Equinox Issue

SCHOLARLY REVIEW ONLINE

Dragon's Ascent: The Significance of Stock Exchanges in the Chinese Financial Revolution

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Introduction

The world's second by GDP, first by net exports, and second by domestic companies market capitalization, China is an unignorable participant of the world economy today (World Bank, 2021). However, this status on the world stage cannot be achieved without the financial revolution that forever altered the nation's economic destiny. The establishment of stock exchanges in China in the early 1990s was one the most important turning points in Chinese financial history, as it allowed for centralized exchanges of securities and, more importantly, signaled to the world China's determination to reform and open, ultimately resulting in huge success.

Financial Condition of China

When Mao died in 1976, he left China with an economy in desperate need of reform. At this point for nearly three decades, China strictly followed a Soviet-style planned economy, characterized by state ownership of the means of production, coordination of demand of supply through central planning, and five-year plans guiding China's industrialization. But even though the Soviet Model made China a largely industrialized country, it brought huge problems such as the low production efficiencies of State-Owned Industries, and the inability to replace the market allocation of goods with socialist production for use, causing China to remain a country still in poverty (Erasmus Universiteit Rotterdam, n.d.). Foreign investments were essentially nonexistent, as no one dared to "smuggle capitalism" into the hard-line Maoist state. Mao's successor, Deng Xiaoping, identified these flaws in China's system and initiated China's Reform and Opening-up Project. When the tide of reforms rolled around during the early 1980s, Deng implemented many ambitious plans to revitalize the dying economy.

Politically wise, through the speech "Advance Along the Road of Socialism with Chinese Characteristics", the Chinese leadership introduced the idea of setting economic development instead of class struggle as the new central task of the government. The government also made "Reform and Opening-up" a basic point of the government, thereby creating the slogan "One Central Task and Two Basic Points." This political reform will prove crucial to back future economic reforms in the country (China.org.cn, 2009).

When it came to the real economy, Chinese authorities used a more experimental approach. Deng acknowledged that pushing market reforms countrywide would be met with widespread opposition from conservative communists, so in 1980 he selected a few regions to experiment with opening up by "implementing special policies and flexible measures" (Zeng, 2010, p. 55). In these Special Economic Zones (SEZs), the city government was given autonomy to create market-like systems to attract investors. The most known of the SEZs are the city of Shenzhen and the

Pudong region of Shanghai, exactly where the two stock exchanges will be located in the future.

In terms of the financial market, a "stock" system started in the 1980s due to the need for enterprises to raise capital to bypass constraints on bank loaning set by the planned economy. In 1984 and 1985, Shanghai companies "Flying Music" and Yanzhong became the first to experiment with issuing company shares to the public with permission from the Central Bank. In the same year, Beijing Tianqiao Department Corporation became the first state-owned company to adopt a joint-stock system. In 1987, China held the Chinese Communist Party's thirteenth National People's Congress, in which the leaders of China specifically noted the importance of securities markets in the process of market reforms. The Congress encouraged the implementation of stock reforms for certain state-owned enterprises, laying the theoretical base for stock markets. By 1989, 6000 companies from all over the country had issued stocks in China, totaling RMB3.5 billion of capital raised through equity financing (国务院发展研究中心 市场经济研究所, 2019, p. 176).

With the increased issuance of stocks, the demand for stock transfer transactions gradually emerged. Stock buyers need to cash out their stocks when they have financial needs, but cannot find a place to trade them (Zhang, 2020, p. 7). To meet the needs of investors, on September 26, 1986, an over-the-counter (OTC) trading exchange for stocks, the Jing'an Securities Business Department of the ICBC Shanghai Trust and Investment Company, was opened after gaining approval from the central government. The Jing'an Department traded stocks from 8 companies, having a traded amount of US$400 million by 1990 (Avery et al., 2009, p. 238). However, OTC markets have significant differences from a formal stock exchange. The trading method of OTC markets was only through brokerage without computers or market display screens as in a stock exchange. Stock clearings and settlements, account registrations, stampings, and other procedures are all done manually with low efficiency. An OTC market can be a step to explore the possibility of capital market reforms but is not sufficient to be the backbone of the financial system.

