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The Limits of Financial Globalization

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The last 60 years have seen a dramatic change in world financial markets. At the end of World War II, the capital markets of most countries were separated from one another by barriers of various kinds. For instance, many countries prohibited their investors from owning foreign securities or obtaining the foreign currency to purchase them. But since 1945, many countries have sharply reduced such barriers to cross-border trade in financial assets, giving rise to a development that is often called "financial globalization."

According to most economists, the globalization of financial markets is expected to have major economic benefits. In theory, it should lead to better sharing of risks among investors worldwide, allow capital to flow where its productivity is highest, and provide individual countries with greater opportunity to reap the benefits of their respective comparative advantages.[1]

In the process, moreover, significant cross-country differences in asset prices, investment portfolios, and corporate financial policies are eventually expected to disappear, resulting in a condition that economists refer to as "country irrelevance." According to this theoretical proposition, investors in all countries will end up holding essentially the same "world market portfolio," one that contains representative proportions of all global economies. And as a consequence, comparably profitable companies operating in the same industry but domiciled in different countries ought to have similar capital structures and roughly the same cost of capital and market valuations.

But the evidence in support of these predictions is at best mixed. While some studies have reported a positive effect of financial globalization on growth,[2] most of the evidence to date suggests limited benefits. Consider, for example, the following conclusion of a 2003 study of developing countries by the International Monetary Fund: "[W]hile there is no proof in the data that financial globalization has increased growth, there is evidence that some countries may have experienced greater consumption volatility as a result."[3] And contrary to the "country irrelevance" proposition espoused by economists, the bulk of the evidence also suggests that asset prices, investor portfolios, and corporate financial policies all continue to have significant "country-specific" components.

In this article, I argue that despite a dramatic increase in cross-border trade in financial assets, the positive impact of financial globalization has been surprisingly limited. My explanation for this puzzle is that the expected effects of increasingly global capital markets have been limited by what I call "the twin agency problems." These problems stem from the reality that, in pursuing their own interests, both the rulers of sovereign states and corporate insiders often take actions that reduce the value of companies to outside investors.

Why "twin problems" rather than two distinct problems? Because the problems tend to occur together and to feed on one another. When one agency problem is well managed, the other tends to be as well.

The severity of these problems varies across countries, depending on the soundness of a country's institutions. At one extreme are countries such as the U.K., Canada, and the U.S., where the twin problems are limited by well-established legal, regulatory, and market institutions. At the other extreme, countries like Russia provide minority shareholders with little protection against expropriation by either controlling shareholders or the state. In such countries, I show why corporations have a tough time attracting investment capital unless corporate insiders "co-invest" heavily with outside suppliers of equity.

One result of such co-investment is a highly concentrated ownership structure. While such ownership can certainly have benefits—for example, it has clearly played a critical role in the successes of LBOs, venture capital, and other forms of private equity—it also has two negative effects that can limit economic growth and the development of financial

