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Are emerging equity markets responsive to cross-country macroeconomic movements? Evidence from Latin America

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Abstract

In this study, we examine the response of Latin American stock markets to movements in cross-country Latin American macroeconomic variables. We find little evidence that Latin American stock markets are responsive to these changes. Alternatively, we find that Mexico's stock market affects other Latin American stock markets but not vice-versa. We also find that the exchange rate of a Latin American country affects its own stock market, suggesting that currency risk is an important source of risk in Latin America. We conclude that the use of cross-country macroeconomic variables is not very useful for forecasting Latin American stock market movements.
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1. Introduction

Since the early 1980's, Latin American equity markets have grown in importance to foreign and domestic investors seeking to diversify their portfolios. To better understand

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the underlying characteristic of these markets, researchers have investigated the transmission patterns of stock market movements between the stock markets of the US, Mexico, Argentina, and Brazil (Soydemir, 2000; Meric et al., 2001a,b; Ratanapakorn and Sharma, 2002); the interdependence of Latin American stock markets (Ratner and Leal, 1996; Choudhry, 1997; Meric et al., 1998; Christofi and Pericli, 1999; Pagan and Soydemir, 2000; Chen et al., 2000; Pretorius, 2002; Johnson and Soenen, 2003); macroeconomic variables and Latin American stock markets (Bailey and Chung, 1995; Bilson et al., 2001; Adrangi et al., 2001); response asymmetries within Latin American stock markets (Pagan and Soydemir, 2001); the response patterns of Latin American equity markets to changes in the US Treasury Bill (Soydemir, 2002); the time series characteristics of Latin American stock markets (Ortiz and Arjona, 2001); and the issue of contagion (Calvo and Reinhart, 1996; Bazdresch and Werner, 2000).

However, an area of research that has received no attention in the literature is whether the macroeconomic movements of one Latin American country impact the equity markets of other Latin American countries. This issue is important because these emerging, fragile Latin American equity markets could be vulnerable not just to macroeconomic movements within their own country but also to the macroeconomic movement of other Latin American countries. Changes in the terms of trade, interest rates, business cycle, and economic and political developments within a Latin American country can conceivably have an impact on the equity market of other Latin American countries. The linkages between the economic fundamentals of a Latin American country and the equity market of another Latin American country have neither been questioned nor examined.

This study extends prior research by analyzing the extent to which changes in macroeconomic variables in Mexico, Argentina, Brazil and Chile individually affect each other's stock markets. Moreover, if the markets do respond to each other's influence, are the responses homogenous for all the countries in the region? For example do changes in macroeconomic variables in Mexico identically affect the stock markets in Argentina, Brazil and Chile? Answers to these questions are important since development of economic fundamentals in one country might play an important role in forecasting the stock markets of other countries in the region. They also have important implications for policymakers that seek to reduce country spillover effects and investors who aim to improve their portfolio performance.

Using the impulse response functions of a vector auto regression model (VAR) and monthly data on interest rates, exchange rates, money supply, goods prices and stock market indexes we obtain a number of important results. First, we find that changes in the macroeconomic variables of one Latin American country do not affect the stock market of other Latin American countries. Second, and consistent with prior findings, we find that Mexico's stock market significantly affects other Latin American stock markets and that the reverse does not hold. This suggests that the Mexican stock market drives or leads the other stock markets of the region. Third, we find that depreciations in the exchange rates of Mexico, Brazil and Chile negatively affect their own stock markets, suggesting that currency risk is an important source of risk in these countries. Lastly, we find that an increase in the interest rates of Mexico and Chile negatively affect their own stock markets while the interest rates of Brazil and Argentina do not affect their own stock markets. We conclude that the use of cross-country macroeconomic variables

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