



Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin



Do foreign institutional investors destabilize China's A-share markets? ☆

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ARTICLE INFO

Article history:

Received 25 March 2009

Accepted 25 October 2009

Available online 6 November 2009

JEL classification:

G14

G15

G18

Keywords:

Foreign institutional investors

Feedback trading

Chinese stock markets

Regulation

Ownership restrictions

ABSTRACT

This paper investigates the effect of foreign institutional investors on the stability of Chinese stock markets. Previous literature views this investor group as destabilizing feedback traders. We use the abolition of ownership restrictions on A shares as a natural experiment. There is strong evidence that foreign institutions have a stabilizing effect on Chinese stock markets and contribute to market efficiency. This finding is robust across exchanges, sample periods, size quintiles and alternative model specifications. By contrast, domestic investors appear to engage in positive feedback trading. Our results have important implications for market regulation.

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1. Introduction

In rational models of stock price formation, investors base their decisions on fundamental asset values. In contrast to this view, the last two decades have seen a rapidly growing body of behavioral finance literature dealing with deviations from such rational behavior. Among other things, some stock

☆ The authors thank Jianxiang Bi, Gerhard Kling, Matthias Neuenkirch, Christian Salm, Peter von Staden, Mark Trede, an anonymous referee as well as audiences at Bristol Business School (University of the West of England), the International Conference on Macroeconomic Analysis and International Finance (Rethymno) and the annual meeting of the German Economic Association (Magdeburg) for useful comments and suggestions.

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market participants may base their investment decisions on past returns performance. Buying after prices have risen and selling in response to price declines irrespective of fundamental values is usually called positive feedback trading or momentum investing. The presence of positive feedback traders may destabilize stock markets by driving prices away from fundamentals (De Long et al., 1990b) and impeding arbitrage (De Long et al., 1990a; Brunnermeier and Nagel, 2004).

In the case of Chinese stock markets, there is widespread popular belief that the tremendous growth in recent years has attracted sentiment-driven investors. Eun and Huang (2007) for instance cite the Wall Street Journal (August 22, 2001) comparing domestic stock markets to “casinos, driven by fast money flows in and out of stocks with little regard for their underlying value.” A voluminous literature suggests that domestic Chinese investors indeed engage in non-fundamental trading. Mei et al. (2005) analyze domestic investors’ trading activity, building on a model where heterogeneous beliefs and short-sale constraints imply a positive relationship between a speculative stock price component and trading volume. Their empirical tests confirm that uninformed trading by domestic investors has an impact on bubbles in A-share prices. This is in line with conclusions from a recent paper by Fong (2009). He shows that A-share returns stochastically dominate B-share returns, which leads to a rejection of risk-based explanations of the A-share premium.

Furthermore, a number of studies provide evidence of herding and trend-chasing by domestic Chinese investors. Measures of return dispersion analyzed by Tan et al. (2008) indicate herding in both Shanghai and Shenzhen markets during the 1994–2003 period. Investors in A-share markets appear to herd in response to positive market returns, as well as high levels of trading volume and volatility. A recent contribution by Li et al. (2009) comparing volume-based herding measures for institutional and individual investors trading in the Shanghai A-share market arrives at similar conclusions. The authors also find that institutions herd more than do private investors and that institutional (individual) herding occurs primarily in small (large) stocks.

In related work studying the relationship between institutional transactions and volatility, Li and Wang (2008) argue that institutional investors have stabilized Chinese stock markets. They show that institutional investors engage in herding but not in momentum trading. However, their dataset only covers constituents of the Shanghai 180 index and does not distinguish between transactions of foreign and domestic institutions. Kling and Gao (2008) construct an index of Chinese institutional investors’ sentiment. They present evidence that domestic institutional investor sentiment is driven by previous market returns, implying a positive feedback process. Finally, the study by Chen et al. (2005) looking at individual brokerage accounts finds that account holders buy stocks in response to short-term trends but care less about long-term past performance.

Summing up, there is a large body of evidence of sentiment-driven trading by Chinese domestic investors in the A-share market. Such trading activity may cause asset prices to deviate from their fundamental values, which leads to a distortion in investment and consumption decisions and a potential misallocation of capital. It also increases the probability of stock price bubbles and subsequent crashes. In this sense, sentiment traders may threaten financial stability and put economic development at risk.

At the same time, the rapid growth of the Chinese economy requires domestic firms to raise capital from abroad. Chinese regulators therefore had to open financial markets to foreign institutional investors. Moreover, foreign institutions were thought to follow rational long-term investment strategies dampening speculative activity (Walter and Howie, 2006). In the public debate about financial market liberalization, however, foreign institutional investors are often alleged to exert a potentially destabilizing influence on emerging financial markets. Such concerns are partly fueled by empirical evidence that capital flows are highly sensitive to past returns (Froot et al., 2001). In addition, a large body of literature argues that foreign institutional investors in emerging markets tend to herd and engage in positive feedback trading (Choe et al., 1999; Borensztein and Gaston Gelos, 2003; Kaminsky et al., 2004; Chen et al., 2008). These findings suggest that financial liberalization may have unintended consequences.

In this paper, we are interested in whether foreign investors indeed have a destabilizing effect on Chinese stock markets in terms of trend-chasing behavior. This issue is particularly relevant in the case of a transition economy that has gradually opened its financial markets to foreign capital while trying to maintain financial stability. The liberalization of A-share markets in Shanghai and Shenzhen provides us with a unique opportunity to shed light on the impact foreign institutional investors cast

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