At this point, it became obvious that China needed a complete system for a new capital market.

Establishment of the Stock Exchanges

On December 2, 1989, Zhu Rongji, then the Mayor of Shanghai, held a meeting on how to deepen the reform of Shanghai's financial system. Specifically, it mainly focused on the practicality of a Shanghai Stock Exchange. During the meeting, many pointed out potential problems that might arise from the privatization of previously state-owned companies, fearing that capitalism will bring widening of wealth gaps thereby leading to social unrest. However, after communicating with Shanghai bank officials, Zhu still concluded that the stock exchange was necessary for Shanghai's reform, and it must be completed despite obstacles. In the summer of 1990, Zhu officially announced the establishment of the Shanghai Stock Exchange (SSE) within the year during his visit to Hong Kong. As various preparatory work for the exchange made progress, on November 14, the Head Office of the People's Bank of China approved the establishment of the SSE, and on December 19, 1990, after the efforts and help of many parties, the SSE was officially established, signifying the birth of the first stock exchange in New China. On this day, the door to China's capital market officially opened.

This door was widened with another stock exchange in Shenzhen, China's newest financial capital in the south, on July 3, 1991. In April 1979, Deng said to the Guangdong provincial official: "Set aside an area in your Guangdong province," and "Establish a special zone. The central government didn't have money, so you had to do it yourself." With this said, on August 26, 1980, the Shenzhen Special Economic Zone was established. Shenzhen is a special city in China, its position as the fastest developing SEZ made it the best city to represent China's reform and opening up. As the testing hub for market reforms, Shenzhen allowed the issuance of stocks by many enterprises back in 1986, including the Shenzhen Development Bank, and had OTC trading counters similar to Shanghai. In May 1988, the then Shenzhen Mayor Li Hao led a delegation to visit London and attended a symposium, where many European mutual funds managers explained to him that European and American countries were willing to invest large amounts of capital in China, especially coastal cities such as Shenzhen. However, they also explained that their investment methods are generally through securities, and not direct investment in industry. They hope China could establish a standardized securities trading institution to provide them with an investment venue to enter the Chinese securities market as soon as possible. From Shenzhen's perspective, a stock exchange can continuously raise foreign capital in the securities market for Shenzhen's enterprises to improve economic efficiency. Therefore, in more than a year, the early builders of the Shenzhen Stock Exchange (SZSE) completed various preparatory work, and it opened the second door to China's capital market in July 1991 (Yu, 2020).

Just like how financial infrastructures brought prosperity to the Dutch and English centuries ago by connecting people to companies, the Chinese stock exchanges are made to connect both Chinese and foreign capital with enterprises in need of capital to expand.

Stock Exchanges' Role in China's Reform and Opening up

Nevertheless, in the years following the establishment of the two stock exchanges, they were more of a political showcase of China's determination to reform rather than an economic infrastructure crucial to the country (Xu, 2022).

One need for a political showcase would be that the sudden political turmoil at the end of the 80s raised doubts regarding China's reform policy. It is under such a difficult background that the Deng administration seeks to stabilize public opinion that China's reform will not stop, and there will be no return. Therefore, shouldering the "political significance", establishing the Shanghai Stock Exchange was put on the agenda (Tan, 2009).

The most straightforward goal of the Stock Exchanges is to smooth the path for future reforms. Affected by recent political movements, Chinese people start to think that their reform is simply a conservative compromise to preserve the current regime. However, all doubts cleared away as Zhu Rongji, the mayor of Shanghai, stated, "The SSE marks that our country will unswervingly continue to pursue the policy of reform and opening up," during the opening of the exchange. CCTV China also commented on the issue: "The establishment of the Shanghai Stock Exchange shows that our country is unswervingly continuing to pursue the policy of reform and opening up, adopting internationally accepted forms, and using securities to raise funds to serve socialist construction" (Yu, 2021). This delivers a message from the central government: radical political reforms at the moment will only cause unrest similar to those in the Soviet Union, so instead China will pursue a moderate path fitting to the reality that will eventually reach the goal, starting with economic reforms. Wei