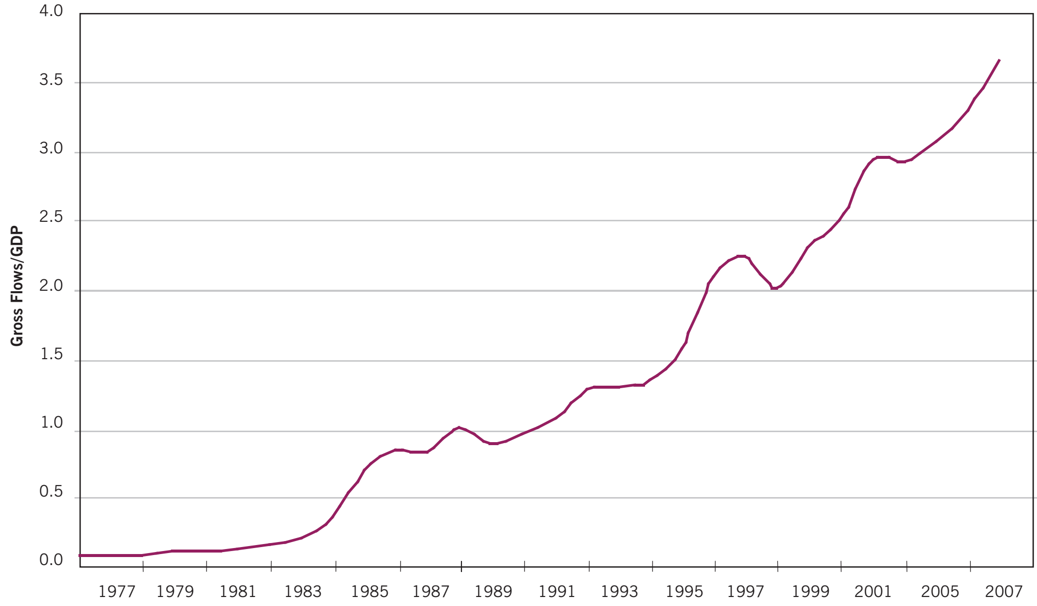
* This is an edited transcript of the author's presidential address to the American Finance Association in Philadelphia on January 6, 2005.

1. For a review of such advantages, see my article "Globalization, Corporate Finance, and the Cost of Capital," *Journal of Applied Corporate Finance*, Vol. 12 No. 3 (Fall 1999), 8-25.

2. For instance, Geert Bekaert, Campbell R. Harvey and Christian Lundblad, "Does Financial Liberalization Spur Growth?," *Journal of Financial Economics*, Vol. 77 No. 1 (2005), conclude that a country's equity market liberalization leads to an increase in economic growth of 1%.

3. See Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," International Monetary Fund, (2003).

Figure 1 **Gross Cross-Border Securities Transactions for the U.S. (Sum of Purchases and Sales) to U.S. GDP (2006 Number Estimated from January-October Data)**



markets. First, it limits risk-sharing by forcing insiders to bear far more firm-specific risk than if they held diversified portfolios. Second, it means that a company's investment is limited by the wealth of its insiders, who can co-invest only to the extent they have the resources to do so.

As mentioned earlier, much of the expected benefit of financial globalization is assumed to come from the expanded risk-sharing that results from attracting investors from different countries with different risk exposures. The willingness of such investors to pay a "diversification premium" for a foreign company's shares is expected, all other things equal, to reduce the firm's cost of capital and thus stimulate investment. Unfortunately, however, in most international settings all other things are not equal. In countries that pose considerable risks for investors of expropriation by controlling investors and the state, the demand for co-investment effectively means that most of the risk of the firm must be borne by corporate insiders, not by well-diversified international investors. And this not only limits the gains from financial globalization for many nations, but creates the possibility that, in countries where such problems are particularly acute, the globalization of financial markets can at times end up *reducing* growth. The massive capital outflows experienced by a number of such countries during periods of crisis could not have happened had they not opened up their markets.

