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Proceeding:

Political Economy of Trade Liberalization in Developing East Asia: Sustainability, Governance, and the Role of Small Business



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BUSINESS FREEDOM AND STOCK PRICES IN FIVE ASEAN COUNTRIES

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Abstract

The purpose of this paper is to see the impact of business freedom in five ASEAN countries namely Singapore, Malaysia, Thailand, Philipinnes and Indonesia from 1995-2010. Business freedom is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process. While other researchers predict that the higher business freedom, the higher stock price will be, we found that this did not exist in ASEAN countries. Surprisingly, we found a different result. In five ASEAN countries, higher business freedom leads to lower stock prices. Business freedom that is not supported with a strong political and social fundamental will lead to unhealthy competition which leads to uncertainty and will reduce stock prices.

INTRODUCTION

Research about what factors affecting stock prices in five ASEAN countries has not been done extensively except on the period of monetary crisis ini 1997. The result of previous research is various and can not explain what factors affecting stock prices in stock markets in ASEAN countries. After the crisis ended, there are no researches about what factors affecting stock prices in ASEAN countries.

Understanding what factors affecting stock prices are very important for investors. If investors want to gain in stock market, they have to understand about the market and what factors affecting the market. One of the ways to understand the behavior of stock prices in ASEAN is understanding the characteristics of ASEAN stock market. Financial liberalization has been done in ASEAN countries in the 80's. The result is a huge amount of capital inflow in ASEAN countries. There is an expansion of financial and stock market. But this liberalization was not supported by a strong regulation and supervision of financial system. The result is monetary crisis in 1997 (Atmadja, 2004)

ASEAN stock market has undergone many developments such as deregulation package that opened many ways for foreign investors. So ASEAN stock market had grown fast but also very vulnerable to the changing of macroeconomic condition, social and politics in these countries. There are many speculations entering these markets. Financial Times stated that hot money entering in Asian markets in 2009, has reached US$ 26 billion. The movement of stock price index will be influenced by the perception of foreign investors. One of the cause of foreign investment in these countries is caused by the opennes of stock market in ASEAN countries. One of the ways to see the opennes of a country is by looking at the index of economic freedom. This index is written by James Gwartney, Robert A Lawson and Walter E Block from The Heritage Foundation and Wall Street Journal. The index scores nations on 10 broad factors of economic freedom using statistics from organizations like the World Bank the IMF and the Economist Intelligence Unit. Index of economic freedom consists of Business Freedom, Trade Freedom, Monetary Freedom, Government Size, Fiscal Freedom, Property Rights, Investment Freedom, Financial Freedom, Freedom from Corruption, Labor Freedom

It is widely believed that economic freedom engenders prosperity, and that there is some correlation between a country's economic freedom and capital market size/equity returns. For example, Li (2002) shows that greater economic freedom and stronger shareholder protections are positively related to the relative market capitalization. La Porta et al. (1997) also report that a country's legal environment positively affects its market capitalization. Stocker (2005) provides a review of the relationship between economic freedom and equity returns In his paper, a strategy for global investors is proposed, which essentially ties the rate of increase in

economic freedom directly with equity returns, and it is shown that an investment strategy based on the change in economic freedom yields attractive returns

In this paper we will mainly focuses on business freedom because there were not many researches that study the relationship between business freedom and stock price in ASEAN countries. While similar research has been done in developed countries such as research conducted by Stocker (2005),researches on developing countries has not been done extensively .This research stated that the higher business freedom will reduce transaction cost and then it will increase expected cash flow and eventually will increase stock price.We will try to prove it in five ASEAN countries.

Previous Research

Li (2002) shows that developed countries with greater economic freedom and stronger shareholder protections have larger total equity market capitalizations as a percentage of GDP. In particular, the size of their equity markets is negatively correlated to the size of government, as measured by government consumption as a percentage of GDP. For developing countries, Li finds that openness to trade is conducive to the growth of the equity market. Other research has shown that the observed size of a county's equity market is associated with institutions similar to those measured by the Fraser Institute's economic freedom of the world (EFW) index. La Porta et. al. (1997) show that the legal environment affects the size and extent of a country's capital markets (size is measured by total market capitalization as a percentage of gross national product, and extent is measured by the number of listed companies and initial public offerings per capita). The reason is simple: Countries with strong legal protections for investors have larger and broader capital

markets. Levine and Zervos (1998) conclude that total stock market capitalization becomes a larger percentage of GDP following capital control liberalization.

