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**Working Paper**

## Institutional development and stock price synchronicity: Evidence from China

BOFIT Discussion Papers, No. 20/2013

**Provided in Cooperation with:**

Bank of Finland, Helsinki

*Suggested Citation:* Hasan, Iftekhar; Song, Liang; Wachtel, Paul (2013) : Institutional development and stock price synchronicity: Evidence from China, BOFIT Discussion Papers, No. 20/2013, ISBN 978-952-6699-25-7, Bank of Finland, Institute for Economics in Transition (BOFIT), Helsinki,  
<https://nbn-resolving.de/urn:nbn:fi:bof-201408072083>

This Version is available at:

<https://hdl.handle.net/10419/212775>

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BOFIT Discussion Papers  
20 • 2013

Iftekhar Hasan, Liang Song and Paul Wachtel

Institutional development and  
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Bank of Finland, BOFIT  
Institute for Economies in Transition

BOFIT Discussion Papers  
Editor-in-Chief Laura Solanko

BOFIT Discussion Papers 20/2013  
12.8.2013

Iftekhar Hasan, Liang Song and Paul Wachtel: Institutional development and  
stock price synchronicity: Evidence from China

ISBN 978-952-6699-25-7  
ISSN 1456-5889 (online)

This paper can be downloaded without charge from <http://www.bof.fi/bofit>.

Suomen Pankki  
Helsinki 2013

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Iftekhar Hasan, Liang Song and Paul Wachtel

## Institutional development and stock price synchronicity: Evidence from China

### Abstract

Better developed legal and political institutions result in greater availability of reliable firm-specific information. When stock prices reflect more firm-specific information there will be less stock price synchronicity. This paper traces the experience of China, an economy undergoing dramatic institutional change in the last 20 years with rich variation in experiences across provinces. We show that stock price synchronicity is lower when there is institutional development in terms of property rights protection and rule of law. Furthermore, we investigate the influence of political pluralism on synchronicity. A more pluralistic regime reduces uncertainty and opaqueness regarding government interventions and therefore increases the value of firm-specific information that reduces synchronicity.

JEL Classification Numbers: G14; G15; G24; G38

Keywords: Institutions; China; stock price synchronicity.

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Acknowledgement: The authors are grateful to Diyue Guo for excellent research assistance, to the editor and the reviewers for their suggestions and Randall Morck and Thorsten Beck for their helpful comments. Earlier versions of this paper were presented at the conference on “Bridging the GAAP: Recent Advances in Finance and Accounting” at Hebrew University, Jerusalem, Israel, in July 2010, and at the “Conference on Chinese Capital Markets” at the New York University Center on US-China Relations, New York in May, 2011.

# 1 Introduction

The influence of institutional characteristics on the synchronicity of stock prices can be traced to Grossman and Stiglitz (1980), who argued that informed trading and informative pricing, which are central determinants of firm-specific stock variation, are determined by the costs and benefits of information collection. Following their rationale, we argue that poor legal institutions increase the cost of information collection and reduce investors' incentives to collect private information. This reduces the information content of stock prices and increases stock price synchronicity. Furthermore, we introduce a related argument regarding the openness of political institutions, namely, that there is greater availability of private information in more open political environments.

For the most part, the existing literature relates the quality of institutions to economic performance with cross country studies in which the heterogeneity of country specific characteristics makes it difficult to identify the effects even with panel data (Acemoglu et. al., 2005; Glaeser et. al., 2004; Wachtel, 2011). In this paper we focus on one country, China, where the pace of both legal and political development has varied across the provinces, and we relate these developments to the quality of information and, hence, synchronicity in equity markets. Rapid development over the last 20 years has both improved Chinese institutions and increased the variation among China's provinces in the level of legal and political development. Specifically, we use a panel of Chinese provinces to investigate the effect of institutions, both legal and political, on stock price synchronicity.

We show that the differences in stock price synchronicity are in part due to the variation among the provinces in institutional characteristics regarding property rights protection and the extent of the rule of law, as well as the degree of political pluralism. That is, stock price synchronicity is lower (i.e., the information content of stock prices is higher) in provinces with a better legal environment and greater political openness.

A priori, there are two reasons why poor institutions can lead to less collection of private information. First, in provinces where property protection for investors is weak, the risk of expropriation by corporate insiders could make firm-specific information less valuable, and informed risk arbitrage is unattractive. Second, even good regulations regarding information disclosure are often not fully enforced when there is poor rule of law. The entrenched managers are able to withhold relevant information to cover their own self-

serving behavior.<sup>1</sup> The argument regarding political pluralism is similar. A more pluralistic political structure reduces the uncertainty and opacity of political decision making because the dominant Communist party has to contend with non-party members and is subject to increased monitoring from them. Thus, greater political pluralism in a province will reduce the costs that result from political risk in collecting private information, which, in turn, decreases synchronicity.

The cross country literature on synchronicity has shown that firm-specific stock return variation is high or stock price synchronicity is low in countries with more developed institutions because reliable firm specific information is more readily available (Morck, Yeung and Yu, 2000). Furthermore, countries where investors have more firm-specific information will also have greater efficiency of capital allocation and lower costs of capital (Durnev, Morck and Yeung, 2004; Wurgler, 2000). However, a potential drawback of the cross country studies is that firms operating in different national environments are also affected by other country specific characteristics, such as diversity of historical experience. We are able to hold national characteristics constant by focusing on the province-level differences in institutional development across China.

The literature on synchronicity focuses on the effects of investor protection from the perspective of the legal and information environment with no discussion of the direct influence of the political environment (i.e., Jin and Myers, 2006; Fernandes and Ferreira, 2009). We suggest that the political environment may be equally important because politicians can change investor protections if they choose to do so (Pagano and Volpin, 2005). Political authorities can alter the legal environment with legislative changes or by changing the way laws are applied. An authoritarian political regime can enact new legislation or change the existing legal environment as it relates to investor protection. There is significant variation across China's provinces in the extent of influence of the Communist party and the diversity of the political environment. We show that differences across the provinces in political pluralism influence stock price synchronicity.

Stock price synchronicity among the Chinese provinces has been examined by Gul, Kim and Qiu (2009) in a study of ownership concentration and corporate governance. We adopt their approach to the measurement of synchronicity and apply it to a study of local institutions. The measures of legal and political development in China at the provin-

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<sup>1</sup> For a discussion of these issues in emerging markets, see Chan and Hameed (2006) and Fan and Wong (2005).

cial level were first developed by Hasan, Wachtel and Zhou (2009), who use the data to explain differences in the growth rate across provinces. Data are available for 31 Chinese provinces for the period 1998-2007.

The possible endogeneity of synchronicity presents a major challenge which we attempt to solve by using GMM estimation. The results are often over identified, but when they are not we find that our results with OLS and GMM are largely the same. Furthermore, we present a number of tests to support the robustness of our results. For example, Morck, Yeung, and Yu (2000) find that the relationship between investor protection and stock price synchronicity is different in emerging markets as compared to developed countries. There are large differences in the level of development across China; we divide our sample between those provinces with above and below median GDP per capita. Our results are not driven by the differences between the two sub samples. We also explore some alternative explanations for the roles of institutions. For instance, Khanna and Thomas (2009) suggest that poor institutions may enhance the development of business groups, vertical integration, and operating diversification, which further increases stock price synchronicity. We examine the role of corporate governance by looking at the interaction between our institutional measures and firm characteristics, such as ownership that is related to better corporate governance. We find that better institutions have a more pronounced effect on stock price informativeness for firms with poorer corporate governance, as indicated by a higher proportion of government ownership or a lower proportion of foreign ownership. These results support our hypothesis that the negative relationship between institutional development and stock price synchronicity is due to poor institutional development that provides less investor protection. This increases the cost of information collection and reduces investors' incentives to collect private information, which further reduces the information content of stock prices and increases stock price synchronicity.

Our study contributes to the literature in several ways. First, as noted earlier, by using province level data from one country, we overcome the problem faced by all cross country studies regarding omitted country characteristics. We provide a unique focus on the effect of province-level investor protection in the single most important emerging market, China. Second, in addition to the effects of property rights and law enforcement, we also examine the effect of another important aspect of institutional development, political pluralism—a measure of the strength of democracy—on stock price informativeness, which has not been previously investigated. Third, China utilizes a quota system to select



companies from each province for listing or raising additional equity on a stock exchange. Du and Xu (2009) show that provinces in which listed firms have more firm-specific information incorporated into stock prices were rewarded with more stock quotas in the subsequent periods. Thus, our study shows that policies to improve institutions can also increase access to capital.

