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Are Financial Crises Indeed 'Crises?' Evidence from the Emerging ADR Market

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Posted: 23 Jun 2004

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Date Written: March 1, 2004

Abstract


The recent episodes of financial turmoil in Mexico, East Asia, Russia, Brazil, and Argentina are often dubbed financial crises. However, the severe downturns in equity markets, abrupt currency devaluations, and massive capital flight that characterize these events can still be deemed compatible with efficient and functioning financial markets. Thus, why is a financial crisis a "crisis?" To answer this question, we conduct an empirical investigation of the efficiency and pricing of the emerging ADR market. More specifically, using a non-parametric technique, we test for regime shifts in two basic structural relationships for ADR returns in 20 emerging countries, identified via arbitrage and capital mobility considerations. We find that "normal" market conditions were violated in proximity of financial crises: The law of one price often ceased to hold, and domestic sources of risk became more important for many depositary receipts in our sample. We also find that some popular explanations for the occurrence of financial crises in emerging economies, in particular uncertainty among investors, exchange rate volatility, economic integration, and liquidity (but not financial integration, currency devaluations, or capital flight) made their equity markets less efficient as well. Based on this evidence, we can state with greater confidence that those episodes of financial turmoil were indeed "crises."

Keywords: Regime Shifts, Financial Crises, ADRs, Market Efficiency

JEL Classification: F37, G15

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