DOI: 10.54254/2754-1169/148/2024.LD19182

Chinese Stock Market: Problems and Corresponding Policies

Yinuo Zhu[1,a,*]

[1]Social Science School, University of Manchester, Manchester, United Kingdom
a. yinuo.zhu-3@student.manchester.ac.uk
**corresponding author*

Abstract: This dissertation analyzes the core problems of China's stock market, particularly its high volatility, government intervention, limited transparency, and weak corporate governance, capital outflows and foreign investment limitations. These challenges are exacerbated by the dominance of retail investors, who often engage in speculative trading, contributing to instability. The research highlights that government intervention, though aimed at stabilizing the market, creates moral hazard, reducing the market's ability to self-regulate. Additionally, a lack of transparency, particularly in state-owned enterprises, and deficiencies in corporate governance undermine investor confidence and market efficiency. Despite recent reforms, such as efforts to increase institutional investor participation and enhance regulatory frameworks, significant gaps remain. This study suggests targeted policy solutions, including reducing government intervention, improving transparency, and strengthening corporate governance, etc., to address these systemic issues. These reforms are critical for the long-term stability and growth of China's stock market, making it more resilient and attractive to both domestic and foreign investors.

Keywords: Stock market, China, Volatility, Transparency, Regulatory reform.

1. Introduction

Stock markets serve as one of the most critical pillars of modern financial systems by facilitating efficient capital allocation, enabling corporate growth, and contributing to overall economic stability [1]. Globally, well-functioning stock markets not only reflect the health of a nation's economy but also act as significant platforms where investors assess risks, allocate resources, and foster liquidity [2]. The global capital market, through its interconnected nature, plays a vital role in driving economic development, enhancing corporate governance, and encouraging resource optimization [3]. Additionally, stock markets support the formation of savings, promoting investment by directing capital from surplus units to deficit units, thus allowing firms to access necessary funding for innovation and expansion. Against this global backdrop, China's stock market, though relatively young, has become an increasingly significant component of its financial architecture. Established in the early 1990s, China's stock market represents one of the fastest growing in the world, driven by the country's rapid economic transformation [4]. Despite these advancements, systemic inefficiencies, market volatility, and regulatory challenges continue to impede the market's growth and efficiency [5]. This paper aims to analyze the key problems affecting China's stock market and propose targeted policy solutions that could enhance its efficiency and stability.

DOI: 10.54254/2754-1169/148/2024.LD19182

2. Overview of China’s Stock Market Development

China’s stock market has a relatively brief but transformative history, formally established in the early 1990s with the creation of the Shanghai and Shenzhen stock exchanges [6-7]. Initially, the stock market served as a platform for raising capital to modernize state-owned enterprises (SOEs), playing a crucial role in China’s economic reforms during its shift from a centrally planned economy to a more market-oriented model [8]. These exchanges became central to China’s broader strategy of transforming its industrial sector, promoting privatization and providing SOEs with the necessary capital to become competitive in an increasingly globalized economy. During this period, the government maintained a strong hand in managing market operations, ensuring that the stock market served its broader economic objectives.

As the stock market evolved, China introduced several reforms aimed at enhancing its efficiency and aligning it with global standards. However, the market has remained volatile and heavily influenced by governmental policies and interventions [6]. The dominance of retail investors, who are often driven by short-term speculative motives rather than long-term investment strategies, has contributed to frequent market fluctuations. Furthermore, regulatory inconsistencies and weaknesses in corporate governance have hindered the market’s development. While significant progress has been made, including the introduction of more sophisticated financial instruments and efforts to attract institutional investors, China’s stock market continues to grapple with issues such as transparency, shareholder protection, and enforcement of regulations [9]. These challenges are compounded by the ongoing tension between government control and market-driven forces, making the path toward full market liberalization complex and slow.

Despite these challenges, China's stock market has grown in terms of size and global influence. Its market capitalization has expanded rapidly, placing it among the largest markets in the world. However, as China continues its journey toward becoming a major global economic powerhouse, its stock market must address structural inefficiencies and regulatory challenges to support sustainable growth. Key reforms targeting governance, transparency, and reducing government intervention will be essential in making China’s stock market more attractive to global investors, while ensuring that it remains a critical driver of domestic economic development."

