What Determines the Quality of a Country's Financial Authenticity: Examining the Impact of Foreign and Domestic Market Size

Chaminda Wijethilake, Lecturer Department of Management & Finance – KDU

Imendra Wattuhewa Senior Lecturer Head of the Department of Management & Finance - KDU

INTRODUCTION

World economy has been experiencing unexpected challenges especially over the last two decades due to structural and institutional failures. It has been proved that failures of legal systems in many countries in terms of institutional settings have a long lasting adverse effect. For instance, in Sri Lanka, the debatable hedging transaction between the Ceylon Petroleum Corporation and Standard Chartered Bank caused a disastrous effect on the Sri Lankan economy, and failed due to institutional failures in terms of legitimate perspective. Matters in this context indeed link with the size of the country's domestic and foreign market that assist in the determination of the type of transaction to be dealt with, who to consulted, how to resolve the agreement, and particular stakeholders to be involved in transactions etc. Our attention in this stance is drawn on the effect of market size in the improvement of quality of financial legal structure of a country. This is mainly because the size of the market in terms of local and global has a significant influence in identifying the financial legal structure. For instance, Pistor (2002) suggested that national financial legal structures are largely influenced by the global market framework due to the integration and coordination of international organizations. This proposition has been a long debated issue as to ascertain the effectiveness of financial laws derived from self-regulatory disciplines in the domestic market forces or that it requires additional support from the global market as well. (De Jong, DeJong, Mertens, & Wasley, 2005).

LITERATURE REVIEW AND HYPOTHESES

Foreign and Domestic Market Size and Financial Legitimacy

Determination of the quality of financial legitimacy, which we define as the value of laws and best practices on financial matters in a particular national economy, is based on diverse contextual factors and the impact of such factors would be varied depending on the influential power. Shon (2005) described that legitimacy arises when "rule are widely applicable, provide clarity, are coherent with other rules, are relatively constant over time, and are possible to perform" (p.489). As it is known that the market size of a country, in terms of domestic and foreign, is a determinant factor of the financial structure, it is worthy to analysis the level of influence of these two criteria on the assessment of financial legitimacy as a primary component of the financial structure. Particularly, foreign market for a country is largely depending on the level of globalization that the country is engaging in the world economy. Hanson, Honohan, & Majnoni (2003) recognized that the small size of most developing countries limits the efficiency of financial services, which indeed it is the size of domestic market that ultimately determines the quality of financial regulations and legitimacy. However, countries having a substantial foreign market share would enhance the quality of such financial practices in terms of effective regulation and supervision to ensure quality information, transparency, market integrity, and prudent investments (Hanson, Honohan, & Majnoni, 2003). Further, compare to domestic market, foreign market considerably forces the shared values, institutionalized

practices, bridging the gaps in the international governance practices (Kell & Ruggie, 1999). This perspective is certainly supported by the fact that the global market practices tend to standardize the financial legal conducts as to harmonize the legal application around the globe (Pistor, 2002). Kerner & Kucik (2010) proposed that laws on insider trading are largely influenced by the interaction of rising international competitive pressures to attract investors through investor friendly lows and regulations. Thus, our proposition in this setting is that the size of the global and local market of a country has a higher significant impact on the financial legitimacy. This argument further strengthens the following hypotheses derived from different legitimate perspectives.

Hypothesis 01: Regulations of Securities Exchange

Foreign and domestic market size significantly influences the regulations of securities exchange.

Hypothesis 02: Strength of Auditing and Reporting Standards

Determination of a country's strength of auditing and reporting standards is highly influenced by the foreign and domestic market size.

Hypothesis 03: Efficiency of Legal Framework in Settling Disputes

Efficiency of legal framework in settling disputes in a country is influenced by the foreign and domestic market size.

Hypothesis 04: Affordability of Financial Services

Foreign and domestic market size of a country significantly impacts the affordability of financial services.

Hypothesis 05: Protection of Minority Shareholder Interests

Protection of minority shareholder interests is influenced by a country's foreign and local market size.

RESEARCH METHODOLOGY

DATA COLLECTION AND ANALYSIS

Sample and Data:
The study utilized secondary data sources collected from the Global Competitive Report published by the world economic forum yearly, which is a highly recognized and referred database by academics and professionals in policy making practices. The report ranks countries based on different measurements under 12 indicators namely; institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation. The study sample encompasses 145 countries around the globe regardless of development level of the economy. This assures that the findings of the study are generalized.

