The Limits of Financial Globalization

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Despite the rapid growth of globalization, country choice matters in financial decision making. The threat of state expropriation of a company's assets varies by country, which affects the behavior of corporate insiders. When controlling insiders are threatened, they act to the detriment of outside minority shareholders, which in turn thwarts the risk-reduction benefits of globalization.

Globalization is the reduction in explicit barriers of trade in financial assets among countries. Measured as the fraction of foreign assets to GDP, globalization has increased by a factor of 10 since its nadir at the end of World War II. Indeed, the trend has accelerated in recent years, and globalization is nearly double its high observed a century ago.

Under complete financial globalization, neoclassical models of international economics predict that portfolio holdings, asset prices, and financial policies are not country dependent. By contrast, empirical evidence shows that *country choice matters in finance*. U.S. investors held a trivial proportion of foreign stocks in their portfolios prior to the early 1990s, and today, that share is just over 10 percent; the home bias measure introduced by Ahearne, Griever, and Warnock (*Journal of International Economics*, 2004) in 2001 was 78 percent for the United States with an average of 63 percent for 18 developed countries (maximum bias is 100 percent). The distribution of insider ownership of a company's stock varies by country: Using block holdings as a proxy for shares held by insiders, Worldscope data show that market capitalization held by insiders in the United States in 2002 is near 16 percent and the median of 48 countries is close to 51 percent.

Because the lowering of formal trade barriers fails to explain the dominance of countries in finance, Stulz's model can explain how

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country attributes matter because of so-called "twin agency problems." Rulers of states may improve their own welfare by reducing the return to shareholders through expropriation, ranging from the confiscation of assets to the favoring of certain investors ("the agency problem of state ruler discretion"). When expropriation risk is high, corporate ownership tends to be highly concentrated. Corporate insiders, either managers or controlling shareholders, under threat of ruler expropriation will increase their discretion but at the expense of minority shareholders ("the agency problem of insider corporate discretion"). Insiders overweight the shares in their own company, so their portfolio holdings are not optimal. Concentration increases as the threat of expropriation increases, and the risk-sharing benefits of globalization, including the lowering of cost of equity capital, fail to materialize as predicted by the neoclassical model.

Stulz's model differs chiefly because it considers the possibility of expropriation, which itself is exogenous and deterministic (rather than endogenous and stochastic). In the one-period model, companies are initially assumed to be all equity financed. Stulz tests the model using cross-section data on controlling shareholders (four variables), constraints on state rulers (three variables), and financial development (five variables) across 35 countries. Stulz conducts Tobit and ordinary least-squares (OLS) regression analysis, wherein the dependent variable relates to ownership concentration and the independent variables reflect ruler expropriation and financial development. The analysis generally confirms that ownership concentration is related to the intensity of the twin agency problems.

The co-investment of insiders under threat of expropriation limits the risk-sharing benefits of globalization, and the twin agency problems can explain why finance and corporate governance vary across countries. For example, in countries where the twin agency problems are severe, companies will use less equity and more debt, especially from banks with links to rulers. The United Kingdom and the United States have successfully controlled the twin agency problems, but for the world as a whole to benefit from globalization, the twin agency problems must be controlled.

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