

LINKAGES AMONG SELECTED WESTERN AND ASIAN STOCK MARKETS



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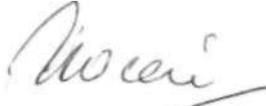
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NOVEMBER 2011

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This research was completed as a fulfillment to the requirement of the Sabbatical leave taken.



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Chapter 1

INTRODUCTION

1.1 Introduction

This empirical research investigates the international inter-relatedness among a number of national equity markets. These markets are from Malaysia, Singapore, Thailand, Japan, Korea, Taiwan, Australia, Hong Kong, Indonesia, the United States, the United Kingdom, the Philippines, France, Germany, Denmark, Switzerland, Spain, Canada and Belgium. These markets were chosen as they include both emerging markets as well as well-established markets. Some authors such as Rhee and Chang (1991) studied the performance of the Pacific Basin stock markets (Australia, Japan, Hong Kong, Singapore, Malaysia, Korea, Taiwan and Thailand) and of the top five markets in the world (Japan, United States, United Kingdom, France and Germany). Together, these markets represent around 90% of the world's stock market capitalization.

As the title implies, this study examines the structure of international stock market linkages. Knowledge of international stock market linkages, or interdependencies, is useful for international portfolio diversification, where investors can try to reduce a portion of the risk.

Within the last five years, major institutional restructuring of the financial sector occurred, with governments generally getting out of the provision of financial services. The role of securities markets relative to intermediation expanded and securitization, managed investments and corporate bond issues all increased in significance (Hall, 2003).

Various studies on market integration found that international stock markets have become increasingly integrated in recent years (Hashimi and Liu, 2001, Mat Saad and Abdullah, 2001). Even though a few authors found out otherwise (e.g. Brackert, Docking and Koch, 1999), most of the recent studies find equity markets to be interlinked. These linkages can be attributed to various factors such as the advancement of communication systems and information technology, the lower cost of transactions, the deregulation of international markets and the development of new

financial instruments and techniques. Other factors that affect linkages are major events such as the 1973 and 1979 oil price shocks, the end of the Bretton Woods system, the abolition of exchange controls in UK in the late 1970s, the 1987 stock market crash and the 1991 Gulf War, and the September 11, 2001 attack on the U.S. World Trade Center (Hashimi and Liu, 2001).

There are various contradictory findings that emerge from the studies on stock market linkages and integration. Some interesting findings are that the New York market acts as the global leader and many markets, including Malaysia, are affected by it. Also, excluding New York, the other markets tend to have stronger relations with geographically closer markets than with the remote ones. (Hilliard, 1979 and Dekker et al, 2001). This research will seek to find out whether the New York stock market still leads the market before and after the 1997 Asian Financial Crisis and whether the Malaysian stock market have stronger relations with geographically closer markets than with the remote ones.

A study by Hashimi and Liu (2001) found that inter-linkages among South East Asian (SEA) markets have increased after the emergence of a crisis. The New York market affects the South East Asian markets but is not affected by them. The Tokyo market seems to be isolated from the region and its effect on them is even greater than that of New York. Their study also noted that all five South East Asian markets (Singapore, Kuala Lumpur, Bangkok, Jakarta and Manila stock markets) affect one another.

There are some studies that concentrate on linkages among Asian markets (Pan et al, 1999 and Dekker et al 2001) and very limited studies on the effects of the 1997 crisis on linkages (Hashimi and Liu, 2001). The very limited studies on this topic led to this research, which studies the effects of the 1997 crisis on linkages among stock markets. It can be concluded that it would appear that few have attempted to study the effects of the 1997 crisis on linkages between the Malaysian market and both the Asia-Pacific and Western markets.

Goetzmann, Lingfeng and Rouwenhest (2001) examined the correlation structure of the major world equity markets over 150 years. They found that correlations vary considerably through time with peaks in the late 19th Century, the Great Depression and