

# An information-based trade off between foreign direct investment and foreign portfolio investment

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## Abstract

The paper develops a model of foreign direct investments (FDI) and foreign portfolio investments (FPI). FDI enables the owner to obtain refined information about the firm. This superiority, relative to FPI, comes with a cost: a firm owned by the FDI investor has a low resale price because of asymmetric information between the owner and potential buyers. The model can explain several stylized facts regarding foreign equity flows, such as the larger ratio of FDI to FPI inflows in developing countries relative to developed countries, and the greater volatility of FDI net inflows relative to FPI net inflows.

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## 1. Introduction

International equity flows are the main feature of the recent globalization of capital markets both in developing and in developed economies. These flows take two major forms: Foreign Direct Investments (FDI) and Foreign Portfolio Investments (FPI). An empirical regularity is that the share of FDI in total foreign equity flows is larger for developing countries than for developed

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countries.<sup>1</sup> Regarding the second moments of foreign equity flows, it is known that the volatility of FDI net inflows is, in general, much smaller than that of FPI net inflows.<sup>2</sup> Moreover, empirical analysis has established that the differences in volatility between FPI and FDI flows are much smaller for developed economies than for developing economies.<sup>3</sup>

Despite the empirical interest in foreign equity flows, very little work has been done on jointly explaining FDI and FPI in a rigorous theoretical framework. In this paper, we propose such a framework, and provide a model of a trade off between FDI and FPI, which is consistent with the empirical facts mentioned above.

Our model highlights a key difference between the two types of investment: FDI investors, who take both ownership and control positions in the domestic firms, are in effect the managers of the firms under their control; whereas FPI investors, who gain ownership without control of domestic firms, must delegate decisions to managers, but limit their freedom to make decisions because the managers' agenda may not be always consistent with that of the owners. Consequently, due to an agency problem between managers and owners, portfolio investment projects are managed less efficiently than direct investment projects.<sup>4</sup> To be more specific, direct investors, who act effectively as managers of their own projects, are more informed than portfolio investors regarding changes in the prospects of their projects. This information enables them to manage their projects more efficiently. This effect generates an advantage, with an added value in the capital markets, to direct investments relative to portfolio investments.

There are, however, costs to direct investments. We specify two types of costs. The first type reflects the initial cost that an FDI investor has to incur in order to acquire the expertise to manage the project directly. This cost is exogenously given in the model. The second type, an information-based cost, is derived endogenously in the model. It results from the possibility that investors need to sell their investments before maturity because they face liquidity shocks. In such circumstances, the price they can get will be lower if they have more information on the economic fundamentals of the investment project. This is because when potential buyers know that the seller has more information, they may suspect that the sale results from bad information on the prospects of the investment, and will thus be willing to pay a lower price. Thus, if they invest directly, the investors bear the cost of getting a lower price if and when they are forced to sell the project before maturity.

Our model, therefore, describes a key trade off between management efficiency and liquidity.<sup>5</sup> Both sides of this trade off are driven by the effect of asymmetric information, which comes with control. When they invest directly, investors get more information about the fundamentals of the

<sup>1</sup> For a summary, based on World Bank data, see [Albuquerque \(2003\)](#).

<sup>2</sup> Net inflows account for net investments made by foreign investors (that is, new investments by foreign investors minus withdrawals of old investments by foreign investors).

Using World Bank data on 111 countries, [Albuquerque \(2003\)](#) shows that 89% of the countries in his sample have lower coefficient of variation of net FDI inflows than that of other net inflows. A related set of evidence suggests that FDI has proven to be much more resilient during financial crises, and thus contributes to the stability of the host country. (See: [Chuhan et al., 1996](#); [Frankel and Rose, 1996](#); [Lipsey, 2001](#); and [Sarno and Taylor, 1999](#)).

<sup>3</sup> [Lipsey \(1999\)](#) shows that the ratio of FDI's volatility to other long-term flows' volatility is 0.59 in Latin America, 0.74 in South East Asia, 0.86 in Europe, and 0.88 in the US. Thus, the differences in volatilities between net FDI inflows and other types of net inflows are smaller in developed economies.

<sup>4</sup> For a recent survey on agency problems and their effect on financial contracting, see: [Hart \(2001\)](#).

<sup>5</sup> Note that the interpretation of the word "liquidity" here is different from the one in the phrase "liquidity shock". Here, "liquidity" means that when they invest in FDI, investors will face a less liquid market when they want to sell, in the sense that they will get a lower price. A "liquidity shock" means that an investor is facing a shock that forces her to liquidate the investment.

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