CHAPTER I
INTRODUCTION

1.1 Background of Study

Macroeconomic conditions have a meaningful impact on stock return volatility (SRV) and financial distress, which are interrelated and affect sustainability of business and stability of economy. Tabash et al. (2024) found that emerging markets are more heavily affected by SRV due to governance weakness and weakened financial systems, whilst structural strength in developed markets is able to mitigate such volatility. The 2008 crisis and the COVID-19 pandemic have exposed the vulnerability of financial markets to economic shocks. Such incidents underscore that SRV may climb on higher uncertainty and lead to tightening of lending conditions and lesser investment activity. (Albulescu, 2021).

SRV is a significant metric of investor confidence, reflecting the volatility of stock prices caused by macroeconomic instability. Financial distress occurs when firms struggle to pay financial commitments owing to decreased revenues, limited access to capital, and increasing operating expenses (G. T. H. Vuong et al., 2024). Altogether these components stress the critical need for a well-founded understanding of how macroeconomic aspects influence SRV as well as the crisis in finance.

Economic crises often expose flaws in financial systems. COVID-19 pandemic created unprecedented volatility in global markets as a result of economic lockdowns and highly uncertain recovery trajectories (Khan et al., 2024). Poor cash flows for real estate developers, inadequate financial

infrastructures and limited government interventions in developing nations exacerbated the challenge, increasing the threat of a financial disaster (Muguto & Muzindutsi, 2022). The common economics perspective of SRV and financial distress suggests that they mirror underlying economic coordinates and reflects the macroeconomic environment.

The SRV has received much attention in literature because of its considerable implications on overall financial stability Chen et al. (2010). It is important, especially for corporate governance and policy making, to comprehend the link between SRV and financial distress; simply put, these relationships can aid towards efforts to improve financial stability and control of risks in developed and developing paradigm.

The rising attention toward SRV is due to its significant impact on firms' financial wellness. However, SRV of increase can be a signal for potential operational challenges or operational financial issues that we needed to have in mind at least, or at a worst-case scenario operational effective loss. An explanation is given by the fact that if the stock price undergoes volatility, this leads to increase in the risk associated with the success of a company and is thus discouraging a potential long-term investor (G. T. H. Vuong et al., 2024). Moreover, SRV could also signal potential financial distress for a company, given that significant variations in stock prices often represent weakness in the corporation or its current economic climate (Aloui & Jarboui, 2018; Samir et al., 2023).

Financial distress has a significant impact on the future of a firm, affecting stakeholders such as workers, creditors, and shareholders. Financial

distress may lead to restricted access to money, higher costs, and decreased market trust. A financial crisis may lead to a self-reinforcing cycle, where deteriorating market confidence worsens a company's financial status and hinders rehabilitation attempts (Nguyen et al., 2023). Organizational stability relies heavily on understanding the causes of financial instability.

SRV is highly correlated with financial instability, so corporate governance in publicly listed firms has a pivotal role in addressing SRV. Managers must watch stock price movements and take steps to reduce volatility. Improving transparency, financial reporting, and consistent profitability can help achieve this aspiration. This would leave investors secure, and the company could access financial markets at a reasonable cost. Given the higher levels of volatility in frontier and creating economies, as well as external shocks, management constraints and financial restrictions within these markets, policymakers should consider how SRV impacts business financial distress. There is a need for regulatory frameworks that encourage transparency in financial transactions, prudent risk management practices, along with sound corporate governance.

The financial systems of the developed economies, in particular the G7 economies, are generally more developed, and their regulatory frameworks are successfully mitigating excessive volatility. But these markets are vulnerable to sharp and significant volatility spikes at times of financial stress, especially if conditions deteriorate globally.

The COVID-19 outbreak has also demonstrated that even the most well-developed economies can suffer from a financial crisis, as seen by the

fluctuations in country-evident markets. Analysis by Albulescu (2021) revealed a dramatic increase in stock return volatility in G7 markets at the initial stage of the pandemic. The rise was largely related to the unexpected economic lockdowns and the unknown length and intensity of the crisis.

Stock returns in emerging economies are often more volatile. This can be largely attributed to political instability, economic uncertainty, and weak financial institutions. Such markets are subject to external shocks such as changes in commodity prices or sudden changes in capital flows that may increase financial distress and increase volatility (Tabash et al., 2024). In this paper Yu et al. (2021) investigated the market returns volatility in emerging markets during the COVID-19 epidemic. The volatility in these markets was shown by the researchers to be much more than in developed markets. This was mostly shaped by declining government measures, weak economic foundations, and great vulnerability to outside economic shocks.

