Financial Globalization & Democracy
Foreign Capital, National Capital, and Political Uncertainty in Emerging Markets

Raphael Cunha
The Ohio State University
Governments face inexorable pressure from capital flows (Goodman & Pauly 1993)
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- Liberalization as a signal (Bartolini & Drazen 1997)
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Liberalization as a signal (Bartolini & Drazen 1997)

Financial globalization & emerging markets

- Governments face inexorable pressure from capital flows (Goodman & Pauly 1993)


- Liberalization as a signal (Bartolini & Drazen 1997)


- Has globalization gone too far? (Rodrik 1997)
Global market reactions to domestic politics driven by domestic investors:
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- Contagion from domestic to international investors
Global market reactions to domestic politics driven by domestic investors:

- Contagion from domestic to international investors
- Domestic investors overexposed to domestic political risk
Global market reactions to domestic politics driven by domestic investors:

- Contagion from domestic to international investors
- Domestic investors overexposed to domestic political risk

Market responses do not reflect underlying political risk, but overexposure of domestic investors
Mechanism 1: Contagion from domestic to int’l investors

Information asymmetry in financial markets
Mechanism 1: Contagion from domestic to int’l investors

Information asymmetry in financial markets

- Information is costly
Mechanism 1: Contagion from domestic to int’l investors

Information asymmetry in financial markets

- Information is costly
- Prices are informative
Mechanism 1: Contagion from domestic to int’l investors

Information asymmetry in financial markets

- Information is costly
- Prices are informative
- Domestic advantage: national investors closer to information/lower information costs
Information asymmetry in financial markets

- Information is costly
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- Domestic advantage: national investors closer to information/lower information costs
  - Proximity, familiarity
  - Connections, privileged access
Mechanism 1: Contagion from domestic to int’l investors

Information asymmetry in financial markets

- Information is costly
- Prices are informative
- Domestic advantage: national investors closer to information/lower information costs
  - Proximity, familiarity
  - Connections, privileged access
  - Ability to process/interpret information
Mechanism 2: Home bias

Home bias in global portfolio allocation
Mechanism 2: Home bias

Home bias in global portfolio allocation

- Domestic investors overinvested in home country
Home bias in global portfolio allocation

- Domestic investors overinvested in home country
- Overexposed to domestic political risk
Mechanism 2: Home bias

Home bias in global portfolio allocation

- Domestic investors overinvested in home country
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- Bias larger in emerging economies (Bekaert & Wang 2009)
Mechanism 2: Home bias

Home bias in global portfolio allocation

- Domestic investors overinvested in home country
- Overexposed to domestic political risk
- Bias larger in emerging economies (Bekaert & Wang 2009)
- Response of domestic investors to elections > response of foreign investors
How to distinguish foreign from domestic investors?
How to distinguish foreign from domestic investors?

Closed-End Country Funds

- Fund Price
- Net Asset Value
How to distinguish foreign from domestic investors?

Closed-End Country Funds

Fund Price
- Determined in New York

Net Asset Value
- Determined in emerging market
How to distinguish foreign from domestic investors?

Closed-End Country Funds

Fund Price
- Determined in New York
  - International Investors

Net Asset Value
- Determined in emerging market
  - Domestic Investors
21 emerging-market country funds

| Argentina Fund | Korea Equity Fund |
| Brazil Equity Fund | Malaysia Fund |
| Brazil Fund | Mexico Fund |
| JPMorgan Brazil Investment Trust | Mexico Equity & Income Fund |
| Chile Fund | New South Africa Fund |
| First Philippine Fund | Taiwan Fund |
| India Fund | Taiwan Equity Fund |
| India Growth Fund | Thai Fund |
| Indonesia Fund | Thai Capital Fund |
| Jakarta Growth Fund | Turkish Investment Fund |
| Korea Fund |  |

- Source: Bloomberg and Lipper/Thomson Reuters
Do domestic investors lead foreign investors?

Fractional ECM (Granger 1986, Dittmann 2004)
Long-run contagion (weekly data)
Do domestic investors lead foreign investors?

Fractional ECM (Granger 1986, Dittmann 2004)
Long-run contagion (weekly data)
Do domestic investors lead foreign investors?

