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Emerging markets and financial crises: Regional, global or isolated shocks?

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This paper investigates financial contagion of three emerging market crises of the late 1990s, as well as the subprime crisis of 2007, focusing on financial markets of emerging economies, USA and 2 global indices. Conventional cointegration and vector error correction analysis show long and short run dynamics only among emerging stock markets during the Russian and the Asian crises, for both stock and bond markets during the subprime crisis, while the Argentine turmoil has no impact on any of the examined markets. Further analysis into a multivariate time-varying asymmetric framework provides evidence on the global impact of the Russian default, the contagion effects of the subprime crisis, the regional aspect of the Asian crisis and the isolated nature of the Argentine turmoil. Moreover, stock markets seem to constitute a stronger transmission mechanism during the three contagious crises. Our findings have crucial implications for international investors, policy makers and multi-lateral organizations.

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1. Introduction

A central issue in asset allocation and risk management is whether financial markets become more interdependent during financial crises. This issue has acquired great importance among academics and practitioners, especially since the appearance of several emerging market crises of the 1990s

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(Mexican currency crisis in 1994–1995, Asian crisis in 1997, Russian default in 1998, Argentine crisis in 1999–2001, and Brazilian stock market crash in 1997–1998). Until then, financial crises models were developed with regard to crises as events occurring in individual countries. However, those crises episodes refocused the empirical research on the examination of contagion effects and the inter-regional or inter-continental nature of the shocks. Common to the majority of these events was the fact that the turmoil originated in one market extended to a wide range of markets and countries, in a way that was hard to explain on the basis of changes in fundamentals (Rodriquez, 2007).

There is an extensive literature on financial contagion during several crises of the 1980s and 1990s (see Dornbusch et al., 2000; Kaminsky et al., 2003, for excellent surveys). To measure volatility spillovers and contagion among markets, early research used a range of different methodologies, such as the principle components model (e.g., Calvo and Reinhart, 1996), spillover models (e.g., Glick and Rose, 1999), cointegration and vector error correction models (e.g., Sheng and Tu, 2000), models of asymmetries and non-linearities (e.g., Baur, 2003), and models of interdependence (e.g., Bekaert et al., 2005). Furthermore, the existence of financial contagion has been studied mainly around the notion of "correlation breakdown" (a statistically significant increase in correlation during the crash period) (e.g., King and Wadhwani, 1990; Calvo and Reinhart, 1996). However, since the thought-provoking paper by Forbes and Rigobon (2002), a number of limitations to the literature on financial contagion have been highlighted (e.g., a heteroskedasticity problem when measuring correlations, a problem with omitted variables and the need for a dynamic increment in the regressions, affecting at least in the second moments correlations and covariances). To overcome those restrictions and provide sufficient evidence of contagion, researchers have been already using more sophisticated approaches, such as models of conditional asymmetries and correlations (e.g., Chiang et al., 2007; Kenourgios et al., 2011), regime-switching models (e.g., Pelletier, 2006), and dynamic copulas with or without regimes (e.g., Rodriquez, 2007; Okimoto, 2008).

This paper investigates the existence of a correlated-information channel, through which contagion can be viewed as the transmission of information from more-liquid markets or markets with more rapid price discovery to other markets, focusing initially on three major emerging market crises (Asian crisis, Russian default and Argentine turmoil).[1] The analysis covers both equity and bond markets in selected emerging market economies (EMEs) of various regions (Latin America, Asia, Europe, Middle East and Africa), as well as USA and 2 global indices for equities and bonds, for comparative reasons. To expand the scope and the contribution of our research, we also investigate the contagion effects of the subprime crisis of 2007–2008 in the examined EMEs.[2] Our purpose is to identify in a broader framework the propagation mechanism of crises with different characteristics occurred in emerging (Asian currency crisis, Russian and Argentinean government defaults) and developed countries/regions (U.S. subprime crisis), and elucidate how vulnerable emerging financial markets are to both emerging and global shocks. To serve this purpose, we maintain, following similar studies in the literature (e.g., Forbes and Rigobon, 2002; Bekaert et al., 2005), an equivalently strict definition of contagion as the increase in the probability of crisis, beyond the linkages in fundamentals, and the rapid increase in co-movements among markets during a crisis episode. Understanding the nature

[1] The contagion literature identifies at least three possible contagion mechanisms: (i) a correlated-information channel (Kaminsky et al., 2003; King and Wadhwani, 1990, among others); (ii) a liquidity channel, through which contagion occurs through a liquidity shock across all markets (e.g., Allen and Gale, 2000, among others); (iii) a risk-premium channel, through which contagion occurs as negative returns in the distressed market affect subsequent returns in other markets via a time-varying risk premium (e.g., Acharya and Pedersen, 2005, and others). In this paper, we restrict our investigation only on the first contagion mechanism, due to the lack of availability of consistent and compatible financial data in emerging markets.

[2] Asian crisis contagion clearly receives the highest share of attention in the literature (e.g., Glick and Rose, 1999; Baig and Goldfajn, 1999; Sheng and Tu, 2000; Chiang et al., 2007; Kenourgios et al., 2011). On the other hand, little empirical investigation of the Russian default has been performed, while there is limited consensus regarding its contagious effects (for example, Gelos and Sahay, 2000, find no contagion, while Forbes, 2000, and Dungey et al., 2007, confirm the contagion effect). On the contrary, empirical evidence on the contagion of the Argentinean default in global financial markets is surprisingly scarce (e.g., Boschi, 2005). Although the literature on the international impact of the U.S. subprime crisis is still developing, only few studies focus in EMEs. For example, Dooley and Hutchison (2009) provide evidence on the decoupling of emerging markets from early 2007 to summer 2008, but after that point confirms their recoupling due to the deteriorating situation in the U.S. financial system and real economy, while Aloui et al. (2011) find strong evidence of time-varying dependence between each of the BRIC equity markets and the U.S. markets.

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