Analytical Approach:

The relationship between the quality of financial legitimacy and market influence was assessed using multiple regression analysis. There are two independent variables namely domestic and foreign market size, whose influence were assessed on five dependent variables namely; regulations of securities exchange, strength of auditing and reporting standards, efficiency of legal framework in settling disputes, affordability of financial services, and protection of minority shareholder interests. Furthermore, gross domestic production and population were controlled in order to avoid external influence on the assessment of the relationship.

<u>Variables and Measurements</u>

Independent Variables:

1. *Domestic market size:* Sum of gross domestic product plus value of imports of goods and services, minus value of exports of goods and services, normalized on a 1-7 (best) scale – 2009

2. *Foreign market size:* Value of export goods and services, normalized on a 1-7 (best) scale -2009

Dependent Variables:

1. *Regulations of securities exchange:* How would you assess the regulation and supervision of securities exchanges in your country? (1=ineffective, 7=effective)

2. *Strength of auditing and reporting standards*: In your country how would you assess financial auditing and reporting standards regarding company financial performance? (1= extremely weak, 7=extremely strong)

3. *Efficiency of legal framework in settling disputes:* How efficient is the legal framework in your country for private businesses in settling disputes? (1=Extremely inefficient, 7=highly efficient)

4. *Affordability of financial services*: To what extent does competition among providers of financial services in your country ensure the provision of financial services at affordable price? (1=not at all, 7= extremely well)

5. *Protection of minority shareholder interests*: In your country, to what extent are the interests of minority shareholders protected by the legal system? (1=not protected at all, 7= fully protected)

Control Variables:

1. *Gross Domestic Production*: Gross domestic production in 201

2. *Population*: Total population in millions in year 2010-2011.

RESULTS

Table 01 demonstrates the results for descriptive statistics for researched variables.

TABLE – 01

DESCRIPTIVE STATISTICS OF VARIABLES

Variables	Mini	Maxi	Mean	S.D.
Regulations of securities exchange	1.90	6.00	4.24	.804
Auditing and reporting standards	2.90	6.40	4.77	.720
Efficiency of legal framework	2.00	6.30	3.85	.874
Affordability of financial services	2.60	6.00	4.30	.624
Protection of minority shareholders	2.80	6.00	4.34	.624
Domestic market size	1.00	7.00	3.55	1.130
Foreign market size	1.10	7.00	4.28	1.094
Population	.30	1345.80	49.42	152.21
GDP	357	14582400	410566	1441842

Table 02 is the results of regression analysis.

Hypothesis 01: The first hypothesis of the study suggested that country's financial regulations on securities and exchange would be influenced by the size of foreign and domestic markets. Regression results of the analysis depict that only the foreign market size has a significant effect ($\beta = .436$, $t = 2.144$, p .05) on the relationship. The influence of domestic market size is positive ($\beta = .470$, $t = 1.484$) but insignificant. Moreover, as a whole the model 2 shows that 30% of variance of independent variable is explained by the dependent variables.

Hypothesis 02: We examined the relationship between the domestic and foreign market influence on strength of auditing and reporting standards under the hypothesis 02. Interestingly, results illustrate that both foreign ($\beta = .503$, $t = 2.669$, p .01) and domestic ($\beta = .594$, $t = 2.021$, p .05) market size have a positive significant impact in determining the quality of country's auditing and reporting practices. The R^2 of the model is 40%.

Hypothesis 03: The relationship between country's efficiency of legal framework in setting disputes and domestic - foreign market size was assessed under the hypothesis 03. Results reveal that foreign market size ($\beta = .423$, $t = 1.956$, p .10) has a positive significant impact while domestic market ($\beta = .301$, $t = .893$) has a positive insignificant association. Total variance explanation of the independent variable is 20%.

Hypothesis 04: The aim of the hypothesis 04 was to identify the effect of foreign and domestic market size on the country's affordability of financial services. Regression results are only significant to foreign market influence ($\beta = .567$, $t = 3.052$, p .05), while domestic market size demonstrating a positive effect ($\beta = .226$, $t = .667$). The R^2 of the model is 40%.

Hypothesis 05: We tested our last hypothesis examining the influence of local and foreign market

size on the protection of minority shareholder interests. Regression results are only significant on the association between the foreign market size and minority interest protection (β = .455, t= 2.092, p .05). Influence of the domestic market size is insignificant (β = .226, t= .667) but positive. The dependent variable's variance explanation power for protection of minority shareholder interest is 20%.

