The efficiency of emerging stock markets: empirical evidence from the South Asian region

Arusha V. Cooray  
*University of Tasmania, arusha@uow.edu.au*

G. Wickramasighe  
*Victoria University*

Follow this and additional works at: https://ro.uow.edu.au/commpapers

Part of the Business Commons, Finance Commons, and the International Economics Commons

Recommended Citation

https://ro.uow.edu.au/commpapers/564
The efficiency of emerging stock markets: empirical evidence from the South Asian region

Abstract
This paper examines the efficiency in the stock markets of India, Sri Lanka, Pakistan and Bangladesh. The Augmented Dickey Fuller (ADF-1979, 1981), the Phillips-Perron (PP-1988), the Dicky-Fuller Generalized Least Square (DF-GLS-1996) and Elliot-Rothenberg-Stock (ERS – 1996) tests are used to examine weak form stock market efficiency. Weak form efficiency is supported by the classical unit root tests. However, it is not strongly supported for Bangladesh under the DF-GLS and ERS tests. Cointegration and Granger causality tests are used to examine semi-strong form efficiency. Semi-strong form efficiency is not supported as these tests indicate a high degree of interdependence among the South Asian stock markets. The above results have implications for domestic as well as foreign investors in South Asian stock markets.

Keywords
South Asia, India, Sri Lanka, Pakistan, Bangladesh, unit root tests, stock markets, market efficiency, impulse response analysis

Disciplines
Business | Finance | International Economics | Social and Behavioral Sciences

Publication Details
This article was originally published as Cooray, AV and Wickramasighe, G, The efficiency of emerging stock markets: empirical evidence from the South Asian region. Journal of Developing Areas, 41(1), 2007, 171-183.

This journal article is available at Research Online: https://ro.uow.edu.au/commpapers/564
THE EFFICIENCY OF EMERGING STOCK MARKETS: EMPIRICAL EVIDENCE FROM THE SOUTH ASIAN REGION

Arusha Cooray*
University of Tasmania, Australia
Guneratne Wickremasinghe*
Victoria University, Australia

ABSTRACT
This paper examines the efficiency in the stock markets of India, Sri Lanka, Pakistan and Bangladesh. The Augmented Dickey Fuller (ADF-1979, 1981), the Phillips-Perron (PP-1988), the Dicky-Fuller Generalized Least Square (DF-GLS-1996) and Elliot-Rothenberg-Stock (ERS – 1996) tests are used to examine weak form stock market efficiency. Weak form efficiency is supported by the classical unit root tests. However, it is not strongly supported for Bangladesh under the DF-GLS and ERS tests. Cointegration and Granger causality tests are used to examine semi-strong form efficiency. Semi-strong form efficiency is not supported as these tests indicate a high degree of interdependence among the South Asian stock markets. The above results have implications for domestic as well as foreign investors in South Asian stock markets.

JEL Classifications: F150, F210, G140, G150
Keywords: South Asia, India, Sri Lanka, Pakistan, Bangladesh, unit root tests, stock markets, market efficiency, impulse response analysis
Corresponding Author’s Email: arusha.cooray@utas.edu.au
Guneratne.Wickremasinghe@vu.edu.au

INTRODUCTION
The purpose of this study is to examine the efficiency of the post-deregulation stock markets of South Asia. Stock market efficiency has important implications for investors and regulatory authorities. In such a market, the role of the regulatory authorities is limited as stocks are accurately priced. The efficient dissemination of information ensures that capital is allocated to projects that yield the highest expected return with necessary adjustment for risk. With an efficient pricing mechanism, an economy’s savings and investment are allocated efficiently. Hence, an efficient stock market provides no opportunities to engage in profitable trading activities on a continuous basis. If on the other hand, a market is not efficient, the regulatory authorities can take necessary steps to ensure that stocks are correctly priced leading to stock market efficiency.

