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Financial openness & institutions in developing countries

Chander Kant

Department of Economics, Seton Hall University, South Orange, NJ 07078, USA

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ABSTRACT

The paper examines for foreign portfolio investment recent result that foreign direct investment has positive effect on institutions in developing countries. Promise of firms to improve governance (in order to raise funds from outsiders) is more credible if they cross-list on the U.S. stock exchange. Stringent disclosures required by the U.S. are available to domestic regulators who become under pressure to follow global standards. Using 48 developing countries, I show greater openness of stock and bonds markets leads to better quality relevant institutions. I use both a natural experiment, viz. 2008 financial crisis outflows, and 2SLS/IV estimation to examine the endogeneity issues.

1. Introduction and literature review

Kant (2016a) shows that foreign direct investment (FDI) has a positive effect on institutions in developing countries. This paper examines whether foreign investment in portfolio equity and bonds has a similar effect on institutions directly relevant to them. The seminal work of North (1981) on the role of institutions on economic activity has generated a vast literature both on the broad macro cross-country investigations and on the micro level studies of specific countries or sectors. As articulated by Ray (2008), the former finds Solow factors of capital stock and labor in efficiency units only explain one-half to one-third of cross-country income differences. Technological differences, sectoral structure, investment prices, and institutional social, cultural, policy, and geographical factors explain the rest. The micro studies, that rely more on theoretical modelling, also emphasize family ties, cultural transmission through parents, trust in the society, and institutions. Both approaches ascribe important role to institutions.

The literature, while emphasizing the role of institutions in the economy, has not adequately examined how contemporary economic variables may affect them. The phrase capital account openness includes openness of any or all of the following types of foreign capital. “Pure” finance capital, e.g., i) foreign lending and ii) foreign investment in equity, bond (securitized), bank-deposit, or money markets. Real capital, multinational corporations and FDI that also has aspects of finance capital if it does not borrow funds in the local markets. A hybrid of finance and real capital, FDI in the banking, insurance, and brokerage sectors and trade credits.¹ From among the various types of openness, this paper examines the effect of financial markets openness, viz. the effect of openness of portfolio equity and bonds markets on institutions. Doidge et al. (2007) show portfolio globalization in the sense of cross listing on a major U.S. stock exchange leads to an improvement in private institutions (or private corporate governance) – especially in less developed countries. By extension, I expect it also leads to an improvement in regulatory institutions – since the stringent disclosures required by the U.S. are available to domestic regulators who become under pressure to follow global standards.

In the literature on the subject, some authors ascribe low financial flows between rich and poor countries to weak institutions, some do not, and some suggest financial openness affects private institutions, i.e., corporate governance. Not all support their views

E-mail address: chander.kant@shu.edu.

¹ FDI can possibly result solely from reinvested earnings of the foreign affiliate and/or borrowed funds in the host country totally funding initial investment in the affiliate.

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with analytical models or econometric studies. [Alfaro et al. \(2008\)](#) find poor institutions to be the main reason for low capital market globalization. They consider the sum of FDI and portfolio investment, and normalize the flows by population. Using observations for 81 countries ending in 2000, they examine with cross-country regressions whether average institutional quality explains the flows in constant 1996 U.S. dollars, averaged over 1970–2000. They use cross-country regressions to discern the effects in the long run, and employ log of GDP per capita in 1970 as the control variable given its high correlation with institutional quality. [Kant \(2016a\)](#) finds FDI effects institutions positively. He normalizes FDI by GDP (rather than by population), uses a sample of all countries (total 169, 125 developing and 44 developed) for which both FDI and institutional data are available, and shows the effect is greater when the sample is restricted to the 125 developing countries.

[Fratzcher and Imbs \(2009\)](#) find openness mutes adverse effect of poor institutions on foreign capital inflows. Desire to continue accessing foreign capital deters borrowing countries from action detrimental to foreign investors. Openness negatively relates to the likelihood of detrimental action and acts as a substitute to poor institutions. Although they do not clearly state it, the implication is openness tempers poor institutions, e.g., threat of expropriation. [Gourinchas and Jeanne \(2006\)](#) clearly state implications of their exercise. Calibrating the usual neo-classical model for non-OECD countries, they find international financial integration (IFI) with unchanged productivity raises their domestic consumption by only 1%. Nevertheless, if it reduced their productivity gap with the US by just 25%, the gains would be 50 times larger. One channel for this possible rise in productivity is that IFI “induces countries to have good governance and a high level of transparency in order to attract foreign investors *ex ante* and to maintain these good policies *ex post* in order to avoid a capital flight.”

