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Stock market's response to real output shocks in Eastern European frontier markets: a VARwAL model

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ABSTRACT

We study stock market's response to real output shocks in the small and young Eastern European frontier markets, and compare to the larger European emerging- and world's most developed markets. To obtain a complete time profile of stock market's response, we use a Vector Auto-regression with Asymmetric Leads (VARwAL) model, which is a special case of the mix (noncausal) VARs. Results confirm its efficacy: in every country, both the forward-looking and delayed components of stock market's response are significant. Stock market returns forecast future real output equally well in Eastern European frontier markets as in developed and larger-emerging markets. The distant-horizon forward-looking response is larger in frontier markets, whereas the near-horizon forward-looking response is larger in developed markets.

JEL classification: E44, P34, G14, C58

Keywords: stock market – real output interaction; Eastern European frontier markets; VARwAL model

1. Introduction

Following Fama's (1990) seminal work, the interaction between the stock market and macroeconomic activity has been studied on developed markets (Lee, 1992; Gallinger, 1994; Choi et al., 1999; Binswanger, 2000, 2004; Shanken and Weinstein, 2006; Laopodis, 2011) and on emerging markets (Rangvid, 2001; Mauro, 2003; Tsouma, 2009). Major Central and Eastern European (CEE) emerging markets have been covered within this literature (Hanousek and Filer, 2000; Lyocsa et al., 2011). However, a comprehensive study of the young frontier stock markets in Eastern Europe is currently a gap. These young stock markets and transition economies offer a suited opportunity to investigate the effect of market development on stock market's ability to forecast future macroeconomic activity, as they form a relatively homogenous group with standardized macroeconomic statistics.

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