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Cross-border trading as a mechanism for implicit capital flight: ADRs and the Argentine crisis ☆

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Abstract

Cross-listed shares may confound government efforts to control capital outflows by providing a legal means through which investors can transfer their wealth outside the country. We study the recent experience of investors who while subject to capital controls, were able to purchase cross-listed shares using local currency, convert them into dollar-denominated shares, re-sell them abroad, and deposit the dollar proceeds in foreign bank accounts. Capital controls drive a wedge between the

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price of local shares and their corresponding cross-listed shares. This wedge provides an implicit devaluation forecast and the market's valuation of capital control circumvention.

JEL classification: F32; F36; G12; G15

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1. Introduction

The role and consequences of capital controls continues to be a subject of controversy for many developing countries. Governments that under normal circumstances advocate financial integration with global markets are often tempted to resort to capital controls in the face of economic crisis. Argentina and Venezuela are two recent cases in point. In December 2001, after a decade of open capital markets, the Argentine government imposed a series of financial market controls in an ultimately unsuccessful bid to forestall economic crisis. In early 2003, Venezuela established capital controls in the wake of a 20% devaluation. These experiences with capital controls afford an opportunity to examine the reactions of investors within and outside of the country to a drastic change in financial market conditions.

The same economic conditions that encourage governments to impose capital controls also give residents and investors in these countries incentives to remove their wealth. Capital flight can be accomplished through various channels. In this paper, we examine one potential channel for capital flight that is made possible by the existence of cross-listed shares. By converting locally purchased shares into their corresponding shares listed abroad, investors can effectively move their wealth out of the country, thereby confounding government efforts to control capital outflows.

There is an extensive literature on cross-listed shares and their role in the global integration of financial markets (see, for example, the survey by Karolyi (1998)). Cross listing of shares on the U.S. stock market allows firms to enjoy the advantages of greater liquidity, transparency and access to the U.S. capital market.[1] From the perspective of U.S. investors, cross-listed shares are a convenient way of obtaining global diversification.[2] This paper describes a new, and largely unstudied, role for cross-listed shares as a mechanism for capital flight.[3]

In the absence of capital controls, the law of one price should hold for cross-listed shares in the home and foreign market after controlling for the exchange rate and transaction costs. When capital controls are in place, however, the factors that determine demand for cross-listed shares in the home market may diverge from those in the foreign market resulting in a wedge between the two prices. In Section 2 below, we show how controls on

[1]See, for example, Alexander et al. (1987), Foerster and Karolyi (1999), Miller (1999), Ahearne et al. (2004), Melvin and Valerno-Tonone (2003), and Doidge et al. (2001).

[2]See, for example, Officer and Hoffmeister (1987), Wahab and Khandala (1993), and Jiang (1998). Domowitz et al. (1997), Errunza et al. (1999), and Karolyi and Stulz (2003) examine the broader influences of cross-listed shares on the development and integration of markets.

[3]Melvin (2003) and Kadiyala and Kadiyala (2004) also examine the role of cross-listed shares during the recent Argentine capital control regime.