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A Joint Test of Market Segmentation and Exchange Risk Factor in International Capital Market

| Article | Published: 01 March 1997

| Volume 28, pages 29–49, (1997) [Cite this article](#)



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Abstract

Market segmentation and exchange risk are two main factors that distinguish international financing and investment decisions from domestic ones. Existing studies of market segmentation have been conducted within a framework in which exchange risk is not explicitly recognized. This paper performs a joint test of market segmentation and exchange risk pricing based on individual stock data from seven major countries, outside of the U.S., for the period January 1981 to December 1989. The theoretical framework used is a multifactor model with domestic and world market factors and an exchange risk factor. The maximum likelihood method is used to estimate risk premia, and factor analysis is used to provide additional evidence on the pricing of risk factors. The results indicate that

(a) the factor structure of asset returns is internationally heterogeneous, (b) many national capital markets can be described as partially segmented, rather than the polar cases of complete segmentation or integration, and (c) exchange risk is a significant factor affecting asset returns in addition to the domestic and world market risk factors.

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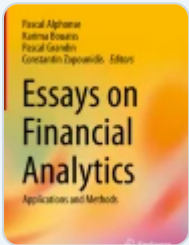
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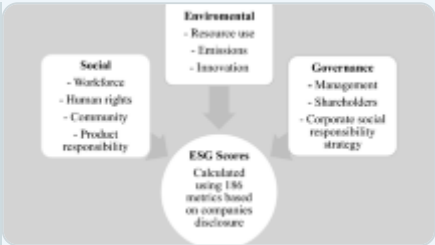
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Author information

Authors and Affiliations

Temple University,

Jongmoo Jay Choi

University of Scranton,

Murli Rajan

Additional information

*Jongmoo Jay Choi is Professor of Finance and International Business at Temple University. He has a Ph.D. from NYU and was formerly an Economist at Chase Manhattan Bank. He has published widely in international corporate finance and investment, exchange risk management. and international capital markets.

**Murli Rajan is Associate Professor of Finance at University of Scranton. He holds a Ph.D. from Temple University and is a CFA. His current research interests are in investments and international finance.

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Cite this article

Choi, J., Rajan, M. A Joint Test of Market Segmentation and Exchange Risk Factor in International Capital Market. *J Int Bus Stud* **28**, 29–49 (1997). <https://doi.org/10.1057/palgrave.jibs.8490092>

Received

01 August 1995

Published

01 March 1997

Revised

01 December 1996

Issue Date

01 March 1997

Accepted

01 December 1996

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