CHANGES IN THE COMPOSITION OF
GLOBAL FINANCIAL FLOWS:
WHAT CAN WE LEARN FROM MICRO EVIDENCE

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Introduction

It is an honor to be the Foote Lecturer this year and it is a pleasure to be a guest of the Business School at the University of Alberta.

My remarks today will focus on global financial flows, and how those flows have changed in response to the series of financial crises that swept through emerging markets in the mid- to late-1990s. Development is fundamentally about moving resources to the places where they are needed most. Somehow the movement of those resources needs to be financed, whether as outright transfers, through loans, direct investment in foreign corporations or through securities markets. The nature of development finance has changed dramatically over time, and I think we have learned some things, sometimes through painful experience, about how the composition of capital flow from rich to poor countries matters. While the composition of capital flow is by definition a “macro” phenomenon, I am going to suggest today that micro evidence on the way firms structure their lending to emerging markets contains importance clues about the vulnerabilities of the global financial environment, and how firms have responded to those weaknesses.

I will start today by talking briefly about the history of financial flows and how those flows responded to the reforms adopted under the auspices of the Washington Consensus. The financial crises that swept through East Asia and Latin America interrupted those global flows, but one feature that stands out is the resilience of, and even the expansion of, FDI flows. The message I want to convince you of today is that one can think of the policy reforms applied to emerging markets in two phases: first as the “Washington consensus I”, which emphasized getting prices right. What we learned from financial crises is that getting prices right is not enough, and there is a new perspective that I have labeled “Washington consensus II”, which is about getting institutions right. I will argue that in an environment with weak institutions, FDI flow in the form of cross-border acquisitions are one mechanism for importing institutions from industrialized countries.

Global financial flows and the Washington Consensus

Historically, flows to developing countries moved through official channels – from multilateral agencies or governments to recipient governments. Bank lending and FDI played a role, but official flows accounted for the majority of capital flow to developing countries. In the 1990s, the composition of capital flow began to shift away from official assistance toward private capital flow. Much of this shift was due to the dramatic changes in policy that occurred under the “Washington Consensus.”

The Washington Consensus, a term coined by John Williamson at the Institute for International Economics, was a convenient label for the broad set of policies supported by the U.S. Treasury and the IMF for reforming economies in emerging markets. (It is now a convenient scapegoat for those critical of globalization and failures of US and IMF policies, but I will leave that for another day.)
The Washington Consensus covered three broad areas. First, the consensus was that developing countries should have greater macroeconomic discipline, including: a reduction in fiscal deficits, reprioritization of expenditures and tax reform. The second major component was to encourage policies that foster the market economy: to liberalize interest rates, liberalize the banking system, deregulation, privatize government-run enterprises, and encourage greater securitization, in other words, to allow a greater role for market-determined prices to affect allocations. One of the key prices in small open economies is the exchange rate, although the debate still rages today about the best way to manage exchange rates. (That also is a topic for another day.)

Finally, the Consensus supported opening the economy to the global marketplace, through trade liberalization and, to some extent, capital account liberalization. Ex post, there is now a heated debate about whether capital account liberalization is a good idea and if so, how it should best be accomplished, but ex ante, the view of many economists was that emerging market economies would benefit from lifting restrictions on the extent of foreign control, allowing foreigners to become shareholders in local firms and encouraging the entry of foreign banks. In response to pressure from the IMF and other institutions, a number of countries undertook massive privatization programs and liberalized their capital markets. These privatization programs took place in conjunction with a removal of capital account restrictions that permitted increased market access to foreign investors.

Economists predicted that such reforms would generate a number of benefits for emerging markets. Economic theory suggests that opening to global financial markets should stimulate the flow of capital from capital-rich to capital-poor countries and reduce the cost of capital in markets where capital is scarce. The reforms should increase the efficiency of financial sector and facilitate the transfer of technology. A second-order effect is to help diversify risk, by reducing local investors’ exposure to country-specific risk. At a minimum these reforms, even if they do not change the long-run growth rate, the flow of capital would speed the transition to the country’s long-run steady state. The more optimistic view is that financial liberalization and openness could potentially increase economic growth rates.

