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Econ 541: Short Paper 2

What Keeps Countries from Capital Account Liberalization?

The Case of China Stock Market[[1]](#footnote-1)

1. **Introduction**

Peter Blair Henry (1999) states that “stock market liberalization may reduce the liberalizing country’s cost of equity capital”, and he further points out that such prediction has two implications: first is people should observe “an increase in a country’s equity price index”, and second is “an increase in physical investment following a stock market liberations”. From a policymaker’s point of view, these two implications are attractive features for a state since, theoretically, more physical investment will result in a higher economics output equilibrium, and increasing equity price index is usually referred to a phenomenon of the economy boom in common sense.

Despite the promising advantages of stock market liberalization, almost forty years have passed since its successful economic reform at 1978, the Chinese government has not fully lifted its restrict on capital accounts yet. Although there is news reporting that China’s government leaders are planning to dismantle all the capital controls before 2020 (*Bloomberg News*), it is interesting to discuss why the Chinese government is reluctant to implement a complete capital account liberalization for the past period and what potential outcomes will be if such a liberalization is realized. In this paper, I will try to build up the link between capital account liberalization and economic growth, which is one of the main goals of government, and analyze whether the growth promised by standard economic theories could happen after the liberalization in China’s capital accounts.

1. **Background**

Peter Henry (1999) conducts from a sample of 11 emerging capital markets that stock market liberalizations lead private investment boom. Many developing countries liberalized their stock markets in the late 1980s and early 1990s, and from 11 selected markets, their mean growth rate of private investment jumped high by 22 percentage points, and most of them remained an abnormal higher growth rate of private investment in the following three years after liberalization. In another paper, Peter Henry (2000) also argues with the data from a similar sample of countries that, after controlling for many economic factors, stock markets experience average abnormal returns of 3.3 percent per month in real dollar terms during an eight-month event window following the country’s initial stock market liberalization. Other literatures, such as Kim and Singal (2000) and Patro and Wald (2003), find similar results as Henry (1999, 2000) does.

Meanwhile, China experienced a phenomenal high growth rate of the economy during the same period. By May 2015, China’s stock market was worth over $10 trillion, around a quarter of world market cap; in contrast of the huge capital volume, several policies like Qualified Foreign Institutional Investor (QFII) Scheme and RMB Qualified Foreign Institutional Investor (RQFII) Scheme only relieved the restraints on foreign capital investment in China’s domestic stock markets, but a complete market capital liberalization is absent. In fact, China’s stock market was mostly segmented from global capital market (B share market is exclusive for foreign investors, but only 24 companies were listed) till November 5, 2002, when China regulatory announced the QFII scheme. While this is the most important stock market liberalization policy enforced by China, QFII did not fully open the door to foreign capitals to participate in China’s stock market, as currently QFII quota is $10 billion, less than 2 percent of Chinese stock market shares. China’s stock market is still insulated from world market, and apparently, there are more liberalization policies that government can implement to fully open the stock market. Besides, China’s control of capital outflow remains restricted currently, as from personal experiences, individuals in China can exchange RMB for U.S. dollars with an annual quota of $50,000. While it is surprised that China owns such a huge stock market without many activities of global capitals, the reasons why Chinese government implemented a tight policy towards capital inflows and outflows are important from an economist’s aspect.

Many potential answers may explain why China’s government keeps its regulation: first, government regulates the inflow and outflow capitals strictly due to its desire for a stable currency rate. On one hand, government cannot allow a huge amount of foreign capital inflow that brings an appreciation in RMB and deteriorates the term of trade. On the other hand, capital outflows could increase tremendously when people’s expectation of economics growth goes down and thus a capital flight, which is more dangerous than the currency appreciation, may happen. Due to Mundellian Trilemma, government must sacrifice the capital mobility to ensures a stable exchange rate as well as an independent monetary policy.

Second, it is the economy fluctuation might stop the liberalization process. Back to 2015, there used to be news about a deeper liberalization would happen when Chinese stock market started its latest boom. Unfortunately, in June 2015, the stock market collapsed and the index fell from peak over 5000 points to almost half of it. The huge fluctuation prevented the policymakers implementing further liberalization but start to stabilize the stock market.

