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Stock market cycles, financial liberalization and volatility

Sebastian Edwards [a,*], Javier Gómez Biscarri [b], Fernando Pérez de Gracia [c]

[a] *National Bureau of Economic Research and University of California, Los Angeles, 90095-1681 Los Angeles, USA*
[b] *IESE Business School and Department of Economics, Universidad de Navarra, 31080 Pamplona, Spain*
[c] *Department of Economics, Universidad de Navarra, 31080 Pamplona, Spain*

Abstract

In this paper we analyze the cycles of the stock markets in four Latin American and two Asian countries, and we compare their characteristics. We divide our sample in two subperiods in order to account for differences induced by the financial liberalization processes of the early 1990s. We find that cycles in emerging countries tend to have shorter duration and larger amplitude and volatility than in developed countries. However, after financial liberalization Latin American stock markets have behaved more similarly to stock markets in developed countries whereas Asian countries have become more dissimilar. Concordance of cycles across markets has increased significantly over time, especially for Latin American countries after liberalization.
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1. Introduction

During the last decade the emerging markets have been characterized by a high degree of financial instability. This has been particularly the case in Latin America, where currency crises have become recurrent and where equity markets have experienced dramatic swings. Partially motivated by this instability, a number of

* Corresponding author. Tel. +1-310-206 6797; fax: +1-310-206 5825.
E-mail address: sedwards@anderson.ucla.edu (S. Edwards).

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authors have recently investigated the behavior of Latin American financial markets.[1] Fischer (2002), for example, has analyzed the implications of the Latin American currency crises for the future of the international monetary system. Eichengreen (2003), De Gregorio et al. (2000), and Edwards (1999) have investigated the role played by capital mobility in Latin America during the financial crises of 1990s. Goldstein (2003) has looked more specifically at the forces behind the financial turmoil in Brazil during 2002.

Rigobon (2003) has focused on alternative volatility measures in both equity and bond markets in the period surrounding recent financial crises. Kaminsky and Reinhart (2002) have investigated how interest rates, equity returns and bond spreads behave in times of global financial stress. Their main interest was to analyze whether these variables exhibited co-movement across countries. Bekaert and Harvey (2000) analyzed equity returns in a group of emerging markets, including six Latin American countries, before and after the financial reforms. Edwards and Susmel (2003) investigated the time pattern of interest rate volatility in four Latin American countries, and compared them to that of Hong Kong. Other recent studies on financial volatility and contagion in the emerging markets, including Latin America, are Karolyi and Stulz (1996); Janakiramanan and Lamba (1998); Edwards (2000); Eichengreen and Mody (2000), Bekaert et al. (2002a), Bekaert et al. (2002b), Chakrabarti and Roll (2002); Chen et al. (2002); Forbes and Rigobon (2002) and Bekaert et al. (2003).

An important question, and one that we address in this paper, is whether stock markets have similar features in the emerging nations and in the advanced countries. The answer to this question is particularly germane to the current debate on the role of financial liberalization and macroeconomic instability in the emerging and transition economies. Some authors – including Krugman (2000) and Stiglitz (2002) – have argued that financial markets in emerging nations are poorly developed and thus they do not function properly – e.g. in the way that financial markets in advanced countries do. Under these circumstances, the argument goes, the emerging nations should not liberalize fully their capital markets; instead, they should impose some form of controls that regulate cross-border movements of portfolio capital.

More specifically, in this paper we analyze stock market cycles in a group of Latin American countries: We investigate the characteristics of stock market cycles in Argentina, Brazil, Chile and Mexico during 1975–2001, and we focus on the behavior of "bear" and "bull" markets, as defined by Pagan and Sossounov (2003), among others: "Bull" and "bear" phases of stock markets are identified with periods of a generalized upward trend (positive returns) and periods of a gen-

[1] During the late 1980s and early 1990s the vast majority of the Latin American countries embarked on ambitious market-oriented reforms. The reform blueprint has come to be known as the "Washington Consensus." A number of authors have argued that this reform process has failed, and that the Latin American countries have grown at slower rates and have become more unstable. For an analysis of the reforms see, for example, Edwards (1995). See Stiglitz (2002) for criticism of the reform process. Edwards (2003) assesses the validity of Stiglitz's critique.

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