The growth prospects of new and old emerging markets[♣]

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Abstract

Since the 1980s emerging markets have grown over 11,000%. Although the growth is well documented it is not commonly recognised that the recently created emerging stock markets are the main drivers of this impressive growth rate rather than those emerging markets that were in existence in before 1985. This paper documents the core characteristics of the growth of emerging markets, but argues that the past trends are over and that the future growth of the emerging markets must be ‘organic’. Building up the inner-strength, rather than a simple physical expansion, is the only way forward. To achieve this, however, the emerging markets must improve their governance and legal framework. The article shows that in terms of governance and legal framework the emerging markets lag far behind developed markets and no improvement over the last twenty years or so can be detected. This conclusion has important policy implications but it is somewhat depressing given the numerous programmes and initiatives that have been put in place to stimulate the growth and development of capital markets in developing countries.

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1. **Introduction**

One of the most impressive technical developments in the last twenty years has been the stunning reduction in the time it takes to diffuse information around the world and the huge growth in the associated market for information. Whether we are thinking of natural phenomena (e.g., hurricanes, earthquakes) or human and market activities (e.g., stock market crashes, government coups, wars, etc.) news is perpetually flashing around the world 24 hours a day, 7 days a week. The effect has been particularly significant for financial markets, which in the last couple of decades have seen major new technologies introduced (electronic trading and transfer systems), new financial instruments developed (e.g., ECAPS), and new markets created across the globe. For many countries the creation of a new stock market is the biggest event or at least one of most important events in shaping and/or reforming the financial structure of the country. Hence, it could be argued that the burst of new stock markets is the big global financial innovation of modern history!

The dramatic change in the number, geographic coverage of stock markets and growth rates jumps out in a comparison of the current position with the financial map of the early 1980s:

- The number of countries with stock markets is almost two and half times the 1985 figure (142 compared to 58). Put another way, a staggering number of countries (84) have opened their first stock exchange in the last two decades.[1] Almost by definition, all these new markets are classed as 'emerging', hence there are currently nearly 5 times as many countries with emerging stock markets (118) than countries with developed stock markets (24). So in terms of pure numbers,

[1] In some cases (e.g., Russia, China) more than one exchange has been opened in a country.

the emerging markets dominate, whereas in the mid 1980s the position was more equally balanced (34 countries with emerging stock markets compared to 24 countries with developed stock markets).[2]

- Turning to growth, the capitalisation of emerging stock exchanges has grown almost 11,000% and the volume of share trading by 19,000% since the early 1980s. This is an astonishing statistic especially when stacked up against the corresponding growth rates for the developed stock exchanges over the same period of time, which are around 1,900% and 6, 500% respectively.

This trend to create new stock markets is not accidental or driven purely by technological progress. Numerous efforts and programmes have been put in place to stimulate financial liberalisation and the evolution of capital markets (e.g., privatisation programmes, pension reforms), not only by individual governments but also international bodies (e.g., IMF, WB, WFSE) that have been engaged in the process of stimulating the stock market development. Why is this happening?

First, although there is still a lot of research that needs to be done, the existing studies clearly document a strong causality between stock market development and economic growth (e.g., Demirguc-Kunt and Levine, 1995; Beck and Levine, 2004; Calderon and Liu, 2003, Claessens, Klingebiel and Schmukler, 2006). Therefore, developing efficient capital markets, and financial markets more generally, is often perceived as an important step in economic development and reduction of poverty. Second, the liberalisation of capital flows among the developed markets has resulted in a decrease of diversification benefits, which in turn has forced big (mostly institutional) investors to search for alternative investments opportunities. Hence, the development of emerging markets has

[2] As a country we consider all the 192 countries recognised by the UN, plus Hong Kong and Taiwan.

in part been driven by the demand from international investors. Third, domestic institutional investors, both in developed and in developing countries, can be a driving force for change. Pension reforms, and in particular, the creation of vast compulsory and voluntary saving schemes, are expected to stimulate investment and economic growth, but to do so they require diverse investment opportunities, and hence the development of local stock markets (e.g., Impavido, Musalem and Tressel, 2003; Zalewska, 2006). Finally, the desire to provide incentives, stimulate innovation and improve efficiency has resulted in numerous privatisation programmes. Naturally, stock markets were needed to absorb the assets of privatised enterprises, and to provide financing opportunities for them and for governments (government bond markets were created in parallel to many equity markets and sometimes were created prior to the equity markets).

