Journal of International Money and Finance 44 (2014) 1–23

Contents lists available at ScienceDirect

Journal of International Money and Finance

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

The determinants of the volatility of returns on cross-border asset holdings☆

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JEL classification:
E44
F36
G15

Keywords:
Asset return volatility
Financial integration
International portfolio choice
Asset holdings
Endogeneity bias

ABSTRACT

Using both panel and cross-sectional models for 28 industrialized countries observed from 2001–2009, we report a number of findings regarding the determinants of the volatility of returns on cross-border asset holdings (i.e., equity and debt). Greater portfolio concentration and an increase in assets held in emerging markets lead to an elevation in earning volatility, whereas more financial integration and a greater share held in Organization for Economic Cooperation and Development countries and by the household sector cause a reduction in the return volatility. Larger asset holdings by offshore financial corporations and non-bank financial institutions cause higher market volatility, although they affect volatility in the equity and bond markets in the opposite way. Overall, both panel and cross-sectional estimations provide very similar results (albeit of different magnitude) and are robust to the endogeneity problem.

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☆ An anonymous referee deserves thanks for thoughtful and constructive comments which have substantially improved the paper. We are grateful to the seminar participants at the 2012 European Financial Management Association meeting for helpful comments and suggestions, and to Megan Foster for help with proofreading. The views expressed here are authors' own and do not necessarily reflect those of the affiliated institutions. The usual disclaimer applies.

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http://dx.doi.org/10.1016/j.jimonfin.2014.01.004

1. Introduction

After growing in tandem with gross domestic product (GDP) for most of the first eight decades of the 20th century, (global) financial assets grew at a more rapid pace after 1980 as companies and financial institutions turned increasingly to capital markets for financing. Although a spate of currency and financial crises in the late 1980s and early 1990s interrupted the process, advances in information and communication technology, financial market liberalization and, in particular, the creation of the European Monetary Union (EMU) have contributed to a dramatic surge in global capital flows in recent years. According to Deutsche Bundesbank (2009), total cross-border assets and liabilities documented worldwide amounted to some US$192 trillion at the end of 2007 – reflecting an almost four-fold increase compared with 1999.[2] However, the upheaval in financial markets in late 2008 abruptly halted this decade-long expansion of the global capital market, resulting in an 8% drop in the value of world's financial assets by the end of 2008, the largest decline compared with those seen in the previous economic and financial turmoil seen in 1990–91, 1997–98 and 2000–02 (McKinsey Global Institute, 2009). At the time of writing (summer 2012), the financial markets have yet to recover fully from the global financial crisis.

The surge in cross-border capital flows[3] in the first decade of the new millennium has stimulated numerous empirical investigations that can be roughly divided into two strands of literature. The first strand of the literature concentrates on the determinants of bilateral asset holdings, covering[4] the role of geography, culture and information costs (Ahearne et al., 2004; Chan et al., 2005; Portes and Rey, 2005); trade (Aviat and Coeurdacier, 2007; Lane and Milesi-Ferretti, 2008); exchange rate risk and currency unions (Lane, 2006; Coeurdacier and Martin, 2009; De Santis and Gerard, 2006; Fidora et al., 2007); institutions (Vlachos, 2004; Wei and Gelos, 2005; Daude and Fratzscher, 2008) and corporate governance (Dahlquist et al., 2003) as important determinants of cross-border asset holdings. Controlling for many of these determinants of international portfolios, Coeurdacier and Guibaud (2011) found that investors tend to tilt their foreign holdings towards countries that offer better diversification opportunities.

The second strand of the literature looks at the diverse patterns of foreign capital flows, including topics such as the changing nature of a country's (gross) external positions and the associated composition of international portfolios (Lane and Milesi-Ferretti, 2007), portfolio investment as a channel of international risk sharing (Sørensen et al., 2007; Demyanyk et al., 2008; Kose et al., 2009; Bracke and Schmitz, 2011; Balli et al., 2011a,b; 2013) and the impact of the recent financial crisis on international diversification (Vermeulen, 2013; Balli et al., 2013). In fact, studies on international capital flows have burgeoned so rapidly in recent years that they are collectively referred to today as a completely new branch of literature, namely "Open Economy Financial Macroeconomics" (Coeurdacier and Rey, 2011).

However, all the aforementioned studies have one shortcoming in common: they remained silent on the underlying risk affecting cross-border portfolio returns. Risk, captured by the volatility in returns, is one of the two pillars of investors' risk-return profiles underlying their investment decisions. Our goal in this paper is to examine the factors that are likely to be determinants of the earning volatility in cross-border asset holdings.[5] Understanding the (major) sources of earning volatility is crucial if appropriate policy responses are to be framed, especially to minimize the potential welfare costs associated with unstable asset returns. When investment earnings are unpredictable and volatile, so is growth. Although wider swings in the performance of various asset classes create increased profit opportunities for strategies such as macro and convertible arbitrage, these short-term gains should not be traded off for a country's overall financial stability. Across the board, the equity loss from the 2008 stock market crash was so damaging that at the 2008 savings rate, it would take 18 consecutive years for the world's households to amass the lost $28.8 trillion of global wealth (McKinsey Global Institute,

[2] As a result, financial depth (the ratio of a country's financial assets to GDP) has been increasing consistently across all countries. For example, in 1990–2006, the number of countries whose financial assets' value exceeded that of their respective GDPs increased from 33% to 72% (Farrell et al., 2008).

[3] This includes foreign direct investment, purchases and sales of foreign equities and debt securities, and cross-border lending and deposits.

[4] This collection of studies was originally compiled by Coeurdacier and Guibaud (2011, p. 291).

[5] Our paper does not focus on the volatility of international capital flows, e.g., sudden reversals of capital flows or sharp declines in inflows.

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