Some Evidence on Financial Globalization and Country Relevance

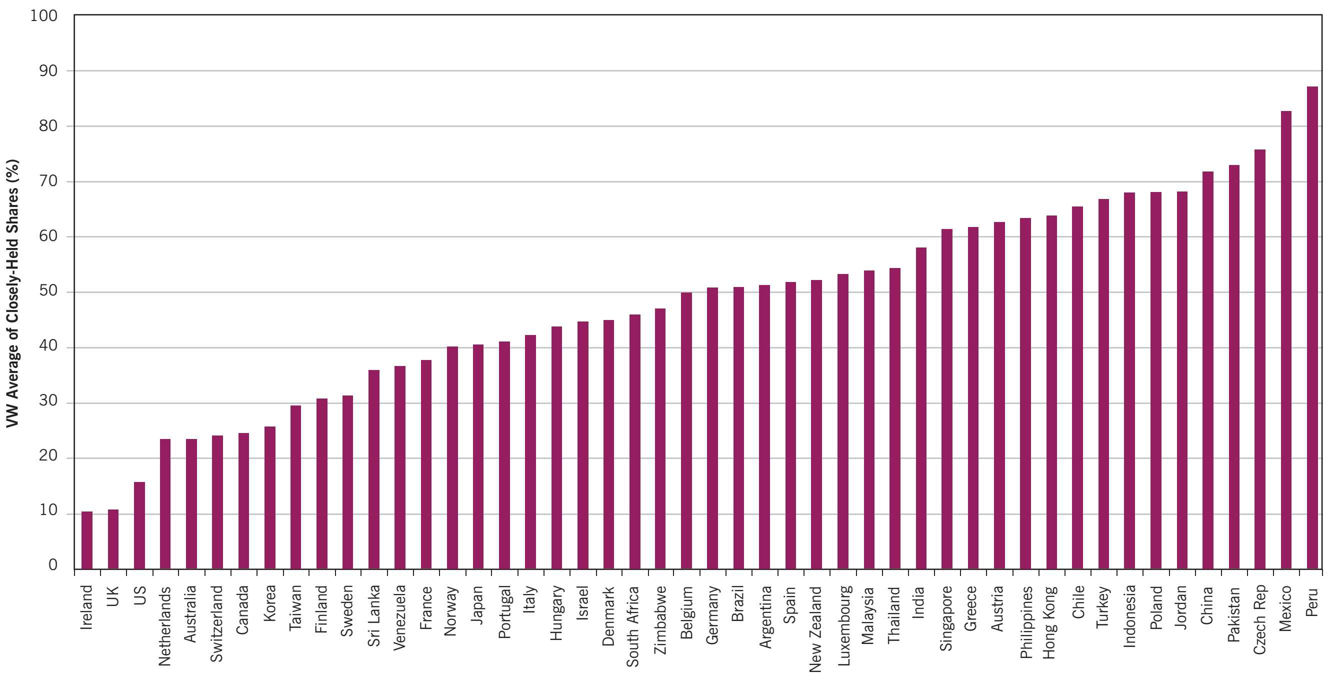
Since the end of World War II, there has been dramatic progress in reducing formal barriers to trading financial assets. In every year since 1950, the International Monetary Fund has published information on restrictions on international financial transactions. An index of "openness" compiled and updated by Dennis Quinn shows that such restrictions have almost completely disappeared in industrialized countries and have decreased considerably in developing countries.[4]

As can be seen in Figure 1, the volume of transactions in stocks and bonds between U.S. and foreign investors increased dramatically from 1977 through 2006. During that period, the volume of such transactions as a percentage of GDP increased by a factor larger than 60, from just under 6% to over 365%. By comparison, the dollar volume of transactions on the NYSE grew from just over 7% of GDP to about 130% of GDP, or by a factor of 19.

With such a dramatic increase in cross-border trade in securities and the disappearance of many formal barriers to international investment, we would have expected institutional and other differences among countries to have steadily diminishing effects on both investors' and companies' investment and financing decisions. But it has not happened. According to a number of recent studies,

4. Dennis Quinn, "The Correlates of Change in International Financial Regulation," *American Political Science Review* 91 (1997), 531-551.

Figure 2 **Value-Weighted Average of the Percentage of Shares Held by Corporate Insiders for 48 Countries in 2002**



"countries" continue to have a major influence on asset returns, investment portfolios, and corporate financial policies.

The evidence shows that countries continue to be important for portfolio choice. Investors continue to overweight domestic securities in their portfolios. Although such "home bias" has decreased over time, a study of global investor portfolios showed that, as of the end of 2004, the share of foreign equities in U.S. portfolios was roughly one-fourth of what it would have been had investors chosen to hold the "global market portfolio," with holdings in all the world's national economies in proportion to the size of their equity markets.[5]

