Summary

Understanding Asian equity flows, market returns and exchange rates

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Capital flows have always been a topic of interest and concern among emerging markets, no less because of their implications for exchange rate movements and possibly financial vulnerability. There was a time when these markets were worried about “sudden stops” and outflows. In more recent years, however, the worry has at times been more about inflows and the associated upward pressure on the exchange rate.

With the liberalisation of the capital account, cross-border portfolio flows have gained importance. In emerging Asia, despite rapid bond market development in the post-crisis period, the longer history and better accessibility of equity markets have kept equity flows relatively more important than bond flows in a number of markets. Accordingly, equity flows are seen as one of the key drivers of short-term exchange rate dynamics in these markets.

In this paper, we examine from different angles the behaviour of daily net flows in six emerging Asian equity markets in the post-crisis years (1999–2006). We focus on three main relationships. First, following a well-established area of research, we look at the relationship between net flows and market returns. In particular, we check for indications of “returns chasing” or even “positive feedback trading” behaviour among foreign investors in these Asian markets. Second, we explore the relationship between net flows and exchange rate movements. Not only do we consider exchange rate changes (currency returns) as one component of total returns influencing foreign investors’ demand for equities, we also want to assess explicitly whether net equity flows have any systematic influence on short-term exchange rate movements. Third, in addition to studying the average behaviour in individual markets, we investigate the coincidence and correlation of equity flows across markets. The analysis of cross-market relationships will shed light on questions such as whether foreign investors tend to go in or out of Asia at the same time, or whether foreign investors flock into Asian markets only when times are good and always leave at the first sign of trouble.

To investigate these three relationships, we use a variety of techniques. We start off with some commonly used time series techniques – Granger causality tests and vector autoregression (VAR) analysis – to investigate the full-sample relationships in individual markets. We then turn to other statistical techniques and event study analysis to characterise the cross-market relationship of net equity flows.

Our main findings are as follows:

- Consistent with the findings of earlier works, there is a significant relationship between daily net equity flows and stock market returns, with some indication of the presence of “returns chasing” and “positive feedback trading” behaviour.

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- While currency returns are found to matter relatively little for net equity flows, there is evidence that net equity flows matter for short-term exchange rate movements. This finding supports market economists' rationale of considering daily net equity flows as one popular factor for explaining day-to-day fluctuations of a number of Asian currencies.
- These typical average relationships are the most clearly detected in Korea, Taiwan, Thailand and, to a lesser extent, India. The typical relationships tend to be weak or absent in Indonesian and the Philippines, possibly reflecting the lower foreign investor participation and the relative dominance of domestic factors in these two equity markets
- There is evidence that net flows in the six markets are not independent. Foreign investors do go simultaneously in or out of Asian market sometimes. However, the nature of any such behaviour (be it intentional or purely coincidental) varies across episodes. In particular, there is at least some anecdotal evidence that at times of heightened market volatility (not necessarily a crisis), foreign investors expresses more optimism about Asian markets than do domestic investors, thus providing a stabilising force on stock prices. This last finding is consistent with the observation in several earlier studies that foreign investors' "returns chasing" behaviour during normal times disappeared during the Asian crisis.

The paper is organised as follows. Section 2 reviews the related literature and places the contribution of this paper. Section 3 introduces the data and some preliminary diagnoses. Section 4 kicks off the time-series analysis with Granger-causality tests. Section 5 continues with the analysis using a VAR framework. Section 6 looks at the behaviour of net equity flows more closely and presents the cross-market and event study analysis. Section 7 concludes.