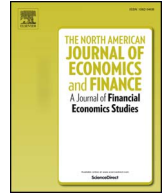


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Foreign equity flows: Boon or bane to the liquidity of Malaysian stock market?

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ABSTRACT

This paper examines the impact of gross foreign equity inflows on aggregate liquidity of the Malaysian stock market using newly assembled foreign trading data and the best performing bid-ask spread proxy. Employing vector autoregression, we discover a one-way causality from gross inflows to aggregate liquidity, and foreign investors erode liquidity of the Malaysian stock market. Additional analyses reveal that uncertainties in the U.S. markets negatively affect aggregate liquidity through the flows of foreign institutions, whose positive feedback trading destabilizes the local bourse. Despite the shocks, there is sufficient liquidity provision from local state-backed institutional funds and local proprietary day traders.

1. Introduction

Many emerging market economies have embarked on financial liberalization policies since the late 1980s, which include the removal of statutory restrictions on foreign equity flows. The desirability of having foreign investors' presence in emerging stock markets is a contentious topic. On the positive side, previous studies find that financial liberalization reduces cost of capital (Bekaert & Harvey, 2000), stimulates growth in productivity (Kose, Prasad, & Terrones, 2009) and national output (Bekaert, Harvey, & Lundblad, 2005), increases market efficiency (Bae, Ozoguz, Tan, & Wirjanto, 2012), and improves firm performance (Mitton, 2006). On the other hand, several prominent economists such as Rodrik and Subramanian (2009) and Stiglitz (2010) argue that unfettered capital mobility is detrimental to financial stability, especially in the developing economies. Empirical evidence, however, is generally in favor of financial liberalization. Some studies show that the boom-bust cycle in stock prices is only present in the short run, and the positive effects on economic growth brought by financial openness far outweigh loss in growth from crisis (see Kaminsky & Schmukler, 2008; Ranciere, Tornell, & Westermann, 2006). Nonetheless, it should be noted that an economy needs to attain a certain level of financial and institutional development before the benefits of financial liberalization can be reaped (for details, see Kose, Prasad, Rogoff, & Wei, 2009).

Liquidity, defined as the ease of trading a security without large price swings, is severely understudied in the vast literature examining the costs and benefits of financial liberalization. Often taken for granted during good times, liquidity, or rather the lack thereof, takes center stage during crises as the primary channel through which financial contagion occurs (Brunnermeier & Pedersen, 2009; Calvo, 2012; Longstaff, 2010). One classic example of how evaporation of liquidity in one market could lead to a full-blown financial crisis is the complete dry-up in the U.S. interbank market in August 2007. On the policy side, stock exchange regulators, particularly those in emerging markets, have been working on enhancing market liquidity. Relatively low level of liquidity in these

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markets remains a major threat to investment return and a barrier to further growth in foreign portfolio investment. In the last decade, ultra-loose monetary policies in developed countries which sent hot money flooding the emerging markets had raised one important policy debate – does the local bourse suffer from liquidity dry-up when foreign funds fled the market in droves? Unfortunately, the literature does not provide useful policy guides as the liquidity effects of foreign portfolio flows have been severely understudied. Even among the pool of limited literature on this aspect, empirical evidence is at best mixed. Cross-country studies generally find liquidity-enhancing effect of foreign participation (Bekaert, Harvey, & Lumsdaine, 2002; Lee & Chung, 2018; Levine & Zervos, 1998; Ng, Wu, Yu, & Zhang, 2016; Vagias & van Dijk, 2012; Wei, 2010), whereas individual-country studies conclude otherwise (Agudelo, 2010; Lim, Thian, & Hooy, 2017; Peranginangin, Ali, Brockman, & Zurbruegg, 2016; Rhee & Wang, 2009; Vo, 2016).

Adding further complication is the ambiguous theoretical predictions on the relationship between foreign trading and liquidity. The asymmetric information model (Easley & O'Hara, 1987; Glosten & Milgrom, 1985; Kyle, 1985) argues that privileged access to private firm-specific information gained by informed traders drives a gap in market knowledge between them and the uninformed traders. When these privately informed investors capitalize on such superior information in their trading activity, bid-ask spreads widen and hence liquidity declines due to the increases in adverse selection costs. The opposing effect has been predicted by Admati and Pfleiderer (1988) whose model shows that liquidity is an increasing function of noise trading. Noise traders, who are uninformed and do not have exogenous reasons to trade, allow specialists to recoup their losses from trades with informed traders. The reduction in adverse selection costs permits specialists to offer lower spreads, hence boosting liquidity in the market. Unfortunately, previous studies are not able to precisely distinguish whether liquidity is driven by informed or noise trading as predicted by the two competing theoretical models due to their use of foreign ownership data that do not capture trading activity. This is because foreign investors who prefer longer investment horizon might resort to buy-and-hold strategy and rarely engage in active trading, and thus the detected causal relationship from foreign ownership to liquidity might operate through other non-trading channels such as information competition (see references cited in Lim et al., 2017) and corporate governance (see Chung, Elder, & Kim, 2010; Prommin, Jumreornvong, & Jiraporn, 2014).

