



Domestic versus foreign equity shares: Which are more costly to trade in the Chinese market?

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ABSTRACT

This paper investigates the transaction costs of the domestic and foreign shares in the Chinese market after the 2001 reform. We find that the higher transaction costs of foreign shares (vs. domestic shares) on the Shanghai Stock Exchange are attributable to their less active trading activities, higher volatility of trade-by-trade price returns, higher probability of information-based trading, and bigger relative tick for quoted prices. In contrast, the lower transaction costs of foreign shares (vs. domestic shares) on the Shenzhen Stock Exchange are mainly due to their lower degree of discreteness for quoted prices.

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1. Introduction

China, with a fifth of the world's population, is becoming the world's second-largest economy.¹ In addition, the Chinese currency (RMB) has started to trade in world markets outside mainland China's borders.² To international investors and global portfolio managers, the publicly traded companies in China may offer a faster growth potential than those in the developed countries. The modern Chinese equity markets, with only about two decades of history, have their unique regulations and structures. Currently, there are more than one thousand publicly traded firms in China, and their stock shares are listed on the Shanghai or the Shenzhen Stock Exchange, but not both. Most of the public firms only issue domestic (A) stock shares, and a small number of the public firms issue both domestic (A) and foreign (B) stock shares. Generally speaking, the domestic share investment is restricted to Chinese citizens, whereas the foreign share investment is restricted to foreigners. Before February 19, 2001, the domestic and foreign markets were completely segmented. After that, the B-share market has opened up for domestic individual investors with foreign currency holdings. This policy removed some barrier between the A- and B-share markets. Nevertheless, since the Chinese citizens cannot buy foreign currencies freely, they cannot purchase B-share stocks readily. Thus, the A- and B-share markets are still segmented to a certain degree.

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¹ See the article "Today's Economic Reports, Made in China" which appeared in the Wall Street Journal, September 1, 2010.

² See the article "China Speeds Yuan Push" in the Wall Street Journal, April 20, 2011.

Researchers have explored extensively the A- and B-share differences in three areas: pricing, price discovery, and market efficiency. First, studies have shown that in most countries where firms issue both foreign and domestic shares, the prices of the foreign shares tend to be higher than those of the domestic shares. But in China, it is the opposite; that is, the B share is sold at a discount, though the discount declines after the 2001 reform. [Fung, Lee, and Leung \(2000\)](#) find that the latent risk premiums for the A and B shares are weakly correlated. The result suggests that the A- and B-share markets are segmented and are affected by different fundamental forces. [Chen, Lee, and Rui \(2001\)](#) document significant price discounts for the B shares relative to the A shares, and attribute the price difference to illiquidity of the B-share market. [Yeh, Lee, and Pen \(2002\)](#) report that the lagged premiums of the A over B shares have predictive power for future returns and volatility of both shares. [Eun and Huang \(2007\)](#) point out that investors value the A shares more than the B shares, implying a lower cost of capital for the A shares. [Lee, Rui, and Wu \(2007\)](#) find that the B-share price discount declines substantially after the lifting of restrictions on foreign ownership in China, but the H-share discount remains virtually unchanged. This implies that the B-share discount is largely due to the market segmentation. [Chan, Menkveld, and Yang \(2008\)](#) examine the effect of information asymmetry on equity prices in the A- and B-share markets in China. They show that the price impact measure and the adverse selection component of bid–ask spread explain 44% and 46% of the variation in the B-share price discount, respectively.

