Impacts of benchmark-driven investment on volatility and connectivity of emerging market capital flows

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Summary

Recent research finds that benchmark-driven investment has increased markedly since the global financial crisis, a phenomenon that has arguably led to more volatile capital flows and increased vulnerability for emerging markets. We investigate how far this is true by examining the contribution of benchmark-driven investment to the volatility of foreign portfolio flows of emerging markets, focusing on equity flows, and the sensitivity of benchmark-driven investment to factors that tend to have an influence on the global economy or emerging markets. Interestingly, we find that benchmark-driven-investment-related flows are generally less volatile, thus having an effect of reducing, rather than increasing, the overall volatility of foreign portfolio flows. However, our results also show that they are more interconnected with each other due

possibly to their higher sensitivity to global and emerging-market-related factors, supporting the notion that their rapid growth could make emerging markets more vulnerable in times of extreme market adversity, as sudden and simultaneous withdrawal of portfolio flows would potentially expose them to greater risks of external financing or balance of payment difficulties.