The remainder of the paper proceeds as follows. Section 2 discusses the specific hypotheses that we will test. Section 3 presents the calculation of synchronicity, our other measures, data sources, and descriptive statistics. Section 4 describes our empirical methodology and provides the baseline estimates of the relationship between institutional development and stock price informativeness. Section 5 provides extensions of the results, including an examination of the investment behavior of firms and our robustness tests. The final section concludes.

## 2 Hypotheses and related literature

China has followed an incremental approach to reforming its centrally planned economy into a market system, which has resulted in remarkably high growth rates for almost three decades (Prasad and Rajan, 2006). Rapid economic growth both demands and facilitates the development of legal institutions and the evolution of political systems (Williamson, 1996). There are a few empirical studies on the role of institutional development in China that show, for example, that the institutional environment matters for Chinese firms' reinvestment decisions and for fostering entrepreneurship (Cull and Xu, 2005; Djankov, Qian, Roland and Zhuravskaya, 2006).

An important feature of the evolution of the legal environment in China is that many of the laws adopted are enacted locally following national legislation; as such, their implementation varies from province to province (Krug and Hendrischke, 2003). Such variation is found for laws and regulations that ensure the protection of property rights (Hasan, Wachtel and Zhou, 2009).

Studies with cross country data have established the importance of intellectual property rights protection for economic growth (Gould and Gruben, 1996; Park and Ginarte, 1997). Hasan, Wachtel, and Zhou (2009) use the number of trademark applications in Chinese provinces as a proxy for the awareness of property rights and show that it is related to growth rates.

The link between property right protection and the information in stock prices has been discussed in Morck, Yeung, and Yu (2000). They argue that poor protection for property rights could discourage informed risk arbitrage because expropriation risk will make such behavior less valuable and increase the cost of collecting firm-specific private information. The resulting reduction in informed trading will impede the capitalization of firm-specific information into stock prices and decrease firm-specific return variation. Thus, they show that equity returns of firms in economies with poor country-level property rights exhibit relatively high synchronicity.

Our first hypothesis is: **H1:** *Stock price synchronicity is lower for firms in provinces with better property rights.*

Another notable feature of the evolution of the modern Chinese legal system was the spread of the rule of law, specifically the gradual development of institutional structures for the enforcement of rules and the settlement of disputes. For instance, in 1995, the State Compensation Law allowed citizens to sue the state (Burns, 1999). The functions of the Party and government in the People's Congress system were separated to strengthen the rule of law (Burns, 1999). In this process, many members of the legal profession, such as lawyers and judges, were rehabilitated, which significantly improved the quality of law enforcement (Hasan, Wachtel, and Zhou, 2009).

The effect of rule of law and related issues on firm-specific return variation were explored by Ball (2001) and Chan and Hameed (2006). Even when there are adequate laws on the disclosure of corporate information, they are often not fully enforced when there is poor rule of law. Entrenched managers might find it in their interests to withhold information, which increases the cost of collecting private information and leads to less firm-specific information being reflected in stock prices. The cross country study by Morck, Yeung and Yu (2000) relates aspects of the rule of law, such as an efficient judiciary, to stock price synchronicity.

Our second hypothesis is: **H2:** *Stock price synchronicity is lower for firms in provinces with higher quality of law enforcement.*

China's leaders have long recognized the need for political reform, albeit very gradual political reform. While China is still a largely authoritarian communist state, there have been

significant movements towards political pluralism (White, 1993, Chapter 8). For example, non-party members such as professional experts, entrepreneurs, and members of minority political parties occupy approximately one third of the seats in the National People's Congress (NPC), the highest legislative body in China. This significantly contributes to elements of pluralism in Chinese political structures and decision making. The delegates to the NPC are elected by the provincial People's Congresses, and the degree of pluralism varies across provinces. Thus we will be able to examine the effect on stock price synchronicity of a more open and pluralistic political structure.

The cross country literature has shown that more democratic political environments are associated with economic growth (Rodrik and Wacziarg, 2006; Borner, Brunetti and Weder, 1995). Shleifer and Vishny (1993) and Mauro (1995) document that poor quality political institutions are associated with substantial economic costs, especially in developing economies. Furthermore, the literature shows a positive association between liberal democracy and successful economic liberalization (e.g., Zack-Williams, 2001).

Increasing numbers of non-party members are elected to both national and provincial People's Congresses. New members include many owners of private firms who have a motivation to promote the recognition and protection of private-property rights. If there is a higher proportion of non-Communist Party members in the provincial People's Congress than in the national People's Congress, we suggest that the province has a more pluralistic political environment. A more pluralistic political environment could lead to improved decision making due to increased debate and monitoring. This mechanism is similar to the competition among political parties in western countries; it improves the quality of the local government by reducing the uncertainty and opacity of political decision making. Thus, greater political pluralism in a province will reduce the costs resulting from political risk to collect private information which decreases synchronicity. Morck, Yeung, and Yu (2000) linked one aspect of the country-level quality of government, an absence of corruption, to stock price synchronicity.

Our third hypothesis is: **H3:** *Stock price synchronicity is lower for firms in provinces with more political pluralism.*

## 3 Data

### 3.1 Sample

Our sample covers the period 1998-2007 and includes all non-financial firms in China with available stock returns data from DataStream for at least 200 trading days in a particular year.<sup>2</sup> Altogether, the sample includes 1012 firms and 5570 firm-year observations.<sup>3</sup> Firms are assigned to the province where the company is incorporated. Each firm's location was collected by hand from the prospectus. Importantly, there is no evidence that firms are concentrated in particular regions; there are as many provinces (five) with 15-20 firms as there are with 60-65 firms.<sup>4</sup>

### 3.2 Measurement of stock price synchronicity

Stock price synchronicity is based on annual market model regressions for each firm where the daily stock returns are regressed on the returns of an industry index and the market index. That is, we estimate the following market model for each stock and each year using daily returns data:

$$Return_{it} = \alpha + \beta_1 IndustryReturn_t + \beta_2 MarketReturn_t + \varepsilon_{it} \quad (1)$$

where  $Return_{it}$  denotes the daily return for firm  $i$  and day  $t$ .  $IndustryReturn_t$  is the industry return calculated as a value-weighted stock return of all other firms within the same industry as firm  $i$  (with  $Return_{it}$  omitted);  $MarketReturn_t$  is the value-weighted return for all firms; and  $\varepsilon_{it}$  represents unspecified random factors.

The Chinese market has a unique feature: there are shares issued to domestic investors (A-shares) and two types of shares issued to foreign investors (B-shares that trade on the Shanghai or Shenzhen stock exchanges and H-shares that are traded in Hong Kong). Equation (1), as specified above, uses A share returns. We also estimate market models that include the influence of foreign investors through B or H share trading. We follow the approach in Gul, Kim, and Qiu (2010) to account for differences among the

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<sup>2</sup> We begin in 1998 because the province level data on the institutional environment are not available earlier and we end before the onset of the global financial crisis.

<sup>3</sup> We exclude the observation for the year in which a firm concludes its IPO.

<sup>4</sup> There are 22 provinces, 5 autonomous regions, and 4 municipalities. The Special Administrative Regions are not included in the sample.

various markets where Chinese shares are traded. For firms with only domestic A-shares, the extended model is equation (2a) which adds the world market returns:

$$\begin{aligned} Return_{it} = & \alpha + \beta_1 IndustryReturn_t + \beta_2 MarketReturn_t + \\ & \beta_3 WorldMarketReturn_t + \varepsilon_{it} \end{aligned} \quad (2a)$$

$WorldMarketReturn_t$  is the world market return calculated using the MSCI World index for day  $t$ . For firms with A and B-shares, we also add the value-weighted B-share market return  $BShareMarketReturn_t$  as in equation (2b):

$$\begin{aligned} Return_{it} = & \alpha + \beta_1 IndustryReturn_t + \beta_2 MarketReturn_t + \beta_3 BShareMarketReturn_t + \\ & \beta_4 WorldMarketReturn_t + \varepsilon_{it} \end{aligned} \quad (2b)$$

And for firms with A and H-shares, we add the world market factor and the H-share market returns as in equation (2c):

$$\begin{aligned} Return_{it} = & \alpha + \beta_1 IndustryReturn_t + \beta_2 MarketReturn_t + \beta_3 HShareMarketReturn_t + \\ & \beta_4 WorldMarketReturn_t + \varepsilon_{it} \end{aligned} \quad (2c)$$

where  $HShareMarketReturn_t$  is the value-weighted Hong Kong market return. Thus, the extended market model is estimated for each firm for each year using (2a) or (2b) or (2c).

