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Capital Market Liberalization and Inter-City Corporate Investment

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Abstract. As a core component of institutional reform in China's financial system, capital market liberalization raises an urgent and critical question: Can it overcome financing barriers and information frictions that hinder cross-regional capital flows, thereby advancing the development of a unified national market? Using the official launch of the Shanghai-Hong Kong Stock Connect as a quasi-natural experiment, this study constructs a difference-in-differences model based on data from A-share listed companies between 2000 and 2024 to systematically examine the impact of capital market opening on corporate cross-regional investment. The findings show that the implementation of the Shanghai-Hong Kong Stock Connect significantly promotes firms' investments across regions, a result that remains robust after a series of sensitivity tests. Mechanism analysis reveals that capital market liberalization operates through three channels: improving corporate information disclosure quality to reduce information identification costs in distant markets, alleviating financing constraints to broaden funding sources for cross-regional expansion, and increasing institutional investors' shareholdings to strengthen external oversight over management's cross-regional investment decisions. This research offers a new perspective on the microeconomic consequences of capital market liberalization and provides empirical support based on firm-level data for overcoming institutional barriers to capital mobility and advancing the construction of a unified national market through financial supply-side reforms.

Keywords: Capital market opening, cross-regional investment by enterprises, Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect

1. Introduction

Cross-regional capital flows are a problem in the construction of a unified national market and a necessary condition for the good allocation of resources. The company has set up a branch in a different area for cross-location investment; this is a representative case of a micro-level cross-regional capital flow. High demand does not always lead to good off-take. At the same time, there are other reasons; local protectionism has been a feature of the Chinese economy for a long time, and institutional barriers, such as implicit financing guarantees, administrative discrimination, restrictions on market access and judicial favouritism, continue to obstruct the free flow of funds among regions. Under the leadership of the local government, regional financial institutions have

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raised the lending threshold and interest rates for out-of-area enterprises. Financial protectionism and administrative barriers have prevented many companies that wish to expand outside their home regions from doing so because there are no cross-regional financing channels and the costs are too high. At the same time, the company's own demand for cross-regional investment is also growing, but at the same time, institutional friction and financial fragmentation have risen to become practical obstacles to such investment. The above is the main problem that this paper will discuss in practice. To break through the "glass ceiling" on cross-regional capital flow at the financial supply end and promote the construction of a unified national market, this has become an urgent policy problem.

Many studies have explored all kinds of motives and reasons for cross-regional investment by companies. Some studies have examined the effect of local protectionism and market division on cross-regional capital flows, and others have studied the promotional effect of institutional reform, such as increased openness of services, construction of free trade zones, marketisation of data elements and digital finance, on cross-regional investment. Most of the above studies start with product markets or the general institutional environment and do not pay much attention to how structural changes in financial markets affect cross-regional investment decisions by firms. China's stock market has been changing significantly and is now open to institutions. Significant progress has been made, such as the start of the Stock Connect program linking Shanghai, Shenzhen and Hong Kong; easing of quota restrictions for QFII/RQFII; inclusion of A-shares in the MSCI index; all of which have gradually advanced market integration. At the same time, the investment and financing environment for enterprises has been organised in a certain way. It is still unknown whether the opening of the capital market will change firms' cross-regional allocation of resources and how. Therefore, it has not been determined how exactly the opening of cross-regional investment in capital markets is caused, which links occur, and what conditions apply.

The official launch of the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect (Stock Connect) will be taken as a quasi-natural experiment in this paper to study the effect of capital market opening on cross-regional investment by listed companies in China and Hong Kong, and a difference-in-differences model will be employed for this purpose. The first two are: Whether the opening of capital markets changes companies' cross-region investment plans, and if so, how? How is it achieved to this end?

