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CHINA'S FINANCIAL MARKET CONTINUES TO EVOLVE

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Abstract

The breadth and depth of financial markets in contemporary China has been improving over the past forty years. This paper seeks to analysis of achievements and challenges in the development of financial markets in contemporary China. The findings in this paper revealed that although China's financial markets have a modern and quickly developing appearance, the financial markets are, nevertheless, still slowly and constantly developing, presenting new investment opportunities for both domestic and foreign investors.

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1. Introduction

Since the founding of the People's Republic of China in 1949. China has been pursuing a modernist vision of rapid economic development by implementing several policy variants. From the 1950s up to the 1970s, China followed the Soviet model of development, which in a way suppressed the economy and functionality of Chinese financial markets. It was only in 1978 that China started to abandon the planned system and gradually returned to a more market-oriented economy. 1978, therefore, marked the beginning of a suite of economic reform policies known as Reform and Opening 改革开放 (gǎigé kāifàng) which were instrumental in the development of Chinese financial markets to this date.

A financial market in general is a platform that permits the buying and selling of financial resources [1]. Financial markets are not particular places, but rather the totality of supply and demand for securities [2]. For this paper, financial markets have been sort into the following categories namely capital markets, money markets, foreign exchange markets, futures and derivatives markets as well as a collection of contractual investment markets, including mortgages, insurances and investment funds [3, 4].

After the adoption of reformist and open-door policy some forty years ago, Chinese financial markets have experienced tremendous development especially in the most recent decades. A strategic approach used by China to reform financial markets is termed “crossing the river by touching the stones” approach, which is a gradualistic method that optimizes policies though experimentation [5]. For the Chinese leadership, the ultimate goal of developing financial markets is to serve the real economy [6].

This gradualistic approach has been working well over the years because now financial markets are playing a greater role in determining the allocation of capital and economic resources [5, 1, 7]. This paper discusses achievements and challenges in the development of financial markets in contemporary China.

2. Overview of Development Financial Markets in Contemporary China

2.1. Capital Markets

The significant development of China's capital markets began in the 1980's, after the economic reforms of the late 1970's. The first 10 years were chaotic, lacking official rules and in some cases partial operations without approval from government [3]. During those days transactions was mostly done over-the-counter and trading was not centralized, a number of local small stock exchanges were in existence [8].

Then the capital markets were reformed in 1990 and this resulted in those small stock exchanges being disbanded to form two national stock exchanges: the Shanghai Stock Exchanges (SSE) and Shenzhen Stock Exchanges (SZSE) [9, 3]. These stock exchanges were established as self-regulatory institutions under the supervision of the China Securities Regulatory Commission (CSRC) [9].

2.1.1. Stock Markets

China's securities market evolved in tandem with the country's economic reform and opening up and the development of socialist market economy. Today, the Shanghai Stock Exchanges (SSE) and the Shenzhen Stock Exchanges (SZSE) are both amongst the top ten biggest exchanges in the world when measured by their market capitalization, see table 1. Large corporate listings are concentrated in Shanghai and in contrast, the Shenzhen Stock Exchange has a SME board for small startup companies [10].

Rank	Stock Exchanges	Market Cap
1	The NYSE (New York Stock Exchange)	$28.5 trillion
2	The NASDAQ Stock Exchange	$10 trillion
3	The Tokyo Exchange	$5.1 trillion
4	The Shanghai Stock Exchange	$4.9 trillion
5	The Euronext Stock Exchange	$4.82 trillion
6	The LSE (London Stock Exchange)	$4.59 trillion
7	The Hong Kong Stock Exchange	$4.23 trillion
8	The Shenzhen Stock Exchange	$3.28 trillion
9	The TSX (Toronto Stock Exchange)	$3 trillion
10	The Bombay Stock Exchange	$2.19 trillion
11	The NSE (National Stock Exchange of India)	$2.1 trillion
12	The ASX (Australian Securities Exchange)	$1.6 trillion
13	The Deutsch Börse Exchange	$1.56 trillion
14	The Swiss Exchange	$1.5 trillion
15	The Korea Exchange	$1.46 trillion
16	The NASDAQ Nordic Exchange	$1.37 trillion
17	The Taiwan Stock Exchange	$966 billion
18	Brasil Bolsa Balcão Exchange	$938 billion
19	Johannesburg Stock Exchange (JSE) Limited Exchange	$894 billion
20	Bolsas Mercados Exchange	$764 billion

Table 1: 20 Largest Stock Exchanges In 2019 (Source: finance.yahoo.com; by Haqqi, 2020)

Since the reforms of in the early 1990’s the growth of trade volumes of the two exchanges was very gradual in the first decade and a half. But beginning 2007 the two exchanges registered a significant jump in trade volume, as shown in the figure 1 below, marking the beginning of a growth phase that is more rapid.