The opening of many new stock markets has been strongly linked to the change in the share-ownership of individuals around the world. Although, the numbers of individual investors have increased significantly in many developed countries (e.g., in Canada, the number of shareholders increased from about 2.4m in 1983 to 12.4m in 2004; in Japan it increased from 19.3m in 1980 to 39.3m in 2006; in the UK the number of shareholders tripled between 1980 and 2005 from 3m to 9.1m, and in the US, traditionally known for the broad ownership, the number of shareowners increased from 42.4m in 1983 to 62.9m in 2005), it is the emerging markets again where the changes are most spectacular. For example, although as a percentage of the total population the numbers are still low, there are 80m shareholders in China alone. Thus, China contributes more to the world's aggregate statistics than the US and Canada together. The lack of comprehensive data for emerging markets makes general comparisons difficult but, as Grout, Megginson and

Zalewska (2008) report, there are at least 125m shareholders in in emerging markets.[3] Although it is less than in the developed countries (around 174m) this is a very high figure particularly if one takes into account the short history of the majority of the emerging markets and the much lower disposable income of people living in developing economies. It is however interesting that it is the newcomers that contribute nearly 100m of the 125m shareholders.

In this paper we document the growth of emerging markets with special focus on the *new emerging stock markets*, i.e., those markets that started to operate after 1985 in contrast to the *old emerging markets* that operated before 1985. Although the past enormous growth of emerging markets was driven by the newcomers, we argue that the future growth of emerging markets as a group will lie in the 'organic' growth of the existing exchanges. The trend to open new stock markets is over and if the emerging markets wish to strengthen their position on the world financial scene, they will have to work hard to achieve it. For example, we show that the perception of corruption in the emerging markets has not improved since the 1980s, and in cross-sectional comparisons, emerging markets lag far behind their developed rivals. If the emerging markets fail to attract international investors and assure investors that they provide good investment opportunities, the emerging markets' development may slow down significantly as they will be unable to generate enough domestic capital required to maintain high growth rates.

[3] The number of shareholders in the emerging markets is underestimated, because the data for only 18 developing countries were available. However, the emerging markets that are accounted for are those biggest in the sense of a stock market development and are located in most populated countries

The paper is organised as follows. Section 2 documents the growth of emerging stock markets. Section 3 argues why the future emerging markets' growth must be 'organic'. Section 4 compares and contrasts the quality of governance in countries with developed, emerging and no markets. Section 5 closes with conclusions.

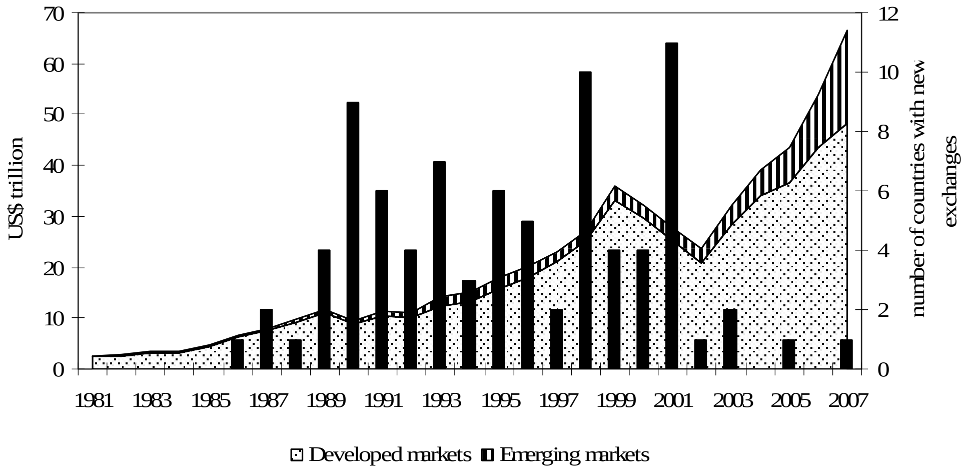
2. Emerging markets boom

The growth of capital markets around the world has been faster over the last couple of decades than ever before. The capitalisation of the world stock markets exceeded US$66 trillion in December 2007 implying that they have grown by about 2,500% since the early 1980s. There are several factors driving it but the growth of emerging stock markets is one of the most significant given that they have grown nearly 11,000% over that period of time. In nominal terms capitalisation of the emerging markets reaching US$8.3trillion by the end of 2007, accounting for over 27% of the world stock market capitalisation. It is not just that the capitalisation of the emerging markets that has grown. They have become more active as well. The volume of share trading of the emerging markets has also increased dramatically in nominal and relative terms. The 2007 figure of over US$7.6trillion translates into a growth rate of over 19,000% since the early 1980s. Even though this accounts for only 13% of the world volume of share trading, it is a great achievement given that the emerging market's share was only around 2.5% - 5% in the early 1980s. Both in size and liquidity the emerging markets are now becoming an important investment partner of the developed markets.

Figure 1 shows the US$ denominated market capitalisation of the developed and of the emerging stock markets over the period 1981-2007 (left-hand-side axis). It is clear that the emerging markets' share started to be 'noticeable' by the late 1980s and over time it has continued to grow to its current two digit figure. Figure 1 also shows how many of the countries that did not have stock markets before 1985 have opened at least one stock market in each calendar year (right-hand-side axis). The trend to open stock markets was particularly strong in the 1990s, and now appears to have slowed down. Indeed, since 1986, there have only been two years, 2004 and 2006, when no stock markets were opened by at least one country.

