Chapter 9

SEcurities Markets in Emerging Economies: An Overview of the Main Issues

Silvio John Camilleri*
Banking and Finance Department,
Faculty of Economics, Management and Accountancy,
University of Malta, Tal-Qroqq, Msida MSD 2080, Malta

Abstract

This chapter surveys the salient concepts relating to the role and development of emerging securities markets. It considers both general securities markets activity as well as the operations of exchanges which facilitate securities trading. The section relating to general securities activity discusses the liberalisation of securities markets in recent years, the risks related to portfolio investment in emerging markets and the impacts of the gradual integration of these markets with global ones.

Part of the business activity of securities exchanges is migrating overseas through the tendency for larger companies to cross-list on major exchanges. This chapter thus explores how emerging economy exchanges may assert their role in international financial markets through supplementing traditional business streams with new ones, enhancing liquidity and using appropriate technology. Finally, the chapter illustrates how securities activity in emerging economies should be supplemented by the appropriate legal and regulatory framework.

Keywords: Emerging Markets; Financial Integration; Liberalisation; Securities Markets.

JEL Classification: G15, G18, G20, G28, O16

1. Introduction

The primary function of securities markets is to channel funds from savers to productive users. In this way, securities markets offer profitable opportunities to investors and provide

* E-mail address: silvio.j.camilleri@um.edu.mt
capital to the real sector. Most emerging securities markets grew steadily during the last decades witnessing increased portfolio flows, share of market capitalisation in world markets and number of listings. Such trends are clearly visible in Asian markets [Ding and Charoenwong, 2006], and similar progress is evident in other emerging markets in Latin America, Eastern Europe and North Africa. Portfolio investment in these markets was facilitated by the pronounced increase in emerging country funds marketed by global asset managers. Asia nowadays accounts for a large portion of total portfolio investment in emerging markets. Despite the above, equity finance still comprises a modest portion of corporate funding in emerging economies which were traditionally bank-dominated. For instance, according to Purfield et al. [2006] the portion of equity financing of total corporate funding amounts to around 10% in emerging Asian countries, and this figure is in the region of 3.7% in non-Asian ones.

Portfolio investment towards emerging economies is at times repatriated at short notice, largely around intermitting times of financial crises. This suggests that it is important for emerging economies to nourish resiliency in their financial systems, and this pre-supposes implementation of international standards relating to investor protection, corporate governance and an adequate setup of subsidiary legislation.

This chapter surveys the main issues relating to the development of securities markets in emerging economies, encompassing both general securities markets activity as well as the role of exchanges in facilitating securities trading. In this way, the scope of the chapter is broad given that it aims to tackle the main concepts and to highlight their possible interactions; indeed most of these topics may be comprehensively studied on their own merits.

Section 2 of the chapter explores the impacts of liberalisation of securities markets, and the risks associated with portfolio investment in emerging economies. The section discusses how emerging securities markets are becoming integrated with developed ones and the related effects on diversification and contagion possibilities. Section 3 is concerned with the development prospects for securities exchanges in emerging economies. It reviews the issues impinging on the progress of these exchanges which include increased internationalisation and the drive to augment securities business and consolidate liquidity. Section 4 explores how securities markets in emerging economies should be complemented with an adequate legal and regulatory framework in order to maintain a competitive edge. Section 5 concludes.

This chapter emphasises relatively recent literature. Given the range of issues involved, it is not possible to describe any particular study in detail or to delve into the respective methodologies. Whilst most of the research papers cited in the chapter focus on emerging stock markets, other studies focusing on general financial markets, or stock markets in industrialised countries are occasionally referred to, especially in the context of those issues which are relevant to both emerging and industrialised markets.

2. THE LIBERALISATION OF EMERGING SECURITIES MARKETS AND RELATED ISSUES

The liberalisation of financial services industries in emerging economies was encouraged by increased cross-border trade and this materialised in increased investment flows towards
these countries [Phylaktis and Ravazzolo; 2002]. Financial liberalisation in the context of securities markets may be defined as the removal of restrictions on cross-border equity and debt investment flows. Bekeart and Harvey [2000] suggested alternative definitions of capital market liberalisation, such as the earliest date of an American Depository Receipt (ADR) issue or a country fund launch. Given that liberalisation is a process, the latter events are likely to occur on different dates usually clustered around a particular period.

