Introduction

I. THE CHINA PUZZLE

China set up its two stock exchanges, the Shang Hai Stock Exchange (SHSE) and Shen Zhen Stock Exchange (SZSE) in 1990 and 1991 respectively. After about 20 years’ growth, by the end of 2008, there were a total of 1625 companies listing on these two stock exchanges and the combined market capitalization reached 12.13 trillion yuan. Investors’ accounts totalled 152 million, 107 securities companies had been set up with total assets of 1.1912 trillion yuan (The China Securities Regulatory Commission, 2008 Annual Report). In terms of market capitalization, it ranked as the second largest market in Asia, next only to Japan, and fourth in the world.

The rapid expansion of the Chinese stock market represented a sharp contrast to the failure of its former socialist counterparts such as the Czech Republic. In 1995, the Prague Stock Exchange (PSE) had 1716 listings (Int’l Herald Tribune, 17 March 1999). By early 1999, the number of listings on the PSE had fallen by more than 80 per cent to 301 and fewer than a dozen of them enjoyed any liquidity (Coffee, 1999a, p. 9). So the question arises, how did the Chinese stock market develop in this form? What makes the difference between it and other transition countries?

Law and finance scholars, such as La Porta, Lopez, Shleifer and Vishny, based on considerable empirical evidence across countries, claimed that strong legal protection of investors is the determinant of capital market development (1997, 1998, 2000a, b). However, Allen et al., (2005), and Pistor and Xu (2005) found that legal protection of investors is not the sole factor. Other factors such as political stability, government intervention, and market structure also play crucial roles.

1 Referred as the CSRC hereinafter.
2 The calculation does not include Hong Kong Stock Exchange (HKSE). In July 2009, the market capitalization of the Chinese stock market once overtook Japan and became the second largest in the world. See Financial Times Chinese, 17 July 2009. However, it must be noted that the prevalent figure does not reflect the real size of the Chinese stock market. In the Chinese stock market, two-thirds of shares are non-tradable whose value should be heavily discounted. This issue will be discussed in detail in Chapter 4.
shareholders in China’s stock market is very weak. In fact, the level of investor protection in China is not only significantly below developed countries, it is also not ahead of any of the other major emerging economies\(^3\) (Allen et al., 2005). Apparently, the growth of the Chinese stock market cannot be explained by the ‘law and finance’ school. Instead, it raises a serious challenge for the law and finance literature.

Pistor and Xu (2005) made an attempt to explain the growth of China’s stock market. They argued that the quota system that was adopted during 1993–2000 (de facto until 2004) by the CSRC, created an incentive for the regional bureaucrats to select more over less viable companies to list and thereby operated as an alternative to legal protection of investors in information disclosure. Nevertheless, as will be discussed in this book, Pistor and Xu’s argument is based on unsound assumptions and ignores some important factors which render it problematic. As a result, the development of China’s stock market thus far still remains a puzzle. The purpose of this book is to try to solve this puzzle.

II. THE SIGNIFICANCE OF THE QUESTION

Explaining the development of China’s stock market has important implications, most directly, for corporate governance study. Corporate governance study has become a mainstream concern in the past two decades, as a result of the worldwide wave of privatization; the takeover wave of the 1980s; the 1998 East Asia, Russia and Brazil crises; pension fund reform and the growth of private savings; deregulation and the integration of capital markets; a series of US and European scandals that triggered some of the largest insolvencies in history (Becht, Bolton and Roell, 2005). Empirical evidence confirmed that good corporate governance is critical to economic growth through increasing access to external financing by firms (Demirguc-Kunt and Maksimovic, 1998); lowering the cost of capital and enhancing the valuation of firms (La Porta, et al., 2002; Claessens, et al., 2002; Caprio et al., 2003); resulting in better allocation of resources and better management (Beck et al., 2000; Beck and Levine, 2002; Wurgler, 2000); reducing risk of financial crises (Claessens, 2006).

Although the importance of corporate governance has been widely recognized, the question of how to achieve good corporate governance

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\(^3\) Allen et al. (2005) showed that China’s corruption index is the worst among the seven developing countries, while its measures of anti-director rights (creditor rights) is only higher than that of India and Mexico.
still remains in debate. But in the past two decades, the Anglo-America shareholder model seems to gain some advantage over its competitors. As a result, a good number of corporate governance codes, principles that were based on the Anglo-American model have been produced by various organizations and spread across countries. The Anglo-American model has different versions: apart from the ‘law and finance’ school which emphasizes legal protection of shareholders, the ‘law and economics’ version suggests that corporate governance can be effectively addressed through private contracting and contractual arrangements, regulation is unnecessary or even harmful (Easterbrook and Fischel, 1991) and the role of law is marginal (Easterbrook and Fischel, 1991) or even trivial (Black, 1990). Both schools attracted many followers and had a significant influence on policy making internationally.

