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Testing the Three Roles of Equity Markets in Developing Countries: The Case of China

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Summary. — The role of equity markets in economic development has been increasingly recognized in recent years. Yet few studies have analyzed the transmission mechanisms between them. This paper looks at this missing agenda by indirectly assessing whether the equity markets fulfill the following roles: (a) financing firms' investment; (b) improving firms' corporate governance and, hence, performance; and (c) signaling information regarding issuers to public investors through stock prices—all of which are essential in achieving economic growth for developing countries. This paper assesses the development stages of China's equity markets by testing whether the above three roles are fulfilled.

Key words — developing countries, China, equity market, investment, corporate governance, stock prices

1. INTRODUCTION

The role of equity markets in countries' economic development has been increasingly recognized in recent years. The main advantages of developing equity markets arise from their unique features that cannot be demonstrated by debt (loan and bond) markets. First, equity markets enable risk-sharing between issuing firms and shareholders, thereby promoting long-term investment and economic growth. Namely, firms do not have to pay dividends in a downturn phase of the economy, so production is not cut back and bankruptcy is less likely to arise as compared with debt finance (Greenwald & Stiglitz, 1988). Moreover, liquid equity markets enable shareholders to sell shares quickly and cheaply, thereby encouraging them to finance otherwise illiquid projects (Levine, 2000). Despite these advantages, the financing role of the equity markets is limited in industrial countries, since a relatively large fraction of new funds is raised through retained earnings (Mayer, 1989). By contrast, equity financing has become an important external source in developing countries, since firms find it more difficult to accumulate retained earnings and, at the same time, obtain financing from banks that are under severe pressure to improve their balance sheets and meet global capital adequacy and soundness standards. Equity financing is also important in many developing countries, given that corporate bond markets are virtually nonexistent because of the lack of large, liquid government bond markets that can provide benchmark assets used for pricing corporate bonds.

Second, shareholders can potentially claim unlimited upside returns, while downside risks are limited to the value of initial investment by virtue of limited liability. This is why the equity markets are able to finance firms with growth opportunities even if their collateral is insufficient. The markets also support a venture capital industry by permitting venture capitalists to exit through an initial public offering

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(IPO). Thus, equity markets are able to grow quickly, even when the lack of adequate informational (accounting, auditing, and disclosure), legal, and judicial infrastructures for the prompt enforcement of contractual terms impedes the development of a market for corporate bonds, for which the upside return is limited by the contractual interest rate (Herring & Chatusripitak, 2000). Furthermore, even though the equity markets may grow without all of this infrastructure being in place, well-functioning equity markets help to strengthen accounting, auditing, and disclosure systems that are applicable to issuing firms, which stimulate standardization of information (Levine, 2000). While Stiglitz (1985) argues that the availability of information to investors at large may discourage individual investors from spending much time and money researching firms, the equity markets encourage the emergence of a large number of information-producing firms, which could collect and process information and charge investors at reasonable cost.

Third, equity markets provide an alternative tool for corporate governance through the use of shareholders' monitoring devices as well as a market for corporate control, where raiders can buy up the shares of badly-managed firms, replace the management, and make capital gains, as seen in the United States and United Kingdom (Allen & Gale, 2000). In the presence of a large number of small and dispersed shareholders, however, managers may be under less pressure to produce good performance, because small shareholders will not find it worthwhile individually to monitor the quality of the invested firms' management. In addition, there is no clear evidence as to whether buyouts improve the firms' profitability (Canals, 1997). Moreover, recent accounting scandals, exemplified by Enron Corp. and WorldCom in the United States, have made clear that corporate governance would not work if the boards of directors lack independence and capacity to monitor managers due to insufficient information. Nevertheless, the failure of the banking systems in preventing excessive risk-taking behavior, which contributed to the eruption of the East Asian crisis of 1997–99, has convinced many Asian governments that it is an urgent matter to develop market-based monitoring systems, rather than heavily relying on the relationship-based monitoring systems.

These reasons explain why many developing countries have begun to rely on equity markets to finance firms. In Asia, for example, even though their financial systems are still characterized as bank-based, their equity markets have been expanding rapidly recently, with the ratios of market capitalization to GDP as of 2000 reaching 130% in Malaysia, 70% in the Philippines, and 55% in China and India. The number of listed companies reached about 800 in Malaysia, 200 in the Philippines, 1,088 firms in China, and 9,922 in India. Much of the growth of these markets has, however, been driven by expectations of capital gains associated with booming economies, thus generating an uneven pattern of development along with business cycles. In addition, it is often pointed out that their markets suffer from poor accounting practices, insider trading, stock price manipulation, and inadequate disclosure system. The presence of large-scale equity markets does not necessarily imply that their markets are sophisticated.

Notwithstanding the growing awareness of such problems, few empirical studies have focused on the issue of how to measure the soundness of equity market development in the context of developing countries. Many studies have empirically assessed the positive relationship between equity market development and economic growth (for example, Atje & Javanovic, 1992; and Demirguc-Kunt & Levine, 1993), but not the transmission mechanisms between them. This paper looks at this missing agenda by indirectly assessing whether the equity markets fulfill the roles that are viewed as essential in achieving economic growth for developing countries. Those are (a) financing firms' investment; (b) improving firms' corporate governance and, hence, performance; and (c) signaling information regarding issuers to investors through stock prices. The failure to fulfill these three functions would suggest that equity markets are underdeveloped despite their rapid growth. The purpose of this paper is, therefore, to investigate empirically these suggested mechanisms linking equity markets to economic development. As a case study, the equity market in (mainland) China is chosen in the light of its remarkable recent growth. Section 2 undertakes an overview of the Chinese equity market development and identifies its characteristics and constraints. Sections 3–5 comprise empirical analyses of each of the three aforementioned roles of the Chinese market. Section 6 contains concluding remarks.