Togetherness: The Increase in Global Stock Market Correlations

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Abstract: We develop a theoretical framework in order to investigate the link between two recent trends: (i) the rise in global stock market correlations over the past two decades, and (ii) the increase in global foreign direct investment (FDI) flows over the same period. The objective is threefold: First, a careful empirical analysis will be conducted to understand the channel through which the rise in global stock market correlations is associated with the observed increase in global FDI. Second, we will develop a multi-country stochastic asset pricing model which incorporates multinational firms that will allow us to quantify the extent to which the recent rise in global FDI can account for the observed increase in global stock market correlations. Third, the model will be used to shed light on how the corporate tax cuts proposed in the EU and in the US will affect global stock market correlations.

Research Progress: The research is partly funded by the British Academy, under the Newton Advanced Fellowship scheme, for the period Oct 2017 to Sep 2020. We effectively started working on this project at the start for 2018. We have now completed a thorough empirical investigation that establishes a strong link between correlations of returns of stock markets in US, Canada, Japan, UK, Germany and France (using MSCI indeces), with their corresponding measures of bilateral FDI positions (FDI data taken from OECD). This has been established with a variety of methods, and the results seem robust. Our next task is to establish similar results but now looking at outward and inward FDI measures between the US and the rest of the world, and linking it to MSCI indeces for US and exc. US. The empirical results seem robust and promising. On the theoretical front, we have developed two variations of models to explain this empirical regularity: the first one is a very simply two country model with asset trees, which enables us to gain intuition, because it can be solved analytically. The second is a more elaborate, calibrated model of two countries with trade and FDI positions, in line with standard general equilibrium asset pricing models in an open economy setting. The preliminary results and simulations indicate that this model can generate the basic fact that increased FDI positions between two countries implies higher correlation or synchronisation between the stock markets of the two countries. The research is still o going.

Current Research Outputs: None at the moment, although we have a substantial amount of results already produced and collected in a file.

Conference and Seminar Presentations: None yet.