The  $R_i^2$  of the market model estimated for a particular firm in a particular year is our measure of its stock price synchronicity. A higher value of  $R_i^2$  means higher stock price synchronicity with market movements and less firm-specific return variation.<sup>5</sup> Because  $R_i^2$  is bounded within  $[0, 1]$ ,  $\psi_i$ , the logistic transformation of  $R_i^2$ , is our preferred measure of the annual stock price synchronicity for firm  $i$ :

$$\psi_i = \log\left(\frac{R_i^2}{1 - R_i^2}\right)$$

We will denote synchronicity from the domestic share model, equation (1), as  $R_i^2(1)$  and synchronicity from the extended model, equations (2a-b-c), by  $R_i^2(2)$ . The corresponding logistic transforms are  $\psi(1)$  and  $\psi(2)$ .

<sup>5</sup> A higher value of  $R_i^2$  is also associated with larger estimates of  $\beta$  from the market model, which is often interpreted as risk. Thus, increased synchronicity is the same as increased risk.

### 3.3 Measures of legal and political institutions

We develop three measures of province-level characteristics in China, each associated with one of our hypotheses: property rights protection, rule of law, and political pluralism. A major challenge in our study is that direct measures of these phenomena are not available; only imperfect proxies exist. Following on the work of Hasan, Wachtel, and Zhou (2009), we were able to collect proxy measures from a variety of Chinese sources.

The variable *PropertyRights* is the number of domestic trademark applications per firm for a certain province and year. Firms will make use of trademarking if they are confident that the institutional environment in the province is good enough to actually protect the property rights that come with a trademark. Thus, a higher value of *PropertyRights* represents a higher level of property rights protection. The data on domestic trademark applications is from the annual issues of the *Almanac of China's Property Rights* and the *Yearbook of China's Industrial and Commercial Administrative*, annual provincial yearbooks, and the government-sponsored trademark website, *China Trademark Online*. When the data are missing in a certain year, we use the product between the national data in that year and the proportion of applications from the province in 1998.

The variable *RuleofLaw* is the number of lawyers per 10,000 people for a certain province and year. An increased presence of legal professionals in a province is associated with both the development of legal institutions and of the mechanisms for law enforcement. Thus, a higher value of the variable *RuleofLaw* represents a higher level of law enforcement. The number of lawyers in each province is taken from the *Statistics Yearbook of China's Legislation* and the annual issues of the *Statistics Yearbooks* of each province.<sup>6</sup> It is supplemented by additional information from Chinese web based resources such as the China Lawyering ([www.china-lawyering.com](http://www.china-lawyering.com)) and China Lawyers Investigation ([www.007cn.cn](http://www.007cn.cn)). If the data are missing, we use interpolated values based on nationwide growth in the number of lawyers. Population data are from the National Bureau of Statistics of China.

The variable *PoliticalPluralism* is the proportion of non-Communist party members in the provincial People's Congress relative to the proportion in the National People's Congress. If the provincial proportion of non-Communist Party members is higher than the national benchmark at that time, then the province arguably has a more open or pluralistic

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<sup>6</sup> They provide data for 1990, 1995, and 2000–2002.

political environment. Thus, a higher value of the variable *PoliticalPluralism* indicates a higher level of political pluralism. The data on political pluralism are taken from the regional *People's Congress Yearbooks* of each province in China and the Examination and Approval Reporting Document issued by the Examination Committee of the People's Congress. Information on the membership structures of the People's Congress in six provinces is not available, and so data from neighboring provinces with similar political characteristics are used as an estimate.

### 3.4 Other variables

The set of control variables includes characteristics of firms and the macro environment that are known to influence synchronicity (Chan and Hameed, 2006; Gul, Kim and Qiu, 2010). Specifically, we include the proportion of equity held by the government and by foreign owners (*GovernmentOwn* and *ForeignOwn*) for each firm-year. The government and foreign ownership data are from the NUS Business School's database of Chinese listed firms' ownership structures. We also include dummy variables for the share structure (*BShare* and *HShare* if the firm has issued B shares and H shares respectively).<sup>7</sup> Firm characteristics included are: a) *AccountingOpacity*, the ratio of the absolute value of accounting accrual to total assets, where accrual is equal to earnings after extraordinary items plus depreciation minus cash flow from operations; b) the annual trading turnover (*Volume*), which is the total number of shares traded in a year divided by the total number of shares outstanding at the end of the fiscal year; c) *Size*, the logarithm of total assets; (d) *Leverage*, total liabilities divided by total assets; (e) *EarningVolatility*, the standard deviation of a firm's ROA for the preceding five-year period, including the current year; (f) *MarketToBook*, the ratio of market value of assets to the book value of assets, where the market value of assets is defined as the book value of assets minus the book value of equity plus the market value of equity; and (g) *Log(IPOAge)*, the logarithm of the number years from the IPO. The stock turnover data are from DataStream and the firm accounting data are from the Worldscope database

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<sup>7</sup> Firms with B-shares and H-shares must report in compliance with International Financial Reporting Standards or Hong Kong Generally Accepted Accounting Principles. The stricter disclosure rules would improve firms' information environments and reduce stock price synchronicity.

We also include two measures of industry size: (a) the logarithm of the number of firms in the industry to which a firm belongs (*IndustryByNumber*) and (b) the logarithm of the total assets of all firms in the industry that are in our sample (*IndustryBySize*). Industries are defined according to the one digit industry code from the Worldscope database. Macro variables in the set of controls are (a) the annual province-level growth rate in per capita real GDP (*GDPGrowth*), and (b) the per capita real GDP (*GDPPerCapita*). The real annual per capita GDP for each province is from China Economic Information Network Database. Table 1 presents a summary of variable names and definitions.

### 3.5 Descriptive statistics

The mean value of the three institutional variables and the mean value of stock price synchronicity measured by  $R^2(1)$  by province are shown in Figure 1.<sup>8</sup> Most of the provinces with higher institutional development have low stock price synchronicity. For example, Gan'Su province has the highest stock price synchronicity. Moreover, it has the lowest value for *PropertyRights* and the second lowest value for *RuleofLaw* and *PoliticalPluralism*. Bei'Jing has the lowest stock price synchronicity; it has the highest value of *PropertyRights* and *RuleofLaw* and the fourth highest value of *PoliticalPluralism*.

Summary statistics for the whole sample are shown in Table 2. All variables are winsorized at the 1 and 99 percentiles to exclude possible outliers. As shown in the table, the mean value of  $R^2(1)$  is 0.490 while the mean value of  $R^2(2)$  is 0.432.<sup>9</sup> The large standard deviations and wide ranges of both  $R^2$  and  $\psi$  indicate that there is considerable cross-sectional variation in synchronicity. All of the institutional variables exhibit a reasonable amount of variation across time and province. On average, the state shareholder holds 31.0 percent and foreign shareholders hold 6.7 percent of shares outstanding, suggesting that the government still has a dominant impact on Chinese listed firms.

Table 3 presents the correlations between our province-level and firm-level variables. The correlation between the two synchronicity measures,  $\Psi(1)$  and  $\Psi(2)$ , is 0.975. Measures of synchronicity are negatively correlated with property rights (*PropertyRights*), rule of law (*RuleofLaw*), and political pluralism (*PoliticalPluralism*). A firm's stock price

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<sup>8</sup> The values are the means for all the available observations of companies in the province.

<sup>9</sup> These statistics are similar to the results reported with cross country data by Morck, Yeung and Yu (2000), as well as in the study of China by Gul, Kim and Qiu (2010).



synchronicity is lower when it is located in a province in which there is sounder institutional development. The simple correlations are consistent with our three hypotheses.

## 4 Baseline regression results

To test for the effects on synchronicity of property rights (H1), of rule of law (H2), and of political pluralism (H3), we estimate the following equation:

$$\begin{aligned} \psi_{it} = & \alpha + \beta_1 \text{PropertyRights}_{it} + \beta_2 \text{RuleofLaw}_{it} + \beta_3 \text{PoliticalPluralism}_{it} + (\text{CONTROL}_{it}) \\ & + (\text{YearDummies}) + (\text{IndustryDummies}) + \varepsilon_{it} \end{aligned} \quad (3)$$

where  $\psi_{it}$  is the measure of stock synchronicity for firm  $i$  and year  $t$ . The institutional environment variables *PropertyRights*, *RuleofLaw*, and *PoliticalPluralism* are our primary interests and we expect that  $\beta_1$ ,  $\beta_2$  and  $\beta_3 < 0$ . CONTROL denotes a set of control variables, including the variables *GovernmentOwn*, *ForeignOwn*, *BShare*, *HShare*, *AccountingOpacity*, *Volume*, *Size*, *Leverage*, *EarningVolatility*, *MarketToBook*, *Log(IPOAge)*, *IndustryByNumber*, *IndustryBySize*, *GDPGrowth*, and *Log(GDPPerCapita)*. Finally, the regressions include fixed effects for the year (*YearDummies*) and industry (*IndustryDummies*).

