Is 'Domestic Circulation' the Future of the Capital Market?

It is impossible to talk about the development of China's capital market without bringing up its US counterpart. Many Chinese start-ups, unable to meet the rigorous requirements for a domestic IPO under China's approval system, have turned to the US as an alternative route for fundraising. The past two decades, however, have seen a drastic decline in the quantity of IPOs the NYSE and Nasdaq host each year. That said, this number harbours a growing percentage of foreign companies and China concept stocks (stocks of companies who conduct significant activities in mainland China) have represented over half of all foreign IPOs in the US during this time.

Lamentably, politics is trending in the US market. With the Holding Foreign Companies Accountable Act passed in the US Senate and the House by unanimous consent in 2020, US-listed foreign companies will be under stricter scrutiny. Companies are allowed three years to meet the new requirement, leaving a window for negotiations between China and the US regarding cross-border regulatory co-operation. Even so, such uncertainties will trouble both US-listed Chinese companies and the US capital market.

For many Chinese companies, the size and frequency of their US fundraising might not be possible if they had chosen to be listed in the Chinese mainland or even in Hong Kong, partly due to regulation and partly due to the level of market sophistication. The US capital market, in my opinion, has made a historical contribution to China concepts stocks and the fostering of China's start-up ecosystem. The depth and sophistication of the US capital market, its clout and the weight of its institutional investors are still arguably unparalleled in any other part of the world.

Either proactively seeking changes or out of fear of a harsher US regulatory environment for Chinese firms, China's capital market has recently undergone significant reforms, which I would call the con-

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struction of "a domestic substitute". In two years since 2019, the number of listed firms in China has increased by more than 400, driving the total number above 4,100. On top of that, an additional 2,000 companies are queueing for an IPO.

The reform of the domestic capital market, in my opinion, should follow a mantra of "capital supports industries, industries repay capital with returns." On the capital side, in a market with much liquidity, money is looking for capital gains and households are seeking wealth management vehicles, yet their investment options are limited by the lack of investment-worthy assets. On the industry side, tech companies are seeking substantial and ongoing funding. Hence, it is only reasonable to introduce the concept of 'domestic circulation' into the capital market. The effective pairing of the capital supply and demand depends on, without a doubt, whether the market can allocate resources efficiently and generate reasonable returns for investors. With that in mind, it is fair to say that China's capital market reform is moving in that direction and that progress has been made.

The capital market in China is still enjoying the dividends from favourable policies that have directly fuelled the boom in the venture capital ecosphere. Unavoidably, however, certain sectors are potentially overvalued, even to an extent comparable to the Nasdaq dotcom bubble or higher. Risks may ensue, but some smart money still chooses to stay and regulators have been relatively tolerant. The real problem in the market is a prevailing short-sightedness owing to a lack of long-term institutions. A short-term focus will lead to market volatilities and work against the long-term thinking much needed by tech start-ups.

The reform of China's capital market comes at the right time. The construction of a multi-layered capital market will better serve the capital operations of different companies throughout different stages of the business lifecycle. In the near future, the number of listed firms will quickly multiply and most industries will still be in their expansion stage. In the longer term, as the capital market plays an increasingly important part in the entrepreneurial world, integration between the industries is inevitable. As that happens, two contrary types of firms are likely to survive – namely, the big, highly profitable ones that can go from 1 to N and small/mid-sized innovative ones that can go from 0 to 1.

Furthermore, forward-looking financial institutions should see beyond the opportunities posed by IPOs. As the market shifts towards greater integration and higher efficiency, financial institutions should chart their future businesses accordingly to better position themselves in the next leg of the race. For them, how to envision new possibilities for their own development while exploring value-added services to guide and assist enterprises in planning the future is a question worth answering.

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