Index of economic freedom is written by James Gwartney, Robert A Lawson and Walter E Block from The Heritage Foundation and Wall Street Journal. The index scores nations on 10 broad factors of economic freedom using statistics from organizations like the World Bank the IMF and the Economist Intelligence Unit They measure the level of economic freedom for 189 countries. The Index of Economic Freedom is a series of 10 economic measurements created by the Heritage Foundation and *Wall Street Journal.* Its stated objective is to measure the degree of economic freedom in the world's nations. The *Heritage Foundation* and the *Wall Street Journal* created the *Index of Economic Freedom* in 1995. According to Heritage, the creators of the Index took an approach similar to Adam Smith's *The Wealth of Nations* that "basic institutions that protect the liberty of individuals to pursue their own economic interests result in greater prosperity for the larger society.The Index's definition of economic freedom is the following; "The highest form of economic freedom provides an absolute right of property ownership, fully realized freedoms of movement for labor, capital, and goods, and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself." The index scores nations on 10 broad factors of economic freedom using statistics from organizations like the World Bank the IMF and the Economist Intelligence Unit: Business Freedom, Trade Freedom, Monetary Freedom, Government Size, Fiscal Freedom, Property Rights, Investment Freedom, Financial Freedom, Freedom from Corruption, Labor Freedom

The 10 factors are averaged equally into a total score. Each one of the 10 freedoms is graded using a scale from 0 to 100, where 100 represents the maximum freedom. A score of 100 signifies an economic environment or set of policies that is most conducive to economic freedom. According to Will Wilkinson of the libertarian Cato Institute, studies show that higher economic freedom correlates strongly with higher self-reported happiness. According to Tomi Ovaska and Ryo Takashima, economic freedom research suggests "that people unmistakably care about the degree to which the society where they live provides them opportunities and the freedom to undertake new projects, strongly with and make choices based on one's personal preferences." According to the Cato Institute, higher economic freedom promotes participation and collaboration. Also claimed is that higher economic freedom is extremely significant in preventing wars. According to their calculations, freedom is around 54 times more effective than democracy (as measured by *Democracy Score*) in diminishing violent conflict

Since the Index was created in 1995, Hong Kong has been the top performing economy. According to the Freedom House, "there is a high and statistically significant correlation between the level of political freedom as measured by Freedom House and economic freedom as measured by the Wall Street Journal/Heritage Foundation survey." Critics such as Jeffrey Sachs have contested the Index's assumption that economic openness necessarily leads to better growth. In his book *The End of Poverty*, Sachs graphed countries' ratings on the index against GDP per capita growth between 1995 and 2003, claiming to demonstrate no correlation between a countries' rating and its rate of economic growth. Sachs pointed out, as examples, that countries with good ratings such as Switzerland and Uruguay had sluggish economic performances, others, like China, with poorer rating

had very strong economic growth. Qatar questioned the rating of their country's economic freedom in 2008, comparing its middling rating with the high rating they had received from other indicators such as Transparency International and Moody's. They also argued that report is "unreliable", because its methodology had changed twice in the last two years.

In finance, the discounted cash flow (DCF) approach describes a method of valuing a project, company, or asset using the concepts of the time value of money. All future cash flows are estimated and discounted to give their present values. The discount rate used is generally the appropriate WACC, that reflects the risk of the cashflows. The discount rate reflects two things: the time value of money (risk-free rate) - investors would rather have cash immediately than having to wait and must therefore be compensated by paying for the delay, a risk premium (risk premium rate) - reflects the extra return investors demand because they want to be compensated for the risk that the cash flow might not materialize after all. Discounted cash flow analysis is widely used in investment finance, real estate development, and corporate financial management. Very similar is the net present value In 1938, John Burr Williams was the first to formally articulate the DCF method in a working paper released with the title "The Theory of Investment Value". Using DCF, any variables that affected expected cash flow and discount rate will affect stock price. By definition, an increase (decrease) in expected cash flows, ceteris paribus, necessitates an increase (decrease) in the equity's present value. An increase (decrease) in the discount rate, which represents the financing cost of equity, ceteris paribus, necessitates a decrease (increase) in the equity's present value. It is important to note that *changes* in cash-flow expectations and in the discount rate will alter equity values.Using discounted cash flow theory, we can say

that any variables affecting discount rate or expected cash flow will have impact on stock price. So we can predict that higher business freedom will reduce transaction cost and then it will increase expected cash flow and eventually will increase stock price.

