Chapter 9
Globalization of Stock Market, Economic Growth, and Geopolitical Risk:
Evidence From Brazil

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ABSTRACT

Although the significance of the foreign investors constructing the significant magnitude of GDP increases for the emerging markets, their equity markets' attractiveness is affected by their vulnerability to geopolitical risk. The purpose of this study is to empirically investigate the effect of the stock market globalization on the correlation between economic growth and geopolitical risk in Brazil. After the dynamic correlation between economic growth and the geopolitical risk in Brazil is obtained by DCC-GARCH(1,1) methodology, the nonlinear autoregressive distributed lag (NARDL) model is employed to examine the asymmetric relationship among variables. The findings demonstrate while the changes in the globalization of the stock market decrease the connection between economic growth and geopolitical risk in the long-run, the positive changes in the participation of foreign investors make economic growth and geopolitical risk more connected the in short-run. Moreover, this impact is asymmetric. This chapter provides valuable implications for international investors and policymakers.

INTRODUCTION

The free movement of capital around the world forms the primary factor of globalization. While the magnitude and the importance of the capital's cross-border flows enhanced rapidly in past few decades, the importance of the foreign capital got even higher for emerging markets as foreign investment constitutes a significant portion of their GDP (Lane and Milesi-Ferretti, 2007; Stulz, 1999). In the last fifty years,

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emerging markets have become substantially more reachable for international investors, allowing companies to choose their preferred market for funding. By finance researchers, this feature of globalization is considered beneficial to both investors and firms (Stulz, 1999). On the other hand, emerging markets' geopolitical risk (GPR) is higher than the developed one's, affecting foreign equity investments negatively (Stulz, 1999). The availability of cross-border investment leads to information asymmetry between domestic and foreign investors, causing reduction in foreign equity investments in case of uncertainty triggered by the political risks (Cooper and Kaplanis, 1994; Stulz, 1999). Caldara and Iacoviello (2018) state that geopolitical risks influence business cycles and global financial markets, therefore they are considered one of the most important elements of investment decisions of central bankers, firm managers, and financial media. Especially, for countries that have a greater geopolitical risk, the impacts of GPR on the investment decisions and financial markets are even more critical (Bouri et al., 2018), also influencing the overall economy and affecting macroeconomic variables like GDP growth negatively. Moreover, the effects of geopolitical risks on the macroeconomic indicators and financial markets vary among countries depending on the regulatory environment and transparency of a country (see Stulz, 1999). In this chapter, we aim to contribute to the extant literature by demonstrating the effect of stock market globalization on the dynamic correlation between economic growth and geopolitical risk in Brazil.

In this study, the foreign holdings of domestic stocks in Brazil are employed as a proxy for stock market globalization. DCC-GARCH(1,1) methodology is utilized to get the dynamic correlation between economic growth and geopolitical risk index for Brazil. Then, in order to examine the asymmetric relationship and cointegrating link between this dynamic correlation and foreign stock holdings, nonlinear autoregressive distributed lag (NARDL) approach is employed. This approach let us to separate the long and short run impacts of the explanatory variables, and to find the asymmetric relationship (Shin et al., 2014). Share price index is also included in the model in order to avoid biased inferences.

The contribution of this study is mainly two folds. First, although the relationship between GPR and economic growth has been examined extensively in the literature, the impact of stock market globalization on this relationship has not been analyzed so far. On one hand, some studies assert that political uncertainty enhances economic growth as it reduces private investment which leads the government to increase expenditure on public investment (Bui, 2018). On the other hand, ample literature demonstrates that political instability influences economic growth negatively by affecting investments and savings negatively (Barro, 1991; Mauro, 1995; Alesina et al., 1996; Jong-a-Pin, 2009). So, there is no consensus on the literature about the relationship between economic growth and GPR. Our chapter sheds more light on this debate by analyzing whether the stock market globalization influences the relationship between economic growth and geopolitical uncertainty in Brazil.

Secondly, this chapter contributes to the literature by demonstrating, the asymmetric impact of the correlation between economic growth and GPR on the stock market globalization. As the influences of geopolitical risk on economic growth and financial markets change among countries depending on the regulatory environment and transparency of a country, changes in the correlation between economic growth and GPR is expected to affect foreign investors investment decisions by signaling the soundness of the economy in that country (see Stulz, 1999). By employing NARDL approach, we intend to show the asymmetric impacts of the increases and decreases in the dynamic correlation between GPR and economic growth on the stock market globalization.

This chapter is structured as follows. Section two explains the variables and methodology, while the third section, empirical findings are stated. The last section concludes the chapter.