Financial Market Development and Institutional Investors

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Scope

Financial market liberalization leads to a more international investment strategy of institutional investors. To illustrate, financial market integration enables pension funds and insurers to allocate a larger share of their overall portfolios to foreign assets, inside as well as outside the euro area. Larger foreign shares in investment portfolios logically lead to larger shares of national assets that are owned by foreigners. Hence, foreign ownership of all kinds of assets - including government bonds and equities – are expected to increase with growing financial market integration. The logic of international portfolio diversification would imply that the foreign ownership of some assets – in particular exchange-traded securities – could approach 100 percent, at least for some of the smaller EU member states. Policy-makers face the challenge to establish a tax and legal regime facing asset holdings so that the EU can reap the potential benefits of foreign ownership in terms of increased productivity and better portfolio diversification. In this context, two main issues will be explored.

Research Goals

Issue 1: Foreign ownership and local institutions

The first issue concerns the international equity investment options of institutional investors such as pension funds and insurers. Should investors invest primarily through portfolio investments or through equity participation in multinational firms? Among the determinants of this choice are the quality of a country's corporate governance, its rule of law and the quality of enforcement. Indeed, multinational firms, which are subject to relatively high-quality home-country investor protection standards, seem to have a comparative advantage to operate in countries with lower standards. The tendency for countries with weak shareholder protection to attract high rates of foreign ownership may provide these countries with an incentive to improve investor protection to ward off losing control completely over their private sectors; for countries with good institutions, inward capital flows can take the form of portfolio investments. Pension funds can thus easily take direct portfolio equity shares in these countries.

Issue 2: Foreign ownership and macroeconomics

The second issue concerns the role of pension funds and insurers in facilitating intertemporal consumption smoothing.

Pension institutions, providing more people with retirement savings options, can be an effective way to improve consumption smoothing through national and international financial markets. It will be explored in which way, and to what degree, institutional investors can contribute to consumption smoothing in various countries, including developing countries.

This project identifies the relative importance of domestic and international financial markets in various countries, including the separate contributions of debt and equity markets.