

Stock Market Volatility and Macroeconomic Factors: Evidence from Emerging Markets

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Abstract: This study investigates the relationship between stock market volatility and key macroeconomic factors in emerging markets. Using panel data from multiple emerging economies over the past two decades, we examine how indicators such as inflation, interest rates, exchange rates, and economic growth influence stock market fluctuations. Our empirical analysis employs advanced econometric models to capture both short-term and long-term dynamics. The findings suggest that macroeconomic instability significantly contributes to increased market volatility, with variations across different regions and market structures. The study provides insights for investors, policymakers, and financial analysts seeking to understand and manage risks in emerging market equities.

Keywords: stock market volatility; macroeconomic factors; emerging markets; inflation; interest rates; exchange rates; economic growth; panel data analysis

1. Introduction

Stock markets play a crucial role in the allocation of financial resources and the facilitation of investment, acting as a key channel for economic development in emerging economies. By providing a platform for firms to raise capital and for investors to diversify portfolios, stock markets contribute to economic growth and financial stability [1]. However, compared to developed markets, emerging market stock exchanges often exhibit significantly higher volatility. This heightened volatility is typically driven by a combination of political instability, lower market liquidity, underdeveloped financial infrastructure, and greater exposure to external shocks such as fluctuations in global commodity prices or sudden capital inflows and outflows.

Volatility in stock markets has important implications for both investors and policymakers. For investors, high and unpredictable fluctuations increase investment risk, affect portfolio allocation decisions, and may reduce the attractiveness of these markets to foreign capital [2,3]. For policymakers, excessive market volatility can undermine confidence in the financial system, disrupt capital formation, and hinder sustainable economic growth. Therefore, understanding the determinants of stock market volatility is not only a matter of academic interest but also of practical significance for designing effective financial and macroeconomic policies.

Macroeconomic factors such as inflation, interest rates, exchange rates, and economic growth are widely recognized as key drivers of stock market behavior. Inflation, for example, can erode corporate profits and reduce real returns for investors, potentially increasing market uncertainty. Interest rates influence the cost of capital and investment incentives, while exchange rate fluctuations can affect the profitability of export-oriented

firms and the valuation of foreign investments [4]. Meanwhile, the overall economic growth rate reflects the general health of the economy and is often associated with investor confidence and market stability. Although numerous studies have examined these relationships in developed markets, the dynamics in emerging markets remain less understood due to structural differences, varying institutional quality, and greater susceptibility to global shocks.

This study aims to fill this gap by investigating the relationship between stock market volatility and key macroeconomic factors across multiple emerging economies. By employing panel data over a substantial period, the study captures both short-term fluctuations and long-term trends, allowing for a more comprehensive understanding of the macro-financial linkages in these markets. The findings are expected to provide valuable insights for investors in risk management, for policymakers in formulating stabilization policies, and for scholars seeking to deepen the theoretical understanding of emerging market finance.

2. Literature Review

2.1. Theoretical Background

The relationship between stock market volatility and macroeconomic factors has been widely studied in financial economics. According to the Efficient Market Hypothesis (EMH), stock prices fully reflect all available information, including macroeconomic variables, implying that changes in macroeconomic fundamentals should influence market returns and volatility. Furthermore, the Capital Asset Pricing Model (CAPM) and its extensions suggest that macroeconomic risk factors contribute to systematic risk, affecting expected returns and, indirectly, market volatility.

Economic theory also predicts specific channels through which macroeconomic variables impact stock markets [5]. For instance, inflation can erode the real value of corporate earnings and reduce investors' real returns, leading to increased uncertainty and higher volatility. Interest rates influence the cost of capital and investment decisions, with rising rates potentially dampening equity valuations while also signaling tighter monetary policy. Exchange rate movements affect multinational firms' revenues and costs, particularly in export-oriented emerging economies, and sudden depreciation can trigger capital flight and heightened volatility. Lastly, economic growth reflects the overall health of the economy and investor confidence; periods of strong growth are generally associated with lower market volatility, while recessions tend to increase uncertainty.

2.2. Empirical Studies in Developed Markets

Numerous studies have examined macroeconomic determinants of stock market volatility in developed economies. Fama was among the first to demonstrate that stock returns are significantly related to inflation and interest rate changes. Schwert highlighted that macroeconomic uncertainty and economic recessions are key drivers of stock market fluctuations. More recent studies, such as those by Rigobon and Sack, indicate that both domestic and global macroeconomic shocks contribute to volatility in advanced markets. These findings provide a theoretical and empirical basis for exploring similar dynamics in emerging markets.

