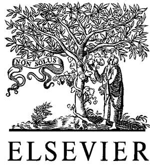
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Economic determinants of emerging stock market interdependence

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Abstract

There is a wealth of literature on *how* integrated stock markets are, but very few studies attempts to determine *why* stock markets are integrated. However, it is arguably even more important to understand the driving forces behind stock market relationships than to know whether they exist. Such an understanding will provide a better grasp of the functioning of the global stock markets and allow investors and policy-makers to ask additional questions such as: Would an increase in bilateral trade between two countries, for example due to a new trade agreement, change the interdependence of their stock markets? If the growth rate of a particular emerging market falls due to the current global economic downturn, will its stock market drag along all the other stock markets or can it be known beforehand which stock markets are more likely to follow? This study empirically estimates cross-section and time-series models to determine the fundamental factors that influence the correlation and evolvement of the correlation between emerging stock markets. © 2002 Elsevier Science B.V. All rights reserved.

Keywords: Emerging markets; International financial markets; Macroeconomics and financial markets

1. Introduction

The financial crisis that erupted in Asia in 1997 and 1998 led to sharp declines in stock markets, currencies and other asset prices. It also threatened these countries' financial systems and disrupted their real economies, with large contractions in

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activity, which created a human crisis alongside the financial one. In addition to its severe effects in Asia, the crisis put pressure on emerging markets outside the region, and has contributed to virulent contagion and volatility in international financial markets. The so-called 'contagion' effect of the crisis drew a lot of attention to the linkages among emerging stock markets and raised the fundamental question: What determines the extent of interdependence among emerging stock markets?

International investors need to understand the forces behind the interdependence of emerging stock markets in order to realize the potential risks and rewards of global diversification. Likewise, policy-makers need to understand the driving forces behind emerging stock market interdependence, since from their point of view, contagion means irrational capital flows, especially capital outflows when capital is needed the most. This reduces the benefits of financial liberalization. Can the extent of interdependence between the emerging markets be explained? Put differently, is the co-movement of emerging stock markets 'contagion' in the true sense of the word or can it be explained by fundamentals?

This calls for an examination of the factors that influence the relationships and dynamic linkages between emerging stock markets. Such an understanding will provide a better grasp of the functioning of the global stock markets, and allow investors and policy-makers to ask additional questions such as: is the level of interdependence among emerging stock markets remaining constant or is it increasing over time? What influence did the 1998 emerging market crisis have on the level of stock market interdependence: did it cause a permanent or temporary increase in stock market interdependence or did it have no lasting effect? Are regional stock markets more interdependent than stock markets in general? Would an increase in bilateral trade between two countries, for example, due to a new trade agreement, change the interdependence of their stock markets? If the growth rate of a particular emerging market falls due to the current global economic downturn, will its stock market drag along all the other stock markets or can it be known beforehand which stock markets are more likely to follow? In addition, if the influence of economic indicators can be estimated empirically, it will enable policy-makers and investors to analyze different scenarios, and to predict the effect of certain macroeconomic changes on the correlation between stock markets.

This study is an attempt to answer these questions surrounding emerging stock markets. Section 2 gives an overview of the literature on stock market interdependence. The theory of stock market interdependence is explained in Section 3 and in Section 4 a regression model is used to empirically determine the factors that influence the extent of emerging stock market interdependence. The forecasting ability of this model is compared with that of three atheoretical models in Section 5, and Section 6 presents the conclusions drawn from this study.

2. Literature review

The literature on stock market interdependence can be divided into three

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