Countries continue to be important for saving and investment. In a study produced more than 20 years ago, Martin Feldstein and Charles Horioka showed an extremely high correlation between domestic saving and investment.[6] This gave rise to what became known among economists as "the Feldstein-Horioka puzzle." The puzzle is this: As investors diversify internationally, saving (which depends on domestic income and wealth) and investment (which depends on local growth opportunities) should become less closely related to each other. Investment should be determined by the amount of promising growth opportunities within a country rather than the availability of funds. While there are signs of a decoupling of investment from saving in some countries, recent studies still find a surprisingly strong correlation. For instance, one study of emerging markets during the 1990s—the period when such markets began to take off—showed that the fraction of investment financed by foreign investors did not increase at all during that decade.[7]

Countries continue to be important for consumption. In a fully integrated world, consumption within a given country would not be tightly linked to, and would be more stable than, the country's income. To the extent they could, investors would effectively buy "insurance" against country-specific risks by holding internationally diversified portfolios and using hedging and risk-transfer mechanisms. Economists describe this phenomenon as "consumption risk-sharing." Recent studies, however, find at most a limited increase in consumption risk-sharing over time.

Countries continue to be important for corporate ownership. The composition of corporate ownership varies systematically across countries. In a widely cited 1999 study, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei

5. Bong-Chan Kho, René M. Stulz, and Frank Warnock, "Financial Globalization, Governance, and the Home Bias," Unpublished working paper, The Ohio State University.
6. Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, Vol. 90 (1980), p. 314-329.
7. See Joshua Aizenman, Brian Pinto, and Artur Radziwill, (2004), "Sources for Financing Domestic Capital–Is Foreign Saving a Viable Option for Developing Countries?," National Bureau of Economic Research, Working Paper 10624.

Shleifer showed that, in most countries other than the U.S. and U.K., the representative company has a concentrated ownership structure.[8]

Figure 2 reports the median fraction of market capitalization held by blockholders in large companies representing 48 countries at the end of 2002.[9] The median ownership fraction for the 48 countries was just over 50%. The U.S. was at the "left tail" of the figure, with a median percentage of market capitalization held by blockholders of just over 15.5%. And the median percentage of blockholdings in U.K. companies, at 10.31%, shows a similarly dispersed ownership structure. By contrast, in a country like Italy, that fraction was over 40%.

Countries continue to be important for capital structure. Studies have found that corporate capital structures vary widely among countries. For instance, after studying the capital structures of public companies in 39 developed and developing countries, Joseph Fan, Sheridan Titman, and Gary Twite concluded that "a corporation's capital structure is determined more by the country in which it is located than by its industry affiliation."[10] More specifically, they found that companies in countries with weak governance institutions have significantly higher leverage than comparable firms in countries that provide greater protection for investors—a finding I will discuss later.

Countries continue to be important for governance. Countries explain a very large part of the variation in the quality of governance across companies. In a recent study, Craig Doidge, Andrew Karolyi, and I found that country characteristics explained more than 70% of the variation in companies' S&P corporate governance scores.[11] Thus, in countries with significant agency problems, even companies with highly effective governance systems are likely to find their capital choices limited by where they are domiciled (although, as I will argue later, volunteering to list on an overseas exchange can help address this problem).

Economists have worked hard to explain why countries matter as much as they do. There are more than 100 studies that attempt to explain the home bias of portfolios, with explanations centering on variables such as transportation costs, transaction costs, consumption preferences, and differences in information among investors. But this literature fails to be convincing. Much of it focuses, for example, on differences that are attributable to *distance.* As such reasoning goes, investors who are far away may be less well informed about securities than investors who are on the spot. But there is an obvious problem with this type of argument: According to the "distance" school of thought, portfolios of investors in San Diego should be more like the portfolios of investors in Tijuana than those held by investors in Philadelphia almost 3,000 miles away. But "distance" in this case is clearly at most a second-order effect. That San Diego and Tijuana are separated by a border is *much* more important than their proximity to one another. And if distance has limited explanatory power in accounting for differences in investor portfolios, it has even less to say about cross-country differences in, say, corporate capital structures. In this case, the differences have nothing to do with distance and everything to do with borders.