A number of countries took this policy advice and opened their markets. The number of countries with stock markets open to foreign investors increased from 14 in 1980 (essentially the largest OECD) countries, to 35 in 1992, leveling off to 41 in the late 1990s.¹ Menzie Chinn and Hiro Ito develop an alternative measure of openness, taking into account policy differences across countries in the various components of the capital account. Their measure captures the opening of the capital account in Latin America throughout the 1980s.²

Net resource flows to developing countries, and most notably flows to emerging markets, increased dramatically from the early 1980s to the mid-1990s.³ If we strategically stop time in 1997, it appears that capital flow responded as economists

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¹ These figures are based on Bekaert, Harvey and Lundblad, (2000).
² For more details on their index, see Chinn and Ito (2005), University of Alberta Centre for International Business Studies Joint Series on Competitiveness #29, August 2006.
³ Data from Global Development Finance (various issues), The World Bank.
predicted it would, with a quadrupling of total flow from $75 billion in 1990 to over $300 billion in 1997. Looking at flows by type, FDI followed a similar path, increasing from less than $50 billion to over $150 billion over the same period. International investment in portfolio equity, which was virtually nonexistent in the 1980s, accounted for an increasing share of capital flow in the early 1990s. At its peak 1993, equity flows accounted 20 percent of total capital inflow in developing countries.

Privatization and increased foreign investment led to a boom on emerging stock markets. The growth in stock market capitalization of emerging markets, which reflects both the increase in the number of firms listed on the market as well as the change in stock prices, was a staggering 250 percent over the 1990 to 1996 period. The U.S. equity market, enjoying its own stock market boom over this period, grew about 170 percent, with slower rates of growth in the UK and Japan. Foreign markets, and emerging markets in particular, looked like a good investment and US investors responded. Home bias, measured as the fraction of US equities in the US portfolio, declined from 97 percent in the 1980s to about 88 percent in 1995.

Despite the increased flows to developing markets, international capital markets were still dominated by flows between industrialized countries. Of the total global outflow of direct foreign investment of $322 billion in 1995, 94 percent, or $302 billion was invested in industrialized countries. Similarly, 96 percent of outward investment in portfolio equity was invested in industrialized countries. So while there was some seepage of global flows into developing countries, the volume of that flow remained relatively small.

Capital markets also did not deliver on the promise of redistributing wealth from the rich to the poor. A Lorenz curve of the distribution of wealth for 59 countries, which shows the fraction of global wealth accounted for by each decile of countries ranked by wealth, shows very little change between 1970 and 1995. Wealth here includes the capitalized value of a country’s capital stock as well as its stock of foreign assets. If wealth were distributed approximately evenly, the poorest 10 percent of countries would have 10 percent of global wealth. (If the distribution were exactly equal, the Lorenze curve would lie along the 45 degree line and there would be no distinction between the “rich” and the “poor”.) The data suggest that 10 percent of global wealth is shared by the bottom 50 percent of countries. These figures are an underestimate of the uneven distribution of wealth, because the sample excludes most of sub-Saharan Africa, the poorest countries in Asia, and Eastern Europe because of the lack of information on capital stocks and net foreign assets in those regions.

Even if one thought that wealth might not be affected by the opening of capital markets, one would hope that the allocation of capital would be affected. That is, open capital markets would encourage investment in capital-scarce countries even if ownership of that capital, and therefore wealth, remained in the hands of investors in industrialized countries. Unfortunately, the data suggest that there was also very little change in the distribution of capital across countries between 1970 and 1995. In

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4 Calculations are the author’s based on data from the Penn World Tables and net foreign asset figures from Lane and Milesi-Ferretti (2001).
1995, the richest 50 percent of countries accounted for 85 percent of the global capital stock.

Of course, the clock did not stop in the mid 1990s, and beginning with the Mexican crisis in December 1994, global markets were buffeted with a series of financial shocks that seemed to spread from one market to the next. These crises resulted in (or some would say were caused by) a sudden reversal of capital flow from emerging markets, speculative attacks on fixed exchange rates and the Central Banks that supported them, collapses in the financial sectors of many Latin American and Southeast Asian countries, liquidity crises and ultimately widespread defaults. The cause of these crises remains a topic of heated discussion and is beyond the scope of this talk. For our purposes today it is enough to note that they happened and they had a dramatic impact on the volume and the composition of capital flow.

