other foreign shares, especially H-shares (Chinese shares listed in Hong Kong).[6] As a result, investors—and even enterprises themselves—have become less and less interested in the B-share market. In 2000, only six new B-shares were listed.[7] Against such a background, a major reform of the B-share market was called for by the government and the industry.

Liberalizing the B-Share Market Under Imperfect Currency Convertibility

In February 2001, the China Securities Regulatory Commission (CSRC 中國證券監督管理委員會) announced that the B-share market would be opened also to domestic investors. The liberalization was quickly interpreted as a step toward merging the B-share and the A-share markets.[8] In fact, from the very beginning Chinese securities officials have regarded the B-share market only as a transitional device to solve the dilemma between the need for foreign equity capital on the one hand, and the intention to shelter the domestic stock market from external shocks on the other.[9] Reports hold that when the A-share market becomes mature enough, the B-share market would be merged with it. However, CSRC soon denied that the opening of the B-share market to domestic investors is a move toward this direction. It was made clear by CSRC that the A- and

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[6]Ibid., 380-83.

[7]*Xinbao* (Hong Kong Economic Journal), February 20, 2001.

[8]*China Economic News* (Hong Kong), March 12, 2001; *South China Morning Post* (Hong Kong), February 20, 2001.

[9]Liu Hongru, ed., *Zhongguo qiye haiwai shangshi huigu yu zhanwang* (The overseas listing of Chinese enterprises: Retrospect and Prospect) (Beijing: Caizheng chubanshe, 1998), 2.

B-share markets would not be merged in five to ten years' time.[10]

The real barrier between the A-share and B-share markets in fact lies not in the structure of the stock markets itself, but in the imperfect convertibility of the Chinese currency. The *yuan* is now convertible only on the current account but not on the capital account. Chinese leaders said that China intends to make the *yuan* fully convertible within five years after joining the World Trade Organization (WTO), and this process is expected to be gradual.[11] Before this full currency convertibility is accomplished, a formal removal of the barrier between the A- and B-share markets is technically difficult, if not impossible. Hence, the interpretation of the liberalization of the B-share market as a step toward merging it with the A-share market is only "wishful thinking."[12]

Apart from this technical factor, there are strategic reasons for the continued separation between the A-share and B-share markets. According to a joint study by the CSRC and the World Bank, the partition between the two markets has the advantage of reducing the domestic market's vulnerability to external shocks. A pullout of foreign capital from China would have a direct impact only on the price of foreign—but not domestic—shares. This would save China from a financial crisis such as what occurred in Mexico in early 1995.[13] Due at least partly to the same reason, China has suffered the least among the major Asian economies from the 1997 financial turmoil in Southeast Asia. Liberalization of the B-share market yet keeping the A- and B-share markets separate can be seen as a strategic compromise by China in face of the strong pressure for further financial opening arising from the country's accession to WTO. Moreover, a separate B-share market may be used as a laboratory for China's experimentation of new measures to revamp utilization of foreign equity capital. Possible examples include allowing foreign enterprises to issue B-shares,

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[10]*China Economic News*, April 9, 2001; *Ming Pao* (Daily) (Hong Kong), September 12, 2001; *Xinbao*, March 5, 2001.

[11]Tom Holland, "The Day of the Renminbi," *Far Eastern Economic Review*, November 30, 2000, 76-80.

[12]*Xinbao*, March 6, 2001.

[13]The World Bank, *China: The Emerging Capital Market*, vol. 2 (Washington, D.C.: The World Bank, 1995), 127-29.

dual listing of H-shares on the B-share market, and issuing B-share China depository receipts.[14]

If the B-share market has to exist separately from the A-share market at least in the foreseeable future, then some measures are required to boost this rather inactive market. The February 2001 liberalization of the B-share market was a major move in this regard. Within a month after announcement of the reform, about 500,000 new B-share accounts were opened, and the B-share indexes rose by 87 percent in Shanghai and 187 percent in Shenzhen. Given such clear signs of significant rise in the demand for B-shares, China's securities authority disclosed that it was examining ways to allow more companies in need of foreign exchange to list new shares on the B-share market. Twenty such companies have been in the pipeline. Existing B-share companies might also be allowed to issue additional stock. The central message is that, despite the unsatisfactory performance of the B-share market over the years, the government was still dedicated to developing it.[15]

