



Financial liberalization and changes in the dynamic behaviour of emerging market volatility: Evidence from four Latin American equity markets[☆]

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Abstract

This paper examines whether the dynamic behaviour of stock market volatility for four Latin American stock markets (Argentina, Brazil, Chile and Mexico) and a mature stock market, that of the US, has changed during the last two decades. This period corresponds to years of significant financial and economic development in these emerging economies during which several financial crises have taken place. We use weekly data for the period January 1988 to July 2006 and we conduct our analysis in two parts. First, using the estimation of a Dynamic Conditional Correlation model we find that the short-term interdependencies between the Latin America stock markets and the developed stock market strengthened during the Asian, Latin American and Russian financial crises of 1997–1998. However, after the initial period of disturbance they eventually returned to almost their initial (relatively low) levels. Second, the estimation of a SWARCH-L model reveals the existence of more than one volatility regime and we detect a significant increased volatility during the period of crisis for all the markets under examination, although the capital flows liberalization process has only caused moderate shifts in volatility.

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1. Introduction

During the last 15 years we have witnessed substantial development in the structure of both mature and emerging financial markets. The emerging markets have been the focal point of interest of private and institutional investors as well portfolio managers. More specifically this growing interest has arisen from the recognition of the important positive link between the process of financial liberalization which these economies have undergone and economic development.¹ The flow of portfolio investments to emerging financial markets has increased from a mere \$6.2 billion in 1987 to \$37.2 billion in 1992 to a total of \$211.6 billion for the period 2000–2006 (BIS, 2006). The flow of these funds has been mainly directed to bonds, certificates of deposit and commercial papers, although during the recent period there has been a major shift towards investing in stocks.

Financial liberalization, and especially abolishing capital controls directed to an emerging country's stock market, is the result of the decision by the government of this country to allow foreigners to invest in equity in the country's stock market. Over the recent period several researchers have studied the possible benefits and costs of such liberalization processes. A major argument in favour of such a move is that the opening of financial markets in the emerging economies by removing existing capital controls will help them to attract foreign capital to finance economic growth. Furthermore, these increased capital flows will speed up the development of stock markets which may lead to long-run economic growth. The argument for such a positive relationship is based on the prediction that the liberalization of stock markets reduces the aggregate cost of equity capital. An additional implication is that following the opening of financial markets we should observe a rise in physical investment as a result of the decline in the cost of equity capital. Finally, there will be an urgent need for increased transparency and accountability by the firms' management and this will also result in improved allocation of resources, reduction in the risk of holding stocks as well as to a reduction in the cost of capital (Henry, 2000; Kim and Singal, 2000).

The most important concern by the governments and policy practitioners of emerging economies is that such abolition of capital markets and the subsequent rise in capital flows may give rise to some unpleasant effects. These uncertainties are the result of the fact that international capital flows are very sensitive to changes in interest rates as well as expectations about future economic growth and expected returns from holding stocks. Such changes, even of a small magnitude, may result in negative effects on the domestic economy. Moreover, financial liberalization will result in exposure to foreign influence, making domestic stock prices more volatile as a result of external impact from global financial markets. A final important concern deals with the prediction that capital inflows will cause an appreciation of the domestic currency, which will cause exports to fall for those countries which are export-oriented, whereas in the case of not enough available investment, plans to absorb the money inflow will result in rising inflation.

During the 1980s and early 1990s several Latin American and Asian countries underwent a number of structural reforms, abolition of capital controls and global integration processes.

¹ Bekaert and Harvey (1997, 2000, 2002), Bekaert et al. (2002a, 2002b), Bekaert et al. (2006), De Santis and Imrohorglu (1997), Edwards and Susmel (2001), Edwards et al. (2003), Henry (2000), Huang and Yang (1999), Kaminsky and Schmukler (2003) and Kim and Singal (2000) are among the numerous studies that have studied the effects of financial liberalization on emerging economies.

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