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Why Volatility of Returns Differs across Markets after Liberalization? Do Institution and Market Characteristics Matters

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ABSTRACT

This paper investigates the impact of financial market liberalization on stock returns' volatility for thirty emerging markets by thoroughly looking into the various market characteristics and institutional quality. Using a variant of the GARCH models, the results show that stock market volatility decreases or remains unchanged for countries that generally characterized by better quality institutions and favourable market characteristics. However, volatility increases for countries with low quality markets and institutions. The findings suggest that it is important for emerging countries to prepare better markets and institutions as a prerequisite for financial liberalization. Failure to do so might result in excess financial volatility and the consequent real effects for their economies.

Keywords: Stock market liberalization, stock return volatility, emerging market economies, market characteristics, quality of institutions

INTRODUCTION

One of the main questions which has been least addressed by researchers in the financial liberalization literature is the issue of why volatility differs across markets during the liberalization process in emerging markets? To be more specific, why are some markets more volatile after liberalization compared to others? Finding the correct answer is vitally important for smooth liberalization process in developing economies. If liberalization caused market to be more volatile, it might not only have an adverse financial effect, but a real destabilizing

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