

**Stock Market Development under Globalization:
Whither the Gains from Reforms?**

by Augusto de la Torre, Juan Carlos Gozzi, and Sergio L. Schmukler

Executive Summary

Over the last decades, many countries have implemented significant reforms to foster domestic capital market development. These reforms included stock market liberalization, privatization programs, and the establishment of regulatory and supervisory frameworks. Despite the intense reform efforts, the performance of capital markets in several countries has been disappointing.

This paper analyzes the impact of capital market-specific and related reforms on stock market development and internationalization. The empirical analysis shows that these reforms are followed by increases in capitalization, trading, and capital raising in the local market. The evidence thus suggests that reforms are positively related to domestic stock market development, contrary to the claim that they are not effective and that the variation in panel data studies comes only from cross-country differences. However, we also find that internationalization increases after reforms, relative to both GDP and domestic market activity. This runs contrary to the view that a poor domestic environment prompts firms to access international markets and that reforms reduce incentives to migrate abroad. Rather, it supports the hypothesis that reforms make local firms more attractive, allowing them to access international markets.

The results come with some caveats. Reforms may be timed to coincide with high points in the domestic and/or international business cycles and with the implementation of other reforms. To address these issues, we control for domestic macroeconomic variables, U.S. interest rates, and output growth in OECD countries. We find our results to be robust to the inclusion of these variables. However, these controls may not capture the full impact of other reforms and/or the business cycle. Also, some prior macroeconomic and institutional reforms may be necessary for capital market reforms to be successful. Furthermore, our reform dummies could be capturing the impact of some underlying trend driving the processes of stock market development and internationalization, not captured by the controls included in the regressions.

The conclusions should thus remain tentative. But they do suggest that reforms do not result in a lower level of activity abroad and a concentration of stock market activity in the domestic market, as some arguments predict. The findings also suggest that financial globalization could pose a significant challenge to policymakers, as their efforts to foster domestic stock market development seem to translate into more activity abroad. The migration of trading to international markets may adversely affect the liquidity of those firms that remain in the local market and their ability to raise new equity capital. This could have a significant impact on medium sized firms, which are not able to directly access international markets. The unexpected impact of reforms on internationalization calls for a revision of the reform agenda and related expectations.