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Trading externalities and new equity issues in emerging markets

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Abstract

The volatility in emerging market finance over the last decade has highlighted the importance of developing equity exchanges to enhance risk sharing between international investors. Debt markets do not allow for as much risk sharing. Theoretically, stock market development involves trading externalities, as the decision by one firm to list provides a positive spillover for other firms considering an initial offering. This theory thus has a clear policy implication in terms of deliberate government action to promote stock market development. This paper tests empirically for the existence of trading externalities in developing countries, and finds evidence of such externalities for Latin American, but not Asian, stock markets.

JEL classification: G1; G15

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1. Introduction

The tremendous growth and turbulence of financial markets in developing countries since 1990 has led to renewed attention on the development of local stock markets. The financial crises have led to concerns over reliance on foreign bond issues and a desire to develop

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local financial exchanges (see Eichengreen and Hausmann, 1999). Indeed, while canonical models posit open capital accounts as unambiguously welfare-improving, recent turmoil has led some to question the wisdom of completely open capital accounts for developing countries (see Kaplan and Rodrik, 2001; Edwards, 2000).

Financial market development has been prescribed as a means to obtain benefits from capital account openness, as well as a positive force in its own right in promoting the efficient allocation of capital and economic growth (King and Levine, 1993a, 1993b; Levine and Zervos, 1998; Demirguc-Kunt and Levine, 2001). This view is not universally shared. Lucas (1988) states that economists "badly overstate" the importance of the financial system for economic growth. Shleifer and Vishny (1986) worry that making stock markets more liquid may decrease the incentives of shareholders to monitor management.

Despite the controversies over capital account openness, and financial market development, there has been interest in greater stock market development. Again, while the jury has yet to return a definitive verdict, equity markets are perceived to have a big advantage over bond market finance. Obstfeld (1994) models the greater risk-sharing properties that equity has vis-a-vis debt finance. Policymakers as well as businesses thus have a strong interest in equity market development, since for all of its uncertainties, there are risk-sharing advantages over the alternatives.

Pagano (1989, 1993) models an interesting aspect of stock market development. He posits an externality arising from the entry of new firms and investors into a market. This positive spillover implies that a given firm's listing on an exchange makes it more desirable for subsequent companies to list. This arises from the increased diversification and liquidity benefits that new firms provide investors when they list. As with any positive externality, government can, theoretically, promote a more efficient allocation of resources through targeted policies such as subsidies.

While the trading externalities arising from new firms' participation in a bourse are theoretically important, there has been little research done thus far to empirically investigate their effect or on the determinants of the number of companies listed in general. This paper fills a gap in this literature by empirically testing for the existence of trading externalities. Emerging markets provide a special sort of laboratory, in the form of the Emerging Market Index of the International Finance Corporation, which accounts for 60% of market capitalization of the listed stocks of the participating countries. However, companies may only list if they pass certain capitalization and liquidity requirements. Listing here clearly provides benefits to companies and makes additional capital easier to access.

Employing the probit technique, results indicate that, after controlling for other factors, there is evidence of trading externalities in Latin American stock exchanges, although not in the Asian markets. This distinction is perhaps due, in part, to the level of market development in the Asian countries surveyed. Nonetheless, the trading externalities uncovered do imply a role for policymakers in providing incentives for company listing.

2. Literature on trading externalities and new listings

Pagano (1989) was a seminal paper on the topic of trading externalities. The model was motivated by previous studies which had recognized thin markets as being more volatile