Second, existing studies show that the A and B shares vary in price discovery, but the difference tends to weaken or disappear after the 2001 reform. [Yang \(2003\)](#) examines the links among the six Chinese market price indexes: the Shanghai A share, the Shanghai B share, the Shenzhen A share, the Shenzhen B share, the Hong Kong H share, and the red chip stock price indexes. They find that each of these markets is not linked to other markets in the long run. Further, there is evidence that foreign investors in the Shanghai B-share market are better informed than domestic investors in the two A-share markets and foreign investors in the Shenzhen and Hong Kong markets. [Chan, Menkveld, and Yang \(2007\)](#) analyze the intraday interdependence of order flows and price movement of the A and B shares in the Chinese markets. Before the 2001 reform, the two markets are segmented, and the A-share market leads the B-share market in price discovery. After that, the domestic investors are allowed to invest in the B-share market with foreign currencies, and both markets have the same price discovery. [Chiang, Nelling, and Tan \(2008\)](#) investigate the speed of price adjustment in the Chinese A- and B-share stock markets. They use a VAR model to show that the A shares adjust to information faster than the B shares. They also find that the A shares react more quickly to bad news, while the B shares react more quickly to good news. The difference in the speed of adjustment between the A and B shares decreases following the 2001 liberalization of financial policy.

Third, the A- and B-share markets differ in market efficiency, and the efficiency improves after the 2001 reform. [Gao and Tse \(2004\)](#) study the market response to earnings events. In the B-share market, positive abnormal returns are associated with positive earnings surprise, and negative abnormal returns go with negative earnings surprise. In the A-share market, however, the pre-event abnormal trading volumes exist without significant price changes, which may be due to the information leak in the A-share market prior to earnings announcements. [Huang \(2009\)](#) tests the weak-form efficient market hypothesis (EMH) of the A and B shares on the Shanghai and Shenzhen exchanges. Prior to the 2001 reform, only the Shanghai A shares support the weak-form EMH, whereas the Shenzhen A shares, the Shanghai B shares, and the Shenzhen B shares are rejected for the weak-form EMH. After the reform, all four market segments support the EMH. The improvement of market efficiency can be explained by the increased liquidity accompanying the market deregulation.

Although research outcomes on the Chinese domestic and foreign shares are abundant, much less attention has been paid to the intraday trading activities of the two types of shares. According to [He, Wu, and Chen \(2003\)](#) and [Chen, Kim, and Rui \(2005\)](#), the B shares have much wider percentage bid–ask spreads than the A shares in the Chinese markets, based on the daily data before the 2001 reform. The reform in 2001 may affect the intraday transaction costs and other activities of the domestic versus foreign shares, and this issue warrants an immediate attention. Our study attempts to address the following questions.

- The intraday patterns of transaction costs for the Chinese A and B shares are unknown. Are they comparable to the patterns in other markets such as the NYSE? Do the A and B shares have the same intraday patterns? Do the B shares have higher transaction costs than the A shares throughout a day?
- Given that the A- and B-share differences in pricing, price discovery, and market efficiency have become insignificant after the 2001 reform, does the A- and B-share disparity in bid–ask spread disappear after 2001? If not, on the Shanghai Stock Exchange, are the B shares still more costly to trade than the A shares? What about those on the Shenzhen Stock Exchange?
- Since a pair of A and B shares are issued by the same company, they are the same in terms of fundamental factors such as firm size and expected future cash flows. In addition, a pair of A and B shares are listed on the same exchange, and thus they have basically the same market structure for quoting and trading. Then, how can one explain the difference in transaction cost if there is any? What are the factors that affect transaction cost and cause the A- and B-share difference in transaction cost? Are these factors largely market microstructure factors?

To answer the above questions, we examine the intraday transaction costs and other trading activities of domestic versus foreign shares in the Shanghai and Shenzhen markets. Our sample period is from April 1 to October 31 of 2003, which is about two years after the 2001 reform. Previous studies categorize the Chinese stocks mainly as domestic and foreign shares. By contrast, we classify our sample stocks by ownership and exchange, and divide them into four market segments: the Shanghai A shares (SHA), the Shanghai B shares (SHB), the Shenzhen A shares (SZA), and the Shenzhen B shares (SZB). In our empirical investigations, we analyze the A- and B-share difference in transaction cost on each exchange, and explore whether the A- and B-share disparity patterns are consistent across the two exchanges in China.

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