East Asian Equity Markets, Financial Crises, and the Japanese Currency

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Summary

Following the gradual liberalization of financial markets in the region, there has been considerable foreign interest in the East Asian equity markets. For international investors, portfolio investment in the East Asian countries represents opportunities to share the growth potential of the region and diversify their portfolios. Both academics and practitioners are interested in knowing how various equity markets interact with each other. For instance, information on market interactions helps understand diversification and improve hedging and managing portfolios that contain foreign equities.

The paper studies the interactions between the U.S. and four East Asian markets. The focus is on the change in the information structure/flow between these markets triggered by the 1997 Asian financial crisis. It is shown that the information structure during the crisis period was different from that in the non-crisis periods. The U.S. market had significant impacts on the four East Asian markets before, during, and after the crisis. On the other hand, the U.S. market responded to development in these Far East Asian markets during the financial crisis period but not in the post-crisis sample. Further, the Japanese currency is found to have affected these equity markets during the crisis period. The Japanese yen effect, however, disappeared in the post-crisis sample. The Japanese currency effect was quite robust as it was found from both local currency and U.S. dollar return data and in the presence of Japanese stock returns.

The findings corroborate the contention that financial crises endure extreme market conditions. These extreme market conditions can lead to changes in the channel via which information is incorporated and transmitted across markets. The upsurge and disappearance of the Japanese yen effect is an intriguing phenomenon. The channel and transmission mechanism with which the yen exchange rate affects the East Asian economies is an interesting future research area. The documented changes in the interaction patterns between these equity markets suggest that different investment strategies should be pursued under different market conditions. Further, if changes are not allowed for, the use of long sample data may yield obscure and even erroneous information on market interactions.