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Capital markets in emerging countries: state-capitalist stock exchanges?

Financial markets do not necessarily have to be organized liberally, as the situation in large emerging markets shows. Sometimes for good reasons

In the past two years, the Chinese government has often shocked investors in the capital markets by massively intervening in the functioning of the stock market and imposing penalties on emerging financial groups. Prominent coverage was also given in Europe to the canceled IPO of Jack Ma's Ant Group, a subsidiary of the private Chinese conglomerate Alibaba, or the forced stock market withdrawal of DiDi, the world's second-largest ride service provider after Uber.

The Chinese government's actions are mostly seen as part of power struggles in which the Communist Party secures its position of political power – and condemned as a state capitalist aberration. The background to this view is an implicit equation of capital markets with liberal markets, in which government regulations do not (should not) play a significant role. On closer examination, however, this equation is false.

State intervention in stock markets quite common in emerging markets

It is not only historically misleading because the state has also played an essential role in the establishment of stock exchanges and joint stock companies in Europe. For example, the first "German" joint stock company, the Brandenburg-African Compagnie (originally "Handels-Compagnie auf denen Küsten von Guinea"), was founded in 1682 by Frederick William, the so-called Great Elector. But even today, state intervention in stock markets is quite common, especially in emerging markets, as a recent survey of Brazil, China, India, Russia, South Africa, and South Korea shows. Our study within the DFG-funded StateCapFinance project demonstrates that these interventions sometimes play an important role in national economic development strategies.

As a result, emerging markets are using their derivatives exchanges to establish benchmarks for commodity prices – especially for agricultural products, metals, and oil with strategic relevance for their respective national economic development – and to escape the pricing power of Chicago, London, and New York, a strategy pursued in particular by China, India, and Russia.

National control of financial market infrastructures

Stock exchanges in large emerging markets are also essential for financing national champions that can take on Western companies in the medium term. Here, too, there are a variety of government control mechanisms to avoid excessive speculative volatility in share prices. Apart from Brazil and Russia, for example, high-speed trading is heavily regulated in major emerging markets. The same applies to offshore trading of stock index futures and foreign investors' access to stock exchanges, with exceptions in Brazil and South Africa.

After all, given the importance of stock exchanges to economic development strategies, it is unsurprising that most of these emerging markets place great emphasis on national control of their financial market infrastructures. Only in Brazil and South Africa are foreign shareholders allowed to play a dominant role in stock exchanges; otherwise, national shareholders are privileged if the stock exchanges are not immediately state-owned. Market pressure for domestic stock exchanges – for example through alternative trading systems, dark pools, or from foreign exchanges – is also regularly prevented to avoid weakening this state control instrument.

Maximizing profits versus governmental purposes

In our view, it, therefore, makes more sense to locate stock exchanges on a continuum between liberal and state capitalist organizations. While stock exchanges at the liberal pole are primarily concerned with maximizing profits (of the exchange companies and investors), at the state-capitalist pole governmental purposes are paramount. On this continuum, most major emerging markets are much closer to state capitalism than exchanges in established economies.

Already, the major emerging markets of Brazil, China, India, Russia, South Africa, and South Korea account for a quarter of global stock market capitalization and half of the turnover in exchange-traded derivatives markets (futures/options), with a strong upward trend, especially because of Asia's economic rise. Thus, equating capital markets with liberal markets will be increasingly misleading in the future. The "China shock" was only the tip of the iceberg.

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