Figure 1.

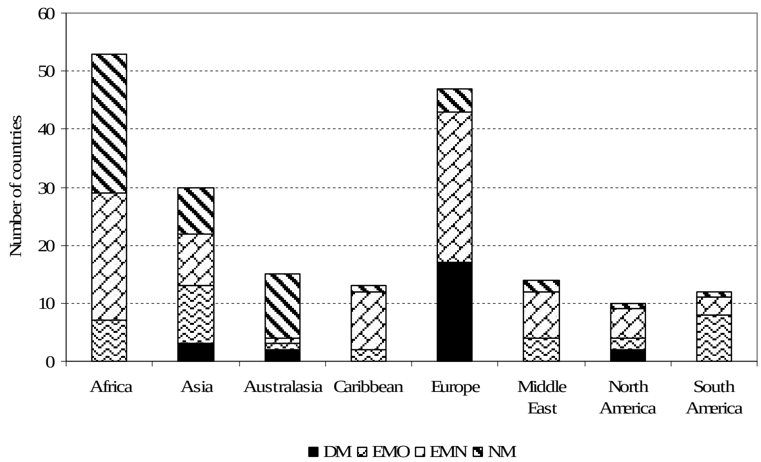
Market capitalisation of the developed and emerging stock markets (left-hand-side axis), and the number of countries that opened stock exchanges (right-hand-side axis); end of year figures; Source: individual stock exchanges.



A consequence of the massive creation of stock markets is that currently there are more countries with stock markets that are no more than 20 years old, than there were countries with stock markets (both developed and emerging) in the early 1980s (84 against 58). This means that the number of countries with emerging stock markets has increased more than threefold from 34 in the early 1980s to 118 in 2007. So currently there are nearly 5 times as many countries with emerging stock markets than countries with developed stock markets (24).

Figure 2 shows the distribution of countries that have stock markets in 2007, separated into eight disjoint geographical regions. Despite the common assumption that if one is talking about an emerging market, then it must concern an Asian or Latin American one, Africa and Europe are the continents with the highest number of countries with emerging stock markets. Indeed, Africa has 29 countries with emerging stock markets and of these 22 have opened in the last twenty years. Africa is also the continent with the largest number of countries that do not have a stock market. Europe, on the other hand, appeared to be a place of developed markets once the Portuguese and the Greek stock exchanges officially became classified as developed in the mid 1980s. However, since the collapse of communism 26 countries opened stock markets pushing Europe to the top of the league of geographical regions with the highest number of countries with emerging stock exchanges.

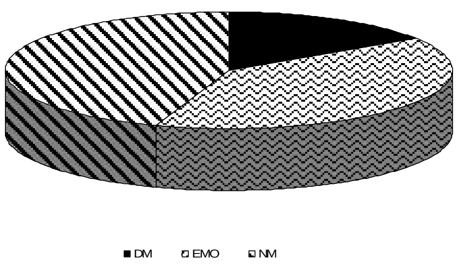
Figure 2. Number of countries with developed (DM), emerging (old and new, denoted EMO and EMN respectively) and no stock markets (NM) by geographical region; end of 2007 statistics.



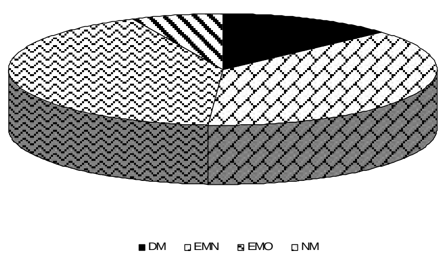
This increase in the number of exchanges also has an interesting demographical aspect. The number of people living in countries that offer stock market investment opportunities has increased dramatically. In the early 1980, about 55% of the world's population lived in countries with stock markets, including less than 40% living in countries with emerging stock markets. Currently, nearly 80% of the world's population live in countries with emerging stock markets, including nearly 40% living in countries that have opened stock markets after 1985. When we add to this the 14% (approximately) of the world's population that live in countries with developed stock markets, we can easily say that nearly everyone lives in a country with a stock market. Figure 3 shows, for 1985 (Panel A) and 2007 (Panel B), the percentage of the world population living in countries with developed stock markets, emerging stock markets, and countries that do not have a stock market.

Figure 3. The percentage of the world population leaving in countries with developed (DM), emerging (old and new, denoted EMO and EMN respectively) and no stock markets (NM); 1985 (Panel A) and 2007 (Panel B)

Panel A: 1985



Panel B: 2007



In the light of these statistics it can be argued that although most of the wealth is still in the hands of the developed markets, population wise, the emerging markets dominate. However, this 'dominance' is highly driven by two countries – India and China. Each of these two countries contributes about 50% to the population of the group they belong to, i.e., India to the population of the old emerging markets, and China to the population of the new emerging markets. This fact can have far reaching consequences. Although China is still in the group of middle-low and India in the group of low income countries, they are fast growing economies with a great appetite to develop their financial sector. Given this position, if shareholder ownership grows over time, then in the near future China and India together may have more shareholders than the rest of the world.