SRV reached high levels in developed countries between 2010 and 2014 during the recovery from the global financial crisis, but then gradually stabilized due to monetary policies such as quantitative easing. Ironically, stock return volatility was low during the 2015–2019 period despite events such as Brexit and US-China trade disputes, with occasional spikes due to geopolitical concerns (Vo, 2016). However, the covid-19 pandemic observed in 2020 brought unprecedented volatility which, at the end, was stabilized by large amounts of fiscal and monetary interventions led by the great powers such as United States and Europe (G. T. H. Vuong et al., 2022).

In contrast, developing economies have experienced heightened SRV due to their vulnerability to global market fluctuations, political uncertainties, and underdeveloped regulatory frameworks. These markets grew significantly between 2010 and 2014, but with greater volatility arising from commodity price changes and capital flows. From 2015 to 2019, external shocks stemming from a slowdown in the Chinese economy and subsequent interest rate hikes in the US led to heightened volatility in the emerging markets, manifested through outflows of capital and depreciation of currencies (Nguyen et al., 2023). The COVID-19 pandemic that started in 2020 exacerbated stability issues in developing countries because of weak healthcare-infrastructure capacity, a slow recovery to pre-COVID economic output level and inflationary forces. Despite a modest reopening, SRV remained elevated from geopolitical uncertainties, including the Russia-Ukraine conflict, and interest rates around the world.

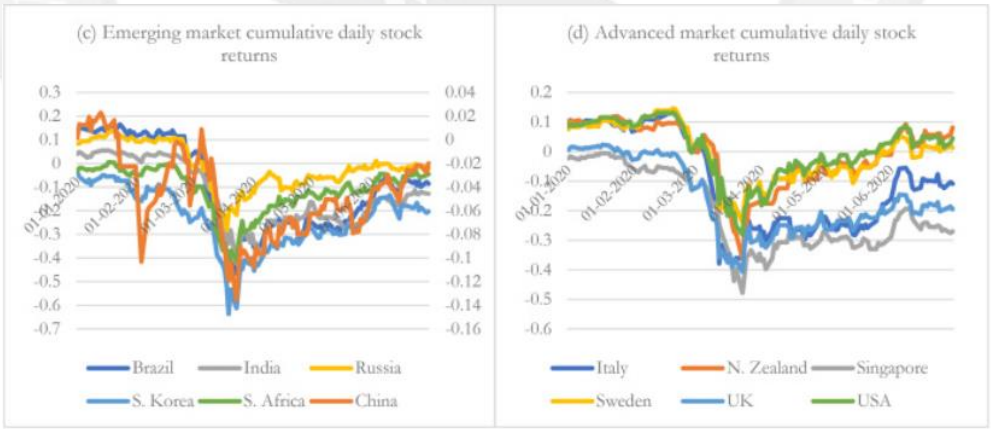

Figure 1. 1 Comparison of stock return between developed and emerging markets
Source: Rakpho et al. (2022)

The figures present the cumulative daily stock returns of emerging and advanced markets through a global financial disruption: the COVID-19 pandemic. These differences show unique traits in resilience, recovery and

volatility, which is a consequence of structural and economic differences in these two market types.

Emerging markets, including Brazil, India, Russia and China, are susceptible to larger declines and fluctuations. Returns in these markets fell considerably at the peak of the crisis, which came in around March 2020. In some cases, such as Brazil, the total losses were close to -0.6. This swift unraveling underscores the acute fragilities of developing countries, such as their reliance on fickle capital flows, slim economic diversification and thinner financial systems. On the other hand, looking at the ten countries with the highest numbers, China shows a relatively fast recovery, estimated to reach a value of 0.1 by the end of the period while countries like Brazil and South Africa have a slower recovery, where breaching back up to the pre-crisis levels is difficult. We see much clearer distinctions in the impact of systemic risk, like political instability, dependence on commodity prices, and slow fiscal responses, in emerging markets than in developed ones, as evidenced by varying recovery rates.

The advanced markets of the United States, Sweden and Singapore show relatively mild declines where the cumulative returns fell to within about -0.2 to -0.3 at the bottom of the cycle. Effective government action, solid financial systems, and competent institutions contribute to market stability. By mid-2020, cumulative returns in the US are expected to be close to 0.1. Advanced economies benefit from international financial integration, increased investor trust, and effective resource allocation during crises, resulting in consistent comeback trajectories. These economies are artificially stable in the long run

through business diversification and advanced financial instruments that help resist disruption.

The graphs exhibit broader consequences of stock return volatility (SRV). The heightened volatility of emerging markets hosts greater vulnerability to risks and uncertainty from global economic activity. So do the sharp and extended drops observed in countries such as South Africa and Brazil; they indicative of such sensitivity. At the same time, developed markets show their capacity to mitigate the effects of these shocks with a wide range of policy measures, including stimulus packages and quantitative easing, which contribute to economic recovery and boost investor confidence.