Fractional ECM (Granger 1986, Dittmann 2004)
Long-run contagion (weekly data)

New South Africa Fd
First Philippine Fd
Argentina Fd
Indonesia Fd
Mexico Eq
Thai Capital
Taiwan Eq
Chile Fd
Brazil Inv Trust
Brazil Eq
Turkish Fd
Korea Fd
Jakarta Growth Fd
Thai Fd
Brazil Fd
India Fd
Taiwan Fd
Mexico Fd
Malaysia Fd
Korea Eq
India Growth Fd

Error correction parameter

Domestic (NAV) International (Fund Price)

Domestic (NAV) International (Fund Price)
Do domestic investors lead foreign investors?

**Fractional ECM** (Granger 1986, Dittmann 2004)

**Short-run contagion** (weekly data)

![Box plot showing F-statistic comparison between Domestic (NAV) and International (Fund Price)]
Event study: Domestic and int’l responses to elections
Majoritarian democracies
Majoritarian democracies
Event study: Domestic and int’l responses to elections

Majoritarian democracies

Cumulative Abnormal Return vs. Event time (weeks)
Majoritarian democracies

Event study: Domestic and int’l responses to elections

Cumulative Abnormal Return

- Fund CAR (Foreign)
- NAV CAR (Domestic)
- Fund Premium CAR (Difference)

Event time (weeks)
Event study: Domestic and int’l responses to elections

Presidential democracies

![Graph showing cumulative abnormal return (%), fund price, net asset value, and fund premium over event time (weeks).]
“Has globalization gone too far?”
“Has globalization gone too far?”

- Global market responses do not reflect underlying political risk, but overexposure of domestic investors
Conclusions

“Has globalization gone too far?”

- Global market responses do not reflect underlying political risk, but overexposure of domestic investors

- Incomplete globalization as a source of market reactions to politics
“Has globalization gone too far?”

- Global market responses do not reflect underlying political risk, but overexposure of domestic investors

- Incomplete globalization as a source of market reactions to politics

- Risk of market overpunishment
“Has globalization gone too far?”

- Global market responses do not reflect underlying political risk, but overexposure of domestic investors
- Incomplete globalization as a source of market reactions to politics
- Risk of market overpunishment
- Emerging economies particularly vulnerable
Financial Globalization & Democracy
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Appendix
Brazil 2002 Election
Lula’s Rise

Market Index

Emerging Markets
Brazil

Brazil 2002 Election
Foreign vs. Domestic Investors

Domestic Investors
International Investors

1st Round
2nd Round

Market Index
% Difference

Apr 2002
Jul 2002
Oct 2002
Jan 2003
Brazil 2002 Election
Foreign vs. Domestic Investors

Market Index
- Domestic Investors
- International Investors
- Difference

% Difference

Tequila Crisis 1994/1995
Foreign vs. Domestic Investors

Market Index

% Difference

- Domestic Investors
- International Investors
- Difference

<table>
<thead>
<tr>
<th>Fund</th>
<th>Weekly frequency</th>
<th>Daily frequency</th>
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<tbody>
<tr>
<td>N</td>
<td>Period</td>
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<tr>
<td>Argentina Fund</td>
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<td>10/25/1991 - 12/14/2001</td>
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<td>04/08/1988 - 06/09/2006</td>
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<td>JPMorgan Brazil Trust</td>
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<td>04/30/2010 - 07/17/2015</td>
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<td>10/20/1989 - 10/10/2014</td>
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<td>First Philippine Fund</td>
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<td>India Fund</td>
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<td>India Growth Fund</td>
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<td>08/12/1988 - 05/23/2003</td>
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<td>04/06/1990 - 10/10/2014</td>
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<td>Jakarta Growth Fund</td>
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<td>04/12/1990 - 06/08/2001</td>
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<td>04/27/1990 - 10/10/2014</td>
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<td>Malaysia Fund</td>
<td>1285</td>
<td>01/08/1988 - 08/17/2012</td>
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<tr>
<td>Mexico Eq. &amp; Income</td>
<td>1210</td>
<td>08/09/1991 - 10/10/2014</td>
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<td>Mexico Fund</td>
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<td>05/06/1988 - 10/10/2014</td>
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<td>New South Africa Fund</td>
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<td>03/04/1994 - 06/02/1999</td>
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<td>Taiwan Equity Fund</td>
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<td>07/22/1994 - 05/05/2000</td>
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<td>Taiwan Fund</td>
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<td>01/08/1988 - 10/10/2014</td>
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<td>Thai Capital Fund</td>
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<td>06/01/1990 - 08/16/2013</td>
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<td>Thai Fund</td>
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<td>02/26/1988 - 10/10/2014</td>
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<tr>
<td>Turkish Inv. Fund</td>
<td>1295</td>
<td>12/22/1989 - 10/10/2014</td>
</tr>
</tbody>
</table>