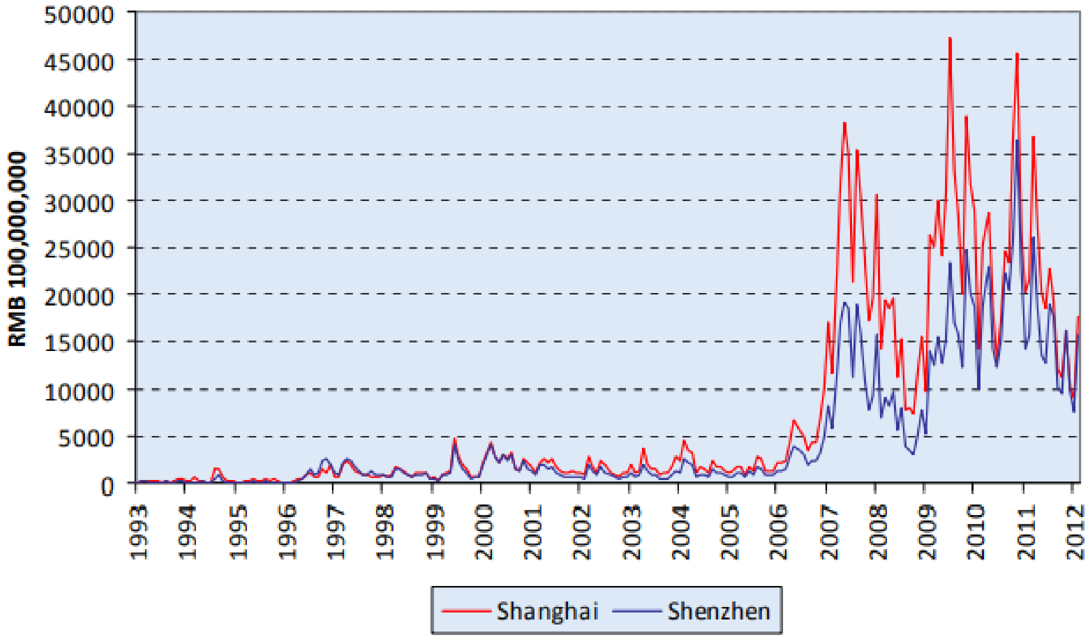

Figure 1:Trade value in SSE & SZSE Jan.1993 – Feb.2012 (Niemi, 2012).

The rapid growth was as a result of shares that belonged to state-owned enterprises, that were previously unavailable for trading, which were released for trading at the end of 2006, which drastically boosted the number of shares available in the markets.

As the supply of shares was increasing, demand for the shares also increased because of the increasing number of mutual funds operating in the stock market [11]. As the government implemented more generous loan policies, the liquidity in the financial markets improved [12].

2.1.2. Bond Markets

The bond markets were previously mostly open to domestic institutional investors [9]. However, under the Qualified Foreign Institutional Investor (QFII), the Renminbi Qualified Foreign Institutional Investor (RQFII) rules, and the Stock Connect programs, the Chinese bonds market have been opened to foreign investors [13]. This access was initially limited to stock exchanges but later expanded to the interbank markets as well, although still limited by quotas [14]. Foreign banks can also now get licence to act as lead underwriters for all deals in Chinese domestic interbank bonds market [15].

China's capital markets function in an advanced, computerized environment maintained by the China Foreign Exchange Trading System (CFETS). Transaction costs are lower enough to allow private individuals to trade. Lower interest returns from bank savings, high inflation and limited investment opportunities all are motivating factors why people invest hence markets are active [14]. The volume of trade is very good, making the secondary markets much liquid. To foreign investors, China's capital markets are tempting because of China's strong economic growth.