2.1. Impacts of Securities Markets Liberalisation

Research has converged on the point that allowing overseas investors to access the home market may lead to a higher degree of pricing efficiency, partly because overseas investors include professional fund managers (Niarchos and Alexakis [1998], Tian and Wan [2004] and Kim et. al. [2005]). This should translate into a more efficient channelling of funds from savers to productive users.

Theoretical and empirical studies which considered the longer-term connection between securities markets and economic growth yielded mixed results since such relationship may differ depending on whether it is analysed in the context of an emerging economy as opposed to a developed one. For instance Minier [2003] empirically studied various developed and emerging countries and found that a positive relationship between stock market development and economic growth may not emerge in countries with low market capitalisation. In addition, the setting up of a (small) stock exchange might not lead to automatic growth effects. Beck and Levine [2004] analysed panel data from 40 emerging and developed countries and concluded that stock markets and banks contribute towards economic growth, however it is unclear whether stock markets provide a valuable service distinct from banks, as opposed to the possibility that financial development spurs growth irrespective of whether this emanates from the banking sector or the securities market. Whilst such mixed results were partly explained through an array of factors including the legal setup and investor protection, further research is needed to account for these diverse country experiences.

One factor which complicates the analysis of financial liberalisations is that the latter are typically accompanied by wider reforms and this makes it difficult to single out the real effects which are exclusively attributable to liberalisation. Bekaert et. al. [2001] addressed this problem by accounting for variables representing developments in the macroeconomic environment, banking sector and stock markets, and concluded that equity market liberalisations in emerging countries may be associated with real GDP growth.

Other studies point at adverse effects of financial liberalisation. For instance, according to Devereux and Smith [1994] the liberalisation of securities activity enhances the potential for international risk sharing and this may reduce savings rates and economic growth. Stiglitz [2000] noted that capital market liberalisation exposes countries to factors outside their economy, such as changes in investors’ perceptions regarding the risk of the home market. The author argued that short-term capital flows are not usually appropriate to fund longer-term corporate requirements, and at times it might be prudent to implement restrictions on short-term capital flows. Similarly, Lin [2006] argued that the increased potential for mass selling activities around financial crises may reduce the benefits of liberalisation. Whilst policies to curtail destabilising capital flows might be sensible, the issue of capital controls remains controversial given that these may hinder cross-border portfolio investment.
The effects of stock market liberalisation were also analysed at a micro level, on the grounds that as a firm’s stock becomes available to overseas investors it should facilitate access to funds, lowering the cost of capital. In addition, increased market surveillance adds on to the onus of the firm to offer an efficient risk-return combination. These effects may eventually spill over to other firms in the same economy. Mitton [2006] analysed a sample of firms from 28 developing countries that were opened up to foreign investment and found evidence of improvements in operating performance including higher growth, investment, profitability and efficiency.

The role of financial liberalisation on economic development has been extensively analysed and readers are referred to Auerbach and Siddiki [2004] for a detailed survey. Further research is required to explore the inherent country characteristics which impinge on the success of liberalisation programmes and how liberalisation affects listed and unlisted firms and the setting up of new ones. In addition the relationship between stock market liberalisation and financial stability has not yet been settled; whilst the availability of an alternative funding source may make the economy more resilient to shocks in one particular financing channel, it may potentially increase the exposure to external shocks.

2.2. Risks of Financial Investment in Emerging Economies

The risks relating to financial investment may differ in the context of emerging economies as compared to developed ones, given that some kinds of risks may become pronounced in emerging markets. Goriaev and Zabotkin [2006] in an empirical study of the Russian stock market, noted that investors take account of both country and firm-specific risks, and securities pricing is sensitive both to actual risks and to participants’ perceptions of such risks.

One salient risk relating to cross-border investment emanates from political factors. Research shows that political risk is priced in emerging market securities [Bekaert et. al.; 1997] and emerging economies may reduce the cost of funds through reducing political risk.