Research with regard to international financial markets has developed along four lines. The first relates to the integration of markets as opposed to segmented markets – Agmon (1972). The second strand deals with asset pricing models – Sölnik (1973), Grauer et al. (1973); the third examines shareholder participation in international diversification – Brewer (1981) and fourth are studies based on the efficient market hypothesis (EMH – Fama (1970)). While the Brewer study is carried out at a micro level on multinational companies and US national companies, a number of studies on the stock market have been carried out at
the macro level in relation to the EMH as defined by Fama(1970). Many of these studies are
applied studies that use Vector Autoregression, Cointegration and Error correction
methodology in order to test for market efficiency. These include the work of Phylaktis and
Ravazzolo (2005), Chen, Firth and Meng (2002), Solocha and Saidi (1995), Masih and
Masih (2004, 1999) among many others. This study examines weak’ and semi-strong’ forms
of the EMH as defined by Fama for the stock markets of Sri Lanka, India, Pakistan and
Bangladesh.

Studies of stock price behaviour for the developing economies can be found in
Magnusson and Wydick (2002), Chiang et al. (2000) and Alam et al. (1999), Narayan et al.
(2004). The results of these studies have been mixed. Magnusson and Wydick (2000) test
the random walk hypothesis for a group of African countries and find that there is greater
support for the African stock markets than for other emerging stock markets. Chian et al.
(2000) analyzing stock returns for a group of Asian economies find that most markets exhibit
an autoregressive process rejecting weak form efficiency. Alam et al. (1999) test the random
walk hypothesis for Bangladesh, Hong Kong, Sri Lanka and Taiwan. They find that all the
stock indices except the Sri Lankan stock index follow a random walk. Narayan et al.
(2004) examine the linkages between the stock markets of Bangladesh, India, Pakistan and
Sri Lanka using a Granger causality approach among the stock price indices within a
multivariate cointegration framework. They find that in the long run, stock prices in
Bangladesh, India and Sri Lanka Granger-cause stock prices in Pakistan while in the short
run there is unidirectional Granger causality running from stock prices in Pakistan to India,
stock prices in Sri Lanka to India and from stock prices in Pakistan to Sri Lanka. Bangladesh
is found to be the most exogenous of the four markets.

The South Asian economies introduced a series of reforms starting in the 1980s and
1990s - Sri Lanka in 1977. Therefore this study attempts to see if the removal of restrictions
on foreign investment has improved the pricing efficiency of stock markets in the South
Asian region. The study makes use of four unit root tests to investigate weak form
(1996) and the ERS (1996) tests developed by Elliot, Rothenberg and Stock. Weak form
efficiency is supported for all four countries by the classical unit root tests; however, it is not
strongly supported for Bangladesh under the DF-GLS and ERS tests. The multivariate
cointegration test (Johansen, 1988; Johansen and Juselius, 1990) indicates three long run
stochastic trends among the South Asian stock markets suggesting a high degree of
interdependence between the South Asian stock markets. These results are corroborated by
the block causality tests. The generalized impulse response analysis used to examine the
effects of a price shock of the Indian stock market on the stock prices of Sri Lanka, Pakistan
and Bangladesh suggests that Pakistan and Sri Lanka are more responsive to price shocks in
India than Bangladesh.

This paper is structured as follows. Section 2 describes the data and presents the results
of preliminary analysis. Section 3 outlines the methodology. The empirical results are
analysed in Section 4 and Section 5 concludes the paper.

DATA AND PRELIMINARY ANALYSIS

The data set consists of stock market indices for India, Sri Lanka, Pakistan and
Bangladesh. The stock indices used are the FTSE for India and Pakistan, the All Share
Index for Sri Lanka and the S&P for Bangladesh. The data used are monthly and cover the
period January 1996 to January 2005. All data are obtained from Datastream. In order
to obtain a better understanding of the behaviour of stock prices, a preliminary analysis of the
data is carried out in this section. Table 1 presents summary statistics for the logarithms of
the first differences of the stock price indices or continuously compounded returns.
Table 1 shows that the means of the stock returns for India, Pakistan, and Sri Lanka are not far apart. For Bangladesh the mean return is negative. The standard deviations of all stock returns appear to be similar. The stock returns for India and Pakistan are skewed to the left while those for Sri Lanka and Bangladesh are skewed to the right. All the series exhibit kurtosis. The coefficient of variation indicates that stock returns for Pakistan and Bangladesh are more variable than those for India and Sri Lanka.

