

Asymmetric impacts of global risk appetite on the risk premium for an emerging market

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Abstract

This paper analyzes the impact of global risk appetite on the risk premium utilizing high-frequency data. Taking the Turkish economy as our laboratory, we find that the risk premium volatility responds only to a worsening in the risk appetite for the Turkish economy, which is a result that we do not observe for the other emerging markets. Then, we investigate the role of current account dynamics on this asymmetric effect, by focusing also on an economy with similar current account performance. The empirical results find supporting evidence for the role of current account dynamics on the estimated asymmetry.

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1. Introduction

After the global financial turbulence of May–June 2006, the fragility of the emerging market economies against global financial shocks has regained the interests of both policymakers and the academia. In this context, two related points deserved serious attention. First, the impact of the risk appetite, which is the willingness of the investors to bear risk, on the risk premium, which can be defined as the extra yield gained for holding a risky asset, came into question. The attitude of the investors towards risk is expected to affect their holdings of risky assets such as investment instruments in emerging markets and hence the risk premium for these markets. In other words, risk appetite and risk premium are expected to be closely related. In fact, Calvo [6] argues that, for emerging market economies, risk appetite is the driving force for the capital flows which significantly affect the risk premium for the economy.

Second, the reason(s) for why these economies have different responses to changes in the risk appetite emerged as an important issue. The last global financial turbulence has shown again that, depending on their financial and macroeconomic characteristics, emerging market economies are affected differently to a significant extent from these global shocks. Thus, revealing the source(s) for such an asymmetric response is crucial to have a deeper understanding of the dynamics of the emerging market economies.

This study stays at an intersection point of the above-mentioned issues by focusing on an emerging market, namely the Turkish economy. In particular, it analyzes whether different types of asymmetries in the impact of the risk appetite

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on the risk premium exist. In addition, current account deficit is investigated as a possible source for these asymmetric effects. Given the fact that the Turkish economy was one of the most severely affected emerging markets in the last financial turbulence, a thorough analysis of the issue for the Turkish economy has the potential to reveal important results.

There are two main contributions of this study to the literature on the emerging markets. First, on the empirical side, it analyzes the impact of the risk appetite on the level and the volatility of the risk premium by utilizing conditional heteroscedasticity models and daily data. The previous studies, which stress the above-mentioned issues, mostly use monthly data, where the possible impacts of the risk appetite on the risk premium volatility at a high frequency cannot be adequately captured. Thus, handling the analysis by using different conditional heteroscedasticity specifications for a daily data set can be considered as a contribution to the related literature. Moreover, to our knowledge there exists no study that relates the risk appetite and the risk premium for either the Turkish economy or another emerging market by using the above-mentioned methodology.

Second, it is found that there is an asymmetric impact of the risk appetite on the conditional volatility of the risk premium for the Turkish economy. Beginning with the second-quarter of 2004, while the conditional volatility of the risk premium for the emerging markets as a whole are equally affected by increases and decreases of the risk appetite, the conditional volatility of the risk premium for the Turkish economy responds only to a worsening in the risk appetite. However, just the opposite results are found for the period before the second-quarter of 2004. Considering the fact that the second-half of the sample corresponds to a period of rapidly increasing current account deficit, it is questioned whether current account dynamics can be held responsible for the asymmetry in findings. Extending the empirical exercise to the Republic of South Africa as the only emerging market besides Turkey to have a high and threatening current account deficit, it is found that the same case also applies for that economy. Consequently, in addition to detecting an asymmetric impact of the risk appetite on the risk premium volatility, convincing evidence is also obtained for the source of that asymmetry, which is the current account deficit.

The next section briefly reviews the related studies that stress the relationship between risk appetite and the risk premium. Conditional heteroscedasticity specifications and the data characteristics are presented in the third section. The fourth section displays the estimation results. The final section concludes.

2. Literature review

Starting with Edwards [7], the determinants of the risk premium are mostly analyzed by utilizing log-linear models. While Ferrucci [9] shows evidence for the effect of macroeconomic fundamentals – including real exchange rate, inflation and the current account dynamics – and external liquidity conditions on the risk premium, Cline and Barnes [5], Min [16], Kamin and Kleist [14] find the impact of external variables like oil prices and the international interest rates to be negligible. However, Eichengreen and Mody [8] challenge this view and claim that primary spreads may not rise proportionately as secondary markets rise, especially in poor market conditions. Contrary to the papers mentioned above, they find that an important determinant of the capital flows and spreads in the emerging markets is the real interest rates in the developed economies.

Unlike the above-mentioned contradictory results that the literature have produced, the importance of global risk aversion, or alternatively the global risk appetite, on the dynamics of the risk premium is commonly agreed upon. Herrera and Perry [11] and Herrero and Ortiz [12] find that global risk aversion and sovereign spreads are positively related. Calvo [6] argues that once the effect of global risk aversion is taken out, domestic factors are almost irrelevant in explaining sovereign spreads. Finally, Baek et al. [1] construct a measure of Risk Appetite Index (RAI) and find that it has a larger and significant impact on the Brady bond yield spreads, when compared with the macroeconomic variables.¹

There is one common characteristic of all of the studies which are cited above. Most of these papers concentrate on the effects of risk appetite solely on the *level* of the risk premium. Given the fact that these studies utilize monthly (or even lower frequency) data, the possible effects of the risk appetite on the *volatility* of the risk premium cannot be analyzed to full extent. In this paper, we fulfill this gap by employing daily data and conditional heteroscedasticity

¹ It is also possible to extend the literature review and discuss the relationship between the risk premium and the risk appetite within a 'contagion' framework in the emerging markets. However, such an approach would not directly serve the main purpose of this study. See Eichengreen and Mody [8], Baig and Goldfajn [3], Kumar and Persaud [15] for a discussion of the issue within the context of 'contagion' models.

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