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Liquidity and stock returns in emerging equity markets

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Abstract

Using data for 27 emerging equity markets for the period January 1992 through December 1999, we document the behavior of liquidity in emerging markets. We find that stock returns in emerging countries are positively correlated with aggregate market liquidity as measured by turnover ratio, trading value and the turnover–volatility multiple. The results hold in both cross-sectional and time-series analyses, and are quite robust even after we control for world market beta, market capitalization and price-to-book ratio. The positive correlation between stock returns and market liquidity in a time-series analysis is consistent with the findings in developed markets. However, the positive correlation in a cross-sectional analysis appears to be at odds with market microstructure theory that has been empirically supported by studies on developed markets. Our findings regarding the cross-sectional relation between stock returns and liquidity is consistent with the view that emerging equity markets have a lower degree of integration with the global economy.

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1. Introduction

The importance of emerging equity markets in the context of investment portfolios and international diversification has received considerable attention. Six emerging markets rank among the top 20 markets in the world in terms of capitalization.¹ With respect to trading value, Taiwan, Korea, and Malaysia were among the 10 most active markets during 1998. Furthermore, trading in these three markets is not concentrated in a few companies. Many emerging markets trade a large number of domestic companies. For example, as of December 2000, there were approximately 6000 companies listed in India, second only to the US, Korea has more companies listed than either France or Germany. Nevertheless, many emerging markets are still very concentrated, with high trading costs and low trading volume.²

We investigate the time-series variation in aggregate liquidity for several emerging equity markets and also examine the cross-sectional behavior of liquidity across countries. Aggregate liquidity, as opposed to the cross-sectional analysis of individual securities in traditional microstructure theory, is critical because it is related to the important issue of whether liquidity is a priced factor in global equity markets. We find that stock returns in emerging countries are positively correlated with market liquidity as measured by turnover ratio, trading value, and turnover–volatility multiple. The results hold in both cross-sectional and time-series analyses, and are quite robust even after we control for world market beta, market capitalization and price-to-book ratio.³

The positive correlation between stock returns and market liquidity in a time-series analysis is consistent with the findings for developed markets. However, the positive correlation between stock returns and liquidity in the cross-sectional analysis appears to be at odds with market microstructure theory that has been empirically supported by studies on developed markets.⁴ Evidently, our study identifies what seems to be a unique characteristic of stock returns in emerging equity markets.

It is important to emphasize that the notion of liquidity for individual assets is quite different from the notion of liquidity of an overall equity market. While supply and demand conditions determine liquidity in both cases, the factors that characterize the supply and demand functions for individual assets within a market are different from the factors that characterize the liquidity of a country's equity market. Whereas unique individual security characteristics determine its relative liquidity, the liquidity of a country's equity market is largely determined by macroeconomic factors that are systemic to the economy.⁵ Moreover, the assessment of liquidity in a given

¹ These countries are Malaysia, South Africa, Mexico, Korea, Singapore and Thailand.

² For example, of the 6000 companies listed in the Indian stock exchange, only 1500 trade on a daily basis. Moreover, the top 200 companies account for almost 95% of daily traded volume.

³ These variables have been identified in the literature (Fama and French, 1995, 1996) as having explanatory power for stock returns.

⁴ Section 2 discusses the relationship between liquidity and stock returns in greater detail.

⁵ For instance, legal, political as well as macroeconomic factors are likely to play an important role.

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