Table 2 presents the pair-wise correlation coefficients for the stock returns. The correlation coefficients are in the range of -0.11 to 0.43. The correlation coefficients between the stock returns of India and Pakistan, India and Sri Lanka and Pakistan and Sri Lanka are positive. However, those between the stock returns of India and Bangladesh, Pakistan and Bangladesh and Bangladesh and Sri Lanka are negative. The highest correlation (+0.44) is found between the stock returns of India and Pakistan. The positive correlation indicates that the stock returns of these two countries move in the same direction.

<table>
<thead>
<tr>
<th>Country</th>
<th>India</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
<th>Bangladesh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum</td>
<td>0.17215</td>
<td>0.29201</td>
<td>0.19330</td>
<td>0.64531</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.21176</td>
<td>-0.47010</td>
<td>-0.19110</td>
<td>-0.35881</td>
</tr>
<tr>
<td>Mean</td>
<td>0.00472</td>
<td>0.00331</td>
<td>0.00770</td>
<td>-0.00471</td>
</tr>
<tr>
<td>Std Deviation</td>
<td>0.08782</td>
<td>0.12914</td>
<td>0.06699</td>
<td>0.12134</td>
</tr>
<tr>
<td>Skewness</td>
<td>-0.49111</td>
<td>-0.71437</td>
<td>0.10561</td>
<td>1.60912</td>
</tr>
<tr>
<td>Kurtosis-3</td>
<td>0.02460</td>
<td>1.51680</td>
<td>0.29781</td>
<td>8.91161</td>
</tr>
<tr>
<td>Coef of Variation</td>
<td>18.4031</td>
<td>39.07400</td>
<td>8.09460</td>
<td>25.6470</td>
</tr>
</tbody>
</table>

Table 2 Correlation Matrix of Stock Returns Between Countries

<table>
<thead>
<tr>
<th></th>
<th>India FTSE</th>
<th>Pakistan FTSE</th>
<th>Bangladesh</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td>India FTSE</td>
<td>1.0000</td>
<td>0.43242</td>
<td>-.11280</td>
<td>.30887</td>
</tr>
<tr>
<td>Pakistan FTSE</td>
<td>0.43242</td>
<td>1.0000</td>
<td>-.03387</td>
<td>.25320</td>
</tr>
<tr>
<td>Bangladesh S&amp;P</td>
<td>-.11280</td>
<td>-.03387</td>
<td>1.0000</td>
<td>-.06293</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>.30887</td>
<td>.25320</td>
<td>-.06293</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

**Autocorrelation Test Results**

If a market is weak form efficient stock prices should follow a random walk. The random-walk hypothesis states that successive price changes are independently and
identically distributed random variables. In an efficient market, the information contained in past prices is fully and instantaneously reflected in current prices. Hence, the opportunity for any abnormal gain on the basis of the information contained in historical prices is eliminated. If stock prices are uncorrelated they follow a random walk.

**TABLE 3 AUTOCORRELATION COEFFICIENTS AND LJUNG-BOX Q STATISTICS FOR STOCK RETURNS**

<table>
<thead>
<tr>
<th>Country</th>
<th>Lag</th>
<th>Autocorrelation coefficient</th>
<th>Ljung-Box Q statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>1</td>
<td>-0.10103</td>
<td>0.98029</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>0.12123</td>
<td>2.4071</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>-0.11432</td>
<td>4.4405</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>-0.05201</td>
<td>6.4630</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>0.04663</td>
<td>21.5050</td>
</tr>
<tr>
<td>Pakistan</td>
<td>1</td>
<td>-0.02971</td>
<td>0.084868</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>-0.06565</td>
<td>0.50322</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>0.12496</td>
<td>2.0631</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>0.04984</td>
<td>4.3842</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>-0.09156</td>
<td>10.3642</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>1</td>
<td>0.30896</td>
<td>9.1669</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>-0.77000</td>
<td>9.7425</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>0.11717</td>
<td>11.1814</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>0.02092</td>
<td>20.6825</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>-0.03802</td>
<td>26.5097</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>1</td>
<td>0.16615</td>
<td>2.6511</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>0.09853</td>
<td>3.5936</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>-0.019389</td>
<td>5.0967</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>0.01468</td>
<td>7.2020</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>0.08438</td>
<td>11.6351</td>
</tr>
</tbody>
</table>
The autocorrelation coefficients and Ljung-Box statistics for the first differences of the stock returns are reported in Table 3. The null hypothesis is that the autocorrelation coefficients are equal to zero and the alternative is that they deviate from zero. If the $t$ statistics for the autocorrelation coefficients fall within $\pm 1.96$ the null hypothesis that $\rho = 0$ is not rejected. The autocorrelation coefficients for 1, 2, 4, 8 and 16 are reported.

