



Financial markets of the LAC region: Does the crisis influence the financial integration?

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ARTICLE INFO

JEL classification:

C58
G10
G11
G12
G14
G15
F30

Keywords:

Financial integration
Emerging markets
Long memory
Risk diversification

ABSTRACT

This paper aims to analyse financial integration in the emerging markets of Latin America in the context of the dot-com and subprime financial crises. To do so, different approaches were adopted to answer two questions, namely: (i) the financial markets of Latin America show significant levels of integration in periods of financial crisis? and (ii) if there are persistent long memories in the data series, will portfolio risk diversification be called into question? The results obtained suggest that the markets are partially integrated in crisis and non-crisis periods. In addition, financial series do not present significant persistent long memories arising from the subprime crisis. The 2008 crisis was found to have a greater impact on the cross correlation coefficients of the Latin American stock markets than the dot-com crisis. In terms of conclusion, it is considered that the financial markets of Latin America were affected by the dot-com and subprime crises. However, there was a re-balance in these regional markets which could create conditions for possible diversification strategies.

1. Introduction

Financial instability is a very important factor for society, since a financial crisis or a stock market crash can affect, directly or indirectly, the level of economic well-being of a country's inhabitants. If a given stock market is closely linked to that of another country's, the financial stability of the former depends partly on the latter's financial stability. For that reason, a close or strong connection between markets increases the levels of vulnerability to external shocks, and consequently influences the respective countries' economic conditions and levels of well-being. The occurrence of integration between markets can have relevant implications in terms of international risk diversification (Jouini, Majdoub, & Bouhouch, 2013).

In the field of stock market integration, investors generally seek to include in their portfolios assets with lower levels of correlation to promote effective diversification strategies. In the same context, Grubel (1968) and Levy and Sarnat (1970) argue that investment in international stock markets is grounded on the fact that the correlation between assets is less than that found in domestic assets. So the low correlation between international stock markets is a key factor for portfolio diversification.

The integration of financial markets between developed countries

has registered significant increases. Given this situation, investors have examined stock markets expecting correlations between developed markets and emerging markets to be low. Driessen and Laeven (2007) and Chang, Chen, Chi, and Young (2008) analysed the risk diversification strategies adopted by international investors in emerging stock markets due to these presenting lower levels of integration than developed markets.

In recent decades, the phenomenon of globalization has demonstrated that the correlation between international financial markets has increased, particularly between developed markets. Forbes and Rigobon (2002) suggest that the links between international stock markets can be strong in calm periods, as well as in crisis periods, which can make risk diversification difficult.

The connections between stock markets can prevent investors' diversification strategies, particularly in periods of great instability such as the stock market crash of 1987, the Asian financial crisis of 1997, the technological firm crisis of 2000, and recently, the financial crisis of 2007–2009.

The main goal of this research work is to analyse the level of financial integration in the emerging markets of Latin America, in the context of the technological firm and subprime financial crises. Understanding the integration relationships between international

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