Government related shareholders are more likely to be associated with expropriation risk and information asymmetry problems compared to foreign shareholders. Thus, we expect the coefficient on *GovernmentOwn* to be positive and the coefficient on *ForeignOwn* to be negative. Since foreign investors are presumably more skilled at collecting and trading on firm-specific information, we expect that the variables *BShare* and *HShare* are negatively correlated with stock price synchronicity. We expect that the coefficient on *AccountingOpacity* is negative because firms with higher accounting opacity have a worse information environment. We expect that the coefficient on *Volume* is negative because more trading will help incorporate more firm-specific information. We expect that the coefficient on the variable *Size* is positive because stocks of large firms are more likely to be aligned with the whole market. The coefficient on the variable *Leverage* is likely to be positive because the cost of collecting private information may be higher for firms with greater risk of financial distress. We expect that the coefficient on *EarningVolatility* is negative because stocks of firms with higher earning uncertainty have more firm-specific variation. The coefficient on the variable *MarketToBook* is expected to be negative because

stocks of firms with higher growth potential are likely to incorporate more firm-specific information. We expect that the coefficient on  $\text{Log}(IPOAge)$  is positive because more of the time-invariant firm-specific information such as managerial quality is already incorporated in the stock price of older firms and there is generally less firm-specific information that is not yet reflected in the stock price (Dasgupta, Gan, and Gao, 2010).

Estimates of Equation (3) with  $\psi(1)$  as the dependent variable are shown in Table 4. The t-statistics are calculated using robust standard errors corrected for firm-level clustering which may result from serial dependency in the firm data. The first three columns in the table show each of our key institutional variables separately estimated with OLS. The last two columns include all of the variables first estimated with OLS and then with GMM. Since simultaneity among the variables is a potentially serious problem, equation (5) of Table 4 shows estimates of the full equation using the two-step system GMM estimator. We treat all institutional variables and control variables excluding *IndustryByNumber*, *IndustryBySize*, *GDPGrowth*, and *Log(GDPPerCapita)* as endogenous and the other variables as exogenous. We also add another instrument, *RelativeDistance*, which is defined as the distance from Beijing to each of the provincial capitals scaled by the longest distance from Beijing to a provincial capital. This variable is chosen because firms are less likely to be influenced by the central government if they are located in a province that is far from Beijing. We use a Hansen test for the overall validity of our instruments; the null hypothesis is that the instruments as a group are exogenous. The p-value of the Hansen test is larger than 0.1, suggesting our instruments are exogenous.<sup>10</sup> GMM estimates are not shown for the other specifications because the estimates are over identified.

In all the results shown, we find that stock price synchronicity is lower when there is sounder institutional development in term of property rights protection, rule of law, and political pluralism. That is, our measures of institutional development all have the expected negative impact on synchronicity and, moreover, the coefficients are all statistically significant.

The effects of these institutional factors on stock price synchronicity are also economically relevant. We use the results reported in Column (4) of Table 4 to assess the impact of the institutional variables on stock price synchronicity. A one standard deviation

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<sup>10</sup> The p- value for the Hansen test for equation (5) is 0.191 and the values for the AR(1) and AR(2) tests are 0.000 and 0.925, respectively.

increase in *PropertyRights* decreases stock price synchronicity (i.e.  $\psi(1)$ ) by  $0.154 \times 0.484$  or 0.075, which is about 2.5 percent of the range of synchronicity (the difference between the largest and smallest values of  $\psi(1)$  is 2.993). A one standard deviation increase in *RuleofLaw* decreases stock price synchronicity by  $0.050 \times 0.715$  or 0.036, roughly 1.2 percent of the range. Finally, a one standard deviation increase in *PoliticalPluralism* decreases stock price synchronicity by  $0.119 \times 0.119$  or 0.014, just over 0.5 percent of the range. Taken together, these examples underline the importance that different institutional factors have for stock price synchronicity.

All the control variables have the expected signs in the OLS estimates, though there are some exceptions with the GMM estimator. The coefficient on *GovernmentOwn* is significantly positive, suggesting that higher state ownership is associated with less use of firm-specific information in determining stock prices. The coefficient on the variable *ForeignOwn* is significantly negative, suggesting that higher foreign ownership increases the use of firm-specific information. However, this result is not found with the GMM estimator. The coefficients of the variables *Volume* and *MarketToBook* are significantly negative, but only with OLS. Firms with high growth opportunity tend to commove less. The coefficient estimates of the remaining variable generally have the expected signs, but are insignificant.

The significant negative signs on *BShare* in Table 4 indicate that the presence of foreign investors increases the information content of stock prices. The degree of synchronicity of these firms is likely to differ from those restricted to the domestic stock market for at least two reasons. First, compared with firms that exclusively issued A-shares, these firms have stricter financial reporting regulation and their financial statements are more likely to be audited by international auditing firms. Second, foreign investors are more likely to have superior capabilities, resources, and skills to collect and process firm-specific information (Gul, Kim and Qiu, 2010).

Since the number of firms with either B-shares (available to foreigners on the Shanghai or Shenzhen stock exchanges) or H-shares (trading in Hong Kong) is relatively small, we do not estimate the relationships separately. Instead, we use the measure of synchronicity from the extended market model (2a-b-c) to account for international market influences. Table 5 presents a summary of regression results that use synchronicity calculated from the extended market model,  $\psi(2)$ , as the dependent variable. Each equation

includes all the control variables shown in Table 4; to conserve space, only key coefficients are shown in the table. The coefficient estimates in Table 5 are qualitatively similar to those reported in Table 4. The presence of foreign traders is important but does not obviate the significance of local institutions.

## 5 Model extensions and robustness checks.

### 5.1 Alternative measures of institutional quality

Our proxies for institutional quality reflect our efforts to measure the relevant characteristics directly. In this section, we compare our constructed variables to published indices that measure related aspects of the institutional development of Chinese provinces. We were able to locate two such measures; although the data are limited, they are sufficient to test the robustness of our results.

The first measure is an index of administrative transparency constructed since 2009 by the Beijing University Center for Public Participation Studies and Supports (China Law Center, 2011). It is an assessment of local governments with regard to the transparency of government communication and efforts to build government systems. For the lack of any earlier data, we use the 2009 administrative transparency index for all years. The second measure is a broader index of marketization constructed by the National Economic Research Institute (NERI, 2010). The marketization index is available annually from 1997-2007. The index is based on a large number of indicators that reflect institutions and the economic structure. Among the elements of the index are the extent of state ownership, barriers to inter-regional trade, price controls, the environment for FDI and the financial sector, labor mobility, and the legal framework (including a measure of patent registration).

These indexes are far from perfect for at least two reasons. First, they weight diverse bits of information with an arbitrary scaling; it is unclear how to properly interpret a unit increase in the index. Second, the actual components of the indices are not provided in the sources, so their meaning is opaque. Nevertheless, we add the indexes to our baseline regressions as a robustness test.

Table 6 provides a summary of results; only coefficients for the institutional variables are shown. Each equation includes all the control variables shown in Table 4. The

scaled marketization index is the province's marketization score relative to the average for all provinces in that year. We show each index separately and with our three proxy measures of institutional quality. There is a strong negative relationship between synchronicity and the marketization and the administrative transparency indexes. Furthermore, the coefficients are reduced somewhat when we also include our proxy measures for property rights, rule of law, and pluralism. Importantly, there is little difference in the coefficients on our three institutional proxies between the baseline estimates (column (4) Table 4) and the estimates in Table 6 that include the overall institutional indexes. After controlling for these additional institutional variables, our main results still hold.

A final robustness check is based on the changing nature of our political pluralism variable. In 2002, the Party revised its Charter to allow private entrepreneurs to join. Since then, many such "red capitalists" became members of the Chinese Communist Party and even members in the People's Congress, which has contributed to pluralism (Dickson, 2003; Chen and Dickson, 2008). In a sense, this reform represents an exogenous shock which might influence stock price synchronicity. In results not shown here, we add a dummy variable for this post reform era to our baseline equation. The coefficient on the dummy is significantly negative, suggesting that stock price synchronicity decreased after the party charter revision that allowed private entrepreneurs to join; furthermore, the coefficients on the institutional variables are largely unaffected.

## 5.2 Threshold effects

Morck, Yeung, and Yu (2000) find that the relationship between investor protection and stock price synchronicity is different in emerging markets as compared to developed countries. To see if there are any similar threshold effects within China, we divide our sample into provinces with above and below median GDP per capita. We estimate synchronicity regressions for each sub sample and the results are summarized in Table 7. The coefficient estimates across these two sub samples are qualitatively identical to those reported in Table 4, which thus support our previous conclusions and indicate that our results are not driven by the differences between more and less developed provinces.

