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The stock market in China: An endogenous adjustment process responding to the demands of economic reform and growth

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ABSTRACT

Evaluations of China's stock market range from extremely favourable assessments that emphasise GDP growth rates, financial depth or the rapid growth of privatisation to extremely negative assessments that favour market efficiency or short-term profitability to the exclusion of alternative interpretations. This paper investigates the stock market performance in China through an overview of the rationale and events underpinning its development and by exploring the hypothesis that the co-evolution of stock market alongside financial development is in no way limited to attaining market efficiency. The paper argues that China's stock market, which is mainly accessible to large state-owned enterprises (SOEs), can be seen as adaptive and effective if its emergence and rapid development are understood as an endogenous adjustment process of financial development in response to both the demands of economic growth and changes in political constraints. The findings of this study present a conceptual model of China's stock market efficiency that takes into account the country's idiosyncratic social, economic and political environments. The paper contributes to the literature by offering a holistic view of the role of historical developments, policy initiatives, investors' behaviour and the economic aspirations of China as they pertain to stock market efficiency.

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1. Introduction

The stock market in China has developed rapidly since the early 1990s, with the establishment of the Shanghai Stock Exchange and the Shenzhen Stock Exchange. In 2007, the Chinese stock market overtook the Japanese market in terms of capitalization and topped the world in initial public offerings (IPO), underlining the dramatic surge in the country's financial sector. Nonetheless, within one year the Chinese stock market plunged to less than a third of the value it held at its peak. This marks the most rapid decline of any major market in the world even against the backdrop of a global financial crisis.

The high level of volatility and the rapid growth of the Chinese stock market have attracted numerous empirical studies that have focused on market operation and efficiency. The traditional concept of the efficient-market hypothesis (EMH) has been widely used to explore the market efficiency of shares traded on the two Chinese stock exchanges. The literature shows that there have been departures from weak-form efficiency in terms of predictability or returns on the basis of their own past values (Fifield & Jetty, 2008; Groenewold, Tang, & Wu, 2001). Wang, Burton, and Power (2004) concluded that, over the observed period in their study, the conventional impression that there is greater efficiency in the pricing of domestically owned equities, namely A shares, is also open to debate.

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That being said, it is not realistic to expect China to meet market efficiency criteria that are more relevant to a developed market economy—a stage China has clearly not yet attained. The difficulty facing China is in implementing regulatory changes in a rapidly evolving economy that are consistent with her political, social and economic objectives and realities. There is no doubt that regulatory changes that improve information quality will lead to prices impounding information more rapidly, improving market efficiency. This paper investigates and extrapolates on the assessment of the Chinese stock market presented by Maswana (2008) and Park (2004) by considering the hypothesis that a co-evolving stock market as an aspect of financial development is in no way limited to attaining market efficiency. Rather, the workability of this emerging capital market depends on whether it is compatible with economic reform and growth targets. The economic direction of China's quasi open market economy is still strongly influenced by the state. Keynes (1936) stated that stock valuation might not necessarily be an estimate of the fair value of stocks, but rather a convention that provides the necessary stability and liquidity for investment. According to Keynes (1936, p. 152), 'the essence of this convention, though it does not, of course, work out so simply, lies in the assumption that the existing state of affairs will continue indefinitely, in so far as we have specific reasons to expect a change'. In this context, the 'state of affairs' is very much influenced by the state in the Chinese economy, including the growth targets of the government.

The structure of this paper is as follows: the next Section 2 provides a brief review of the theory of financial development. Section 3 outlines China's financial reform and the need to establish a stock market in China. Sections 4 and 5 detail the development phases of the stock market as an endogenous adjustment process responding to reform and growth targets. Section 6 discusses the effectiveness of the stock market, while the final Section 7 presents the conclusion and suggests directions for further research.

2. Financial development theories

Is finance a leading sector in economic development, or does it simply follow growth in real output that is generated elsewhere? Systematic analyses of the relationship between financial development and economic development first emerged in the 1950s and 1960s, conducted by Goldsmith (1955, 1969), Gurley and Shaw (1955), Mauri (1965) and Patrick (1966). The treatment of financial development as a process and strategy within economic development was pioneered by Gurley and Shaw (1967), McKinnon (1973) and Shaw (1973). Yet it was some time before development economists recognized the importance of financial development to economic growth.

Financial development, according to Drake (1980), is defined as the expansion and elaboration of financial structure, which encompasses institutions and instruments over time and space. Kitchen (1986, Ch. 3) argues that a fully developed financial system consists of 'a wide range of institutions, instruments, and activities, such as may be seen in the industrialized countries of the West. It is not of course a static system, but one which is changing continuously as new institutions and instruments are developed'.

McKinnon (1973) and Shaw (1973) assert that usury restrictions on interest rates and compulsory credit allocations interact with price inflation to reduce the attractiveness of holding claims on the domestic banking system. In such a repressed financial system, real interest rates on deposits are often negative, and are difficult to predict when inflation is high and/or unstable. Thus, the demand for money falls in proportion to gross national product (GNP). A rise in real interest rates will reduce the demand for investible funds; however, in so far as this also increases savings it can actually increase the level of investment overall. Therefore, the real rate of interest is the key to a higher level of investment and greater investment efficiency. The increased quality and quantity of investment has a positive impact on the rate of economic growth.

In recent decades, in part due to the influence of the McKinnon–Shaw hypothesis that financial deregulation in financially repressed developing countries is likely to induce higher savings, increase credit supply, and stimulate investment and economic growth, many developing countries have expressed their commitment to improving the mobilization and allocation of domestic resources through financial sector reform. While programs of gradual reform in some Asian economies such as Korea and Taiwan have turned out to be successful, a number of developing countries have experimented with rather dramatic financial liberalization programs.

Empirical studies performed in developing countries over a substantial period of time have unfortunately failed to convincingly support the McKinnon–Shaw hypothesis and related policy prescriptions. McKinnon (1989, p. 39) admits that 'successful liberalization is not simply a question of removing all regulations', and asserts that 'premature financial decontrol could come to grief'.

In the 1990s, financial development theories began to be extended to the analysis of financial and economic reforms in centrally planned economies. Studies of financial reform have been conducted by a considerable number of scholars, including Blejer and Sagari (1991) in the case of Hungary; Lane (1992) in the case of Poland; Borensztein and Montiel (1991), Calvo and Coricelli (1992) and Calvo and Kumar (1993) in the case of Eastern Europe in general; and Tam (1986, 1987, 1991), Li (1992, 1994) and McKinnon (1994) in the case of China.

In a study on China's capital market development, following on the example of Woo (1986), Cho (1986) and Snowden (1987), Tam (1995) attempted to redress the neglect of the role of capital markets in orthodox financial development theory. According to Demirguc-Kunt and Levine (1996), in the 1990s World Bank programs increasingly began to stress the development of capital markets in general and stock markets in particular rather than focusing on the banking sector. Levine

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