Foreign Capital and Stock Market Development - Do the Macro- and Microeconomic Studies Agree

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The theoretical argument for the effects of foreign capital on stock market depth is the fact that additional capital needs additional financial intermediation. Foreign investors would need to finance their investment with either external capital or by selling equity. However, the fact that foreign investors oftentimes list their companies global stock exchanges rather than domestic ones tends to be overlooked. This article surveys the evidence on the impact of foreign capital on domestic stock market development, comparing the findings of macroeconomic vs. microeconomic studies. We find little agreement between these studies and a great need for more comprehensive analysis and understanding of the channels of the impact.

JEL Classification: G1, G15, F21, F41

Keywords: Stock market deepening, stock market capitalization, stock market development, foreign capital

1. Introduction

Increased interest in financial system fragility has recently intensified investigations in financial deepening. The Global Financial Crisis has shifted researchers’ focus to systemic risk and likelihood of crises. When rapid expansion of credit is added to the typical information asymmetries and agency problems, financial systems can become fragile and susceptible to shocks (Barajas et al., 2013)\(^2\). Thus, while financial markets depth reduces asset price volatility and improves overall stability when it is within certain bounds, it can increase instability in the presence of financial distortions and the same financial system functions that help the economy

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\(^2\) Barajas, et al. (2013) establish a constrained optimum level of financial development and introduce the concept of financial possibility frontier, which takes into account structural, institutional, and macroeconomic country characteristics. The authors derive credit booms and busts as overshooting beyond level predicted by the structural fundamentals.
grow can become reasons for potential economic crises. As part of financial deepening, stock market deepening plays an important role in financial instability.

Similarly to globalization of trade and capital flows, securities activities worldwide have become a lot more global in the past several decades. This process has been especially beneficial for firms, originating from emerging market economies whose stock market activities can be now moved abroad and cross-listed on the main capital market exchanges, such as New York and London (Claessens et al., 2002). Advances in technology have only exacerbated this trend and stimulated capital market convergence. Stock market trading has become easily accessible from everywhere. As a result, world capital market centers have gained liquidity, while many local markets have experienced pressures. Listing on the global stock market exchanges has lowered costs and improved liquidity of traded shares for corporations. On the other hand fully-fledged local stock exchanges have become less necessary for many economies (Claessens et al., 2002).

The theoretical argument for the effects of foreign capital on stock market depth is that the additional capital would need additional banking system and stock markets financial intermediation. Foreign investors would need to finance their investment with either external capital or by selling equity. Therefore, the liquidity of stock markets will rise. However, foreign investors have the option to list their companies not only on the local stock exchange, but also on foreign stock exchanges, including the global stock markets in New York, Tokyo, etc. Although this opportunity potentially exists for domestic investors as well, foreigners may be more prone to utilizing it. Thus, stock market capitalization may increase on the domestic market, foreign markets or both. The willingness to list domestically (or cross-list with domestic exchanges) may depend on the sector of the international investor (Doytch, 2013).

This survey has the goal of critically examining critically the literature on determinants of stock market development and identifying the role, which foreign capital plays in it. Comparing the macroeconomic and microeconomic evidence, we find little agreement between studies and a great need for more comprehensive analysis and understanding of the channels of the impact.

2. Macroeconomic Determinants of Financial Development

Financial systems are viewed as crucial for economic growth because of their functions of allocating capital to its most productive uses, maintaining property rights and promoting effective legal environments (Mishkin, 2009). They are instrumental in making allocation decisions in environments with high information and transaction costs, since they provide fund pooling, risk diversification, and liquidity management, screening and monitoring (Garcia and Liu, 1999). They also help economies grow through performing a liquidity transformation from short-term savings to long-term investments.

Early literature on financial development tends to focus on the relationship between financial development and economic growth (Gurley and Shaw, 1955; 1960; 1967; McKinnon, 1973; Lopez, 1988). However, empirical evidence is mixed and inconsistent (Shaw, 1973; 1983). The mechanism of financial development is not well understood, and the relationship is non-linear in nature (Ghosh and Savvides, 2001). Therefore, a comprehensive analysis is needed to understand the channels of the impact.

