

Globalization, free markets and investor protection

Theophilus A. Lartey¹ & Albert Danso¹

Corresponding author: Albert.danso@dmu.ac.uk

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¹ Leicester Castle Business School, De Montfort University, UK.
Email: Theophilus.lartey2@dmu.ac.uk
Albert.danso@dmu.ac.uk

Abstract

Using data from 29 countries, this paper is the first attempt to examine whether economic, political and social integration explain how well investors, both shareholders and creditors, are protected from expropriation by firms. We show that: (i) globalization drives both shareholder and creditor protection; (ii) least restrictive markets rather than paternalistic markets matter particularly for shareholders' protection; (iii) the globalization-protection nexus favoured only creditors during the crisis; and (iv) our result significantly holds for OECD-member countries.

1. Introduction

While Investor Protection (IP) delineates the extent of legal protection afforded to investors to mitigate expropriation by controlling shareholders or managers (Shleifer and Wolfenzon, 2002), globalization epitomizes global integration driven by the natural evolution of markets, economies, cultures, technologies and governance (Sobol et al., 2018). Globalization of countries and markets represents a core development in the last half century (Steenkamp, 2019), though it is analogous to a double-edged sword (Djelic and Quack, 2018). Indeed, increasing cross-border holdings and external portfolio sizes of countries have ratified the surge of economic-financial integration among countries (Lane and Milesi-Ferretti, 2007).

Extant literature primarily considers economic integration, even though political and social integration are effective towards improving risk-sharing and protection (Flood et al., 2012). Political and social integration facilitate growth (Alesina et al., 2000), the international enforceability of contracts (Balli et al., 2018), and the efficient execution of cross-border mergers and acquisitions (Weber and Camerer, 2003). Economic integration is usually the outcome of political arrangements and social proximity. Indeed, the European Monetary Union's institution of a common currency uniquely motivates an investigation into the impact of economic and socio-political integration. Yet, no evidence exists on whether these forms of global integration drive improvements in investor protection laws. Thus, we empirically assess whether, along with economic integration, political and social globalization play roles in smoothing the legal protection of international investors, both shareholders and creditors.

2. Data and Methodology

2.1 Data

We utilize data on financial and macroeconomic aggregates from the World Development Indicators database for 29 countries, combined with shareholder and creditor protection data from the Centre for Business Research, and the KOF globalization index spanning between 1990 and 2013. The choice of the 29 countries and the period are driven by availability of data for this study. The KOF index provides globalization data along economic, social and political lines. Economic globalization characterizes exposure to global market forces; social globalization captures exposure to global media, the spread of ideas, information and people; and political globalization characterizes diffusion of government policies, alliance with international organizations and bilateral relations with other countries (Gygli et al., 2018; Eppinger and Potrafke, 2016).

2.2 Methodology

Our baseline model is estimated via the two-stage General Method of Moment (Arellano and Bover, 1995; Blundell and Bond, 1998) estimator specified as:

Stage 1: We regress investor protection on the instruments and other exogenous variables:

$$P(\text{Globalization}_{i,t} = 1 | \text{Globalization}_{i,t-1}, \text{Inforflows}_{i,t}, Y_{i,t}) = \delta_1 + \delta_2 \text{Globalization}_{i,t-1} + \delta_3 \text{Inforflows}_{i,t} + \delta_4 Y_{i,t} + v_i + \omega_t \quad (1)$$

Stage 2: We replace the fitted value of $\text{Globalization}_{i,t}$ derived from the first stage with $\text{Globalization}_{i,t}^*$ in the main regression (Eqn. 2):

$$\text{Investor_Protection}_{i,t} = \alpha + \beta_1 \text{Globalization}_{i,t}^* + \beta_2 X_{i,t} + v_i + \omega_t + \varepsilon_{i,t} \quad (2)$$

where $\text{Investor_Protection}$ is the measure of shareholder and creditor protection, $\text{Globalization}_{i,t}$ is the instrumented globalization measure (economic, social, political and aggregate where appropriate), $\text{Globalization}_{i,t}^*$ is the predicted value of globalization from the first stage regression, $\text{Inforflows}_{i,t}$ is the instrumented information flows variable, Y_{it} represents the control variables that include Trade (%GDP) and FDI flows (%GDP) capturing trade/economic openness; log of income per capita captures the general level of development;

