

EFFECT OF S&P500'S RETURN ON EMERGING MARKETS: TURKISH EXPERIENCE

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Abstract: This paper assesses the effect of S&P500 return on the Istanbul Stock Exchange within a dynamic framework. In order to capture the effect, we build a block recursive VAR model allowing that S&P500 affects the ISE returns with its current and lag values but not vice versa. The estimates from daily data suggest that returns on S&P500 affect ISE return positively up to 4 days.

Key words: Emerging Markets, Stock Markets, Block Recursive VAR.

JEL codes: G15, N20 and F02

1. Introduction

World economies and financial markets are becoming increasingly interconnected in today's world. The globalization process helps to speed up this interconnection. Therefore, analysis of this interrelation becomes important for both portfolio managers and academics in the global era. In order to see the importance of interconnection in financial markets, we examined the relationship between the US stock market and the Turkish stock market using daily data for the period from 1987 to 2004. We used the S&P500 index and the ISE100 index for the US and Turkish stock markets, respectively. Our model incorporates the assumption that returns on S&P500 affect the return on ISE100 but not vice versa. In order to incorporate and capture the dynamic relationship among prospective returns, we used a block recursive VAR as in Zha (1999). We found that an innovation in the S&P500 return increases the ISE100 return for up to 4 days in a statistically significant fashion.

Research on the interaction between global stock markets and US stock markets provides various results. Eun and Shim (1989) found that US equity markets affect world markets. They argued that the US is the most dominant market in the world. Tokic (2003) found a long run relationship between the US and five markets; Australia, Japan, Hong Kong, New Zealand and Singapore. According to Cheung and Mak (1992), Liu and Pan (1997), Wu and Su (1998), both US and Japanese stock markets affect Asian countries. Cha and Oh (2000) reported that Japanese and US markets affect Hong Kong, Korea, Singapore and Taiwan. Gilmore and Mcmannus (2002) found a correlation between the US and three central European markets: the Czech Republic, Hungary and Poland. Kasa (1992) and Arshanapalli and Doukas (1993) found bivariate co-integration of European Markets and the US. Seweel (1996) provided varying degrees of integration between Pacific Rim equity markets and the US. Ghosh (1999) found that the US shares a long run equilibrium relationship with Hong Kong, India, Korea and Malaysia. Some studies also elaborate on the time-varying nature of the US and other stock markets. Eun and Shim (1989) and Arshanapalli and Doukas (1993) reported that US and global financial markets have stronger correlation, especially after the October 1987 collapse in US financial markets. Although relationships between the US and other stock markets were found in the research mentioned above, some studies are opposed to the idea of

interaction between stock markets. Ghosh (1999) could not find any effect of the US and Japan on the stock markets of Taiwan and Thailand. Byers and Peel (1993) and Kanas (1998) found no linkage between US and European markets, constituted by both developed and emerging markets. Felix (1998) found no long run co-movement between the US and a number of emerging markets.

The research cited above examines relationships between stock markets, including those of emerging markets, using two alternative approaches: Co-integration tests and Vector Autoregressive (VAR) models. Co-integration tests capture any long run relationships among the stock markets but these tests do not allow for short-term interaction. However, the VAR technique allows dynamic interactions among markets. In this paper, we use the VAR model in order to assess short-term correlations and capture dynamic interaction.

While correlation between US stock markets and a number of emerging markets had not been found in many studies, assessing any correlation between US stock markets and stock market of Turkey is a worthwhile exercise. Turkey is distinct from other liberalized emerging markets in important aspects. Turkey has been liberalizing her economy since the early 1980s. Although never experiencing hyperinflation, as some Latin American economies, Turkey has had persistent inflation at considerably high and varying levels for about three decades because of the unstable political and social environment. The importance of the stock market in the overall economic activity grows, as indicated by the rise in stock market capitalization from 12.6 percent of the GDP in 1990 to 34.8 percent in 2000. These features distinguish the Turkish stock market from the emerging markets that constitute the foundation of the research mentioned above.

The outline of this paper is as follows; the second section elaborates on the methodology and provides the empirical evidence. Finally, the paper is concluded in the last section.

