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Why Regulated Funds Are a Relatively Stable Source of Foreign Investment for Emerging Economies

By Chris Plantier

The press and policymakers focus a great deal of attention on flows to U.S. and European regulated mutual funds and exchange-traded funds (ETFs), in part because these funds are perhaps the most easily observed and readily measured players in capital markets. As we've pointed out in our discussion of "dark matter" in the financial markets, regulated funds are more likely to be a source of stability—not instability—because funds account for relatively small shares of the markets they engage in and usually are among the less-active players in those markets as well.

Lately, the attention paid to funds' activities in emerging markets (EMs) has been especially intense. Press stories are often written as if funds are the only foreign investors in EM capital markets, and much academic work—including a recent paper by the Bank for International Settlements—has focused squarely on fund flows. But regulated fund investors are not the only foreign investors in EMs, as recent analysis by the Institute of International Finance has shown.

Last month, we presented the data to demonstrate that U.S. and European domiciled funds constitute a small share of EM capital markets—8.1 percent of equity markets and 4.2 percent of bond markets at year-end 2012 ("Sizing Up Mutual Fund and ETF Investment in Emerging Markets"). That article concluded that funds should not be singled out among EM investors—domestic and foreign—for special attention based on financial stability concerns.

But by itself, the data showing regulated funds' relatively small share of EM capital markets cannot fully address the hypothetical concerns that funds may destabilize EM economies. So let's advance the analysis further by taking an empirical look at two questions:

1. What share of foreign portfolio investment in EMs comes from funds?
2. Do funds contribute more or less than other foreign investors to the variability of EM capital flows?

The answers, in advance: Yes, among foreign investors, funds are significant contributors to EM portfolio investment. But fund investments are more stable—i.e., they contribute less to variability—than other foreign investments. In fact, for the EMs with the most investment from U.S. and European funds, those funds' contribution to the variability in foreign portfolio flows is less than their share of all foreign portfolio investment. Thus, regulated funds provide a sizable and relatively stable source of foreign financing for EM countries.

Funds Provide a Sizable Fraction of Foreign Portfolio Investment in EM Countries

It's important to remember that in many countries, domestic investors provide the vast majority of the capital. Most Chinese stocks and bonds, for example, are held by Chinese investors—just as most U.S. investments are held by Americans. But foreign portfolio investment is still important, particularly in EMs. And among foreign investors, funds collectively play an important role.

As Table 1 illustrates, funds account for 39 percent of *foreign* portfolio investment—i.e., foreign holdings of equities and bonds—in 11 EM countries.[1] In eight of the 11 countries, funds' share ranged between 25 and 40 percent; in China, India, and Russia, funds accounted for a larger share. On average, other foreign investors (e.g., defined benefit pension funds, sovereign wealth funds, hedge funds, individual investors with direct holdings) held the remaining 61 percent. Thus, funds hold a sizable fraction of the EM country equities and bonds that are held by all foreign investors.

Table 1: Regulated Funds Account for a Sizable Share of Foreign Portfolio Investment in EMs

	Fund share of foreign portfolio investment, percent *Year-end 2012*
Brazil	29
Chile	30
China	82
India	56
Korea	25
Mexico	30
Poland	26
Russia	47
South Africa	39
Thailand	34
Turkey	29
Simple average	**39**

Source: ICI calculations based on EPFR Global and International Monetary Fund (IMF) balance-of-payments data (June, 2014 CD-ROM)

Funds Are a Relatively Stable Source of Foreign Investment to EM Countries

Funds also are a relatively stable source of capital to EM countries. To reach this conclusion, we calculated the variance of net foreign portfolio capital flows to these 11 countries. We then broke this variance into the proportions attributable to mutual funds and ETFs (Column 1) and that attributable to all other foreign investors (Column 2).[2] A residual amount of the variance in capital flows, which we report in Column (3), is attributable to the correlation between the flows in Columns (1) and (2).[3]

Table 2: Regulated Funds' Flows to EMs Are Not a Primary Source of Variability

Quarterly data, 2005:Q1–2013:Q4[2]