CBOE volatility index captures investors' short-term fears about instability and uncertainty in global financial markets; interpolated GINI captures inequality; level of democracy captures the system of government; sovereign lending captures short-term sovereign lending rate in the global economy; urbanization captures population living in urban centres; log of population density captures the effects of knowledge spillovers; v_i (and w_t) are the country (and year) effect and $\varepsilon_{i,t}$ is the error term. The choice of the Arellano–Bover/Blundell–Bond two-stage GMM accounts for endogeneity, time-varying endogenous effects, reverse causality and is more fitting for our large sample (i.e. $N = 29$ countries). As instruments, we use the lagged globalization index (specific for each model) and the level of information flows of each country. The intuition is that current-year integration may be positively related to prior-year integration and the country-specific information flows to (from) other jurisdictions. However, we do not suggest that these instruments have a direct economic effect on investor protection, and thus they may be uncorrelated with the error term in the second stage regression. We regress each globalization measure on the country-specific variables (trade, income per capita, CBOE volatility, FDI, GINI, democracy, sovereign lending, urbanization, population-density), and include the predicted variables in the second stage.

3. Results

3.1 Globalization and IP

Table 1 reports the results of estimating Eqn. (1). The coefficients of our four globalization measures on the IP indicators, Shareholder Protection and Creditor Protection, are positive and statistically significant at one percent, hence suggesting that erosion of boundaries and integration of economies/markets, cultures, technologies and governance drive improvements in IP. Economically, a point increase in globalization induces an increase in Shareholder Protection and Creditor Protection by 0.08 (0.08) points, representing a 5.3% (5.3%) increase relative to the sample standard deviation for aggregate globalization of 15.1.

Table 1: Globalization and IP (GMM)

	Shareholder Protection				Creditor Protection			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Economic Globalization	0.057*** (0.012)				0.048*** (0.011)			
Social Globalization		0.043*** (0.012)				0.052*** (0.016)		
Political Globalization			0.028*** (0.007)				0.028*** (0.009)	
Aggregate Globalization				0.080*** (0.014)				0.080*** (0.015)
Trade (%GDP)	-0.427* (0.253)	0.075 (0.199)	0.381** (0.169)	-0.209 (0.211)	0.304 (0.306)	0.632** (0.300)	0.999*** (0.254)	0.408 (0.292)
Income per capita	0.733*** (0.150)	0.578*** (0.219)	1.032*** (0.146)	0.579*** (0.175)	-0.262 (0.169)	-0.556** (0.257)	-0.008 (0.175)	-0.461** (0.199)
CBOE Volatility	0.009 (0.009)	0.004 (0.010)	0.008 (0.010)	0.003 (0.009)	0.007 (0.012)	0.001 (0.012)	0.006 (0.012)	0.002 (0.012)
FDI (%GDP)	0.034 (0.095)	0.038 (0.099)	0.131 (0.094)	-0.017 (0.094)	-0.382*** (0.134)	-0.431*** (0.120)	-0.308** (0.128)	-0.456*** (0.125)
Interpolated GINI	0.001 (0.007)	0.039*** (0.009)	0.025*** (0.008)	0.034*** (0.007)	-0.040*** (0.012)	0.001 (0.015)	-0.018 (0.012)	-0.010 (0.012)
Level of Democracy	-0.026 (0.245)	-0.001 (0.258)	-0.039 (0.262)	-0.170 (0.255)	0.255 (0.253)	0.234 (0.245)	0.216 (0.263)	0.091 (0.248)
Sovereign Lending	-0.156*** (0.035)	-0.182*** (0.034)	-0.148*** (0.033)	-0.151*** (0.032)	-0.010 (0.043)	-0.033 (0.043)	0.001 (0.043)	-0.000 (0.041)
Urbanization	-0.039*** (0.008)	-0.029*** (0.007)	-0.036*** (0.007)	-0.040*** (0.007)	0.022** (0.008)	0.031*** (0.007)	0.024*** (0.008)	0.020*** (0.008)
Population-Density	0.443*** (0.068)	0.284*** (0.075)	0.223*** (0.082)	0.253*** (0.072)	0.403*** (0.071)	0.243*** (0.080)	0.198** (0.082)	0.227*** (0.073)
_cons	-8.270*** (1.953)	-7.197*** (2.248)	-10.373*** (1.867)	-7.299*** (1.996)	-3.268 (2.729)	-1.268 (3.308)	-5.139* (2.692)	-2.011 (2.836)
Country Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	696	696	696	696	696	696	696	696
K-P WF statistic	657.030	568.467	333.124	639.980	657.030	568.467	333.124	639.980
K-P LM statistic	77.504	97.743	57.260	75.959	77.504	97.743	57.260	75.959
Hansen J statistic	1.809	1.632	1.552	1.743	0.069	0.017	0.080	0.037
Hansen J p-value	0.179	0.201	0.213	0.187	0.793	0.897	0.778	0.847

Standard error robust to heteroscedasticity in parentheses and clustering at country and year level.