2.2. Money Markets

After many decades of development, the Chinese money market is growing rapidly and playing an increasingly important role in the financial markets of China [16]. It has registered significant improvements in light of its scale of trade and it aids as a key channel for monetary policy and a source of funding.

China's money markets perform a vital role in the financial markets of serving the needs of borrowers looking for short-term funding as well investors seeking for a low-risk cash management solution [17, 7]. The money markets are wholesale markets where trading usually involve large transactions [3]. China's money markets can be further categorized into four: the renminbi (RMB) lending market, the repo (outright repo) market, the bond market, and the bills market [9, 3, 18].

Historically, corporations operating their business in China had few options to manage their liquidity compared to international markets. Corporations operating in China have often faced the challenge of where to put their excess cash, with the best option not necessarily offering a good investment. However, improvements in China's credit rating and regulatory change have allowed Chinese money markets to develop substantially in recent years [19]. Regulatory changes and the quickening pace of interest rate liberalization are important forces in the Chinese financial market [17].

These reforms are pushing China's money markets further towards being truly market-led, and away from the communist-era command economy where officials set both the price and quantity of credit [20].

Operatively the money markets are technically modern and without excessive transaction costs [3, 20, 9]. The system is operated by CFETS under the Peoples Bank of China supervision. The authority makes no excessive profits from its services; therefore, the market is operationally efficient.

The liquidity in the money markets is decent, trading is mostly in short maturity and the volumes have increased greatly during the past years. Expanding the repo and bonds markets to the stock exchanges also contributed to the development of this market.

2.3. Foreign Exchange Markets

Foreign trade plays a central role in vitalizing China's economic growth. The resulting international transactions requires some form of market for exchanging different currencies.

Before the economic reforms of 1979, during the planned economy period which started in the 1953s, foreign trade was wholly conducted by state-run foreign trade companies and the foreign exchange transactions handled by the Bank of China. During the 1980s the state then gradually relaxed its control over foreign domestic trade. The Chinese government started to gather foreign reserves by insuring that of all the foreign currency that ended up in China, a portion was to be sold to the government at an official rate [3]. The remainder was allowed to be freely traded at market rate. This created a double-tracked exchange system [9].

During the most part of the planned economy period the RMB was fixed to the U.S. dollar at a rate of 2.4618 RMB against one U.S. dollar. Because the Chinese government was forced to adjust the rate on several accounts, it finally adopted a two-tier system in 1981, where the exchange rate was fixed at 1.50 RMB against one dollar as shown in figure 2. Again, due to the pressure from the appreciating U.S. dollar, China was forced to re-adjust the rate several times during the period from 1981 to 1994.

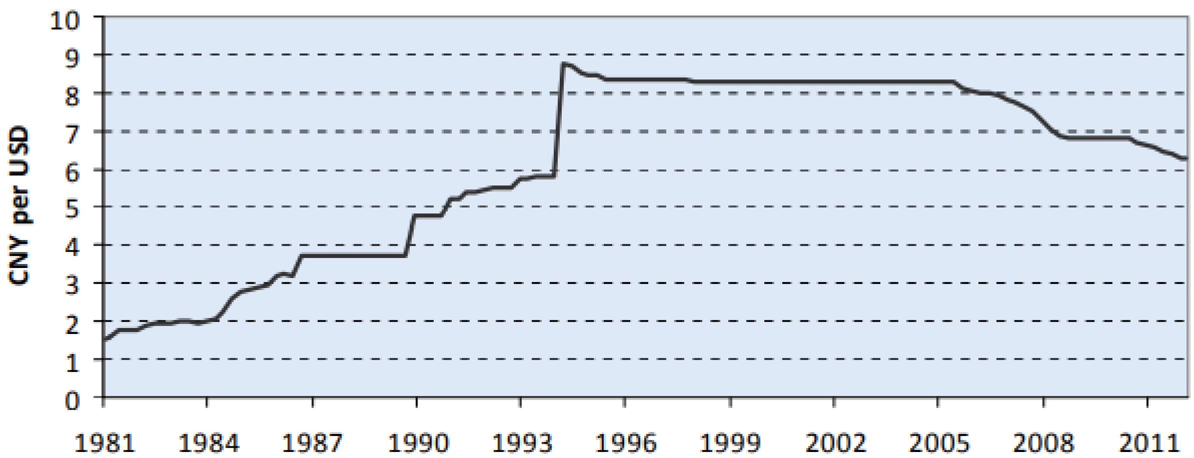

Figure 2: U.S. Dollar to Chinese Yuan Renminbi Exchange Rate (Niemi, 2012)

