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## Financial openness and market liquidity in emerging markets

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### ABSTRACT

The goal of this study is to explore the effect of financial openness in emerging markets on the domestic financial market liquidity and then to clarify the linkage between financial openness and market liquidity. The empirical results show that higher the degree of the financial market openness enhances the domestic financial market liquidity, and the effect of the financial market openness on the emerging markets is more significance than the developed markets. We expect the empirical results of this study can provide a new insight into the development of emerging financial markets.

### 1. Introduction

Against a backdrop of growing globalization and Internet use, worldwide financial markets have become increasingly more integrated over the last decade, prompting cross-border trade between developed countries, and the rapid growth of emerging economies (Lane and Miles-Ferretti, 2001, 2003, 2008). The globalization of financial markets has caused structural changes in capital markets across the world. In particular, modes of saving and investment in emerging economies induce structural changes in their financial markets as they become increasingly more open. Moreover, financial market liberalizations, accompanied by more financial and technical resources from advanced economies flow into the young emerging countries are expected to boost their domestic productivity and promoting market development (Kose et al., 2009).

Capital market globalization strengthens the links between the financial markets of industrialized countries and emerging economies, and then encourages the trading of assets (e.g., bonds, shares, and currencies) between markets, banks, firms, and governments. Levine and Zervos (1996) show that financial liberalization results in an increase in stock market liquidity. Levin (2005) suggests that although the significant differences in financial market development across countries exist, the capital markets globalization allows emerging economies to obtain funds at substantially low costs in global capital market. Therefore, emerging economies can accumulate capital, and increase the size of local financial markets. Moreover, previous studies have observed that opening financial markets in emerging economies fosters the development of local financial intermediaries in the following ways: (1) By enabling local financial markets to expand, opening financial market renders financial intermediaries more efficient, causing monetary regulations to be lifted, and enabling floating interest rates to enhance competition between institutions, thereby reducing capital costs (Baldwin and Forslid, 2000). (2) By improving financial service quality and bank competitiveness in local financial markets, it increases the efficiency of financial intermediaries and reduces capital costs (Levine, 1996; Caprio and Honohan, 1999). Finally, (3) by expediting the replacement of inefficient financial institutions with more efficient ones, it creates pressure for domestic financial reform; reduces information asymmetry, adverse selection, and moral hazards; and attracts

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investment (Stulz, 1999; Stiglitz, 2000; Claesens et al., 2001; Chinn and Ito, 2006). In summary, the previous studies have indicated that opening financial markets in emerging economies can facilitate the operation of local financial institutions, thereby facilitating capital cost reduction and attracting more investment; and also that increased investor participation can improve the capital liquidity of markets.

In a capital market, the capital liquidity could reflect the transaction costs of investors, which are subject to investors' transactional behaviors. The liquidity of a financial market therefore affects asset prices in an emerging economy. Institutional investors share the view that high-market liquidity facilitates block trades, thereby reducing transaction costs. For firms in emerging economies, high-market liquidity facilitates lowering the cost of fundraising and increasing a firm's value. High-market liquidity also attracts further investment, thereby boosting market vitality, accelerating capital use, and promoting capital formation and economic development (Amihud and Mendelson, 1986, 1988; Hasbrouck and Schwartz, 1988). Thus, further opening of financial markets in emerging economies can increase investor participation in financial markets and improve the investors' financial market liquidity.

The openness of financial markets in emerging economies not only increase the liquidity of financial market, but also prompt financial institutions to engage in investment behaviors that involve further risks (Allen and Gale, 1999; Schneider and Tornell, 2004; Cubillas and González, 2014; Luo et al., 2016), which could aggregate the impact of a financial crisis on a regional scale (Bremus and Buch, 2017; Tornell and Westermann, 2005). This underlies the need to elucidate the influence of financial opening on local markets in emerging economies. The outcome of opening a financial market may depend on the structure of the emerging economy. Mayer and Sussman (2001) observe that information disclosure, accounting standards, and legal restrictions strongly affect the financial development of emerging economies. However, Levine (2002) and Claessens et al. (2002) argue that protection for the equity of shareholders in shallow stock markets is characteristically weak, and that opening financial markets can affect their equity. Given these contradictory arguments, the effects of opening financial markets on the financial development of emerging economies and financial market liquidity are yet to be defined.

The objective of the present study is to investigate the relationship between the openness of a financial market and its liquidity in an emerging economy, thereby clarifying the effects of financial opening on financial development. To fulfill the objective, this study endeavors to achieve the following: (1) to determine whether increases in cross-border trade improve financial market liquidity in emerging economies, thereby deepening their stock markets; (2) to measure the effects of macroeconomic growth, inflation rates, and the degree of financial market development on the relationship between financial market openness and financial market liquidity; and (3) to control the endogeneity of financial market openness on the basis of the research of Faria et al. (2007) and Faria and Mauro (2009). In comparison to previous studies, the present study contains two advantages: First, it employs panel data to examine the effects of financial market openness on financial market liquidity without the need to account for the influence of cross-border trade on financial market openness. Second, it employs instrumental variables to address the effect of endogeneity concerning the effect of financial market openness on financial market liquidity.

This paper provides several contributions to the related literature. First, in response to the call for research on the effect of financial openness in emerging markets on the domestic financial market liquidity, we find that higher the degree of the financial market openness enhances the domestic financial market liquidity, and the effect of the financial market openness on the emerging markets is more significance than the developed markets. Second, the empirical results show that emerging economies opening up their financial markets facilitates domestic financial reform, thereby reducing information asymmetry, adverse selection, and moral hazards within the markets, and subsequently improving market efficiency, liquidity, and the potential for attracting foreign investment. Finally, our results provide new insight into investment strategy, financing strategy, and policy decision for investors, corporation managers and governments to improve their investment performance and environments.

The remainder of this paper is structured as follows. Section 2 describes the data source, the definition of variables and empirical model. Section 3 presents empirical results regarding the effects of financial market openness on financial market liquidity in both emerging and developed economies. Section 4 concludes.

## 2. Data and methodology

### 2.1. Data

For exploring the relationship between financial market liquidity and openness, the selection criterion of sampled countries is based on whether the countries in Datastream and the International Financial Statistics database of the International Monetary Fund (IMF) have enough data to construct the all variables. Therefore, it yields a final sample of 11 countries (Australia, Canada, France, Italy, the U.K., China, the Czech Republic, Egypt, Indonesia, the Philippines, and Taiwan) after those sample selection procedures. Considering that the different degree of financial development across sampled countries (Levine, 2005), we further classify these countries into two groups: the developed economies (Australia, Canada, France, Italy, and the U.K.) and the emerging economies (China, the Czech Republic, Egypt, Indonesia, the Philippines, and Taiwan). In accordance with the number of sampled countries and the quantity of data collected from those countries, this study employs quarterly data spanning the period from the first quarter of 2001 to the fourth quarter of 2016. The data were obtained from Datastream and the International Financial Statistics database of the International Monetary Fund (IMF).

### 2.2. The definitions of variables

In this study, we use the Amihud (2002) illiquidity measure (*illiq*) and trading volume (*TV*) to be the proxy variables of the

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