To boost the B-share market by allowing entrance of domestic investors would also have favorable effects on the globalization of China's stock market. For example, a rise in B-share market capitalization resulting from the liberalization would increase the weight of the B-share market in the MSCI (Morgan Stanley Consumer Index) China Free Index. MSCI is a leading indicator for international institutional investors, and the MSCI China Free Index, a market capitalization-weighted stock index covering all Chinese stocks available to investors outside mainland China, is widely used among fund managers investing in Asia. Estimates hold that about 90 percent of international institutional equity assets in Asia are benchmarked to MSCI indexes.[16] That is to say, the liberalization of the B-share market would have an almost immediate and automatic effect of drawing the attention of international institutional investors to the market.

Another speculation about the reason behind the liberalization was

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[14]Pauline Loong, "Putting the Bite into China's Park," *Asiamoney* 12, no. 6 (July 2001): 39.

[15]*Ming Pao*, June 12, 2001; *South China Morning Post* and *Xinbao*, March 28, 2001.

[16]MSCI at <http://www.msci.com/overview/index.html> and HKEx at <http://www.hkex.com.hk/futures/futuresproduct/MSCI_proeip.htm>, October 13, 2001.

that the government was seeking to use these changes to boost up B-share prices in order to reduce their gap with A-share prices. A- and B-shares are both common shares, and by law they bear the same rights and same obligations. The separation between the two markets has produced different price trends, however, with A-shares traded at significant premium above B-shares. Some companies even have different issue prices and allotment prices for A- and B-shares. This practice has resulted in the situation of "same shares, same rights, same obligations, but different prices," which violates the basic principle of equality of shares of the same stock, as laid down in Article 130 of the Company Law.[17] The liberalization of the B-share market can be expected to help solve this problem by pushing B-share prices toward the A-share level.

However, there are at least two preconditions for the above to materialize: a rich possession of foreign exchange by Chinese domestic investors, and their willingness to invest the foreign exchange in the B-share market. After about two decades of economic opening to the outside world, the Chinese people have accumulated about US$130 billion of foreign exchange in domestic bank accounts, US$75 billion of which is held by individuals. On the other hand, total B-share market capitalization was merely US$7 billion at the time of liberalization of the market.[18] The amount of domestic private foreign exchange savings should thus be sufficient to bring about a rally of the B-share market.

How willing, however, are Chinese residents to invest their foreign exchange savings in the B-share market? They in fact do not have many legitimate choices. Under current foreign exchange control, Chinese holders of hard currencies cannot freely remit the money out from the country, but must leave the money either as idle cash or deposit it in commercial banks to earn artificially low interest.[19] However, the higher investment

[17]Chen Xiaoyun, *Zhongguo gupiao shichang* (China's stock market) (Hong Kong: Shangwu yinshuguan, 1997), 172, 224; *Xinbao*, March 1, 2001; Yao, *Stock Market and Futures Market*, 13.

[18]*South China Morning Post*, February 21, 2001.

[19]Xinhua Economic News Service, February 14, 2001; *Zhongguo waihui guanli* (Foreign Exchange), April 2001, 5.

returns overseas have induced capital flight through false invoicing, black market foreign exchange deals, and other malpractices. Earlier estimates of the amount of illegal capital flight from China range from US$20 billion to US$70 billion a year,[20] and the latest figure is US$17.6 billion per year between 1997 and 1999.[21] Opening the B-share market to domestic investors may help slow down such capital outflow by making B-shares a legal alternative to bank deposits. This is in fact the Chinese official reason for the liberalization of the B-share market.[22]

As B-share prices are expected to rise toward the A-share level, there has been an immediate rush for B-shares after the liberalization. Some domestic investors have even attempted to obtain the foreign exchange required for the purchase of B-shares from the black market, driving up the black market rates of both the U.S. and Hong Kong dollars.[23] To prevent black marketeers from entering into the B-share market, CSRC announced that foreign exchange deposited in Chinese domestic banks prior to February 19, 2001 could be used to buy B-shares. Foreign exchange deposited after this date could be so used only after June 1. Domestic residents have been allowed to open B-share accounts only in local banks and with local securities dealers (but not those in other cities). They cannot cash foreign exchange from the B-share accounts nor remit the foreign exchange in these accounts to a foreign country.[24] These rules represent China's effort to make liberalization of the B-share market compatible with the inconvertibility of the *yuan* on the capital account; that is to say, the stock market reform was not allowed to exceed the currency constraint.