The autocorrelation coefficients reported in column three indicate that except for the first autocorrelation coefficient for Bangladesh, the rest of the autocorrelation coefficients are not statistically significant. The $t$-ratios for the autocorrelation coefficients for the other countries are within the critical values of the standard normal distribution at the five per cent level. Therefore the results support the weak form efficiency.

METHODOLOGY

Four unit root tests are used in order to see if the stock prices follow a random walk. Stock prices follow a random walk if stock they reflect all available information. It is for this purpose that unit root tests are used. If the unit root tests indicate that the return series are non-stationary, then they are said to follow a random walk.

Next, tests for semi-strong form are performed. These include the Johansen and Juselius (1990) cointegration test, a multivariate Granger causality test or block causality test and impulse response analysis. Cointegration tests are carried out in order to see if the markets share a long run stochastic trend. The multivariate generalisation of the Granger causality test is used to test for causal relationships between the stock markets and impulse response analysis is carried out to see if a shock in one stock market is transmitted to another.

Weak form efficiency is tested using four unit root tests: the Augmented Dickey-Fuller (ADF – 1979), Phillips-Perron (PP-1987, 1988), the Dickey-Fuller Generalised Least Squares (DF-GLS 1996) and the Elliott, Rothenberg and Stock (ERS-1996) tests. These tests are described below.

The ADF unit root test is based on the estimation of the following equation:

$$\Delta X_t = \beta_0 + \beta_1 X_{t-1} + \beta_2 T + \sum_{i=1}^{\infty} \beta_i \Delta X_{t-i} + \varepsilon_t$$

(1)

Where $X_t$ = the time series; $T =$ linear time trend; $\varepsilon_t =$ the error term with zero mean and constant variance. Using equation (1), the null hypothesis of a unit root is $\beta_1 = 0$ which is tested against the alternative hypothesis that $\beta_1 < 0$. The $Z_t$ statistic of Phillips and Perron (1987, 1988) is a modification of the Dickey-Fuller $t$ statistic which allows for autocorrelation and conditional heteroscedasticity in the error term of the Dicky-Fuller regression. This is based on the estimation of equation (2).

$$\Delta X_t = \alpha_0 + \alpha_1 T + \alpha_2 X_{t-1} + \omega_t$$

(2)

Dickey-Fuller Generalised Least Squares (DF-GLS) Test

The DF-GLS is a more powerful test than the Dickey-Fuller test. In the Augmented Dickey-Fuller (ADF) (1979, 1981) test regression, either a constant or a constant and a linear time trend is included to take account of the deterministic components of the data. Elliot, Rothenberg and Stock (ERS), propose a modification to the ADF regression in which data are detrended before the unit root test is conducted. This de-trending is done by taking the explanatory variables out of the data (see, Elliott et al., 1996). The following equation is then estimated to test for a unit root in the variable.

$$\Delta y_t = \alpha_0 y_{t-1} + \beta_1 \Delta y_{t-1} + ... + \beta_p \Delta y_{t-p} + \nu_t$$

(3)
where \( \Delta \) is the difference operator, \( y_t^d \) is the generalised least squares de-trended value of the variable, \( \alpha, \beta_t \) and \( \beta_p \) are coefficients to be estimated and \( \nu_t \) is the independently and identically distributed error term. As in the case of the ADF test, a test for a unit root of the variable \( y \) involves examination of whether the coefficient of the AR(1) term, in this case \( \alpha \), in equation (3) is zero against the alternative of \( \alpha \neq 0 \). In making inferences, the critical values tabulated in Elliott, Rothenberg and Stock (1996) are used.

