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THE EFFECTS OF THE SUBPRIME CRISIS ON THE LATIN AMERICAN FINANCIAL MARKETS: AN EMPIRICAL ASSESSMENT

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NON-TECHNICAL SUMMARY

The aim of this paper is to answer the following question: can the considerable rise in the volatility of the Latin American countries' (LAC) equity markets in the aftermath of the 2007/2008 crisis be explained by the worsening financial environment in the US markets? While it may be thought obvious at first sight, the answer to this question is not straightforward. Indeed, some countries experienced a situation of financial decoupling with respect to the US markets, while others seem to have been strongly affected. More specifically, due to the disastrous consequences of the financial crises they faced during the decades of 1990 and 2000, LAC's policymakers adopted measures aiming at insulating their markets from external shocks. Firstly, they adopted macroeconomic policies to avoid future crises due to flawed fundamentals. Secondly, there was a passionate debate among the policymakers regarding the opportunity of adopting measures such as capital controls as a management tool in times of crises. Mexico and Argentina opted for a total liberalization, while Brazil, Chile and Colombia chose to adopt capital controls during the years preceding the 2007 crisis. The question of financial decoupling is still a debated issue in Latin America.

The modeling strategy adopted is based on regime-switching volatility models, and aims at investigating whether a financial stress in the US markets increases the likelihood of a financial turbulence in the LAC markets. Compared to the previous ones, the time-varying probability Markov-switching model has the advantage of being helpful in investigating whether the impact of the financial stress indicators is nonlinear, with an influence differing between crisis and non-crisis episodes. Crisis and non-crisis regimes are identified endogenously, and the switch from one regime to the other can happen at any time. In other words, contrasting with structural break models, the time of the changes is not forced *a priori*, and we do not separate, *ex ante*, the sample into two parts with respect to a given time.

Considering daily data from January 2004 to April 2009, we find that financial stress was unequally transmitted from the US market to the various LAC's equity market volatility: Mexico and Chili are the countries for which the interdependencies with the United States are the most important, while Brazil, Colombia and Peru seem to be more sensitive to the volatility of the regional financial markets. Moreover, the transmission mechanism is evidenced to be nonlinear since the pass-through in the crisis regime is stronger than in the calm period expanding from 2004 to 2006.

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