Given the inconclusive empirical evidence and ambiguous theoretical predictions, this study therefore aims to empirically examine the effect of gross foreign equity flows¹ (hereafter referred to as gross inflows) on the aggregate liquidity of the Malaysian stock market, known as Bursa Malaysia. Our research framework addresses five main drawbacks in the extant liberalization-liquidity literature. First, the commonly applied proxies for foreign participation are the official liberalization dates, stock market openness indicators, investable weight and foreign ownership data. Such proxies, however, do not capture the dynamics of foreign portfolio flows at a higher frequency. Only three liquidity papers utilize trade data of foreign purchases and sales, either at the intraday (Peranginangin et al., 2016), daily (Agudelo, 2010) or monthly (Vagias & van Dijk, 2012) intervals. We are able to obtain the weekly foreign trading data from Bursa Malaysia. Second, although the cross-country study by Vagias and van Dijk (2012) reports liquidity-enhancing effect of foreign portfolio flows, the findings from such large sample panel analysis cannot be generalized for policymaking due to institutional heterogeneity and the declining authority of one-size-fits-all policy. Moreover, their data from Treasury International Capital (TIC) have been heavily criticized for capturing financial transactions of at least USD50 million that involve only U.S. investors, and its inability to distinguish the identity of investors when a transaction goes through a third-country intermediary (for details, see Warnock & Warnock, 2009). This paper thus provides a country-specific study on Malaysia, which might serve as a reference point for other developing countries experiencing huge foreign portfolio flows. Third, given the dominance of firm-level studies, we instead complement the limited country-level liquidity work by constructing aggregate market liquidity which has gathered momentum in recent years due to its macro policy implications and media coverage during periods of financial instability (for details, see Liew, Lim, & Goh, 2016 and references cited therein).² Fourth, while the regression method is popular among previous studies, its finding merely provides evidence of association but cannot rule out the possibility of reverse causality that foreign investors are attracted to higher liquidity. We adopt the vector autoregression (VAR) framework where the direction of causal relation can be ascertained through the Granger non-causality test, and the associated impulse response function provides statistical inference on whether foreign investors enhance or erode liquidity. Finally, Fong, Holden, and Trzcinka (2017) show that each market has its own best performing liquidity proxy that might not necessarily be the best in another market. For instance, the popular Amihud (2002) illiquidity ratio is only found to be the best cost-per-volume liquidity proxy for Italy, Japan, Norway, Spain and Sweden. The liquidity measure of “Zeros”, previously advocated by Lesmond (2005) and Bekaert, Harvey, and Lundblad (2007) for emerging markets, has been found to be the worst performer for most countries. The selection of our liquidity proxy is based on its strong correlations with intraday benchmarks in liquidity horserace and hence provides more accurate measurement of local liquidity.

Among developing countries, the Malaysian stock market was one of the earliest to open its door to foreign investors. Since the liberalization of the local bourse, Malaysia had witnessed a few episodes of major changes in the country's capital control policy which were closely associated with the occurrence of financial crises. In September 1998, Malaysia imposed selective capital controls

¹ In the terminologies of the capital flows literature, gross inflows refer to the net purchases of domestic assets by foreign investors, gross outflows are the net purchases of foreign assets by domestic investors. Hence, net inflows are computed by subtracting gross outflows from gross inflows. This study focuses solely on the gross inflows of foreign investors.

² For instance, Smimou and Khallouli (2015) show that aggregate market liquidity promotes economic growth, whereas Næs, Skjeltorp, and Ødegaard (2011) find that this variable is superior in predicting the real economy than stock prices. Additionally, Brockman, Chung, and Pérignon (2009) and Chordia, Roll, and Subrahmanyam (2000) report a strong co-movement between the liquidity of individual stocks and aggregate liquidity, and such liquidity commonality is found to be exceptionally strong among emerging Asian stock exchanges.

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