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Financial liberalization and stock markets efficiency: New evidence from emerging economies

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ABSTRACT

This paper aims to assess the impact of financial liberalization on the degree of informational efficiency in emerging stock markets while considering three types of financial crises, i.e. banking, currency and twin crises. To this end, a treatment effects model with time-varying parameters is estimated for 13 emerging economies from January 1986 to December 2008. Empirical results show that there is a greater efficiency in recent years and that financial liberalization not only improves the degree of efficiency but also reduces the probability of financial crises. They also suggest that improving efficiency depends upon several internal characteristics.

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1. Introduction

According to emerging countries regulatory agencies, liberalization leads to a reduction of risk, especially if it is accompanied by an improvement of the financial market performance. Therefore, although it may reduce volatility for most emerging markets over the long term,[1] it is also important to assess the informational efficiency in these markets (Fontaine and Nguyen, 2006). According to Fama (1991), an efficient market is a market where the prices fully reflect all available information. This has strict implications on stock market analysis and portfolio management. Indeed, in the case of an efficient market, the abnormal profits are non-existent. According to Fontaine and Nguyen (2006), in the case where the market is efficient, investors are able to easily determine the risk and the return of their investments because there are no overvalued and/or undervalued assets. In addition, because in an efficient market, the price accurately reflects the perspectives of the listed company, capitals will be allocated efficiently to the most profitable investments, which are beneficial for the market development and probably helps in promoting economic growth.

It should be noted that emerging countries are characterized by a low quality of information disclosure, a weak trading volume and an inadequate accounting regulations. This may lead to a weak dependency of prices over time, and markets are considered as weakly efficient in this case. For these reasons, financial literature focuses on testing the weak form efficiency in emerging markets. Moreover, it is important to check whether future prices movements of financial assets can be predicted from past prices movements. However, so far there is no consensus on the validity of the weak efficiency hypothesis in emerging markets. Indeed, some studies conclude that emerging market returns are not autocorrelated, which supports the weak efficiency hypothesis (Füss, 2005; Kim and Singal, 2000a, 2000b), while others emphasize the invalidity of the weak form efficiency (Dockery and Vergari, 1997; Emerson et al., 1997; Harrison and Paton, 2005; Rockinger and Urga, 2001; Zalewska-Mitura and Hall, 1999).

Since the liberalization of emerging stock markets in the mid-1980s, these markets have become more integrated into the global markets. They try to attract international investors and benefit from their experiences to diversify the portfolio risk, to increase the level of liquidity, to improve informational transparency and consequently the degree of efficiency. However, in spite of this increased integration, previous attempts to test the relationship between the stock markets liberalization and the informational efficiency have remained inconclusive. Indeed, the expected impact of financial liberalization[2] has not always been confirmed by the financial literature. The divergence of the empirical results does not allow reaching a clear cut conclusion regarding the relationship between financial liberalization and informational efficiency in emerging markets.

The divergences in empirical results may be due to the fact that most existing studies have examined the effects of financial liberalization on the informational efficiency by comparing measures of the market efficiency in two sub-periods (pre-liberalization and post-liberalization). We do believe that this way of

[1] This finding is corroborated by several previous studies including Bekaert and Harvey (1997, 2000), Kim and Singal (2000a, 2000b), Kassimatis (2002) and recently Ben Rejeb and Ben Salha (2013), Nguyen (2010) and Jayasuriya (2005).

[2] The expected impact of financial deregulation on efficiency is usually manifested by a gradual improvement in the degree of informational efficiency.

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