Third, how much affect, if it is positive, could capital account liberalization bring to economy growth is questionable. Chen and Shen (2012) states that QFII did not work well in improving equity index pricing as only significantly negative correlation between stock market index and the announcement of QFII is found in the post-event period of 20 days. Moreover, Prasad et al. (2003) in a survey of capital account liberalization research conclude that “…an objective reading of the vast research effort to date suggests that there is no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth.” In contrary, according to the neoclassical economics model, a capital account liberalization results in more allocative efficiency, as capitals flow from developed countries to developing countries and cost of capital decreases in the liberalizing countries. With this effect, more investment projects can become profitable due to less costs of investment, thus investment growth increase and push up the economy output. The two opposite views address the question that when there are many other distortions to the economy other than barriers to free capital flows as the case of many LCDs in the real world, does the theory-promising increase in investment brought by the capital account liberalization still exist?

These factors, especially the third one, might concern the Chinese policymakers and make them less confident to deeply liberalize the capital market. In the following section, I will try to illustrate the channel between capital account liberalization and economy growth, and explain why it might be better to open the stock market more for Chinese government.

1. **Capital Account Liberalization and Economy Growth**

Before further analyze whether capital account liberalization has effect on economy growth, it is better to clarify first how stock market liberalization can result in an investment boom since the object of this paper is Chinese stock market. Henry (1999) completes a comprehensive research, both theoretically and empirically, on how stock market liberalization correlates to investment growth and here I briefly summarize his work.

A country’s cost of equity capital consists of the equity premium and the risk-free rate. The stock market liberalization could increase net capital inflows thus reduce the risk-free rate; it also increases risk sharing between domestic and foreign investors, thus reduces the equity premium. Besides, a possible positive effect on market liquidity by increased capital inflows can reduce equity premium as well. With all these effects, the country’s cost of capital falls and temporary increase in investment growth appears until the marginal product of capital falls to the same level of the new cost of capital. Meanwhile, the discounting rate used in evaluating equity shares also decreases due to decreased risk-free rate and equity premium, thus a revaluation of stock shares with higher prices is expected to be accompany with the increase in investment growth after the stock market liberalization.

However, many literature (Rodrik, 1998; Eichengreen 2001; Edison et al., 2004; Prasad et al., 2003) argue that according to empirical analysis, there is no correlation between the capital account liberalization and investment growth, economy growth or any economics variables with welfare implications. They conclude that capital account liberalization, at best, has only ambiguous effect on economy growth. In contrast to these findings, Henry (2007) demonstrates that the neoclassical model only predicts temporary increase in the growth rate, not permanent, while “the cross-sectional regressions done in the previous literature could only look for permanent effects on differences in long-run growth rates across countries”. In other words, the empirical testing for a permanent growth effect cannot exclude the possibility that liberalization affects the investment growth temporarily after the event.

While it is not safe to conclude that the capital market liberalization can bring countries higher investment growth rate, Henry (1999) already answered part of the question, as what is the effect of the stock market liberalization. By empirical analysis using the time-series data, a positive correlation between investment growth and stock market liberalization is robust after controlling country-specific economics factors, world business cycle effects, etc. With these results, Chinese government should feel more confident to implement further stock market liberalization policies, such as an expansion on the quota of QFII or allowing direct anticipation from foreign investors.

What needs to notice is that the theory of decreased cost of capital has an implicit assumption, that is a country’s risk-free rate falls after the stock market liberalization. But this condition may be violated when the capital inflows is overwhelmed by a huge capital outflow by domestic residents, or the autarky risk-free rate is already lower than the world rate. In the case of China’s stock market, such concerns are unnecessary. Although researches (Collins and Bosworth, 1996; Young, 1995; Kim and Lau, 1994) show many emerging Asian countries have had very high saving rates which may drive down the interest rate, comparing the risk-free rate of China’s money market to other major currency markets will conclude that China has a relatively high interest rate, thus a higher cost of capital than the level of world market. As a result, as far as China’s government keeps its regulation on capital outflows and keeps liberalizing the stock market, it is expected to see a temporary increase in investment growth and a permanent increase in GDP per capita.

1. **Further Research**

In the term paper, I will compare the data of China’s economy growth before and after its initial stock market liberalization with other countries that experienced the liberalization since 1980s. Also, I will check whether the common increase in investment growth after the stock market liberalization happened between 1986 to 1991 is a result of a rising trend of global trade during that period. After the bubble of emerging markets grew up, the Asian 1997 Financial Crisis happened and many emerging markets suffered huge loss during the crisis. Since then, the appeal for financial regulation on capital markets and critics against the liberalized capital account policies appeared. As Peter (1999) also admits that government could choose to implement the stock market liberalization policy foreseeing the increasing investment growth and the causality between liberalization and growth is still unknown, it is crucial to investigate more on what are the main factors of the investment growth.

1. This short paper will work as the first part of the term paper for our class. And changes to the current paper may appear in the final draft. Due to limit of data, the thesis of the term paper may also slightly differ from this one. [↑](#footnote-ref-1)