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[20]Francois Gurtner, "The Stability of the Renminbi in the Wake of the Asian Financial Crisis," *Intereconomics* 34, no. 3 (May/June 1999): 135-43.; Steve H. Hanke, "Why China Won't Devalue," *Forbes* 164, no. 5 (September 6, 1999): 168; Pei Minxin, "Will China Become Another Indonesia?" *Foreign Policy*, no. 116 (Fall 1999): 94-109; Gerald Segal, "Does China Matter?" *Foreign Affairs* 78, no. 5 (September/October 1999): 24-36; *Xinbao*, May 23, 2001.

[21]*South China Morning Post*, July 26, 2001.

[22]Ibid., February 20, 2001; *Xinbao*, February 27, 2001.

[23]*Ming Pao*, February 21 and March 6, 2001; *Xinbao*, March 1, 2001.

[24]*Xinbao*, February 23, 2001.

"Domestification" of Foreign Equity Capital

In fact, the liberalization of the B-share market occurred simply to make an existing irregularity official. Estimates hold that about 70 to 80 percent of B-share investors were domestic investors, who entered the market by setting up illicit foreign accounts.[25] Now will the liberalization make the B-share market more attractive to foreign investors, thereby inducing additional inflow of foreign equity capital? Or will these changes result mainly in a "domestification" of foreign equity capital, meaning that B-shares will be transferred from the hands of foreign to domestic investors? Preliminary evidence seems to suggest that the trend has been toward the latter.

The B-share market reacted to the liberalization with an immediate soar in share prices. By the end of April 2001 (that is, two months after liberalization), the B-share price index had increased by more than twofold in both Shenzhen and Shanghai, and the premium of A-share prices over B-share prices had fallen to 44 percent, compared to 76 percent on the day before the liberalization.[26] Such response is rather expected, as the new policy allows domestic investors to capture arbitrage opportunities arising from the price disparity between A- and B-share prices. The question is: If it was so certain that B-share prices would rise dramatically after liberalization, and given that there was still significant premium of A-share prices over B-share prices, who would have been willing to sell their B-shares?

There are indications that those selling B-shares are mainly foreign investors. After the announcement of the liberalization and before the B-share market reopened, some fund managers had already stated that the new policy would attract only domestic investors and that foreign investors

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[25]Ibid., February 20 and 24, 2001; *Yazhou zhoukan*, February 26-March 4, 2001, 15.

[26]China Online at <http://www.chinaonline.com/financial_services/ABindexes/discount.asp>, May 1, 2001. For detailed analyses of the premium of A-share prices over B-share prices, see G.M. Chen, Bong-Soo Lee, and Oliver Rui, "Foreign Ownership Restrictions and Market Segmentation in China's Stock Markets," *Journal of Financial Research* 24, no. 1 (Spring 2001): 133-55; Qian Sun and Wilson H.S. Tong, "The Effect of Market Segmentation on Stock Prices: The China Syndrome," *Journal of Banking and Finance* 24, no. 12 (December 2000): 1875-1902.

who had suffered losses from the market would be unlikely to return.[27] Subsequent evidence seems to confirm these predictions. As a Hong Kong-based analyst wrote, "While tens of thousands of Chinese investors caught B-share fever, the reform has little significance for foreign institutional investors: the B-share markets' capitalization is still negligible even after the price surge. Moreover, the liquidity can dry up quickly, and there are few high-quality companies on the B-share markets whose fundamentals justify a price-to-earnings (PE) ratio higher than 30 times."[28] In late March 2001, foreign shareholders of two B-share companies announced a reduction of 5 percent of their B-share holdings.[29] Overall, the proportion of B-shares held by foreign investors has fallen from 40 percent in 1999 to less than 10 percent in August 2001.[30] On the other hand, a significant amount of domestic foreign exchange savings seemed to have shifted to the B-share market since announcement of the liberalization. From February 19 to May 30, 2001, the amount of domestic foreign exchange savings in the Shanghai branch of the Bank of China fell by US$130 million.[31]

