Research in International Business and Finance xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Full length article

Cyclical behavior of international fund flows[☆]

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A R T I C L E I N F O

JEL classification:
E32
F30
F32
G15
G23

Keywords:
International fund flows
Cyclicality
Equity flows
Bond flows
Push and pull factors

A B S T R A C T

We investigate the cyclicality of international fund flows employing correlation and regression analysis using monthly data for almost 70 countries between 1996 and 2013. International fund flows are cross-border investments by global funds. Our results suggest that contemporaneously international fund flows are counter-cyclical: fund flows are above trend when output is below trend. Bond flows are more counter-cyclical than equity flows. Furthermore, the counter-cyclical behavior of fund flows has become more pronounced after the global financial crisis. Fund flows into non-OECD countries are mainly driven by global factors while fund flows into OECD countries are more influenced by country-specific factors.

1. Introduction

The cyclical behavior of capital flows has received much attention in recent years (Kaminsky et al., 2005; Levy Yeyati et al., 2007; Smith and Valderrama, 2009; Broner et al., 2013; Contessi et al., 2013). The standard endowment model of a small open economy suggests that capital flows should be counter-cyclical because a country would like to borrow abroad to sustain the permanent level of consumption during recessions. But most empirical studies find that capital flows are pro-cyclical, especially in developing countries (Kaminsky et al., 2005; Broner et al., 2013).

As the behavior of different types of capital flows is likely to be driven by different factors (Forbes and Warnock, 2012), several recent studies do not employ net capital flows but focus on the cyclical properties of gross capital flows (Broner et al., 2013) or on specific capital flows, such as foreign direct investments and portfolio investments (Levy Yeyati et al., 2007; Smith and Valderrama, 2009; Contessi et al., 2013). This sometimes leads to different outcomes concerning the cyclicality of capital flows. For instance, Smith and Valderrama (2009) conclude that bond and equity flows tend to be pro-cyclical with domestic investment while FDI tends to be counter-cyclical, while Contessi et al. (2013) find that total inward capital flows are pro-cyclical with respect to output, but net outflows are counter-cyclical with respect to output.

So far, the cyclicality of one type of capital flows, namely international fund flows, has received scant attention. International

☆ This research is supported by National Natural Science Foundation of China (NSFC Grant Numbers: 71273257, 71532013). The views expressed do not necessarily reflect those of De Nederlandsche Bank.