Whilst most emerging economies implemented reforms to reduce political risk, other countries may still be in need of more significant efforts to achieve this objective. For instance, Girard and Omran [2007] considered the current state of various Arab capital markets and argued that institutional reforms are needed to reduce political risk, such as curtailing corruption and improving legal frameworks to ensure rule and contract enforceability.

The risks of emerging market investment may exacerbate during financial crises. Experience shows that financial crises are usually caused by a variety of factors such as overvalued exchange rates, bank balance sheets unprepared for financial or real asset volatility, and deficiencies in financial system supervision. Emerging economies should therefore strive to make their financial systems more resilient to external shocks through emphasising prudential regulation and supervision and upgrading their settlement systems to make them less prone to liquidity shocks. The former problems tend to be amplified by the tendency of portfolio investors to withdraw funds at the first signs of financial distress, reducing liquidity in the emerging economy and amplifying asset price volatility. In fact, Reynolds [2001] argued that liberalisation has made emerging markets more vulnerable to global financial crises.
The overall risk of particular markets is often gauged by measuring volatility, and research has also focused on whether liberalisation may lead to volatility changes. One may argue that as speculative capital moves in and out of emerging markets, it may impact on stock prices and induce higher volatility. Yet, one may also expect that as emerging markets become integrated with their overseas counterparts, they should become more informationally efficient, and therefore less prone to excess volatility. Research presents mixed evidence on volatility changes following liberalisation; for instance Jayasuriya [2005] considered changes in stock return volatility following liberalisation in eighteen emerging markets and found that whether countries experience lower or increased volatility might depend on market characteristics. In particular, when markets allocate significant priorities to higher transparency, investor protection and ancillary factors, they are likely to experience reduced volatility. Cuñado et. al. [2006] analysed long-term time series for six emerging markets and argued that past research might have overstated volatility changes. They concluded that financial liberalisation might have reduced average volatility in these markets, whereas the higher post-liberalisation volatility inferred by other researchers might have been due to occasional large shocks.

Further risks associated with emerging market investment emanate from deficiencies of the broader legal and regulatory setup such as transparency and corporate governance requirements. This is discussed in Section 4 of this chapter.

2.3. The Integration of Emerging Markets with Global Ones

Integration should be considered as a distinct issue from liberalisation. Whereas the latter term is associated with removal of restrictions on capital market activity, integration requires actual cross-border capital flows, information availability and possibly ADR activity. Integration implies that assets of comparable risk in different countries should promise similar expected returns.

As markets become more integrated, the diversification prospects traditionally offered by emerging economies may be reduced as returns become more correlated across markets. According to Purfield et. al. [2006], the correlation between global equity markets and Asian ones has increased since the 1990s, and this trend seems representative of emerging markets in general. Contrasting evidence was presented by Hunter [2006] who found no significant evidence of integration between Latin American stock markets and international ones. The degree of integration seems to change around crisis periods, a finding confirmed in other literature such as Yang et. al. [2003] in the context of Asian stock markets.

Empirical studies on the effects of financial integration suggest mixed results; whilst integration may result in increased portfolio flows towards emerging markets and upgrades of country credit ratings [Bekaert and Harvey; 2003] it is not clear whether this may translate into significant real effects. For instance Edison et. al. [2002] considered a sample of 57 countries in various stages of development, and they did not reject the null hypothesis that integration does not accelerate economic growth. Various researchers maintained that financial integration makes emerging markets more prone to currency devaluations, capital flight and contagion. Grabel [2003] thus argued that measures which are not usually provided for in neo-liberal policies may be needed to curb financial crises. These include transaction
taxes and trip wires that warn investors when signs of distress emerge. If such measures curb
the former risks, they may translate in lower risk premiums.

