BANK FOR INTERNATIONAL SETTLEMENTS

Patnaik & Shah's "Investment choices of foreign and domestic institutionsal investors": Comments

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Agenda

I. Theory: the “tourist model” of international finance

II. No return chasing?

III. International risk sharing: foreign investors’ call on the harvest in emerging markets

IV. Questions

The “tourist model” of international finance

- Of Neil Soss, Chief Economist, CSFB (Genberg et al, 7th Geneva Report on the International Economy (2005))
- Financial tourists have their favoured investments.
  - Tourists hit Florence, Venice, Rome.
  - Financial tourists buy large cap, liquid shares, especially telcoms and IT; benchmark government bonds.
  - Patnaik and Shah confirm size and liquidity preference of foreign investors.
- Patnaik and Shah’s finding of export focus of foreign investors may be more characteristic of small countries (Nokia) than large countries (Telmex, Petrobras).
- Similarly, focus on young firms may not be typical.

The “tourist model” of international finance: time series aspects

- When tourists are present in strength, their favoured locations become tourist traps
  - Similarly, when financial tourists are present in strength, investments rise in price relative to the rest of the market.
- Over time, tourists learn to visit smaller cities, and eventually buy apartments.
  - Financial tourists learn over time to buy smaller and less liquid investments.
  - Private capital and direct investment.

No return-chasing?

- Chakrabarti, “FII flows to India: Nature and causes” in ICRA Bulletin (2001) interpreted positive correlation between returns and flows as returns drawing inflows.
- Chai-anant and Ho, “Understanding Asian equity flows, market returns and exchange rates”, BIS working paper (2008) analyse daily flows and returns and find return chasing by foreign investors, also effects on currencies.
- Do the cross-sectional data of Patnaik and Shah permit much of an inference?

Return-chasing and international risk sharing

- Textbook case has investors in different economies exchanging claims on harvest to smooth consumption.
- Instead, global investors buy rising emerging markets and sell falling emerging markets.
- In effect, not an outright long position as in the textbook but a (dynamically managed) call option on the emerging market harvests.

Questions

- Who are the domestic institutional investors? Are the holdings arm's length investments or cross-holding cementing relationships? Cross-holdings within state sector or industrial groups?
- Weight observations by market capitalisation?
- Can authors make inference regarding return chasing from these data?
- Who buys when foreign investors sell? Who is providing liquidity under the current circumstances? Role of government-affiliated institutional investors?