The three reasons for this are: First, it expands the research scope of capital market opening from general corporate investment to cross-regional investment; this is a type of strategic investment, and thus it adds depth to the study of how financial liberalisation affects the real economy. Second, given the rapid progress of institutionalisation in the opening-up process of the Chinese capital market, it is necessary to clarify the actual effects of market opening on corporate cross-regional investment strategies and provide supporting micro-level evidence for further policy optimisation, offering insights into how financial supply-side reforms can promote the development of a unified national market. Thirdly, cross-regional investment at the firm level is a way to combine resources and expand the market in different areas. The results of this paper can help the company better understand the changes in the financing environment after the opening of the capital market and thus plan cross-regional expansion in a reasonable manner. At the general level, to improve the efficiency of resource allocation, promote coordinated development of regions, and achieve high-quality economic growth, it is necessary to free up cross-regional capital flows. Financial institutional reform and opening up of the capital market are the new empirical bases that can be used to study how to address the institutional obstacles enterprises face in cross-regional investment.

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2. Literiture review

Capital market liberalization refers to an institutional arrangement whereby a country allows foreign investors to enter its domestic capital market for trading in marketable securities, thereby achieving the free cross-border flow of capital. From the dimension of openness, capital market liberalization includes both investment openness, i.e., the free movement of funds between international and domestic markets, and service openness, i.e., permitting foreign securities institutions to participate in domestic securities business. China's capital market liberalization has followed a gradual process, from the issuance of B-shares and the introduction of the QFII scheme to the progressive implementation of connectivity mechanisms such as the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, and Shanghai-London Stock Connect. In this paper, capital market liberalization specifically refers to the two-way opening of the stock market represented by the "Shanghai-Hong Kong Stock Connect" and "Shenzhen-Hong Kong Stock Connect" schemes, whose core feature is to allow foreign institutional investors to enter China's A-share market for investment and trading through designated channels. The essence of capital market liberalization is to improve the market participant structure by introducing foreign investors, enhance market pricing efficiency and information transmission efficiency, and thereby exert far-reaching effects on micro-level corporate behaviour.

Inter-city corporate investment refers to the cross-regional investment activities of firms, such as establishing subsidiaries or branches or conducting mergers and acquisitions beyond the administrative boundary of the city where they are registered. Inter-city corporate investment is the micro-level carrier and core manifestation of the cross-regional flow of capital factors, directly reflecting the direction and efficiency of capital allocation in the national unified market. In this paper, inter-city corporate investment specifically refers to the behaviour of listed companies that set up subsidiaries in cities other than their parent company's registered city. This indicator has been widely adopted in the existing literature as a proxy variable for cross-regional capital flows [1]. The decision regarding inter-city corporate investment is essentially a comprehensive response to investment opportunities and institutional environments in different regions, subject to the dual constraints of firms' internal resource endowments and external market environments [2].

Regarding the economic consequences of capital market liberalisation, the existing literature has conducted relatively systematic research at both the macroeconomic and micro-enterprise levels. At the macroeconomic level, studies show that the steady and prudent advancement of capital market liberalisation can significantly reduce idiosyncratic stock price volatility [3]. At the micro-enterprise level, the effects of capital market liberalisation manifest in multiple dimensions: in terms of investment efficiency, stock market liberalisation significantly improves firms' investment efficiency, especially for firms with opaque information environments and weak governance [4]; in terms of information disclosure, capital market liberalisation significantly improves both the willingness and the precision of voluntary disclosure [5]; in terms of investment, capital market liberalisation strengthens the sensitivity of corporate investment to non-financial information pricing [6]; moreover, in weak-institution markets, liberalisation induces firms to increase private disclosures through foreign brokers, which improves price discovery and liquidity [7].

As for determinants of inter-city investment, the literature approaches from both formal and informal institutions. Formal institutional factors such as fiscal incentives and tax sharing arrangements shape such decisions, while informal factors such as inter-regional trust also play important roles [8].