[Portes and Rey \(2005\)](#) do not ascribe any importance to the role of institutions in shaping bilateral portfolio equity flows. [Lane \(2004\)](#) finds debt flows only weakly relate to the index of social infrastructure constructed by [Hall and Jones \(1999\)](#) and not at all to the political stability index constructed by [Kaufmann et al. \(1999a and 1999b\)](#). Imposition of capital controls may provide a screen for cronyism. [Johnson and Mitton \(2003\)](#) show stocks of politically connected Malaysian firms performed far better as compared to those of other firms after imposition of restrictions on cross listing in foreign stock exchanges in September 1998. Similarly, [Morck, et al. \(2000\)](#) find heir-controlled Canadian firms’ share prices fell with the expectation of Canada-US free-trade agreement’s ratification. The agreement provided for opening of capital markets, reducing the advantages heir-controlled firms had to accessing capital.

[Doidge et al. \(2007\)](#) employ firm-level information collected in March 2001, and April and November 2003 in up to 40 developed and less developed countries.² They show all of the following. i) Transaction costs of raising funds depends partly on protection to investors provided by the state and partly on the country’s economic and financial development; ii) corporate governance and firm-level investor protection negatively relates to ownership concentration; and iii) outside the U.S., firms are controlled by large shareholders. The last finding is consistent with [La Porta et al. \(1999\)](#)’s observation that firms all over the world, on average, have high ownership concentration levels. With the expectation that large shareholders extract value to their own benefits from minority shareholders/outside investors, protection of investors depends almost entirely on the state. For example, [Gonzalez et al. \(2017\)](#) find firms in six Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, and Peru) have high ownership concentration, (largest shareholder owning 43% of the shares), and extract benefits from minority shareholders. [Doidge et al. \(2007\)](#) state such a firm may promise to improve corporate governance to entice funds from outsiders for expansion. Its promise lacks credibility in the absence of externally verification of its financial statements. Financial openness in the sense of cross listing on a major U.S. stock exchange (with its disclosure requirements) makes the promise credible, and leads to an improvement in corporate governance – especially in less developed countries. See, [Mishkin \(2006\)](#).

Recently, the role of foreign institutional investors in improving corporate governance and institutions in host countries has been examined both in the context of foreign direct investment and portfolio investment. [Sugathan and George \(2015\)](#) show foreign institutional investors act as a vigilant check on profit shifting by foreign owners – a check that get magnified since profit shifting and managerial diversion have been shown to be complementary. On the other hand, [Kim et al. \(2015\)](#) show that a strengthened monitoring role of institutional investors weakens managers’ incentive to exploit their informational advantage over retail equity investors.

The provision of foreign exchange and tax revenue by foreign capital may be important to Developing countries. If so, they may gradually give-in to foreign capital’s expectation of similar accountability and institutions locally as at home, and adjust their corporate governance structures in response. See, [Bekaert et al. \(2011\)](#) who tentatively suggest mere presence of foreign investors has beneficial effects on a country’s institutions. Using observations for 86 developed and emerging market economies for 1980–2006, they find equity market liberalization, has a positive effect on macroeconomic environment that in turn correlates with institutional quality. Foreign investors may demand better corporate governance that has associated disciplinary effect on governments; and may threat to leave with adverse institutional developments. On the other hand, they find it has ambiguous effect on law and order. Surveying the literature, [Prasad and Rajan \(2008\)](#) conclude the main benefit of financial openness seems to be indirect, more related to their role in building institutions than to increased financing provided by capital inflows. They outline the following possible channels for financial openness to improve domestic institutions: a) make the financial sector more competitive and lead to its development, b) improve financial intermediation and lead to more efficient financial services, c) spur improvements in corporate governance, and d) restrain irresponsible macroeconomic and government policies. Nevertheless, they do not empirically establish

² They run some regressions splitting the sample in two equal halves by median log GNP per capita and call those in the lower half as poorly or less developed, and those in the upper half as developed countries. I call countries included by the World Bank in its low, lower middle and upper middle-income groupings as developing countries and its high-income grouping as developed countries.

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