### 5.3 Alternative explanations

Throughout this paper, we have maintained that poor institutional development increases the cost of information collection and reduce investors' incentives to collect private information. This reduces the information content of stock prices and increases stock price synchronicity. However, there may be other explanations of our main results. For example, Khanna and Thomas (2009) use a unique dataset in Chile and show that two firms with more connections are more likely to have synchronized stock returns. Poor provincial institutions may enhance connectedness among managers, resulting in the development of business groups, vertical integration, and operating diversification, all of which further increase stock price synchronicity. Another possibility is that regions with stronger institutions have a bigger investor pool. If investors favor firms in their home province then stock price synchronicity is lower.

In the only other study of synchronicity in China, Gul, Kim and Qiu (2010) argue that state ownership is associated with inefficient corporate governance and less protection for minority shareholders. Better investor protection increases investors' incentives to collect private information, which will result in less synchronicity. Thus, we expect that the effect of institutional development on synchronicity is more pronounced for firms with higher government ownership.

To formally address this issue, we add interaction terms between our institutional variables and the state ownership variable in the synchronicity regressions. The equations are estimated with OLS and include all the standard control variables shown in Table 4. The results are summarized in Table 8, which shows that the interactions between government ownership and the variables *PropertyRights* and *RuleofLaw* are negative and significant. This is true when all three variables and the interaction terms are in the regression together (column (4) of Table 8). That is, the (negative) effect of institutional quality on synchronicity is more pronounced for firms with higher government ownership.

Next we test whether provincial institutional development has a more significant impact on synchronicity for firms with lower foreign ownership. To do so, we add interaction terms between our institutional development variables and the foreign ownership variable to the synchronicity regressions. Foreign shareholders are less likely to be associated with expropriation risk and information asymmetry problems (Kang and Stulz, 1997; Jiang and Kim, 2004). If, in fact, the higher investor protection provided by the better institu-

tional environment decreases the cost of information collection and increases investors' incentives to collect private information, which contributes to the incorporation of information into equity prices, we expect to find that the effect of institutional development on synchronicity is more pronounced for firms with lower foreign ownership and that there is a positive coefficient on this interaction variable. The estimates in columns (5) to (8) of Table 8 show that the coefficients on the interactions between foreign ownership and the three institutional development variables are all positive and significant. This is true when the interactions with the three institutional variables are considered individually or when all three variables and the interaction terms are entered into the regression together in column (8) of Table 8. That is, increased foreign ownership decreases the size of the negative effect of institutional quality on synchronicity.

In summary, we find that better institutions have a more pronounced effect on stock price informativeness for firms with higher government ownership and lower foreign ownership.<sup>11</sup> These results suggest that the poor institutional development provides less investor protection. This increases the cost of information collection and reduces investors' incentives to collect private information. This further reduces the information content of stock prices and increases stock price synchronicity.

In addition, West (1988) and Siew, Yang, and Zhang (2010) suggest that low stock price synchronicity may be associated with a poor information environment, which questions the validity of stock price synchronicity to measure stock return informativeness. Veldkamp (2006) provides a theoretical model to show that low stock price synchronicity is a good measure of a better information environment and that the empirical studies cited are supportive (e.g., Morck, Yeung, and Yu, 2000). If low stock price synchronicity means that there is more information in stock prices, then investment should be more sensitive to lagged company valuation for firms with lower stock price synchronicity.

We can explore this specifically with our data by estimating equation (4):

$$\begin{aligned} Investment = & \alpha + \beta_1 Q + \beta_2 CashFlow + \beta_3 Q * DR\Psi(1) + \beta_4 Q * DRAccountingOpacity \\ & + (YearDummies) + (IndustryDummies) + \varepsilon_{it} \end{aligned} \quad (4)$$

where the dependent variable, *Investment*, is capital expenditure scaled by beginning-of-year total assets. *Q* is equal to *MarketToBook* at the end of the previous year. Although

<sup>11</sup> The interpretation of the interaction terms is symmetric; that is, higher foreign ownership and lower state ownership matter more for stock price synchronicity in provinces with poor institutions.

this approach follows a q-theory of investment, we also hold cash flow constant to account for financing constraints. *CashFlow* is the sum of income before extraordinary terms and depreciation, net of cash dividends, scaled by beginning-of-year total assets.  $DR\Psi(I)$  is the scaled decile rank score of  $\Psi(I)$ . *DRAccountingOpacity* is the scaled decile rank score of *AccountingOpacity*. To obtain these scaled decile rank scores, we classify the observations in each year into deciles from 0 to 9 and then scale these ranks to range between 0 and 1. Table 9 presents estimates of equation (4). The  $Q$  and *CashFlow* coefficients are significantly positive, reflecting that the company valuation and free cash flow are important determinants of investment. Moreover, the coefficients on  $Q*DR\Psi(I)$  are significantly negative, which implies that investment is more sensitive to lagged company valuation for firms with lower stock price synchronicity. The results suggest that managers depend on the information content of stock prices about the firms' fundamentals to make their investment decisions, and so lower stock price synchronicity is a good measure of stock return informativeness. These findings are consistent with the results reported in Chen, Goldstein and Jiang (2007).

## 5.4 Additional robustness checks

In this section we summarize some additional robustness tests that are not shown here for the sake of space, though they are available from the authors on request.

First, estimates of the market model are based on daily returns and a potential bias can be introduced by non-synchronous trading because some stocks do not trade every day (Scholes and Williams, 1977; French, Schwert, and Stambaugh, 1987). In order to account for this, we also estimated the market models with lagged industry and market returns without any noticeable effect on the results. In addition, we estimated the market models with weekly rather than daily data, which does not alter our results and conclusions.

Second, we varied the windows used to winsorize the data to 2 and 98 percentiles or 5 and 95 percentiles. Our results are still robust to such variation in the size of the data set.

Third, some variables, such as *Ruleoflaw*, have interpolated values for certain years. To ensure that interpolation of this variable does not affect our results, we use the firm-year observations without those interpolated values to estimate our base line synchronicity regression. We obtain similar results and the same conclusions.



Fourth, four large municipalities (Beijing, Chongqing, Shanghai, and Tianjin) are under much stronger control by the central government than the other provinces. Thus, we re-estimated the models without these four municipalities, and find that our results are robust. Similarly, we find that our results are robust when the institutional variables are clustered at the region level.

## 6 Conclusions

China has experienced dramatic changes over the last 20 years in the establishment of secure property rights, the enhancement of law enforcement, and the liberalization of political institutions with varied experience across China's 31 provinces. China provides a unique opportunity to examine the effects of institutions within one national environment, rather than the more common cross country panel approach. Specifically, this paper investigates whether and how stock price synchronicity is associated with province-level institutional characteristics unique to China.

The province-level institutional variables we examine are two measures of legal development—property rights and the rule of law—and political pluralism. Our evidence indicates that improved property rights, better law enforcement, and greater political pluralism are all associated with more stock price informativeness. Additionally, better institutions have a more pronounced effect on stock price informativeness for firms with higher government ownership and lower foreign ownership.

Our evidence has some clear policy implications for emerging economies which suffer from high stock price synchronicity. We know from Wurgler (2000) and Durnev, Morck, and Yeung (2004), among others, that the efficiency of capital allocation and investment will be improved if stock prices incorporate more firm-specific information (i.e., synchronicity is reduced). And our results show convincingly that institutional improvements and political openness are associated with reduced stock price synchronicity, thus establishing a clear channel by which improvements in the institutional environment are associated with improved economic outcomes.