The two-tiered system was ended in 1994 when China adopted a single exchange rate system. A new foreign exchange market was formed in the interbank market amongst authorised banks. At that time the official rate was fixed to a at a rate of 8.70 RMB against one dollar, and later adjusted to 8.2770 RMB against one dollar following the 1997 Asian financial crisis [3].This fixed rate almost lasted for a dacade as shown in the figure 2 and then the government adopted the "Managed Floating Currency System" on 21 July 2005 [9].

The adoption of the Managed Floating Currency System was intended to improve the independence of monetary policy and to ease trade friction with the United States [21]. This system allowed the RMB to fluctuate in any direction as determined by the market forces, but then again, the government limited the rate at which it would fluctuate. At first the RMB was permitted to appreciate up to +/- 0.3% per day against the U.S. dollar, but this was later adjusted to +/- 0.5% per day [22].

Figure 3: U.S. Dollar to Chinese Yuan Renminbi Exchange Rate (Refinitiv, 2021)

Although floating exchange rate has been halted on several occasions during the financial crises to ensure stability, China continued progress towards a floating exchange rate in the first half of 2018 [22, 23]. Compared to 2005, when China initiated the reform of its exchange rate regime, the RMB is now more flexible with respect to the U.S. dollar and is now linked to the CFETS basket of currencies. This basket link allows China to manage competitiveness relative to a greater number of trading partners, rather than just the U.S. [22]. The rate between RMB and USD continues to trade in a narrow range on a daily basis. Although the flexibility of the renminbi had increased, predominantly since 2018, it still exhibits less volatility than other floating currencies (see figure 3). The Chinese government has been able to keep a tight control over the value of the renminbi because of the strong foreign reserves that China has accumulated over the years due to trade surpluses (see figure 4).

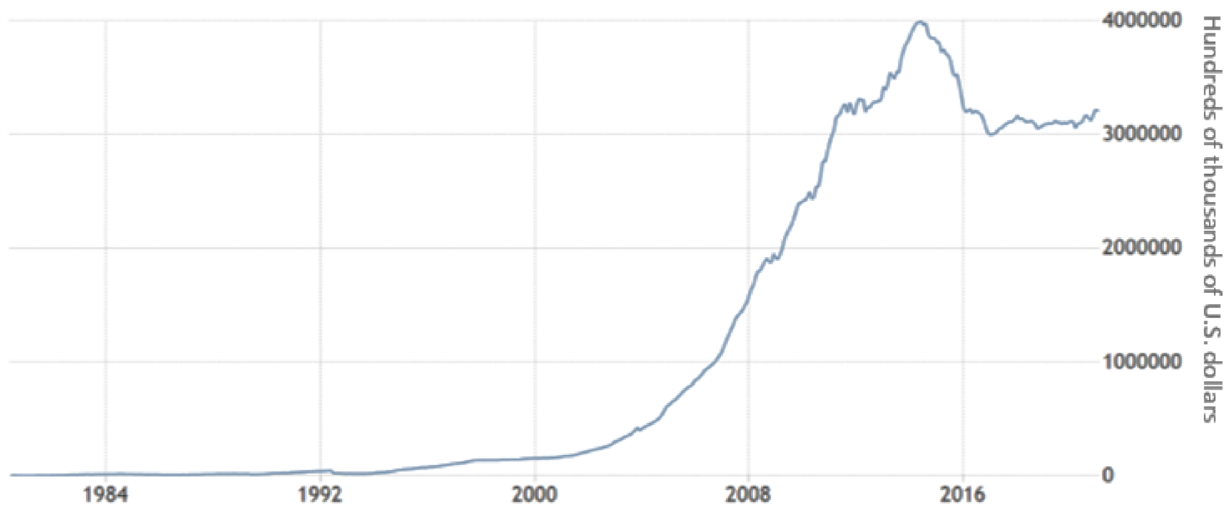

Figure 4: China Foreign Exchange Reserves, Source: tradingeconomics.com |People's Bank of China

The People's Republic of China took the initiative of ensuring that the Chinese Yuan was recognized internationally and used across the board [24]. This move was very important to the future internationalization of the yuan, making sure that it was the accepted currency of choice by all. It was also aimed at making conversion to other currencies much easier [3, 24].

