

[Foreign Direct Investment as a Determinant of Cross-Country Stock Market Comovement](#)

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Cross-country stock market correlations have seen a sharp rise in the past 30 years. This is a well documented fact, but not much is known about the factors that have contributed to this increase. In this paper we establish a relationship between the rise in cross-country stock market correlations and the increase in foreign direct investment (FDI) positions in the last thirty years, both empirically and theoretically. The increase in stock market correlations observed in the data very clearly coincides with a sharp increase in FDI positions among big developed economies that took place between mid 1990s to mid 2000s. This positive relationship between stock market correlations and FDI is still present even when controlling for other potential determining factors such as trade, the business cycle, monetary policy, etc. Our theoretical framework is rich enough to provide a meaningful calibrated asset pricing model of the US economy versus the rest of the world, yet parsimonious enough to be able to disentangle the channels that matter for the comovements of stock markets. There are two key elements of the model that are important for establishing the link between FDI and stock markets: first the multinational firms, that engage in foreign direct investment, and second the presence of intangible (technology) capital in the production functions of the firms. With these two in place, we show that the comovement of investment drives to a large extent the comovement in stock prices. Calibrating the model to the US economy vs the rest-of-the world, we find that FDI generates approximately one third of the observed rise in stock market comovement. We have show that the level of financial market completeness can be an important determinant of the level of stock market correlations, indicating that an improvement in asset market trade opportunities could potentially explain some of the additional unexplained increase. However, we argue that, at least in the context of our model, increased portfolio diversification alone cannot help in explaining stock market correlations increases.