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ScienceDirect
Emerging Markets Review 7 (2006) 339 – 360
EMERGING MARKETS REVIEW
www.elsevier.com/locate/emr

Is locking domestic funds into the local market beneficial? Evidence from the Polish pension reforms

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Received 31 May 2006; received in revised form 31 August 2006; accepted 4 September 2006
Available online 9 November 2006

Abstract

This paper is concerned with the effect of enforced home bias on the development of emerging stock markets. It provides a detailed study of the impact on the Warsaw Stock Exchange of the Polish pension fund reforms and the associated restrictions on international investment. The time-path of market development for the Warsaw Stock Exchange is compared with a benchmark sample consisting of the other seven post-communist countries that joined the EU in May 2004. It is shown that benefits arising from the pension funds' increased investment in the home market are short-lived. In the long run, the relative performance of the Polish market returned to pre-1999 levels or worse, suggesting that enforced home bias on emerging markets may be detrimental, rather than beneficial, to the long-run development of the market.

JEL classification: G23; G28; G11

Keywords: Pension reforms; Home bias; Stock market development; Transition countries

1. Introduction

Almost all governments and, in particular, those of developing countries, impose some restrictions on the portfolio composition of pension funds. In particular, tight limits are commonly imposed on international investment. This attitude is in stark contrast to the received wisdom of

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1566-0141/$ - see front matter
doi:10.1016/j.ememar.2006.09.007

the financial literature, which suggests that such restrictions can have a negative impact on the efficiency of portfolio allocation. This empirical finance literature, however, has concentrated on the existence of home bias and its negative impact within developed markets.[1] The impact of enforced home bias on the development of emerging markets has received almost no attention and consequently is less understood. However, as Roldos (2004) says, understanding the phenomena is "one of the key questions in emerging markets and one of the key challenges for regulators of securities markets and the pension industry". There are reasons to think that home bias may be particularly detrimental for emerging markets.[2] For example, big institutional investors (and in particular, pension funds) may have far more effect on the development of an emerging market since, by nature, these markets are less liquid, less informationally efficient, and more prone to instabilities. One of the reasons that this issue has not been analysed empirically is that it is hard to find case studies that have two characteristics: (i) the volume of funds that are restricted need to be significant relative to the emerging home market and (ii) there has to be a relatively good set of benchmark markets at a similar stage of development so that the impact of the enforced home bias can be isolated. This paper focuses on an experiment that encompasses these two requirements. It looks at the development of the Polish stock exchange and compares it against the development of other emerging stock markets operating in Central and Eastern Europe in the period 1996–2004.

In 1999, as the result of the introduction of mandatory pension schemes in Poland, pension funds started to operate on the Polish market. From the beginning these funds faced strong restrictions on international investments. In consequence, the funds had no choice but to invest heavily on the local market and the equity investment of these funds quickly became significant relative to the overall size of the market (e.g., in 2003 the equity investment of the pension funds already represented 38% of all equity under free float on the Warsaw Stock Exchange, WSE).

To fully answer the question of whether pension funds' equity investments have a positive impact on the development of a stock market (in this case on the development of the WSE), the analysis needs to be conducted on two levels. First, the characteristics of the exchange over time must be examined in order to observe whether there are any differences in characteristics of the pre, and during pension funds' investment periods. Second, to be able to fully isolate the effect and to abstract from other specific effects, as far as possible, the comparison must also be conducted on an international level. The "difference in difference" analysis aims to distinguish between changes that are characteristic to the Polish market and changes that characterise all the local markets at a similar level of development operating in a similar (local and global) economic environment.[3] Due to its geographical location, the economic transition experience and the current EU enlargement the Polish equity market can be compared with and contrasted against the equity markets operating in the other seven post-communist countries that joined the EU in May 2004. Therefore, the processes taking place on the WSE can be better understood than if the Polish data alone were analysed.

To give a foretaste of the main results, I show that the intensive investment of the pension funds in the local market had a strong short-term effect on the WSE. The market rose in absolute

[1] See, e.g., Cai and Warnock (2006), Kang and Stulz (1997), Lewis (1999).

[2] In the case of developed markets a positive link between stock market development and development of institutional investors is documented (e.g., Catalan et al., 2000; Davis, 1995; Davis and Stein, 2001; Demmogrüc-Kunt and Levine, 1995; Harichandra and Thangavelu, 2004).

[3] When the communist block fell apart several emerging markets were created at roughly the same time and are thus at a very similar state of development as the WSE.