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Corporate governance and FDI: Firm-level evidence from Japanese FDI into the US

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ABSTRACT

Better corporate governance can reduce the scope for increasing shareholder value and thus discourage M&A FDI inflows. Sound governance may also discourage non-M&A FDI inflows in light of the complementary relationship between M&A and non-M&A FDI. We use firm-level evidence to empirically examine the effect of US corporate governance on Japanese M&A and non-M&A FDI. We find that two landmark US corporate governance regulations help explain the sharp drop in both Japanese M&A and non-M&A FDI into the US during the 1990s. Our evidence suggests that corporate governance may affect both M&A and non-M&A FDI.

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1. Introduction

Traditional theories of foreign direct investment (FDI) are based on industrial organization motives related to the ownership of firm-specific assets such as advanced technology, superior management skills, and global marketing and distribution networks. While such traditional theories are useful, they fail to explain the stylized fact of FDI sometimes occurring in waves, as happened in the case of Japanese FDI into the US during the 1980s and 1990s. To address this gap, Froot and Stein (1991) put forth relative wealth—i.e. depreciation of the US dollar increasing the relative wealth of foreign firms—as a key driver of FDI into the US. A depreciation of the US dollar increases the dollar value of those funds and enables foreign firms to bid more aggressively for US assets.

The Froot and Stein hypothesis does a good job of explaining the stylized facts of the 1980s and early 1990s. During that time, Japanese FDI into the US rose when the dollar weakened and fell when the dollar strengthened. However, after 1991, Japanese FDI fell sharply despite a depreciation of the US dollar. To explain the paradoxical drop in Japanese FDI, Klein, Peek, and Rosengren (2002) propose the relative access to credit hypothesis. The basic idea is that the sharp drop in Japanese FDI in the 1990s can be explained by the reduction in credit flows to Japanese firms. The KPR hypothesis is based on the confluence of two stylized facts—the Japanese banking crisis of the 1990s and the Japanese main bank system. The deterioration of the financial health of Japanese banks adversely affects the flow of credit to Japanese firms from their main banks.

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Another potential explanation for the sharp decline of Japanese FDI into the US despite the dollar's depreciation has to do with improvement in corporate governance in the US since the early 1990s. In particular, two landmark corporate governance regulations by the US Securities and Exchange Commission (SEC) in 1992 reshaped the US corporate governance landscape. [1] This explanation is especially relevant for M&A FDI since M&A activity in the US and elsewhere has been motivated to a large extent by improving corporate governance to create shareholder value. There is some empirical evidence for the notion that corporate governance influences M&A FDI. Rossi and Volpin (2004) find evidence from a cross-section of 48 countries that protection of shareholder rights has a negative effect on M&A FDI inflows.[2] Alba, Park, and Wang (2009) also find that improved corporate governance in the US had a negative effect on rate of firm-level Japanese M&A FDI in the United States.

In this paper, we go beyond the corporate governance as a determinant of M&A FDI hypothesis to test empirically the possibility that corporate governance also influences non-M&A FDI. Although M&A FDI is an important form of FDI, it is only one of several forms of FDI, along with new plants and joint ventures. However, there are strong grounds for at least some complementarities between M&A and non-M&A FDI. For one, assets, including assets acquired as a result of M&A FDI, are usually not perfectly divisible (Penrose, 1959). Therefore, utilizing the indivisible assets acquired from M&A FDI more efficiently may require additional non-M&A FDI (Teece, 1980). For example, when a Japanese company buys a high-tech US company, it may build new production facilities in the US or enter into joint ventures with US firms to more fully utilize its newly acquired technology assets. In fact, Calderón, Loayza, and Servén (2004) find that M&A FDI is followed by other types of FDI in a large sample of countries. This implies that to the extent that improved corporate governance has a negative impact on M&A FDI, it may also adversely affect other types of FDI such as new plants and joint ventures.