The integration of emerging capital markets may also have implications for contagion
possibilities given that financial or economic instability may spread across markets. The
empirical evidence on contagion may be sensitive to the definition of the term; in particular
whether contagion is considered as contemporaneous comovement across markets, or whether
it entails a significant increase in such comovement following a particular shock. Inferences
tend to be hampered by the facts that correlations are unstable over time [Longin and Solnik;
1995], and that correlation estimates tend to be biased upwards given that volatility typically
increases during crises [Forbes and Rigobon; 2002]. Whereas these factors lead to debates on
scientific conclusions, the notion that markets are prone to instability imported from overseas
seems to be generally accepted. In particular, developed markets may be prone to crises
originating in emerging markets in terms of higher risk premium demands [Dungey et. al.;
2006]. In addition, contagion effects might have been more pronounced in case of “smaller”
crises which have so far been sidelined by researchers, such as the Brazilian one of 1999
[Collins and Gavron; 2005].

Theoretical and empirical literature relating to the integration of stock markets has
flourished, and readers are referred to Kearney and Lucey [2004] for a detailed survey.


Exchanges assist in the efficient running of securities activities. Through providing
liquidity and price discovery, exchanges facilitate secondary market trading and foster the
primary issues of securities. Most exchanges in emerging economies were established in
conjunction with government privatisation programmes and some of them are characterized
by small size and meek liquidity. This section considers the main issues impinging on the
progress of emerging exchanges which include increased internationalisation, the drive
towards augmenting securities business and consolidating liquidity, and the competitive edge
which may potentially be gained through technology.

3.1. The Internationalization Challenge

Technological improvements and deregulation have enhanced investors’ ability to access
information about securities issued overseas and to trade such instruments. This
internationalisation process facilitated the issuers’ task of marketing securities to overseas
investors, commonly by issuing Global Depository Receipts (GDRs). The latter securities are
backed by underlying shares and pay dividends similarly to the underlying shares. US and
major European exchanges often attract significant GDR activity migrating from emerging
markets. Factors which may account for such cross-listings include issuers aiming to exploit
new sources of capital and reducing funding costs, and investors seeking overseas profitable
opportunities.

The impacts of cross-listing activity are not confined to the particular issuer, but extend
to the trading activity on the home (and possibly the host) exchange. Karolyi [2004] showed
how the ADR activity emanating from twelve Latin American and Asian emerging markets resulted in more cross-border capital flows and increased integration. The author also found empirical evidence of adverse effects emanating from decreased trading activity in the home markets, fragmentation of trading activity, and the possibility of hindering development of the home market. Auguste et. al. [2006] noted that cross-listed shares may have served as a means of facilitating capital flight during the Argentine crisis.

The effectiveness of internationalization was also investigated in previous literature. For instance Karolyi [2004] noted that trading activity in some depository receipts may be minimal due to negligible interest in the originating markets on part of international investors. Similarly, Pirrong [1999] and Baruch et. al. [2003] constructed theoretical models predicting that the order flow for a given product tends to converge to a single exchange. There are reasons to expect the home market to be a more liquid venue for securities, given that home traders may be following the particular security more closely and are more likely to trade immediately on new information. Notwithstanding this, O’Hara [2001] cited practical examples illustrating how the venue where the order flow migrates to may be unpredictable; in particular trading does not always migrate to the largest venue.

One salient issue is that the larger and more liquid securities are more likely to be successful in cross-listing overseas and if the order flow relating to such securities migrates from the home markets, this would imply considerable lost business [Levine and Schmukler; 2003]. Moel [2001] found that such decline in liquidity may result in reduced ability of the local stock market to promote economic growth.

When drafting a course of action on how emerging exchanges may deal with internationalisation, one should identify the factors that encourage firms to cross-list in order to address them. Possible motivations for cross-listing, include the ability to tap funds at a lower cost, broadening the investor base, and the prestige related to listing on a larger market. Reese and Weisbach [2002] studied a cross section of US bank depository receipts and argued that one motivation for listing abroad is to protect the interests of minority shareholders. Similar evidence was found by Pagano et. al. [2002]. La Porta et. al. [1997] and Pagano and Volpin [2005] presented evidence of a positive correlation between shareholder protection and stock market development and this implies that increased shareholder protection in the home market should encourage local trading activity.