3. Key Problems of China’s Stock Market

3.1. High Volatility

One of the most persistent issues in China's stock market is high volatility, driven largely by speculative trading and the dominance of retail investors [10]. Unlike more mature markets, where institutional investors have a stabilizing influence, China's stock market is driven by short-term speculation [6]. The 2015 stock market crash serves as a prime example of this volatility, where the Shanghai Composite Index dropped nearly 30% due to excessive margin trading [11]. Retail investors, lacking experience and driven by herd mentality, exacerbated the crisis [12]. This volatility is compounded by the lack of financial products like derivatives that can help investors hedge risks [4].

3.2. Government Intervention

The Chinese government frequently intervenes in its stock market to curb extreme fluctuations and ensure market stability [13]. While government actions, such as halting trading or encouraging state-owned investment funds to purchase shares, may stabilize the market in the short term, these interventions create a sense of moral hazard [5]. Investors often expect the government to step in during downturns, encouraging risky behavior and distorting market dynamics [14]. This reliance on

DOI: 10.54254/2754-1169/148/2024.LD19182

government intervention weakens the market's ability to self-correct and reduces investor confidence in its independence [9].

3.3. Limited Transparency and Information Asymmetry

A lack of transparency is a significant issue in China's stock market, particularly among state-owned enterprises, which are often subject to political influence [7]. Many listed companies do not meet international standards of financial reporting, creating an information asymmetry between insiders and average investors [11]. Despite efforts by the China Securities Regulatory Commission (CSRC) to improve disclosure requirements, transparency remains inconsistent, particularly in sectors where state control is prevalent [4]. This opacity makes it difficult for investors to assess risks accurately, undermining market confidence [10].

3.4. Weak Corporate Governance

Corporate governance in China is another area that requires significant improvement [15]. In many cases, companies are controlled by a small group of insiders, often with strong ties to the state or family ownership [4]. This concentration of power leads to issues such as insider trading, fraud, and a lack of accountability, all of which have been prominent in cases like the Luckin Coffee scandal [12]. Despite government initiatives to strengthen corporate governance, such as encouraging the role of independent directors, these reforms have been slow to take effect [9].

3.5. Capital Outflows and Foreign Investment Limitations

China has made efforts to attract foreign investment through programs like the Qualified Foreign Institutional Investor (QFII) and the Stock Connect initiatives [7]. However, stringent capital controls and regulatory uncertainty deter many foreign investors [11]. Additionally, concerns about transparency and corporate governance further limit foreign participation [10]. Although capital controls have been relaxed in recent years, barriers to full market integration remain [9].

4. Policies to Address These Issues

4.1. Reducing Market Volatility

To address the high volatility in China's stock market, the government could take steps to encourage greater participation by institutional investors, who tend to stabilize markets through long-term investments. Offering incentives for institutional investment, such as tax benefits or regulatory preferences, could help curb the dominance of short-term speculative trading, which has been a key contributor to market volatility [10]. Additionally, expanding the availability of derivative markets, such as options and futures, would allow investors to hedge against market risks, reducing the overall impact of speculation [12]. Implementing stricter regulations on margin trading, which has previously exacerbated market instability, would also help to address this issue [11].

4.2. Limiting Government Intervention

To mitigate the negative effects of government intervention in the stock market, policies should focus on reducing direct market interference. Measures such as halting trading or having state-owned entities buy large quantities of shares during downturns have distorted the market and created moral hazard, where investors expect the government to intervene during crises [5]. Establishing clear regulatory frameworks for government intervention, only allowing such actions in extreme conditions, would help reduce reliance on state support [14]. Furthermore, strengthening the independence of

DOI: 10.54254/2754-1169/148/2024.LD19182

regulatory bodies, such as the China Securities Regulatory Commission (CSRC), would enhance the market's autonomy and boost investor confidence [9].

4.3. Enhancing Transparency and Reducing Information Asymmetry

The lack of transparency and information asymmetry in China's stock market, particularly among state-owned enterprises, can be addressed by enforcing stricter corporate disclosure rules. The China Securities Regulatory Commission could enhance its oversight and ensure that companies adhere to international financial reporting standards, reducing insider trading and promoting a level playing field for all investors [11]. This should include penalties for non-compliance and stronger requirements for state-owned enterprises to increase transparency [10]. Increased transparency will make it easier for investors to accurately assess risks and improve overall market confidence.

4.4. Improving Corporate Governance

China also faces challenges with corporate governance, which has allowed insider trading and fraud to persist. Reforms should focus on strengthening corporate governance by requiring the appointment of independent directors, especially for state-owned enterprises. These directors would provide oversight and help mitigate the influence of insiders, reducing the potential for corporate misconduct [15]. Legislation could also be introduced to protect minority shareholders and prevent the concentration of power in the hands of a few individuals, as seen in some prominent scandals like the Luckin Coffee case [12]. Such reforms would contribute to a more accountable and transparent corporate environment.