Hence, one could argue that the initial major result of the liberalization of the B-share market has been to provide foreign investors with an opportunity to "exit" from the market. If this is the case, B-shares will remain as "foreign" shares only in terms of the transaction currency used rather than the nationality of the owners. B-shares will become mainly an investment alternative of Chinese private foreign exchange deposits, a trend that is contrary to the original function of the B-share market as a vehicle to attract portfolio equity flow from foreign countries. Nevertheless, this is perhaps consistent with the present Chinese economic priorities, given that in China today the problem of inefficient capital utilization is more acute than troubles with capital shortage. By the end of January 2001, China's foreign exchange reserves had grown to US$170 billion, the second largest

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[27]*Xinbao*, February 21, 2001.

[28]Jun Ma, "Financial Liberalization: Slow and Steady," *The China Business Review* 28, no. 3 (May/June 2001): 14.

[29]*Ming Pao*, March 30, 2001.

[30]*Xinbao*, May 18 and August 25, 2001.

[31]*Ming Pao*, June 1, 2001.

in the world.[32]

Conclusion

The liberalization of China's B-share market was not intended to facilitate a merger with the A-share market, but rather to achieve more efficient utilization of private foreign exchange savings. After the reform, the Chinese stock market remains divided into two sectors—domestic and foreign, but the basis of the separation has changed from owner nationality to transaction currency. In the sense that domestic residents are now allowed to trade B-shares as long as they have the foreign exchange from legitimate sources, given that foreign investors are still denied entry to the A-share market,[33] the liberalization is in favor of Chinese nationals but unfair to foreign investors. The resulting "domestification" of foreign equity capital may even be paralleled with a protectionist import-substitution in the product market.

The above, however, is not likely to prevent an eventual complete opening of China's stock market. After entering the WTO, national treatment for foreign companies requirement implies that foreign companies will also be allowed to enter the A-share market.[34] More importantly, as mentioned above, China intends to make the *yuan* fully convertible within five years after joining the WTO. By that time, the final barrier between the A- and B-share markets will disappear.

While the overall direction of China's reform has been toward further integration with the world economy, the recent liberalization of the B-share market shows that China still exercises a good grip on the sequence of reform. In the early 1990s, there was a debate about the desirable sequence of reform in the transition of centrally planned economies to a market system. The implied gradualism soon gave way to the "big bang" strategy,

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[32]*Global News Wire*, April 9, 2001.

[33]Art. 138 of China's Securities Law states explicitly that only Chinese nationals or Chinese legal persons may open A-share trading account.

[34]*Xinbao*, March 6, 2001.

which emphasizes comprehensiveness and speed.[35] However, the success of the Chinese reform, at least relative to that of many of the former Soviet bloc countries, suggests that China's "easy-to-hard reform sequence" is more viable than the all-at-one-time approach.[36] In the stock market experiment, China first established a separation between the domestic and foreign share markets, now opens the latter to domestic investors, and is expected to completely remove the barrier after the introduction of full currency convertibility. Such reform sequence—liberalization of foreign market after liberalization of domestic financial market—is consistent with McKinnon's well-known "order of economic liberalization."[37] The future development of China's stock market will offer a further test of this formula.

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[35] Jozef M. van Brabant, "Governance, Evolution, and the Transformation of Eastern Europe," in *The Evolutionary Transition to Capitalism*, ed. Kazimierz Z. Poznanski (Boulder, Colo.: Westview Press, 1995), 157-82.

[36] Anthony Koo and Norman P. Obst, "Dual-Track and Mandatory Quota in China's Price Reform," *Comparative Economic Studies* 37, no. 1 (Spring 1995): 1.

[37] Philip Arestis and Panicos Demetriades, "Financial Liberalization: The Experience of Developing Countries," *Eastern Economic Journal* 25, no. 4 (Fall 1999): 441-57.