**Elliott, Rothenberg and Stock (ERS) Point Optimal Test**

The ERS point optimal test has been found to dominate other commonly used unit root tests, when a time series has an unknown mean or a linear trend. This test is based on the following quasi-differencing regression.

\[
d (y_t | a) = d (x_t | a) \delta(a) + \eta_t
\]

(4)

Where \( d (y_t | a) \) and \( d (x_t | a) \) are quasi-differenced data for \( y_t \) and \( x_t \) respectively and \( \eta_t \) is the error that is independently and identically distributed. Details on computing quasi differences are given in Elliott, Rothenberg and Stock (1996). In equation (4), \( y_t \) is the variable whose time series properties are tested, \( x_t \) may contain a constant only or both a constant and time trend and \( \delta(a) \) is the coefficient to be estimated. ERS recommend the use of \( \bar{a} \) for \( a \) in equation (4) that is computed as \( \bar{a} = 1 - 7 / T \) when \( x_t \) contains a constant and \( \bar{a} = 1 - 13.5 / T \) when \( x_t \) contains a constant and time trend. In the ERS point optimal test, the null and alternative hypotheses tested are \( \alpha = 1 \) and \( \alpha = \bar{a} \), respectively. The relevant test statistic \( P_T \) to test the above null hypothesis is:

\[
P_T = (SSR(\bar{a}) - (\bar{a})SSR(1)) / f_0
\]

(5)

Where \( SSR \) is the sum of squared residuals from equation (4) and \( f_0 \) is an estimator for the residual at frequency zero. In making inferences, the test statistic calculated is compared with the simulation based critical values of ERS. In the empirical analysis, the four unit root tests are conducted with a constant and a time trend in the test equations.

**IMPULSE RESPONSE ANALYSIS**

A study by Masih and Masih (1999), on the linkages between the OECD and emerging South East Asian stock markets, reveals that stock market fluctuations in the emerging markets are caused by their own regional markets rather than fluctuations in the advanced markets. Given that India is the largest country in the South Asian region, it is important to examine the generalized impulse responses of Sri Lanka, Pakistan and Bangladesh to a price shock in India. Following Pesaran and Shin (1998), the impulse response function can be represented by the following. If \( X \) has a VAR representation of the following form:

\[
\Delta X_t = \mu + \sum_{i=1}^{p} \phi X_{t-i} + \epsilon_t
\]

(6)

Where \( \mu \) is a vector of constant terms and \( \epsilon_t \) is a vector of Gaussian error terms with \( E(\epsilon_t) = 0 \) and \( E(\epsilon_t \epsilon_t') = \Sigma = (\sigma_{ij}) \). The generalized impulse response of \( X_{t+n} \) relating to a unit shock in the \( j \)th variable at time \( t \) is:

\[
Z_n \Sigma \epsilon_t / \sigma_{jj} = Z_n \epsilon_t / \sigma_{jj}
\]

Where \( Z_n = \phi_1 Z_{n-1} + \phi_2 Z_{n-2} + \ldots + \phi_p Z_{n-p} \quad n=1, 2, \ldots \) and \( Z_n = 0 \) for \( n<0 \).

The forecast variance of \( i, n \) periods hence takes place due to the innovations in the \( j \)th variable. This can be calculated as:
The above equations will hold in a system of cointegrated variables.

\[
\sigma_{ij} = \sum_{k=0}^{n} (\epsilon_i Z_k \Sigma \epsilon_j)^2 / \epsilon_i Z_k \Sigma Z_k' \epsilon_j \quad i, j = 1, \ldots
\]

**TABLE 4 UNIT ROOT TESTS FOR LOG LEVELS OF STOCK PRICE INDICES**

<table>
<thead>
<tr>
<th>Country</th>
<th>ADF</th>
<th>PP</th>
<th>DF-GLS</th>
<th>ERS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Constant</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>-1.921 (7)</td>
<td>-1.626 (2)</td>
<td>-1.819 (7)</td>
<td>2.543 (7)</td>
</tr>
<tr>
<td>India</td>
<td>-2.449 (0)</td>
<td>-2.529 (2)</td>
<td>-1.844 (0)</td>
<td>4.863 (0)</td>
</tr>
<tr>
<td>Pakistan</td>
<td>-1.708 (0)</td>
<td>-1.708 (0)</td>
<td>-1.692 (0)</td>
<td>4.423 (0)</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.408 (1)</td>
<td>0.250 (4)</td>
<td>-0.055 (1)</td>
<td>11.152 (1)</td>
</tr>
<tr>
<td><strong>Panel B: Constant and linear trend</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>-2.705 (7)</td>
<td>-2.431 (3)</td>
<td>-2.528 (7)</td>
<td>1.834 (7)</td>
</tr>
<tr>
<td>India</td>
<td>-2.540 (0)</td>
<td>-2.641 (2)</td>
<td>-2.185 (0)</td>
<td>11.232 (0)</td>
</tr>
<tr>
<td>Pakistan</td>
<td>-1.519 (0)</td>
<td>-1.519 (0)</td>
<td>-1.678 (0)</td>
<td>14.253 (0)</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.690 (0)</td>
<td>0.345 (3)</td>
<td>-0.348 (1)</td>
<td>43.950 (0)</td>
</tr>
</tbody>
</table>

