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Stock market liberalization and operating performance at the firm level ☆

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Abstract

I use firm-specific measures of openness to foreign investors to study the impact of stock market liberalization on firm-level operating performance. In a sample of over 1,100 firms from 28 countries, firms with stocks that are open to foreign investors experience higher growth, greater investment, greater profitability, greater efficiency, and lower leverage. Strategies to address potential endogeneity suggest that the observed relation reflects, at least in part, a causal effect of openness on operating performance.

JEL classification: G15; G32; F36; F43

Keywords: Financial liberalization; Investability; Foreign investors; Operating performance

1. Introduction

The opening of a country's stock market to foreign investors is associated with an increase in stock price indexes in the liberalizing country (Henry, 2000a; Kim and Singal, 2000). The same factors that affect stock price performance might also be expected to affect the operating performance of firms in liberalizing countries. Several studies suggest that this may be true for some measures of operating performance. Henry (2000b) shows

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that liberalization is associated with an increase in a country's overall level of private investment. Chari and Henry (2004a) find that an increase in a firm's investment is correlated with expectations of changes in its future cash flows. Bekaert et al. (2005) estimate that stock market liberalizations lead to a 1% increase in a country's annual economic growth. Gupta and Yuan (2004) and Li (2003) also find a positive relation between liberalizations and growth using alternative methodologies. Schmukler and Vesperoni (2003) find a decrease in firms' long-term debt following liberalization.

In this paper, I study the impact of stock market liberalization using a more comprehensive set of operating performance measures and a larger set of countries and firms than previous studies employ. In addition, the primary innovation of this paper is that, by using firm-level measures of openness to foreign investors, I am able to address methodological shortcomings of previous studies on liberalization and performance. In the above-mentioned studies, stock market liberalizations are treated, empirically, as a countrywide event that impacts all firms in a country on a specific date. Consequently, these studies are subject to three limitations. First, although researchers take special care to identify liberalization dates (Henry, 2000a; Bekaert and Harvey, 2000), it is difficult to pinpoint an exact date on which a country's equity market can be considered liberalized because liberalizations are typically gradual processes, not one-time events. Second, stock market liberalizations are often concurrent with other economic reforms, and thus it is difficult to disentangle the separate effects of these multiple events on performance. Third, an endogeneity issue clouds the interpretation of these studies because it is unclear whether liberalizations cause performance improvements or whether countries time liberalizations to coincide with periods of strong economic growth.

I address the above three limitations of previous studies as follows. First, I avoid the problem of trying to pinpoint countrywide liberalization dates by identifying firm-specific dates on which individual stocks become open to foreign investors. I identify such dates using data from the International Finance Corporation (IFC), which indicates the degree to which individual stocks are open to foreign investors and specifies dates on which stocks can be designated "investable". Because investable status is based on the elimination of country-level *and* firm-level investment barriers, it is obtained by different firms in the same country over a period of many years.[1] Second, firm-level dating of investability largely eliminates the concern that the results may be driven by economic reforms that are concurrent with liberalization. Because different firms in the same country become investable at different times, it is unlikely that their collective performance improvements are attributable to any other countrywide policy reform that occurs on a specific date. In addition, because I compare the performance of investable and noninvestable firms within the same country, the analysis essentially holds constant other reforms that would impact firms whether investable or not. Third, while not decisively settling the issue, I offer new contributions toward resolving the endogeneity of openness and performance. In particular, a firm-level analysis allows for the use of additional strategies—including firm-fixed effects, firm-level controls for growth opportunities, and intracountry cross-sectional tests – to address the issue of causality.

[1]Others exploit the distinction between investable and noninvestable firms in other contexts, including Chari and Henry (2004b) for stock performance, Bae et al. (2004) for return volatility, Boyer et al. (2005) for crisis transmission, and Bae et al. (2004) for the information environment.