The differences in cumulative stock returns illustrate the stark divergences in market infrastructure, economic robustness and government interventions. Mature markets show their ability to stabilize and recover, while developing markets struggle to contain global contagion. This study emphasizes the importance of SRV, macroeconomic stability, and institutional strength in the context of financial crisis and recovery. These findings render significant considerations for future research about the multifaceted economic effects of a global economic slowdown on both developed and emerging economies.

This linkage is particularly salient in developing countries, in which volatility is often exacerbated by political turbulence, currency fluctuations and vulnerable financial markets. Developed economies, with more advanced finical systems and relatively stable governance and better ability to deploy coordinated monetary policies, are less susceptible to such changes and thus

less likely to face financial distress (Bekaert & Harvey, 1997). A high SRV signals financial distress across all market types while corporate governance matters greatly in ensuring less volatility, maintaining investor trust and financial stability. Viable policy measures and precautionary actions can mitigate the adverse effects of SRV on corporate performance and ensure long-term growth. Studying SRV patterns across developed and emerging countries allows academics and policymakers to understand how various market conditions, economic and financial policies, as well as governance can impact financial stability. This comparison-focused inquiry has the potential to make them better able to tailor their risk management and corporate governance, keep volatility in check and minimize the incidence of financial distress, depending on their type of market.

Previously, the relationship between financial distress and stock return volatility (SRV) has been extensively researched, including for various market conditions. Muguto & Muzindutsi (2022) argue that BRICS markets are more volatile than G7 markets due to less stable financial systems, while Vuong et al. (2024) focus on Vietnam and illustrate that SRV effects are compounded by poor governance. Khan et al. (2024) found that the COVID-19 pandemic is associated with increased volatility, particularly in markets with loose rules. Chen et al. (2010) provide evidence on the impact of idiosyncratic volatility on financial soundness but highlight the relevance of corporate governance, while Kwabi et al. study how political instability increases SRV and financing cost (2024). Harjoto et al., in their analysis of market reactions to COVID-19 (2021), show that developed and emerging markets respond differently to volatility.

Despite extensive research on the volatility of stock returns and financial distress, a significant gap remains in the literature. There is a notable absence of cross-country comparisons that investigate the correlation with a broader geographical scope. Current research tends to concentrate on particular countries, failing to thoroughly examine the effects of stock return volatility across various economic contexts. Nonetheless, there is a lack of research that methodically assesses these processes across various countries, particularly in a cross-national context that includes both developed (G7) and emerging (E7) economies. This study aims to address this information gap through a systematic cross-country examination of the relationship between stock return volatility and financial distress in both developed and developing nations. With that being said, this research will be entitled with **A MULTIDIMENSIONAL APPROACH TO FINANCIAL DISTRESS: THE IMPACT OF STOCK RETURN VOLATILITY ACROSS MARKET STRUCTURES, ECONOMIC DYNAMICS, AND FIRM-LEVEL CHARACTERISTICS IN DEVELOPED AND EMERGING MARKETS**

1.2 Scope and Limitations of Research

Given time limits and the difficulty of obtaining perfection, the study concentrated mostly on a few key topics, which will now be investigated:

1) Variable used in Research

   Market size and leverage play further roles in explaining the relationship between stock return volatility and financial crisis. However, there may be more variables influencing this relationship, such as corporate governance, financial constraints, and so on.

2) Limitations of Research Period

   The period used in this research will cover from 2014 to 2023, with the rationale as follow:

   1) The chosen period includes significant events in global financial markets, such as the aftermath of the Asian Financial Crisis, periods of economic growth, and recent market developments.
   2) This period allows for analysis of stock return volatility during various market conditions and economic cycles globally.
   3) The availability of reliable data for this period enhances the robustness of the study.

3) Limitations of Samples Used

   The data included secondary data from G7 and E7 countries. Stock across all businesses, except the finance industry owing to variations in financial structure. The data is classified as secondary owing to its derivation from an external source, namely the S&P Capital IQ platform. The data used consisted of stock prices over several periods and the financial information

relevant to each component of the study. Approximately 89,640 samples were used for each variable gathered during a ten-year period. The selected samples were used as the focus of the investigation, anticipated to provide solutions to the research queries.

1.3 Problem Formulation

Particularly in different economic settings, the interaction between stock return volatility (SRV) and financial distress (FD) is still a crucial topic of study. Often an indicator of financial instability, SRV may greatly affect the risk profiles of companies; FD is a main result of financial difficulties. Still, few research examine how SRV and FD interact across different market structures—especially when contrasting industrialized and developing nations.