**Notes:**
1. a, b and c imply statistical significance at the 1%, 5%, 10% level, respectively.
2. The numbers within brackets for the DF-GLS and ERS statistics represents the lag length of the dependent variable used to obtain white noise residuals.
3. The lag length for the DF-GLS equation was selected using Akaike Information Criterion (AIC).
4. The numbers within brackets for the PP statistics represent the bandwidth selected based on Newey-West method using Bartlett Kernel.
5. The numbers within brackets shown for the ERS statistic indicate the spectral OLS AR based on SIC.

**EMPIRICAL RESULTS**

Table 4 presents the unit root test results for the log levels of the four stock market indices.

Panel A of Table 4 presents results when a constant is included in the test equation. The results show that the stock index of Bangladesh is stationary in levels at the five per cent level under the DF-GLS and ERS unit root tests. The stock price indices for India and
Pakistan exhibit a unit root at the 10% level under the DF-GLS test. For Sri Lanka, the stock index is non-stationary under all four unit root tests providing support for weak-form market efficiency. Panel B of Table 4 presents unit root test results when a constant and a time trend are included in the test equation. The results show that all four stock price indices behave as random walks except that of Bangladesh under the ERS test.

Table 5 presents unit root test results for the logs of the first differences of the series. The results indicate that all four series are stationary under ADF, PP and ERS unit root tests. Stock returns for India and Pakistan are not stationary under the DF-GLS unit root test.

**Table 5: Unit Root Tests for Log First Differences of Stock Price Indices**

<table>
<thead>
<tr>
<th>Country</th>
<th>ADF</th>
<th>PP</th>
<th>DF-GLS</th>
<th>ERS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Constant</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>-3.682 (11)*</td>
<td>-6.859 (4)*</td>
<td>-2.624 (6)*</td>
<td>1.739 (0)*</td>
</tr>
<tr>
<td>India</td>
<td>-10.573 (0)*</td>
<td>-10.535 (2)*</td>
<td>-1.052 (5)</td>
<td>1.738 (0)*</td>
</tr>
<tr>
<td>Pakistan</td>
<td>-10.025 (0)*</td>
<td>-10.024 (2)*</td>
<td>-0.932 (5)</td>
<td>2.644 (0)*</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>-7.548 (0)*</td>
<td>-7.661 (3)*</td>
<td>-7.584 (0)*</td>
<td>1.153 (0)*</td>
</tr>
<tr>
<td><strong>Panel B: Constant and linear trend</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>-4.752 (11)*</td>
<td>-6.830 (4)*</td>
<td>-4.959 (11)*</td>
<td>3.717 (0)*</td>
</tr>
<tr>
<td>India</td>
<td>-10.520 (0)*</td>
<td>-10.488 (2)*</td>
<td>-1.511 (5)</td>
<td>3.770 (0)*</td>
</tr>
<tr>
<td>Pakistan</td>
<td>-10.160 (0)*</td>
<td>-10.193 (4)*</td>
<td>-1.721 (5)</td>
<td>4.033 (0)*</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>-7.983 (0)*</td>
<td>-8.038 (3)*</td>
<td>-7.732 (0)*</td>
<td>2.647 (0)*</td>
</tr>
</tbody>
</table>

Notes:
6. a and b imply statistical significance at the 1% and 5% level, respectively.
7. The numbers within brackets for the DF-GLS and ERS statistics represents the lag length of the dependent variable used to obtain white noise residuals.
8. The lag length for the DF-GLS equation was selected using the Akaike Information Criterion (AIC).
9. The numbers within brackets for the PP statistics represent the bandwidth selected based on Newey-West method using Bartlett Kernel.
10. The numbers within brackets for the ERS statistic indicate the spectral OLS AR based on SIC.
Cointegration tests are carried out next. The cointegration test results presented in Table 6 indicate four cointegrating vectors for the six bivariate models, the India FTSE-All Share, India-FTSE-S&P, Pakistan-FTSE-S&P and All Share-S&P. The multivariate tests indicate three cointegrating vectors implying the existence of three common stochastic trends in the system of four variables.