To close the discussion of the growth of the emerging markets Table 1 shows results of seven cross-section regressions that seek to assess the contribution of the new emerging markets to the aggregate growth of stock markets. The regressions cover the period 1985-2006. We start the regressions in 1985 as this is the earliest year for which comprehensive data across exchanges for the control variables are available. This is also the last year without new emerging stock markets. The analysis is performed for: (i) the whole period 1985-2006 for which there are data for 47 countries out of 58 that had stock markets, (ii) 1990-2006 for which there are 57 observations out of 75,[4] (iii) 1995-2006 with 79 observations out of 101 countries with stock markets, and (iv) 2000-2006 with 94 observations out of 119 countries with stock markets.

[4] In this regression the annualised change of GDP PPP pc, market capitalisation and corruption for Ghana, Hungary, Iran and Saudi Arabia cover the 1991-2006 period. This is because no data for 1990 for these countries could be found for 1990.

To control for the change in the economic situation of each country we introduce the percentage change in GDP PPP per capita (in US$), and the percentage change in corruption. The latter is measured as the change in the International Country Risk Guide (ICRG) corruption index. The growth of stock markets is measured by the percentage change in market capitalisation of the corresponding exchange, or exchanges if in a particular country there is more than one stock exchange. To make the comparison across the periods possible we annualise the three variables. In addition, dummies are used in each regression to indicate emerging markets. To test how significant new emerging markets are we separate the emerging market dummy into two dummies, one for the old and one for the new emerging markets, for all the periods but 1985-2006.

The 2006 figures are used as the end of the period because it is the most recent year for which the ICRG Corruption Index is available. The ICRG corruption index is used since it goes back to the 1980s and hence offers the longest time series among available corruption measures. The ICRG corruption index aims to measure the corruption within the political system that is a threat to foreign investment by distorting the economic and financial environment, reducing the efficiency of government and business. It varies between 1 (most corrupt) and 6 (least corrupt). We control for corruption since numerous studies discuss its significance for economic and financial sector development (e.g., La Porta, Lopez-De-Silanes and Shleifer, 2000).

The results of Table 1 are clear and consistent across periods – the emerging markets have been growing faster than the developed markets, and it has been the new emerging markets that have been the drivers of this growth. The estimated coefficients for the emerging market dummy are significant for the four periods in question, although in the

1995-2006 regression the significance is only at the 10% level. When the dummy is separated into two, the new emerging market dummy is the one that is highly significant. The estimated coefficient for the new emerging markets is also much higher than the one for the old emerging markets. The old emerging market dummy is significant in the 1990-2006 period only. This may result from the fact that very few new emerging markets are included in the regression (only 5 out of 43 that already existed). The lack of data for the markets created in between 1985-1990 is the reason of this poor representation.

The change in the corruption index does not carry significant explanatory power. We have also tried to use the level of the corruption index rather than its change (because the corruption index does not change much) but this regression delivers results that are consistent with the ones describe above, so for the sake of space we do not present them.

Table 1. Regression results

	1985-2006	1990-2006		1995-2006		2000-2006	
Intercept	0.559	0.448	0.336	-0.324	-0.254	-0.209	-0.142
	(0.948)	(1.071)	(0.787)	(-0.909)	(-0.756)	(-0.834)	(-0.559)
ΔGDP PPP pc in	0.419534**	-0.054	0.039	0.977**	0.807**	7.639**	6.328*
US$	(2.226)	(-0.164)	(0.115)	(2.505)	(2.181)	(2.442)	(1.961)
ΔICRG	33.793	-7.435	-9.678	1.265	-2.288	2.161	1.979
corruption index	(1.196)	(-0.877)	(-1.123)	(0.205)	(-0.387)	(1.158)	(1.065)
Emerging	1.819**	0.817***		0.589*		0.565**	
market dummy	(2.572)	(2.733)		(1.924)		(2.241)	
Old emerging			0.689**		0.106		0.396
market dummy			(2.191)		(0.328)		(1.442)
New emerging			1.347**		1.113***		0.754***
market dummy			(2.601)		(3.390)		(2.689)
Observations	47	57	57	79	79	94	94
R^2	0.249	0.160	0.185	0.127	0.240	0.169	0.189
Adjusted R^2	0.197	0.113	0.122	0.092	0.199	0.141	0.153

Consistent with previous research, we find that economic growth is positively related to the growth of stock markets (only in the 1990-2006 regression is the estimated coefficient negative, but this is not statistically significant).