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In summary, although both strands have yielded rich findings, direct research linking them is scarce. A few studies have examined the information consequences of capital market liberalization. For instance, Zhang et al. find that the Shenzhen-Hong Kong Stock Connect significantly enhances firms' forward-looking information disclosure [9]. More directly related to spatial investment, Hong et al. explore the impact of capital market liberalization on inter-city investment and confirm a positive effect [10]. However, the transmission mechanisms through which liberalization affects inter-city investment still require further systematic examination. Three deficiencies remain: first, most liberalization studies focus on firms' financial and operational outcomes, not spatial investment decisions; second, inter-city investment studies rarely consider macro-institutional changes like liberalization; third, the few directly related studies have not yet fully revealed the channels through which liberalization affects inter-city investment.

3. Mechanism analysis and hypothesis development

Capital market liberalisation will decrease the cost of capital for investment by inter-city enterprises. Capital market liberalisation has introduced foreign institutional investors into the domestic equity and bond markets, added new sources of funds and new investors to the market, and improved the overall liquidity and price discovery efficiency of the market. With the development of sophisticated risk assessment models and information processing technology, foreign investors are now more capable of identifying and pricing the credit risk and operating risk of listed companies; thus, their equity and bond financing costs have fallen. Liberalisation of the capital market has promoted the development of domestic financial intermediary services, and with the entry of foreign investment banks and rating agencies, the external financing environment has been liberalised; thus, financially healthy and well-governed companies can raise long-term funds at lower capital costs. A lower financing cost will reduce the overall cost of expansion for the company in different areas. Therefore, based on the net present value method, the financial appeal of inter-city investment projects is relatively high, and cross-regional development plans that had been postponed or excluded due to high financing costs have now been added back to the company's plan. The better structure of long-term funds under capital market liberalisation will also help to optimise the maturity matching of corporate capital, so firms will no longer need to raise high-cost short-term funds urgently for the long cycle of inter-city construction and market development. Therefore, the financial situation and capital security of cross-regional investment are relatively good.

Capital market liberalisation has increased the quality of corporate information disclosure and promoted inter-city corporate investment. Capital market liberalisation has promoted bond-issuing companies and listed enterprises to increase the level of foreign financial reporting and information disclosure. The professional interpretation ability of foreign investors is consistent with the company's disclosure and leads to more standardised information in the main areas of accounting, such as revenue recognition, asset measurement, impairment testing and risk disclosure. The improved comparability of accounting information has reduced the difficulty for external parties to carry out horizontal comparisons and longitudinal tracking of a company's financial data; thus, financial institutions, suppliers and government departments in the host city can quickly and accurately assess the financial situation and operating conditions of listed companies. When a company enters a new foreign country, using the same accounting information will help reduce the problems of different accounting rules in different areas and lower the costs of collection and utilisation. Local credit institutions can assess the credit risk and approve loans based on the standardised financial statements. An increase in the comparability of accounting information will make it easier to collect and analyse financial data from the parent company and its inter-city

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subsidiaries in the corporate group. The head office will be able to get more up-to-date information on the asset turnover efficiency and return on capital of the inter-city project, providing a more stable and reliable foundation for cross-regional investment decisions in financial information.

Capital Market Liberalisation has reduced the scope of foreign-direct investment in China. Foreign institutional investors who have joined after the opening up of the capital market are more vigilant in monitoring and processing information, so an increase in their shareholding will directly alter the outside governance situation of the company. Institutional investors will use their voting rights at the shareholders' meeting, communicate with the company off-channel, and take other exit measures to prevent cross-regional development of the company. Since the inter-city investment projects are spread out geographically and have long information chains, it is inevitable that management will pursue private interests under the pretext of expansion. Institutional investor monitoring can solve the problems of excessive diversification and inefficient expansion in inter-city investment by directing funds to cross-regional projects with a high net present value; thus, both the quality and efficiency of inter-city investment will be improved. Given their experience with overseas investments, foreign institutional investors can provide more strategic advice on how to distribute the company's branches abroad and avoid excessive investment in any single place.

