Testing Stock Market Convergence: A Non-Linear Factor Approach

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first version: 11 May 2009, this version: 09 September 2009

Abstract

This paper applies the Phillips and Sul (2007) method to test for convergence in stock returns to an extensive dataset including monthly stock price indices for five EU countries (Germany, France, the Netherlands, Ireland and the UK) as well as the US over the period 1973-2008. We carry out the analysis on both sectors and individual industries within sectors. As a first step, we use the Stock and Watson (1998) procedure to filter the data in order to extract the long-run component of the series; then, following Phillips and Sul (2007), we estimate the relative transition parameters. In the case of sectoral indices we find convergence in the middle of the sample period, followed by divergence, and detect four (two large and two small) clusters. The analysis at disaggregate, industry level again points to convergence in the middle of the sample, and subsequent divergence, but a much larger number of clusters is now found. Splitting the cross-section into two subgroups including Euro area countries, the UK and the US respectively provides evidence of a global convergence/divergence process not obviously influenced by EU policies.

JEL Classification Codes: C32, C33, G11, G15

Keywords: Stock Market, Financial Integration, European Monetary Union Convergence, Factor Model

1 Introduction

Financial integration is an issue which has been extensively investigated in the literature, recently with an increasing focus on the European case, as the EU has put considerable emphasis on achieving a higher degree of convergence of financial markets in its member states. Several different approaches have been taken to establish whether or not such convergence has taken place or at least whether the process is under way. Most of these methods rely on rather restrictive assumptions about the properties of series being analysed and the type of convergence which might occur.

This paper exploits some recent developments in the econometrics literature which provide a more flexible framework for the analysis. Specifically, it applies the Phillips and Sul (2007) method to test for convergence of stock returns to an extensive dataset including monthly stock price indices for five EU countries (Germany, France, the Netherlands, Ireland and the UK) as well as the US over the period 1973m1-2008m8. This approach has several advantages over others previously used in the literature, as it does not require stationarity and it is general enough to cover a wide range of convergence processes. We carry out the analysis on both sectors (35 cross-section units as a whole) and individual industries within sectors (overall, 119 cross-section units, see Appendix A for details). The data source is Datastream. As a first step, we use the Stock and Watson (1998) procedure to filter the data in order to extract the long-run component of the series; then, following Phillips and Sul (2007), we estimate the relative transition parameters.

To preview the main results, in the case of sectoral indices we find convergence in the middle of the sample period, followed by divergence, and detect four (two large and two small) clusters. The analysis at disaggregate, industry level, again points to convergence in the middle of the sample, and subsequent divergence, but a much larger number of clusters is now found. Splitting the cross-section into two subgroups including the Euro area countries, and both the UK and the US respectively, provides evidence of a global convergence/divergence process not clearly affected by EU policies.

We try to rationalise these results on the basis of the country versus industry effects literature, and consider their implications for portfolio management strategies. Traditionally, a top-down approach has been followed in selecting portfolios, i.e. a country is chosen first, and stocks within that market are then selected. Such a strategy is effective if country effects are the main driving force of stock returns. However, it might have to be revised if industry effects were shown to have become more important over time. Our clustering results combined with correlation analysis of stock index returns imply that indeed the relative weight of industry effects has increased over time, and therefore a traditional top-down investment strategy might not be effective any longer.

The remainder of the paper is organised as follows. Section 2 briefly reviews the existing literature on (European) stock market integration. Section 3 outlines the Phillips and Sul (2007) method. Section 4 presents the empirical results and provides some interpretation. Section 5 offers some concluding remarks.

2 Literature Review

European financial integration is a topic of extreme interest both to portfolio managers and policy-makers. The creation of a single market, and then the introduction of the euro together with the adoption of various measures promoting financial integration are all thought to have resulted in less segmented financial markets. Obviously, this is a gradual process, which takes time to complete, as many obstacles to integration have had to be removed over the years. EU countries still have national stock markets and numerous derivatives markets, cross-border transactions are still much more expensive than domestic ones (see, e.g., Adjaoute et al., 2000), taxation, reporting and accounting standards have not been harmonized across member states. Further, although the introduction of the euro has eliminated currency risk as a risk factor for portfolio investors, home bias might still persist to some extent. As a result, full financial integration has yet to be achieved, and clearly the EU is a considerably less homogeneous financial area compared with the US. However, ever-increasing (and eventually full) integration has been a top priority for the EU, and one would expect substantial progress to have been made and significant convergence to have occurred already.

The question arises how one could measure the degree of stock market integration and/or convergence, and whether global or local risk factors determine returns. In principle both price-based and quantity-based indicators could be appropriate. Measures obtained from asset prices models have the disadvantage that these are difficult to estimate and require specific assumptions (see, eg, Bekaert and Harvey, 1995). Nevertheless, some studies have taken this approach - for instance, Hardouvelis et al. (2007), who report a lower cost of capital reflecting higher financial integration in Europe. Chen and Knez (1995) put forward a general arbitrage approach which does not require specifying an asset model, but is not, however, very informative about the convergence process. This has been applied by researchers such as Fratzscher (2002), who reported increasing correlations across European stock markets. Ayuso and Blanco (1999) have suggested a refinement of this approach based on a no-arbitrage condition; they also find increasing global financial integration in the 1990s.

