The Co-Movements of the Regional Stock Markets and Some Implications on Risk Diversification

*Maran Marimuthu**

As risk diversification is the main concern for most investors, they tend to look into the possibility of broadening their investment activities across the countries or creating a region-based investment policy. This requires the understanding of regional and global linkages of stock markets. Specifically, this study makes an attempt to re-examine the co-movements among the Malaysian, Indian and Chinese equity markets. This study also includes the stock market linkages between Malaysia and the developed markets (the US and the UK) for a more meaningful argument with regard to the importance of market linkages among Malaysia, India and China. Statistical testing includes Johansen multivariate cointegration, Vector Error Correction Model (VECM) to a five-variable model, followed by Granger causality test. The results indicate that there is a long-run relationship among the regional markets. Malaysia and India Granger cause each other, however, this study is unable to detect China's role in the regional market. In fact, in the Asian context, shocks in one country seem to have an effect in other countries for a very short period. Finally, the US market is still the main influential factor in the Asian markets.

Introduction

The understanding of the market linkages among the international financial markets is especially important for investors be it for regional or global investment decisions. However, studies on market linkages tend to become more prevalent only when a specific region experiences a 'shock'. Undoubtedly, the Asian region is vulnerable to 'shocks' (i.e., financial crisis) and as crisis is contagious, there is a need to understand the interdependency of its financial markets in order to get rid of the financial turmoil. It is to be noted that the Asian Financial Crisis began with the collapse of the Thai baht in July 1997 and further erosion in Hong Kong and other Asian markets in October 1997, and as a result, the co-movement among the Asian financial markets increased. Besides that, Ghosh *et al.* (1999) found that the volatility and co-movement of financial markets increased several months after the financial crisis. Choudhry (2001) indicated that stock returns of Asian stock markets could be predicted for the long run. Poon and Lin (2001) in their extensive work on 12 stock markets, noted that stock markets' downturn could reduce the benefits of international diversification. Chaterjee and Maniam (2003) argued that significant correlation among the Asian markets may not be felt, especially in the presence of

* Faculty of Accountancy and Management, Department of Economics, Tunku Abdul Rahman University, Bandar Sungai Long Campus, Lot PT 21144, Jalan Sungai Long, Bandar Sg Long, Cheras, 43000 Kajang Selangor DE, Malaysia. E-mail: maran@utar.edu.my