A study of the Chinese stock market development provides us with an opportunity to test the effectiveness of the prevailing theories. As already noted, if the growth of China’s stock market cannot be explained by the ‘law and finance’ literature, then, can it be explained by the ‘law and economics’ literature? If not, what can? Does China represent an alternative approach to stock market development? What experience can other economies learn from it? I believe this research has both theoretical and practical significance to corporate governance study.

More broadly, explaining stock market development has significant implications for the ‘rule of law’ debate. Recent economics literature, echoed in the pronouncements of the World Bank and similar multilateral organizations, emphasized that the rule of law is crucial in fostering economic development (Hall and Jones, 1999; Acemoglu et al., 2001; Rodrik et al., 2004). In spite of its poor ‘rule of law’ profile, China has been the fastest growing country over the past three decades and its economy has already become one of the most important in the world. For the ‘rule of law’ advocates, China is a question that they cannot avoid. The study of the development of China’s stock market can shed light on the ‘rule of law’ issue.

III. METHODOLOGY

In order to explain the development of China’s stock market, we need a conceptual framework which allows us to examine various governance mechanisms on a unified base. However, such a framework does not exist

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4 Such emphasis dates back to Max Weber and is carried forth by Douglass North (1990).
in current research. Previous studies have normally focused on some governance mechanisms while ignoring others, in particular, little attention has been paid to the relationship between different governance mechanisms. Relying on the insights of New Institutional Economics (NIE), an analytical framework under which the role of various governance mechanisms could be better evaluated is established.

The framework runs as follows: looking through agency theory, corporations can be treated as a nexus of contracts (Jensen and Meckling, 1976), among which I focus on the financial contract between external financiers and corporate controllers. The corporate governance problem thereby could be regarded as an enforcement issue, i.e. how to enforce the financial contract between external investors and corporate controllers. Based on the knowledge on contract enforcement that has been accumulated by NIE scholars in the past few decades, we can first establish a conceptual framework for contract enforcement in general. Under this framework, contract enforcement can be divided into self-enforcement and enforcement by third party. Self-enforcement includes enforcement in one-shot games and in repeat games; third-party enforcement contains non-state third-party enforcement and state enforcement. Corporate governance is then brought into this framework: various corporate governance mechanisms are now turned into enforcement mechanisms and reconsidered in an enforcement context.

The next step is to apply this framework to the Chinese stock market and examine the effectiveness of each enforcement mechanism. Based on this comprehensive study, I will try to identify the driving forces in the development of the Chinese stock market.

This methodology has some distinct advantages. First, I believe it catches the essential issue in developing/transition countries. As previous studies have shown, there is often a big gap between ‘law in practice’ and ‘law in books’ in these countries. Thus, more attention should be paid to enforcement than to substantive laws. Second, it allows various governance mechanisms to be evaluated in one unified framework. By doing so, it helps to clarify an important question: What is the relationship between these governance mechanisms?

IV. STRUCTURE OF THE BOOK

The book is divided into five chapters. The first chapter lays down the theoretical framework of the book. This chapter finds that since effective enforcement requires various enforcement mechanisms to work together, for the sustainable development of the stock market, formal enforcement,
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i.e. the enforcement by the state, and informal enforcement such as large shareholders and stock exchanges must work together. However, formal enforcement might not be necessary in the early stage. Informal enforcement could support the market’s growth to a certain extent. This finding is different both from the ‘law and economics’ school which downplays the role of formal enforcement, and the ‘law and finance’ school which seems to misplace the formal enforcement.

The second chapter provides the background settings of China’s stock market and listed companies. It finds that, in order to realize the party-state’s goal of using the stock market to finance state-owned enterprises (SOEs) without losing control, the Chinese stock market is dominated by state-owned listed companies, two-thirds of the shares are not tradable, the market is artificially segmented and most market players are owned by the state.

The third chapter presents a comprehensive study on enforcement in China’s stock market. Various enforcement mechanisms are examined here. It finds that state ownership has fundamentally undermined the foundation of self-enforcement mechanisms. The tradition of centralization has weakened the function of non-state third-party enforcers such as stock exchanges. Formal enforcement is inherently weak in a state where the elites are only constrained by the power of others, not by the rule of law. As a result, neither formal nor informal enforcement is effective in the Chinese stock market.

The fourth chapter provides a critique of Pistor and Xu’s (2005) argument and suggests an alternative explanation to the development of China’s stock market. It argues that the Chinese stock market growth is a result of state guarantee, financial repression, institutional rent seeking and speculation by investors. In the absence of effectual enforcement, although the Chinese stock market expanded quickly in size, it is highly inefficient and unsustainable.

The final chapter outlines the broad conclusions of the book. It summarizes the central arguments and major contributions of this book, highlights relevant policy implications and briefly discusses the future of the Chinese stock market.