Methodology

This research is using a quantitative methods. This research is conducted in five ASEAN countries namely Singapore, Malaysia, Thailand, Philipinnes and Indonesia from 1995-2010. Data are taken from The Heritage Foundation and official site of stock market in each country. Business freedom is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process. The business freedom score for each country is a number between 0 and 100, with 100 equaling the freest business environment. The score is based on 10 factors, all weighted equally, using data from the World Bank's Doing Business study: Starting a business—procedures (number), Starting a business—time (days), Starting a business—cost (% of income per capita), Starting a business—minimum capital (% of income per capita), Obtaining a license—procedures (number), Obtaining a license—time (days), Obtaining a license—cost (% of income per capita), Closing a business—time (years), Closing a business—cost (% of estate), Closing a business—recovery rate (cents on the dollar). Each of these raw factors is converted to a scale of 0 to 100, after which the average of the converted values is computed. The result represents the country's business freedom score. Unless otherwise noted, the Index relies on the following sources in determining business freedom scores, in order of priority: World Bank, Doing Business 2010; Economist Intelligence Unit,

Country Report, Country Commerce, and Country Profile, 2007–2009; U.S. Department of Commerce, Country Commercial Guide, 2007–2009; and official government publications of each country. We use a quantitative approach, using regression analysis. In regression analysis we analyze the relationship between two or more variables. The relationship between two or more variables could be linear or non linear. This research is actually a part of more extent research, and try to see the relationship between ten components of index of economic freedom and stock prices in five ASEAN countries.

Result

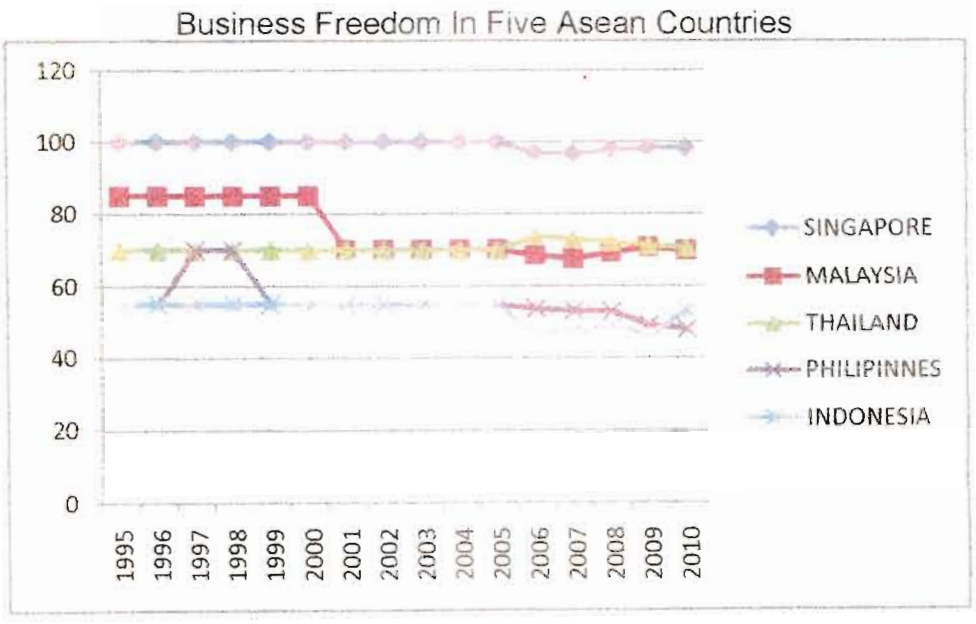
In ASEAN, Singapore has the highest average of business freedom and Indonesia has the lowest average of business freedom. In 2007 for example, to start a business in Indonesia the process takes more than 35 days, and to obtain a business permit it takes more than 18 days; both periods are longer compared to most other countries'. And to close a business in Indonesia also takes time and money. It takes only an average of three days to start a new business in Singapore compared to an average of 11 in Malaysia. Prime Minister Lee Hsien Loong also made it to the survey's list of Top 10 world leaders. Lee is described as "the steward of the fastest-growing economy in the world" and a "master at risk management." He is credited with "saving the banking shock that hit other nations" and international credit insurers now rate Singapore as the safest place to do business in the region. From a sleepy fishing village to one of the world's most competitive economies, Singapore has undergone a remarkable transformation thanks to its strong fundamentals – an open and flexible trade policy based on the laissez faire principle.