One policy adopted by exchanges to tackle internationalization was to create alliances with peers in order to reduce operating costs and to augment the importance of their trading venues. Exchanges may collaborate in activities which offer potential for economies of scale if conducted jointly. These include order execution, data warehousing, clearing and settlement, information dissemination and marketing functions. Exchanges may also outsource particular functions, as discussed by Claessens et. al. [2003].

There is still significant potential for further research relating to internationalisation and ADR activity, primarily given that trends may change over time. This is also related to the notion that ADR activity should be considered as a continuing process, rather than a series of events clustered around a particular period, as outlined by Karolyi [2004]. A detailed review of the literature relating to cross-listing activities goes beyond the scope of this chapter and readers are referred to a survey by Karolyi [2006].
3.2. Increasing Business

Two pre-conditions for stock exchange survival are competitiveness and profitability, entailing that institutions monitor their expenditures and revenues. As for the expenditure side, cost cutting strategies might not be optimal since they can make markets less attractive [Claessens et. al.; 2003]. On the other hand, if exchanges attempt to increase revenues through higher fees, it might be difficult to attract new listings and to avoid migration of stocks [Pagano et. al.; 2002]. One alternative strategy which exchanges may adopt is to increase the volume of business to benefit from scale and scope economies.

Enhancing listing and trading activity on exchanges is a two sided effort, in the sense that both the demand and supply of securities have to be nurtured. Encouraging investors to approach the market entails an adequate legal setup in line with international standards which safeguards shareholders’ rights and guarantees efficient dispute resolution. In addition, securities market regulation has to be enforced. In enhancing the supply of securities, exchanges can target first-time listing companies through programmes set up with this specific aim. Yet, according to Claessens et. al. [2003] such initiatives had limited success in the context of newly set up European exchanges. Attracting first time-listing companies implies that exchanges have to cater for differing listing processes and requirements, and therefore most exchanges organise different tier markets.

O’Hara [2001] advocated that exchanges should lay particular emphasis on medium-sized companies in order to attract both domestic listings and possibly regional cross-listings. This rests on the notion that larger companies are likely to cross-list on global exchanges rather than smaller emerging markets, whilst smaller companies tend to remain at home and therefore these are not likely to generate significant cross-listing activity.

Finally, exchanges may consider generating higher revenues by diversifying in related services such as settlement systems. Derivatives constitute another alternative offering potential for increasing business, although these require well-developed underlying markets, increased safeguards to foster financial stability, effective transparency and disclosure requirements, and possible regulatory amendments in respect of short-selling restrictions and contract enforceability [Purfield et. al.; 2006].

3.3. Enhancing Liquidity

Liquidity may be defined as the degree to which a trader may promptly transact assets at reasonable cost. Larger exchanges have a competitive edge in terms of their ability to offer liquidity at low cost. This implies that increasing liquidity should be a top priority across emerging market exchanges; indeed liquidity may be deemed as one pre-condition for attracting portfolio investment.

Liquidity generation is a major objective of the trading protocols adopted by exchanges. Increasingly, modern markets are relying on automated systems such as electronic order-matching facilities, where queued orders are executed through price and time priorities. Such systems are usually cost-effective and transparent however they might be insufficient to ensure liquidity for less traded stocks. Therefore exchanges may consider including human input such as the services of market makers. Clayton et. al. [2006] noted that less developed markets tend to encourage market making activities on the grounds that completely automated
systems rely on the continuous participation of traders, which may not always be forthcoming. Trading protocols feature different elements designed to enhance liquidity and price discovery such as call auctions and dealership systems. Transparency may be a complex issue since whilst it enhances fairness, it may also facilitate market manipulation and information may be used to free-ride on other traders’ strategies. The impacts of trading protocol features on liquidity may differ across markets and the interactions of such features have not been explored in detail. As discussed by O’Hara [2001] the optimal trading design is likely to depend on the characteristics of the particular market, and therefore trading venues should not replicate the procedures adopted by other venues. Comerton-Forde and Rydge [2006] considered the market setup of various Asia-Pacific exchanges in industrialised and emerging economies. The authors noted that these exchanges collectively differ when compared to other international ones and they may improve through fostering pre-trade transparency and by offering different trading mechanisms intended to suit the needs of different investor types.