In the light of this evidence a natural question is to ask whether emerging markets and, in particular, new emerging markets can retain their reputation for fast growth, or at least continue to grow faster than the developed and the old emerging exchanges over the next decade or so.

Simple logic suggests that, since the economic growth of developing countries is on average higher than the economic growth of the developed countries, it is not at all implausible that emerging stock markets, as a group, will grow faster than the developed stock exchanges. However, it would be naïve to believe that the emerging markets will outpace the developed markets as easily as they have done in the last couple of decades. There are several reasons to support this view and be at least a bit pessimistic about the growth opportunities of the emerging markets. Here we discuss a few reasons in support of this view.

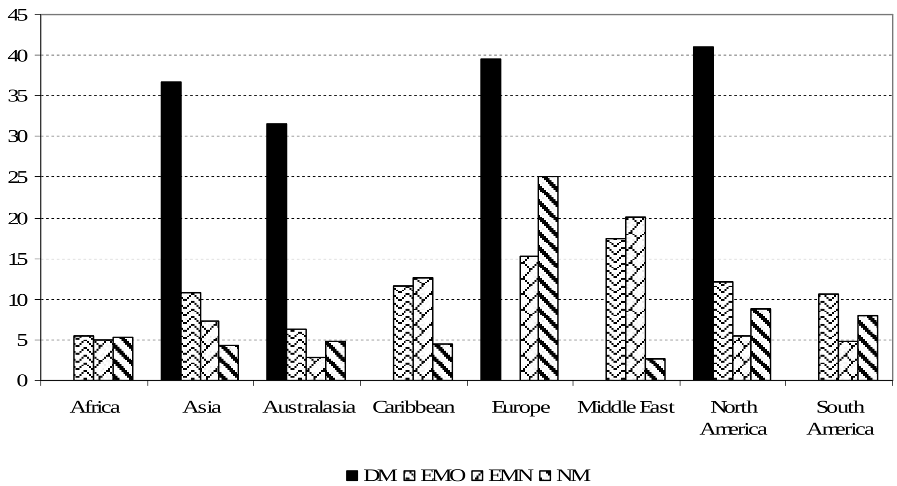
3. What next?

The growth figures of the emerging markets as a group have two components: the growth of the old emerging markets and the emergence and subsequent growth of the new exchanges. The new emerging markets already contribute more than 55% to the total capitalisation of the emerging markets with their $10trillion capitalisation accumulated over the last couple of decades. This money has been raised in the process of stock market creation (from scratch) and often massive privatisation programmes (e.g., so far the biggest IPO offerings in the world are a result of privatisation programmes). However, is it sensible to believe that the development of the emerging markets can be significantly supported by the emergence of new stock markets in the future? First, these new stock markets would either have to be in addition to the existing newly opened exchanges, or created in countries that do not have stock markets so far.

However, opening additional new exchanges in countries where exchanges already exist is not a process that can bring any significant change. Most of the existing emerging stock markets are small and illiquid enough to discourage local authorities from opening more exchanges. In general, local authorities realise the trouble early enough and restrict the number of new exchanges (they focus on one or two). When multiple exchanges pop up, it is usually a sign of a lack of control and forthcoming financial and economic distress. Bulgaria and Russia are good examples of such problems. Bulgaria had 15 stock exchanges in the early 1990s, with just 21 stocks listed on them. The 1995-6 economic crisis resulted in collapse of all of them. Similarly 56 exchanges of Russia that sprung off after mass privatisation of the early 1990s did not survive the economic collapse of 1998. The few successful stories concern old emerging markets. For instant, the opening of the National Stock Exchange (NSE) in India in 1993 (equity trading started in 1994) seems to nicely complement the Bombay Stock Exchange (BSE) that has been in operation since 1875. The newly open exchange is nearly as big as the old one (end of 2007 market capitalisation of the NSE was $1.66bn and of the BSE was $1.82bn), and already more active with the value of share trading of $751.4bn against $343.8bn of the BSE.

Another possibility is that those 52 countries that still do not have stock markets will open them in coming years. Although the creation of new stock markets has been a dominant factor of the emerging markets' growth, one cannot expect this trend to prevail. The 'no-exchange countries' are small in population and often economically weak. Figure 3 shows that currently less than 7% of the world's population live in countries that do not have a stock market. Figure 4 confirms that the countries without stock markets are often very poor. Indeed, according to the WB classification 26 countries without a stock market, i.e., half of the group, are low income countries. The only rich countries without stock markets are located in Europe. These are Andorra, Lichtenstein, Monaco and San Marino. Obviously, there is no immediate need for these countries to open stock exchanges, and even if they decided to do so, it is not reasonable to expect that these new exchanges could have a dramatic impact on the emerging markets as a group. In addition, it is hard to believe that citizens of, say Monaco, feel deprived of possibility of investing in stock markets, and would need one in Monaco to invest in equity.