Hypothesis 1: Capital market liberalisation increases the amount of inter-city corporate investment.

4. Variable definition and model selection

4.1. Data sources

This paper selects data from China's A-share listed companies for the period 2000–2024. The following data processing procedures are applied: (1) firms classified as ST (special treatment) or *ST are excluded; (2) observations with obviously abnormal financial data are removed; (3) samples with incomplete data for the fiscal year are deleted; (4) to mitigate the influence of extreme values on the test results, all continuous variables are winsorized at the 1st and 99th percentiles. All variable data are obtained from the Wind and CSMAR databases, and the data are processed using Stata 18.0 econometric software.

4.2. Variable definition

Treat is a dummy variable indicating whether a firm is a constituent of the Shanghai-Hong Kong Stock Connect or the Shenzhen-Hong Kong Stock Connect. It takes the value of 1 if the firm is included in the Stock Connect list during the sample period, and 0 otherwise. Treat = 1 denotes the treatment group (eligible firms), and Treat = 0 denotes the control group (non-eligible firms). Post is a dummy variable for the implementation year of the Stock Connect schemes; it equals 0 for years before the implementation, and 1 for the implementation year and thereafter. FTR is the dependent variable in some contexts (measuring the forward-looking information disclosure level in corporate annual reports). However, in this paper, the primary dependent variable is inter-city corporate investment (Dinv). The interaction term Treat × Post equals 1 for firm-years after the firm becomes a Stock Connect eligible stock (2014 for Shanghai Connect, 2016 for Shenzhen Connect), and 0 otherwise.

Specifically, for the dependent variable Dinv (inter-city corporate investment), we identify newly established cross-city subsidiaries by matching the registration locations of the parent company and its subsidiaries. The number of such subsidiaries is then aggregated by year and by parent firm,

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yielding the annual number of newly added cross-city subsidiaries, which serves as our measure of inter-city corporate investment.

The control variables in this paper include firm size, leverage, profitability, firm age, and Tobin's Q

4.3. Model selection

To examine the impact of capital market liberalization on firms' cross-regional investments, this study employs a difference-in-differences (DiD) model for regression analysis and constructs the following regression model (1):

$$Dinv_{it} = \beta_0 + \beta_1 * FTR_{it} + \sum \alpha_k controls_{it} + \lambda_t + \mu_i + \varepsilon_{it} \quad (1)$$

where ε_{it} represents the random error term; i and t denote firm and year, respectively. The model controls for year fixed effects λ_t and firm fixed effects μ_i. k indicates the number of control variables, β_0 is the constant term, and β_1 is the coefficient of the independent variable. Since both firm fixed effects and year fixed effects are included, the coefficient β_1 of the interaction term Treat×Post represents the DiD estimator.

5. Empirical analysis

5.1. Descriptive statistics

Table 1 is the description statistics. The mean of the capital market liberalisation variable (FTR) is 0.2027 and the standard deviation is 0.4020; approximately 20% of the observations are in the post-policy period, and there is significant cross-firm variation in policy exposure over time, so this variation can be used to identify the effect of the policy. The dependent variable, inter-city corporate investment (Dinv), has a mean of 10.7058, a standard deviation of 29.9634, a minimum of 0, and a maximum of 1113; there is a large variation among firms, with most firms having relatively low cross-regional investment and a few being very high. The statistical properties of the control variables are the same as those in the previous studies, and the sample and distribution of the variables are representative and reasonable for the following empirical analysis.

