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Country financial risk and stock market performance: the case of Latin America

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Abstract

We use the Clark [*Cross-border investment risk*. Euromoney Books (1991a); Euromoney (1991b); Euromoney (1991c)] methodology to estimate the macroeconomic financial risk premium from 1985 to 1997 for six Latin American countries with the largest stock markets, and test whether and to what extent it affects their stock markets' performance. We find that the macroeconomic financial risk premium is a significant explanatory variable for five of the countries, that accounts for about 12% of annual variations in the stock market indices. The results indicate that there are no country-specific fixed effects and that sensitivity to changes in the financial risk premium is similar for all five countries.

JEL classification: F30; G15; C23

Keywords: Financial risk; Equity return

1. Introduction

In this paper, we measure a country's default risk as a financial risk premium and investigate its effect on the performance of the six largest Latin American stock markets, namely: Argentina, Brazil, Chile, Colombia, Mexico and Venezuela. We focus on Latin America because it has a long history of capitalism and reliance on foreign debt to finance its development. In fact, the debt crisis of 1982 was born in Latin America and a large percentage of outstanding Brady bonds is still associated with Latin American borrowers. Consequently, foreign investors are familiar with the region and the financial risks asso-

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ciated with the countries that comprise it. Besides having the largest stock markets in the region, the six countries in our study are also major international borrowers with the high levels of outstanding foreign debt that are necessary for the existence of a financial risk premium.

Country default risk refers to the probability that a country will be unable to generate enough foreign exchange to enable its residents, both public and private, to meet interest and principle payments on their foreign debts. It plays a prominent role in the literature on sovereign debt and country creditworthiness (see, for example, Callier, 1985; Cline, 1984; Feder & Just, 1977; McFadden, Eckaus, Feder, Hajivassiliou, & O'Connell, 1985) and has profound implications for a country's economic and social well being. First of all, a de jure or de facto default indicates that a country is unable to generate the foreign exchange it requires to maintain internal and external economic equilibrium. Restoration of equilibrium implies relative price changes, resource reallocation, and income redistribution, with resulting painful effects on levels of output, employment and standards of living.[1] Besides the costs associated with economic adjustment, debt default also inflicts two other penalties on the country. The first refers to the costs associated with the loss of access to international capital markets (Eaton & Gersovitz, 1981). The second concerns the costs due to direct sanctions such as the elimination of trade credits or the seizure of assets (Bulow & Rogoff, 1989).

Domestic stock markets are intimately linked to domestic economic performance.[2] They have also become a major source of foreign capital. Thus, when a de jure or de facto default occurs, the domestic stock market will suffer from the effects of economic adjustment. For example, during the Mexican peso crisis, the Mexican stock market index dropped by 38.7% from December 1994 to February 1995. From July 1, 1997 to February 16, 1998 during the Asian crisis, Thai stocks fell by 48.4%, Indonesians by 81.7%, Malaysians by 58.4%, Philippines by 49.2% and Koreans by 63.1%. The Russian crisis of 1998 caused a stock market decline of 41.3% in the month of August alone. Furthermore, foreign capital fleeing the stock market can also exacerbate the balance of payments crisis and increase the pain of economic adjustment.

In spite of the interest in emerging stock markets and country risk in general, there are few papers that deal directly with country default risk and stock market performance. The early literature on default was wrapped up in general country risk with respect to sovereign debt and the determinants of default.[3] For example, Feder and Just (1977), McFadden et al. (1985), and Callier (1985) focus on the financial variables, Berg and Sachs (1988) on structural variables, Huizinga (1989) on prices and Hajivassiliou (1989) on debt overhang.

[1] This "foreign exchange constraint" figured prominently in the international economics literature of the 1950s and 1960s. For some of the original work, see Meade (1951), Alexander (1952, 1959), Pearce (1961), Tsiang (1961), Gerakis (1964) and Caves and Johnson (1968).

[2] For an interesting analysis of linkages among different indices within the same country, see Arbelaez, Urrutia, and Abbas (2001).

[3] Country risk is difficult to quantify. Many studies show relationships between sovereign debt discounts and various structural, financial and other economic and qualitative phenomena that are designed to capture its effects but none of them quantify it directly. Furthermore, there is a lack of solid theoretical ground underpinning country risk and its link to the macroeconomy. One attempt was made by Ciarrapico (1992), but as Wynn (1994) reports, her model fails to show explicitly how country risk links with the various macroeconomic variables.