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Living with the "enemy": an analysis of foreign investment in the Japanese equity market

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Abstract

This paper studies the impact of foreign investment on domestic financial markets. In particular, it examines the empirical validity of some protectionist claims used by regulators to restrict foreign investment. These people argue that: (1) trading by foreign investors tends to increase market volatility more than trading by domestic investors; (2) foreign investors have more sophisticated investment technology than do their domestic counterparts, causing domestic investors to "lose out" to foreign ones; and (3) foreign investors tend to make investment decisions on the basis of short-term gains rather than long-term fundamentals, such as corporate dividend growth. We find no evidence supporting these claims from the Japanese experience. To the contrary, we find that foreign investors tend to be long-term contrarian players in the market.

JEL classification: F39; G15

1. Introduction

Theoretical and empirical research in finance has demonstrated that international diversification brings enormous benefit to portfolio investors.[1] A recent economic study by Obstfeld (1994) also shows that international diversification can spur economic growth in developing countries by allowing risk-averse investors to take on risky projects. Few studies, however, have systematically examined the impact of foreign equity portfolio investment on domestic financial markets. This is an

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[1] See, for example, Bailey and Stulz (1990), Eun and Resnick (1988), Grauer and Hakansson (1987), Hardy (1990), Harvey (1995) and Stulz (1987). Stulz (1999) gives a comprehensive survey of the topic.

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important issue, particularly given the recent dramatic declines in stock prices of many emerging markets that have resulted from foreign money outflow, and the severe financial disruption that has been created in these economies. Indeed, a serious question is raised about whether international "hot money" really facilitates long-term market development in emerging markets.[2] The presence of foreign investment barriers in many countries suggests that government regulators have serious doubts about the long-term benefits of foreign investment.

Financial authorities in these vulnerable emerging markets often argue that foreign portfolio investment would increase market volatility, hence exposing them to unduly high risk. Another concern is that investors in developed markets have sophisticated investment technology to which domestic investors do not have access, so that domestic investors tend to "lose out" to foreign investors. Open market reform can become quite difficult under the strained political circumstances that result. Emerging market regulators are also concerned that foreign investors tend to be short-term players whose presence in the market today may not be guaranteed tomorrow. In Thailand, for example, investment by foreigners is restricted to a different class of shares that are traded on a separate exchange.[3] Similar regulation exists in China. High withholding taxes on investment gains are another form of restriction against foreign investment (see Harvey (1995) for a description of various capital restrictions in the emerging markets).

In this paper, we study the empirical validity of some of the arguments against foreign investment by examining the behavior of foreign investors in the Japanese stock market. We evaluate and contrast this behavior with that of Japanese domestic investors. The questions we ask are: (1) Do foreign investors demonstrate different investment behavior compared to domestic investors? In particular, are foreign investors contrarians or counter-contrarians, or are they short-term oriented in their investment horizon? (2) How do domestic and foreign investors fare with respect to investment results? and (3) Is there evidence that foreign investors cause higher volatility in the domestic market?

Although there may well be other concerns of financial market regulators, such as protection of domestic financial institutions and investors against foreign competition, here we focus on the above three general questions that are often asked in the context of open-market reforms of emerging markets.

The sample period of this study encompasses the gradual deregulation of the Japanese market, especially with regard to foreign investment over the last 30 years. Our data dates back to the early 1970s when the market was much smaller and more tightly regulated against foreign investment. Then, following the significant amendment to the Foreign Exchange Control Law that took effect at the end of 1980, Japan was, in principle, open to foreign ownership.[4] As a result, our more recent data on trading volume shows a significant increase in trading activities by foreign

[2] "Private-Capital Flows Can Hurt Poor Nations," *Wall Street Journal*, January 30, 1995.

[3] Bailey and Jagtiani (1994) document capital market segmentation in the Thai stock market.

[4] Kang and Stulz (1998) examine foreign ownership in Tokyo Stock Exchange listed firms.