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The information content of stock markets: why do emerging markets have synchronous stock price movements?[☆]

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Abstract

Stock prices move together more in poor economies than in rich economies. This finding is not due to market size and is only partially explained by higher fundamentals

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correlation in low-income economies. However, measures of property rights do explain this difference. The systematic component of returns variation is large in emerging markets, and appears unrelated to fundamentals co-movement, consistent with noise trader risk. Among developed economy stock markets, higher firm-specific returns variation is associated with stronger public investor property rights. We propose that strong property rights promote informed arbitrage, which capitalizes detailed firm-specific information. © 2000 Elsevier Science S.A. All rights reserved.

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1. Introduction

Stock returns reflect new market-level and firm-level information. As Roll (1988) makes clear, the extent to which stocks move together depends on the relative amounts of firm-level and market-level information capitalized into stock prices. We find that stock prices in economies with high per capita gross domestic product (GDP) move in a relatively unsynchronized manner. In contrast, stock prices in low per capita GDP economies tend to move up or down together. A time series of stock price synchronicity for the U.S. market also shows that the degree of co-movement in U.S. stock prices has declined, more or less steadily, during the 20th century. These findings are not due to differences in market size or economy size.¹

We consider three plausible explanations for our finding. First, firms in low-income countries might have more correlated fundamentals, and this correlation might make their stock prices move more synchronously. For example, if low-income economies tend to be undiversified, firm-level earnings may be highly correlated because industry events are essentially market-wide events. Second, low-income economies often provide poor and uncertain protection of private property rights. Political events and rumors in such countries could, by themselves, cause market-wide stock price swings. Moreover, inadequate protection for property rights could make informed risk arbitrage in their stock markets unattractive. According to De Long et al. (1989, 1990), a reduction in informed trading can increase market-wide noise trader risk, which we would observe as increased market-wide stock price variation unrelated to fundamentals. Third, in countries that provide poorer protection for public investors

¹ At present, we only have a long panel of returns for the US. We are beginning our exploration of historical patterns of other advanced economies.

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