The central objective of this paper is to examine empirically the impact of corporate governance on both M&A and non-M&A FDI. More specifically, we look into the impact of two landmark corporate governance regulations by the US SEC in 1992 on Japanese M&A and non-M&A FDI into the United States. To do so, we use firm-level data from Japanese FDI into the US. We use the same set of firm-level explanatory variables as Klein et al. (2002)—i.e. relative access to credit, relative wealth, profitability and size. In addition, we include a dummy variable, which captures the change in the US SEC regulations in 1992. For our purposes, this is the most significant variable since we seek to investigate the relationship between corporate governance and FDI. In contrast to KPR, we use a Markov bivariate zero-inflated negative binomial regression model (hereafter MBZINB) which is well suited to positively correlated bivariate panel data with a high proportion of zeros, such as number of M&A and non-M&A FDI projects. MBZINB has the added advantage of modeling the serial dependence of repeated observations over time as a Markov chain with transition probabilities that depend on covariates. For comparative purposes, we also estimate the bivariate zero-inflated negative binomial regression model (hereafter BZINB), which is a special case of MBZINB.[3]

2. Data and empirical model

In this section, we discuss the data and empirical model that we use to analyze the impact of corporate governance and other explanatory variables on firm-level Japanese FDI into the US. Our model is based on a stylized two-stage investment process. In the first stage, we look at the probability of whether the Japanese firm intends to invest in the US. In the second stage, we investigate the effect of the various determinants of FDI, including US corporate governance, on both M&A and non-M&A FDI.

2.1. Data

Our sample consists of 317 firms listed in the first section of the Japan Company Handbook (JCH) with at least one FDI in the United States from 1987 to 1994. Each firm is associated with one of the 11 banks identified by Klein et al. (2002) as a main bank. Table 1 shows the descriptive statistics. There are 2057 observations in the sample and each observation indicates the number of both M&A and non-M&A FDI projects for a given firm in a given year. For M&A FDI, 89.4% of 2057 observations are zeros with the sample mean and standard deviation of 0.13 and 0.43, respectively. For non-M&A FDI 75.6% of 2057 observations are zeros with the sample mean and standard deviation of 0.39 and 0.95, respectively. The sample correlation between M&A and non-M&A FDI is 0.23 with p-value of 0.0000. This suggests a high proportion of zero counts and positive correlation between M&A and non-M&A

[1] Vafeas and Afxentiou (1998) empirically examine the effect of the 1992 SEC compensation disclosure rule and find that CEO pay could be better explained by accounting and market performance measures following the rule compared to the pre-rule period. Gillan and Starks (2000) find that investor activism, particularly institutional investors and coordinated groups of investors, has increased after the 1992 SEC proxy ruling. The institutional and coordinated activism typically applied pressure on management to improve corporate governance. However, the literature is controversial. Karpoff (2001) reviews the impact of increased shareholder activism beginning in the 1990s and he concludes that the controversy lies in the metrics used by researchers. He notes that researchers emphasizing changes in corporate governance structure conclude that shareholder activism is a useful tool in improving firm performance while those emphasizing changes in share values and earnings conclude that shareholder activism has negligible effects on the target firms.

[2] Rossi and Volpin (2004) also examine cross border differences in investor protection and find that acquirers' countries are usually from countries with better consumer protection than countries of their target companies. In examining the impact of both investor and creditor protection from acquirers' country to US target firms, Kuipers, Miller, and Patel (2009) find that rule of law and creditor protection from the acquirers' country is positively and significantly related to the targets' returns. Kang (1993) and Pettway, Sicherman, and Spiess (1993) note that Japanese firms have acquired target firms in the US that have significant and positive returns whereas acquirers from other countries have zero or slightly negative returns. This seems to imply that Japan has better investor and creditor protection than the United States in the 1980s. Creditors such as banks play an important role in the corporate governance as discussed by Yafeh (2000) and Yashu (2001).

[3] Please refer to Wang (2003) for a comprehensive discussion of the BZINB model. Ho, Wang, and Alba (2009) apply the model to foreign direct investment (FDI). However, the BZINB model assumes that the M&A and non-M&A FDI are independent.

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