Table 1. Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Dinv	43443	10.706	29.963	0	1113
FTR	43443	0.203	0.402	0	1
Size	43443	21.993	1.283	19.171	26.484
Lev	43443	0.422	0.207	0.028	0.99
ROA	43443	0.036	0.071	-0.485	0.255
TobinQ	43443	1.986	1.318	0.787	17.729
FirmAge	43443	2.867	0.417	0.693	3.714

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5.2. Baseline regression

Table 2 reports the baseline regression results of capital market liberalization (FTR) on inter-city corporate investment (Dinv). Across different model specifications (fixed effects, pooled OLS, with or without controls), the coefficients on FTR are all positive and significant at the 1% level. Taking the most stringent specification (column 4) with full controls and firm fixed effects, the coefficient is 7.5126 (s.e. 0.42, $p < 0.01$). Economically, a one-unit increase in FTR raises Dinv by approximately 7.5126 units, which corresponds to about 70.2% of the sample mean (10.706), indicating both statistical and economic significance.

Table 2. Baseline regression results

	(1) Dinv	(2) Dinv	(3) Dinv	(4) Dinv
FTR	6.9864***	13.6297***	12.6369***	7.5126***
	(0.41)	(0.38)	(0.38)	(0.42)
Lev			25.3038***	14.2509***
			(0.77)	(0.95)
ROA			4.3506**	-1.8746
			(2.21)	(1.98)
TobinQ			-1.2339***	-0.8920***
			(0.11)	(0.11)
FirmAge			2.3007***	-8.0743***
			(0.44)	(1.12)
Dual			0.7647**	1.0941***
			(0.31)	(0.34)
_cons	-0.8876	2.4188*	-10.4596***	9.2176***
	(1.03)	(1.40)	(1.65)	(2.08)
N	43443	43443	43443	43443
R^2	0.079	0.046	0.082	0.088
year	yes	yes	yes	yes

Standard errors in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

5.3. Robustness checks

To ensure the reliability of the baseline results, we conduct five robustness tests: (1) using one-period-ahead dependent variable to mitigate reverse causality (coefficient = 8.1634, $p < 0.01$); (2) employing heteroskedasticity-robust standard errors (coefficient = 7.5126, $p < 0.01$); (3) adding board size and top-1 shareholder concentration as additional controls (coefficient = 7.4236, $p < 0.01$); (4) further controlling for industry fixed effects (coefficient = 7.5492, $p < 0.01$); and (5) excluding pre-2005 observations to account for the structural impact of the split-share structure

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reform (coefficient = 7.3240, p < 0.01). All coefficients remain positive and statistically significant, ranging from 7.3240 to 8.1634. These results consistently confirm that the positive effect of capital market liberalization on inter-city corporate investment is robust across alternative specifications, estimation methods, and sample restrictions. The baseline findings are therefore reliable and credible.

Table 3. Robustness checks

	(1) Dinv	(2) Dinv	(3) Dinv	(4) Dinv	(5) Dinv
FTR	8.1634***	7.5126***	7.4236***	7.5492***	7.3240***
	(0.47)	(1.19)	(0.42)	(0.41)	(0.43)
Lev	14.6438***	14.2509***	13.8384***	13.4798***	13.2217***
	(1.10)	(2.50)	(0.99)	(0.95)	(1.05)
ROA	2.9863	-1.8746	-2.5560	-2.9745	-3.4208
	(2.39)	(2.77)	(2.06)	(1.97)	(2.13)
TobinQ	-0.5955***	-0.8920***	-0.7900***	-0.8381***	-0.7084***
	(0.13)	(0.15)	(0.11)	(0.11)	(0.12)
FirmAge	-9.1510***	-8.0743**	-8.5633***	-7.7220***	-8.4690***
	(1.28)	(3.16)	(1.40)	(1.12)	(1.57)
Dual	1.0271***	1.0941*	1.1272***	0.9552***	1.0835***
	(0.39)	(0.60)	(0.36)	(0.34)	(0.37)
Board			4.5980***		
			(0.95)		
Top1			0.7853		
			(1.71)		
_cons	10.7406***	9.2176**	2.4476	11.4983***	14.8431***
	(2.36)	(4.60)	(3.82)	(3.08)	(3.58)
N	37411	43443	42013	43443	40266
R^2	0.082	0.088	0.085	0.103	0.080
year	yes	yes	yes	yes	yes

Standard errors in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

6. Mechanism tests

Given that capital market liberalisation has increased inter-city corporate investment substantially, we will now explore how it has been achieved. The three directions of the research are to reduce financing costs, improve the information environment and strengthen external governance. The three mediating variables in the mediation test are the Disclosure Quality Index (DQI), the Weakening

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Index of Financing Constraints (WWI) and Institutional Ownership (INST). DQI is scored from 4 (excellent) to 1 (unqualified) according to the stock exchange rating; WW index is the financing constraint index based on six financial indicators; INST is the proportion of shares held by institutional investors.