	Percentage of variance in net foreign portfolio capital flows due to:			*Memo:*
	Regulated funds	Other foreign portfolio investors	Residual[1]	Standard deviation of net foreign portfolio capital flows *Billions*
	(1)	(2)	(3)	(4)

Brazil	25.2	73.1	1.6	8.4
Chile	4.1	100.0	-4.1	1.6
China[2]	48.4	48.2	3.3	7.8
India[2]	10.8	64.8	24.5	5.6
Korea	7.6	74.7	17.7	8.2
Mexico	5.4	89.4	5.2	7.7
Poland	4.5	74.9	20.7	3.6
Russia	21.9	72.5	5.6	5.4
South Africa	10.8	91.9	-2.7	3.0
Thailand	13.2	66.1	20.7	2.2
Turkey	4.7	82.0	13.3	4.3
Simple average	**14.2**	**76.2**	**9.6**	**5.2**

[1] "Residual" is due to the correlation between net fund flows and net flows from other foreign investors.

[2] In the IMF database, China's balance-of-payments data are only available from 2010:Q1 to 2012:Q4, and India's balance-of-payments data on debt flows are only available from 2009:Q2 to 2013:Q1.

Source: ICI calculations based on EPFR Global and IMF balance-of-payments data (June, 2014 CD-ROM)

The numbers presented in Table 2 strongly suggest that fund flows are not the primary source of foreign capital flow variability in EMs. On average, less than 15 percent of the variance of net foreign portfolio capital flows is attributable to regulated funds. By contrast, more than 75 percent is directly attributable to other foreign investors.

Significantly, funds' contribution to the variability of capital flows is generally much smaller than funds' contribution to total foreign portfolio investment (Table 1) in these EM countries. As can be seen by comparing the two tables, for every country Column (1) in Table 2 is always less than the corresponding figure in Table 1.

Funds Flows Are Not Necessarily Indicative of Other Investor Flows

Contrary to views expressed by some policymakers, fund flows are not necessarily a good measure of the sentiment of other foreign investors toward investments in emerging economies. The "residual" reported in Column (3) of Table 2 shows the contribution to the variance of net foreign capital flows arising from any underlying correlation between flows from funds and flows from other foreign investors. In two cases (Brazil and Russia), these correlations are about zero, while in two other cases (Chile and South Africa), the correlations are *negative* (i.e., funds and other investors tend to move in opposite directions). This negative correlation reduces variability in foreign capital flows.

The small overall contribution from Column (3) to capital flow variability (less than 10 percent on average) indicates that there is weak underlying correlation on average—in fact, the correlation equals 0.2—and that there is little herding between regulated fund investors and other foreign investors in these EM countries.

A Holistic Approach Is Necessary

In the wake of the financial crisis, regulators have a duty to look for sources of instability in the financial system. But they must take a holistic approach.

Based on this analysis, there seems to be no reason for authorities to single out regulated fund flows to emerging economies for special monitoring. In particular, we find evidence that flows from funds to emerging economies are not the primary driver of variability in foreign portfolio capital flows in such economies. We also show that fund flows are not highly correlated on average with other foreign portfolio investor flows—in other words, there is little herding between fund and non-fund foreign investors.

If anything, our results suggest exactly the opposite policy advice: emerging market countries should encourage stable fund investment from the United States and Europe as part of a diverse funding base to fuel their continued growth.

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[1] According to EPFR Global's country classification (which includes Korea as an EM), these 11 countries represent more than 72 percent of funds' estimated allocations to EM capital markets.
[2] Column (1) shows the percentage of variation attributable to the variation of EPFR Global's net equity and bond fund flows. Column (2) shows the percentage of variation attributable to the variation of net portfolio flows by other foreign investors (defined as net foreign portfolio flows to country X minus EPFR Global's estimated flows to country X). Column (4) is the standard deviation of net foreign portfolio flows to country X in billions of dollars based on quarterly data for the period 2005:Q1 to 2013:Q4.
[3] Columns (1), (2), and (3) must by definition sum to 100 percent, although components may not add exactly to 100 due to rounding of each individual component.

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