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Routes to equity market integration — the interplay between politicians, investors and managers

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Abstract

Most econometric studies of equity market integration suggest that national markets are increasingly becoming part of a global equity market. As regards the extent of this integration, however, the results are often inconclusive. Further analysis calls for a closer scrutiny of the basic requirements for perfect integration. This paper presents an analysis of market segmentation in terms of existing regulatory and informational wedges, based on conditions in the Nordic welfare states. It is found that no barriers remain to cross-border equity market transactions, nor consequently to the perfect global integration of Nordic equity markets in a capital-flow perspective. However, certain residual cross-border tax wedges do challenge the view of perfect equity market integration. Further, continuing cross-border information gaps for small and medium-sized companies indicate the presence of a two-tier equity market integration.

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1. Introduction

Researchers and practitioners both tend to attribute today's economic crises in Asia, Russia and Latin America to the globalization of financial markets. It is assumed that existing or anticipated problems in a national market, previously handled by the government and central bank of the country concerned, are contagious and will spill over into the rest of the world. Investors act in their own interest, moving capital across national borders. Policy-makers can do nothing but look on; policy-making and regulations have lost their bite. At a time when capital controls have reappeared on government agendas, this popular view calls for a deeper analysis of the interplay between politicians, managers and investors, in order to see just how far globalization has actually gone. In the present global financial turmoil the results of such an assessment can make a crucial contribution to the search for appropriate policy prescriptions.

Over the last two decades a significant volume of research has focused on ways of measuring equity market integration from an econometric point of view. Various schools of thought have developed, but for most of them the point of departure has been much the same: *the law of one price*, which states that if two or more markets are integrated, then identical securities should be priced identically in them all. The controversial issue dividing the different schools concerns what 'being priced identically' actually means.

One strand in the literature, which highlights identical movements, is based on the analysis of co-movements of equity-market returns (for the analysis of correlation of returns (see, e.g. Eun and Shim, 1989; Hamao et al., 1990; Lau and Diltz, 1994; Lin et al., 1994) for correlation of hourly returns (see, e.g. Susmel and Engle, 1994), for testing the stability of correlation coefficients (see, e.g. Jorion, 1985; Kaplanis, 1988), for stability over longer periods (see, e.g. Erb et al., 1994; Ibrahimi et al., 1995; Longin and Solnik, 1995) and for stability around the Crash of 1987 (see, e.g. Roll, 1988; Bertero and Mayer, 1990; Arshanapalli and Doukas, 1993; King et al., 1994)). Solnik (1996) provides an overview of correlations between industrialized markets. This strand in the literature can be regarded as the main one. Whereas measuring co-movements in isolation leads to conclusions in terms of weak integration, measures of strong integration also involve the analysis of return gaps.

Most schools focusing on strong integration also start from the law of one price, but after risks have been taken into account. In studies adopting this more stringent definition of integration the thrust of the analysis can vary from the role of currency risk (see, e.g. Jorion, 1989), to the long-term differences in risk-adjusted returns (see, e.g. Ibbotson et al., 1985), to optimal international asset allocation (see, e.g. Glen and Jorion 1993; Odier and Solnik, 1993), to international asset pricing with extended CAPM (see, e.g. Black, 1974; Stapleton and Subrahmanyam, 1977; Errunza and Losq, 1985; Eun and Janakiramanan, 1986; Hietala, 1989), to home country preference bias (see, e.g. French and Poterba, 1991; Cooper and Kaplanis, 1994; Tesar and Werner, 1995), to the international pricing of risks (see, e.g. Jorion and Schwartz, 1986; Gultekin et al., 1989; Harvey, 1991; Dumas, 1994),