6. INTERNAL CAPITAL MARKET MISALLOCATION AND INEFFICIENT EXTERNAL CAPITAL MARKET: THE GUANGDONG ENTERPRISES GROUP

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Abstract: This chapter is a case study on the efficiency of internal and external capital markets in a representative “red chip” group—Guangdong Enterprises (Holdings) (GDE). Acting as a government fund-raising and investment vehicle, GDE has run the “government business” with little regard to economic logic and rules. We demonstrate that internal capital misallocation and external capital market inefficiency in this case are the outcomes of the contradictions between a government business and business economics in a market economy.

The business unit of a conglomerate can either raise capital directly from the external capital market or get funds from its corporate headquarters through the internal capital allocation process. In principle, many internal capital market transactions can take place in the external market. As a matter of fact, an important part of the capital allocation process in a diversified group is carried out in an internal market through which the corporate headquarters allocates capital to its their business units. In an internal capital market, the corporate headquarters pools all the funds available and is responsible for capital deployment within the group.

In recent years, research based on evidence from the United States and elsewhere has indicated that a policy of corporate diversification is value-reducing. The issue is directly related to the roles of external and internal capital markets. Stein (1997) identified conditions under which internal capital markets can function more efficiently than external capital...
markets, and Shafstein and Stein (1997) provided some explanations for the value reduction of corporate diversification. It is understood that financial institutions and financial markets may perform well in developed economies; hence, raising money from external capital markets may be efficient. However, a number of institutional fundamentals that are prerequisites for setting up an efficient external market are immature or incomplete in developing economies; therefore, internal capital markets may still play an important role there. Khanna and Palepu (2000) addressed the corporate focus issue in emerging capital markets by studying companies in India. They showed that, unlike the U.S. case, in India, firms affiliated with the most diversified groups outperform unaffiliated firms. However, Lins and Servaes (1999), in a sample of many firms from seven emerging markets, found diversified firms traded at an 8 percent discount compared to single-segment firms. These results provide little support for internal capital market efficiency in economies with severe capital market imperfections. To date, the evidence provided for emerging markets is inconclusive.

China provides a good opportunity to study the roles of external and internal markets. Over the past two decades, reforms in China have gradually transformed its command economy into a market economy. Under a command economic system, there is no external capital market (in a strict sense, state banks perform only as the coffers of the government), and capital is allocated predominantly through an internal mechanism. In the progress of the economic reform and opening up, China has established its fledging capital market, which is playing an increasingly important role in financing Chinese enterprises. In the meantime, China has permitted a small number of Chinese enterprises to tap international capital markets. In this context, red chips have been formed and developed. Red chips refer to mainland-controlled conglomerates incorporated and listed in Hong Kong. Red chips are mostly set up by, and represent, the interests of various branches of ministries, or the provincial and municipal governments in China. They raise funds from overseas capital markets and then allocate them, through an internal market, to many projects in China. Many red chips are engaged in well-diversified businesses both in Hong Kong and China. Thus, the unique features of red chips provide a good opportunity to study the roles of external and internal capital markets in Chinese enterprises.

In this chapter, a detailed clinical study of Guangdong Enterprises (GDE) and its group is reported. Boasting the two distinct characteristics of a red chip, a government background and stock exchange listing, GDE was established and wholly owned by the Guangdong provincial government in the early 1980s, acting as the province’s Hong Kong-based “window” company. GDE was one of the two key financing and investment arms of