Correlations are often found to be time-varying and increasing in periods of higher economic and financial integration (see Goetzmann et al., 2005). Low correlations between stock markets could be due to a number of reasons, i.e. the already mentioned home bias, country-specific factors (such as policy framework, legislation etc.), differences in the pricing of risk, and possibly in the composition of indices. An alternative explanation for convergence patterns in stock markets could be based on changes over time in the relative importance of industry and country effects as driving forces of stock returns[1], as

[1]This topic has been of interest to scholars for a long time indeed. Lessard (1973) has shown with a single-factor model that only a small proportion of the variance of national portfolios is common in international context which gives rise to considerable risk reduction through international dimension. He also argues that the industry dimension is much less important than the national dimension in defining groups of securities that share common return elements from 1959 to 1972.

suggested by Ferreira and Ferreira (2006), with important implications for the gains from international portfolio diversification. In particular, these authors investigate whether lower cross-country correlations reflect differences in the composition of indices across countries. Specifically, they use a sample of 10 industry indices in 11 EMU countries and estimate the model proposed by Heston and Rouwenhorst (1994) to decompose the return of a given stock or industry index into a common factor, an industry effect and a firm-specific disturbance. They find that, although country effects are still predominant, over time industry effects have become increasingly important. This implies that international portfolio diversification across countries is still a more effective tool for risk reduction than industry diversification within a country, but increasingly less so. Baca et al. (2000) and Cavaglia et al. (2000) also reach the conclusion that the importance of industry factors increased towards the late 1990s. However, Brooks and Del Negro (2004) argue that higher correlations across national stock markets were a temporary phenomenon, explained by the IT bubble, following which diversification across countries might still work better. Another study by Adjaoute and Danthine (2003) simply calculates the cross-sectional dispersion in country and sector returns respectively, and also finds that the benefits from diversification across sectors have become greater since the end of the 1990s. Baele et al. (2004) use Hodrick-Prescott filtered dispersion series in order to focus on the slowly moving component, and conclude that country dispersion in the euro area has been higher than sector dispersion (i.e., cross-country correlations were typically lower than cross-sector correlations). However, their measure of sector dispersion surpassed that of country dispersion in 2000, consistent with a possible shift in the asset allocation paradigm from country-based to sector-based strategies. They also note that diversifying portfolios across both countries and sectors still yields the greatest risk reduction. Ferreira and Gama (2005) use a volatility decomposition method to study the time series behaviour of equity volatility at the world, country and local industry levels for the most developed 21 stock markets. Their findings suggest that industry diversification became a more effective tool for risk reduction than the geographic diversification in the late 1990s, since industry volatility has been rising relative to country volatility and correlations among local industries have declined in fact globally.

The economic interpretation of ex-post correlations of stock market returns, however, is questionable. Therefore, quantity-based measures such as the shares of equities managed by equity funds with an international investment strategy are recommended by authors such as Adam et al. (2002). Baele et al. (2004) update their results considering investment funds, pension funds and the insurance industry, and again find evidence of a decrease in the home bias and a rising degree of stock market integration. They also use a news-based measure of financial integration to establish whether the sensitivities of country returns to shocks (the "betas") have changed over time in response to deeper economic and monetary integration, and conclude that the degree of integration has increased both within the euro area and globally, and especially so in the former.

In the last two decades a new literature has also developed based on the concepts of β- and σ-convergence introduced by Barro and Sala-i-Martin (1991, 1992). Presence of β-convergence implies mean reversion for the panel units, whilst σ-convergence is a reduction in overall cross-section dispersion. Islam (2003) shows that β-convergence is a necessary but not sufficient condition for σ-convergence, but has a more natural interpretation in the context of growth models. He also points out some problems arising when testing convergence empirically (see also Durlauf and Quah, 1999 and Bernard and Durlauf, 1996). First, the implications of growth models for absolute convergence and convergence "clubs" are not clear (for alternative testing methods, see Hobijn and Franses, 2000, and Busetti et al., 2006). Second, different tests do not have the same null hypothesis and therefore are not directly comparable. Third, most tests are based on rather specific and restrictive assumptions about the underlying panel structures.

A new approach which overcomes these difficulties has recently been introduced by Phillips and Sul (2007). Theirs is a "non-linear, time-varying coefficient factor model" with well-defined asymptotic properties. A regression-based test is proposed, together with a clustering procedure. This approach is not dependent on stationarity assumptions and allows for a wide variety of possible transition paths towards convergence (including subgroup convergence). Moreover, the same test is applied for overall convergence and clustering. Fritsche and Kuzin (2008) apply this method to investigate convergence in European prices, unit labour costs, income and productivity over the period 1960-2006 and find different transition paths of convergence as well as regional clusters.

In the next section we outline this procedure, which is then applied to analyse convergence in European and US stock markets in Section 4.