Figure 4. Regional GDP PPP per capita with separation for countries with developed (DM), emerging old (EMO), emerging new (EMN) stock markets and without stock markets (NM). All figures are express in US$ for the end of 2007.



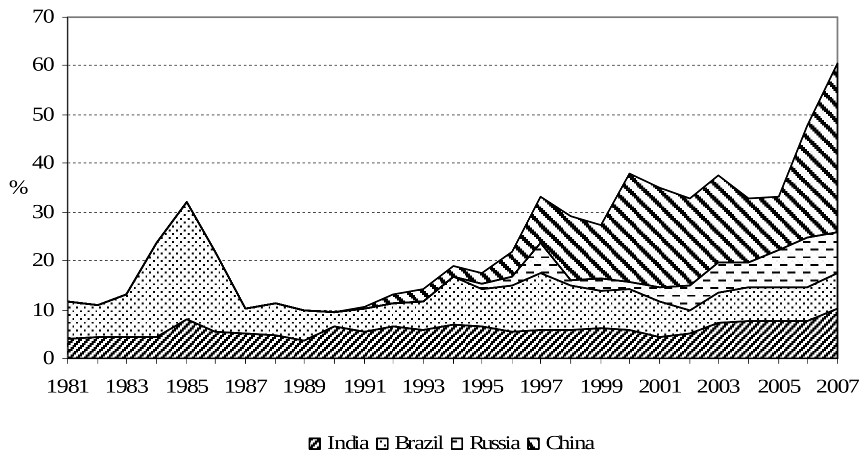
Therefore, the growth of the emerging markets cannot be further stimulated by new countries ‘joining the club’ to the degree it has happened over the last two decades. The days when the growth figures were inflated by newcomers with high growth potentials are over. Consequently, if the emerging markets are to grow, it must be the ‘organic’ growth of the existing exchanges.

4. Growth prospects of the existing emerging stock markets

The path to become a developed market can be long and is not always straightforward. It is not just the regulation of the exchange or sophistication of its electronic trading system that matters, but a broad range of factors that have roots in the economic and political system of a country in which the exchange operates. In the mid-1980s there was only a handful of exchanges that were upgraded to the status of a developed market, and there have been none since. Indeed, currently the emerging markets group seems more diverse than it was a few decades ago. Next to very big exchanges trading thousands of companies and having the capitalisation of trillions of US$ (e.g., China) there are minute exchanges trading just a few shares with the capitalisation less than a billion of US$ (e.g., Armenia). Figure 5 shows that BRIC, as Brazil, Russia, India and China, are commonly referred to, contribute towards 60% of the emerging markets capitalisation, with China contributing more (35%) that the other three markets together.

With such strong concentration of capital, these few big markets can drive the averages up or down depending on their performance, however, it does not change the fact, that when we want the emerging markets to develop, we have in mind a broad range of countries (usually small) rather than a few big ones. In the absence of development of the small markets the whole experiment of the creation of stock markets will be a wasted time and money. Unfortunately, the developing countries are not rich enough to effort to misallocate vast sums of money. Therefore, doing it right is of vital importance.

Figure 5. The time-path of market capitalisation of the Indian, Brazilian, Russian and Chinese stock markets as a % of market capitalisation of the emerging stock markets.



Stock markets do not operate in a vacuum but are strongly interlinked with the legal structure of the country in which they operate. The long-run growth of markets is strongly correlated with the development of the letter of the law and governance, and a country's ability to implement them. Monitoring, regulation, and shareholder protection are all vital for securing efficiency of stock market operations and trading, and, as a result, to secure lower investment risk. Emerging markets are particularly weak in this regard. There is a strong negative correlation between the level of economic development, i.e., its wealth, and its lawlessness. Countries that suffer from corruption, poor efficiency of governmental institutions and officials, political instability, etc., are those that remain poor. In consequence, the development of stock markets in such countries is hampered and may not be possible at all.

It is difficult to find an objective measure of a country's lawlessness, as there are many aspects of it, and these are themselves often hard to measure. Therefore, it may be informative to look at such country indicators as bureaucracy, corruption, effectiveness of government, voice and accountability, political stability and regulatory quality to get some feel for what the characteristics of emerging markets are and how much they differ from the developed countries.

To provide a better understanding of the environmental differences among countries with developed, emerging and no exchanges Figure 6 presents averages of various WB governance indicators for 2007 for the four market groups discussed in the paper separated into geographical regions in which they operate. The averages are equally weighted to provide a general picture for a region and group of markets rather than concentrate on a few dominant markets. Panel A presents the averages for the four regions with developed stock markets (Australasia, Asia, Europe and North America), and Panel B shows the averages for the four regions without developed stock markets (Africa, Caribbean, Middle East and South America).[5] Each of the six governance

[5] The World Bank's Aggregate Governance Data Set. The presented statistics are averages of governance indicators that reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations.

indicators is measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes.