2.4. Futures and Derivatives Markets

Financial derivatives, for example futures and forward contracts and options contracts, are useful in offsetting speculative risk involved in financial assets. Financial derivatives are still a relatively new product in China in contrast to Western markets [25].

The China's commodities futures market was established around the same time with the stock market. It was chaotic, lacked proper laws and regulations in the beginning and later in 1994 the futures market was placed under CSRC's supervision. The futures market was made available in three centers: the Shanghai Futures Exchange, the Zhengzhou Commodity Exchange, and the Dalian Commodity Exchange. More reforms and development continued in the early 2000s [3, 9].

In 2006 a financial futures exchange was created as a joint effort of the three commodities futures exchanges and the two stock exchanges. To date, China does have five domestic derivatives exchanges offering futures and options on agriculture, energy, metals, chemicals, equities and bonds.

Trading volumes have been rapidly increasing in recent years, as domestic participants are becoming more familiar with futures and options, and also demand from foreign participants is increasing [25]

2.5. Mortgage, Insurance and the Funds Industry

The China's strong economic growth brought about a budding middle-class population. A growing number of people now have excess income at their disposal. The need for social security like health, welfare and retirement creates a very strong desire to save money.

2.5.1. Mortgage Industry

The most common form of investment in China is the real estate. It is estimated that roughly two-thirds of Chinese household assets are tied up in real estate [26, 27]. Reasons why China's real estate gained popularity are many. China has a very huge population and people need a place to live in. Having a physical property is understandably considered a safer investment for many people.

2.5.2. Funds Industry

In China investment funds are a relatively new financial service for investors. The first investment funds were established in the early 1990s, but the industry only really begun to develop after new regulations were issued by the CSRC in November 1997. The funds can invest in both money and capital markets, but also in alternative investments such as real estate or venture capital [9].

2.5.3. Insurance Industry

During the planned economy before the reforms of the late 1970s, the insurance industry in China was run under one state-owned company, the People's Insurance Company of China. In the 1980s, reforms then made it possible for new companies to enter the insurance market (refer to figure 5). In China, property insurances and life insurance are the most popular types of insurance. The market segment is growing strong along with the growing middle-class population, showing great potential for the future.

