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International investment patterns: Evidence using a new dataset

Anil V. Mishra

Department of Finance and Banking, University of Southern Queensland, QLD 4350, Australia

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Abstract

This paper examines the bilateral, source and host factors driving portfolio equity investment across a set of countries using International Monetary Fund's new dataset on international equity holdings at the end of 1997, 2001 and 2002.

The paper finds that the bilateral equity investment is strongly correlated with the underlying patterns of trade in goods and services. The information asymmetries and cultural-institutional proximity are important for bilateral equity investment. The size of domestic stock market is the key correlate of aggregate foreign portfolio equity asset and liability holdings. The scale of aggregate foreign equity asset holdings is larger for countries having high income per capita.

Keywords: International portfolio equity investment; Source and host country factors; Trade

1. Introduction

International parity relations suggest that in a fully-integrated global economy without frictions in product or asset markets, the investors should hold identical portfolios, regardless of nationality. However, it is observed that, in the international equity investment patterns, there is a strong bilateral variation in portfolio allocations. The study of asymmetries in the portfolio allocations raises several questions. For instance, which bilateral factors are responsible for explaining the overall size of countries' portfolio investment holdings? Are cultural, informational factors important in explaining the asymmetries in portfolio allocations? How do financial frictions in

E-mail address: anil.mishra@usq.edu.au.

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markets affect the structure of international portfolio allocations? What is the connection between domestic and international financial development? The answers to these questions are important to several fields in economics including international macroeconomics and international finance, portfolio analysis, behavioural finance, etc. This paper focuses on identifying the bilateral factors that explain the asymmetries in portfolio allocations.

There is a voluminous literature that tries to explain the international patterns of bilateral investment. Investments may be broadly classified as direct investment, portfolio investment, financial derivatives, reserve assets and other investment. According to International Monetary Fund's (1993) Balance of Payments Manual 5 (BPM5), direct investor has ownership of a minimum of 10 percent of the ordinary shares or voting power or the equivalent in the direct investment enterprise. Wei (2000) and Stein and Daude (2003), among others focus on the geography of foreign direct investment. These studies employ the readily available, Organization for Economic Cooperation and Development (OECD) database for foreign direct investment.

Other investment category includes trade credits, loans, currency and deposits and other assets and liabilities. Buch (2002, 2003), Buch et al. (2003) and Kawai and Liu (2001) study the bank lending by employing the readily available Bank for International Settlements (BIS) database.

Portfolio investment category includes financial instruments in the form of equity and debt securities that are usually traded (or tradable) in organized markets. Resident holders/issuers of portfolio investment are mainly driven by the consideration of portfolio diversification. Ghosh and Wolf (2001) and Sarisoy (2003) study the comparative analysis of the impact of spatial factors on different international investment categories. Portes et al. (2001) investigate the roles of explicit informational variables and distance in explaining cross-border trade in corporate equities, corporate bonds and government bonds, for the United States.

These studies have used the OECD and BIS database on direct investment and bank lending, respectively. BIS data measures the gross claims and liabilities of all banks located in a reporting country vis-à-vis entities located in other countries. In addition, BIS data also measures the foreign claims of the banks' head office and all its branches and subsidiaries on a worldwide consolidated basis, excluding positions between offices of the same group. OECD data measures international direct investment to and from the OECD area. This paper employs a new International Monetary Fund's (IMF's) Coordinated Portfolio Investment Survey (CPIS) dataset on portfolio equity investment. CPIS collects information on the stock of cross-border holdings of equities, long and short term debt securities valued at market prices prevailing at the time of the CPIS, and broken down by the economy of residence of the issuer. CPIS data focuses on bilateral equity holdings as against BIS dataset which does not differentiate between equities, bonds and cross-border bank lending. This is important because informational costs differ for different types of assets (Portes et al., 2001). This paper also employs International Investment Position (IIP) data. IIP is the balance sheet of the stock of external assets and liabilities of an economy. IIP data focuses on countries' external assets and liabilities as against OECD dataset which focuses only on OECD countries' international direct investment.

Some authors focus specifically on the pattern of bilateral equity investment. Portes and Rey (2005) use panel data set on bilateral gross cross-border equity flows among 14 countries, for the period from 1989 to 1996. They show that gross transaction flows depend on market size and trading costs. The geography of information is the main determinant of the pattern of international transactions. Some studies on the geography of the stock of portfolio equity investment focus on a single source country. Studies by Ahearne et al. (2004), Mann and Meade (2002) and Dahlquist et al. (2003) focus on United States (US). Coval and Moskowitz (1999) and Huberman (2001) study the regional investment patterns within US. Honohan and Lane (2000) focus their research