Why Countries Might Matter: The Twin Agency Problems

The key difference between explanations that rely on distance and those that rely on borders is the role of the sovereign state. There are two main reasons why the twin agency problems depend critically on the state: First, the sovereign state affects the extent of the agency problem between corporate insiders and other investors because it is a critical determinant of the extent of investor protection. Second, although the rulers of the sovereign state can expropriate investors, their powers to do so stop at the border.

To illustrate the implications of the twin agency problems for corporate ownership and risk-bearing, let's examine a simple example in which there are assumed to be two kinds of investors: entrepreneurs and portfolio investors. An entrepreneur has a unique investment opportunity. If she takes advantage of that opportunity, she starts a firm, sells equity to outside investors, and becomes a corporate insider. But if she decides to pass on the investment opportunity, she becomes a portfolio investor.

Let's consider now how the twin agency problems affect the entrepreneur and investors. Since the corporate insiders observe the cash flow produced by the company before anybody else, they have the ability to expropriate some of it before it comes to the attention of outsiders or representatives of the state. The rulers of the sovereign state are next in line; they can confiscate cash flows outright, tax them, redirect them to their favorite causes or allies, and so on. The cash flow left after expropriation by corporate insiders and the rulers of the sovereign state can then be (and let's assume for our example that it is) distributed to shareholders as a liquidating dividend.

Corporate insiders can transfer value from outside investors to themselves by consuming private benefits in relatively benign ways, such as buying fancy airplanes, or through more extreme ways, including outright theft. But it's important to keep in mind here that the corporate insiders, precisely *because of their ability to expropriate wealth from minority holders*, are limited in the amount of equity they can raise from outside investors. When pricing the equity

8. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Corporate Ownership Around the World," *Journal of Finance*, Vol. 54 (1999).

9. Using data reported in Worldscope.

10. Joseph P.H. Fan, Sheridan Titman, and Garry Twite, "An International Comparison of Capital Structure and Debt Maturity Choices," Unpublished working paper, University of Texas, (2006).

offering, such investors assume that expropriation will take place. And given that the shares are priced to reflect such expected expropriation, insiders may have little choice but to expropriate; indeed, they can be viewed as having *already paid* for the "right" to expropriate in the discount at which the shares are sold.

The problem with such an "equilibrium," however, is that when they routinely expropriate minority shareholders, insiders also incur "deadweight costs" in the form of risk of embarrassment and possible exposure to legal sanctions. The size of such deadweight costs varies widely among countries. In countries such as the U.S. and U.K., expropriation is costly for insiders and so outside investors expect little of it to take place. But in countries where expropriation is expected, insiders can sell shares at a higher price (or, alternatively, reduce the deadweight costs associated with the possibility of expropriation) only by co-investing more with outside investors. As insiders increase their investment in a company, they have less to gain from expropriating minority shareholders.

To understand why, consider a simple example. Assume that the state expropriates 10% of a firm's cash flows after the controlling shareholders have already taken their cut in the form of private benefits. In that case, the outside shareholders receive dividends of 90 cents from each dollar of cash flow net of private benefits. And let's start by supposing that insiders own just 10% of the firm. In this case, by taking one dollar of private benefits, insiders would reduce the liquidating dividend by 90 cents, of which their share would be just 9 cents. As a consequence, the net gain to insiders of one dollar of private benefits before deadweight costs would be 91 cents in this case—and insiders would be expected to refrain from consuming this dollar of private benefits only if the associated deadweight costs exceeded 91 cents.

But now consider what happens when insiders own 50% of the company. In this case, each dollar of private benefits causes insiders to forgo 45 cents of dividends—and they accordingly stop consuming private benefits when the marginal deadweight cost reaches 55 cents. Thus, the net gain to insiders of a dollar of private benefits is reduced by increases in their ownership share. By co-investing more, insiders reduce their own incentives to extract private benefits. And the result of higher co-ownership is less expropriation of value by insiders, and thus higher values for all shareholders.