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http://dx.doi.org/10.1016/j.ribaf.2017.07.123
Received 18 November 2016; Accepted 5 July 2017
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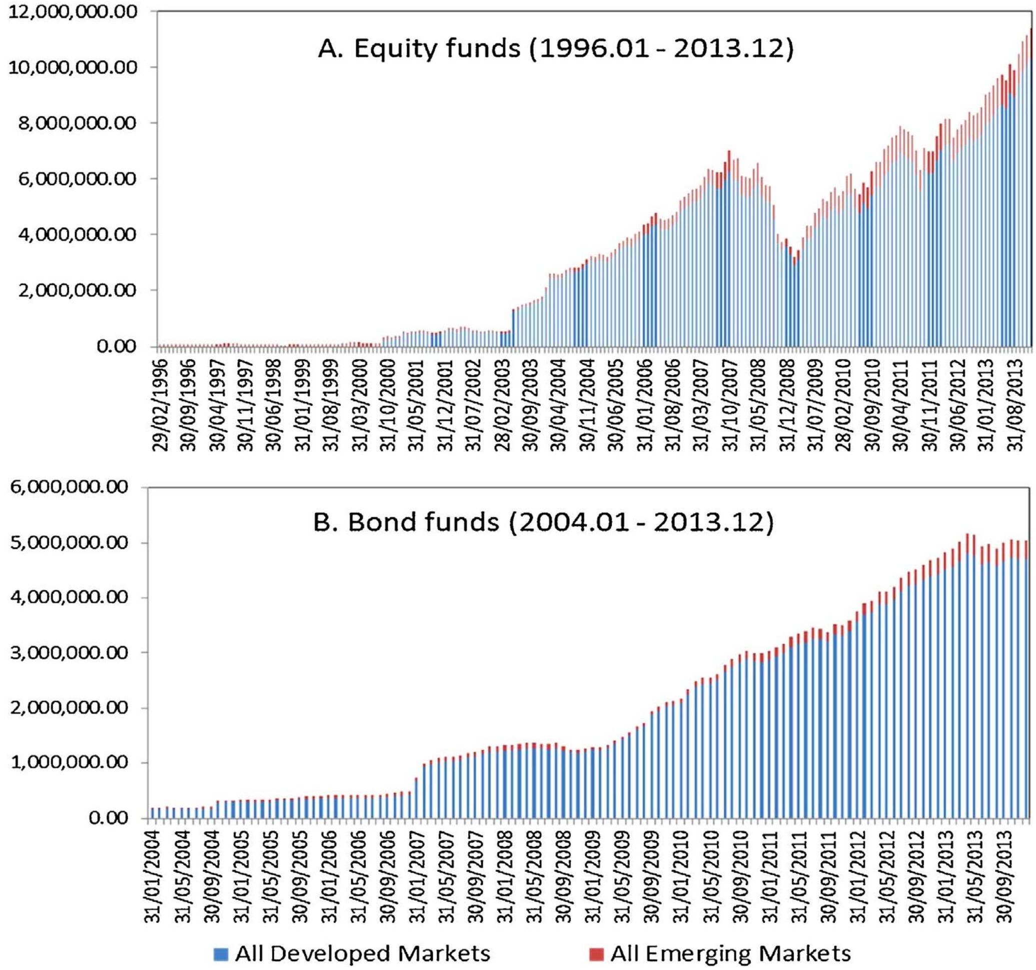

Fig. 1. Total net assets of funds (US $ million).

fund flows are cross-border investments in bond and equity markets by global funds, such as mutual funds, exchange traded funds (ETFs), closed-end funds and hedge funds. Fig. 1 shows that total net assets under management by international funds (covered by Emerging Portfolio Fund Research (EPFR) Global) increased dramatically since 1990s, especially after 2004. While assets under management reverted during the global financial crisis, especially for equity funds, they reached unprecedented heights after the crisis. Compared with equity funds, bond funds have fewer assets under management. As noted by Gelos (2013), fund flows are more volatile than most other types of capital flows. In addition, they play an increasingly important role in international financial markets and the transmission of shocks (Gelos, 2013; Raddatz and Schmukler, 2012). Hence, investigating the cyclicality of international fund flows is of great importance.

The cyclicality of fund flows depends, inter alia, on their investment strategy. Under a positive-feedback trading strategy (Bohn and Tesar, 1996; Froot et al., 2001), equity investments tend to flow into the country with higher equity returns. If equity returns are related to domestic output growth, such an investment strategy may cause fund flows to be pro-cyclical. However, under a portfolio-rebalancing strategy (Hau and Rey, 2006), higher domestic equity returns enable investors to reduce equity holdings in this country to diminish their FX risks. In that case fund flows are more likely to behave in a counter-cyclical fashion.

Two previous studies have examined the behavior of international fund flows. Raddatz and Schmukler (2012) analyze the behavior of investors in and managers of mutual funds. They find that investors react to shocks by redeeming from funds investing in countries that are in crisis and by increasing investments in funds investing in countries where conditions improve. Fund managers behave in a similar fashion. They tend to move capital out of crisis countries. Puy (2016) defines periods of at least two consecutive monthly fund inflows or outflows as “surge phase” or “retrenchment phase”, respectively. Using a diffusion index to measure the share of countries experiencing the same phase he concludes that international portfolio flows co-move across countries. Although these studies are related to our work, Raddatz and Schmukler (2012) and Puy (2016) do not investigate the relationship between country-level fund flows and domestic business cycles, which is the focus of our research.

Kaminsky et al. (2005) were among the first to address the cyclicality of capital flows. They consider capital flows as counter-cyclical if the correlation between the cyclical component of capital inflows and the cyclical component of output is negative. Based

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