3 Non-Linear Factor Analysis

Model Factor analysis is an important tool for analysing datasets with large time series and cross section dimensions, since it allows to decompose series into common and country specific components in a very parsimonious way. A simplest example is a linear factor model, which has the following form

$$X_{it} = \delta_i \mu_t + \varepsilon_{it}, \tag{1}$$

for $i = 1, \ldots, N$ and $t = 1, \ldots, T$, where X_{it} are observable series and μ_t as well as ε_{it} unobservable components. In many cases unobservable components can be easily estimated using the method of principal components and the asymptotic properties of estimators are well defined for large N and T (see Bai, 2003).

However, the loading coefficients δ_i are assumed to be time invariant in (1) and for the country specific components ε_{it} stationarity or at least difference stationarity properties are required. As long as convergence is understood as a non-stationary process, such as

σ-convergence (Barro and Sala-i-Martin, 1991,1992), analysing it proves to be problematic in this framework. Phillips and Sul (2007) adopt a different specification from (1) and allow for time-variation in the loading coefficients as follows

$$X_{it} = \delta_{it}\mu_t, \tag{2}$$

where δ_{it} absorbs the idiosyncratic component ε_{it}. Next, non-stationary transitional behaviour of factor loadings is proposed, so that each coefficient converges to some unit specific constant:

$$\delta_{it} = \delta_i + \sigma_i \xi_{it} L(t)^{-1} t^{-\alpha}. \tag{3}$$

The stochastic component declines asymptotically since ξ_{it} is assumed to be independent across i and weakly dependent over t, and $L(t)$ is a slowly varying function, i.e. $L(t) = \log t$. Obviously, for all $\alpha \geq 0$ the loadings δ_{it} converge to δ_i enabling us to consider statistical hypotheses of convergence in the observed panel X_{it}. In particular, the null of convergence is formulated as follows

$$H_0 : \delta_{it} \to \delta \text{ for all } \delta \text{ and } \alpha \geq 0.$$

Transition paths The central issue of the proposed approach is the estimation of the time-varying loadings δ_{it}. Phillips and Sul (2007) suggest a simple non-parametric way to extract information about δ_{it} by using their relative versions - the so-called relative transition parameters:

$$h_{it} = \frac{X_{it}}{\frac{1}{N}\sum_{i=1}^{N} X_{it}} = \frac{\delta_{it}}{\frac{1}{N}\sum_{i=1}^{N} \delta_{it}}. \tag{4}$$

Provided that the panel average $N^{-1}\sum_{i=1}^{N} X_{it}$ is not zero, the relative transition parameters measure δ_{it} in relation to the panel average at time t and describe the transition path of unit i. Obviously, if all loadings converge to the same value $\delta_{it} \to \delta$, the relative transition parameters converge to one, $h_{it} \to 1$, so that the cross sectional variance goes to zero. Based on this property the following convergence testing procedure was proposed by Phillips and Sul (2007).

Testing First, a measure for the cross sectional dispersion of the relative transition parameters relative to one is calculated:

$$H_t = \frac{1}{N}\sum_{i=1}^{N} (h_{it} - 1)^2. \tag{5}$$

Second, the following OLS regression is performed:

$$\log(H_1/H_t) - 2\log L(t) = \widehat{a} + \widehat{b}\log t + \widehat{u}_t, \tag{6}$$

for $t = [rT], [rT]+1, \ldots, T$ with some $r > 0$. As in the previous case, $L(t)$ denotes some slowly varying function, where $L(t) = \log(t+1)$ turns out to be simplest and obvious choice. The convergence speed α is estimated by $\widehat{b} = 2\widehat{\alpha}$. It is important, since the focus is on convergence as the sample gets larger, to discard the first $[rT]-1$ observations. The choice of the subsample to be discarded plays an important role, because both the limit distribution and the power properties of the procedure depend on it. Phillips and Sul (2007) suggest $r = 0.3$ based on their simulation experiments.

Finally, the regression coefficient $\widehat{b}$ is tested under the one sided null hypothesis $\alpha \geq 0$ and using a HAC standard error. Under some regularity conditions stated in Phillips and Sul (2007) the test statistic $t_{\widehat{b}}$ is asymptotically standard normally distributed, so that standard critical values can be employed. The null is rejected for large negative values of $t_{\widehat{b}}$.

Clusters Rejecting the null of convergence does not mean that each unit in the panel follows only its own independent path. Obviously, subgroups can also converge and build convergence clubs. Accordingly, Phillips and Sul (2007) also propose an algorithm for sorting units into converging clusters given some statistical significance values. The algorithm is based on the logarithmic regression (6) and consists of four steps, which are repeated until all units are sorted into cluster formations (see Phillips and Sul, 2007, for details). Two critical values need to be fed into procedure in order to run it: one for testing a given subgroup for convergence, set to the standard -1.65 in the following analysis, and the other for testing if a particular unit belongs to a given group. Phillips and Sul (2007) argue in favour of a much strict setting for the second value; they suggest using a zero threshold and even increasing it, if the null for the whole subgroup is rejected in subsequent steps. The procedure possesses great flexibility enabling us to identify cluster formations with all possible configurations: overall convergence, overall divergence, converging subgroups and single diverging units.

