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INTRODUCTION

Chinese capital markets: challenges to the China model

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1. Introduction

Eight years ago, *The European Journal of Finance* (EJF) published the first special issue on the Chinese Capital Markets. This was at a time when Chinese topics were not widely accepted by internationally excellent finance journals. Since then, *The European Journal of Finance* has published five special issues both containing and encouraging studies that reveal the unique institutions of China. These special issues thus provide an important publication outlet for Chinese studies and a valuable platform within which scholars in this research area can network. From 2011 to 2017, the market capitalisation of listed domestic companies has increased from $3.412 to $8.711 trillion, and China's GDP increased from $7.573 to $12.238 trillion (World Federation of Exchange Database by World Bank). More importantly, China has emerged as the world's market leader in Fintech and Green Finance. China has by far the highest Fintech adoption rate[1] and market size of crowdfunding (Rau 2018). China's green bonds reached $32.4 billion, accounting for 40% of green bonds issued globally and making China the largest issuer worldwide.[2]

Following the success of the four conferences in 2011, 2012, 2013 and 2014 (Cumming et al. 2014, 2016, 2017; Guariglia et al. 2018), the 5th Conference on the Chinese Capital Markets was hosted by the I.H. Asper School of Business at the University of Manitoba, Canada, on July 16 and 17, 2015. The conference venue was James W. Burns Executive Education Centre, University of Manitoba, located in downtown Winnipeg. A total of 13 papers were selected for presentation by conference participants in four sessions, namely Financial Distress and Investment, Innovation and Reform, Board and Ownership, and Market Integration and Efficiency. Six papers are included in this special issue after the standard double-blind review process.

The keynote speaker was 'Mr. IPO', Professor Jay R. Ritter, Joseph B. Cordell Eminent Scholar Chair at Warrington College of Business, The University of Florida. A Special Interactive Session on Entrepreneurial Finance was also led by him as well as Drs Min Maung and Craig Wilson from the University of Saskatchewan. Professor Ritter's keynote speech was entitled *Pre-market trading and IPO pricing: Evidence from Taiwan* (Chang et al. 2017). The most important debate in the IPO literature is on the rationale of underpricing: either it is fair to compensate investors for bearing risks, or it is excessive and driven by agency problems between underwriters and issuers. Taiwan has the only mandatory pre-IPO market in the world where firms are required to be traded on a so-called 'Emerging Stock Market (ESM)' for at least six months before applying for an IPO. They find that the pre-market price largely determines the offer price and the more accurate the pre-market price is in predicting the aftermarket price, the lower the discount of the offer price relative to the pre-market price. The reason of high underpricing despite the pre-market trading is that both underwriters' fees collected from investors and their brokerage revenues increase as underpricing increases. Overall, the results imply that agency problems contribute to the IPO underpricing even in the absence of information asymmetry.

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2. Contributions in the special issue

This section summarises the six articles included in this special issue.

Liu et al. (2019), titled *the real effect of liquidity provision on entrepreneurial financing: evidence from a natural experiment in China*, regard the establishment of the SME Board as an exogenous shock to increase liquidity provision for illiquid investment in the VC market. They find that the establishment of the SME Board increased VC investment, especially from newly founded VCs, but not entrepreneurial activities in China. They interpret the results as a supply-side increase in entrepreneurial financing. The also find that the establishment of the SME Board increased government-backed VCs more than private VCs, and increased VC investment in less developed regions more than in developed regions. We encourage future studies to also examine the effects of start-up Boards and of the to-be-established Science and Technology Innovation Board that adopts a registration-based IPO system.

Ding, Knight, and Zhang (2019), titled *Does China overinvest? Evidence from a panel of Chinese firms*, document evidence of overinvestment of both state-owned and private firms in China. The former invest less efficiently than the latter. They attribute the overinvestment of private firms to the abundant cash flow generated from high profits and attribute the overinvestment of state-owned firms to weak screening and monitoring of banks. They indicate that overinvestment is likely to lead to overcapacity. We encourage future studies to discuss overinvestment of Chinese firms in the context of the literature of soft budget-constraint by Kornai (1979). In centralised economies, firms often acquire subsidies or loans more than would have been considered efficient.

Jacoby, Li, and Liu (2019), titled *Financial distress, political affiliation and earnings management: the case of politically affiliated private firms*, find that private Chinese firms that experience financial distress are more likely to engage in positive earnings management in order to ensure continued access to debt financing than publicly-listed firms. Since politically-connected private firms, especially those located in regions with less developed institutions, can still access financial resources and government support under financial distress, they have less incentive to engage in positive earnings management. Future studies may compare the effects of different types of political connections.

