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International equity market integration in a small open economy: Ireland January 1990–December 2000

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Abstract

We examine the relationship between the Irish, German, UK and U.S. equity markets. Our main finding is that the Irish equity market depends heavily on trading activity in the other markets but not vice versa. Significant return and volatility spillover effects occur in the direction of, but not from, the Irish market. We also find that dual listing in the form of American Depositary Receipts (ADRs) has an important role to play in these spillover effects. Our findings obtain throughout the sample, but are strongest for the period after the ERM crises and before the introduction of the euro.
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1. Introduction

Ireland is recognized as a small open economy with a heavy reliance on external trade that has been increasing over time (EUROSTAT, 2000). The nature of Ireland's capital flows is less clear, however, and this paper addresses this subject by describing the bivariate interactions between the Irish equity market and the markets in Germany, the United Kingdom and the United States. Traditional strong interactions between the Irish and the UK markets for economic and political purposes may have been superseded by

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new relationships with the Eurozone-dominated German market and the globally dominant U.S. market.

The literature provides some insights into the areas of investigation. Capital markets in general have been characterised by increased integration (Claessens & Forbes, 2001).[1] Within this, the extent and speed of these interactions have also increased. Harmonisation of regulatory and market structures, and the removal of capital control barriers are driving forces in these increased market interactions. Market linkages are decomposed into short- and long-run components with strong support for the former and weaker evidence on the latter (Malliaris & Urrutia, 1992). These interactions have incorporated both return and volatility linkages in a time-varying fashion (Bae & Karolyi, 1994; King, Sentana, & Wadhwani, 1995). Dual-listing equities also have an important influence on the time-varying interactions (Karolyi, 2002).

The Irish equity market is small by international standards, with the majority of companies thinly traded and dominated in size by a few organizations. These latter equities have a dual listing with the American Depositary Receipts (ADR) programme being a popular mechanism. Accounting for these features, this paper examines market interactions during the 1990s by focusing on four issues: *first*, the long-run relationship between the markets; *second*, the dynamic relationship between them; *third*, the return and volatility transmission process between them; and *fourth*, the impact of dual listing with ADRs on the return and volatility linkages. We also break the full sample into a number of separate subperiods to discern whether our findings change as a result of key political and economic events.

The paper proceeds as follows. In the next section, a discussion of related studies that model the Irish market is presented, coupled with an outline of the methodological framework. Section 3 describes the data and some preliminary findings. The main empirical results are discussed in Section 4. Finally, a summary and conclusions are given in Section 5.

2. Prior related studies and methodological framework

From a vast literature that examines the relationship between international equity markets, a number have specifically modelled the Irish market. Hardouvelis, Malliaroupoulos, and Priestley (1999) examine the development of the euro and its impact on equity market integration from a European-wide context using weekly price data. In a time-varying process, each county's returns are linked to an EU benchmark index and currency returns, and they use the Baba, Engle, Kraft, and Kroner (1990) model to detail volatility spillovers. They find that the development of EMU led to increased integration due to a reduction in restrictions related to the currency composition of investors' portfolios.

[1] This finding documented extensively has implications for equity pricing and asset allocation procedures (Ang & Bekaert, 2002; DeSantis & Gerard, 1998; Longin & Solnik, 1995). Traditional asset pricing models, such as the Capital Asset Pricing Model (CAPM), need to incorporate the impact of international diversification and time-varying correlation features. Furthermore, asset allocation needs to be examined in the context of reduced benefits from international diversification.

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