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Dynamic Effects of Currency Depreciation on Stock Market Returns during the Asian Financial Crisis

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Abstract

The current international integration of financial markets provides a channel for currency depreciation to affect stock prices. Moreover, the recent financial crisis in Asia with its accompanying exchange rate volatility affords a case study to examine that channel. This paper applies a bivariate GARCH-M model of the reduced form of stock market returns to investigate empirically the effects of daily currency depreciation on stock market returns for five newly emerging East Asian stock markets during the Asian financial crisis. The evidence shows that the conditional variances of stock market returns and depreciation rates exhibit time-varying characteristics for all countries. Domestic currency depreciation and its uncertainty adversely affects stock market returns across countries. The significant effects of foreign exchange market events on stock market returns suggest that international fund managers who invest in the newly emerging East Asian stock markets must evaluate the value and stability of the domestic currency as a part of their stock market investment decisions.

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