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Regulatory lessons for emerging stock markets from a century of evidence on transactions costs and share price volatility in the London Stock Exchange

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Abstract

This paper draws regulatory lessons for emerging stock markets from an empirical study of the relationship between transactions costs and share price volatility in the London Stock Exchange. We concentrate our analysis on direct pecuniary costs of trading, namely transactions taxes (stamp duty) and brokerage charges, which derive directly from regulation. In a novel contribution to the transactions cost literature, we identify stock market performance with various measures of market volatility, and distinguish among *market* volatility, *fundamental* volatility and *excess* volatility; we also propose some simple ways of identifying the separate impact of transactions costs on these volatility measures. Our findings suggest that changes in transactions costs have a significant and dependable effect on share price volatility but the sign of this effect depends critically on the concept of volatility being measured. Among the important lessons for emerging stock markets is that transactions costs are an important factor in share market volatility and the regulatory regime therefore needs to take account of the impact of regulation on such costs. This is particularly important for those emerging stock markets that rely on stamp duty or other transactions taxes as a regulatory tool.

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1. Introduction

In this paper, we seek to draw regulatory lessons for emerging stock markets from a study of the historical development of transactions costs and share price volatility in the London Stock Exchange. [1] We focus on transactions costs as one particular aspect of market operating and regulatory conditions; specifically, we study the relationship between transactions costs and market volatility, which we interpret as a measure of market performance. The regulatory regime is a key determinant of transactions costs, both indirectly through the institutional and competitive structure of the market, and more directly through any taxes or regulatory charges on market participants. Transactions costs, in turn, affect market performance, particularly but not exclusively, through their effect on trading volumes. [2]

One difficulty in evaluating these arguments is that transactions costs data for most stock markets are of short span. Hence, the main innovation of this paper is that we analyse the relationship between transactions costs and market performance with the aid of a new long-term dataset on the London Stock Exchange covering almost one-and-a-quarter centuries – from 1870 to 1986. An additional innovation of the paper is that it draws on the research on the British stock market for over a century to provide some new benchmarks for appraising aspects of government policy and regulation that may influence the behaviour of stock prices and returns in emerging stock

[1] Although most emerging stock markets have exhibited phenomenal performance, the financial crisis that broke out in South East Asia in the summer of 1997 has renewed the calls for a careful examination of the organisational and regulatory practices in these markets. In general, most of the markets do not have the basic legal and institutional framework for an efficient microstructure i.e., they are not efficiently organised, operated and regulated; see Lo (1995) and O'Hara (1995). Moreover, at the operating level, many of these markets are characterised by high transactions costs associated with intermittent trading of a relatively few stocks, often held by a relatively small group of investors (Murinde, 1996). Such thin markets may be subject to excess volatility or to speculative bubbles (Shiller, 1989).

[2] There is a substantial literature on these relationships which we briefly review in Section 2 of this paper. In general, regulatory policy has a direct impact on stock market efficiency in that trading arrangements, costs and taxes may produce too little or too much trading, and thus cause inefficiency (see Stiglitz, 1989; Roll, 1989).