Whither the Gains from Capital Market Reforms?

The reforms are associated with increases in stock market capitalization, trading, and capital raising

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Over the last two decades, a large number of countries, both developed and developing, have implemented significant capital market reforms, including stock market liberalization, improvements in securities clearance and settlements systems, and the development of regulatory and supervisory frameworks. These reforms, together with improved macroeconomic fundamentals and related reforms, such as privatization and pension reforms, were expected to foster domestic financial development.

Despite the intense reform efforts, the performance of local capital markets in many developing countries has been disappointing. Although some stock markets grew, the growth was not as significant as the one witnessed by the most advanced nations. Other countries experienced an actual deterioration of their domestic capital markets. Stock markets in many developing countries remain highly illiquid and segmented, with trading and capitalization concentrated on few stocks.

Do Capital Markets Respond to Reforms?

We analyze how reforms have impacted on both the development of domestic stock markets and the internationalization of stock market activities (listing, trading, and capital raising). The reforms we study include:

- *Stock market liberalization*, whereby a government allows foreign investors to purchase shares in the local stock market and domestic investors to purchase shares abroad. This increases the pool of capital available to local firms, broadens the investor base, and reduces the cost of capital. The scrutiny by foreign investors may increase transparency and promote the adoption of better corporate governance practices.
- *Enforcement of insider trading laws*. For example, many countries introduced new standards in voting rights, tender procedures, and the structure of the board of directors. Some countries also enacted new insider trading regulations and improved accounting and disclosure standards.
- *Introduction of fully automated electronic trading systems* to replace traditional trading floors. These systems may increase liquidity and improve efficiency by reducing transaction costs, increasing information availability, and providing affordable remote access to investors.
- *Privatization programs*, which have had a direct impact on domestic stock markets, as many governments carried out privatization sales through share offerings on local exchanges, as well as on internationalization, as many privatization sales involved offerings in international financial markets.
- *Structural pension reform*, i.e., shifting from a public defined benefit pay-as-you-go system to a privately managed funded defined contribution system. These reforms were expected to improve macroeconomic stability by reducing the demographic pressures of pay-as-you-go systems, inducing fiscal reform, reducing labor market distortions, increasing savings, and promoting capital market development.
- *Institutional reforms* in five major areas: government size, legal structure and security of property rights, access to sound money, freedom to trade internationally, and regulation of credit, labor, and business.

In the analysis we use three measures of domestic and international stock market activity: market capitalization, value traded, and amount of equity capital raised.

Reforms are Effective

Our estimations show that all the reforms are followed by increased domestic stock market development and internationalization. In the case of stock market liberalization, for example, the difference between the pre-liberalization and post-liberalization periods in a country's stock market capitalization over GDP is 14.2 percentage points. Similar results are found for value traded domestically and capital raised domestically. All the reforms, with the exception of stock market liberalization, seem to be followed by increased trading activity in the local market. In the case of capital raised, only pension reform is not significant.

This suggests that reforms make local firms more attractive to foreign investors, who then grant them access to international markets at attractive terms.

Are the reforms followed by similar increases in domestic and international activity? Our results suggest that all the reforms, with the exception of privatization and the introduction of electronic trading systems, seem to be followed by large increases in the share of trading that takes place in international markets. This runs contrary to the view that a poor domestic environment prompts firms to access international markets and that reforms reduce internationalization.

After the liberalization, the stock market capitalization over GDP is 14.2 percentage points higher than before the reforms

Thus, contrary to the claim that the reforms are not effective, our findings confirm that reforms are associated with increases in domestic stock market capitalization, trading, and capital raising. However, reforms are also associated with increased internationalization, and a higher share of activity in international markets.

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