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Stock market liberalization and volatility in the presence of favorable market characteristics and institutions

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Abstract

In this study, we first examine the effect of stock market liberalization on stock return volatility for eighteen emerging markets. Similar to findings from previous work, we find that volatility may decrease, increase, or remain unchanged following liberalization. We then link post-liberalization volatility with market characteristics and quality of institutions, which is the main contribution of the study. Interestingly, countries that experienced lower post-liberalization volatility are in general characterized by favorable market characteristics such as higher market transparency and investor protection, and better quality of institutions such as a higher regard for rule of law and lower levels of corruption.
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1. Introduction

Equity market liberalization could have a favorable impact on the economy in many aspects. For instance, several empirical studies have shown that liberalization has had a

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positive effect on developing economies via the decreased cost of equity, increased returns, and increased private physical investment.[1] However, liberalization may make a country susceptible to economic and political turmoil abroad making the domestic markets more volatile. Some would agree that the 1997 East Asian crisis is an example of turmoil in domestic stock markets due partly to equity market liberalization policies.

The effect of stock market liberalization on return volatility in particular is an important issue that emerging market economies must consider before their decision to liberalize and perhaps even after. This is because volatility is an unattractive feature that has adverse implications for decisions pertaining to the effective allocation of resources and, therefore, for investment.[2] For instance, volatility makes investors more averse to holding stocks due to uncertainty. Investors in turn demand a higher risk premium in order to insure against the increased uncertainty. A greater risk premium results in a higher cost of capital, which then leads to less private physical investment. In addition, greater volatility may increase the value of the 'option to wait' thereby delaying investment. Also, weaker regulatory systems in developing markets reduce the efficiency of market signals and the processing of information, which further magnifies the problem of volatility.

Why should stock market liberalization affect return volatility? One explanation is that liberalization attracts a new group of investors, mostly institutional investors from already developed markets, whose decisions are based more on rational investment analyses and whose strategies focus on fundamental valuation factors. Hence, the possibility of reduced volatility after liberalization. On the other hand, a market opening may expose the liberalizing country to uncertainties abroad that could be reflected in increased domestic stock price volatility. Therefore, the possibility of increased volatility after liberalization. Also, competing effects may offset each other and liberalization may not have a significant impact on volatility after all. Bekaert and Harvey (1997) point out that a poorly developed stock market in a relatively closed economy is likely to be characterized by high stock market volatility to begin with and liberalizing such a market to foreign investors can only decrease volatility. This is because a fully integrated market is influenced by world factors rather than local factors such as political risk and unstable macroeconomic policies that are prevalent in countries with poorly developed stock markets.

Several studies have in fact examined the issue of liberalization and volatility in the stock market and shown empirically that market opening may decrease or increase volatility. See Table 1 for a summary of existing work on liberalization and volatility. We, too, examine stock market liberalization and the volatility of stock returns, which is one of two objectives of the paper. The major contribution of our work lies in the second objective, which is to link post-liberalization volatility with market characteristics and the quality of institutions. The market characteristics that we consider are market transparency, investor protection, and market exit restrictions. The quality of institutions is the risk of repudiation of contracts by the government, the risk of expropriation, corruption, rule of law, and bureaucratic quality. Specifically, we first test whether liberalization has a significant impact on stock return volatility. We then group countries that experienced either a significant decrease or increase

[1] See Bekaert and Harvey (2000), Bekaert et al. (2005), Henry (2000a,b), Kim and Singal (2000), Klein and Olivei (1999) and Stulz (1999).

[2] See Kim and Singal (1993, 2000), Bekaert and Harvey (1997), and Singh (1993).

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