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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.
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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.[3] 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.[4]

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.[5] 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.[6] 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.[7]

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

[3] This has been deemed an important goal, as financial development is linked to economic growth. See Levine (2005) for a comprehensive review of the literature on the finance-growth nexus.

[4] The literature on domestic stock market development has found that more developed countries tend to have deeper stock markets (see, for example, Rajan and Zingales, 2003 and La Porta et al., 2006) and that the laws and enforcement mechanisms that protect the rights of minority investors foster equity market development (La Porta et al., 1997, 1998). Macroeconomic stability has also been found to promote financial development (Inter-American Development Bank, 1995; Boyd et al., 2001).

[5] There are different alternatives to cross-list domestic stocks in international financial markets. A very popular way to do so is through depositary receipts, called American depositary receipts (ADRs) or global depositary receipts (GDRs). These are foreign currency denominated derivative instruments issued by international banks, representing home securities held with a local custodian.

[6] Karolyi (2004), for example, argues that the growth of ADR programs in emerging economies is the result of poorly functioning stock markets, resulting from economic, political, legal, or other institutional forces that generate incentives for firms to leave. This view is also behind the recent literature on "bonding", which argues that cross-listing in an exchange with better investor protection is a form of bonding, creating a credible and binding commitment by the issuer to protect the interests of minority shareholders. See Benos and Weisbach (2004) for a review of this literature.

[7] Levine and Schmukler (forthcoming, 2006) analyze the impact of migration to international markets on domestic stock market trading and liquidity. Moel (2001) and Karolyi (2004) also present evidence on how the use of ADRs is related to stock market development in emerging economies.

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