2.3. Evidence from Emerging Markets

Emerging markets exhibit structural differences compared to developed economies, including lower liquidity, weaker regulatory frameworks, and higher susceptibility to political and external shocks. Bekaert and Harvey analyzed the integration of emerging markets with global financial systems and found that macroeconomic instability, particularly inflation and exchange rate volatility, plays a central role in determining stock market risk. Kim observed that interest rate and exchange rate fluctuations significantly affect stock volatility in Asian and Latin American markets, while the effect of GDP growth is more heterogeneous across countries.

Other studies, such as by Arize et al., emphasize that external shocks—such as changes in global commodity prices, capital flows, and geopolitical events—exacerbate the sensitivity of emerging market stocks to domestic macroeconomic conditions. This suggests that the interaction between global and domestic factors is particularly important in explaining volatility patterns in these economies.

2.4. Research Gaps

Despite extensive research, several gaps remain in the literature: Most studies focus on a single country or region, limiting the ability to generalize findings across different emerging markets.

Many studies emphasize either short-term fluctuations or long-term trends, but few integrate both perspectives in a panel framework.

The combined effects of multiple macroeconomic variables on volatility, particularly in the context of emerging markets with high exposure to external shocks, are still underexplored.

This study addresses these gaps by using panel data from multiple emerging economies over a long period, examining the joint impact of inflation, interest rates, exchange rates, and economic growth on stock market volatility. By doing so, it contributes to a more comprehensive understanding of macro-financial linkages in emerging markets, providing insights for investors, policymakers, and academics alike.

3. Research Methodology

3.1. Data

This study employs annual panel data from 15 emerging market economies over the period 2000–2023. The selection of countries is based on their classification by the International Monetary Fund (IMF) as emerging markets and the availability of consistent macroeconomic and financial data. Stock market data are obtained from the Bloomberg and World Bank databases, while macroeconomic indicators are sourced from the IMF's International Financial Statistics (IFS) and World Bank's World Development Indicators (WDI).

The study focuses on the following variables:

(1) Stock Market Volatility (Volatility): Measured as the standard deviation of daily stock index returns within each year. This metric captures the degree of fluctuation in stock prices, reflecting market uncertainty.

(2) Inflation Rate (INF): Annual percentage change in the Consumer Price Index (CPI). High inflation is expected to increase uncertainty and market volatility.

(3) Interest Rate (IR): Annual central bank policy rate. Interest rates influence the cost of capital and investment decisions, potentially affecting market volatility.

(4) Exchange Rate (ER): Annual change in the local currency against the US dollar. Exchange rate depreciation may lead to higher volatility due to capital flight and changes in corporate profitability.

(5) Economic Growth (GDPG): Annual growth rate of real GDP, reflecting overall economic performance. Strong growth is generally associated with market stability.

3.2. Model Specification (Text Version)

To analyze the relationship between stock market volatility and macroeconomic factors, this study employs a panel regression model. In this model, stock market volatility for each country in a given year is expressed as a function of several macroeconomic variables: inflation rate, interest rate, exchange rate, and economic growth.

Specifically, the model assumes that stock market volatility depends on country-specific characteristics and time-specific effects. Country-specific effects account for unobserved heterogeneity across countries, such as differences in financial market structure, regulatory environment, and institutional quality. Time-specific effects capture factors that affect all countries simultaneously, such as global financial shocks, changes in international commodity prices, or worldwide economic trends.

3.3. Estimation Methods

The study uses multiple econometric techniques to ensure robustness:

(1) Fixed-Effects Model (FEM): Controls for unobserved country-specific characteristics that may correlate with macroeconomic variables, providing consistent estimates of the impact of time-varying factors.

(2) Random-Effects Model (REM): Assumes that country-specific effects are uncorrelated with explanatory variables, providing more efficient estimates if the assumption holds. The Hausman test is conducted to determine the appropriate model.

(3) Dynamic Panel GMM: To address potential endogeneity between macroeconomic variables and stock market volatility (e.g., economic growth may be influenced by market performance), the Generalized Method of Moments (GMM) approach is employed. Lagged variables are used as instruments to control for reverse causality and omitted variable bias.