TABLE – 02

RESULTS OF REGRESSION ANALYSIS

Variables		Popula-tion	GDP	Domestic Market Size	Foreign Market Size	R^2	Adj-R^2	Model F
Regulations of securities exchange (H1)	M-01	-.131	.404***			14.8	13.6	12.34***
	M-02	-.524	-.174	.470	.436*	30.8	28.8	16.17***
Strength of auditing and reporting standards (H2)	M-01	-.312***	.388***			17.4	16.2	14.93***
	M-02	-.792***	-.313**	.594*	.503**	40.4	38.7	26.98***
Efficiency of legal framework in settling disputes (H3)	M-01	-.238**	.302***			10.4	9.1	8.2***
	M-02	-.539***	-.162***	.301	.423†	21.7	19.4	10.1***
Affordability of finan-cial services (H4)	M-01	-.111	.461***			19.3	18.2	17.03***
	M-02	-.555***	-.209	.480	.567**	42.0	40.4	27.4***
Protection of minority shareholder interests (H5)	M-01	-.203*	.309***			10.0	8.6	7.75***
	M-02	-.477**	-.128	.226	.455*	20.7	18.5	9.59***

n= 145. Standardized coefficients are reported. $† p \leq .10, * p \leq .05, ** p \leq .01, *** p \leq .001$

DISCUSSION AND CONCLUSION

Considering the emerging financial market concerns on the determination of effective financial regulatory settings, as a way of responding continuous financial malpractices and institutional failures around the globe, we examined what factors would decide the country's financial legal structures. Further, it has been a debatable issue among academic scholars and practitioners as to find out what perspectives would enhance financial legitimate rational responding the increasing globalization practices, which is indeed important to decide whether to base on home grown local applications or international implications.

Addressing these two perspectives, we utilized global and local market size ascertaining the quality of national financial regulations from a sample of 145 countries. Regression analyses based on the hypotheses development reveal that foreign market size of a country has a significant influence in determining the quality of national financial regulations. This fact is notably supported by all five hypotheses. Findings of this study are also inline with prior similar research in these settings. For instance, Kerner and Kucik (2010) found that countries are more likely to adopt and practice international insider laws and regulations when they face global competitive pressures. Moreover, the study also found that the domestic influence of domestic institutional factors is declining when the

international market pressures are increasing. On the other hand, domestic marker size shows only a very marginal or no significant influence on the relationship. In this view, the only significant variable reflects a significant relationship is strength of auditing and reporting standards.

These contradictory outcomes from two different viewpoints draw our particular attention on the financial regulatory establishment practices. Firstly, the question to be raised here is that why domestic market size does not show a significant influence in determining national financial regulations structure. Reasons behind this outcome may be policy making inefficiencies at domestic level, which is highly embedded with local political pressures and invisible stock market malpractice involvements. In particular, the situation may be further elaborated by the level of transparency and accountability of policy making and regulatory bodies. Specially, it has been argued that national financial policy making practices in developing countries are mostly performed in favour of the existing political agendas rather than economics interests, which indeed would not be the interest of general public and nation at large.

On the other hand, as we expected, the relationship between the global market size and quality of financial regulatory determinants reflect a significant association emphasizing the prominent role played by global forces in this context. In the global financial settings, it is worthwhile to identify what are the important forces that would influence the local business legal structures. Obviously, influential pressure force by international governance bodies and international financial regulators would largely persuade countries to comply with such applications. For instance, firstly, applications of securities and exchange rules would be forced by international organizations such as World Trade Organization (WTO), International Monetary Fund (IMF), World Bank (WB), and Organization for Economic Corporation and Development (OECD) etc. in terms of adopting corporate governance and good governance practices and, foreign direct investments. Secondly, effective formulation and implementation of auditing and reporting standards may be induced by applications such as International Accounting Standards, International Auditing Standards, and International Financial Regulations etc. Thirdly, national financial laws on settling disputes may be influenced by international forces such as the Association for International Arbitration (AIA). Next, factors such as developing the market for fair trade, building trust in fair trade, speaking out for fair trade, providing networking opportunities, empowering the regions introduced by the World Fair Trade Organization (WFTO) would be a determinant factor on quality on affordability of financial services in countries. Finally, protection of minority shareholder interests of country would be influenced by global market factors such as global institutional competitive pressure and international stakeholder pressures. Therefore, the study concludes that the quality of national financial legal aspects is largely influenced by the global phenomenon rather than the domestic facts.

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