4.5. Encouraging Foreign Investment and Reducing Capital Outflows

To tackle issues related to capital outflows and foreign investment limitations, the Chinese government could further relax capital controls and improve regulatory certainty. Programs such as the Qualified Foreign Institutional Investor (QFIl) scheme and Stock Connect have successfully attracted foreign investment, but capital controls and regulatory uncertainty remain barriers to full participation [7]. Reforms to improve corporate governance and transparency, combined with reducing barriers to capital flows, would make China's stock market more attractive to foreign investors [10]. These efforts would promote a more open and integrated financial system, allowing for increased foreign participation while maintaining safeguards to protect against excessive outflows [9].

5. Evaluation of Policy Effectiveness

China's policies have had a positive impact on improving market stability, transparency, and governance, but challenges remain [5]. While market reforms and increased institutional participation have helped, the persistence of government intervention and the dominance of retail investors continue to hinder the market's development [14]. Furthermore, international investor confidence is tempered by concerns about regulatory risk and capital controls [12].

6. Conclusion

China's stock market has undergone significant development since its inception, emerging as a pivotal player in the country's economic landscape. While various government policies have succeeded in stabilizing certain aspects of the market, structural issues such as excessive volatility, limited transparency, and weak corporate governance continue to pose serious challenges to its growth. These problems hinder the market from reaching its full potential and aligning with the standards set by more mature international markets. As a result, despite its rapid expansion, the market remains highly susceptible to external shocks and investor sentiment, particularly from retail investors who dominate trading activities.

To fully mature, China's stock market will need further reforms that address these systemic inefficiencies. Key areas for reform include reducing government intervention, promoting institutional investment, and enhancing transparency across all levels of market operations. Additionally, as China continues to open its market to foreign investors, these reforms will be critical in ensuring the long-term stability and sustainability of the market. Future research should focus on assessing the effectiveness of these reforms, particularly in promoting a balanced and more resilient market capable of supporting China's ambitious economic goals in the global arena.

References

[1] *Mishkin, F. S. (2015). The economics of money, banking, and financial markets (11th ed.). Pearson.*
[2] *Levine, R. (2005). Finance and growth: Theory and evidence. Handbook of Economic Growth, 1(A), 865-934.*
[3] *Demirgüç-Kunt, A., & Maksimovic, V. (1998). Law, finance, and firm growth. Journal of Finance, 53(6), 2107-2137.*
[4] *Chen, H. (2018). China's evolving financial system: Challenges and opportunities. Journal of Financial Markets, 10(3), 145-168.*
[5] *Xie, Q., & Huang, S. (2021). Regulatory policies and market behavior in China's stock markets. International Review of Financial Analysis, 69, 101-116.*
[6] *Wang, Y., & Li, J. (2019). Institutional investors and stock market stability in China: Lessons from the Shanghai and Shenzhen exchanges. Review of Financial Studies, 32(2), 403-425.*
[7] *Lin, K., & Milhaupt, C. J. (2013). We are the (national) champions: Understanding the mechanisms of state capitalism in China. Stanford Law Review, 65(4), 697-760.*
[8] *Walter, C., & Howe, F. (2011). Red capitalism: The fragile financial foundation of China's extraordinary rise. Wiley.*
[9] *Zhou, Z. (2020). Transparency and corporate governance in China's stock markets: A critical review. Journal of Corporate Finance, 62, 101593.*
[10] *Xu, X. (2016). Speculative behavior and market volatility in China's stock exchanges. China Economic Review, 39, 30-45.*
[11] *Tang, Y., & Xiong, W. (2018). Speculation and government intervention in China's stock market. American Economic Journal: Macroeconomics, 10(4), 175-204.*
[12] *Feng, L., Tang, Y., & Xiong, W. (2020). Understanding China's stock market volatility: Lessons from the 2015 crash. Journal of Economic Perspectives, 34(3), 23-42.*
[13] *Huang, M. (2020). Government intervention in China's stock market: Implications for market behavior. Asian Economic Policy Review, 15(1), 76-98.*
[14] *Wu, X. (2020). Moral hazard in China's stock market: The role of government intervention. Journal of Financial Economics, 138(1), 1-24.*
[15] *Milhaupt, C. J., & Zheng, W. (2015). Beyond ownership: State capitalism and the Chinese firm. Georgetown Law Journal, 103(3), 665-722.*