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Institutions, Corporate Governance and Capital Flows

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ABSTRACT

Countries with weaker domestic investor protection hold less diversified international portfolios. An equilibrium business cycle model of North-South capital flow with corporate governance frictions between outside investors and corporate insiders explains this phenomenon through two channels. First, weak governance leads to concentrated ownership in the South because international diversification by insiders is penalized by lower stock market valuation. This reduces the float portfolio, or the supply of South assets. Second, weak governance tilts the demand of South outside investors towards domestic assets to hedge labor income risk. This is due to a higher share of labor in income, which increases labor income risk. In addition, the dynamics of investment under insider control leads relative dividend and labor income to be more negatively correlated in the South, making domestic assets a better hedge against local labor income risk. I find that the insider ownership and hedging channels are responsible for at least 29% and 11%, respectively, of the cross-country variation in international diversification. Thus, weak institutions lower international diversification primarily through concentrated ownership of firms, with outsider hedging also playing a quantitatively significant role.

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1. Introduction

Institutions, which cover a broad spectrum of economic arrangements such as courts of law, corporate governance standards and the quality of contract enforcement, have recently received much attention as determinants of economic performance. Though it is acknowledged that the dual institutions of investor protection laws and corporate insider ownership play a critical role in setting the “limits of financial globalization” (see Stulz, 2005), the precise channels through which they influence international capital flows, as well as their magnitudes, are not well understood.[1] This paper presents a theory and some empirics that fill this gap in the literature on international capital flows.

The main stylized fact that motivates this paper, the so-called limits of financial globalization, can be seen in Fig. 1. The first (second) panel draws a scatter plot with institutional quality on the horizontal axis and foreign equity – portfolio equity and FDI – assets (liabilities) as a fraction of national wealth on the vertical axis for a group of 41 countries (20 developed markets, 21 emerging markets).[2] It appears that countries with lower institutional quality (“the South”) hold fewer foreign equity assets and issue fewer foreign equity liabilities. I show later using regressions that this appears to be robust to a variety of control variables and alternative explanations, and is not driven by broad differences across the groups of advanced and emerging nations. This feature has been noted by Coeurdacier and Rey (2013), and has also been found in disaggregated data on foreign equity liabilities by authors such as Dahlquist et al. (2003) and Kho et al. (2009). The second characteristic of the data that motivates the paper is the greater ownership of firm equity by domestic corporate insiders in the South (see LaPorta et al., 1999; Kho et al., 2009).

The first pattern appears to be counter-intuitive at first pass: why would countries with worse domestic institutions be more home-biased in their equity holdings, while having apparently better alternatives in countries with better institutions (“the North”)? The two patterns together raise several intriguing questions about portfolio allocation when corporate insiders, and outsiders, co-exist. For instance, to what extent is poor investor protection responsible for insider ownership and the lack of international diversification? Given a certain amount of insider ownership, what determines the composition of ownership of the float portfolio between foreign versus domestic investors?[3] What are the general equilibrium channels through which investor protection affects the extent of international diversification of countries?

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[1] René Stulz in his presidential address delivered at the American Finance Association Meetings in 2005 speaks about the “limits of financial globalization”.

[2] Details about the sample selection criteria, data sources, and construction for Fig. 1 are provided in Section 3 and the appendix.

[3] The float portfolio is the fraction of a country's stock market that is actively traded in equity markets, and is equal to the part not held by insiders.

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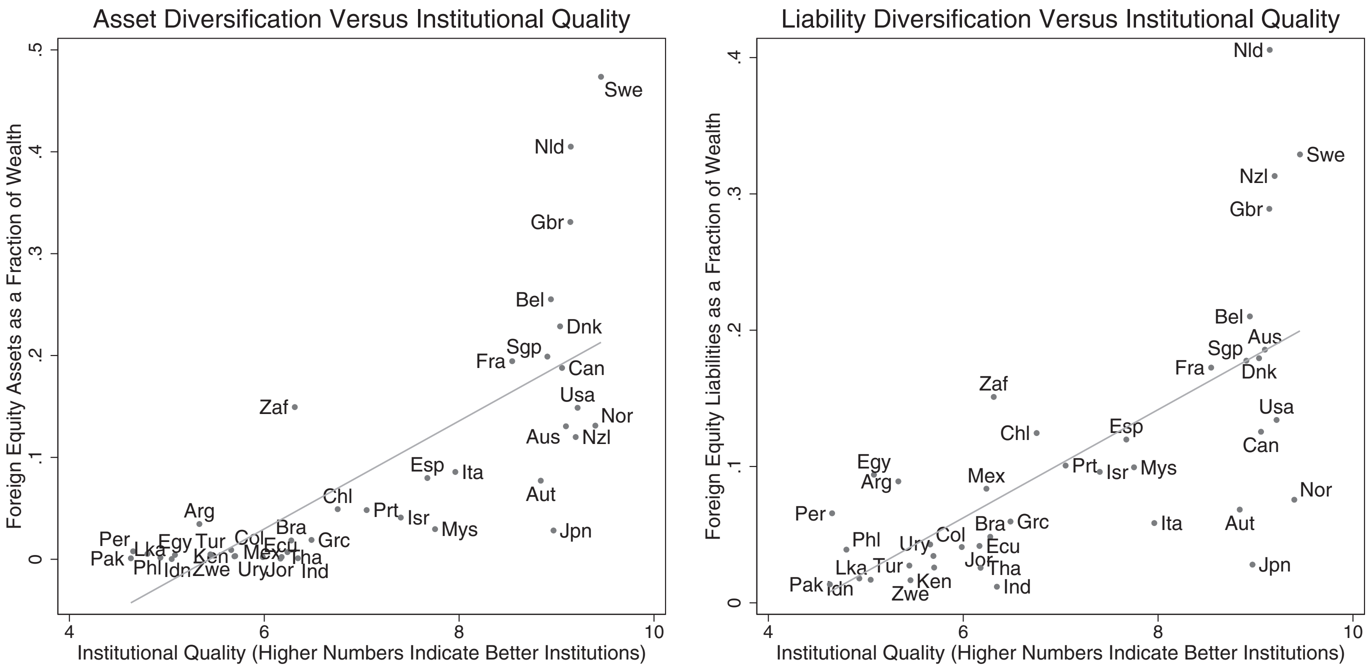