<table>
<thead>
<tr>
<th>Null Hypothesis</th>
<th>$m\lambda$</th>
<th>Trace</th>
<th>$m\lambda$</th>
<th>Trace</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>India FTSE-Pakistan FTSE</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$r = 0$</td>
<td>10.17</td>
<td>13.32</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>3.13</td>
<td>3.13</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>19.44</td>
<td>26.25</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>6.79</td>
<td>6.79</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>41.70</td>
<td>50.80</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>9.10</td>
<td>9.10</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>6.95</td>
<td>8.47</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>1.52</td>
<td>1.52</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>41.26</td>
<td>48.91</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>7.64</td>
<td>7.64</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>34.68</td>
<td>37.19</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>2.51</td>
<td>2.51</td>
<td>9.16</td>
<td>9.16</td>
</tr>
<tr>
<td>$r = 0$</td>
<td>44.67</td>
<td>116.89</td>
<td>28.27</td>
<td>53.48</td>
</tr>
<tr>
<td>$r \leq 1$</td>
<td>39.72</td>
<td>72.24</td>
<td>22.04</td>
<td>34.87</td>
</tr>
<tr>
<td>$r \leq 2$</td>
<td>26.04</td>
<td>32.48</td>
<td>15.87</td>
<td>20.18</td>
</tr>
<tr>
<td>$r \leq 3$</td>
<td>6.42</td>
<td>6.42</td>
<td>9.16</td>
<td>9.16</td>
</tr>
</tbody>
</table>
Block causality tests are performed to see if lags of changes in stock market indices cause changes in other stock market returns. The block causality tests involve estimation of the following multivariate regressions:

\[ \Delta P_{It} = \alpha_1 + \psi_1 \Delta P_{I(t-1)} + \psi_2 \Delta P_{SL(t-1)} + \psi_3 \Delta P_{P(t-1)} + \psi_4 \Delta P_{B(t-1)} + \nu_{it} \]  
(7)

\[ \Delta P_{SLt} = \alpha_2 + \gamma_1 \Delta P_{SL(t-1)} + \gamma_2 \Delta P_{B(t-1)} + \gamma_3 \Delta P_{P(t-1)} + \gamma_4 \Delta P_{B(t-1)} + \nu_{lt} \]  
(8)

\[ \Delta P_{Pt} = \alpha_3 + \phi_1 \Delta P_{I(t-1)} + \phi_2 \Delta P_{B(t-1)} + \phi_3 \Delta P_{SL(t-1)} + \phi_4 \Delta P_{B(t-1)} + \nu_{lt} \]  
(9)

\[ \Delta P_{Bt} = \alpha_4 + \delta_1 \Delta P_{I(t-1)} + \delta_2 \Delta P_{SL(t-1)} + \delta_3 \Delta P_{P(t-1)} + \delta_4 \Delta P_{B(t-1)} + \nu_{lt} \]  
(10)

Where \( P_{It}, P_{SLt}, P_{Pt}, \) and \( P_{Bt} \) indicate respectively the stock price indices of India, Sri Lanka, Pakistan and Bangladesh.

Table 6 presents summary statistics for the results of block causality tests.

<table>
<thead>
<tr>
<th>Null Hypothesis</th>
<th>( \chi^2 ) (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \Delta P_{It} ) does not Granger cause ( \Delta P_{SL_{t-1}}, \Delta P_{Pt}, \Delta P_{Bt} )</td>
<td>1.29 (0.73)</td>
</tr>
<tr>
<td>( \Delta P_{SLt} ) does not Granger cause ( \Delta P_{I_{t-1}}, \Delta P_{Pt}, \Delta P_{Bt} )</td>
<td>3.12 (0.37)</td>
</tr>
<tr>
<td>( \Delta P_{Pt} ) does not Granger cause ( \Delta P_{I_{t-1}}, \Delta P_{SL_{t-1}}, \Delta P_{Bt} )</td>
<td>0.08 (0.99)</td>
</tr>
<tr>
<td>( \Delta P_{Bt} ) does not Granger cause ( \Delta P_{I_{t-1}}, \Delta P_{SL_{t-1}}, \Delta P_{Pt} )</td>
<td>1.46 (0.69)</td>
</tr>
</tbody>
</table>

**Note:** The figures within brackets after the Chi-square statistics indicate the corresponding upper tail probabilities for the reported Chi-square values.