Sources: Bloomberg and Lipper/Thomson Reuters.
Divergence between foreign and domestic investors

Country fund premia

Chile Fd
Indonesia Fd
Korea Fd
Mexico Fd
Thai Fd

Fund Premium (%)
Country fund premia
Fractional error correction approach
(Granger 1986, Dittmann 2004)

\[ \Delta P_t = \phi_1 + \alpha_1 [(1 - B)^d - (1 - B)] z_t + \sum_{i=1}^{L} \gamma_{1i} \Delta N_{t-i} + \sum_{i=1}^{L} \omega_{1i} \Delta P_{t-i} + \nu_{1t} \]

Long-run contagion

Short-run contagion

\[ \Delta N_t = \phi_2 + \alpha_2 [(1 - B)^d - (1 - B)] z_t + \sum_{i=1}^{L} \gamma_{2i} \Delta P_{t-i} + \sum_{i=1}^{L} \omega_{2i} \Delta N_{t-i} + \nu_{2t} \]

Long-run contagion

Short-run contagion
Fractional cointegration – Sowell’s MLE estimator

Daily Country Fund Data
Fractional cointegration – GPH (nonparametric) estimator

Daily Country Fund Data

- Argentina Fd
- Brazil Eq
- Brazil Fd
- Brazil Inv Trust
- Chile Fd
- India Fd
- Indonesia Fd
- Jakarta Growth Fd
- Korea Eq
- Korea Fd
- Malaysia Fd
- Mexico Eq
- Mexico Fd
- Taiwan Fd
- Turkish Fd

Price | Net Asset Value | Cointegrating Residuals
Weekly Country Fund Data

Fractional cointegration – Sowell (1992) MLE estimator

- **Argentina Fd**
- **Brazil Eq**
- **Brazil Fd**
- **Brazil Inv Trust**
- **Chile Fd**
- **First Philippine Fd**
- **India Fd**
- **India Growth Fd**
- **Indonesia Fd**
- **Jakarta Growth Fd**

- **Korea Eq**
- **Korea Fd**
- **Malaysia Fd**
- **Mexico Eq**
- **Mexico Fd**
- **New South Africa Fd**
- **Taiwan Eq**
- **Taiwan Fd**
- **Thai Capital**
- **Thai Fd**
- **Turkish Fd**

Legend:
- **Price**
- **Net Asset Value**
- **Cointegrating Residuals**
Fractional cointegration – GPH (nonparametric) estimator

Weekly Country Fund Data

- Argentina Fd
- Brazil Eq
- Brazil Fd
- Brazil Inv Trust
- Chile Fd
- First Philippine Fd
- India Fd
- India Growth Fd
- Indonesia Fd
- Jakarta Growth Fd
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- Korea Fd
- Malaysia Fd
- Mexico Eq
- Mexico Fd
- New South Africa Fd
- Taiwan Eq
- Taiwan Fd
- Thai Capital
- Thai Fd
- Turkish Fd

- Price
- Net Asset Value
- Cointegrating Residuals
Do domestic investors lead foreign investors?

Long-run contagion (daily data)

- Chile Fd 2009
- Malaysia Fd 1999
- Korea Fd 1997
- Turkish Fd 2002
- Mexico Fd 2006
- Jakarta Growth Fd 1999
- Taiwan Fd 2008
- Taiwan Fd 2012
- Korea Eq 2012
- Mexico Fd 2000
- Korea Eq 2007
- Malaysia Fd 1995
- Korea Fd 2002
- Brazil Fd 1999
- Indonesia Fd 2009
- Brazil Inv Trust 2014
- Korea Fd 2007
- Indonesia Fd 2004
- Turkish Fd 2014
- Indonesia Fd 2014
- Korea Eq 2002
- Malaysia Fd 1995
- Brazil Eq 2002
- Argentina Fd 1999
- Brazil Fd 2002
- Mexico Fd 2012
- Malaysia Fd 2008
- Turkish Fd 2007
- Malaysia Fd 2004
- Turkish Fd 2011
- India Fd 2014
- Mexico Eq 2012
- Korea Eq 2007
- Korea Fd 2012
- Mexico Fd 2000
- Korea Eq 2012
- Taiwan Fd 2012
- Taiwan Fd 2008
- Indonesia Fd 2014
- Korea Fd 2002
- Turkish Fd 2014
- Indonesia Fd 2019
- Malaysia Fd 2004
- Turkey Fd 1997
- Indonesia Fd 2009
- Chile Fd 2009

Error correction parameter

- Domestic
- International

Domestic (NAV)
International (Fund Price)

$t$-statistic
Do domestic investors lead foreign investors?