3 Such financial distortion could be due to dissimilarities between domestic and external balance sheets and excessive leverage.

4 Stock market deepening is one part of financial deepening. Financial deepening can be defined as \[ \frac{1}{2}(DA + DL) + \frac{1}{2}(FA + FL) \]/GDP, where DA and DL are domestic assets and liabilities and FA and FL are foreign assets and liabilities (Source: IMF, 2013). Stock market capitalization is part of the overall measure of capital markets depth.
1973, and Shaw, 1973). Studies of the 1990s and early 2000s tend to analyze this relationship using relatively small country panels (King and Levine, 1993a, 1993b; Ndikumana, 2000; Rajan and Zingales, 1998; Demirgüç-Kunt and Maksimovic, 1996; Levine et al., 2000; Beck et al., 2000b; Levine and Zervos, 1998; Levine, 1997). This line of research has a positive relation between financial development and economic growth. Moreover, when the type of financial structure has been considered, studies have established that both bank-based and stock market-based systems produce a positive impact on economic growth (Ndikumana, 2005 and Beck and Levine, 2004).

More recently, the financial development literature has been heavily influenced by analyses of the World Bank data set on Financial Development and Structure (Thorsten Beck, Aslı Demirgüç-Kunt, and Ross Levine, 1999), initially published in 1999. The Financial Development and Structure contains measures of the size of the banking sector and the liquidity of the stock markets. It covers a large country sample. Using the new measures of financial development, researchers have confirmed a high correlation and a causal relationship between them and GDP per capita growth (Beck, Demirgüç-Kunt, and Levine, 1999; Beck, Demirgüç-Kunt, and Levine 2009; Narayan et al., 2011).

A useful survey of the finance-growth nexus literature is available in Levine (2005). A discussion of the newly uncovered non-linearities in the stock market - economic growth relationship are discussed in Barajas et al. (2012), who find that effect of financial development on growth is the strongest in middle-income countries. The non-linearities are also linked to the level of private credit- the relationship becomes negative for levels beyond 110 percent of GDP (Arcand et al., 2012). In addition, excessive financial deepening is linked to elevated macroeconomic volatility Dabla-Norris and Srivisal (2013).

The past several decades have produced a shift of literature attention from the role of the banking sector to the role of stock markets. The shift has been motivated by the surge of world stock markets, including emerging countries’ stock markets in the past decades. New theoretical and empirical work shows how stock market development might boost long-run economic growth and new studies on determinants of stock market development cast light on the reverse relationship (Demirguc-Kunt and Levine, 1996; Singh, 1997; and Levine and Zervos, 1998). Stock market development as a concept has many dimensions- size, liquidity, volatility, concentration, integration with world capital markets, regulation and supervision etc. Many of the recent studies have focused on stock market capitalization, value traded and turnover ratio (Narayan et.al, 2011). Researchers compare stock market capitalization in role and functions to monetization, i.e. the role private sector plays in financial intermediation.

A large share of the empirical literature on stock market development has emphasized institutional determinants. Legal systems, property rights and contract enforcement have all been proven important for capital markets in general. The seminal work by La Porta et al. (1997, 1998) shows the impact of contract enforcement in the form of protection of creditor’ and shareholder’ rights. Further studies show the importance of the regulatory environment in terms of judicial system, accounting standards, enforcement of the law in general, and lack of corruption (Lombardo and Pagano, 2002; Mayer and Sussman, 2001; Pistor, Raiser and Gelfer, 2000).
A number of macroeconomic determinants of stock market development has been studied. Among them are the level of income per capita, both the investment and the saving rates, the level of private credit, stock market liquidity, interest rates and level of inflation (Garcia and Liu, 1999; Huybens and Smith, 1999; Boyd, Levine and Smith, 2001; Do and Levchenko, 2004 and Huang and Temple, 2005). In addition, several studies focus on the effects of openness on stock market capitalization and value traded. Trade openness is found to have a positive effect on stock market development (Do and Levchenko, 2004; Huang and Temple, 2005) and remittances as well (Aggarwal et al., 2011). And in resource-rich countries, stock market capitalization has been shown to be driven by the oil price (Billmeier and Massa, 2007).

