Speculative trading, price pressure and overvaluation

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Abstract

Prior theoretical studies (e.g., Harrison and Kreps, 1978) show that investors pay prices over their valuation of assets if potential buyers are willing to pay even more in the future. This study provides supporting evidence by focusing on the Hong Kong “through train” scheme in August 2007, through which mainland Chinese investors were allowed to directly invest in Hong Kong market, but the decision was reassessed (actually suspended) in November 2007. Our findings show that Hong Kong stocks exhibit excess trading volume associated with the two announcements, and stocks are traded higher after the launch-decision day and lower after the reassessment-decision day.

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1. Introduction

Prior literature (Miller, 1977; Harrison and Kreps, 1978; Chen et al., 2002; Scheinkman and Xiong, 2003; Hong et al., 2004; Xiong and Yan, 2008) emphasizes the joint effects of heterogeneous beliefs in asset valuation and short-sale constraints on stock prices. When the ability of arbitrageurs to short over-valued shares is limited, valuation discrepancies introduce a speculative motive among...
investors. Investors have the option to resell their shares to other more optimistic investors in the future for a profit, and equilibrium prices reflect this option. This results in a positive association between speculative trading and stock overvaluation. Although there are a number of theoretical studies present in prior literature, direct empirical evidence is limited, possibly due to the difficulty in testing speculative trading and verifying different beliefs in valuation (Mei et al., 2009).

In this research, we study the price bubble in Hong Kong associated with the mainland China’s decision of “Share Investment Through-Train Scheme to Hong Kong” (Forbes, 2007a), which was announced on August 20th, 2007 (hereafter August 20th announcement) but is yet to kick off. Under the Scheme, mainland authority initially allowed individual mainland investors to directly purchase Hong Kong stocks.2 However, the implementation of this scheme has been plagued by repeated delays. Then, in a speech by Chinese Premier Wen Jiabao on November 3rd, 2007 (Forbes, 2007b), the scheme would have to be re-assessed, as he reiterated the concern that excess fund flows could affect market stability in both China and Hong Kong and he urged the scheme to be rolled out ‘cautiously and pragmatically’ (Forbes, 2007c). The speech did not explicitly indicate a suspension of the scheme, but in fact the scheme made no progress since then.

Although mainland investors do not officially purchase any Hong Kong shares under the scheme, the scheme is viewed as a catalyst for the dramatic rising share prices in Hong Kong between August and November 2007 (Market Watch, 2008).3 Hong Kong stocks have rallied to record highs by driving up the Hang Seng Index by 48%, but the index slid gradually subsequent to the November speech (see Fig. 1). We argue that the scheme generates market optimism and speculative motive in Hong Kong, because Hong Kong investors could take speculative positions against mainland investors as a response to the scheme. Hong Kong speculators purchase Hong Kong shares and they are willing to pay more for the purpose of reselling their shares to more optimistic mainland investors in the future for a profit. The main hypothesis of our empirical analysis is that the announcement to launch this scheme generates price bubble in Hong Kong market, which alleviates after the announcement to reassess the scheme. We find supporting evidence for our conjecture.

This research contributes to the literature in a number of ways. First, our study provides direct empirical evidence to support the heterogeneous beliefs and speculative overvaluation hypothesis (e.g., Harrison and Kreps, 1978). Empirically, it is difficult to verify investors with heterogeneous beliefs in asset valuation, and Hong Kong through-train scheme provides an excellent opportunity: Hong Kong

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2 This outward investment scheme is intended to provide a release valve for some of the money that is piling up in China due to its global trade surplus and robust inward foreign investment, which is stoking inflation and putting upward pressure on the Chinese currency.

3 Beijing to delay “through-train” scheme by two years (Market Watch Hong Kong, January 15, 2008), may be available online: http://www.marketwatch.com/news/story/beijing-delay-through-train-scheme-two/story.aspx?guid=%7BF5F210B3-38A0-4357-AC76-730AD656C974%7D.
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