Filtering However, in many economic applications the underlying time series often contain short-run components, i.e. business cycle comovements, which render representation (2) inappropriate. Equation (2) can be extended by adding a unit specific additive short-run component:

$$X_{it} = \delta_{it}\mu_t + \kappa_{it}. \tag{7}$$

Any subsequent convergence analysis is eventually distorted by this additive components, so that some filtering techniques are necessary to extract the long-run components $\delta_{it}\mu_t$. The particular filtering techniques applied in this paper are discussed in the next section.

4 Data and Filtering

Data We employ two datasets of stock market indices on monthly basis. Both datasets were taken from Datastream and contain stock market indices for five EU countries as well the United States. The European countries included are the United Kingdom, Ireland, Germany, France and the Netherlands. The first dataset consists of aggregate stock market indices for six economic sectors in each country: basic materials, consumer goods, industrials, consumer services, health care and financials. 35 series are available for the sample period from 1973m1 to 2008m8. Health care was excluded in case of Ireland since it is avalaible only for a shorter period. The second dataset contains data for the same six sectors as in the previous case but at more disaggregated, industry level and has a much higher cross-sectional dimension (see Appendix A for details). Also in this case we only use data from 1973m1 excluding shorter series and end up with 119 cross sectional units. Finally, all indices are transformed into monthly returns since we do not consider convergence in their levels.

Filtering Since convergence is a long-run concept, we are only interested in whether stock returns are getting closer or buildung clusters at low frequencies. However, this type of analysis turns out to be quite problematic, because stock returns contains a huge amount of short-run variation that would distort the results, as already mentioned at the end of section 3. Therefore, the returns should be filtered before testing for convergence.

The most obvious alternative is the Hodrick-Prescott filter; however, whenever stock returns exhibit strongly stationary patterns, the HP-filtered series contain a lot of medium run swings and seem to be are hardly appropriate for convergence analysis (see the two upper graphs in Figure 1).

In order to be able to work only with long-run swings we base our analysis on another filtering strategy and employ time-varying parameter framework proposed by Stock and Watson (1998). The following state space model is set up

$$r_t = \beta_t + u_t \tag{8}$$
$$\beta_t = \beta_{t-1} + \tau\epsilon_t, \tag{9}$$

where $t = 1, \ldots, T$ and (u_t,ϵ_t) are uncorrelated white noise processes. The model is applied to each unit but the cross-section index i is dropped for simplicity. The condition $\sigma_u^2 = \sigma_\epsilon^2$ is necessary for identification purposes. Furthermore, it is assumed that τ is small and depends on the sample size

$$\tau = \lambda/T, \tag{10}$$

which guarantees that a particular stock return process r_t consists of a white noise process u_t and a slowly varying random walk β_t eventually with very small variation compared to

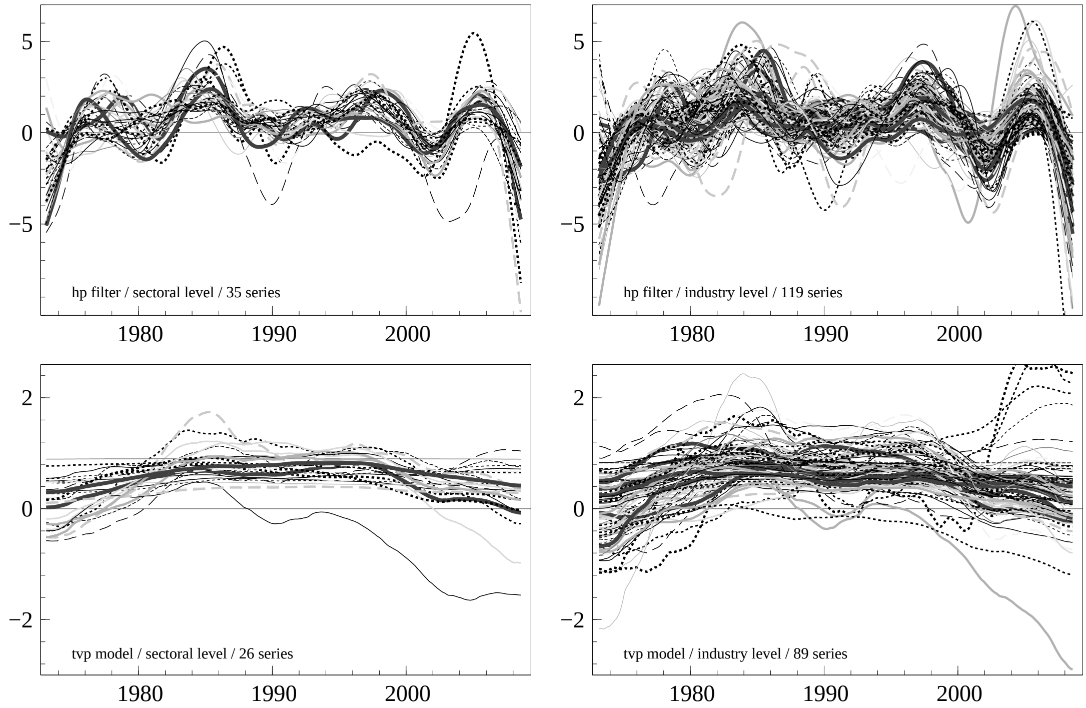

Figure 1: Filtered return series / HP-trends vs. TVP-model

the variance of the original series. The variation parameter λ is estimated using the median unbiased estimation procedure proposed by Stock and Watson (1998). In particular, we use the Quandt likelihood ratio statistic to compute $\widehat{\lambda}$. Finally the local level model is estimated by Maximum Likelihood conditionally on $\widehat{\lambda}$.