The “sudden stop” in capital flow to emerging markets, to adopt a phrase used by Guillermo Calvo, is illustrated below. From the peak of $310 billion in 1997, total flows to developing countries stalled in 1998 and plunged in 1999. Flows of long-term debt fell in 1999, and became negative in 2001. Portfolio equity flows were reduced to a trickle. Interestingly, while the other types of flow declined, FDI remained steady from 1997 on. This is seen even more clearly when one looks at the decomposition of flows by type (i.e. as a percent of total flow). Throughout the entire 1980-2001 period, FDI as a fraction of total inflow steadily increased, and by 2001 it accounted for 80 percent of the total volume of flow to developing countries. Why this is the case, and how one should think about FDI flows in this environment, is the focus of the remainder of this talk.

To understand FDI flows, it helps to make the distinction between greenfield investment, the inflow of “new” investment, and mergers and acquisitions (or “brownfield” investments), which reflect the purchase of existing plant and equipment. Throughout the late 1990s the fraction of FDI that is accounted for by the acquisition of firms in emerging markets by firms in industrialized countries increased. In 1999, over ninety percent of FDI in Asia was due to cross-border M&As.

The rise in cross-border M&As as a form of external finance was in part due to changes in the regulations affecting foreign ownership. In many countries in East Asia, foreign investors were explicitly prohibited from gaining a controlling share in local firms. For example, in 1996 the ceiling on the amount of stock foreigners could acquire in all Korean companies without the approval of the board of directors was only 18%. Another feature of the market for corporate control in Korea was that cross-holdings across business groups (Chaebols) were substantial. This situation changed dramatically as a consequence of the financial crises that swept the region during 1997. The IMF bail-out packages to Thailand, Korea and Indonesia included explicit provisions for restructuring domestic capital markets and to allow foreign competition in the market for corporate control.

Another feature of FDI inflows is that they are lumpy. That is, a single transaction in a small market can have a huge impact on aggregate flow. Argentina is an interesting example. In 1999, forecasts about Argentina’s near economic future and the viability of its currency board were grim. Debt flows steeply declined and portfolio inflows turned negative. FDI, however, surged upward to unprecedented
levels. A careful look at the data reveals that the sale of YPF, an oil and gas company, to Repsol, a Spanish enterprise, accounted for 63 percent of total FDI inflow in that year. Had Repsol not made the purchase, net flows to Argentina would have been close to zero.

The next question is how to interpret the boom in foreign acquisitions in emerging markets. A number of views are expressed in the press, ranging from firms now having access to the “exciting opportunities” in emerging markets, to a fire sale of assets resulting from the liquidity crises, to the fear of “recolonization” by foreign entities (this last attributed to Malaysia’s Prime Minister Mahathir). Economists also express a range of opinions, from FDI as the “good cholesterol” (borrowing may not be good for you, but if you have to do it FDI is the least dangerous form), to a more neutral perspective (FDI is simply the transfer of assets from domestic to foreign hands and therefore may have little real economic impact) to a more positive view that FDI enables the transfer of technology and creates synergies between parents and their affiliates.

To try to shed light on the factors that drive cross-border M&As, I will explore three questions. First, is there value creation from the transfer of assets from domestic to foreign hands? Second, if there is value creation, who captures the gains – targets in emerging markets or acquirers from industrialized countries? And finally, are there special circumstances under which gains exist, and why? To get at these questions, I will use the stock price reaction of acquirer and target firms to the announcement of an M&A transaction as a summary statistic for the value created through cross border M&A activity.

The results that I report here are drawn from “Acquirer Gains in Emerging Markets” by Chari, Ouimet and Tesar (2005). The returns are cumulated average abnormal returns over a three-week window around the announcement date. Our dataset includes all acquisitions of firms in 9 emerging markets in Asia and Latin America by firms from industrialized countries. The sample period covers 1988-2002 making it possible to test for the effects of financial crisis on the gains from an acquisition. The dataset includes various firm, industry and transactions characteristics. We also have data for a control group that includes acquisitions by US firms in Europe. This allows us to compare the gains from acquiring a target in an emerging market relative to the gains from acquiring a target in another industrialized country.