The chi square statistics for the LR causality tests are all below the 5 per cent critical value of 7.81 suggesting that share returns of any country do not Granger cause those of the other three countries. These results indicate that share returns of a country in the South Asian region cannot be predicted from those of another country in the region in the short-run. In other words, the semi-strong form of the EMH applies to these markets in the short-run.

**IMPULSE RESPONSE ANALYSIS**

This section examines the generalized impulse responses of Pakistan, Bangladesh and Sri Lanka to a price shock in India. Figure 1 shows the generalized impulse response function of the India FTSE with respect to a price shock in the India FTSE and the generalized impulse response of the Pakistan FTSE to a standard deviation shock of the India FTSE. Figures 2 and 3 show the impulse response of Bangladesh and Sri Lanka respectively to a standard deviation shock of the India FTSE. A standard deviation shock in the India FTSE has greater and more variable effect on the Sri Lanka and Pakistan stock price indices. Figure 1 indicates that prices diverge up to a time horizon of 30 and beyond that point a price shock in India affects Pakistan with a time lag. Figure 2 indicates that a price shock in India affects Sri Lanka with a lag of up to a time horizon of about 80, and beyond that point prices move in the opposite direction. In Bangladesh on the other hand, the effect of a standard deviation shock of the India FTSE is smaller and appears to wane with time.
This paper examines weak and semi-strong form efficiency in the stock markets of India, Sri Lanka, Pakistan and Bangladesh. The classical unit root tests support weak form efficiency for all four countries while the DF-GLS and ERS tests do not support weak form efficiency for Bangladesh. Hence, the post-deregulation stock markets of South Asia appear in general to be efficient except in the case of Bangladesh for which the results are mixed. The multivariate cointegration tests reveal that the markets share a long-run stochastic trend.
The generalized impulse response functions show that stock price shocks in India have a greater effect on the stock market of Pakistan than those of Sri Lanka and Bangladesh. The above results refute the validity of the semi-strong form of the efficient market hypothesis for South Asian emerging stock markets. However, the results of the Granger causality tests indicate that the share returns of none of the countries examined Granger cause those of the other three countries in the region. These results are consistent with the semi-strong version of the efficient market hypothesis in the short-run. In other words, participants of South Asian stock markets cannot use share returns of a particular market in the region to predict the movement in the share returns of the other three countries to make gains on a consistent basis.

The fall in investor confidence following stock price manipulation in Bangladesh in 1996 is perhaps the explanation for the mixed results with respect to Bangladesh. The manipulation of stock prices led the Dhaka Stock Index (DSI) to rise from 1000 in October 1996 to 3600 in November 1996 and subsequently crash. The government of Bangladesh formed a committee to inquire into the manipulation of prices after which the Stock Exchange Commission sued 42 individuals from 15 companies. The lack of a proper regulatory framework however, led those sued to evade leading to further erosion of investor confidence. Currently the Dhaka stock exchange is undergoing a number of changes which include automated trading and a Central Depository System in order to achieve greater transparency.

The results of this study, particularly those of the multivariate tests, have important implications for investors and government policy makers in these countries. The identified relationships can be used by local and international investors to predict the movements of stock markets in order to invest in profitable stock markets. Government policy makers can take necessary steps to improve corporate disclosures in a timely manner so that stock prices instantly reflect all available information.

ENDNOTES

*We wish to thank an anonymous referee for valuable comments. The second author gratefully acknowledges the financial support of Professor Maxwell King of Monash University.

1 According to Fama (1970) a market is weak form efficient if a person cannot devise a rule to consistently beat the stock market using past share prices.

2 A stock market is semi-strong form efficient when its share prices reflect all publicly available information (Fama, 1970).


REFERENCES


