Enter the Dragon: Interactions between Chinese, US and Asia-Pacific Equity Markets, 1995-2010

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Summary

Not very long ago developments in most Asian markets other than Japan were little more than an afterthought to western observers. The People's Republic of China did not even have operating stock markets until 1992 and most other Asian exchanges seemingly remained too limited in size to exert any meaningful influences on the United States or other major western financial centers. The 1997-1998 Asian financial crisis brought home how interconnected the world had become. The integration of mainland China's financial markets with other world markets remains very much an open question. This paper seeks to shed new light on the degree of Asia-Pacific financial market integration, and the actual extent to which Shanghai has become more linked with other markets, by examining short-run and long-run relationships between stock returns. Previous work has generally not offered a comprehensive examination of the group of Asia-Pacific markets nor included data extending through the onset of the global financial crisis. Our econometric analysis confirms the importance of shifts in market behaviour during crisis periods while also suggesting that the evidence for contagion-type effects remains very much dependent on which market group one examines. For example, there is virtually no evidence of contagion between the benchmark markets of the United States and Japan and the more mature regional markets such as Australia, Hong Kong and Korea. The Shanghai market plays a significant role in influencing many other regional markets over our 1995-2010 sample period, with its growing influence clearly evident in the sharply rising conditional correlation of returns around the outbreak of global financial crisis in 2007 – just as the US market's relationship with the Asia-Pacific equity markets falls off. Our empirical work confirms the importance of crises in affecting the persistence of equity returns in the Asia-Pacific region but yields only limited support for contagion effects. Our tests for long-run cointegrating relationships utilize a post-Asian financial crisis sample of 1999-2010 and employ quantile regression techniques to allow for variation over the spectrum of the return distributions. We find substantial evidence of integration of the Shanghai market with the US market and many other regional exchanges. Cointegration is particularly prevalent at the higher end of the distribution. Our results suggest that the enormous growth of the Shanghai market in the new millennium has indeed been accompanied a meaningful level of integration with other regional and world markets in spite of the capital controls that continue to be imposed by the Chinese government. It will be interesting to see if subsequent data confirm whether this apparent move away from US leadership is just a temporary phenomenon or is signaling a more enduring shift in the pole of influence.