Inferring whether a particular protocol is optimal for generating liquidity is not a straightforward task. Indeed, according to Purfield et. al. [2006] liquidity problems may arise from the “wider framework” such as inadequate investor protection. In this way, enhancing liquidity may also entail upgrading market regulations relating to transparency and corporate governance, apart from changes in the trading procedures.

3.4. Technology

Exchanges should aim to process transactions at a low cost in the interest of profitability and competitiveness; technology is a decisive factor which impinges on how this objective may be achieved. Hasan et. al. [2003] analysed time series data for a cross section of industrialised and emerging market exchanges and considered the impact of technology on operating efficiency. The authors found evidence of revenue and cost inefficiencies across various exchanges, and these are particularly pronounced for exchanges in Latin America and the Asia-Pacific region. The authors concluded that technological improvements, organisational structure and market competition may be associated with higher operating efficiency. Improvements in technology may also reduce fragmentation, if these enable exchanges to manage the trading flow across different venues.

Cost savings may be realised by using the software and/or hardware of other exchanges. According to Schmiedel [2001], agreements which permit exchanges to join forces and invest in tailor-made systems may enhance operating efficiency. In addition, shared costs make it easier for exchanges to reap the benefits of economies of scale related to investing in a new trading system.

4. THE BROADER FRAMEWORK OF SECURITIES MARKETS ACTIVITY

In order to ensure that emerging capital markets foster the interest of overseas investors, these should be complemented with a regulatory infrastructure of international standard and an adequate base of international operators which bring the markets more in line with
developed country practices. La Porta et. al. [2006] focused on the legal framework governing securities issues in 49 stock markets, and presented evidence that appropriate securities laws such as disclosure requirements, contribute to stock market development since they facilitate the formalisation of private contracts between issuers and investors. In the theoretical model of Shleifer and Wolfenzon [2002], firms located in countries with better investor protection can raise more funds, due to a reduction in agency costs which increases production efficiency. Chung [2006] analysed ADR data for stocks originating from various countries, and found that firms originating in countries with better investor protection are more liquid. This may be attributed to the possibility that reduced investor protection exacerbates information asymmetries, resulting in liquidity providers posting wider bid-ask spreads.

Different emerging markets face different obstacles in upgrading their regulatory frameworks. Mensah [2000] described the factors hindering the implementation and enforcement of international corporate governance practices in African countries. These include:

- Dominant state enterprises and family-owned businesses which may have incentives not to follow international standards;
- Laws and administrative procedures which do not provide for a “level playing-field”;
- Limitations in legal systems which result in inconsistent enforcement of subsidiary legislation; and
- Insufficient institutional investors and human resource capabilities to insist on reforms.

5. CONCLUSION

This chapter discussed the salient trends shaping the operations of securities markets in emerging economies. It explored how liberalisation may further impact on the risks and the degree of integration of emerging markets, and the related challenges which should be addressed if the latter markets are to develop further. As the diversification prospects offered by emerging economies become less obvious, these countries should strive to curtail political risk in order to retain the interest of overseas investors.

Other challenges are specifically related to emerging market exchanges. These include the drive to augment listings and liquidity as portions of the current business get cross-listed overseas. The way in which such challenges are addressed may impinge on the survival of these exchanges and according to Claessens et. al. [2000] some economies such as Eastern European ones in transition may end up without exchanges. Yet this may not necessarily be the case; as outlined by Kavajecz [2002] it might not be optimal for a country to depend on an overseas exchange since the ability to raise capital might be compromised should political disagreements arise. Claessens et. al. [2003] also outlined the necessity for countries to have their own exchanges whose practices such as listing fees and market tiers are in line with the profiles of home companies.

Smaller emerging exchanges should serve as a means through which smaller companies may tap funds. Such companies may be well known within their region however they may
find the marketing campaigns and fees involved in listing on a major exchange to be prohibitive. The above factors emphasize the importance that exchanges and other institutions involved in securities activity should be equipped with the appropriate human resources and technological systems to effectively address future challenges.

REFERENCES