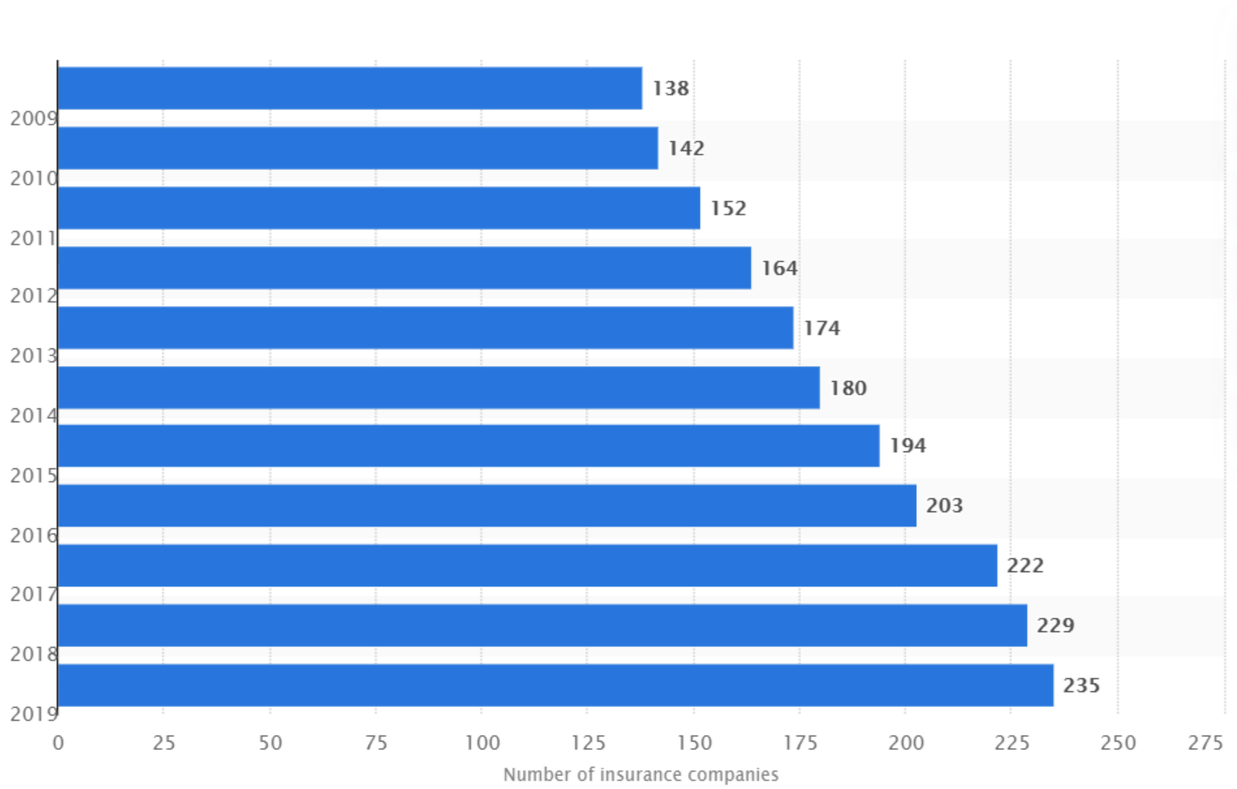

Figure 5: Number of insurance companies in China 2009-2019 | Statista 2020

3. Findings and discussions

As a result of the numerous reforms that has been stimulating growth and development in contemporary China over the past four decades, the impression that one gets is that China's financial markets are fully developed. China's financial markets are modern and operationally efficient; especially because its trading is done using the latest technology and there have been efforts to reform to match up against Western markets.

China's heavy investment in its markets' infrastructure, resulted in the costs of trading becoming lower and fair.

Liquidity in the China's financial markets is very good and is as a result of its very active economy.

However, underneath this establishment still exist some challenges that threaten the development and opening up of financial markets. Chief amongst them is heavy government control. The regulatory offices favor state-controlled businesses whilst it remains difficult for private operators to get licenses. This is not a surprise since the Chinese government is using a gradualistic approach in liberalizing their financial markets.

Accessibility is another critical factor which mostly affect foreign participants in the markets. Access by foreign participants is still limited and restricted, various government interventions, unpredictability and uncertainty outside the government circles adversely affect liquidity

Perhaps another biggest hindrance to further development of efficiency of the financial markets of China is the State control over both the value and the accessibility of the renminbi. This restricts the free flow of capital and suffocates the development of other financial markets. However, it is important to note that the Chinese government is making considerable efforts to curb this by internationalizing the renminbi.

The overall goal is to have a more open and international system. However, the development, is taking place at a careful pace decided by the Chinese government, not at the pace that the international audience might hope for.

Despite the gradualism in the development of financial markets in the contemporary China, its government shows great determination to continue reforming in the future. Though the business environment seems to be very harsh now, China's financial markets will continue to evolve. Those financial participants who will endure through the bureaucracy, legal challenges and sometimes corruption may as well be rewarded in the future.

China's financial markets are already very lucrative even though still developing. Big foreign financial institutions are aware of the positive developments taking place in China and are investing to ensure they may have a share on the future profits. However, for smaller foreign participants the entry to the Chinese financial markets maybe too difficult or expensive at this stage.

4. Conclusions

The breadth and depth of financial markets in China has been improving over the past forty years. However, despite the registered growth, the financial markets still show great potential for further positive development in the future through the continuation of economic reforms. This research was more explorative and qualitative in nature and the purpose of this study was to examine and analyze the development of contemporary China's financial markets.

This qualitative study was done by gathering facts and then analyzing them to assess the efficiency of the Chinese financial markets. Liquidity and accessibility, allocative and operational efficiencies were all used as measuring stick for this paper. It is in my opinion that, with appropriate policy and market reforms, development of China's financial markets would out do its current achievements and as well as overcoming current problems still prevalent in its financial markets. It is probably safe to conclude the financial markets will continue to evolve in the contemporary China.

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