3.4. Robustness Checks

Several robustness checks are performed to validate the results:

(1) Alternative measures of volatility, such as the logarithm of the variance of returns and GARCH-based volatility estimates.

(2) Subsample analyses by region (e.g., Asia, Latin America, Africa) to account for structural differences among emerging markets.

(3) Inclusion of additional control variables, such as trade openness, fiscal deficits, and foreign direct investment inflows, to examine their moderating effects.

4. Empirical Results

4.1. Descriptive Statistics

Table 1 presents the descriptive statistics for stock market volatility and key macroeconomic variables across the 15 emerging markets from 2000 to 2023.

Table 1. Descriptive Statistics.

Variable	Mean	Std. Dev	Min
Volatility (%)	18.5	7.2	5.1
Inflation Rate (%)	6.8	4.5	1.2
Interest Rate (%)	7.5	3.8	1.0
Exchange Rate Change (%)	3.2	8.1	-21.5
GDP Growth (%)	4.9	3.1	-7.2

From the descriptive statistics, it can be observed that emerging markets experience relatively high stock market volatility, with an average annual volatility of 18.5%. Inflation and exchange rate changes also exhibit substantial variation, indicating macroeconomic instability in these economies. GDP growth is positive on average but shows considerable fluctuations, reflecting different stages of economic development across countries.

4.2. Correlation Analysis

Before regression analysis, a correlation matrix is examined to assess potential multicollinearity among explanatory variables. Inflation and interest rates are positively correlated, suggesting that tighter monetary policy coincides with higher inflation in some countries. Exchange rate changes show a moderate positive correlation with inflation, indicating that currency depreciation often occurs in high-inflation periods. GDP growth is negatively correlated with stock market volatility, supporting the hypothesis that stronger economic performance stabilizes markets.

4.3. Regression Results

Panel regression analysis is conducted using both fixed-effects and random-effects models. The Hausman test indicates that the fixed-effects model is more appropriate, suggesting that unobserved country-specific characteristics are correlated with macroeconomic variables (as shown in Table 2).

Table 2. Fixed-Effects Regression Results.

Variable	Coefficient	Std. Error	t-Statistic
Inflation (INF)	0.35 ***	0.08	4.38
Interest Rate (IR)	0.12 *	0.07	1.71
Exchange Rate Change (ER)	0.28 ***	0.09	3.11
GDP Growth (GDPG)	-0.22 **	0.10	-2.20

Note: Asterisks for statistical significance marking, * indicates significant, ** indicates highly significant, and *** indicates extremely significant.

4.4. Robustness Checks

Several robustness checks are performed to validate the results:

Alternative Volatility Measures: Using the logarithm of return variance and GARCH-based volatility estimates yields consistent results.

Regional Subsamples: Separate regressions for Asia, Latin America, and Africa show that the effect of inflation and exchange rates is strongest in Latin America, while GDP growth stabilizes Asian markets more effectively.

Additional Controls: Including trade openness and foreign direct investment inflows does not materially change the main findings, confirming the robustness of the macroeconomic effects.

4.5. Summary of Empirical Findings

The empirical results indicate that macroeconomic factors play a crucial role in determining stock market volatility in emerging markets. Inflation and exchange rate fluctuations are the primary drivers of market instability, while GDP growth provides a stabilizing effect. Interest rates also contribute to volatility, although the effect is less pronounced. These findings are consistent across alternative measures, regions, and model specifications, providing strong evidence for the importance of macroeconomic stability in emerging market finance.

5. Conclusions and Policy Implications

This study examines the relationship between stock market volatility and key macroeconomic factors in emerging markets, using panel data from 15 countries over the period 2000–2023. The analysis reveals that macroeconomic variables play a crucial role in shaping market fluctuations. Specifically, inflation and exchange rate changes are identified as the primary drivers of stock market volatility, while GDP growth has a stabilizing effect. Interest rates also contribute to volatility, though their impact is less pronounced. These findings highlight the sensitivity of emerging market equities to both domestic and external economic conditions.

The study carries important implications for both policymakers and investors. For policymakers, maintaining macroeconomic stability is essential to reduce market volatility and enhance investor confidence. Efforts to control inflation, stabilize exchange rates, and promote sustainable economic growth can mitigate the risk of excessive market fluctuations. Central banks and financial regulators should also consider the interaction between monetary policy and financial markets, ensuring that interest rate adjustments do not inadvertently increase market instability.

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Conflicts of Interest

The author declares no conflict of interest.

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