2. Methodology

A model, similar to the structural vector autoregressive (SVAR) model proposed by Cushman and Zha (1997), is used to examine the effect of a large economy's stock exchange movement on a small economy's stock exchange movement. The foreign stock

exchange index follows its own dynamics (an AR process is used as a proxy). Turkish stock exchange movements are affected by its own lag and movements of the foreign stock exchange. Therefore, the foreign stock exchange can be thought to have an exogenous affect on the Turkish stock exchange. None of the lag variables of the Turkish stock exchange determine foreign stock exchange; however, lag values and spot values of the foreign stock exchange affect Turkish stock exchange movement.

The VAR model has some advantages relative to the single equation model since the VAR model allows dynamic interactions among variables and the VAR model has predictive power compared to the single equation model. We also use VAR with block exogeneity since in conventional VAR; stock exchange movements of foreign markets are affected by domestic stock exchanges including lag values. By block exogeneity, we overcome this problem.

The general specification of the identified VAR model of Cushman and Zha (1997) is;

$$A(L)y(t) = \varepsilon(t) \quad (1)$$

in which, the $A(L)$ is an $m \times m$ matrix polynomial in the lag operator L , $y(t)$ is the $m \times 1$ observations vector, and $\varepsilon(t)$ is the $m \times 1$ vector of structural disturbances. Equation 2 shows the specification of the model.

$$y(t) = \begin{bmatrix} y_1(t) \\ y_2(t) \end{bmatrix}, \quad A(L) = \begin{bmatrix} A_{11}(L) & 0 \\ A_{21}(L) & A_{22}(L) \end{bmatrix}, \quad \varepsilon(t) = \begin{bmatrix} \varepsilon_1(t) \\ \varepsilon_2(t) \end{bmatrix}. \quad (2)$$

In Equation 2, we assume that $\varepsilon(t)$ is uncorrelated with $y(t-j)$ for $j > 0$ and $A(0)$ is non-singular. Block exogeneity is represented by $A_{12}(L)$ in the matrix, which is zero. This means that $y_1(t)$ is exogenous to the second block both simultaneously and also for lagged values. To calculate the standard errors of the impulse response functions, we used the modified error bands of Bernanke, Hall, Leeper, Sims and Zha (1996) for the maximum likelihood estimation (MLE)¹

The observation matrices are such that $y_1 = [Foreign Stock Exchange]$, $y_2 = [Domestic Stock Exchange]$ and the lag order of the identified VAR model is 5 as

¹ See Sims (1986) and Gordon and Leeper (1994).

suggested by Bayesian information criteria. All error bands in this paper were generated with 5000 Monto Carlo draws.

The period, starting from the establishment of the Istanbul Stock Exchange on 23.10.1987 to 08.06.2004, has many interruptions, so various sub periods have been considered for the analysis. The major break periods were the financial crisis in April 1994; the beginning of the disinflation program in December 1999; the financial crises in November 2000 and in February 2001; the September 11 2001 terrorist attack on the twin towers in the US, which also affected the ISE; the memorandum crisis in the Turkish Parliament, when logistic support for the USA in war with Iraq was refused in February 2003.

The corresponding impulse responses are reported in the figures. Figure 1 reports the impulse response functions for 20 days regarding how the ISE100 returns responded to a one-standard deviation shock to S&P500 returns by considering the full sample period. The middle line is for impulse responses and the other two lines are for the confidence bonds at 90% level of confidence bonds. It is important to recognize that a shock to the S&P500 does not affect the ISE100 return contemporaneously. The main reason for this is that when the NYSE closes, it is the beginning of the next day in the ISE (the time difference between Istanbul and New York being 7 hours). However, a positive shock on the S&P500 index causes a change on the ISE100 for 6 days and also causes an increase in the ISE100 index for 2.5 days in a statistically significant manner.

Figures 2 to 7 report the impulse responses for different sub samples. Except for the period between 01.01.2002 to 28.02.2003, a statistically significant effect of the S&P500 returns on the ISE100 returns is observed. It is not surprising that the adaptation of the new government and their struggle with the memorandum to give logistic support to the USA for the war in Iraq caused uncertainty in the Turkish market, so the effect of the S&P500 on the ISE100 was not observed in that period. In general, for all sub-samples, except for Figure 6, a one standard deviation shock to the S&P500 caused an increase in the ISE100 returns in a significant manner. However, the effect of the shock continued for 16 days at most as shown in Figure 5.

