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Government intervention and institutional trading strategy: Evidence from a transition country[☆]

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ABSTRACT

This study investigates the effectiveness of government intervention in rescuing bearish markets in a transition economy. Focusing on a pre- and a post-intervention period, the findings reveal that government intervention successfully rescued bearish markets in China and led to a fundamental change in institutional trading strategy after the intervention. We observe that following an intervention, institutions are more sensitive to long-term stock market regulations, whereas individual investors are more concerned about the rules related to their short-term interests. Evidence suggests that a credible signal from the government can be helpful in creating a positive outcome in the market (Bhanot & Kadapakkam, 2006). The findings are important to the current debate regarding the role of government intervention in markets in other transitional economies, as well as in developed countries.

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1. Introduction

Could a government intervention turn around a bear market? Or could a government intervention rebuild institutional confidence in a bear market and consequently change institutional trading strategy?

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Answers to those questions have begun to accumulate over the last several years, but the sum conclusion is still unclear. Many economists believe that government intervention plays an important role in reducing stock market volatility by enforcing new rules, whereas opponents believe that government intervention creates inefficiency in the stock market.

Official governmental intervention in the stock market is relatively rare, unlike in the foreign-exchange markets. Even during a crash, governments of developed countries generally prefer to affect their stock markets by indirectly adjusting interest rates. In some emerging markets, however, the practice is different. For example, in China, a country in which the stock market is an experiment that blends a market economy with central planning, government intervention plays an essential and active role. In fact, the Chinese government indirectly intervenes in overheated stock markets or stock market crashes, usually by implementing a series of new regulations and requirements (including market control, administrative control, and sometimes both). Such interventions provide an opportunity to investigate typical examples of government intervention in the stock market. This study evaluates the market reactions to the Chinese government's 2004 intervention efforts to rescue a bearish market.

From 2001–2003 the Chinese equity-market index fell approximately 40%, thereby reaching the lowest point ever in China's stock market history and thus precipitating the 2004 intervention. This plummet was mainly fueled by investors' expectations of "Split Share Structure Reform" (SSSR), which significantly changed the ownership characteristics of many Chinese companies.[1] As a result of such a large drop in the stock market following the announcement of this split structure, the Chinese government temporarily discontinued SSSR in October 2001 (see Table 2). In order to rebuild investors' confidence, China's State Council (the country's highest governing body) sent another intervention signal to the market in February 2004 by implementing a series of new regulations that encouraged foreign institutional investment (increasing the supply of investment to the stock market), adjusted stamp taxes, and controlled the magnitude of initial public offerings (IPOs) and seasoned equity offerings (SEOs) in order to move stock prices upwards (see Table 2). This regulation, known as *Guo Jiu Tiao* or "the 2004 Regulation," has been considered the most important regulation in the history of the Chinese stock market.

Overall, SSSR and the 2004 Regulation were considered contradictory government interventions. First, investors expected a negative market reaction (liquidity problem) to SSSR, which was eventually enacted in May 2005. On the other hand, the 2004 Regulation sent a positive signal regarding ensuring steady capital-market development.

The main objective of this study is to investigate, from an institutional perspective, the effectiveness of China's 2004 Regulation in rescuing its 2001–2003 bearish markets. We find that institutions regarded the 2004 Regulation as a long-term credible signal from the Chinese government, and therefore made rational trading decisions and changed their trading strategies after the 2004 intervention, unlike individual investors. Because no index future is available in China, institutions cannot hedge long or short positions against declines in value. Instead, institutional holdings and their abnormal returns are significantly positively related.

Nevertheless, individual investors were affected not by the 2004 Regulation, but by SSSR; investors were more worried about the short-term negative impact of SSSR than were institutional investors. Individual investors in turn became optimistic about the market after SSSR became effective in 2005. Although SSSR and the 2004 Regulation constitute indirect market intervention, a recent example of the Chinese government's direct intervention in the stock market occurred in 1998, when Hong Kong's Hang Seng index fell 30% in a single month. The next month, the Hong Kong (HK) government purchased HK$118 billion worth of shares in the 33 Hang Seng stocks that accounted for more than 75% of the market trading volume. Su, Yip, and Wong (2002) find that the 1998 HK government intervention had a significant and positive impact on the stock market, as the intervention reversed the declining market trend and stabilized the volatile market. Bhanot and Kadapakkam (2006) attributed such an impact to "information effects associated with a credible signal from the government," rather than temporary or permanent price-pressure effects.

[1] In China's transition economy, literally all listed firms are carved out of state-owned enterprises (SOEs). The parent SOEs are controlling shareholders that hold the nonpublic, nontradable shares of listed firms, whereas the minority shareholders hold tradable shares (in the wake of initial public offerings). Nontradable shares can only be bought and sold through negotiations or auctions with special approval from the government. Because tradable and nontradable stocks have the same voting rights but different prices, the Chinese government attempted to convert nontradable shares to tradable shares by implementing SSSR. However, if all nontradable stocks became tradable, the number of shares outstanding would increase by three times and investors would consequently face tough liquidity problems because of insufficient money supply in China's stock market.

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