Wenyuan, the first general manager of the SSE, also believed that "We can build even a stock exchange, the "jewel" on the "crown" of capitalism, so this fully demonstrates that China's determination to persist in reform will not waver" (Xu, 2022). Moreover, in the fourteenth National People's Congress held in 1994, the leadership recognized the importance of the new stock market to the economy and its role in helping create the new "socialist market economy system," finally settling questions around this new stock exchange (Avery et al., 2009, p. 239). Recognizing the gradual return of confidence among Chinese citizens, the Deng administration continued reform projects that were hindered by the chaos from the 1989 Tiananmen Incident. From Deng's southern tour and the establishment of the China Securities Regulatory Commission (CSRC) in 1992 to the inclusion of the market economy into the Constitution in 1999 to eventually the entry into WTO in 2001, Deng and his successors made countless reforms in the following years that essentially shaped modern China.

The "Reform and Opening-up" project is not just about reforms, but also about opening up. The 1989 political crisis in Beijing not only caused domestic doubts about this reform but also scared off foreign investors, leading to a halt in foreign investment and the withdrawal of foreign capital, both crucial for China. Therefore, another significant goal of the emergence of stock systems in China is a huge increase in confidence in foreign capital. Immediately after they were established, the Shanghai and Shenzhen exchanges introduced the B shares, shares traded in USD, to foreign investors. This B shares market enabled a channel for foreign investors to access the Chinese capital market. Examples of these B shares included the Shanghai Vacuum Electronic Device Corporation, which raised $74 million through equity financing from foreign investors' B shares. Internationally, this caused widespread relief and increased confidence. The New York Times believed that "China's socialist Government is racing ahead. China's bid to sell stocks to foreigners underscores its appetite for ways to raise foreign capital," and the emergence of B shares "is an eye-opener for both the Western underwriters." Moreover, when the Swiss Bank invested in Chinese firms through B Shares, Chinese companies further sought to "gain advice on how to adjust to a free market economy" (Wudunn, 1991, p. 1). Since the first B shares, China's emerging stock markets became an attractive destination for international investments, making conditional favorable for further integration into the world economy.

Growths and Developments of Chinese Stock Exchanges

The stock exchanges' roles as crucial economic infrastructures have only become of great importance in the long term, especially as China opens itself more to international finances. More and more international financial institutions and investors are actively participating. From January to August 2021, foreign investors' cumulative net purchases of Chinese stocks reached 1717 billion RMB, holding approximately 4.7% of the circulating market value. This aligns with China's national focus on the continuation of the opening-up policies (CSRC, 2020). However, the stock exchanges' most important use is still to serve the real economy. Over the past 30 years, the capital market has achieved a cumulative equity financing of more than 2.9 trillion dollars. As of November 2022, the Chinese stock exchange combined is the world's second-largest by total market capitalization with a total of 11.4 trillion dollars, the biggest out of any outside of the United States. In terms of capital raised through IPOs, China's two exchanges take the first and second spot by a large amount. On top of all of this, the Chinese stock system is the world's most liquid system, having 19.4 billion shares traded in 2022, more than double that of the US's 8 billion shares (WFE Statistics Team, 2023). This is all to show the immense impact that these exchanges have on the real economy of China.

Conclusion

In conclusion, establishing the Shanghai and Shenzhen Stock Exchanges marks a significant turning point in China's economic history, underscoring the transformative journey from a closed, planned economy to a dynamic, market-oriented powerhouse closely tied to the world. They were not merely financial institutions but a signal to continue the process of reform and opening up to both domestic and foreign capital. As China continues to open its doors wider to international finance, the exchanges will be the signal that China is not a guest to the capitalist world, but an active participant welcoming cooperation. In the end, stock exchanges are only one out of the infinite changes China experienced under Deng's leadership, making this era of great changes arguably the most important period in modern Chinese history.

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