



Interrelationships among regional stock indices[☆]

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Abstract

This study investigates the short-run and long-run relationships among stock indices of the US, Europe, Asia, Latin America, and Eastern Europe–Middle East for the pre-Asian crisis and for the crisis period. The findings from these two periods are compared and contrasted. No long-run relationship is observed among these indices during the pre-Asian crisis period. However, during the crisis period, one significant cointegrating vector is observed and more short-run (i.e., causal) relations are observed in this period as compared to the pre-crisis period. Based on the analysis, we infer that during the Asian crisis period, the globalization increased and only the European markets directly effected the US market, while the other regional markets indirectly influenced the US market via the European market. As regards the effect of shocks, we observe that during the pre-Asian crisis period, the response of all regional markets to shocks in other markets is transitory, whereas during the crisis period, the response of the US stock market is transitory but that of EU market is permanent to all other markets. © 2002 Published by Elsevier Science Inc.

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1. Introduction

Increased economic integration among economies of the world has brought increased attention of investors and academic scholars to the issue of interrelationships among these markets around the world. While integration in banking and financial markets provides some advantages in terms of gains in market efficiency and portfolio diversification, it also offers potential pitfalls. The October 1987 crash of US financial markets led to the doom and gloom in the financial markets around the world. Moreover, the dramatic decline in the Japanese stock market at the beginning of 1990s, as well as the recent recession in mid-1998, and the recent financial crisis in the emerging markets point to an important pitfall for financial institutions investing globally. Peek and Rosengren (1997) argue that the Japanese stock market decline resulted from a decrease in lending by Japanese banks and was transmitted internationally to the US. The economic downturn in Japan originated during the same quarter that the Thai baht was coming under increased pressure in mid-1997. The financial crisis in Thailand rapidly spread to Indonesia, Malaysia, the Philippines, and Korea. In October 1997, the crisis began to affect other economies when speculative pressures intensified against the Hong Kong dollar, the Korean won, and the Taiwanese dollar resulting in drops in their stock markets. A severe drop in Hong Kong's financial market dramatically pushed the global equity prices (affecting Eastern Europe, Latin America, Japan, Europe, and the United States) into a downturn. Consequently, in mid-1998, the East Asian crisis became a worldwide financial and economic crisis hitting developing economies in Latin America, Middle East, Eastern Europe, and North Africa.

There are several factors that explain the repercussions from financial crises. First, common shocks such as a steep rise in world interest rates, a sharp decline in world aggregate demand, a slowdown in commodity prices, or large changes in exchange rates between major currencies can induce pressure on currencies of several countries simultaneously. Second, a significant currency depreciation in one country experiencing a financial crisis may affect other countries through trade spillovers due to the improved price competitiveness of the crisis country. Third, the occurrence of a crisis in one or more countries may induce investors to rebalance their portfolios for risk management or other reasons. Fourth, a crisis in one country may wake up other financial markets to reassess their countries' circumstances.

Thus, many researchers have investigated the short-term and long-term interrelationships among worldwide financial markets. The primary focus of the empirical research has been the G-7 and other industrialized countries. Lai, Lai, and Fang (1993) observe both the short-run and the long-run feedback relationships between the New York and Japanese stock markets. Kasa (1992) finds a single common stochastic trend among G-7 countries. Among the major European markets, Choudhry (1996), Koutmos (1996), and Serletis and King (1997) all discover long-run relationships. Booth, Martikainen, and Tse (1997) notice a weak relationship among the Scandinavian markets. There are some studies available for the Asian and Pacific markets. Engle and Susmel (1993) test for common volatility in 18 nations' stock markets and report two closed-boundary groups

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