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Currency risk in emerging equity markets

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Abstract

The paper develops an international capital asset-pricing model (ICAPM), which includes foreign currency risk, and examines the impact of capital market liberalisation on the pricing of risks. It applies the model to data from Pacific Basin financial markets and finds substantial evidence that not only currency risk is priced in both pre- and post-liberalisation periods, but the model is superior to one which does not include currency risk. This evidence suggests that an international capital asset-pricing model, which omits currency risk, will be misspecified. Furthermore, the results imply that since currency risk is priced and investors are compensated for bearing such risk they should not be discouraged by more flexible exchange rate regimes from investing in emerging markets.
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1. Introduction

The recent emergence of highly remunerative equity markets, following the relaxation of foreign investment restrictions, and the developments in communication and trading systems, has attracted on the one hand, the attention of academics to explain their impressive

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returns, and on the other hand, the interest of international fund managers as opportunities for portfolio diversification benefits. The adoption of more flexible exchange rate regimes by many emerging economies however in the late 1980s and early 1990s is likely to have affected the foreign currency risk associated with international investment and to have made the choice of currency denomination an important element in the overall portfolio decision.

The objective of this paper is to develop an international capital asset-pricing model, which includes currency risk, and to examine the impact of capital market liberalisation on the pricing of risks. Previous capital asset-pricing models can be classified into three groups based on the type of risk considered in pricing expected returns: segmented market models, which evaluate expected equity returns as a function of only the country-specific risk represented by stock returns variance (see, e.g. Black, 1972); the integrated market models where studies assume that all the world capital markets are perfectly integrated, and therefore the source of their risk can be associated with the covariance of the local stock market returns with the world market portfolio (see, e.g. Ferson and Harvey, 1994); and the partially segmented market models, which considered an asset-pricing model, where the framework in which the polar segmented/integrated cases are replaced by a mild segmentation structure (see Errunza et al., 1992). While this model presents the advantage of avoiding the choice between the scenario of full segmentation and perfect integration, the framework has the disadvantage of selecting a degree of segmentation that is fixed through time.

Errunza et al.'s limitation has recently been overcome by Bekaert and Harvey (1995) and De Santis and Imrohoroglu (1997). Bekaert and Harvey (1995) proposed a one-factor asset-pricing model that allows the conditional expected returns of a country to be affected by their covariance with a world benchmark portfolio when the market is integrated and by the variance of the country returns when the market is segmented. When applying the model to a group of emerging capital markets over the period 1975 to 1992, they find that countries with extensive foreign ownership restrictions, such as Korea and Taiwan, were integrated with the world capital markets.

De Santis and Imrohoroglu (1997) study the stock returns and the volatilities of a group of emerging capital markets under different degrees of integration by introducing a dynamic integration version of the classic CAPM framework that assumes full-market segmentation until the official liberalisation date of each capital market, and full integration thereafter to capture the fact that the analysed markets were legally segmented for part of the sample period. The evidence shows that neither the country-specific risk is priced when markets are segmented, nor the world market risk when markets are integrated.

At the same time, another strand of literature (see Dumas, 1994; Dumas and Solnik, 1995) has shown theoretically and empirically that when using the international capital asset-pricing model (ICAPM) framework with currency risk for a sample of securities in Germany, US, Japan and UK, the currency risk is priced. The pricing of currency risk has also been confirmed by De Santis and Gerard (1998) when considering a conditional version of the ICAPM based on multivariate GARCH, with foreign exchange risk, for equity markets and 1-month Eurocurrency deposits for the same group of countries examined by Dumas and Solnik (1995).[1]

[1] Carrieri (2001) repeats the same analysis of De Santis and Gerard (1998), but for France, Italy, Germany and UK, and confirmed the pricing of currency risk.

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