

The role of foreign investors

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The great debate about financial globalisation

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- If anything, there is a small increase in crisis probability
- But the systematic fact is: EMs continue to open up.

The great debate about financial globalisation

- Growth regressions find little impact of capital account liberalisation upon growth.
- If anything, there is a small increase in crisis probability
- But the systematic fact is: EMs continue to open up.
- Existing explanations:
 - 1 Growth regressions have problems
 - 2 There is a one-time rise in GDP (only).
 - 3 Decontrol helps raise financial development.
 - 4 Finance follows trade.

The key idea of this paper

- There are infirmities in the domestic financial system
- These effects are large
- Foreign investors help alleviate distortions of resource allocation of the local financial system

Misallocation is of first order importance in poor countries

- Banerjee and Duflo (2005), Jeong and Townsend (2007), Restuccia and Rogerson (2008), Hsieh and Klenow (2009), Bartelsman et al. (2008), Alfaro et al. (2008) and Buera et al. (2008) all argue that the extent of misallocation of resources in poor countries is large enough to explain a very large part of the TFP gap between rich and poor countries.
- A weak financial system is one potential source of misallocation.
- Example: In China, formal finance starves private and small firms.

Could it be that foreign investors allocate capital wisely?

- The home bias literature has emphasised that foreign investors send too little money out
- Portes & Rey: Notions of the gravity model in the capital account also
- Clearly, information processing is hard for foreign investors
- Could the imperfect information processing of foreign investors be superior to the imperfect information processing of a weak financial system?

Investment behaviour of foreign and domestic institutional investors

- E.g. Dahlquist & Robertsson, JFE, 2004
- Their main finding: there is no difference between the firm characteristics sought by domestic vs. foreign institutional investors
- Could domestic institutional investors differ from foreign institutional investors:
 - 1 Home bias, information distance?
 - 2 Domestic institutional investors part of a weak financial system?
- This motivates the questions:
 - 1 Are the investment choices of DII different from FII?
 - 2 If so, are these differences related to home bias or are they related to infirmities of domestic finance?
 - 3 Is there an economically significant impact upon firms and their growth?

Part I

Empirical strategy

The dataset

- Firm data in India, where ownership structure is observed for each firm.
- Unbalanced panel data from 2007 to 2011 (five years). Number of firms:

2007	2008	2009	2010	2011
1765	1917	1889	2030	2115

- Observe a broad array of firm characteristics.

Three kinds of investors

- 1 Foreign institutional investors “FII”
- 2 Mutual funds “MF”
- 3 Other domestic institutions (banks, insurance companies) “ODII”
- 4 (Sum of the latter two is “DII”)

FII Only foreign *institutional* investors are permitted into India; fairly free once they register.

MF Market share of public sector has dropped to 10%; the best regulatory structure found in India.

Other DII Public sector market share is 80% with banks and 90% with insurance. Weak regulation in both areas.

Firms with non-zero institutional ownership

Year	FII	MF	ODII	DII	Total
2007	1031	1136	1350	1485	1765
2008	1158	1205	1391	1580	1917
2009	1132	1141	1362	1529	1889
2010	1175	1186	1407	1595	2030
2011	1243	1218	1477	1652	2115

The preferences of institutional investors

- Want to run regressions explaining ownership based on firm characteristics
- But there are many zeros
- Hence, use a Tobit model (with clustered standard errors and year fixed effects)

Simple patterns in the data: by firm age

	Q1	Q2	Q3	Q4	Q5
Age	13	19	24	32	61
FII	1.91	0.02	0.28	0.07	2.96
ODII	0.09	0.02	0.09	0.62	8.24

Simple patterns in the data: by asset tangibility

	Q1	Q2	Q3	Q4	Q5
Tangibility	6	29	46	65	95
FII	8.8	1.7	0.9	0.1	0.0
ODII	0.4	0.1	0.2	0.4	1.7