With an eye on market traits like size and leverage, this study seeks to investigate the interplay between SRV and FD. The following important questions will direct the research:

1) What is the relationship between SRV and FD in both developed and emerging markets, considering institutional and governance structures?
2) What role do market variables like market capitalization and financial leverage play in shaping the link between SRV and FD?
3) Are firms in emerging markets more susceptible to SRV and FD due to weaker financial infrastructure compared to firms in developed markets?
4) What is the impact of COVID-19 towards developed and emerging countries financial stability?

5) How can understanding SRV and FD help in risk management and financial planning in both market contexts?

1.4 Objectives of Research

Based on the problem formulation mentioned above, the objective to be achieved in this research are as follow:

1) To examine the key determinants of stock return volatility (SRV) and financial distress (FD) across firms in both developed and emerging markets.
2) To evaluate the influence of variables such as market capitalization, leverage on the relationship between SRV and FD.
3) To explore how SRV affects FD in firms operating in developed versus emerging markets with different institutional structures.
4) To analyse pre and post COVID-19 impact towards developed and emerging countries financial stability.
5) To investigate the implications of SRV and FD for risk management strategies and financial planning in diverse market contexts.

1.5 Benefits of Research

This research is expected to contribute benefits for few parties, especially in financial educational institutions as well as user for deeper insights as follows:

1.5.1 Theoretical Benefit

1) For Writer

This study seeks to further knowledge of the link between financial distress (FD) and stock return volatility (SRV), therefore helping to shape risk management ideas. This work may assist close gaps in current financial models by including SRV and FD into the research, therefore providing a more complex knowledge of how company financial health and market swings interact. Investigating the moderating functions of market capitalization, leverage, and financial limitations also helps one to understand the variation of these effects across companies and hence promote the creation of customized risk assessment models.

2) For Financial Educator

The results will provide real-world proof of the connection between SRV and FD, therefore enhancing instructional resources. It will improve knowledge of how systematic and firm-specific hazards support either financial stability or instability. This study may be used by teachers to show useful applications of risk management ideas and explain the need of multifarious analysis in comprehension of market behaviour. This study enhances the dialogue surrounding firm-specific resilience in financial contexts by elucidating the moderating roles of company characteristics.

1.5.2 Practical benefit

1) For Investor

This study provides investors with tools to assess risk-return trade-offs by understanding the impact of financial crises on stock return volatility. Incorporating firm-specific elements such as leverage or financial restrictions into assessments enhances the decision-making process for investors. Additionally, the findings enhance our comprehension of volatility dynamics, aiding in the identification of troubled stocks that may present unique investment opportunities or risks, thus promoting more effective portfolio diversification.

2) For Financial Institutions

The paper highlights the relationship between SRV and FD, thereby assisting financial institutions in developing stress-testing systems. More accurate forecasts of financial weaknesses during economic downturns may follow from this. By identifying companies that are less prone to financial crisis and immune to volatility shocks, the study also helps to build credit and investment products. Including these ideas into product offers will help to improve client risk assessment and portfolio customizing, thus raising client happiness and market competitiveness.

3) For Public

By investigating the dynamics of SRV and FD, the study may improve public financial literacy especially with respect to the hazards connected to highly volatile equities or financially troubled

companies. It provides a basis for realizing how macroeconomic and company-specific elements affect market behaviour, therefore enabling people to make more wise investment choices. Furthermore, by clarifying the wider consequences of financial crisis, our research might help public debate on market resilience and company stability.

1.6 Research Structure

The framework of this study is to provide a comprehensive overview from inception to conclusion. This framework defines chapters 1 to 5, providing clarity on the subjects addressed in each chapter. Consequently, the research framework will be organized as follows:

CHAPTER I: INTRODUCTION

This chapter provides a comprehensive comprehension of the research's context, the rationale behind its conduct, and the previous studies or research that have been conducted in the past to support the research.

CHAPTER II: LITERATURE REVIEW

This chapter provides a comprehensive examination of the theories and studies that served as the foundation for this research. It was anticipated that the reader would gain a more profound understanding of the topics to be discussed in this investigation by comprehending the literature. This chapter addresses the theory's relevance to the research.

CHAPTER III: RESEARCH METHODOLOGY

The empirical model, the operationalization of the variables, and the data will be elaborated upon in this chapter. The methodology for data collection

was explained from the very first stage of the research, and the variables that were analyzed in this study and the formulation of the empirical model for the research were emphasized.

CHAPTER IV: RESULT AND DISCUSSION

This chapter will address the primary objective of the research by presenting the findings. In this chapter, the validation test, descriptive statistics from data description, and two step GMM results will be detailed and discussed.

CHAPTER V: CONCLUSIONS AND RECOMMENDATIONS

The researcher will conclude the findings of the research and offer recommendations for future research and practical application to achieve superior results. This will be done after the results of the previous chapter have been obtained.