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## Tables and figure

Table 1 Variable definitions

|                            |  |
|----------------------------|--|
| $R^2(1)$                   | The $R^2$ of the market model in equation (1).   |
| $R^2(2)$                   | The $R^2$ of the market models in equation (2).  |
| $\Psi(1)$                  | Logarithmic transformation of $R^2(1)$   |
| $\Psi(2)$                  | Logarithmic transformation of $R^2(2)$   |
| <i>PropertyRights</i>      | The number of trademark applications per firm in a province; proxy for the awareness of property rights.   |
| <i>RuleofLaw</i>           | The number of lawyers per 10,000 people in a province; proxy for rule of law.  |
| <i>PoliticalPluralism</i>  | The proportion of non-Communist party members in the provincial People's Congress relative to the proportion in the National People's Congress                                       |
| <i>GovernmentOwn</i>       | The percentage of shares held by government owner(s) at year beginning   |
| <i>ForeignOwn</i>          | The percentage of shares held by foreign owner(s) (Hong Kong, Taiwan, other countries) at year beginning   |
| <i>Bshare</i>              | A dummy variable which equals 1 if a firm issues B-shares and 0 otherwise  |
| <i>Hshare</i>              | A dummy variable which equals 1 if a firm issues H-shares and 0 otherwise  |
| <i>AccountingOpacity</i>   | The absolute value of accounting accrual, accrual is equal to earnings after extraordinary items plus depreciation minus cash flow from operations, and then divided by total assets |
| <i>Volume</i>              | The total number of shares traded in a year, scaled by the total number of shares outstanding at the end of fiscal year  |
| <i>Size</i>                | The logarithm of total assets  |
| <i>Leverage</i>            | Total liabilities divided by total assets  |
| <i>EarningVolatility</i>   | The standard deviation of a firm's ROAs over the preceding five-year period, including the current year  |
| <i>MarketToBook</i>        | Market value of assets over book value of assets. Market value of assets are measured as book value of assets minus book value of equity plus market value of equity                 |
| <i>Log(IPOAge)</i>         | The logarithm of the firm age since IPO  |
| <i>IndustryByNumber</i>    | The logarithm of the number of firms in the industry to which a firm belongs   |
| <i>IndustryBySize</i>      | The logarithm of year-end total assets of all sample firms in the industry to which a firm belongs   |
| <i>Investment</i>          | Capital expenditure scaled by beginning-of-year total assets.  |
| <i>CashFlow</i>            | The sum of income before extraordinary terms and depreciation, net of cash dividends, scaled by beginning-of-year the total assets   |
| <i>Q</i>                   | <i>MarketToBook</i> at the end of the previous year.   |
| <i>DRΨ(1)</i>              | The scaled decile rank score of $\Psi(1)$ .  |
| <i>DRAccountingOpacity</i> | The scaled decile rank score of <i>AccountingOpacity</i>   |
| <i>GDPGrowth</i>           | Annual growth rate in per capita real GDP  |
| <i>GDPPerCapita</i>        | The per capita GDP deflated to the base year of 1998   |
| <i>Log(GDPPerCapita)</i>   | The logarithm of per capita GDP deflated to the base year of 1998  |

Table 2 Descriptive statistics

| Variables                 | Mean     | Std dev  | Min     | Max       |
|---------------------------|----------|----------|---------|-----------|
| $R^2(1)$                  | 0.490    | 0.176    | 0.133   | 0.821     |
| $R^2(2)$                  | 0.432    | 0.174    | 0.132   | 0.830     |
| $\Psi(1)$                 | -0.231   | 0.340    | -1.921  | 1.072     |
| $\Psi(2)$                 | -0.332   | 0.333    | -1.921  | 1.042     |
| <i>PropertyRights</i>     | 0.472    | 0.484    | 0.002   | 5.011     |
| <i>RuleofLaw</i>          | 0.691    | 0.715    | 0.101   | 7.451     |
| <i>PoliticalPluralism</i> | 1.016    | 0.119    | 0.651   | 1.434     |
| <i>GovernmentOwn</i>      | 0.310    | 0.132    | 0.000   | 0.716     |
| <i>ForeignOwn</i>         | 0.067    | 0.046    | 0.000   | 0.399     |
| <i>Hshare</i>             | 0.039    | 0.193    | 0.000   | 1.000     |
| <i>BShare</i>             | 0.131    | 0.337    | 0.000   | 1.000     |
| <i>AccountingOpacity</i>  | 0.202    | 0.078    | 0.009   | 0.438     |
| <i>Volume</i>             | 2.080    | 0.716    | 0.211   | 3.511     |
| <i>Size</i>               | 20.670   | 1.035    | 19.120  | 22.812    |
| <i>Leverage</i>           | 0.385    | 0.219    | 0.121   | 0.962     |
| <i>EarningVolatility</i>  | 0.203    | 0.139    | 0.000   | 0.492     |
| <i>MarketToBook</i>       | 2.773    | 1.566    | 0.726   | 5.491     |
| <i>IPOAge</i>             | 11.645   | 4.026    | 2.000   | 18.000    |
| <i>IndustryByNumber</i>   | 5.232    | 1.193    | 3.261   | 6.693     |
| <i>IndustryBySize</i>     | 26.776   | 1.169    | 24.145  | 28.410    |
| <i>Investment</i>         | 0.169    | 0.144    | 0.010   | 0.526     |
| <i>CashFlow</i>           | 0.160    | 0.137    | -0.085  | 0.411     |
| <i>GDPGrowth (%)</i>      | 7.200    | 4.526    | -17.100 | 21.574    |
| <i>GDPPerCapita (RMB)</i> | 1704.574 | 1005.678 | 413.000 | 12613.000 |

Variables are defined in Table 1; data are winsorized at the 1 and 99 percentiles.

Table 3 Correlation matrices

Variables are defined in Table 1. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

## Panel A: Province-level variables

|   | $\Psi(1)$ | <i>PropertyRights</i> | <i>RuleofLaw</i> | <i>PoliticalPluralism</i> | <i>GDPGrowth</i> | <i>Log(GDPPerCapita)</i> |
|---|-----------|-----------------------|------------------|---------------------------|------------------|--------------------------|
| <i><math>\Psi(1)</math></i><br>(average for year) | 1.000     |                       |                  |                           |                  |                          |
| <i>PropertyRights</i>                             | -0.524*** | 1.000                 |                  |                           |                  |                          |
| <i>RuleofLaw</i>                                  | -0.481*** | 0.489***              | 1.000            |                           |                  |                          |
| <i>PoliticalPluralism</i>                         | -0.358*** | 0.219***              | 0.336***         | 1.000                     |                  |                          |
| <i>GDPGrowth</i>                                  | -0.123**  | 0.050                 | 0.079            | 0.160***                  | 1.000            |                          |
| <i>Log(GDPPerCapita)</i>                          | -0.110*   | 0.013                 | 0.079            | 0.130**                   | 0.727***         | 1.000                    |

Panel B: Firm-level variables

|                          | $\Psi(1)$ | $\Psi(2)$ | <i>Accounting Opacity</i> | <i>Volume</i> | <i>Size</i> | <i>Leverage</i> | <i>Earning Volatility</i> | <i>Market To Book</i> | <i>IPOAge</i> | <i>Industry By Number</i> | <i>Industry By Size</i> | <i>Investment</i> | <i>Cash Flow</i> |
|--------------------------|-----------|-----------|---------------------------|---------------|-------------|-----------------|---------------------------|-----------------------|---------------|---------------------------|-------------------------|-------------------|------------------|
| $\Psi(1)$                | 1         |           |                           |               |             |                 |                           |                       |               |                           |                         |                   |                  |
| $\Psi(2)$                | 0.975***  | 1         |                           |               |             |                 |                           |                       |               |                           |                         |                   |                  |
| <i>AccountingOpacity</i> | 0.288***  | 0.289***  | 1                         |               |             |                 |                           |                       |               |                           |                         |                   |                  |
| <i>Volume</i>            | -0.312*** | -0.313*** | -0.928***                 | 1             |             |                 |                           |                       |               |                           |                         |                   |                  |
| <i>Size</i>              | -0.011    | -0.008    | 0.001                     | 0.004         | 1           |                 |                           |                       |               |                           |                         |                   |                  |
| <i>Leverage</i>          | 0.003     | 0.003     | 0.016                     | -0.011        | 0.009       | 1               |                           |                       |               |                           |                         |                   |                  |
| <i>EarningVolatility</i> | 0.003     | 0.002     | -0.007                    | -0.001        | -0.013      | 0.006           | 1                         |                       |               |                           |                         |                   |                  |
| <i>MarketToBook</i>      | 0.062***  | 0.063***  | 0.151***                  | -0.158***     | 0.011       | -0.008          | -0.019                    | 1                     |               |                           |                         |                   |                  |
| <i>IPOAge</i>            | -0.174*** | -0.167*** | -0.010                    | 0.003         | -0.010      | -0.007          | 0.012                     | 0.011                 | 1             |                           |                         |                   |                  |
| <i>IndustryByNumber</i>  | 0.004     | 0.003     | 0.008                     | -0.006        | 0.003       | -0.023*         | -0.005                    | -0.013                | -0.024        | 1                         |                         |                   |                  |
| <i>IndustryBySize</i>    | 0.008     | 0.006     | 0.011                     | -0.012        | -0.006      | -0.006          | -0.015                    | -0.004                | -0.024        | 0.433***                  | 1                       |                   |                  |
| <i>Investment</i>        | -0.045*** | -0.039*** | 0.047***                  | -0.054***     | -0.008      | -0.018          | 0.001                     | 0.189***              | 0.003         | -0.011                    | -0.005                  | 1                 |                  |
| <i>CashFlow</i>          | -0.011    | -0.007    | 0.003                     | 0.002         | -0.013      | 0.004           | 0.019                     | 0.021                 | -0.001        | -0.005                    | 0.001                   | 0.030**           | 1                |



