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Exchange rate regimes, globalisation, and the cost of capital in emerging markets[☆]

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ABSTRACT

This paper presents a multifactor asset pricing model for currency, bond, and stock returns for ten emerging markets to investigate the effect of the exchange rate regime on the cost of capital and the integration of emerging financial markets. Our results suggest that a fixed exchange rate regime system can help reduce the cost of capital in emerging markets by reducing the currency risk premia demanded by foreign investors.

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1. Introduction

In an attempt to reduce the uncertainty that firms and investors face when making investment decisions, different countries have pursued policies oriented towards the stabilisation of their exchange rates. However, as claimed in [Sentana \(2002\)](#), the arguments in favour of a fixed exchange rate regime suffer from several criticisms. First, firms might be able to hedge their exchange rate exposure and, henceforth, they might not be affected by any idiosyncratic movement in exchange rates. Second, these idiosyncratic exchange rate risks might not even be priced in a world with complete market integration.

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And finally, a fixed exchange rate system might also increase interest rate volatility because monetary authorities have to defend their respective parities. Therefore, it is conceptually possible that a fixed exchange rate regime can increase the cost of capital if the interest rate volatility is priced in emerging markets. Whether a fixed exchange rate regime is able to reduce the cost of capital in emerging markets remains then an empirical question.

This paper studies the impact of the choice of an exchange rate regime on the cost of capital in emerging markets. To do so, we rely on the framework of the dynamic version of the arbitrage pricing theory developed in King, Sentana, and Wadhvani (1994) and extended in Sentana (2002) to study the impact of European Mechanism System on the cost of capital of European firms. In particular, we use weekly data on currency, bond and stock returns for ten emerging markets over the period from mid 1997 to mid 2006 to estimate a multivariate factor model with time-varying volatility in the underlying factors. In addition, we include two modifications to the analysis done in Sentana (2002). First, we do not restrict the structure of the common factor to be triangular because general equilibrium models usually predict that all common factors affect all asset classes. Second, we follow Jorion (1988), Vlaar and Palm (1993) and Das (2002) and combine a GARCH specification with the presence of Gaussian jumps. This allows the model to capture those episodes of financial distress that occur in the sample (for example, the East Asian crises of 1997, the Russian collapse of 1998, the devaluation of the Brazilian Real in 1999, and the abandonment of the Argentinean currency board in 2002).

In addition, it is difficult to disentangle the study of the impact of the exchange rate regime on the cost of capital and the study of the hypothesis of financial market integration. Ultimately, such an impact on the cost of capital depends on whether country-specific risks are priced. The asset-pricing model we use implicitly assumes that emerging markets are integrated. Thus, testing the cross-equation restrictions of the basic model allows us to answer whether country-specific risks are priced.¹ We also follow Stulz (1999) to gauge the potential gains from stock market globalisation by comparing the risk premia that would prevail in a world of full integration and full segmentation.

Our main results indicate that not only has a fixed exchange rate regime been unable to reduce exchange rate volatility in emerging markets, but it has also increased interest rate volatility. Such a result can be related to Calvo and Reinhart (2002) who suggest that a lack of credibility of exchange rate stabilisation policies causes excess volatility in interest rates. We could thus be tempted to conclude that a flexible exchange rate regime is a better alternative than a fixed system. However, such idiosyncratic movements will only have an impact on the cost of capital as long as the hypothesis of complete market integration fails and, therefore, idiosyncratic risks are priced. In effect, our results suggest that while the idiosyncratic exchange rate factor is more volatile for those countries with a fixed exchange rate regime, it is not priced. Once we take into account this pricing effect, we find that such a system reduces the currency risk premia demanded by foreign (U.S.) investors by 4.5% per annum. Additionally, we find that a fixed exchange rate regime, reduces the bond risk premia demanded by domestic investors by 3.9% while it increases the stock risk premia demanded by local investors by 2.7%. Yet, the reduction in the currency risk premia is the only one that is significant at the 10% level of significance. Overall, these results seem to suggest that a fixed exchange rate reduces the currency risk premia demanded by foreign (U.S.) investors while leaving unchanged both the bond and stock risk premia demanded by local investors.

The paper is organized as follows. Section 2 presents the benchmark model and the estimation procedure. Section 3 reports the estimates of the asset pricing model. The impact of an exchange regime on the cost of capital is found in Section 4. Section 5 discusses whether emerging markets are financially integrated. Finally, Section 6 concludes the paper.

2. Benchmark model

This section borrows from Sentana (2002), where further details can be found. However, any significant change with respect to his work will be highlighted.

¹ See Bruner et al. (2008) and Jacobsen and Liu (2008) for related approaches to testing the hypothesis of complete market integration in developed and emerging markets.

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