Stock market development under globalization: Whither the gains from reforms?

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Abstract

Over the past decades, many countries have implemented significant reforms (including financial liberalization, privatization, and regulatory and supervisory improvements) to foster domestic capital market development. Despite these policies, the performance of capital markets in several countries has been disappointing. To understand the effects of reforms, we study the impact of six capital market reforms on domestic stock market development and internationalization. We find that reforms tend to be followed by increases in domestic market capitalization and trading. But reforms are also followed by an increase in the share of activity in international equity markets, with potential negative spillover effects.

JEL classification: G15; G18; G20

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1. Introduction

Over the last two decades, a large number of countries, both developed and developing, have implemented significant capital market reforms, including stock market

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liberalization, improvements in securities clearance and settlements systems, and the development of regulatory and supervisory frameworks. These reforms, together with improved macroeconomic fundamentals and related reforms, such as the privatization of state-owned enterprises and the shift to privately managed defined contribution pension systems, were expected to foster domestic financial development. These expectations were supported by the growing cross-sectional empirical evidence on the determinants of stock market development, which shows that countries with sounder macroeconomic policies, better institutional environments, and more efficient legal systems, especially regarding the protection of minority investors, have more developed domestic markets.

Capital market reforms were also expected to foster domestic market development through their impact on the stock market internationalization process. According to this argument, poor domestic environments prompt firms and investors to use international markets more intensively. A poor domestic environment has long been considered one of the main reasons for capital flight and greater use by domestic residents of financial services offered abroad (see, for example, Collier et al., 2000). Over the last decades, there has been an increasing migration of securities market activities to major international financial centers, such as New York and London. As part of this globalization process, depositary receipts (DRs) have become increasingly popular instruments. For many developing countries, activity in international markets now exceeds domestic stock market activity. A number of papers argue that this internationalization process is the result of firms trying to escape from poor domestic environments with weak institutions and poorly functioning markets. This view implies that capital market reforms will reduce incentives for firms to internationalize and will result in a lower share of equity market activities taking place abroad. This may have significant implications for domestic market development, as the migration of trading to international financial centers can have negative spillover effects on local markets.

Despite the intense reform efforts, the performance of local capital markets in many developing countries has been disappointing. Although some countries experienced growth of their stock markets, this growth was not as significant as the one witnessed...
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