

The Impact of Evolving Market Integration on APEC Emerging Stock Markets' World Betas

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Abstract

This paper, based on the international capital asset pricing model estimated using the Kalman filter technique, examines the relationship between market integration and the systematic risk of APEC emerging stock markets with respect to the world portfolio. We find strong evidence that local and regional integrations have effects on systematic risk and hence on returns, and certain evidence of the direct effects of market integrations on returns. Our results documented for individual markets show a heterogeneous pattern across the APEC region, implying that a one-rule-fits-all regulation policy would hurt some countries while assisting others.

Statement of Relationship to Practice

The findings of this study provide information that is of practical relevance to APEC policymakers in terms of forming regulation policies on equity market liberalization in the region, and useful guides to international investors in practice who may wish to invest in, for example, "investable assets" of APEC emerging equity markets.

JEL Classification: F3; G12; G15

Keywords: APEC emerging markets; market integration; I-CAPM; Kalman filter

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1. Introduction

One strategic objective of the APEC Finance Ministers' Process, agreed by all APEC members, is to maintain high rates of economic growth as well as financial and social stability, while upgrading the capacity of financial systems in APEC economies to meet the growing financial service demands of increasingly diversified economies. A number of key challenges that are relevant to many APEC economies include, among other things, policy measures to address volatile capital flows, as the continued large cross-border financial flows are a key element of the financial scene nowadays in APEC member economies.¹

Motivated by such a strategic need of the APEC economic/financial policymakers, this paper assesses empirically the impacts of stock market integration on the beta risk of a national stock market relative to the world market portfolio for eleven APEC emerging economies. These economies started to open up stock markets to foreign investors in the late 1980s or the early 1990s, as an important component of their overall liberalization policies. Such policies have facilitated integrating their economies to the world economy and increasing the efficiency and growth opportunities of their domestic markets on the one hand, but might also have brought about certain risks on the other.

Theory suggests that, if a country's equity market is completely segmented from the world market due to various restrictions on foreign investment, its cost of equity capital will depend only on local (idiosyncratic) risk. After a country's market has become fully integrated with the world market, however, its cost of equity capital is directly proportional to the world beta (systematic) risk. Many emerging markets in the APEC (Asia-Pacific Economic Cooperation) region are still in transition between the two extremes. This implies that their costs of equity capital may depend increasingly on world beta risk. Changes in risk partly determine changes in the cost of equity capital, and thus may affect cross-the-board financial flows to and among the APEC member economies. This paper examines the changing behavior of the

¹ <http://www.afdp.org/asp/web/html101/default.asp>.

