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The relationship between developed equity markets and the Pacific Basin's emerging equity markets

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Abstract

Using a trivariate vector autoregression (VAR) model with a proper control for heteroscedasticity, this paper investigates the relationships between the two largest equity markets in the world—the U.S. and Japan—and the four Asian emerging equity markets: Hong Kong, Korea, Singapore, and Taiwan. Evidence indicates that the links between the developed markets and the Asian emerging markets (AEMs) began to increase after the stock market crash in October 1987, and have significantly intensified since the outbreak of the Asian financial crisis in July 1997. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

The predominant feature of the stock market crash of October 1987 was its global scale. Equity markets around the world reacted to the collapse of the Dow Jones Industrial Average of the New York Stock Exchange with their own versions of a crash. Based on this phenomenon, scholars and market participants have developed an increasing interest in examining the relationships among national equity markets.

Various methods have been used in this study. For example, Eun and Shim (1989) use vector autoregression to study the interdependence among world equity markets and find evidence of the U.S. market leading worldwide trends. Arshanapalli and Doukas (1993), using a cointegration analysis, also report an increasing degree of

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interdependence among world capital markets since the Crash. While many other researchers report similar results [see, for example, Brady (1988); Hamao, Masulis, & Ng (1991); and Cheung & Ng (1992)], other researchers, such as Malliaris and Urrutia (1992) argue that there are no lead-lag relationships for the major market indices either before or after the Crash.

Recently, the speed of integration among world capital markets seems to have accelerated, due to the gradual lifting of restrictions on capital flows and the relaxation of exchange controls in many countries. Major progress in computer technology and telecommunications has also expedited the international flow of information and lowered transaction costs. Recent trends of economic unification and regionalization have created various economic blocs that have also contributed to the integration of world capital markets.

Many researchers suggest that the substantially increased use and integration of international stock markets has also enhanced the efficiency of global financial markets. For example, Bailey (1990) examines the effect of U.S. monetary shocks on the Pacific-rim stock markets and shows that the stock indices of countries with relatively few barriers to investment flows exhibit stronger reactions than those with strict capital flow controls. Kohers and Kohers (1995) find that 11 European stock markets are linked with both each other and the rest of the world, and that the presence of these distinct systematic relationships has increased overall market efficiency so that abnormal returns are less common in these markets today.

The studies mentioned above have mainly focused on the interdependence among stock markets of the developed countries such as the U.S., Japan, and Western Europe. Although the Asian stock markets are currently suffering from the recent financial crisis, the importance of stock markets in the AEMs has still grown tremendously in recent years.

More recent studies have investigated stock market correlations between developed countries and AEMs. Cheung and Mak (1992) find that the U.S. market is a global factor, affecting both developed and emerging markets. Liu and Pan (1997) investigate the mean and volatility spillover effects from the U.S. and Japan on the four AEMs (Hong Kong, Singapore, Taiwan, and Thailand). Using data from 1984 to 1991, they find that the spillover effects increased substantially after the Crash of October 1987, and that the U.S. market is more influential than the Japanese market in transmitting returns and volatilities to the four AEMs. Wu and Su (1998) report that returns in large markets lead to returns in small markets and that the Japanese market has a fairly strong influence on other markets in cases where the U.S. impact is isolated. While it is a common belief that the U.S. stock market is the single most influential market in the world, in a study of Asian markets, examining the impact of the Japanese stock market is also important.

The Asian financial crisis, which originated in Thailand in July 1997 and spread into Indonesia and Korea, did not restrict its impact to Asian markets. Stock markets around the world appear to have been significantly impacted by the Asian crisis. Furthermore, these shocks were transmitted throughout world markets faster than ever before. Considering the effect of the 1987 crash on the interrelation of stock

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