



# Financial development and the cost of equity capital: Evidence from China



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## ABSTRACT

This study examines the relation between province-level financial development and the cost of equity in China. Our main findings are that (1) stock market development reduces the cost of equity in general, but the effect diminishes significantly in state-owned enterprises (SOEs) and firms with high growth potential or innovation intensity and (2) banking development only marginally lowers the cost of equity, but the effect is stronger in non-SOEs. Further analysis reveals that stock market development substitutes for such institutional factors as accounting quality, law enforcement, stock market integration and the split-share structure reform in lowering the cost of equity. We also find that lack of banking competition and banking marketization and under-development of the non-state economy partially account for the weak effect of banking development on the cost of equity.

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## 1. Introduction

This study examines the impact of regional financial development on the cost of equity capital in China, using a large sample of Chinese firms listed on the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) over the period from 1998 to 2008. Specifically, following the approach of Jayaratne and Strahan (1996) and Guiso et al. (2004a, 2004b), we investigate whether and how regional province-level financial development within the same country is associated with the cost of equity, and how the relation is

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conditioned upon institutional infrastructures such as legal enforcement, accounting quality and other regulations.

Over the past two decades, voluminous research has extensively examined the role of financial development in lowering economy-wide uncertainty and increasing economic performance and growth in a cross-country setting.<sup>3</sup> Nevertheless, previous research leaves still unresolved the question of whether and how financial development, as an independent institutional factor, affects the cost of equity capital. This line of research suggests that financial development reduces the cost of equity through enhancing liquidity provision (Levine, 2005), improving risk diversification (Acemoglu and Zilibotti, 1997; King and Levine, 1993b) and constraining agency costs and information asymmetry (Grossman and Stiglitz, 1980). However, the relation between financial development and the cost of equity could be endogenous because both are likely to be affected by common institutional infrastructures such as legal enforcement, disclosure regulation or security regulations. For example, La Porta et al. (1997, 2002a) show that a country's legal institution is a key determinant of its financial market development and Rajan and Zingales (1998) and Brown et al. (2013) associate financial disclosure regulation with financial development. The cost of equity is shown to be associated with institutional factors such as security regulations (Hail and Leuz, 2006), accounting disclosure requirements (Bushman and Smith, 2001; Bushman et al., 2004) and insider trading regulations (Bhattacharya and Daouk, 2002).

Previous research also has paid relatively little attention to the impact of financial development on a firm's cost of equity in transitional economies and emerging capital markets, wherein certain unique characteristics of their banking sector and stock markets, including state or government interventions in financial markets may shape the relation in a different way. For instance, in China, the stock market is characterized by a government-controlled listing process and the dominance of state-owned and politically-connected firms with preferential bank lending (Aharony et al., 2000; Li et al., 2008; Hung et al., 2012).<sup>4</sup> Existing evidence suggests that financial development under this backdrop can increase the cost of capital. Particularly, using a cross-country sample, Jain et al. (2012) find that state ownership increases the cost of equity. Their finding suggests that in transitional economies like China where the stock market consists mainly of state-owned enterprises (SOEs), stock market development can possibly increase shareholders' investment risk and thus the cost of equity. David (2008) shows that stock market development, coupled with short-sale constraints, engenders a high level of liquidity and investor heterogeneity, thereby resulting in excessive speculative activities. The banking sector in China is characterized by a lack of competition, and dominance of state-owned banks, lending discrimination against non-SOEs and lending preference to SOEs. In this setting, banking development can possibly deteriorate capital allocation efficiency (Wurgler, 2000; Dinç, 2005; Wiwattanakantang et al., 2006; Claessens et al., 2008) and bank monitoring efficiency (La Porta et al., 2002b; Chen et al., 2011a).

Combined, an important implication from the above discussion is that financial development may not necessarily decrease the cost of equity, and it may increase the cost of equity in certain scenarios. Therefore, the direction of the relation between the two is, in general, an open empirical question. Examining this issue in the Chinese setting is interesting and important for the following reasons. First, it helps us gain additional insights into whether and how stock market and banking development determine the cost of equity, and how their effects in emerging and transitional economies like China differ systematically from those predicted in developed economies. Second, China is the largest transitional economy in the world and its continuous and rapid financial development since the 1980s represents features of an emerging market in general and also exhibits unique Chinese characteristics. The richness of the common and unique features of China's financial

<sup>3</sup> For example, King and Levine (1993a), Levine (1997), Levine and Zervos (1998), and Beck and Levine (2002) examine relations between financial development and economic growth in a *cross-country* setting; Raddatz (2006) examines relations between financial development and uncertainty in economic growth in a *cross-country* setting. A notable exception is Guiso et al. (2004b) and Hasan et al. (2009) in that both studies examine the relation in a *single country* setting of Italy and China, respectively. The consensus of these studies is that financial development accelerates economic growth and/or reduces its uncertainty by providing better financial services such as more efficient liquidity provision, better risk diversification and reduced information, agency and transaction costs.

<sup>4</sup> For example, in China, overseas listing regulation requires approval from various government agencies such as ministries in central and provincial governments and the China Securities Regulatory Commission (CSRC). Hung et al. (2012) report that SOEs with strong political connections are more likely to be approved to list overseas, but their post-listing performance is worse, suggesting that their approval is driven by political motivation or private benefits and may not lead to efficient capital allocation.

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