Spillover effect of US dollar on the stock indices of BRICS

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ABSTRACT

During recent years, researchers have given more attention towards the spillover effects between exchange rates and stock indices, but the literature in this area seems to be inadequate and the interactions between currencies and stock markets are still not clear. This entails more attention to the dynamics of spillover effects between exchange rates and stock indices. Especially, after the global economic crisis BRICS has emerged as an inevitable economic force by strengthening its economic, financial and political relationship. The important reason behind this is that the global investors are considering BRICS as the most favourable destination for portfolios diversification. Besides, the characteristics of stock markets, the investors’ behaviour and the economic policies of BRICS are different from that of developed and other emerging nations. The existing literatures on the interactions between stock and currency markets of BRICS are comparatively limited and there is hardly any research that studied the long-run spillover effect of US dollar on major stock indices of BRICS nations by applying individual and Panel Generalized Method of Moments (GMM). The results indicate that the appreciation in the value of BRICS currencies against dollars has increased the value of the respective nation’s stock indices.

1. Introduction

Underdeveloped countries invited for Bretton woods conference “clearly have nothing to contribute and will merely encumber the ground” and the even larger countries like Russian federation, China, Brazil and Mexico “know little or nothing of international finance” the statements of Keynes no longer holds (UNCTAD Discussion paper, 2015).

The Economic and political power of the emerging economies especially the BRICS can even challenge the supremacy of the existing new international economic order created by G7 under the hegemony of US. BRICS gained impetus after the recent global economic crisis by strengthening its political, economic, financial and social cooperation among the member nations. The establishment of a BRICS bank with an aim to attain growth with its own resources enables the members to reduce their dependence on IMF loans which are attached with structural adjustment conditionalities. Moreover, the financial crisis in US has reduced the level of supremacy of US in the international arena, the euro zone is facing a serious debacle due to Brexit (Exit of Britain form European Union) which has strengthened the position of BRICS.

In addition, the rise of China as a super power has enabled BRICS to enhance its capability to create a new economic order which may lead to sustainable development. The steady increase in the BRICS share of world GDP of (especially due to the drastic increase

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in the contribution of China towards World GDP between 1991 and 2015) and the decline in the share of G7 since 2000 has proved that BRICS has gained the ability to surpass G7. Besides, it has increased its share in world exports substantially (Radulescu, et al., 2014). Goldman Sachs has also predicted that BRICS has the potential to become a greater force in the new economic order in the near future (Bhar and Nikolova, 2009) (Figs. 1 and 2).

The interconnectedness between BRICS and the developed nations has been increased due to trade and capital flows, as BRICS is the major recipient of both direct and portfolio investments, particularly from U.S., Canada, E.U., and Japan. The huge surge of investments from developed nations indicates the substantial growth potential of BRICS which leads to financialization of markets (which intends to accumulate profits through financial channels rather than through production and trade by reducing the work product/service into an exchangeable financial instrument). In a way financialization has also increased the financial dependence and the inter-linkages of BRICS markets with rest of the world (Sui and Sun, 2016). Moreover, another important reason for this inter-linkages is that, the stocks markets of BRICS has been considered as one of the favourable destinations by the global investors for portfolios diversification. Given the significant role played by BRICS in terms of capturing a sizable market share in the global economy in terms of global output, it requires special attention in strengthening its stock indices to attract investments which has been considered as the major economic performance indicator. The empirical literature has identified the flow of international investments is dependent on another economic indicator i.e., the currency value (Blonigen, 1997; Garg and Dua, 2014; Mahalakshmi et al., 2015). Hence, this study aims to explore whether there is any presence of spillover effects of exchange rate on the stock indices of BRICS.

The research study is presented as follows. Section 2 discussed about the empirical literature related to the study. In Section 3 data description and econometric model are explained. In Section 4 results are discussed. Finally, the concluding remarks are presented in Section 5.
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