Figure 1: response of the ISE100 to the S&P500 for the full sample

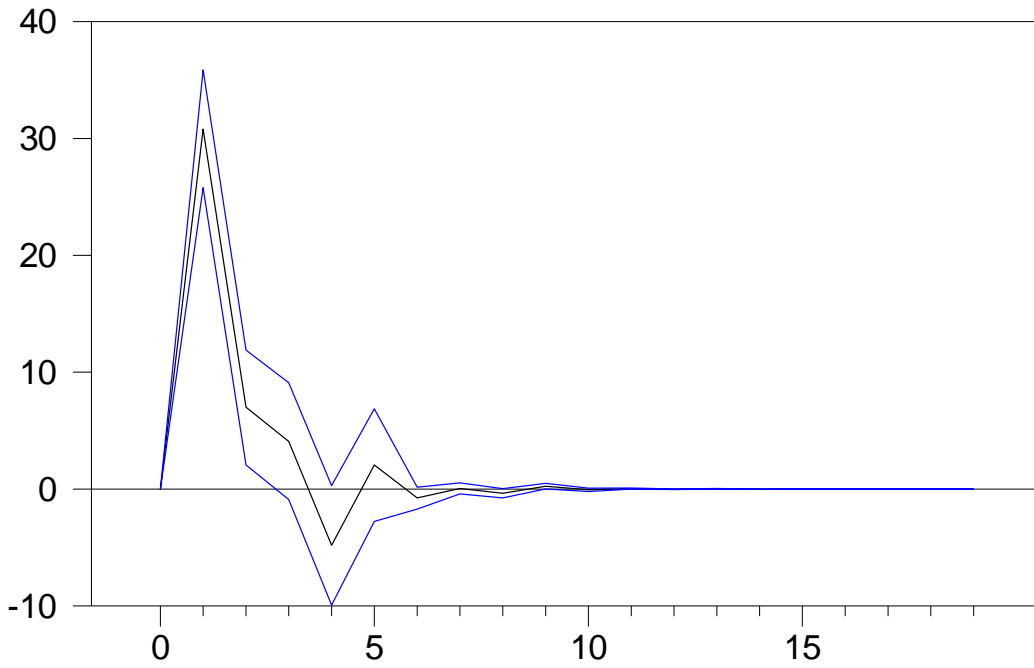


Figure 2: Response of the ISE100 to the S&P500 from 23.10.1987 to 1.12.1993

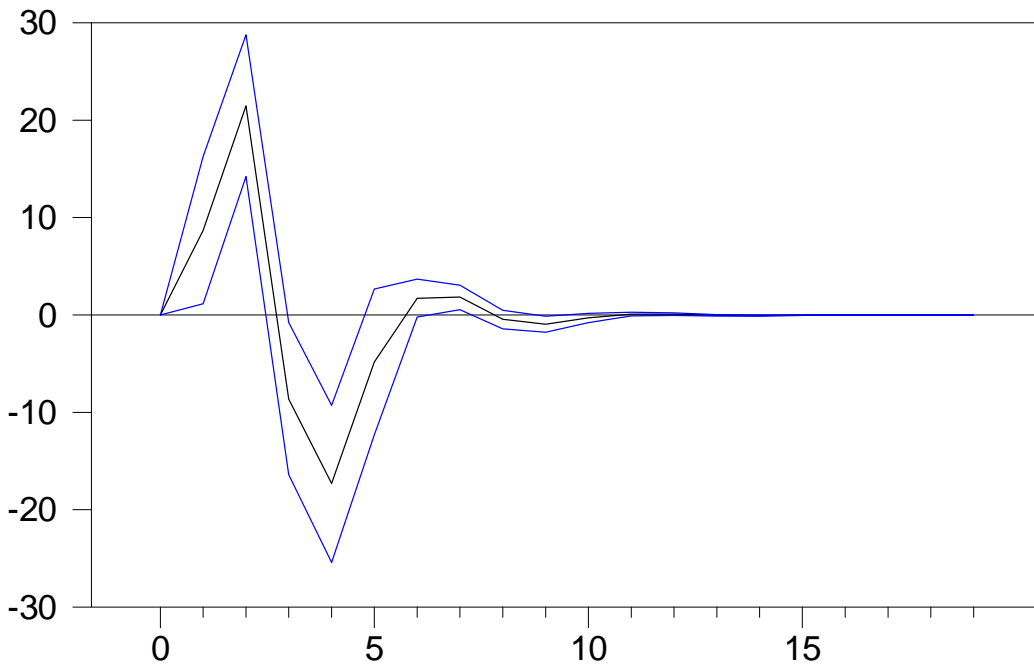


Figure 3: Response of the ISE100 to the S&P500 from 01.06.1994 to 01.12.1999

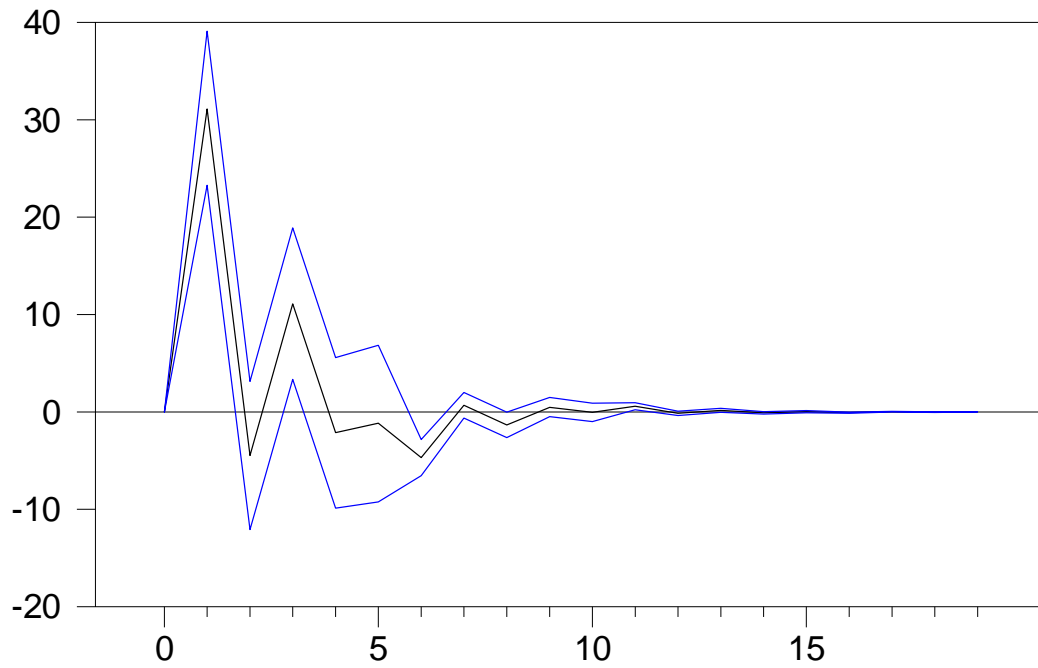


Figure 4: Response of the ISE100 to the S&P500 from 01.01.2000 to 01.11.2000

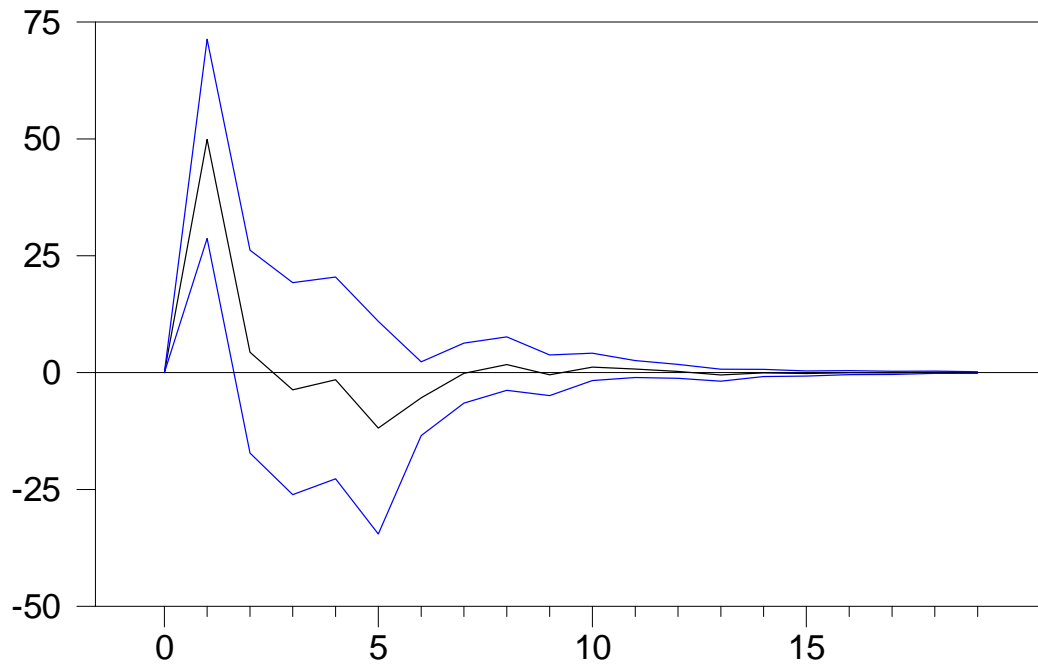


Figure 5: Response of the ISE100 to the S&P500 from 13.03.2001 to 10.09.2001