Our analysis yields three main findings. First, there is value creation from cross-border M&As in emerging markets. The joint returns (the combined market-capitalization-weighted returns of the acquirer and target) resulting from an announced acquisition are significantly positive in emerging markets; our evidence suggests an increase in cumulated abnormal returns of 1.8 percent around the date of the acquisition. When the acquirer obtains majority control of the target, joint returns range from 5.8 to 7.8 percent.

Our second finding is that shareholders of acquiring firms reap the lion’s share of the gains. Acquirers gain 3.3 percent if the target is from an emerging market and the gains are significantly larger if the acquirer gains majority control. Over the period

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5 Our working paper includes robustness checks for different windows around the announcement date.
we study, the cumulated dollar value gain from cross-border acquisitions in emerging markets was $280 billion. Note that this is in stark contrast to the results from the domestic M&A literature where studies find that M&As are value destroying\textsuperscript{6} and that the gains, if any, accrue to the target’s shareholders. This suggests that something very different is going on in the emerging market context. This effect appears to be closely related to corporate control.

Finally, we find that the gains for acquirers are largest in R&D intensive sectors, conditional on gaining control. To obtain this result, we first estimate R&D intensity at the industry level based on a cross-section of US industries. We then use those estimates as a measure of R&D intensity of targets (by industry). When we include this measure of R&D intensity as a control variable in the regression, we find that corporate control, crossed with R&D intensity, is a significant explanator of acquirer gains. One interpretation of this finding is that there are productive synergies from M&As that involve the transfer of technology, but these synergies are only realized (and the technology is transferred) when the acquirer obtains control.

How can we interpret these findings? In a recent book, \textit{Financial Crisis, Liquidity and the International Monetary Problem}, Jean Tirole offers an insight into the potential causes of market failure in emerging markets that has direct bearing on the decision to acquire a foreign firm. Let me briefly (and hopefully accurately) summarize the key points. First, Tirole assumes that there are many lenders and that lenders do not coordinate their actions. On the borrowing side, he assumes that the local government can take actions that affect the payoffs of the firm, and that the incentives of the government are not fully aligned with those of the firm. Two problems then arise.

First, the lack of coordination among lenders means that each lender is uncertain about the borrowing country’s overall level of indebtedness, and each lender is uncertain about the relative seniority of his or her own claim. This situation can lead to sunspot equilibria, speculative attacks and contagion as each investor tries to infer from inexact signals whether or not his or her claim will be honored. The second problem is that lenders would like to contract with the firm, but the government is an implicit partner in the arrangement. Thus, the lender is exposed to expropriation risk, where by expropriation I mean actions that are not in the best interest of the firm.

FDI, in the form of acquiring control of the emerging market firm, offers a way out of these two problems. By contracting explicitly with the shareholders of the target firm, FDI essentially cuts out other lenders (minimizing the multiple lender problem). In gaining majority ownership of the firm, shareholders of the acquiring firm are able to extend the boundary of the firm into the emerging market, effectively replacing the government of the target firm with that of the acquirer. This is not to say that all expropriation risk is eliminated – the target’s government could still violate international law, for example and nationalize the target. But by consolidating the balance sheets of the target and the acquirer, the acquisition effectively extends the reach of the acquirer’s home institutions into the borrower’s market. In a sense, the target imports the corporate and legal institutions from the acquirer.

\textsuperscript{6} See Moeller, Schlingemann and Stulz (2005).
FDI is not, however, a panacea for the weak institutions problem plaguing emerging markets. FDI is relatively immobile, may be inflexible and may not help a country diversify its risk. A second reason that FDI is not a complete solution is that it comes at a price. In order to attract FDI and to compensate for the weak institutions problem, target shareholders in emerging markets give up both control and, relative to target shareholders in industrial countries, give up returns. The only complete solution is for governments in emerging markets to address the weaknesses in their contracting environment, to offer greater property rights protection and to make firms less vulnerable to capricious changes in government policy.

Recap

The composition of global financial flows to emerging markets changed dramatically in the post-financial crisis period. External finance is now much more likely to take the form of the sale of domestic assets, with control rights shifting to the acquiring firm. In my view, this change in the composition of flows is a natural response to institutional weaknesses in emerging markets. Control of foreign subsidiaries allows for both capital flow and for the protection of property rights of the acquiring firm, but is not a perfect substitute for strong institutions that would extend to all firms in emerging markets.

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