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Recent Trends in Financial Globalization and Psychology of Investment in Financial Markets

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Abstract

The global economy has witnessed in recent years major changes in the field of financial globalization and the role of psychological factors in influencing investment decisions in global financial markets. This research aims to give an outline and literature review about these areas that have attracted the attention of recent researchers in the field of financial globalization and psychology aspects of investment in financial markets. Moreover, the paper provides some implications and a future vision for the development of events in the international economy in these fields.

Keywords: Financial Globalization; Emerging Economies; Psychology of Investment; Corruption.

INTRODUCTION

The world economy has witnessed dramatic changes through the recent years. One important trend in the international economy is the financial globalization in emerging economies. The past two decades have witnessed a dramatic financial opening process in many countries, especially in emerging market economies. Moving toward a more open financial system is widely recognized as the right policy strategy and actually becomes one of the major pillars of financial reforms in many emerging market economies.

Moreover, recent research related to financial markets gives more interest to the role psychology of investment (investor mood and sentiment) in capital markets. Add to that, the effect of corruption on financial markets through its impact on foreign portfolio investment and on banks' risk represent another important topic in recent research.

This research aims to give an outline about these areas that have attracted the attention of recent researchers in the field of financial globalization and psychology aspects of investment in financial markets and discusses the recent literature review related to these topics.

FINANCIAL GLOBALIZATION IN THE EMERGING ECONOMIES

Financial globalization as a part of economic globalization refers to the integration of a country’s local financial system with international financial markets and institutions. From a historical perspective, financial globalization is not a new phenomenon, but the depth and expansion of globalization today are unprecedented. The recent wave of globalization has generated an intense debate among economists, attracting both strong supporters and opponents. The report of "the Global Economy in 2030" indicates that global financial markets will no longer be dominated by the mature economies. China for example stands out as a potential source country for outward foreign direct investment (FDI) comparable in importance to the US or the EU (Gros and Alcidi, 2013). China has overtaken the United States to become the world's largest goods trading nation. Indeed, since the beginning of the international financial crisis, increases in China's merchandise trade have been larger than those of the United States, EU and Japan combined. In 2015 China’s per capita GDP growth was 6.4% and India’s 6.3% on World Bank data. These are easily the fastest growth rates for any major economies. In particular, both China and India are growing far more rapidly than the ‘Western’ economies – in 2015 the EU’s per capita GDP growth was only 1.7%, the US 1.6%, and Japan’s 0.6%. Data for 2016 to date shows the same pattern of rapid growth in China and India and slow growth in the US, EU and Japan (Ross, 2016).

Therefore, any model based on copying advanced economies is erroneous if the aim is to catch up with the advanced economies. The model of the main advanced economies is based on slow growth maintained over very many decades – over a century. China using a fast growth model achieves ‘high income’ status by international standards in 5-10 years and closes the gap with the advanced economies. Financial globalization is clearly a matter of considerable policy relevance, especially with major economies like China and

India recently taking steps to open up their capital accounts. A number of developing countries are still in the early stages of financial globalization, facing numerous ongoing policy decisions about the timing and pace of further integration.

Moving toward a more open financial system is widely recognized as the right policy strategy and actually becomes one of the major pillars of financial reforms in many emerging market economies. According to the standard theory of international economics, an increase in financial openness is expected to lead to a decline in macroeconomic volatility. Moreover, financial openness helps to ensure against production risks and thereby reduce output fluctuations. In addition, financial openness may also help promote institutional reforms that can make the financial system more stable, thereby contributing to more macroeconomic stability (Ma, 2016).

However, financial openness may also make it easier for capital inflows to fuel excessive risk-taking on the part of financial institutions and allows financial shocks to be transmitted more readily across borders (Mishkin, 2006). Aghion et al. (2004) argue that opening domestic markets to foreign capital flows may lead to macroeconomic instability in economies at an intermediate level of financial development. Financial globalization can also be related to financial crises. The crises in Asia in 1997–98, Brazil in 1999, Turkey in 2001, are some examples that captured worldwide interest.

The main drivers for economic globalization in emerging economies are liberalization of capital movements and deregulation of financial services and the further opening of markets to trade and investment. UNCTAD's World Investment Prospects Survey 2010–2012 declared that interest in developed countries as destinations of FDI has declined over the past few years FDI compared to other regions and is likely to continue to do so in the near future. Although the majority of FDI still takes place in developed economies, the relative share of such investments in developing and emerging economies has been on the rise (World Investment Report, 2010).