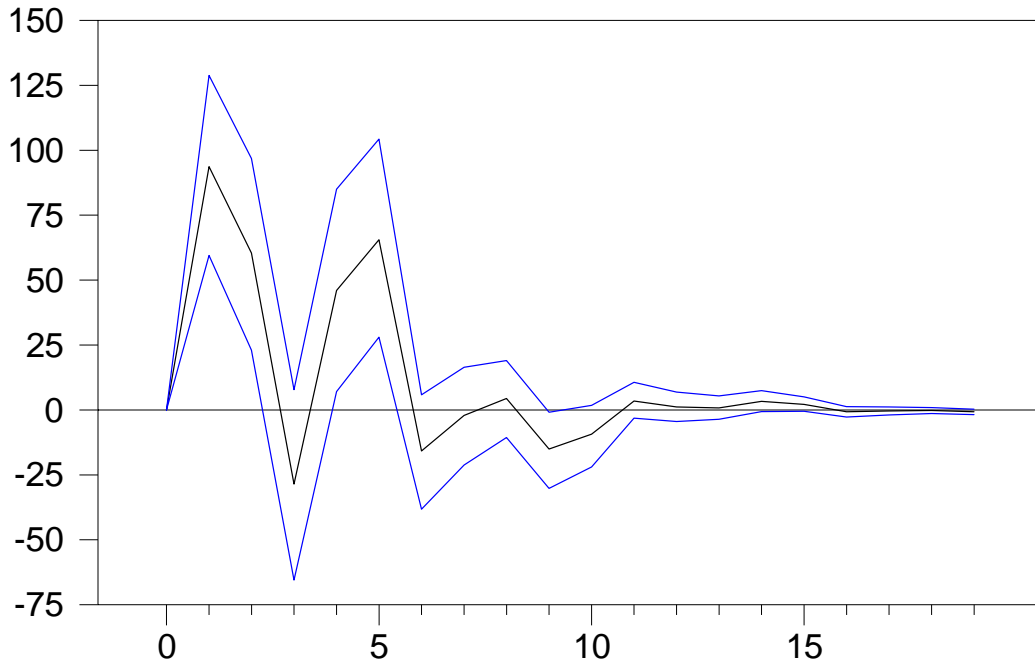


Figure 6: Response of the ISE100 to the S&P500 from 01.01.2002 to 28.02.2003

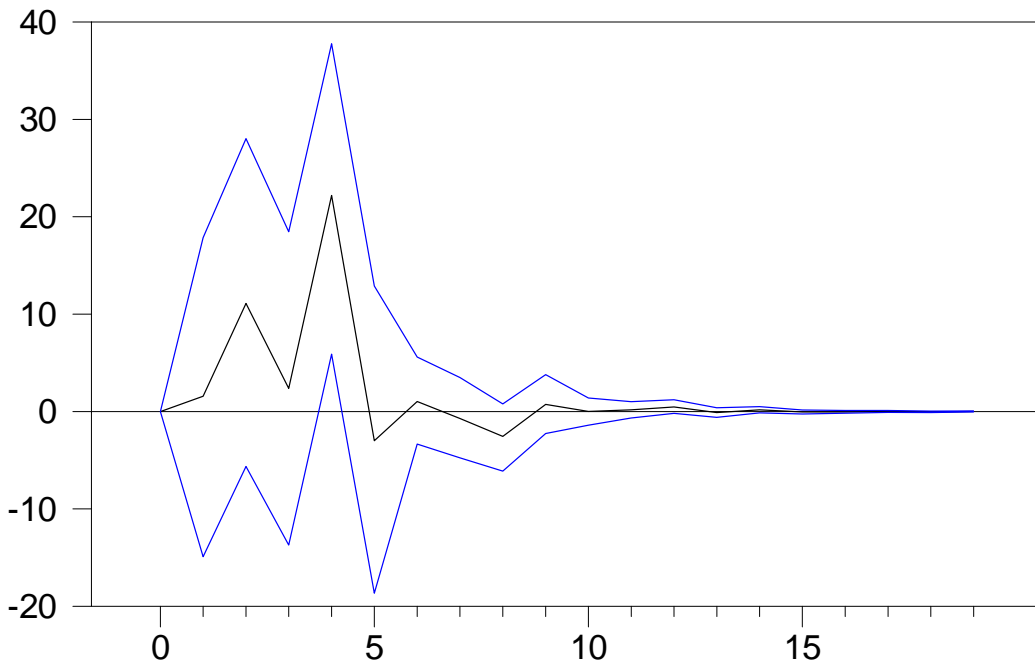
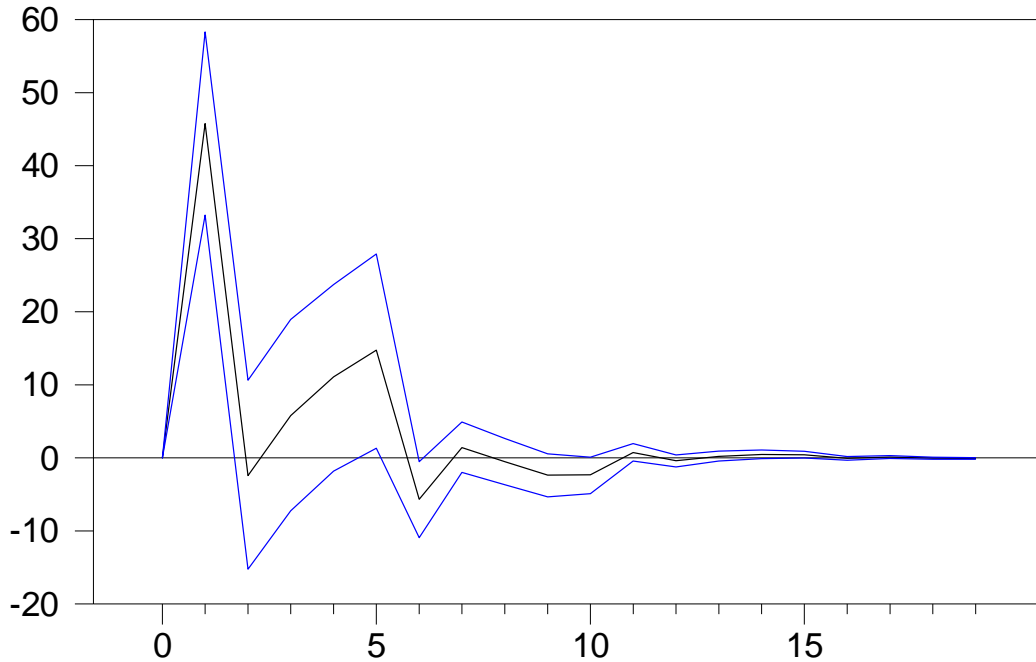


Figure 7: Response of the ISE100 to the S&P500 from 01.05.2003 to 08.06.2004



3. Conclusion

Interactions among stock markets, increasing with globalization process, encourage economists to assess whether any relationships exist. In this paper, we examine the effect of US stock exchange performance on the Turkish stock exchange. We use the S&P500 index for the US stock exchange and the ISE100 index for the Turkish stock exchange. We assume that US stock exchange performance is not affected by Turkish stock market; however, the Turkish stock exchange is affected by both its own dynamics and the US stock exchange. We reflect this assumption in our specification by using the Block recursive VAR model.

Our sample includes the daily observations from 23.10.1987 to 08.06.2004 and we found that a positive shock to the US stock exchange increases the Turkish stock exchange in a statistically significant manner. The sample period is a long period for both US and Turkish markets, so we divided the period into 6 sub-samples. We again found a statistically significant relationship between US and Turkish stock exchanges in our sub-samples except for the period 01.01.2002 to 28.02.2003, which corresponds to the process of adaptation of new Turkish government and memorandum proposal which ended in the refusal of logistic support to United States in the war with Iraq.

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