*Indicates 10% significance.

**Indicates 5% significance.

***Indicates 1% significance.

3.2. Globalization, Free Markets and IP

Higher-regulated markets may favour equality over globalization and growth (Dorn et al., 2018). Hence, to segregate the role of legal systems, we examine whether effectively protecting investors necessitates not only increased globalization but also a free-market system. We capture free-market capitalism by the Economic Freedom Index, which measures the extent to which an economy is free of regulation (Gwartney and Lawson, 2003). In Table 2, we observe a significant impact of globalization on Shareholder Protection but an insignificant one on Creditor Protection. Interestingly, the coefficient of globalization is positive only when the interaction variable and the free market variable enter the estimation model simultaneously. The coefficients of globalization and free markets also increase in magnitude if the interaction term is included. Nevertheless, the coefficients on all interaction variables are negative and statistically significant. Overall, our finding indicates that globalization drives investor protection.

Table 2: Globalization and IP: The Role of Free Markets (GMM)

	Shareholder Protection			Creditor Protection		
	(1)	(2)	(3)	(4)	(5)	(6)
Aggregate Globalization	-0.014*** (0.005)	-0.045*** (0.014)	0.222*** (0.051)	-0.010 (0.005)	-0.055 (0.013)	0.061 (0.039)
Free Markets	0.632*** (0.078)		2.931*** (0.489)	0.677*** (0.085)		1.276*** (0.360)
Agg. Globalization*Free Markets		0.006*** (0.001)	-0.034*** (0.007)		0.009*** (0.001)	-0.009* (0.005)
_cons	1.896*** (0.463)	5.432*** (0.424)	-13.635*** (3.338)	0.954** (0.458)	5.222*** (0.339)	-3.099 (2.507)
Country Effects	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	642	642	642	642	642	642
K-P WF statistic	910.239	147.919	147.834	910.239	147.919	147.834
K-P LM statistic	167.265	191.140	68.786	167.265	191.140	68.786
Hansen J statistic	0.159	1.228	0.409	0.001	0.076	0.020
Hansen J p-value	0.690	0.268	0.523	0.971	0.783	0.888

Standard error robust to heteroscedasticity in parentheses, and clustering at country and year level.

*Indicates 10% significance.

**Indicates 5% significance.

***Indicates 1% significance.

3.3. Globalization and IP: Does Crisis Matter?

Evidence contends that earnings quality declined during the financial crisis particularly for countries with poor investor protection (Persakis and Iatridis, 2015). In Table 3, we examine the effects of the global downturn on the globalization-protection nexus. Our results indicate that globalization had a positive but immaterial effect on shareholder protection but not on creditor protection during the crisis. This, however, reversed post crisis. This finding indicates that legal protection for creditors is more closely related to underlying economic activity and reaffirms the necessity of government intervention and regulation to protect creditors during the financial crisis (Liu et al., 2016).

Table 3: Globalization and IP: Does Crisis Matter? (GMM)

	Pre-Crisis		Crisis		Post-Crisis	
	Shareholder Protection	Creditor Protection	Shareholder Protection	Creditor Protection	Shareholder Protection	Creditor Protection
	(1)	(2)	(3)	(4)	(5)	(6)
Aggregate Globalization	0.084*** (0.014)	0.081*** (0.022)	0.006 (0.020)	0.055*** (0.018)	0.041** (0.017)	0.069*** (0.012)
Trade (%GDP)	-0.513* (0.272)	0.248 (0.424)	-0.474* (0.265)	0.559** (0.282)	-0.363 (0.254)	0.766*** (0.274)
Income per capita	0.445** (0.200)	-0.332 (0.293)	0.825*** (0.263)	-0.480** (0.232)	0.358* (0.188)	-0.524*** (0.183)
CBOE Volatility	0.006 (0.012)	0.013 (0.018)	0.033 (0.067)	0.010 (0.088)	-0.018 (0.020)	-0.000 (0.022)
FDI (%GDP)	-0.351** (0.137)	-0.758*** (0.200)	0.187 (0.172)	-0.151 (0.198)	-0.077 (0.120)	-0.405** (0.169)
GINI	0.067*** (0.009)	0.002 (0.018)	-0.032** (0.013)	-0.024** (0.010)	-0.023** (0.011)	-0.014** (0.006)
Level of Democracy	0.695** (0.342)	0.157 (0.445)	-0.699** (0.301)	0.453* (0.240)	-0.731*** (0.191)	0.206 (0.219)
Sovereign Lending	-0.105*** (0.039)	-0.001 (0.055)	0.101 (0.373)	0.056 (0.490)	0.024 (0.145)	0.035 (0.155)
Urbanization	-0.036*** (0.008)	0.035*** (0.012)	-0.029*** (0.010)	0.006 (0.011)	-0.020** (0.008)	0.012 (0.009)
Population-Density	-0.025 (0.074)	-0.014 (0.126)	0.151* (0.087)	0.427*** (0.047)	0.114* (0.068)	0.387*** (0.062)
_cons	-2.843 (2.201)	0.013 (3.844)	-0.077 (3.802)	-3.560 (3.929)	3.121 (2.559)	-4.222* (2.177)
Country Effects	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	493	493	87	87	145	145
K-P WF statistic	331.485	331.485	168.007	168.007	152.767	152.767
K-P LM statistic	48.378	48.378	17.228	17.228	18.334	18.334
Hansen J statistic	1.314	0.122	1.608	0.447	0.343	0.126
Hansen J p-value	0.252	0.727	0.205	0.504	0.558	0.723