And finally, a new stream of literature has tested the hypothesis of Stock Market Convergence (Narayan et al., 2011; Brada et al.; 2005, Eun and Lee, 2010; Su et al., 2010; Fung, 2009; and Mylonidis and Kollias, 2010). Narayan et al., (2011) test specifically for stock market absolute and conditional convergence within various country groups and total data set for 120 countries. The authors find conditional convergence of stock market capitalization and value of traded stocks within the high income group, the low-income group, OECD panel, and the Sub-Saharan African group, where the speed of convergence is between 20% and 30%. Our paper confirms this result.

3. Foreign Capital and Stock Market Development - the Macroeconomic Evidence

One of the few studies that focus specifically on the effects of foreign capital on stock market development that we were able to find, is Claessens, Klingebiel, and Schmukler (2001). Their paper has been motivated by the migration of stock market activity to international financial centers, which occurs with globalization. First, the study finds that a relatively small number of fundamental factors that affects both domestic stock market capitalization and participation in international markets. Second, the study shows that FDI is positively correlated with stock market capitalization and value traded both at home and abroad. Claessens, Klingebiel, and Schmukler (2001) also predict that with improvement of countries’ fundamentals and technology the trend towards integrate with the international financial markets, as well as migration of trading towards the international market centers will increase and domestic stock market activity will become too little to support many local markets.

Several more recent studies, supporting the result of a positive impact of FDI on stock market deepening are Soumaré and Tchana (2011), who find a causal relationship between foreign direct investment (FDI) and financial market development using panel data from emerging markets, Adam and Tweneboah, 2009), who find long-run relationship between FDI and stock market development in Ghana, using impulse responses and Variance Decomposition from Vector Error Correction Model, and Baltagi et.al. (2009), who explore the question of determinants stock market deepening by the use of country panels, comparing the impacts of trade and financial globalization of banking systems and stock markets and find a positive effect of both on stock market capitalization.

4. Foreign Capital and Stock Market Development- the Microeconomic Evidence

From a microeconomic perspective the decision of where to list or cross-list a company is largely guided by shareholder protection considerations (La Porta et al., 2002, 2006; Doidge et al., 2004; Claessens and Schmukler, 2007; Smirnova, 2008). Since there is a link between firm legal origins, return distribution, and growth rate of market capitalization de-listing and cross-listing
behavior of foreign firms is also of interest for the legal literature (Buchanan and English, 2007). The most often cited legal reasons are that by cross-listing shares in the U.S. is that foreign firms affiliate with a robust legal system that offers investor protection and improves reputation as well as their visibility and prestige (Coffee, 2002, 1999; Abdallah and Goergen, 2008; Fernandez and Ferreira, 2008; Lee and Valero, 2010). However, firms also cross-list to achieve greater liquidity, better capital access, increased transparency, as well as to broaden their shareholder base (Foerster and Karolyi, 1999; Miller, 1999; Doidge et al., 2009b, 2004; Gozzi et al., 2008; Lel and Miller, 2008).

There is also a cultural dimension to the decision where to list a company, which resonates with the institutional economics literature. Culture could be a reason for de-listing of foreign firms, since social norms and cultural values impact economic decisions (North, 1990; Williamson, 2000; Daugherty and Georgieva, 2011). Companies have a tendency to list in countries that are culturally similar the theirs (Pagano et al., 2002; Licht, 2003) and cross-listing activities end up being clustered in geographical groupings (Sarkissian and Schill, 2003). The geographical and cultural factors often dominate the financial considerations for cross-listing behavior (Portes and Rey, 2000; Rauch, 2001).

5. Conclusion
The current survey examines the literature on determinants of stock market development and analyses the role foreign capital plays in it. Comparing the macroeconomic and microeconomic evidence, the survey finds little agreement between the studies. Whereas from macroeconomic perspective we expect to find a positive impact of foreign capital on domestic stock market capitalization, at the microeconomic level the willingness to list, delist or cross-list certain foreign company on domestic stock exchanges is a complex decision that requires further analysis and more thorough understanding.

References