Short-run contagion (daily data)
Domestic and international responses to elections

Event study design

Estimation window (2 years)

Election window (2 months)

$T_0 \quad T_1 \quad T_2$

Abnormal Return = Observed Return − Expected Return
**Impact of elections on foreign and domestic investors**

**Pre-Election Abnormal Returns**

<table>
<thead>
<tr>
<th></th>
<th>Fund Price</th>
<th>Net Asset Value</th>
<th>Fund Premium</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>-Foreign-</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pooled Sample</td>
<td>-0.13 (0.89)</td>
<td>-1.48 (0.14)</td>
<td>0.28 (0.78)</td>
<td>82</td>
</tr>
<tr>
<td>Majoritarian</td>
<td>-2.75 (0.01)</td>
<td>-6.94 (0.00)</td>
<td>-0.35 (0.73)</td>
<td>22</td>
</tr>
<tr>
<td>Proportional</td>
<td>1.15 (0.25)</td>
<td>0.94 (0.35)</td>
<td>0.35 (0.73)</td>
<td>48</td>
</tr>
<tr>
<td><strong>-Domestic-</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Presidential</td>
<td>-0.39 (0.69)</td>
<td>-1.72 (0.09)</td>
<td>-0.19 (0.85)</td>
<td>44</td>
</tr>
<tr>
<td>Parliamentary</td>
<td>0.20 (0.84)</td>
<td>-0.31 (0.75)</td>
<td>0.48 (0.63)</td>
<td>38</td>
</tr>
</tbody>
</table>

Entries are test statistics.

Bold entries significant at 5% level.

*p*-values in parentheses.
### Impact of elections on foreign and domestic investors

#### Pre-Election Abnormal Returns

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<tr>
<th></th>
<th>Fund Price -Foreign-</th>
<th>Net Asset Value -Domestic-</th>
<th>Fund Premium</th>
<th>N</th>
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</thead>
<tbody>
<tr>
<td>Pooled Sample</td>
<td>-1.13 (0.26)</td>
<td><strong>-2.05</strong> (0.04)</td>
<td>-0.07 (0.94)</td>
<td>82</td>
</tr>
<tr>
<td>Majoritarian</td>
<td><strong>-2.54</strong> (0.01)</td>
<td><strong>-7.09</strong> (0.00)</td>
<td>1.27 (0.21)</td>
<td>22</td>
</tr>
<tr>
<td>Proportional</td>
<td>-0.01 (0.99)</td>
<td>0.26 (0.79)</td>
<td>-0.73 (0.47)</td>
<td>48</td>
</tr>
<tr>
<td>Presidential</td>
<td>-1.32 (0.19)</td>
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<td>-0.11 (0.91)</td>
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## Impact of elections on foreign and domestic investors

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<td></td>
<td></td>
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<td>Pooled Sample</td>
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<td>-0.67 (0.50)</td>
<td>2.67 (0.01)</td>
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</tr>
<tr>
<td>Majoritarian</td>
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<td>-5.52 (0.00)</td>
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<td>22</td>
</tr>
<tr>
<td>Proportional</td>
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<td>1.12 (0.26)</td>
<td>2.52 (0.01)</td>
<td>48</td>
</tr>
<tr>
<td>Presidential</td>
<td>0.44 (0.66)</td>
<td>-1.56 (0.12)</td>
<td>4.97 (0.00)</td>
<td>44</td>
</tr>
<tr>
<td>Parliamentary</td>
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<td>0.72 (0.47)</td>
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Bold entries significant at 5% level.
$p$-values in parentheses.
Impact of elections on foreign and domestic investors
Proportional democracies

Event study results
Impact of elections on foreign and domestic investors
Parliamentary democracies
Impact of elections on foreign and domestic investors
Developed democracies