But, as already mentioned, there are two major costs associated with additional co-investment by insiders: the higher cost of capital that results from corporate insiders bearing risks they cannot diversify, and the constraint on the firm's investment and growth stemming from the limits of insiders' wealth and ability to co-invest.

What role does the state play in this corporate governance problem? A significant threat of expropriation by state rulers also encourages co-investment by corporate insiders. By "expropriation" I mean the (presumably self-interested) actions by state rulers that have the effect of reducing the returns of corporate investors. Although the case of Yukos comes to mind, the term "expropriation" covers a wide range of activities. Besides confiscating assets, state rulers can impose redistributive taxes, prohibit or limit value-adding activities (such as laying off redundant workers), favor friends and allies through permits and regulation, or demand bribes.

Such activities are, of course, by no means unknown in developed countries. In the U.S., we have evidence that the stock prices of S&P 500 companies with "Republican-connected" board members reacted positively to the Republican win in the election of 2000 and S&P 500 firms with Democratic board connections responded negatively.[12] And the widespread interference by the state and labor unions in most European countries has clear effects on how corporations are owned and organized.[13] But however common in developed nations, state intervention in business enterprise is likely to be even more pronounced, and destructive, in developing countries.

And such intervention has indirect as well as direct effects on corporate governance and behavior. One fairly direct effect is the heightened incentives of corporate insiders to reduce the state's proceeds from expropriation by increasing their own bargaining power with the state. The corporate insiders can accomplish this by building connections with the rulers and by making themselves more critical to the success of their companies through their choice of investment, contracting, and financing policies. But by making themselves more indispensable to a firm, insiders also become less subject to discipline by the market for corporate control and their outside shareholders—and so their incentive and ability to expropriate value increases, along with the associated deadweight costs. Thus the net result of such managerial entrenchment may be that the gains to minority shareholders from the reduced likelihood of expropriation by the state are completely offset by the losses from expropriation by insiders.

Furthermore, when management has a small ownership stake, it is more likely to use its entrenched position to extract the best deal from the state for itself instead of using its power to protect shareholders. This in turn means that when the expected costs of state expropriation are significant, the governance problems inherent in the separation of

11. Craig Doidge, G. Andrew Karolyi, and René M. Stulz, "Why do Countries Matter so Much for Corporate Governance?", *Journal of Financial Economics*, forthcoming.

12. Eitan Goldman, Jörg Rocholl, and Jongil So, "Does Political Connectedness Affect Firm Value?," Unpublished Working Paper, University of North Carolina, (2006).

13. See Mark Roe, "Political Determinants of Corporate Governance," Oxford University Press, (2003).

ownership and control are likely to become less manageable than when governments do not expropriate.

In sum, corporate insiders with large ownership stakes are more likely to make decisions that limit the potential for state expropriation. And their large ownership stakes can also work to assure outside investors that the insiders will make decisions that benefit *all* investors. Absent such a stake, they might be tempted to let the state expropriate minority shareholders at will in exchange for the right granted by the state to appropriate more private benefits.

How the Twin Agency Problems Blunt the Effect of Financial Globalization

I've discussed each of the two agency problems separately, but now let's consider briefly how they feed on each other.

First, to the extent corporate insiders are connected with state rulers, they can use the state to transfer value from other investors. As Raghu Rajan and Luigi Zingales show in their recent book *Saving Capitalism from the Capitalists*,[14] business incumbents routinely use laws and regulations to tilt the playing field in their favor, thus hindering the development of new competitors. Second, in countries with a significant threat of expropriation by the state, the consumption of private control benefits by insiders is actually encouraged by the fact that such consumption is easier to hide from the state than the corporate cash flows that remain after insiders have extracted their private benefits.

In a recent study investigating the relation between ownership concentration and the risk of state expropriation, I found that the fraction of companies that are widely held—defined as having no blockholder with a stake larger than 20%—was significantly higher in countries with less (below-median) state expropriation risk.[15] Furthermore, both the percentage of companies with family control and the percentage of insider owners (both in terms of numbers and value) were both significantly higher in countries deemed to have greater (above-median) risk of expropriation by the state.