Standard error robust to heteroscedasticity in parentheses, and clustering at country and year level.

*Indicates 10% significance.

**Indicates 5% significance.

***Indicates 1% significance.

3.4. Globalization and IP: Does OECD Membership Matter?

Table 4 examines whether being a member of the Organization for Economic Co-operation and Development (OECD) matters for our globalization-protection nexus. The OECD aims to promote policies that enhance economic and social well-being globally (Allin and Hand, 2017). Our results show that, for OECD-member countries, characterized by a common goal towards

driving economic, commercial/financial, social and environmental change, globalization significantly promotes protection of both shareholders and creditors (at 1% level). For non-OECD-member countries, we observe an insignificant impact of globalization on investor protection, hence suggesting that, when countries follow a common goal, they are more likely to provide a law enforcement system and legal structures that effectively protect property and enforcement rights of owners and creditors.

Table 4: Globalization and IP: Does OECD Membership Matter? (GMM)

	OECD Member		Non-OECD Member	
	Shareholder Protection	Creditor Protection	Shareholder Protection	Creditor Protection
Aggregate Globalization	0.083*** (0.022)	0.053*** (0.014)	0.024 (0.027)	0.037 (0.035)
Trade (%GDP)	-0.301 (0.309)	0.135 (0.286)	1.681*** (0.495)	0.087 (0.895)
Income per capita	0.960*** (0.266)	-0.553** (0.239)	1.035** (0.509)	-0.286 (0.596)
CBOE Volatility	0.005 (0.009)	0.009 (0.011)	0.007 (0.014)	-0.001 (0.022)
FDI (%GDP)	-0.026 (0.105)	-0.390*** (0.138)	-0.129 (0.153)	-0.249 (0.285)
GINI	-0.044 (0.028)	-0.057** (0.023)	0.014* (0.008)	0.013 (0.013)
Level of Democracy	-0.888*** (0.200)	0.305 (0.263)	0.625 (0.445)	-0.768 (0.556)
Sovereign Lending	-0.127*** (0.031)	0.053 (0.039)	-0.094 (0.063)	-0.230*** (0.078)
Urbanization	-0.024* (0.013)	0.019 (0.012)	-0.005 (0.015)	0.021 (0.022)
Population-Density	0.424** (0.169)	0.186 (0.114)	0.904*** (0.152)	-0.183 (0.221)
_cons	-11.694*** (3.664)	4.015 (3.341)	-27.983*** (7.514)	7.329 (10.078)
Country Effects	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes
Observations	175	175	521	521
K-P WF statistic	726.749	726.749	115.337	115.337
K-P LM statistic	38.123	38.123	32.047	32.047
Hansen J statistic	0.091	0.070	2.855	0.060
Hansen J p-value	0.763	0.791	0.091	0.807

Standard error robust to heteroscedasticity in parentheses, and clustering at country and year level.

*Indicates 10% significance.

**Indicates 5% significance.

***Indicates 1% significance.

4. Conclusion

Using panel data for 29 countries, we shed new light on the key role of globalization on investor protection. We observe that globalization explains how well investors, both shareholders and creditors, are protected particularly for least restrictive markets and OECD-member countries. Also, the globalization-protection nexus favoured only creditors during the crisis. Our findings have key policy implications. The work also complements evidence on the relation between globalization and economic growth, international enforceability of contracts, and cross-border mergers and acquisitions (Balli et al., 2018).

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