We can then use the Kalman smoother to compute the time-varying means β_t. The results for both (the sectoral and industry) datasets are plotted in the two lower graphs of Figure 1, where the series without any estimated variation, i.e. $\widehat{\lambda} = 0$, are discarded. For the sectoral dataset we end up with 26 series containing significantly time-varying means. At industry level 89 series with time-variation in the mean are detected. It is easy to see that the extracted time-varying means are much more persistent than their Hodrick-Prescott variants and therefore seem to be more appropriate for convergence analysis. Moreover, the estimation of the variation parameter λ allows us to sort the series into two groups: those with significant long run variation and those without it. This in turn provides more information for analysing convergence isssues.

Non-zero means Since the convergence testing procedure proposed by Phillips and Sul (2007) relies on the so-called relative transition parameters (see Equation 4), it requires all panel cross-section means to be positive and also elsewhere far from zero. Analysing most macroeconomic time series (such as real and nominal GDP, industrial production, prices) is not problematic in this context, since their mean is positive. But the case of stock indicies returns is different, even their smoothed versions often take negative values;

	NL	IE	UK	US	DE	FR
INDUSTRIALS	1	2		1		
CONSUMER GOODS	1	4		2		2
CONSUMER SERVICES	2	1	3	2		2
HEALTH CARE	4	na	1	1	1	2
BASIC MATERIALS	1	1	1		1	
FINANCIALS	3	2	2	2	2	

Table 1: Cluster results for sectoral dataset.

this in turn can lead to cross-section means in the vicinity of zero and distort the testing as well as the clustering procedures heavily.

We try to circumvent this problem in an ad-hoc way by adding a constant to all observations of the panel. The obvious choice is the absolute value of the panel minimun, which guarantees that all transformed panel member are positive and also have positive cross-section means sufficiently far from zero. Although this approach to solve the problem of zero means does not have a theoretical justification, applying it to panels transformed in this way, i.e. the sectoral dataset filtered by the Kalman smoother, does not produce any significant changes in the empirical results.

5 Empirical Results

In this section, our empirical results are presented. The section consists of three parts. First, we investigate convergence in stock market returns based on the smaller sectoral dataset. Sectoral results constitute the main basis for further discussion since they are easier to interpret compared to those obtained for more disaggregate, industry level datasets. Second, convergence analysis at industry level is performed. The aim of this part is mainly to check the robustness of the previous analysis. Finally, rolling cross correlations of stock returns data are estimated and compared to the cluster analysis results.

Sectoral level Now we proceed with the convergence analysis by using the method proposed by Phillips and Sul (2007). First, we use only filtered sectoral returns, where we were able to detect significantly varying means. In this case we end up with 26 estimated time-varying means. The cluster procedure performed on full sample data reveals four clusters, however, two of them contain only two units and therefore can be considered as outliers. The content of all clusters can be found in Table 1[2]. If we do not consider the two small outlier-clusters, we observe that the first cluster contains mostly basic materials and health care units. On the other hand, the second clusters consists for the most part of financials as well as consumer goods and services.

[2]Please note that the numbers in the cells refer to the respective index of a cluster where series (sectoral level) belong to.

	NL	IE	UK	US	DE	FR
INDUSTRIALS	2	2		1		
CONSUMER GOODS	1	div		2		2
CONSUMER SERVICES	2	1	2	2		2
HEALTH CARE	div	na	1	1	1	2
BASIC MATERIALS	1	1	1		1	
FINANCIALS	2	2	2	2	2	

Table 2: Cluster results for sectoral dataset, positively transformed time-varying means.

	NL	IE	UK	US	DE	FR
INDUSTRIALS	2	2	2	1	2	1
CONSUMER GOODS	1	div	2	2	2	2
CONSUMER SERVICES	2	2	2	2	2	2
HEALTH CARE	div	na	1	1	1	2
BASIC MATERIALS	1	1	1	2	1	1
FINANCIALS	2	2	2	2	2	1

Table 3: Cluster results for sectoral dataset, positively transformed time-varying means, all available units included.

