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Stock market development and internationalization: Do economic fundamentals spur both similarly?☆

Stijn Claessens [a,b,c], Daniela Klingebiel [c], Sergio L. Schmukler [c,*]

[a] *University of Amsterdam, The Netherlands*
[b] *CEPR, United Kingdom*
[c] *World Bank, United States*

Abstract

We study how local stock market development and internationalization–listing, trading, and capital raising in international exchanges–are related to economic fundamentals. Using panel data, we find that higher-income economies with sounder macro policies, more efficient legal systems, greater openness, and higher growth opportunities have more developed local markets. Importantly, these fundamentals also relate to internationalization, and actually more so, since the better the fundamentals, the higher the ratio of internationalization to local market activity. Furthermore, we find that greater domestic stock market development is associated with subsequent higher internationalization. These findings are not consistent with firms internationalizing to escape poor domestic environments, but rather with better country fundamentals allowing firms to internationalize and with countries with more developed stock markets experiencing more internationalization. With liquidity agglomeration, better fundamentals might further

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* Corresponding author.
E-mail addresses: sclaessens@worldbank.org (S. Claessens), dklingebiel@worldbank.org (D. Klingebiel), sschmukler@worldbank.org (S.L. Schmukler).

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accelerate internationalization, with potential negative effects on domestic markets, as others have already argued.

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1. Introduction

Financial markets, especially stock markets, have grown considerably in developed and developing countries over the last two decades. Several factors have aided in their growth, importantly, improved macroeconomic fundamentals, such as monetary stability and higher economic growth. General economic and capital market specific reforms, including privatization of state-owned enterprises, financial liberalization, the establishment of stock exchanges and bond markets, and an improved institutional framework for investors, have further encouraged capital market development.

Financial globalization has also advanced in the last two decades with increased cross-border capital flows, tighter links among financial markets, and greater commercial presence of foreign financial firms in countries around the world. An important element of the globalization trend has been the increase in the stock exchange activities that take place abroad, most notably for emerging markets, but also for developed countries. Many firms now cross-list on international exchanges, with depositary receipts being a particularly popular instrument to access international markets.[1] Going forward, many expect these globalization trends to continue as access to information improves, standards (concerning corporate governance, listing, accounting, and others) become more harmonized, technology advances, and inter-market linkages further increase.

In this paper, we try to shed light on how economic fundamentals affect the processes of domestic stock market development and internationalization of stock exchange activities. We do this by analyzing a basic question: how do the macroeconomic and institutional factors that drive the development of local stock markets affect the internationalization process? Many papers have analyzed the factors influencing stock market development. More recently, a number of papers have also studied the factors driving internationalization. However, papers have studied these processes separately, working with different methodologies and samples, making comparisons difficult. In this paper, we use the same framework to analyze how economic fundamentals affect both domestic stock market development and the internationalization of stock market activities (listing, capital raising, and trading abroad) for a large panel of countries and years, thereby facilitating comparisons between the factors driving the two processes.

How economic fundamentals affect domestic stock market development and the internationalization of stock market activities is not obvious. At least two possible views exist on

[1] There are different ways to "list" domestic stocks in international financial markets. A traditional way is to cross-list the share in another exchange. European companies tend to use this method of internationalization most often. A very popular way to internationalize among emerging market firms has been through depositary receipts, called American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs). These are instruments issued by international banks, like Bank of New York or Citibank, representing a claim on the home securities held with a local custodian. DR programs grow or shrink depending on demand, since the issuance of DRs and the conversion back to the underlying shares only involve a small transaction cost. See Levy-Yeyati et al. (2006).