Tobit results comparing FII vs. DII

	FII	't'	DII	't'
Log mktcap	7.806	31.064	4.153	22.748
Turnover ratio	0.000	0.194	-0.001	-2.517
1yr Returns	-0.010	-2.927	-0.006	-4.411
Yield	-0.226	-1.845	0.055	0.703
Domestic β	2.020	2.560	1.189	1.856
Global β	0.835	1.825	-0.217	-0.606
Total risk	-0.035	-1.749	-0.055	-3.936
Insider holding	-0.151	-7.272	-0.008	-0.547
Exports to sales	0.000	2.999	-0.001	-2.699
Age	-0.087	-4.611	0.110	7.331
Is public sector	-6.100	-2.984	9.540	4.771
Tangibility	-0.049	-4.839	0.071	7.413
Low R&D	-1.854	-2.869	1.023	2.012
High R&D	1.470	2.093	-1.678	-2.762

Breaking DII into MF vs. ODII

	FII	't'	MF	't'	ODII	't'
Log mktcap	7.806	31.064	2.973	16.885	2.477	14.770
Turn. ratio	0.000	0.194	-0.000	-2.000	-0.000	-1.604
1r Returns	-0.010	-2.927	-0.001	-1.987	-0.005	-4.215
Yield	-0.226	-1.845	0.117	1.773	0.042	0.577
Domestic β	2.020	2.560	1.367	2.824	1.587	2.685
Global β	0.835	1.825	0.045	0.152	-0.468	-1.422
Total risk	-0.035	-1.749	-0.078	-5.841	-0.013	-1.073
Insider holding	-0.151	-7.272	0.012	0.920	-0.040	-2.868
Exp. to sales	0.000	2.999	-0.001	-1.438	-0.001	-2.463
Age	-0.087	-4.611	-0.004	-0.406	0.128	9.640
Is public sector	-6.100	-2.984	-2.539	-1.687	11.162	6.143
Tangibility	-0.049	-4.839	0.013	2.187	0.082	8.504
Low R&D	-1.854	-2.869	1.701	3.802	0.063	0.154
High R&D	1.470	2.093	0.250	0.505	-2.131	-4.008

Part II

Does this matter?

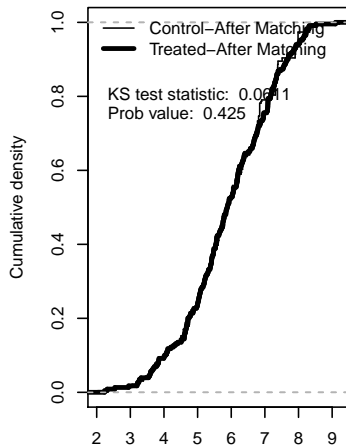
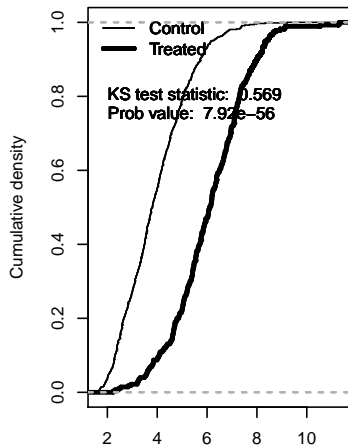
Institutional investors and firms

- Perhaps this merely induces clientele effects – foreign investors invest in certain kinds of firms; other firms obtain local investors.
- How do we evaluate the consequences of the choices of institutional investors?
- A key problem: Asset pricing factors – size, beta, book/price – matter in the thinking of investors and matter for the evolution of firms.

