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Equity market linkage and multinational trade accords: The case of NAFTA

Ali F. Darrat [a,1], Maosen Zhong [b,*]

[a] *Department of Economics and Finance, Louisiana Tech University, Ruston, LA 71272, USA*

[b] *UQ Business School, University of Queensland, Brisbane, QLD 4067, Australia*

Abstract

This paper examines the impact of multinational trade accords on the degree of stock market linkage using NAFTA as a case study. Besides liberalizing trade among the U.S., Canada and Mexico, NAFTA has also sought to strengthen linkage among stock markets of these countries. If successful, this could lessen the appeal of asset diversification across the North American region and promote a higher degree of market efficiency. We assess the possible impact of NAFTA on market linkage using cross-correlations, multivariate price cointegrating systems, speed of convergence, and generalized variance decompositions of unexpected stock returns. The evidence proves robust and consistently indicates intensified equity market linkage since the NAFTA accord. The results also suggest that interdependent goods markets in the region are a primary reason behind the stronger equity market linkage observed in the post-NAFTA period.
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* Corresponding author. Tel.: +61 7 3365 6181; fax: +61 7 3365 6788.
E-mail addresses: darrat@cab.latech.edu (A.F. Darrat), m.zhong@business.uq.edu.au (M. Zhong).
[1] Tel./fax: +1 318 257 3874.

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1. Introduction

Understanding the link between international trade and equity markets is important for pricing securities across borders, for managing multinational asset portfolios, and for global hedging strategies. This study investigates the impact of the North American Free Trade Agreement (NAFTA) on equity market linkage in the region. Ratified in January 1994, NAFTA's primary goal is to liberalize trade among the three North American countries. Evidence suggests that NAFTA has thus far succeeded in promoting trade in the region (e.g., Gould, 1996, 1998; Kouparitsas, 1997).

Although the main focus of NAFTA is on eliminating (or reducing) barriers to regional trade in goods and services, the accord has also sought to promote cross-country investment among the three economies. Article 1109, for example, calls for the free and quick transfer of all payments relating to equity transactions including dividends, interest, and capital gains. Several other provisions relax restrictions on cross-country investing and foreign stock ownership. A growing literature suggests that the evolution of equity market linkage across national borders tends to be associated with international trade and other macroeconomic factors. For example, Kouparitsas (1997) and Bracker et al. (1999) highlight the importance of interdependence among international goods markets when discussing equity market linkages. Phylaktis and Ravazzolo (2002) also report evidence suggesting that financial and economic integrations are significantly related in a group of Pacific Basin countries.

This paper examines the impact of NAFTA on the equity market linkage among the U.S., Canada and Mexico. In addition, our analysis has other important practical and theoretical implications. In particular, if stock markets in the three North American countries have become more linked in the post-NAFTA regime, then asset diversification within the region will lose much of its appeal. Moreover, a higher degree of market comovements promotes faster adjustments of equity prices to information flows from member countries, leading to more efficient markets. The degree of equity market linkage is also important for international capital budgeting. As Cooper and Kaplanis (2000) argue, optimal corporate decision rules in capital budgeting for segmented markets differ from those for fully integrated markets because similar equities provide different net returns depending on the degree of market linkages. If NAFTA has indeed strengthened equity market linkage in North America, companies will have access to capital on equal terms. This may lessen the home-country bias. Another implication pertains to possible welfare gains. Interdependent equity markets complement the goods markets as they effectively provide the price-discovery function for international trade and facilitate an optimal timing for international asset claims. Furthermore, under a stronger market linkage across borders, a multinational version of the capital asset pricing model becomes a more appropriate framework than the domestic version commonly used for individual equity markets.

Our paper contributes to the literature in several other respects. First, prior research suggests that equity market linkage has a time-varying characteristic

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