Table 4 shows the regression results of all mediators as the dependent variables. Column (1) shows that FTR has a positive and significant effect on DQI (coefficient = 0.2409, $p < 0.01$); that is, the Stock Connect policies have improved the disclosure quality of listed companies and reduced information asymmetry in cross-border investment. Column (2) shows that FTR has reduced financing pressure; the coefficient of the WW index is -0.0307 ($p < 0.01$), and the Stock Connect policy has effectively eased the fundraising difficulties for companies expanding in all regions. Column (3) shows that FTR increases institutional ownership (INST) by 0.0349 ($p < 0.01$) and thus advances external governance to control managerial inefficiency in capital allocation for high-value-added inter-city projects. All of the regressions have firm-level control variables and year fixed effects, and the adjusted R^2 values are between 0.096 and 0.399; all the models are reasonable. In short, all the mediation results are in line with what we have theorised.

Table 4. Mediation effect test results

	(1) DQI	(2) WW	(3) INST
FTR	0.2409***	-0.0307***	0.0349***
	(0.01)	(0.00)	(0.00)
Lev	-0.1691***	-0.0667***	0.0084*
	(0.03)	(0.00)	(0.00)
ROA	1.9390***	-0.3169***	0.2652***
	(0.05)	(0.01)	(0.01)
TobinQ	-0.0119***	0.0089***	0.0007
	(0.00)	(0.00)	(0.00)
FirmAge	0.0309	-0.0599***	-0.0586***
	(0.04)	(0.00)	(0.01)
Dual	-0.0162*	-0.0013	-0.0023
	(0.01)	(0.00)	(0.00)
_cons	2.5303***	-0.6935***	0.0100
	(0.07)	(0.01)	(0.01)
N	35084	43330	42783
R^2	0.096	0.306	0.399
year	yes	yes	yes

Standard errors in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

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7. Conclusion

Based on the panel data of A-share listed companies from 2000 to 2024 and the staggered difference-in-differences design method, this paper will empirically investigate the effect of capital market liberalisation on inter-city corporate investment and the corresponding mechanisms after the introduction of the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect. There are three reasons. First, the policies of Stock Connect have promoted cross-regional investment by companies; listed companies are invested in much more than controlling companies. Based on the above, it can be concluded that the effect is both stable and positive. Second, there are three transmission channels: (i) Liberalisation improves the quality of disclosure and reduces information asymmetry; (ii) Financing constraints are eased by increasing sources of funds and lowering costs; and (iii) Institutional ownership is strengthened, external supervision is enhanced, managerial opportunism is reduced, and thus capital is directed towards high-value cross-regional projects. The above results offer a new micro-level view of the actual effect of opening up the capital market and provide evidence from the financial sector for building a unified national market.

Based on the above results, we put forward the following measures: Strengthen the opening up of the capital market, increase the proportion of foreign investment, improve infrastructure, enhance disclosure and accounting standards to reduce information costs, provide targeted support for financially constrained or opaque enterprises with region-specific policies in central and western China, and improve foreign investor channels in governance to promote expansion in line with value creation. The other liberalisation Channels (QFII/QDII, MSCI) need to be studied separately; Mechanisms such as supply-chain adjustment and risk-taking have not been tested; and data constraints cannot rule out confounders from local protectionism—more data or stronger identification will be employed in future work to improve causal inference.

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