Huyghebaert and Wang (2019), titled *Value creation and value distribution in Chinese listed firms: The role of ownership structure, board characteristics, and control*, make use of a panel of Chinese firms listed in Shanghai over the period 2001–2005 to analyse the extent to which Chinese listed companies' ownership structure and board characteristics affect the value creation and the proportional distribution of this generated value among shareholders. The results suggest that what helps to improve firms' value creation does not necessarily contribute to the proportional allocation of their created value. Specifically, the fraction of voting rights controlled by the firm's largest ultimate shareholder is positively associated with value creation. This effect is found to be stronger for privately controlled firms. Further results suggest that a managerial ownership stake and a larger fraction of voting rights controlled by countervailing shareholders are positively associated with value creation only for privately controlled firms. Whilst, board size is not found to have any effect on value creation, independent directors do contribute to value creation for state-controlled companies. All results are robust to using different measures of value creation. Focusing on value distribution, the authors find that for listed state-controlled enterprises, the fraction of voting rights controlled by the State increases the likelihood and size of related-party transactions (RPT), while it reduces the odds and magnitude of cash dividends. The results also suggest that managerial ownership encourages cash dividends in privately controlled firms, whilst it reduced the likelihood of RPT in state-controlled firms. Furthermore, countervailing shareholders restrain RPT and promote cash dividends for all types of firms. Finally, a larger fraction of independent directors on the board stimulates the payout of earnings as cash dividends. Overall, the results of this paper are important because the authors recognise that value creation and value distribution are sufficiently distinct theoretical concepts, while academic research has not always fully accounted for their differences. Moreover, academic research to date has not clearly explored how internal corporate governance mechanisms could play a distinctive role in the processes of value creation versus value distribution.

Haß, Vergauwe, and Zhang (2019), titled *State-ownership and bank loan contracting: Evidence from corporate fraud*, make use of a sample of bank loans and enforcement actions announced between 2001 and 2012 to investigate the extent to which ownership characteristics of borrowers and lenders affect the consequences of corporate fraud. The results suggest that the cost of private borrowing rises significantly after fraud announcements. Yet, this effect does not manifest itself if the loans are issued by state-owned banks and directed towards state-owned enterprises. Furthermore, the authors document that those state-owned companies which benefit from more favourable rates from state-owned banks after the announcement of a fraud perform worse than other companies. These findings have significant policy implications as they suggest that state-owned banks continue to prefer lending to state-owned enterprises, even though these firms generally perform worse than private companies. The government should, therefore, continue to reform China's banking industry in order to improve lending efficiency.

Farag and Mallin (2019), tilted *Monitoring corporate boards: evidence from China*, test the main board structure hypotheses, namely the scope of operations, monitoring and negotiation hypotheses, based on Chinese IPO firms. They find that independent directors might be a substituting mechanism for the supervisors' monitoring role and that there might be conflicts between corporate boards and supervisory boards. We encourage future studies to provide more insights on the interaction between the two boards and make further efforts to make a causal inference.

3. Discussion and future research

2018 marks the 40th anniversary of China's reform and opening-up, which brought about the economic miracle. Xu (2011) attributes this to the regional competition and experimentation governed by China's regionally decentralised authoritarian (RDA) regime, which is a combination of decentralised economic governance and centralised political governance. Allen, Qian, and Qian (2005) indicate that the private sector grows much faster than other sectors and provides most of the economy's growth. The separation between the Party and the government (and the companies) was an important legacy of Deng Xiaoping. In 2017, however, the 19th National Congress of CPC (Communist Party of China) revised the party's constitution and strengthened the CPC's role to 'lead everything'.

The Organisation Department of the CPC and the Party Committee of the State Assets Supervision and Administration Commission had issued a notice on 15 March 2017 requiring all state-owned enterprises, including the non-listed ones, to explicitly put forward the Party building in the bylaws, specifying the Party's organisation structure, status, responsibility, staffing, funding and the operational mechanism for the Party committee to discuss major issues. To comply with this requirement, China Railway Group Limited which floats in both Shanghai and Hong Kong stock exchanges, for example, held a board meeting on 28 April 2017 to deliberate and approve the proposal on a revised bylaw. On 28 June 2017, the revised bylaw was voted through with 95.28% support in the Annual General Meeting (AGM). The revised bylaw added that the board should listen to the advice from the Party Committee before making decisions on important issues and that the chair of the board and the Party Secretary shall be one person. Some private firms also voluntarily made the change. Linewell Software, a private listed firm, for example, revised its bylaw and added that the Party Committee shall bring forward the opinions on the nominated candidates for the posts of senior executives or recommend the list of candidates directly to the CEO.

