Issue Notes
Financial Markets of Emerging Economies
Part I: Do Foreign Investors Contribute to their Volatility?
Part II: Is there Contagion from Mature Markets?

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Part I
Financial Markets of Emerging Economies:
Do Foreign Investors Contribute to their Volatility?

Among the foreign investors mainly institutions are active traders in emerging stock markets. They use these markets to diversify portfolios. International portfolio diversification implies a reduction of risk for investors and is undertaken via active or passive portfolio investment strategies. After the Asian crises in 1997, the so-called Asian "flu", a debate started about the role of foreign investors in emerging capital markets. Following the argumentation of political leaders and journalists foreign investors exert a destabilizing influence on emerging capital markets and are partly responsible for the collapse of currencies and stock markets. Emerging countries are more vulnerable to extreme fluctuations in international capital flows relative to mature markets and, therefore, greater regulation of capital flows to emerging markets than before is needed to keep the benefits from opening capital markets to foreign investors.

Herding and positive feedback trading are the main reasons for the destabilizing investment behavior induced by foreign institutional investors. However, herding and positive feedback trading do not necessarily destabilize stock prices and institutions may have an informational advantage relative to individual investors. The available evidence for Korea before and during Asian crisis in 1997 supports the hypothesis of herding and positive feedback trading investment behavior. Moreover, no convincing evidence can be found that foreign investors play a destabilizing role in the Korean stock market before and during the crisis.

Part II
Financial Markets of Emerging Economies:
Is there Contagion from Mature Markets?

An important phenomenon of financial markets is the transmission of large stock market shocks from a crisis country to other countries. The spillover of a large drop of stock returns to another stock market can be described as interdependence or contagion. While contagion requires a change in the structure of stock market linkages, interdependence is given by a non-significant change in cross-market linkages. Contagion is an excessive transmission of shocks from one crisis stock market to others, beyond fundamental financial links which constitute interdependence.

One implication of the above contagion definition is that the evidence based on correlation coefficients is not valid. Simple correlation coefficients rise automatically during crises due to higher volatility. Hence, a rise in correlation does not necessarily imply contagion as defined above and the use of volatility adjusted correlation coefficients is needed. The available empirical findings show that correlations between stock returns increase in periods of market turbulence due to higher volatility but true correlations remain constant. Consequently, financial markets linkages can be characterized as interdependence but not contagion. This result holds also for emerging markets including Asian stock markets. In this sense emerging capital markets are not more vulnerable to external shocks than mature stock markets.