Chapter 10

Do Stock Markets Comove in Emerging Economies?

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ABSTRACT

Great Recession has brought the need to model and assess the financial markets with unconventional approaches. The nature of consumer behavior in financial markets has become crucial as real and financial sector comoving overtime was a dream of no rationality. The union of consumers looking for higher wealth and speculative stock market participants was not a sustainable case. But, what happened to the consumers/investors in emerging economies? This chapter assesses the behavior of emerging stock markets during the turmoil using weekly data for Brazil, China, India, Indonesia, Russia, South Africa and Turkey with US as the benchmark for January 2003–March 2014. Two unconventional methods are used for checking asymmetric contagion; the wavelet comovement and frequency domain causality. The findings show that markets with rather high concentration of foreign investors are highly affected but consumers were not due to smaller participation. The asymmetric contagion argument is verified for some emerging markets as consumers/investors suffered as much as any other market participant.

INTRODUCTION

The recent technological developments, the facilities of communication, the liberalization activities in terms of economies, the augmentation of international trade, the committed free trade agreements and trading blocks, concisely the fact of globalization, have made economies more integrated among countries. Certainly, some advantages and disadvantages occur with financial integration. For instance, emerging economies have become more attractive places for portfolio investors and portfolio capital. Besides all of these above factors, low transaction costs are also one of the other benefits of this integration. Likewise, the presence of strong economic ties between countries can affect stock markets’ action...
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by time. However, this integration might be more fragile in terms of economies and its’ influences might be contagious. Undoubtedly, these are the disadvantages of the global integration.

On the other hand, it is not possible to argue that stock markets are destined to wipe away the savings of small investors. There are so many financial institutions which have expertise on stock markets and offer portfolio services at very low costs to their customers (that is consumers who are able to save and are willing to invest in stock markets). Most of these institutions try to pick up a balanced portfolio that could only be achieved through diversification depending on the wealth of their customers. It is well known that the value of the customer’s portfolio rises as well as the institution’s earnings through brokerage fees and the increase in the number of new customers. This obviously leads to a bigger portfolio to be managed for the institution, a spiral that could lead to enormous benefits for both sides in the longer term. Hence, the increase in wealth for the consumer is expected to increase his/her purchasing power and the living standards. In a stable economic environment with a healthy growth rate, participating in the financial markets—especially the stock market if speculation is not the dominant factor—should definitely lower the cost of living for those consumers (long-term portfolio owners) as production rises and interest rates and inflation are low and stable. Therefore, the study of stock markets are rather different than other asset markets due to the inherent nature of speculation in the market that needs to be minimized through effective and larger participation of small investors who can save some portion of their income but think about the longer term gains rather than being rich during the day and waking up to be broke the next morning. So, the notion of investing in stock markets especially in emerging economies where savings are relatively very low is a bigger challenge than the high volume stock markets of the advanced economies. But, these markets are an important source of wealth creation for the consumers and also reflect whether consumers who could save have some kind of confidence in the stock markets, which also means trusting the major domestic companies that are open to public. If the consumers believe that the risks outweigh the benefits or they have already been affected in an adverse manner from the stock market fluctuations in the past economic history, they would tend to prefer alternative assets which usually are foreign exchange and gold. Reflecting on this issue, Rua and Nunes (2009) argue that:

...the study of the comovement of stock market is crucial for risk assessment of portfolios. A higher comovement among the assets of a given portfolio implies lower gains, in terms of risk management, stemming from portfolio diversification. Hence, the evaluation of the comovement is of striking importance to the investor so that he can best assess the risk of a portfolio.

Besides, movements in stock markets are crucial in effecting the financial policies of corporations and the monetary authorities given that the former should focus on future investment decision and the latter should prefer a stable financial market and lower volatility in the economy. Focusing on this point, Ali et al. (2011) point out that:

... to study comovements among stock markets would be useful for policy makers in a sense if stock markets are found to be closely linked then there is a danger that shocks in one market may spill over to other markets thus require closer cooperation among the authorities of these countries, whose equity markets are closely linked.

This study examines the comovement of US stock market indices with the selected markets of Brazil, China, Indonesia, India, Russia, South Africa and Turkey. We use the US stock market as the anchor
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