Now, let's look more closely at how the twin agency problems work to limit the impact of financial globalization. As I mentioned at the beginning, theoretical models of financial globalization predict that lowering barriers to international investment will reduce the corporate cost of capital, thereby increasing both the present value of existing profit streams and the number of profitable investment opportunities. But although empirical studies provide some support for these predictions,[16] the changes in firm value detected by these studies seem disappointing.[17] The twin agency problems can help us understand why the impact of financial liberalization might fall short of expectations.

When cross-country barriers to financial trading are lowered, part of the anticipated increase in shareholder wealth is attributable to the expected profits from new investments that can be undertaken only if *more* capital is invested. But because of the twin agency problems, much of the increase in capital investment would have to come from insiders who may already be constrained by limits on their wealth and by their inability to diversify their holdings. In this fashion, the requirement for concentrated ownership could lead to far lower corporate investment than might be expected under a governance system that encouraged more dispersed ownership.

Even if foreign investors could be persuaded to take larger ownership stakes in overseas companies, the resulting decrease in ownership by corporate insiders could well lead, at least in the near term (and for reasons already discussed), to greater expropriation of outsiders by both state rulers and insiders. What's more, in countries where the risk of expropriation by the state is significant, there is also the real possibility that barriers to international investment could be reinstated. Witness the cases of Malaysia and Argentina.

Effect on New Business Formation. But all these considerations concern the effect of financial globalization on existing companies. Now let's look at this issue from the perspective of individual entrepreneurs contemplating the launch of new businesses. On the one hand, globalization reduces the cost of capital for the potential entrepreneur, making the expected earnings stream from the new business more valuable. At the same time, however, globalization could also provide alternative uses for the potential entrepreneur's capital that are more attractive than starting a company. Consider what might happen in a country where the state discourages entrepreneurs and offers few attractive investment choices, and then globalization suddenly provides more attractive investment opportunities outside the country. If the returns to being an entrepreneur were attractive before globalization, they may not be afterwards.

In sum, financial globalization can lead to fewer entrepreneurs and new companies when the twin agency problems are serious. Moreover, as portfolio investment becomes more attractive, insiders may also choose to reinvest less in their

14. Raghuram G. Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists* (New York: Random House, 2003).

15. These empirical results are contained in a more technical article which addresses the issues raised in my presidential address. See René M. Stulz, "The Limits of Financial Globalization," *Journal of Finance* 60, 2005, 1595-1638.

16. See Geert Bekaert and Campbell R. Harvey, "Foreign Speculators and Emerging Equity Markets," *Journal of Finance* 55, (2000), 565-613; Peter Blair Henry, "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices," *Journal of Finance* 55, (2000), 529-564.

17. See my article "Globalization, Corporate Finance, and the Cost of Capital," *Journal of Applied Corporate Finance*, Vol. 12 No. 3 (Fall 1999).

own firms, thereby reducing the amount of investment in existing companies as well.

Effect on Home Bias. When concentrated ownership is optimal because of limited investor protection, insiders cannot hold well-diversified portfolios. As a result, in countries with major twin agency problems, equity investment will continue to display a pronounced home bias—provided corporate insiders are local residents (which is almost invariably the case).

Saving and Investment Correlation. In countries where it is efficient for corporate insiders to have significant stakes in their companies, we would also expect saving and investment to be highly correlated. In such a country, if investment opportunities increase but income and wealth do not, companies will not be able to take advantage of the opportunities because insiders will not have enough wealth to co-invest with outsiders.

Effect on Consumption. Ownership concentration implies that a substantial fraction of equity is in the hands of investors whose wealth is not well diversified. This concentration of holdings resulting from the co-investment of insiders reduces the correlation of consumption across countries. So, for example, when a country with concentrated ownership experiences a disproportionately large drop in income and wealth, it is also likely to suffer a disproportionate (relative to other countries') drop in consumption.

