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ARE DAILY CROSS-BORDER EQUITY FLOWS PUSHED OR PULLED?

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Abstract—We investigate the conditions under which an intertemporal equilibrium model based on investors' portfolio decisions can explain the dynamics of high-frequency equity flows. Our model shows that, when there are barriers to international investment and when the expectations of foreign investors are more extrapolative than those of domestic investors (either due to foreigners being less informed or for behavioral reasons), unexpectedly high worldwide or local stock returns lead to net equity inflows in small countries. We investigate these predictions using daily data on net equity flows for nine emerging-market countries. Equity flows are positively related to host-country stock returns as well as market performance abroad at daily frequencies. Though these effects are remarkably robust at the daily frequency, they dissipate quickly.

I. Introduction

WITHIN the neoclassical paradigm, capital flows to where its marginal product is higher. As a result, the allocation of capital is more efficient and welfare is higher if capital can flow freely across borders. The emerging market crises of the 1990s persuaded many to challenge that view. Since 1997, economists, policymakers, and journalists have talked about shocks being propagated across countries with little regard for fundamentals through the actions of an "electronic herd" (Friedman, 1999, p. 142) of investors. This led Bhagwati (1998) to state that "Capital flows are characterized, as the economic historian Charles Kindleberger of the Massachusetts Institute of Technology has famously noted, by panics and manias." If markets work this way, it is not surprising that Stiglitz (1998), calling for greater regulation of capital flows, argues that ". . . developing countries are more vulnerable to vacillations in international flows than ever before."

In this paper, we investigate the determinants of daily cross-border equity flows for a sample of countries. Our paper builds upon existing empirical observations about holdings of foreign equity by domestic investors.[1] First, the home-bias evidence shows that domestic investors hold less foreign equity than if they held the world market portfolio. Second, there is some evidence that domestic investors buy foreign stocks following unexpectedly high returns on these stocks, a behavior often characterized as trend-chasing or momentum investing. We build a simple intertemporal model of equity flows and show under which conditions the model yields predictions consistent with these empirical facts. We find that a model consistent with these facts also predicts a relation between flows and nonhost-country stock returns that has not been examined empirically in the published literature.

Our main theoretical results are that (1) a model with perfect financial markets and investors who know the true distribution of returns cannot explain the existing evidence on flows, (2) the expectations of nonresident investors regarding the expected returns of a market have to be more extrapolative than the expectations of resident investors in

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[1] See Karolyi and Stulz (2003) for a review of this literature.

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