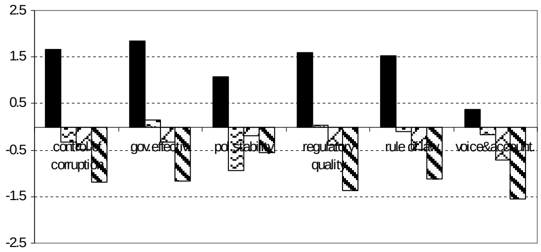
Figure 6 gives a strong and clear message. There is a huge difference between the developed and emerging markets. Across all the four regions that have developed stock markets, the average scores of the developed markets in these regions are positive. In contrast, the emerging markets, both old and new, are negative with the exception of Europe and Caribbean. The figure also confirms our earlier concern about countries without stock markets. The statistics for Africa, Asia, and Australasia are lowest out of presented ones.

Figure 6. Regional averages of statistical compilation of responses on the quality of governance as reported by the World Bank's Aggregate Governance Data Set. Individual responses vary between -2.5 (bad) and +2.5 (good). The six indicators are: (i) voice & accountability: measures various aspects of the political process, civil liberties, political and human rights, measuring the extent to which citizens of a country are able to participate in the selection of governments; (ii) political stability: measures perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means, including domestic violence and terrorism; (iii) government effectiveness: quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies; (iv) regulatory quality: measures of the incidence of market-unfriendly policies (e.g., price controls, inadequate bank supervision), perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development; (v) rule of law: measures the extent to which agents have confidence in and abide by the rules of society.(perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts); (vi) control of corruption: measures the extent of corruption (exercise of public power for private gain). The blue bar represents the average for

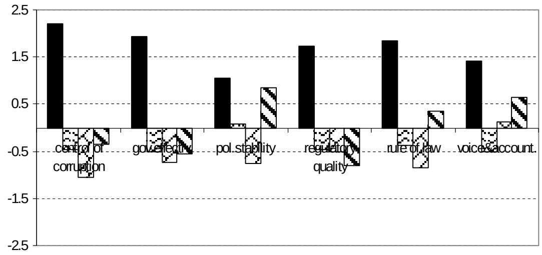
countries with developed markets, the red bar shows the average for countries with emerging markets, and the yellow bar refers to countries without stock markets.

Panel (A)

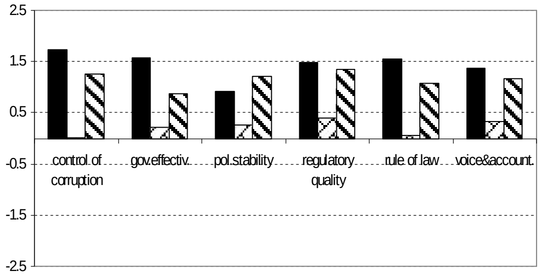
Asia



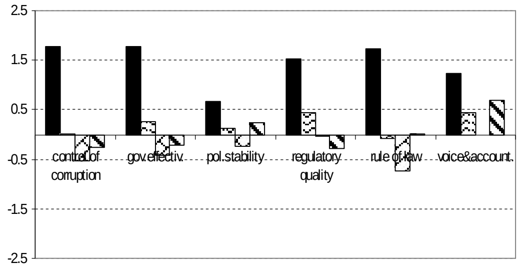
Australasia



Europe

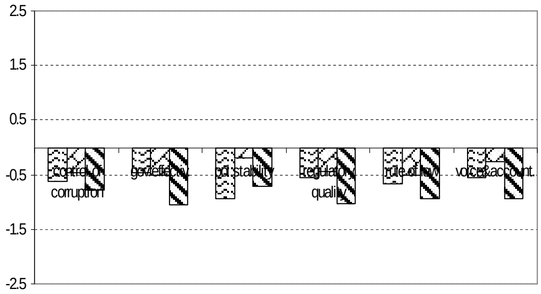


North America

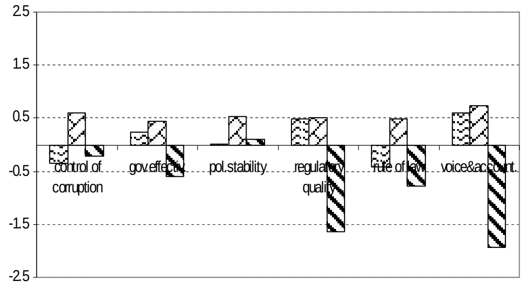


Panel (B)