Effect on Capital Structure. The twin agency problems also lead to higher leverage. Start by making the assumption that debt has to be repaid before consumption of private benefits by corporate insiders. In this case, financing with debt limits the amount that corporate insiders can use to consume private benefits. Because of this advantage of debt, we can expect that, all else equal, companies domiciled in countries where the agency problem of corporate insiders is important will have higher leverage. Higher leverage can also reduce the gains from expropriation by state rulers to the extent that equity claims are more easily expropriated than debt.

There is also one other "surprise" that can be explained by the twin agency explanation—namely, the possibility that what we can think of as effective corporate governance can actually prove counterproductive under states that expropriate. By investing in good governance, companies can commit to providing better protection for minority investors. However, the benefit from investments in good governance may turn out to be a cost because of the states' ability to expropriate such gains in efficiency and profits. As already mentioned, the possibility of managerial entrenchment, which worsens the agency problem associated with corporate insiders, can actually help preserve overall value by reducing the threat of state expropriation. Further, the threat of state expropriation limits the benefits from corporate transparency since it is harder for the state to expropriate a firm whose true situation is hard to evaluate. Finally, state intervention that prevents the enforcement of contracts or changes the interpretation of contracts reduces the ability of companies to use private contracting solutions to reduce the problem of expropriation by insiders.

The (Longer-Term) Promise of Financial Globalization

Up to this point, I have taken the twin agency problems as given. In so doing, I have ignored an important benefit of financial globalization: its potential to reduce the importance of these problems over time.

To begin with, financial globalization reduces the cost of external finance. As external finance becomes cheaper, companies have stronger incentives to be well governed, at least to the extent they have opportunities to make greater use of such capital.[18]

Financial globalization also provides tools for companies to reduce the agency problem associated with corporate insiders. In a world of segmented markets, companies are stuck with their country's institutions. If their country has weak financial markets or poor securities laws, firms have to live with them. But, as barriers to trade in financial assets fall, companies can "rent" the institutions of foreign countries. ADR programs, as I argued in a paper several years ago, effectively enable foreign companies to offer their investors some of the protection afforded by U.S. institutions.[19]

By giving resident investors what amounts to an exit option, financial globalization also reduces the state's ability to expropriate. Having reduced barriers to international investment, states are limited in their ability to expropriate unless they first restore barriers to international investment. If they attempt to do so, resident investors are likely to put their money elsewhere, foreign investors will go home, and local companies will become less competitive.

Since financial globalization gives investors an exit, it is not surprising that they use it when they feel threatened. This is what happens during times of financial crisis. But rather than viewing globalization and capital outflows as the fundamental *cause* of such instability, this view suggests that such capital flows and crises can be traced to governance. The real culprit in such cases is not the mobility of capital flows, but the source of the threat to investors: the twin agency problems.

18. See in this issue Art Durnev and E. Han Kim, "Explaining Differences in the Quality of Governance Among Companies: Evidence from Emerging Markets."

19. See footnote 1.

Conclusion

Although barriers to international investment have fallen sharply over the last 60 years, the positive impact of financial globalization has been limited. Predictions by economists that cross-country differences in investment and financing would narrow or even disappear have largely failed to materialize, and thus countries still "matter" a great deal.

The main explanation for the surprising persistence of cross-country differences in investment, financing, and corporate governance centers on the importance of two agency problems: First, those who control a company can use their power to transfer value from minority shareholders to themselves. Second, those who control the state can use their powers to expropriate wealth from both controlling and minority shareholders.

In countries where these twin agency problems are significant, corporate insiders tend to co-invest more with outside investors, and ownership is thus more concentrated. Co-investment in turn limits the benefit of financial globalization, making it less likely that risks will be shared internationally and capital invested where it is most productive.

The twin agency problems also help explain a number of apparent paradoxes in international finance. Until such problems are addressed, they will limit the impact of financial globalization. But, as countries and companies continue to find ways to control these problems, the citizens of developed and developing countries alike will benefit from the progressive globalization of financial markets.

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