Then we check the results for robustness and transform all time-varying means by adding the absolute value of the whole panel minimum. In this way the panel becomes positive, thus avoiding the problem of having to divide the series by cross-sectional means near zero. The results are presented in Table 2[2]. There are no qualitative changes in the outcome of the clustering procedure. We find two main clusters and two single diverging units. As in the previous case, one cluster contains basic materials and most health care units, whereas the other one includes financials as well as most consumer goods and services sectors. Next we use all available units as input for the clustering procedure. If a series does not reveal any significant mean variation and the estimated λ are zero, its mean is included into the dataset. The sample mean is also an optimal choice conditionally on $\widehat{\lambda} = 0$ in the Kalman smoother setup. After this modification the outcome of the procedure still remains robust (see Table 3[2]). Despite some small changes, most basic materials and health care units are part of cluster one, whereas financials and consumer goods and services tend to be in cluster two. The results for the industrial sectors are inconclusive for the three cluster estimations.

Next we perform some recursive cluster estimation reducing the sample size. The smoothed time-varying means with added constant are employed in order to avoid any problems in the vicinity of zero, but without inclusion of series with constant means. It turns out that the results are not stable over different subsamples. If we shorten the sample by 6 years, the cluster results remain relatively stable. However, after reducing the sample further (ie, considering the two time periods 1973m1-1998m1 and 1973m1-1993m11), the outcome of the Phillips-Sul procedure is very different. Now we get only one cluster, i.e. overall convergence, plus one diverging unit. The bottom left-hand side

	NL	IE	UK	US	DE	FR
INDUSTRIALS	2	2		2		
CONSUMER GOODS	1	2		2		2
CONSUMER SERVICES	1	1	2	1		2
HEALTH CARE	1	na	1	1	1	1
BASIC MATERIALS	2	1	2		2	
FINANCIALS	2	1	2	1	2	

Table 4: Cluster results for sectoral dataset, positively transformed time-varying means, estimation sample 1973m1-1989m9.

	C 1	C 2	C 3	C 4	C 5	C 6
INDUSTRIALS	1	14	2	1	2	0
CONSUMER GOODS	0	13	4	0	0	1
CONSUMER SERVICES	0	5	9	0	1	2
HEALTH CARE	0	3	3	0	0	0
BASIC MATERIALS	2	3	0	1	0	0
FINANCIALS	0	6	11	0	0	1

Table 5: Cluster analysis at industry level, 89 series, full sample.

graph in Figure 1 suggests that all estimated time-varying means seem to move similarly between 1993 and 1998. If the sample size is cut once more time and cluster procedure is run for the period 1973m1-1989m9, the outcome changes again. Now we observe two large clusters without any divergent units (their members are shown in Table 4[2]. The first cluster includes all health care variables, whereas the other one contains most industrials, basic materials, financials and consumer goods production. Finally, after reducing the sample to 1973m1-1985m7 we detect overall convergence in the data.

Industry level At the industry level 119 cross section units for different countries are available and after estimating time-varying means by using the mean unbiased estimation technique proposed by Stock and Watson (1998), we end up with 89 series, with an estimated variation parameter λ different from zero. The estimated time-varying means are plotted at in the bottom right-hand side of Figure 1. Running the clustering procedure with this highly disaggregated data turns out to be more difficult as than in the previous case. At many points the cross-sectional mean is near zero, so that we always have to compute transformed version of the panel by adding the absolute value of the panel minimum to all datapoints. For the full sample (1973m2-2008m8) we identify six clusters and four diverging units (see Table 5[3]). Since there are many industries in the dataset we present the aggregated results in Table 5. For the same reason we do not show the distribution of particular units over countries. The outcome of the cluster procedure at the disaggregated industry level reveals similarities with the corresponding results at the

[3]Please note that the numbers in the cells refer to the aggregate number of series (industry level) in the respective sector and respective cluster.

	nl	ie	de	fr	uk	us
INDUSTRIALS	2	2				1
CONSUMER GOODS	1	div		2	2	2
CONSUMER SERVICES	2	1		2	div	
HEALTH CARE	div	na	1	2	1	1
BASIC MATERIALS	1	1	1		1	
FINANCIALS	2	2	2		2	2

Table 6: Euroarea vs. the US and UK: Cluster results for sectoral dataset, positively transformed time-varying means.

sectoral level. For example, the cluster with most financials units does not contain any basic materials units but it includes most consumer services. There are also differences: the second cluster with most basic materials units consists also of six financials. However, these differences are not surprising, since there are much more industries in some sectors compared to others.

Next we perform recursive estimation as in the sectoral level case. Considering the two subsamples 1973m2-1998m1 and 1973m2-1993m11 reveals overall convergence in the panel of 89 time-varying means. This is strongly in line with the previous results at the sectoral level. However, all further reductions of the sample size do not indicate any divergence in the data, which contradicts the evidence from the sectoral level.

Euroarea vs. the UK and the US The next issue we analyse is whether the detected convergence patterns are due to the process of the European financial integration. For this purpose we divide the data into two parts: the countries of the Euroarea (Germany, France, Netherlands, Ireland) on the one side and the US and UK on the other side. The results at sectoral level for the full sample until 2008m8 are in Table 6[2]. Obviously, the composition and number of clusters do not change a lot if we consider the Euroarea and the US und UK separately. In both cases the algorithm identifies two clusters as well as some divergent units, whereas the first cluster consists mostly of basic materials and healthcare units and the second contains all financials and the most consumer goods and services units.

