



Sovereign wealth funds' cross-border investments: Assessing the role of country-level drivers and spatial competition



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ARTICLE INFO

Article history:

Available online 26 May 2017

JEL classification:

C18
C21
C23
G15
G32
G38
F21

Keywords:

Sovereign wealth funds
Pull factors
Spatial econometrics
Inverse Hyperbolic Sine transformation
Interactions

ABSTRACT

The aim of this paper is to identify the driving forces of cross-border investments emanating from Sovereign wealth funds and to test the existence of spatial competition among recipient countries. For this, we develop an original econometric framework that quantifies the role of spatial dependence in the location of investments, and that uses a modified version of the standard estimation procedure of spatial panel model, which accommodates the Inverse Hyperbolic Sine transformation of the dependent variable. This transformation copes with two critical features of net capital flows, namely an highly skewed distribution and the presence of zero and negative values. Using a large-scale database, we provide evidence of negative spatial dependence, investments in one country being on average at the expense of its neighbors.

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1. Introduction

I don't want European citizens to wake up in several months' time and find that European companies belong to non-European capital, which bought at the share price's lowest point

This might be an opportunity to create our own sovereign wealth funds

[October 21, 2008, N. Sarkozy (President of France) at the European Parliament]

Increasing financial integration as materialized by the sustain rise in both cross-border capital inflows and outflows has critically affected both advanced and emerging economies over the past decades, leading the academic community to examine various facets of this component of globalization such as the impact of financial integration on economic growth or on financial stability to cite a few. One remarkable feature of the recent years regarding international cross-border capital flows has been the emergence of a novel actor, namely Sovereign wealth funds (SWFs) which has rapidly become a major force in

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financial markets worldwide. SWFs are public investment agencies located for their vast majority in developing economies¹ which manage part of the assets owned by national governments resulting from excess of exchange foreign reserves. Whether or not capital flows emanating from these state-owned entities are in the interest of the target country has been the object of heated debates within political circles and the general public. As illustrated in the above quote from the former French President, Nicolas Sarkozy, there have been long lasting fears and reluctance regarding the arrival of SWFs in local markets mainly due to their lack of transparency as well as to the belief that those investments were designed to exert political influence on target firms or countries and to access foreign technology. Today, however, SWFs constitute a major source of capital for world economies with assets under management amounting to \$7.243 Trillion, leading most governments as noted by Megginson and Fotak (2014) to “court” SWF investments.

Given their increasing importance in advanced and emerging economies, the question of how countries can attract capital flows emanating from SWFs has become of major importance. In this paper, we propose to identify both country-level determinants and spatial interaction effects of cross-border SWF net inflows. In particular, we examine the existence of spatial competition among recipient countries of SWF investments that is whether increased capitals received by one target country is on average at the expense of its neighbors. Documenting empirically the drivers of net capital flows is not easy. Neither is the assessment of spatial effects, as it requires addressing a set of important econometric issues. As we argue later in the paper, a careful treatment of these issues is however critical to obtain reliable results. For these reasons, we develop in this analysis an original econometric framework that allows (i) to explicitly model and to test the existence of spatial dependence in the location of SWFs investments and (ii) to accommodate a well-known feature of cross-border capitals: the presence of skewed distributions of net investment flows due to extreme values as well as zero and negative values. Our procedure is then applied to an original large-scale database containing SWF's net flows to 43 countries including both advanced and emerging economies over the 2004–2009 period.

Along with the surge in SWFs' cross-border investments, there has been an increasing interest in the literature in the determinants of SWFs' investments either at the firm level or at the country level. In the former case, the literature builds on existing evidence in corporate finance which has shown that firm-level conditions, such as firm-size (market capitalization, sales), firm-specific risk indicators (leverage, cash of firm, degree of financial constraint, analyst coverage, turnover) as well as firm-performance (ROA, ROE, CAPEX, stock market return, dividend yield) are the main drivers of firm attractiveness for capitals (Kotter and Lel, 2011; Fernandes, 2011; Avendaño, 2010). With respect to these three criteria, Kotter and Lel (2011), Karolyi and Liao (2010) and Avendaño (2010) argue that SWFs tend to invest in large and poorly performing companies which are financially and cash constrained. Beyond firm characteristics, macroeconomic factors along with the financial and institutional factors of the target country have also been documented as important in the decision process of SWF (see Chhaochharia and Laeven (2008) and Karolyi and Liao (2010) among others). Hence, Knill et al. (2012) find that the decision to invest depends positively on the correlation between the market return on the SWF and that on the target country's national market index, mitigating the role of risk diversification in the decision of investment. In the same vein, Fotak et al. (2008) find that SWFs investments tend to be concentrated, especially in the financial sector. Separating the decision to invest from the amount invested, Knill et al. (2012) conclude that the economic and financial variables are important factors for explaining the former but matter less in determining the size of investment.

One important dimension of SWFs decision which is absent from the above discussion pertains to the international allocation of capital. Is there evidence of domestic or foreign equity bias? Do cross-border investments concentrate in specific regions? And if so, why? These are examples of questions related to the spatial dimension of the portfolio allocation which have been discussed in the literature on SWF without being fully addressed (Megginson et al., 2013). In what follows, we review key elements of those discussions along with selected arguments regarding the specific role of interactions in explaining investments flow among countries.

The primary remarkable feature regarding the spatial allocation of SWFs' capitals lies in the large share of foreign assets hold in their portfolio. Looking at investments made by 15 SWFs over the period 1985–2011, Bortolotti et al. (2013) and Megginson et al. (2013) report that nearly 70% are channeled outside the home country. These figures starkly contrast with those usually reported for other categories of funds such as mutual funds or pension funds which exhibit very strong home equity bias (Bortolotti et al., 2013; Megginson and Fotak, 2014). At least two explanations help understand this feature. First, conversely to other types of funds, one of the primary missions of SWF is to help its home country stabilize its wealth. Accordingly, cross-border investments are used as a diversification device which mitigates the impact of domestic economic downturns on the national wealth. Second, large demand in domestic assets could end up building financial bubbles in local markets. This risk is particularly important for countries hosting SWFs as their economies are often of small size compared to the amount under management.

Another interesting feature related to the spatial dimension of cross-border capitals pertains to the concentration of SWF investments in specific regions, notably in western economies which benefit from the lion's share of international SWF capitals with more than 50 % of them (see Megginson and Fotak, 2014 and the Sovereign wealth fund institute). The rest is mainly invested in emerging market economies with specific regions such as Asia-Pacific receiving large flows and others such as Latin America being nearly absent from the map. Traditional arguments from the literature on international asset al-

¹ Among the 79 SWFs listed in the SWF institute website in 2016 only 21 percent are located in developed economies according to the taxonomy adopted by the United Nations; the rest of SWFs are located in developing economies (67 percent) or transition economies (12 percent).

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