Table 4 The effect of property rights, rule of law, and political pluralism on stock price synchronicity

All variables are defined in Table 1. The dependent variable is  $\Psi(I)$ . Year and industry dummies are included in all equations and the sample size is 5570. Numbers in parentheses represent absolute values of t-statistics where the standard errors are corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|   | (1)<br>OLS            | (2)<br>OLS            | (3)<br>OLS            | (4)<br>OLS            | (5)<br>GMM          |
|---|-----------------------|-----------------------|-----------------------|-----------------------|---------------------|
| <i>PropertyRights</i>                                   | -0.193***<br>(16.243) |                       |                       | -0.154***<br>(12.292) | -0.118***<br>(7.82) |
| <i>RuleofLaw</i>  |                       | -0.093***<br>(17.091) |                       | -0.050***<br>(8.940)  | -0.032***<br>(4.04) |
| <i>PoliticalPluralism</i>                               |                       |                       | -0.322***<br>(7.265)  | -0.119**<br>(2.490)   | -0.188**<br>(2.44)  |
| <i>GovernmentOwn</i>                                    | 1.097***<br>(20.529)  | 1.175***<br>(22.486)  | 1.242***<br>(23.109)  | 1.070***<br>(20.194)  | 0.734***<br>(10.34) |
| <i>ForeignOwn</i>                                       | -0.541***<br>(5.548)  | -0.534***<br>(5.248)  | -0.483***<br>(4.605)  | -0.563***<br>(5.839)  | 0.138<br>(1.16)     |
| <i>BShare</i>   | -0.159***<br>(8.153)  | -0.178***<br>(9.878)  | -0.194***<br>(10.223) | -0.154***<br>(8.198)  | -0.265***<br>(5.77) |
| <i>HShare</i>   | -0.032<br>(1.398)     | -0.039<br>(1.563)     | -0.043<br>(1.625)     | -0.031<br>(1.426)     | -0.368***<br>(3.05) |
| <i>AccountingOpacity</i>                                | 0.153<br>(1.429)      | 0.113<br>(1.031)      | 0.099<br>(0.878)      | 0.156<br>(1.485)      | 0.175<br>(0.64)     |
| <i>Volume</i>   | -0.030**<br>(2.494)   | -0.036***<br>(3.045)  | -0.040***<br>(3.291)  | -0.028**<br>(2.456)   | -0.040<br>(1.44)    |
| <i>Size</i>   | -0.002<br>(0.762)     | -0.003<br>(0.987)     | -0.001<br>(0.243)     | -0.003<br>(0.952)     | 0.005<br>(0.73)     |
| <i>Leverage</i>   | 0.029**<br>(2.037)    | 0.033**<br>(2.250)    | 0.036**<br>(2.427)    | 0.032**<br>(2.257)    | 0.072**<br>(2.25)   |
| <i>EarningVolatility</i>                                | 0.001<br>(0.024)      | -0.003<br>(0.153)     | 0.007<br>(0.321)      | 0.001<br>(0.049)      | 0.108**<br>(2.30)   |
| <i>MarketToBook</i>                                     | -0.010***<br>(4.977)  | -0.011***<br>(5.438)  | -0.011***<br>(5.382)  | -0.010***<br>(5.022)  | -0.007<br>(1.50)    |
| <i>Log(IPOAge)</i>                                      | 0.012<br>(0.822)      | 0.014<br>(0.942)      | 0.019<br>(1.186)      | 0.011<br>(0.796)      | -0.008<br>(-0.28)   |
| <i>IndustryByNumber</i>                                 | 0.004<br>(0.471)      | 0.010<br>(1.153)      | 0.009<br>(1.072)      | 0.006<br>(0.732)      | -0.005<br>(0.28)    |
| <i>IndustryBySize</i>                                   | -0.003<br>(0.471)     | -0.005<br>(0.756)     | -0.004<br>(0.549)     | -0.004<br>(0.637)     | 0.004<br>(0.36)     |
| <i>GDPGrowth</i>  | -0.001<br>(0.904)     | -0.004***<br>(2.589)  | -0.003*<br>(1.960)    | -0.001<br>(0.907)     | -0.000<br>(0.02)    |
| <i>Log(GDPPerCapita)</i>                                | -0.052*<br>(1.758)    | -0.010<br>(0.343)     | -0.027<br>(0.867)     | -0.043<br>(1.494)     | -0.062**<br>(2.29)  |
| Adj. R <sup>2</sup> or Wald $\div$ <sup>2</sup> for (5) | 0.567                 | 0.544                 | 0.518                 | 0.577                 | 616.78              |

Table 5 The effect of property rights, rule of law, and political pluralism on stock price synchronicity with extended model

All variables are defined in Table 1. The dependent variable is  $\Psi(2)$ . Each equation contains all the control variables shown in Table 4 as well as year and industry dummies. The sample size is 5570. Numbers in parentheses are the absolute values of t-statistics where the standard errors are corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|   | (1)<br>OLS            | (2)<br>OLS            | (3)<br>OLS            | (4)<br>OLS            | (5)<br>GMM          |
|---|-----------------------|-----------------------|-----------------------|-----------------------|---------------------|
| <i>PropertyRights</i>                                 | -0.167***<br>(14.058) |                       |                       | -0.131***<br>(10.955) | -0.095***<br>(6.17) |
| <i>RuleofLaw</i>                                      |                       | -0.081***<br>(14.720) |                       | -0.044***<br>(7.807)  | -0.027***<br>(3.53) |
| <i>PoliticalPluralism</i>                             |                       |                       | -0.301***<br>(6.777)  | -0.127***<br>(2.684)  | -0.185<br>(2.42)**  |
| <i>GovernmentOwn</i>                                  | 1.082***<br>(20.567)  | 1.148***<br>(22.364)  | 1.205***<br>(22.930)  | 1.056***<br>(20.228)  | 0.771***<br>(10.76) |
| <i>ForeignOwn</i>                                     | -0.546***<br>(5.690)  | -0.541***<br>(5.445)  | -0.497***<br>(4.873)  | -0.566***<br>(5.954)  | 0.144<br>(1.15)     |
| <i>BShare</i>   | -0.158***<br>(8.808)  | -0.174***<br>(10.496) | -0.188***<br>(10.799) | -0.154***<br>(8.878)  | -0.264***<br>(5.99) |
| <i>HShare</i>   | -0.029<br>(1.272)     | -0.035<br>(1.435)     | -0.039<br>(1.494)     | -0.028<br>(1.289)     | -0.346***<br>(3.04) |
| Adj. R <sup>2</sup> or<br>Wald ÷ <sup>2</sup> for (5) | 0.547                 | 0.530                 | 0.510                 | 0.555                 | 625.49              |

Table 6 Effect of alternative institutional indexes on stock price synchronicity

All variables are defined in Table 1. The dependent variable is  $\Psi(I)$ . Each equation contains all the control variables shown in Table 4 as well as year and industry dummies. Numbers in parentheses represent absolute values of t-statistics that are adjusted using standard errors corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|                           | Administrative transparency |                       | Marketization         |                       | Scaled marketization  |                       |
|---------------------------|-----------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| <i>Index</i>              | -0.004***<br>(6.819)        | -0.001**<br>(1.969)   | -0.040***<br>(11.589) | -0.025***<br>(7.527)  | -0.214***<br>(11.322) | -0.135***<br>(7.565)  |
| <i>PropertyRights</i>     |                             | -0.155***<br>(12.246) |                       | -0.131***<br>(11.162) |                       | -0.131***<br>(11.208) |
| <i>RuleofLaw</i>          |                             | -0.039***<br>(6.375)  |                       | -0.042***<br>(7.687)  |                       | -0.044***<br>(8.064)  |
| <i>PoliticalPluralism</i> |                             | -0.122***<br>(2.631)  |                       | -0.087*<br>(1.811)    |                       | -0.095**<br>(2.010)   |
| Sample size               | 5380                        | 5380                  | 5532                  | 5532                  | 5532                  | 5532                  |
| Adj. R <sup>2</sup>       | 0.527                       | 0.580                 | 0.547                 | 0.589                 | 0.545                 | 0.589                 |