Then we redo the recursive cluster analysis at the sectoral level. On the one hand the results for the Euroarea and the US/UK are slightly different, in particluar, both panels first converge and then start to diverge, but in case of the US/UK divergent tendencies emerge earlier, on the other hand there are no general qualitative differences between them - in each case we observe convergence in the middle of the sample and divergence towards its end. The further analysis at more disaggregated industrial level for the Euroarea and the US/UK also do not exhibit any qualitative differences to results for all countries, so that they are not reported.

Correlation analysis In the next step we compute rolling correlations with the untransformed index returns and compare them with the outcome of the previous cluster analysis. Correlation analysis is often used to discover the relevance of country and industry effects (see, for instance, Ferreira and Ferreira, 2006). Since we have 35 series at the sectoral and 119 series at the industry level, analysing all cross correlations turns out to be difficult. For this reason we calculate means of rolling correlations and end up with 35 and 119 series respectively. In particular, at the sectoral level two types of mean rolling correlations are considered. First, for a given sector in a given country the mean correlation with the same sectors in all other countries is computed, thus obtaining a mean correlation within a sector but between countries. Second, the mean correlation of the same sector with all sectors in the given country is computed. This leads to mean correlations with countries but between sectors.

The rolling correlations results between countries and between sectors for sectoral dataset (two upper plots) as well as between countries and between industries for industrial dataset (two lower plots) are shown in Figure 2. The size of the moving window was set equal to 100 months, i.e. approximately 8 years. To obtain a clearer picture, we compute und show only the 0.9, 0.5 and 0.1 quantiles of the corresponding 35 and 119 rolling correlation series, which are capturing the main tendencies. One can see from both upper

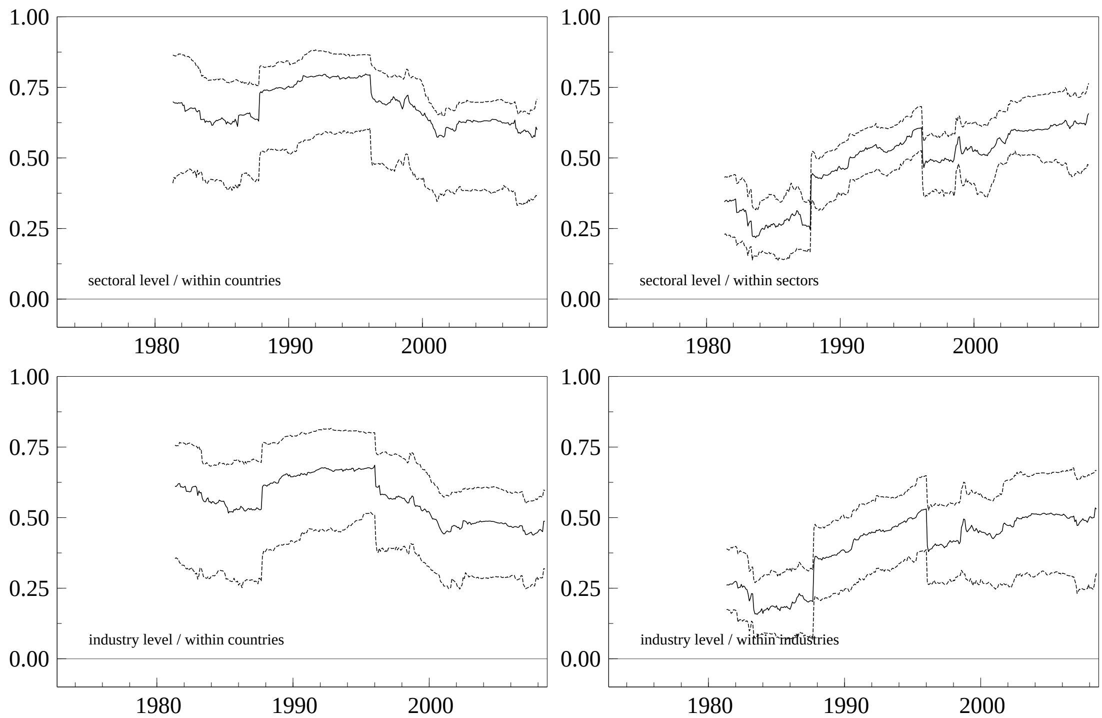

Figure 2: Rolling correlation between countries and between sectors (industries) for sectoral and industry datasets, 0.9, 0.5 and 0.1 quantiles of 35 and 119 series respectively, window size $l = 100$.

plots that the correlations within countries tend to fall, at least at the end of sample, whereas the correlations within sectors tend to rise in the second half of the sample.

However, both type of correlation exhibit a clear local maximum at the beginning and in the middle of nineties. These results are consistent with the recursive cluster results: convergence occurs between 1993 and 1998, but clusters are formed after 1998. The two lower graphs in Figure 2 show that the same type of analysis at the industry level using all 119 units in six countries does not change the outcome either qualitatively or quantitatively.

