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**Chinese securities markets' current status
and future outlook**

In terms of size, Chinese securities markets now rival their counterparts in developed countries, but they still differ substantially from Japanese, European, and American markets in two respects. First, securities settlement and clearing is extremely centralized in China. Second, Chinese markets have yet to develop much diversity of investment instruments. Nonetheless, Chinese securities markets will surely evolve toward convergence with developed countries' markets through changes in government policy and institutional and individual investor behavior.

Stock trading is predominantly DIY in China

The Chinese economy has continued to grow briskly even amid the global financial crisis. Contrary to previous concerns, it is projected to achieve 8% growth, putting it on track to soon supplant Japan as the world's second largest economy.

China's securities markets are likewise growing in tandem with its economy. As of October 31, 2009, stocks listed on the Shanghai and Shenzhen Stock Exchanges had an aggregate market capitalization of some ¥280 trillion (the Tokyo Stock Exchange's market capitalization was ¥301.9 trillion as of the same date). Additionally, there are 137,310,000 securities trading accounts in China.

From these numbers, Chinese securities markets may seem to have developed to approximate parity with Japan's, but in reality they have not.

Photo. Retail investors trade stocks at a brokerage branch



The photograph below shows customers in an ordinary branch office of a Chinese securities brokerage. Some are looking at the electronic share price board in the background. The standing ones facing the wall in the foreground are trading stocks, using trading terminals installed in the branch.

Investment consultations between brokers and clients, a common site at Japanese securities firms, are scarcely seen in China. Most stock trading by Chinese retail investors is done on a DIY (Do It Yourself) basis. In China, over 80% of stock trades are reportedly done online. Given DIY trading's predominance to begin with, online trading's widespread prevalence is only natural¹⁾.

Centralized trade settlement

To open an account and begin trading stocks in China, one must submit a new account application at a brokerage branch office. Information on such applications is uniformly registered in a database of the China Securities Depository & Clearing Corporation (CSD&C), China's central securities depository. Additionally, all stock trades must be executed on the Shanghai or Shenzhen Stock Exchange (mandatory market centralization). Trade data are uploaded en masse to a CSD&C database. Securities brokerages have records of their customers' personal data, account balances, and trading history, but these records are duplicates. In the event of a discrepancy, their records must be corrected to match CSD&C data. Additionally, Chinese individual investors must choose one brokerage to use for stock trading, unlike in Japan, where it is not uncommon for individual investors to have accounts at multiple

brokerages (e.g., one at a full-service brokerage and one at an online brokerage)²⁾.

Securities brokerages thus function solely as an interface with central entities (exchanges and the CSD&C). Extreme centralization of all securities trading (settlement and clearing) is a distinguishing characteristic of Chinese securities markets. Chinese retail investors ask nothing more of securities brokerages than to provide reliable access to the exchanges. Chinese securities brokerages fulfill hardly any of the functions of securities brokerages in advanced markets, such as providing asset allocation advice based on customer information or crossing customer orders in-house in lieu of forwarding them to an exchange³⁾.

Not much investment diversity

Chinese securities markets differ from Japan's in terms of what retail investors invest in. Securities trading in China is currently heavily weighted toward cash-market trading in domestic equities⁴⁾. Retail investors' are predominantly focused on capturing short-term gains through stock picking. The idea of investing in a diverse mix of asset classes with a medium- to long-term holding period is not widely prevalent.

Securities investment funds are available from some 60 asset management companies, but the vast majority of them pursue short-term capital gains through high-growth stock picking based on "proprietary information." Rather than selecting funds to meet diverse investment needs, Chinese fund investors seem to approach buying funds with a betting mentality.

Key drivers of Chinese security markets' future development

Among the factors that will shape Chinese securities markets' future development, the three that I expect to be most influential are (1) official policies, (2) development of pensions as a major force in capital markets, and (3) growth of a new individual investor class.

First, development of Chinese capital markets is led by government authorities, specifically the China Securities Regulatory Commission (CSRC). The authorities have a strong desire to catch up with the world's advanced capital markets. With respect to diversification of investment instruments in particular, the authorities are highly interested in and intensively studying how to promote international trading, develop bond markets, and proactively introduce futures and other derivatives. However, these policies must be coordinated with the overall private economy's development. The authorities will presumably proceed gradually with these policies, implementing them over a number of years.

Second, I expect pensions to emerge as a driving force of capital market development. China's population is aging even faster than Japan's, partly because of its one-child policy. Government policy is consequently shifting away from conventional social insurance, whereby the state comprehensively supports retirees, toward promoting self-funded pension plans. As this trend unfolds, institutional investors that manage pension assets on a medium- to long-term basis are likely to emerge.

The third factor is growth of a new individual investor class. Currently, hardly any wealth-building services are available from securities brokerages or other providers. However, I expect growth in the urban middle-class to be accompanied by growth in an individual investor class that invests its savings in securities to build wealth over the medium to long term. As services for such investors gain prevalence, securities brokerages' modus operandi also could change.

Although China's securities markets differ substantially from their Japanese, European, and American counterparts, they will surely converge with global standards as China continues to develop societally and economically and gain stature in the world. Chinese securities industry leaders are eager to absorb global best practices. They aim to choose the shortest route to developing domestic securities markets to close the gap between ideal and current reality.

Note

1) In China, anyone wishing to open a stock trading account is legally required to apply in person at a security brokerage's branch office. As part of the process, the applicant must be photographed at the office's counter with the branch name visible in the photo. The photo is then registered for identification purposes. Due to this rule, exclusively online securities brokerages do not exist in principle.

2) Strictly speaking, investors need not limit themselves to one brokerage to trade stocks listed on the Shenzhen exchange. Customer information in the CSD&C database can be modified through any securities brokerage. Securities brokerages do not possess customer information exclusive to themselves.

3) Because investors are limited to using one brokerage, securities brokerages' earnings are largely a function of how successful they are at getting investors to open accounts at their branches. Brokerages consequently staff their branches with "recruiters" paid by commission to conduct activities in the local community in the aim of inducing new customers to open accounts at the branch.

4) The government and companies issue bonds, but secondary market activity is limited to trading of listed government bonds and interbank bond trading among qualified participants. In terms of global trading, China is gradually opening its securities markets to foreign participants pursuant to an international convention dating back to China's WTO accession in December 2001. China has an investment quota system that imposes quantitative limits on investment of foreign capital in mainland-listed stocks (A-shares) and investment of domestic capital in foreign securities. Such investing is limited to cash-market transactions. Chinese securities markets lack adequate depth. Margin trading rules and systems have been established but margin trading has yet to begin because the authorities have not issued final approval for its commencement.

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