Fig. 1. International Diversification and Institutions. *Notes:* Institutional quality measured by the LaPorta et al. (1998) indices on the x-axis. The ratio of foreign equity assets (liabilities) to national wealth in panel 1 (2) on the y-axis. The points represents the time average for each country. Data source: Lane and Milesi-Ferretti (2007) and LaPorta et al. (1998).

To answer these questions and better understand the role of agency problems and firm insiders in shaping capital flows, I develop a two-country dynamic stochastic general equilibrium model of international portfolio choice with two distinct representative agents in each country – a corporate "insider" and an "outsider" investor. An insider is an entrepreneur and large shareholder who has control over the investment, dividend, and employment policies of a firm by virtue of her sizeable equity stake. In contrast to an insider, an outsider is a small investor who owns stock in a firm but has no direct control over its operations. The majority of her income comes from supplying labor. In short, she fits the description of the classical atomistic agent in a business cycle model. Weaker institutions lower the ability of outsiders to hold insiders accountable for their decisions through the mechanisms of corporate governance. I incorporate the conflict of interest that arises between these two parties when the latter has full control of the firm, yet owns only a part of it. Weaker institutions, by opening up opportunities for self-interested behavior by insiders, affect the payoffs of claims to the firm's dividends. This influences the portfolio choice of both outsiders and insiders, yielding two main results.

First, I find that lower institutional quality drives lower international diversification by insiders, which in turn lowers the supply of investible domestic assets for outside investors. In other words, the domestic float portfolio in the South is smaller since insiders' demand for foreign assets is lowered by weaker institutions. I label this the "insider ownership" channel. Second, I find that for a given size of the float portfolio, domestic outsiders in the South also wish to hold a smaller share of the foreign stock index. This arises due to a higher labor-dividend ratio in the South and a negative covariance of labor and dividend income. I label this the "outsider hedging" channel. The aggregate country share of foreign assets in wealth in the model is an average of the equilibrium holdings of insiders and outsiders.

The insider ownership channel, that the South has greater insider ownership of firms, and hence, a smaller float portfolio, works through a mechanism that has been studied by Admati et al. (1994) and DeMarzo and Urošević (2006) in closed economy partial equilibrium models. As noted earlier, weaker institutions in the South let domestic insiders extract private benefits of control. Lower insider equity, by reducing the insider's ownership of cash-flow rights of the firm, increases extraction. Thus, risk-averse Southern insiders, wishing to diversify country-specific risk by buying foreign assets, can only sell their stake at a discount; outside investors, anticipating greater extraction, are only willing to trade shares with the insider at a lower price corresponding to the lower post-trade level of insider ownership. This acts as an endogenous "transaction tax" on the insider's portfolio adjustments. The insider's trade-off, between the potential benefits of diversification and the penalty of the transaction tax, determines the size of the float portfolio of a country. Since the effect of the transaction tax dominates in the Southern equilibrium, it ends up with more insider ownership. This outcome can be thought of as home bias on the part of insiders, which also reduces the supply of investible South assets.

The outsider hedging channel, that Southern outsiders hold a smaller share of the foreign equity index, follows from the impact of imperfect corporate governance on the share of labor in total income and the ability of domestic assets to hedge risks related to this labor income. I first show that weaker governance implies a higher share of labor income in total income. This increases the risk arising from labor income. In addition, building on Heathcote and Perri (2013) and Coeurdacier and Gourinchas (2012), I show that domestic assets are a better hedge against labor income risk in countries with weaker institutions.[4] The underlying mechanism, working primarily through the insiders' decisions about the dynamics of investment and how that influences the covariance of dividend and labor income, draws on an extensive literature in financial economics (see LaPorta et al., 2000; Nenova, 2003; Dyck and Zingales, 2004) showing that insiders in the South can extract rents from firms as private benefits of control. Since more rents can be extracted from larger firms, insiders effectively become empire-builders as in the classic free cash flow problem setup described by Jensen (1986).

[4] The hedging properties of domestic assets as a possible explanation of home bias has also been explored by Cole and Obstfeld (1991), Baxter and Jermann (1997), Engel and Matsumoto (2009), van Wincoop and Warnock (2010), and Coeurdacier et al. (2010), among others.

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