The Impact of Trade on Stock Market Integration of Emerging Markets

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Abstract : The emerging markets category for portfolio investment was introduced in 1986 in an attempt to promote capital market development in less developed countries. Investors traditionally diversified their portfolios by investing in different developed markets. However, high growth opportunities forced investors to consider emerging markets as well. Examples include the rapid growth of the “Asian Tigers” during the 1980s, growth in Latin America during the 1990s and the increased interest in emerging markets during the global financial crisis. As such, portfolio flows to emerging markets have increased substantially. In 2002 7% of all equity allocations from advanced economies went to emerging markets; this increased to 20% in 2012. The stronger links between advanced and emerging markets led to increased synchronization of asset price movements. This increased level of stock market integration for emerging markets is confirmed by various empirical studies. Against the background of increased interest in emerging market assets and the increasing level of integration of emerging markets, this paper focuses on the determinants of stock market integration of emerging market countries. Various studies have linked the level of financial market integration with specific economic variables. These variables include: economic growth, local inflation, trade openness, local investment, budget surplus/ deficit, market capitalization, domestic bank credit, domestic institutional and legal environment and world interest rates. The aim of this study is to empirically investigate to what extent trade-related determinants have an impact on stock market integration. The panel data sample include data of 16 emerging market countries: Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Malaysia, Pakistan, Peru, Philippines, Poland, Russian Federation, South Africa, Thailand and Turkey for the period 1998-2011. The integration variable for each emerging stock market is calculated as the explanatory power of a multi-factor model. These factors are extracted from a large panel of global stock market returns. Trade related explanatory variables include: exports as percentage of GDP, imports as percentage of GDP and total trade as percentage of GDP. Other macroeconomic indicators – such as market capitalisation, the size of the budget deficit and the effectiveness of the regulation of the securities exchange – are included in the regressions as control variables. An initial analysis on a sample of developed stock markets could not identify any significant determinants of stock market integration. Thus the macroeconomic variables identified in the literature are much more significant in explaining stock market integration of emerging markets than stock market integration of developed markets. The three trade variables are all statistically significant at a 5% level. The market capitalisation variable is also significant while the regulation variable is only marginally significant. The global financial crisis has highlighted the urgency to better understand the link between the financial and real sectors of the economy. This paper comes to the important finding that, apart from the level of market capitalisation (as financial indicator), trade (representative of the real economy) is a significant determinant of stock market integration of countries not yet classified as developed economies.

Keywords : emerging markets, financial market integration, panel data, trade
Conference Title : ICAFEM 2016 : International Conference on Applied Financial Economics and Management
Conference Location : Copenhagen, Denmark
Conference Dates : June 27-28, 2016