In 2015, global foreign direct investment (FDI) flows jumped by 38 per cent to $1.76 trillion, their highest level since the global economic and financial crisis of 2008–2009. Inward FDI flows to developed economies almost doubled to $962 billion. As a result, developed economies tipped the balance back in their favour with 55 per cent of global FDI, up from 41 per cent in 2014. Developing economies saw their FDI inflows reach a new high of $765 billion, 9 per cent higher than in 2014. Developing Asia, with FDI inflows surpassing half a trillion dollars, remained the largest FDI recipient region in the world. In 2015, 85 per cent of measures were favourable to investors. Emerging economies in Asia were most active in investment liberalization, across a broad range of industries. The largest emerging economies in Asia – China and India – were most active in opening up various industries to foreign investors. Also, Brazil fully liberalized foreign investment in the health care sector. However, macroeconomic factors, such as geopolitical uncertainty, exchange rate volatility and debt concerns in emerging markets, as well as other concerns such as terrorism, are among the factors cited as influencing future global FDI activity (Touny et al. 2019; World Investment Report, 2016).

Kose et al. (2010) suggest that economic policies promoting financial sector development, institutional quality, and trade openness are important factors in helping developing countries derive the benefits of globalization. Similarly, sound macroeconomic policies appear to be an important prerequisite for ensuring that financial integration is beneficial for these countries. They also argue that moving to more flexible exchange rate regimes is likely to considerably alleviate some of the risks countries must endure as they become more financially integrated. In addition, countries that consistently face problems associated with government debt are more likely to benefit from financial globalization if their governments simultaneously take policy measures to avoid an excessive buildup of debt.

PSYCHOLOGY OF INVESTMENT IN FINANCIAL MARKETS

Psychology of investment is the focus of recent and further work in the field of financial markets. The role of investor mood and sentiment has attracted the attention of many analysts and researchers in the field of financial economics and financial markets in particular. Basic behavioral factors affecting investor according to Fischer and Gerhardt (2007) are: fear; love; greed; optimism; herd instinct; the tendency to focus on the recent experience; and the tendency to overestimate oneself. The classical finance theory does not predict any role of investor sentiment in shaping the patterns of stock returns and stock price volatility. However, recent researches have demonstrated the existence of statistically significant relationship between stock returns and the sentiment variables.

Investor sentiment is defined as excessive optimism or pessimism regarding stock prices in general (Shefrin, 2008). The influence of investor psychology on economic behavior has been broadly studied in recent years. Numerous studies from Asian, Middle East and Western countries for example, Kengatharan and Kengatharan (2014), Qadri and Shabbir (2014) and Nofsinger and Varma (2013) have established that psychological factors do have relationships and impacts on the decision making of investors in their stock markets. Individual investors are more easily affected by market performance than institutional investors and, therefore, are more likely to show investor sentiment. Shusha and Touny (2016) indicate that decision accuracy, hasty decision, and investor mood were the main attitudinal determinants that explain why individual investors follow herd behaviour, but the effect of these factors may differ according to the investor's demographic characteristics.

Investor sentiment has important and regular effects on individual firms and on stock market as a whole. Recent studies indicate that both investor sentiment and investor behavior have significant impacts on stock returns. International investor sentiment matters in home stocks' valuation. Investor sentiment plays a significant role in international market volatility. Baker and Wurgler (2006) demonstrate that investor sentiment has larger effects for small stocks, young stocks, high-volatility stocks, unprofitable stocks, non-dividend-paying stocks, extreme growth stocks, and distressed stocks. Daszyńska-Żygadło *et al.* (2014) test the existence of a contemporaneous relationship between sentiment indexes and

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returns at the aggregate market level in eight emerging markets and confirmed a positive contemporaneous relationship between investor moods and excess returns only in Brazilian and Chinese markets.

Corredor *et al.* (2015) examine the effect of investor sentiment on stock returns in the Czech Republic, Hungary and Poland. According to their results, sentiment is a key variable driving the prices of stocks traded on these markets and its impact is stronger there than in more developed European markets. Sayim and Rahman (2015) examine the impact of Turkish individual investors' sentiment on the Istanbul Stock Exchange (ISE) and analyze whether it is related to stock return and volatility. They found that unexpected changes in rational and irrational investor sentiment have a significant positive impact on ISE returns.

