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World market integration through the lens of foreign direct investors

Rui Albuquerque[a,*], Norman Loayza[b,1], Luis Servén[b,1]

[a]William E. Simon Graduate School of Business Administration, Carol Simon Hall, University of Rochester, Rochester, NY 14627, United States

[b]World Bank, 1818 H Street, NW, Washington, DC 20433, United States

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Abstract

This paper is motivated by the unparalleled increase in foreign direct investment to emerging market economies of the last 25 years. Using a large cross-country time-series data set, we evaluate the dependence of foreign direct investment on global factors, or worldwide sources of risk (i.e., factors that drive foreign direct investment across several countries). We construct a globalization measure that equals the share of explained variation in direct investment attributable to global factors. We show that our globalization measure has increased steadily for developing and developed countries. For the full sample of countries, the globalization measure rose by over 10-fold from 1985 to 1999. Furthermore, in recent years, developing countries' exposure to global factors has approached that of developed countries. Finally, our globalization measure correlates strongly with measures of capital market liberalization, supporting our hypothesis that increased market integration leads to a greater role for worldwide sources of risk. We discuss the implications of our results for public policies regarding capital market liberalization and policies directed at attracting foreign investment.
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* Corresponding author. Tel.: +1 585 275 3956; fax: +1 585 461 3309.

E-mail addresses: albuquerque@simon.rochester.edu (R. Albuquerque), nloayza@worldbank.org (N. Loayza), Lserven@worldbank.org (L. Servén).

[1] Tel.: +1 202 473 7451; fax: +1 202 522 2119.

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1. Introduction

Recently, there has been a strong move towards greater integration of emerging market economies into world capital markets. The process of integration starts with the removal of capital market restrictions, most notably the liberalization of foreign investors' participation in domestic stock markets, the listing of domestic firms in foreign markets, and the privatization of state-owned companies.[2] Among the main goals of these reforms are a reduction in the domestic cost of capital, an increase in foreign capital inflows and in economic activity.[3]

This paper analyzes the dynamics of foreign capital flows, particularly foreign direct investment, in response to increased integration of capital markets. We choose to focus on capital flows rather than stock prices for two main reasons. First and foremost, the success and continuity of the liberalization reforms depend on the benefits of such programs, which, on the basis of the current evidence on stock prices, might be viewed as meager by reform opponents.[4] Of course, it is possible that the noted small stock price impact reflects the reforms' imperfect credibility. If that is the case, one would expect flows to behave in a fashion similar to prices; otherwise, one would expect flows to increase significantly.

In addition, not much is known about the dynamics of international capital flows in connection with the recent period of global capital market integration. Our analysis focuses on foreign direct investment as opposed to portfolio equity flows, or total capital flows for three reasons.[5] First, foreign direct investment is the fastest growing form of international capital flows and the most important form of private international financing for emerging market economies. As a fraction of world gross domestic product, total private capital inflows to emerging markets grew from a steady annual average of 1.3% in the period from 1976 to 1989 to an annual average of 2.0% in the period from 1990 to 2000, representing a 56% increase. During this period, foreign direct investment flows increased at an average rate that was 9% points higher than that of portfolio equity and bond flows.[6] To the extent that multinational corporations are vehicles for improving risk sharing across countries (e.g., Errunza et al., 1999; Rowland and Tesar, 2004), they may be partly responsible for the small price response of domestically listed firms after

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[2] See for example Bekaert et al. (2002a), Marston (1995), and Stulz (1999a). Beim and Calomiris (2001) report official dates of financial liberalization measures and other reforms across several countries.

[3] For example, Errunza and Losq (1985) and Bacchetta and van Wincoop (2000) give theoretical arguments for these effects to occur. See Eichengreen (2001) and Bekaert et al. (2002c) for evidence on the effects of capital account liberalization on growth.

[4] There is now considerable evidence on how the cost of capital responds to a financial liberalization program. The consensus view in the literature is that the cost of capital declines in the post liberalization era. However, this decline is not as large as theory would have predicted, in some studies, not even economically or statistically significant (e.g., Bekaert and Harvey, 2000; Henry, 2000; Chari and Henry, 2004; Stulz, 1999b).

[5] See Bekaert et al. (2002b) and Edison and Warnock (2003) for evidence on how liberalization reforms change short term portfolio equity flows.

[6] The average annualized growth rate of foreign direct investment was 17% in the period from 1976 to 2000, whereas the corresponding figure for all private nondirect investment flows was 7.6% (authors' computations using data from the World Bank World Development Indicators 2002 for low- and middle-income countries).

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