6 Conclusions

This paper has analysed convergence in European and US financial markets using a method recently developed by Phillips and Sul (2007) which is much more general and flexible than alternative ones previously applied in the literature. In particular, it is not dependent on stationarity assumptions, and is suitable for various types of convergence processes, including clustering, which might be relevant in the case of Europe.

European financial integration has been at the top of the EU agenda in recent years, and has important implications for portfolio management as well. Our analysis produces a number of interesting results. First, it shows that convergence in mean stock returns occurred up to the late nineties, but was followed by divergence in the subsequent period[4]. A plausible interpretation is that this reflects changes in the relative importance of industry versus country effects, the latter becoming more dominant over the years, as already reported, inter alia, by Ferreira and Ferreira (2006). In order to investigate this issue further, we also examine cross-country and cross-industry correlations, and find that they are both rising over time until the nineties. However, in the following period industry correlations exhibit a positive trend whilst country correlations tend to decline: this suggests that indeed the relative weight of industry factors has increased, and they are behind the observed divergence in stock returns in later years. As a result, traditional top-down investment strategies might have to be revised; geography becomes less relevant to portfolio diversification. Campa and Fernandes (2006) study the determinants of the evolution of country and industry specific returns in world financial markets over the period from January 1973 to December 2004. They find that the main driving force behind the significant rise in global industry shocks is the higher integration of input and output markets in an industry, which implies a faster transmission of shocks to the industry across countries and a higher importance of industry factors in explaining industry returns. Their implications could also help enlightening our results.

A further question we ask is whether the policies implemented by the EU to promote financial integration have had any noticeable effect on the observed convergence patterns. For this purpose, we redo the analysis for subsets of countries, i.e. for the Euro area countries in our sample, and both the UK and the US separately. The results suggest that

[4]This result is in line with those of Adjaoute and Danthine (2003), Baca et al. (2000), Cavaglia et al. (2000) and Baele et al. (2004)

there are no qualitative differences between these two groups of countries, suggesting that there is a global convergence/divergence process not obviously influenced by EU measures, but possibly driven by industry versus country effects[5]. However, these results should be interpreted with caution, as our sample only includes a small subset of EU member states (most of them, EU core countries), and also the method we use focuses on medium- to long-run movements, and therefore convergence in the short-run (highly volatile) components, especially in the case of peripheral countries or relatively new entrants, cannot be ruled out.

Our results are highly relevant for policy makers as well. During the financial convergence periods, policy makers should be aware that financial markets are subject to spillover effects and a shock emerging from a certain country/industry might spread out quickly to other countries/industries. On the other hand, divergence of equity markets could also be an indicator of non homogeneous financial area. In that case policy makers should revise the measures they take for higher degree of convergence of financial markets.

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A Data at Industry Level

Sectors	Industries	FR	DE	IE	NL	UK	US
BASIC MATERIALS	Chemicals	x	x	-	x	x	x
BASIC MATERIALS	Forestry and Paper	-	x	-	-	-	x
BASIC MATERIALS	Industries Metals and Mines	x	x	-	x	-	x
BASIC MATERIALS	Mining	-	-	-	-	x	x
INDUSTRIALS	Construction and Materials	x	x	x	x	x	x
INDUSTRIALS	Aerospace and Defence	x	-	-	-	x	x
INDUSTRIALS	General Industrials	-	x	-	x	x	x
INDUSTRIALS	Electronic and Electrical Equipment	x	x	-	x	x	x
INDUSTRIALS	Industrial Engineering	x	x	-	x	x	x
INDUSTRIALS	Industrial Transportation	-	x	-	x	x	x
INDUSTRIALS	Support Services	-	-	-	x	x	x
CONSUMER GOODS	Automobiles and Parts	x	x	-	-	x	x
CONSUMER GOODS	Beverages	x	x	x	x	x	x
CONSUMER GOODS	Food Producers	x	x	-	x	x	x
CONSUMER GOODS	Household Goods and Home Construction	x	-	x	-	x	x
CONSUMER GOODS	Leisure Goods	x	-	-	x	-	x
CONSUMER GOODS	Personal Goods	x	x	-	-	x	x
HEALTH CARE	Healthcare Equipment and Services	-	x	-	-	x	x
HEALTH CARE	Pharmaceuticals and Biotechnology	-	x	-	-	x	x
CONSUMER SERVICES	Food and Drug Retailers	x	x	-	x	x	x
CONSUMER SERVICES	General Retailers	x	x	-	x	x	x
CONSUMER SERVICES	Media	x	-	x	x	x	x
CONSUMER SERVICES	Travel and Leisure	x	-	x	-	x	x
FINANCIALS	Banks	-	x	x	x	x	x
FINANCIALS	Nonlife Insurance	-	x	-	-	x	x
FINANCIALS	Life Insurance	-	x	-	x	x	x
FINANCIALS	Real Estate Investment and Services	-	-	-	-	x	x
FINANCIALS	Real Estate Investment Trusts	-	-	-	x	x	x
FINANCIALS	Financial Services	-	-	x	-	x	x
FINANCIALS	Equity Investment Instruments	x	-	-	x	x	x

Table 7: Industry dataset: all series available from 1973m2, distribution of industries over sectors and countries, 119 units