Psychological factors that can influence decisions in financial markets include numerous factors affecting human mood, including the weather. Some studies argue that when people feel good as a result of good weather, they hold optimistic opinions of their future prospects. Weather not only affects our daily lives and moods but also decisively influences the trading decisions of investors within the financial markets (Yuan et al., 2006). Some of the literature has noted that market volatility is affected by weather factors, such as cloud cover, temperature and humidity. Yang et al. (2016) examines the effect of investor sentiment and weather on hedging strategy in the Taiwan options market and demonstrated that incorporating investor sentiment and weather effects improved the hedging performance of options.

From individual investors' perspective, religion has been found to affect the propensity to save, the decision to invest in stocks and risk-attitudes. Some studies investigated how investors' mood is shaped by religious occasions. With respect to the role of religion in affecting investor mood and behavior, Pantzalis and Ucar (2014) examined the impact of the Easter week holiday on investors' behavior in the U.S. This religious practice is found to cause investors distraction which may lead to delayed reaction to firm news. Gavriilidis et al. (2015) investigated the relationship between herding and social mood through examining whether the positive mood documented during Ramadan translates into higher herding compared to non-Ramadan days over a sample of seven majority Muslim countries. The study reported significant herding during Ramadan in most of sample markets, and herding appears significantly stronger within rather than outside Ramadan-days.

In summary, the findings discussed in this section show that the stock prices and stock returns are not only affected by information but also by irrational behavior of investors, which seems to be a response to changes in market and individuals' sentiment.

THE EFFECT OF CORRUPTION ON FINANCIAL MARKETS

The World Bank calls "corruption" the single greatest obstacle to economic and social development. Corruption is defined as "the abuse of public office for private gain". Transparency International has been publishing the Corruption Perceptions Index (CPI) to track corruption levels since 1995. The coverage of the CPI has increased from 41 countries to 179 countries. Corruption has been shown to be associated with a wide variety of social and economic problems regarding economic growth, foreign direct investment, and financial markets.

The negative effect of corruption on banking stability is largely realized by reducing banks' profitability and widening the variation of their return. Using the financial data of 29 countries' index, Zhang (2012) found a strong correlation between corruption and financial market stability. Corruption can increase borrowing costs for governments and firms in emerging markets. Akitoby and Stratmann (2010) supported that countries with higher levels of perceived corruption tend to have a higher default risk, thereby raising their borrowing costs. Jain *et al.* (2016) demonstrated that corruption have a negative effect on a country's financial markets. Greater corruption is associated with lower foreign portfolio investment into the country. Cherif and Dreger (2016) explored the institutional determinants for financial development in the countries of the Middle East and North African region and found that for the banking sector, corruption seems to be the most important determinant in the institutional setting. For the stock market, corruption as well as law and order appear to be relevant.

Political stability may have a mediator role between corruption and FDI inflows. Touny (2016) shows that the effect of corruption on FDI inflows is mixed and depends on the level of political instability of the country. He confirms that corruption has a negative effect on FDI inflow in countries with high political instability but a positive impact in countries with relatively low levels of political instability. This implies that corruption is unfavourable for FDI inflows in countries with high levels of political instability and therefore drives out FDI inflows.

In general, corruption is a macro-critical problem that affects both developed and developing countries and affects most sectors of the economy. When government functions are impaired, it can adversely affect a number of important determinants of economic performance, including macro financial stability, investment, human capital accumulation, and total factor productivity.

CONCLUSION AND IMPLICATIONS

The global economy has witnessed in recent years major changes in the field of financial globalization and the role of psychological factors in influencing investment decisions in global financial markets. The past two decades have witnessed a dramatic financial opening process in many countries, especially in emerging market economies. Add to that, recent research related to financial markets gives more interest to the role psychology of investment in capital markets. Moreover, the effect of corruption on financial markets through its impact on foreign portfolio investment and on banks' risk represent another important topic in recent research. This research aims to give an outline about these areas that have attracted the attention of recent researchers in the field of financial globalization and psychology aspects of investment in financial markets.

According to the tremendous changes taking place in the international economy in recent times, we can develop a future vision for the development of events in the international economy, which can be summarized in the following points:

- Increasing the significant role played by emerging economies in attracting foreign direct investment compared to developed countries, which was accounting for the largest share of annual foreign investment inflows.
- Decreasing foreign direct investments directed to the Middle East countries especially those countries suffering from political instability and high corruption.
- The increasing role of psychological factors in influencing investment decisions, particularly in the financial markets in the face of rising cases of uncertainty and lack of economic and security stability that has swept many countries, both developed and developing.

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