Table 7 Stock price synchronicity in sub samples

Variables are defined in Table 1. The dependent variable is  $\Psi(I)$ . Each equation includes year and industry dummies as well as all the control variables shown in Table 4. Numbers in parentheses represent absolute values of t-statistics that are adjusted using standard errors corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|                           | More developed provinces |                       |                      |                      | Less developed provinces |                       |                      |                       |
|---------------------------|--------------------------|-----------------------|----------------------|----------------------|--------------------------|-----------------------|----------------------|-----------------------|
|                           | (1)                      | (2)                   | (3)                  | (4)                  | (5)                      | (6)                   | (7)                  | (8)                   |
| <i>PropertyRights</i>     | -0.186***<br>(13.876)    |                       |                      | -0.152***<br>(9.914) | -0.205***<br>(11.346)    |                       |                      | -0.182***<br>(10.643) |
| <i>RuleofLaw</i>          |                          | -0.084***<br>(14.319) |                      | -0.023***<br>(3.057) |                          | -0.106***<br>(12.630) |                      | -0.086***<br>(12.315) |
| <i>PoliticalPluralism</i> |                          |                       | -0.423***<br>(7.696) | -0.138**<br>(2.361)  |                          |                       | -0.180***<br>(2.696) | -0.120*<br>(1.955)    |
| Sample size               | 2861                     | 2861                  | 2861                 | 2861                 | 2709                     | 2709                  | 2709                 | 2709                  |
| Adj. R <sup>2</sup>       | 0.600                    | 0.570                 | 0.552                | 0.603                | 0.533                    | 0.517                 | 0.486                | 0.555                 |

Table 8 The effect of state and foreign ownership on the relation between institutional development and stock price synchronicity

All variables are defined in Table 1. The dependent variable is  $\Psi(I)$ . Each equation includes year and industry dummies as well as all the control variables shown in Table 4; only the coefficients on institutional and ownership variables and the interactions are shown in the table. Numbers in parentheses represent absolute values of t-statistics that are adjusted using standard errors corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|   | (1)                     | (2)                     | (3)                    | (4)                     | (5)                  | (6)                  | (7)                  | (8)                  |
|---|-------------------------|-------------------------|------------------------|-------------------------|----------------------|----------------------|----------------------|----------------------|
| <i>PropertyRights</i>                           | -0.051<br>(1.605)       |                         |                        | -0.010<br>(0.309)       | 0.312***<br>(12.452) |                      |                      | 0.252***<br>(9.646)  |
| <i>RuleofLaw</i>                                |                         | -0.060***<br>(2.867)    |                        | 0.021<br>(1.005)        |                      | 0.150***<br>(10.223) |                      | 0.088***<br>(5.802)  |
| <i>PoliticalPluralism</i>                       |                         |                         | -0.451***<br>(4.127)   | -0.218**<br>(1.968)     |                      |                      | 0.636***<br>(7.690)  | 0.357***<br>(4.572)  |
| <i>PropertyRights* GovernmentOwn</i>            | -0.669***<br>(4.686)    |                         |                        | -0.695***<br>(5.045)    |                      |                      |                      |                      |
| <i>RuleofLaw * GovernmentOwn</i>                |                         | -0.154<br>(1.606)       |                        | -0.329***<br>(3.464)    |                      |                      |                      |                      |
| <i>PoliticalPluralism * Governmen-<br/>tOwn</i> |                         |                         | 0.491<br>(1.343)       | 0.371<br>(1.054)        |                      |                      |                      |                      |
| <i>PropertyRights* ForeignOwn</i>               |                         |                         |                        |                         | 1.512***<br>(6.254)  |                      |                      | 1.282***<br>(5.116)  |
| <i>RuleofLaw *<br/>ForeignOwn</i>               |                         |                         |                        |                         |                      | 0.731***<br>(4.552)  |                      | 0.481***<br>(2.931)  |
| <i>PoliticalPluralism * ForeignOwn</i>          |                         |                         |                        |                         |                      |                      | 4.284***<br>(4.819)  | 3.342***<br>(4.378)  |
| <i>GovernmentOwn</i>                            | 1.358***<br>(16.252)    | 1.264***<br>(15.434)    | 0.746**<br>(1.988)     | 1.151***<br>(3.246)     | 1.077***<br>(20.264) | 1.169***<br>(22.483) | 1.244***<br>(23.206) | 1.052***<br>(20.068) |
| <i>ForeignOwn</i>                               | -0.486***<br>(1.358***) | -0.531***<br>(1.264***) | -0.484***<br>(0.746**) | -0.503***<br>(1.151***) | 1.225***<br>(8.246)  | 1.005***<br>(7.242)  | 4.804***<br>(5.439)  | 4.824***<br>(6.428)  |
| Sample size                                     | 5570                    | 5570                    | 5570                   | 5570                    | 5570                 | 5570                 | 5570                 | 5570                 |
| Adj. R <sup>2</sup>                             | 0.572                   | 0.545                   | 0.519                  | 0.585                   | 0.572                | 0.547                | 0.521                | 0.584                |

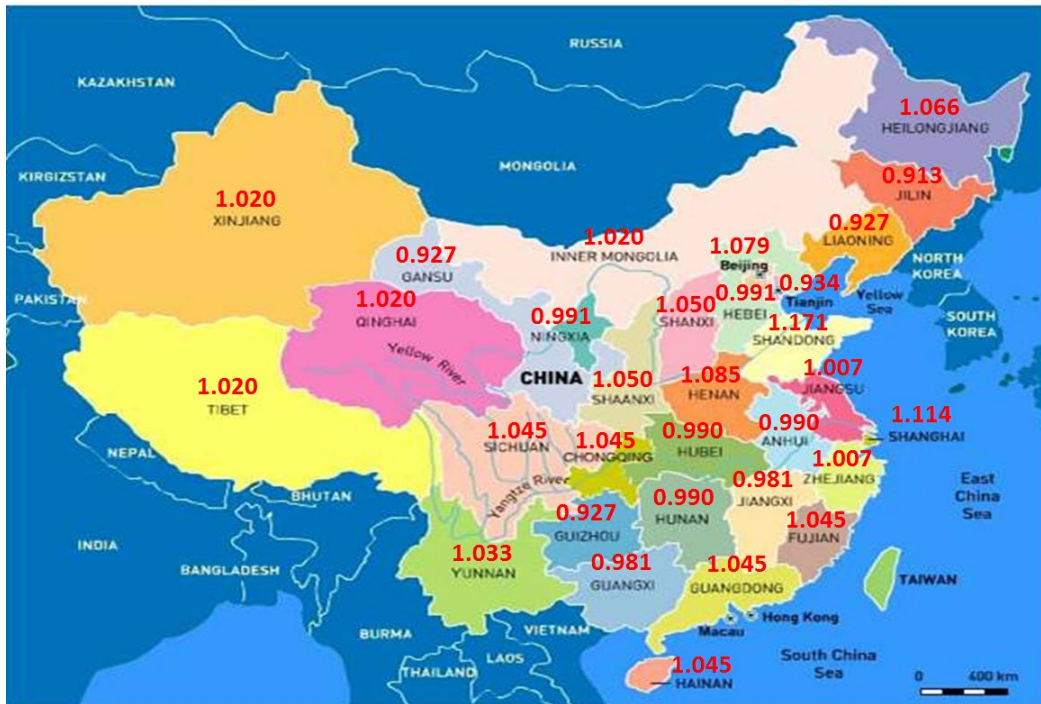
Table 9 The effect of stock price synchronicity on the relation between investment and stock price

The dependent variable is *Investment*, which is defined as capital expenditure scaled by beginning-of-year total assets. *Q* is equal to *MarketToBook* at the end of the previous year. *DRΨ(1)* is the scaled decile rank score of *Ψ(1)*. *DRAccountingOpacity* is the scaled decile rank score of *AccountingOpacity*. Other variables are defined in Table 1. Each equation also includes year and industry dummies. Numbers in parentheses represent absolute values of t-statistics that are adjusted using standard errors corrected for clustering at the firm level. The superscripts, \*\*\*, \*\*, and \* denote the 1%, 5%, and 10% levels of significance, respectively.

|                              | (1)                 | (2)                  | (3)                  |
|------------------------------|---------------------|----------------------|----------------------|
| <i>Q</i>                     | 0.017***<br>(9.381) | 0.021***<br>(9.127)  | 0.021***<br>(8.273)  |
| <i>CashFlow</i>              | 0.027*<br>(1.947)   | 0.026*<br>(1.897)    | 0.026*<br>(1.898)    |
| <i>Q*DRΨ(1)</i>              |                     | -0.008***<br>(3.494) | -0.008***<br>(3.438) |
| <i>Q*DRAccountingOpacity</i> |                     |                      | 0.002<br>(0.682)     |
| Sample size                  | 5570                | 5570                 | 5570                 |
| Adj. R <sup>2</sup>          | 0.037               | 0.039                | 0.039                |



**Political Pluralism (The proportion of non-Communist party members in the provincial People's Congress relative to the proportion in the National People's Congress) - Provincial Distribution**



**R Square - Provincial Distribution**





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