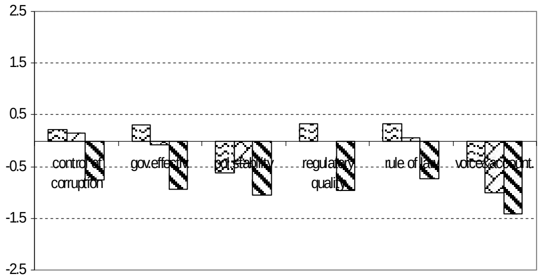
Africa



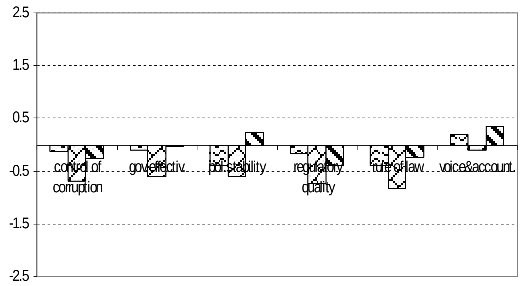
Caribbean



Middle East

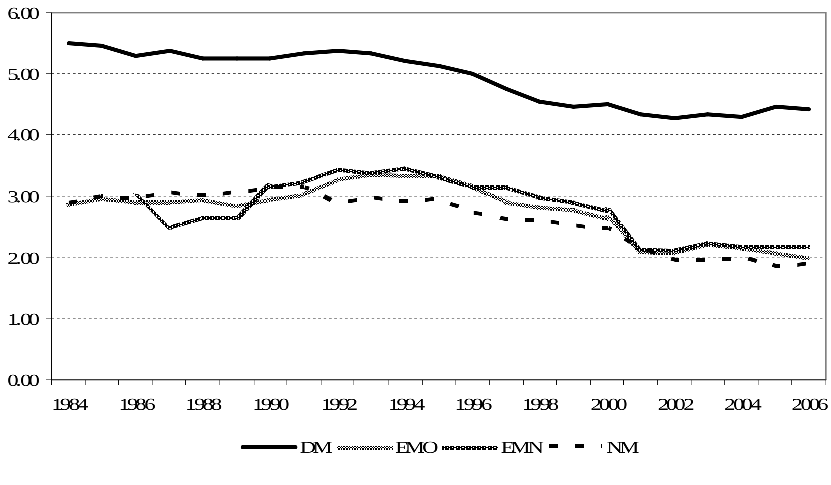


South America



Unfortunately, the WB indicators presented above have been calculated since 1997 and for selected years only. This does not help when trying to identify a long term trend, especially that there is nearly no variability in the indicators across years they are calculated for. Therefore, to have an assessment of changes over time Figure 7 shows the 1981-2006 time-path of the ICRG corruption index averaged (equally weighted) for each of the groups of markets discussed in the paper.

Figure 7. The time-path of the equally-weighted averages of the ICRG corruption index for countries with developed stock markets, emerging stock markets for the period 1981-2007. At a country level the index can vary between 1 (most corrupt) and 6 (least corrupt).



It is interesting to note that (i) the corruption index decreases over time for the four groups in question, (ii) the countries with old emerging markets, with new emerging markets and without exchanges manifest a very similar level of corruption with the new emerging markets being marginally less corrupt, and countries without exchanges being most corrupt (though this is not statistically significant), and finally (iii) the gap between the developed markets and the other markets remains more or less constant over time. Since the index is based on investors perception rather than some hard core fundamentals, the decrease in corruption observed for the non-developed markets in the first half of the 1990s may be the result of investors general enthusiasm for broadening investment opportunities and/or a lack of understanding of the investment climate of the emerging markets. As soon as the Asian Crisis arose the non-developed countries corruption index starts declining with the biggest drop observed around 1999-2000 when investors, hurt by the burst of the e-commerce bubble, projected their pessimism on their assessment of the emerging markets.

All this leads us to a conclusion that growth prospects of emerging markets may be weaker than everyone would wish for. It is not only that they score low at all available indicators of governance and corruption, but the gap between them and the developed markets does not narrow down over time. On the contrary, it seams to expand in relative terms. It is interesting that despite numerous programmes to stimulate development of emerging markets investors are still not convinced about the emerging market environment. Whether this is fair or not (it is beyond the scope of this paper to debate) it does not change the fact, however, that it is investors who shape these markets to a high degree. Therefore, if the international investors do not find the emerging markets a good place to invest in, the emerging markets may find difficult to grow fast using their own capital only.

5. Conclusions

This paper discusses the growth of the emerging markets with a special focus on the exchanges that have been created since 1985 in countries that did not have any exchanges prior to the date. We provide evidence that the high growth of the emerging markets has been driven by these newcomers. However, we argue that this trend is over because opening additional exchanges in countries with markets that already struggle for liquidity, or opening additional exchanges in countries currently without a stock exchange will not help to maintain the high growth figures observed in the last couple of decades. Hence, we believe that the future growth of the emerging markets must be 'organic'. Building up the inner-strength, rather than a simple physical expansion, is the only way forward. To achieve this, however, the emerging markets must improve their governance and legal framework. We show that in terms of governance and legal framework the emerging markets lag far behind developed markets and no improvement over the last twenty years or so can be detected. This conclusion has important policy implications but it is somewhat depressing given the numerous programmes and initiatives that have been put in place to stimulate the growth and development of capital markets in developing countries.

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