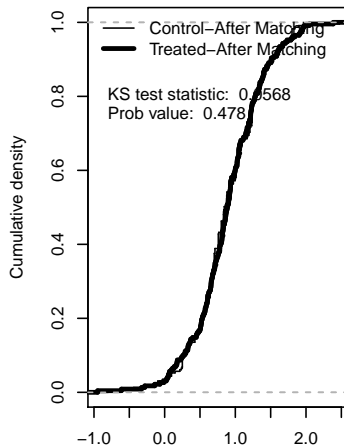
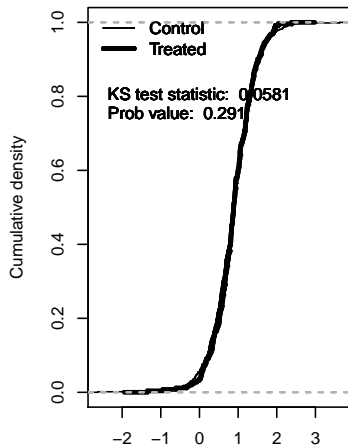
A design

- Identify firms which have no institutional investment – they are the controls
- Identify firms who have foreign institutional investment but not domestic institutional investment.
- Identify firms who have domestic institutional investment but not foreign institutional investment.
- Mahalanobis matching on log size, b/p and beta.
- Measure the changes in firm fundamentals over a four year horizon.

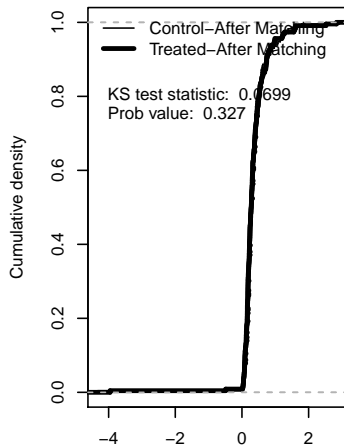
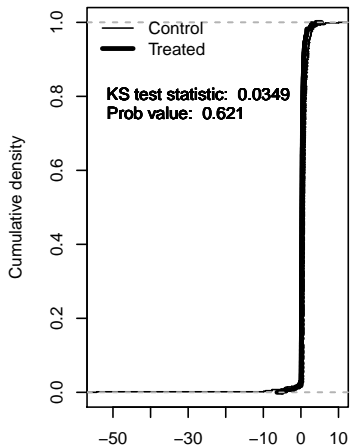
Match balance: Size (FII as treatment)



Match balance: Beta (FII as treatment)



Match balance: Book-to-price (FII as treatment)

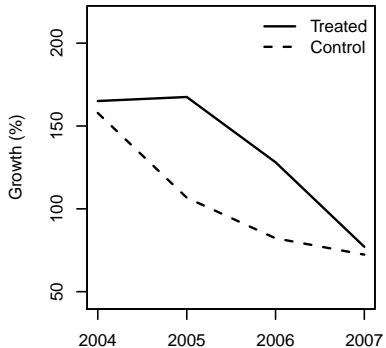


Outcome

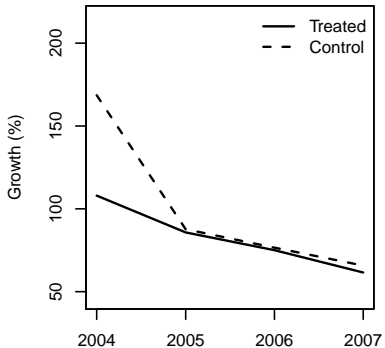
- 1 Sales growth
- 2 Capital growth
- 3 Change in sales/Change in capital
- 4 Employment growth
- 5 Change in employment/Change in capital