The cornerstone of Singapore's free market economy lies in its trade freedom, business freedom, investment freedom, labor market flexibility and legal structure.

According to Fraser's Economic Freedom Index, Singapore scored a perfect 10 on 10 for its income tax rate, freedom to own foreign currency, taxes on international trade, ownership of banks, private sector credit, interest rate controls, hiring regulations and minimum wage. It also scored highly for minimum international trade barriers, ease of starting a business, minimal business licensing restrictions, and low cost of tax compliance. If one were to analyze Singapore's business and trade policies it is evident that the country imposes very low barriers on foreign investment, very low levels of restrictions in the banking and finance sector, low intervention in setting wages, and a low level of business regulation. For instance foreign businesses are treated on an equal footing as domestic businesses. Foreign entrepreneurs who wish to form a Singapore company are free to do so without the need to seek government approval. There are no restrictions on the fields of business activity open to foreigners and foreign owners can have 100% shareholding in a Singapore company. A business can be set up with ease as the timeline for Singapore company incorporation is just 24 hours, with only few businesses requiring licenses. Ever since the liberalization of the banking sector in the late nineties, the banking and financial sector has grown stronger. Singapore's tax rates are one of the lowest in the region with no exchange controls or restrictions on repatriation of profits. Mr. Samir Gosh a senior team member at Janus Corporate Solutions said, "Singapore is the perfect model of a free market economy. Openness has led to a healthy competitive environment, which in turn boosts productivity. Singapore is almost like another Hong Kong, operating on the laissez faire economic policy. There is little government intervention in the economic decisions of

businesses and this is a huge draw for foreign companies. Today there are as many as over 700 MNCs in Singapore and their numbers are growing." Singapore's ranking as the second freest economy in the world certainly adds to the country's investment friendly climate and will continue to play a major role in its economic growth.In the past sixteen years, Singapore can be categorized as a "free" country, Thailand and malaysia can be categorized as moderately free and Philipinnes and Indonesia can be categorized as "mostly unfree". It can be seen in this following table. We can see it in chart 1

Chart 1



Source: The Heritage Foundation

We found interesting result in this research. We can see the result in table 1.

Table 1

Regression Analysis Result

Independent *variables*	Coefficient
Freedom from corruption	0.319 ^{ns}
Property rights	-4.002*
Government size	14.917*
Financial freedom	3.428*
Fiscal freedom	25.404*
Investment freedom	0.590 ^{ns}
Monetary freedom	6.388*
Business freedom	**-4.011***
Trade freedom	15.104*
R square	0,571
F	19,672**

Note: ns: not significant, **: significant at 1% level,

*:significant at 5% level

While other researchers predict that the higher business freedom, the higher stock price will be, we found that this did not exist in ASEAN countries. Surprisingly, we found a different result. In five ASEAN countries, higher business freedom leads to lower stock prices. Business freedom that is not supported with a strong political and social fundamental will lead to unhealthy competition which leads to uncertainty and will reduce stock prices. In a provocative 1990 article titled "Entrepreneurship: Productive, Unproductive, and Destructive," the Nobel Prize–winning economist William Baumol suggested that societies have a relatively fixed proportion of entrepreneurs—"if entrepreneurs are to be defined, simply, to be persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige." How they exercise that ingenuity depends on the incentives their economy supplies. Where the system rewards productive activity, they create start-ups; where violence or corruption offers the greatest opportunities, they prey on the rest of the

citizenry. Mc Cardle (2011) in his article "When freedom is bad for business stated that business freedom without a strong political and social fundamental will lead to entrepreneurial corruption.

Conclusion

Business freedom is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process. The business freedom score for each country is a number between 0 and 100, with 100 equaling the freest business environment.

In five ASEAN countries, Singapore has the highest businees freedom amaong all. In five ASEAN countries, higher business freedom leads to lower stock prices. Business freedom that is not supported with a strong political and social fundamental will lead to unhealthy competition which leads to uncertainty and will reduce stock prices. So we can conclude that, a country should maintain it's political and social fundamental, before increasing business freedom so that it can give a good perspective for investors, increasing their expected cash flow and increasing stock prices in these countries

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