The CSRC (China Securities Regulatory Commission) promulgated the new *Code of Corporate Governance for Listed Companies in China* on 30 September 2018, which intends to integrate the Community Party into the corporate governance of all listed firms. Specifically, Article 5 requires that all listed firms shall set up a Chinese communist organisation to carry out activities of the Party and listed firms shall provide necessary conditions for the activities of the Party organisation. To encourage small and medium-sized private enterprises and foreign firms to carry forward the work of Party building, many industrial parks, office premises, shopping centres and even Internet communities set up Party branches.

On the one hand, this could be regarded as a U-turn of the principle of the separation of enterprises from the administration since the third plenary meeting of the 14th central committee of CPC in 1993. The free enterprise system is undermined since the Party can directly intervene in the operation of firms, including private firms and foreign firms operating in mainland China. Given the finding in the literature (e.g. Fan, Wong, and Zhang 2007) that government bureaucrats, often Communist Party members, lack incentives and ability to enhance firm performance when acting as CEOs, the value of the advice of the Party Committee or its consequences when the board refuses to adopt the Party's advice are not clear. On the other hand, the Party's Central Commission for Discipline Inspection successfully mitigated the corruption of state-owned enterprises (Wang et al. 2018) in the anti-corruption campaign. It is likely that the Party committee could help to monitor executives. The net effects represent an important research question.

Meanwhile, the government also intends to enable employees and the Labour Union to participate in the management of private enterprises. In September 2018, the Ministry of Human Resources and Social Security held a national conference and a vice minister stressed that 'in order to deepen democratic management of private enterprises, the leadership of the Party must be strengthened, the principal position of the staff and workers must be upheld, institutional assurance must be reinforced'. He asked private enterprises to allow employees to participate in the management together and to share the gains of firms, and support the Labour Union in playing an overall coordinating role. In Qingdao, a major city in the east of Shandong Province, the local government sent officials to private enterprises to act as part-time chairmen of the Labour Union, spending there 8 working days a month for two years. While employee representatives typically join supervisory boards in China to perform a monitoring role and the Labour Union has a fundamental responsibility to safeguard the legitimate rights and interests of employees, the legal or theoretical basis for them to directly participate in the management of private enterprises is not clear and the implication on firm policy and outcomes need to be carefully examined.

In 1995, the fifth plenary session of the 14th CPC Central Committee set up the principle of invigorating large SOEs in critical industries while relaxing control over small ones. Following this, many underperforming SOEs were privatised and their performance was improved when controls were passed to a private entity (Chen et al. 2008). The 2014 Central Economic Work Conference, however, put forward a new principle that SOEs should be made unswervingly stronger and better. In 2016, General Secretary Xi Jingping added that it was absolutely not allowed to make SOEs smaller, collapsed or disappear. The fluctuation in profit and even liquidation are normal market phenomena. To ensure SOEs can only grow bigger, adequate resources and favoured treatment must be provided. This new principle may have distorted resource allocation and contributed to the hardship of the private in recent years. When the supply-side structure reform was implemented by means of administrative decapacity and environmental inspection, private enterprises were the major targets. From January to September 2018, at least 24 listed private firms transferred control to holding companies of the government. Foreign firms also find it harder to operate in China. The 2018 China–US trade war also reflects the US's concern on China's expanded usage of state-directed and market-distorting policies.[3]

Overall, there have been a series of legislative and regulatory changes that have strengthened the role of the Chinese Communist Party in the economy and society under the 'Party leads everything' doctrine. We encourage future studies to examine their implications on finance and economics. We believe that the results of such studies will be helpful for the CPC and the Chinese Government to shape future policies to ensure sustainable development.

Notes

1. See https://www.cnbc.com/2018/06/08/this-chart-shows-how-china-is-dominating-fintech.html
2. See https://www.eco-business.com/news/how-china-became-a-global-leader-in-green-finance/
3. See https://foreignpolicy.com/2018/08/08/china-doesnt-want-to-play-by-the-worlds-rules/

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