University of Zurich[UZH]

Department of Banking and Finance

The Government debt and the returns of firms

Evidence from China A-shares market

Master's Thesis

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Executive Summary

To response with the Recession, the governments implement the Fiscal stabilization policies which will lead to a surge in government debt across the globe. However, the increasing public debt is commonly considered to lower the growth rate of economy in the long-run. Such concerns are based on the expectations of higher tax pressure and inflation which tries to inflate debt away in the future, as well as on the risk of political uncertainty. These side effects of public debt and fiscal uncertainty on economic growth are well grounded by the economic theory and the empirical evidence.

Guided by a theoretical model of government policy choice, Bryan Kelly et al. (2016) analyzes the Evidence from the Option Market to study the pricing of political uncertainty. Pastor and Veronesi (2012) develops a general equilibrium model features uncertainty about government policy to prove the role of political uncertainty in determining the cost of capital across firms. Fernandez Villaverde et al. (2015) study how the unexpected changes in uncertainty about fiscal policy affect economic activity. Lustig (2008) and Lustig et al. (2012) examine the nature of fiscal risks. However, those articles only test the data of from the US market which is highly developed, and there are few empirical studies on the China's stock market in terms of economic uncertainty.

Obviously, the markets of emerging economies are different from these of US. As the world's largest emerging economy, China is remarkably different from the US on many aspects. China's economy is heavily dominated by the government policies and state-owned enterprises. The capital control and investment license are largely regulated by the government. Thus, China has a different economic pattern with US and the market liquidity is not as high as developed market.

The explanatory power of the asset pricing model is related to the maturity level of the capital market. Compared with the mature capital market, China's A-shares market still lacks of financial products, the trading strategy of investors, the information disclosure and the perfection of legal and regulatory systems. Meanwhile, the retail investors account for the largest proportion of investors in the A-shares market. Du and Xiao (2018) state that many of the retail investors prefer conceptual speculation to value investment and the herd effect is prevailing in A-shares market. Tian, Wang (2014) say that investors of A-shares market are more concerned about short-term yields and less concerned with long-term investment decisions. Zhang(2014) state that the empirical results of China's market is significantly different from that of US stock market. Those characteristics imply that China's fiscal uncertainty may have different relation with the pricing of stocks.

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The fundamental objective of this thesis is to investigate the role of China's public debt in the cross-sectional pricing of stocks of A-shares market. This thesis proposes a different perspective based on a large cross section of Chinese firms, which considers the policy uncertainty as a risk factor priced in both the cross-section and time-series of stock returns by affecting their cost of capital. Empirically, we test these links on the entire cross-section of China A-share stock returns.