1. Sales growth

FII

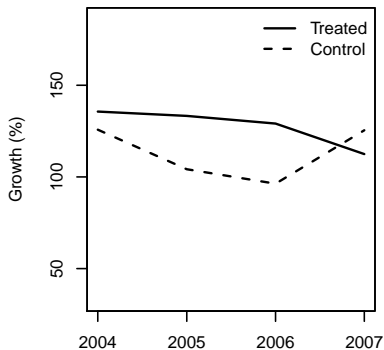


DII

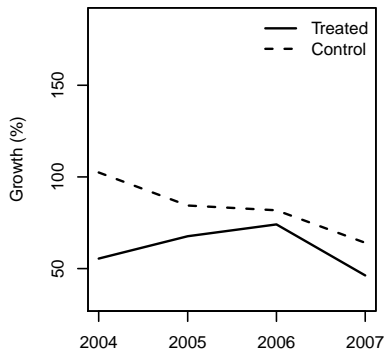


2. Growth of gross fixed assets

FII

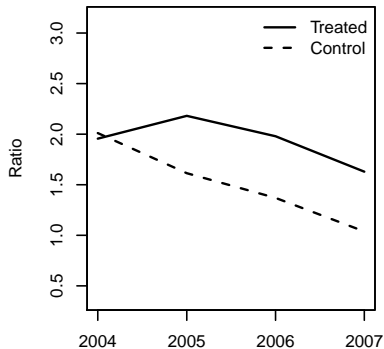


DII

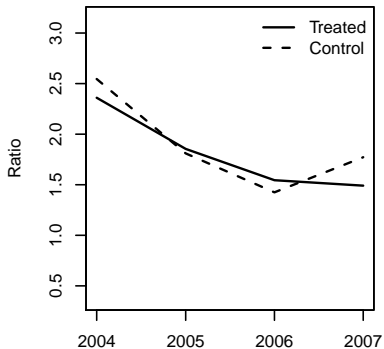


3. Delta sales by delta capital

FII

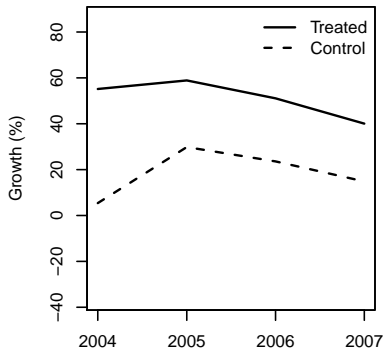


DII

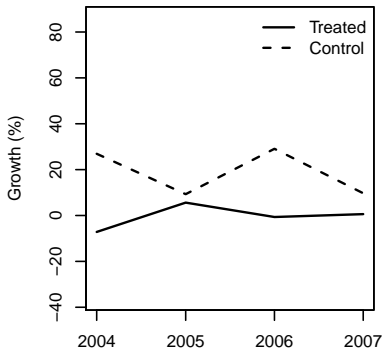


4. Employment growth

FII

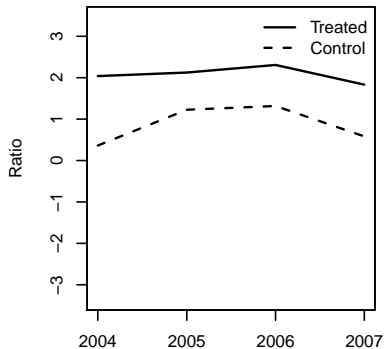


DII

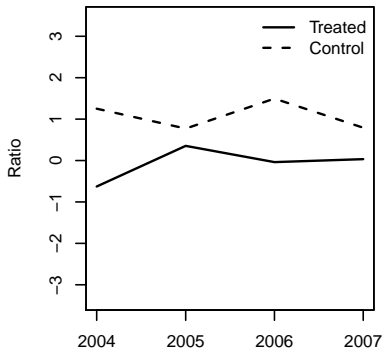


5. Delta employment by delta capital

FII



DII



Conclusions

- Unlike the Swedish results, foreign and local investors are not alike
- Foreign investors distinctly favour a certain kind of firm.
- Mutual funds are the least distorted DII – and they are closer to the FII
- Foreign capital is emphasising dispersed shareholding, exports, young firms, private firms, low asset tangibility and high R&D
- These things matter! Firms with FII ownership, which are shunned by DII had greater sales growth, greater employment growth, and achieved this growth with better use of capital.

Of what use are foreign investors in an emerging market? They help alleviate infirmities of the local financial system.

Thank you.