

# **FREEDOM AND FINANCE**

**Democratization and  
Institutional Investors in  
Developing Countries**

**MARY ANN HALEY**

**INTERNATIONAL POLITICAL ECONOMY SERIES**  
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# Freedom and Finance

## Democratization and Institutional Investors in Developing Countries

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palgrave



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*For Zoë*

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# List of Abbreviations

ADR	American Depositary Receipts
BEMI	Barings Emerging Markets Index
CMO	Collateralized Mortgage Obligations
CPC	Communist Party of Vietnam
EAFE	Europe, Australia, and the Far East
EMC	Emerging Market Country
EMFI	Emerging Markets Free Index
EMH	Efficient Market Hypothesis
EMT	Efficient Market Theory
EOI	Export-Oriented Industrialization
ESAF	Enhanced Structural Adjustment Facility
FAT	Authentic Labor Front
FID	Foreign Investment Directorate
FDI	Foreign Direct Investment
G-7	Group of Seven
GAB	General Arrangements to Borrow
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GDR	Global Depositary Receipt
GDS	Gross Domestic Savings
HIID	Harvard Institute of International Development
ICM	International Capital Markets
IFC	International Finance Corporation
IFCG	International Finance Corporation Global (Index)
IFCI	International Finance Corporation Investable (Index)
IIF	Institute of International Finance
ILBE	Institute for Law-Based Economy
IMF	International Monetary Fund
IPO	International Public Offering
ISG	International Securities Group
LDC	Less Developed Country
MAI	Multilateral Agreement on Investment
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency

MNC	Multinational Corporation
MSCI	Morgan Stanley Capital International (Index)
NAB	New Arrangements to Borrow
NGO	Non-Governmental Organization
NIC	Newly Industrializing Country
NRF	Net Resource Flow
ODA	Official Development Assistance
ODF	Official Development Finance
OECD	Organization of Economic Cooperation and Development
PRD	Partido Revolucionario Democrático
RPC	Russian Privatization Center
SAP	Structural Adjustment Program
SEC	Securities and Exchange Commission
S&P	Standard and Poor's
SOE	State-Owned Enterprise
TNC	Transnational Corporation
USAID	United States Agency for International Development

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# 1

## Introduction: Private Investment Flows and Institutional Investors

The nineteenth-century ideal of erecting a world based on the unencumbered operation of a free market has reemerged and has permeated the public policies and politics at the turn of the millennium. Akin to its role in the nineteenth century, international finance is playing a central role in the promulgation of the free market norm. The developing countries in Asia, Latin America and Africa are perhaps the most affected by this resurgence of liberalism and the demands of international finance. The conventional means of attracting capital into developing countries shifted rapidly from pledging allegiances to one of the cold war rivals to marketing the nation-state to the world's financiers. Once a strategic geopolitical position could have ensured a consistent flow of assistance; now an economic policy, based on deregulation, privatization, and stabilization, is the path to equity. Instead of catering to the governments and international institutions of industrialized countries, leaders in developing countries realize that the power of the purse lies with private institutional investors. The political and social ramifications of this change in finance sourcing for developing countries has yet to be explored fully. The goal of this book is to further the on-going debate about the relationship between liberalization and democratization, and to challenge some convenient assumptions about markets that do not hold in the current emerging financial markets. Close observation of institutional investors – those controlling the majority of capital flowing into developing countries today – draws into question the relative freedom and fairness of these markets.

The new emerging financial markets, occurring simultaneously within the global wave of neoliberal reform, may also have an impact on democratic transitions and consolidations. The neoliberal reform wave, the mix of market-oriented economic reforms coined by John Williamson as the 'Washington consensus,' consists of trade liberalization, exchange rate stabilization, state-owned enterprise privatization, and the reduction of government expenditures. As Paul Krugman puts it 'Governments that had spent half a century pursuing statist, protectionist policies suddenly got free market religion' (Krugman, 1995). The impetus for these reforms was the prospect of reeling in investments. Again, Krugman suggests that if one could 'find a country that has done these things, ... there one may confidently expect to realize high returns on investment' (Krugman, 1995). Demonstrating the non-competitive and inefficient elements within the emerging financial markets challenges the neo-liberal tenet that the market is an abstract entity that serves as simply an apolitical mechanism for distributing goods within society. Instead, these markets do not function by an invisible hand, I argue, but are controlled by the visible hands of institutional investors. The concentration of assets and coordination among these investors indicates that this portion of the expansion of neoliberalism does not necessarily engender the market of 'faceless stock, bond and currency traders sitting behind computer screens all over the globe' popularly portrayed by Friedman (1999). Furthermore, in light of the amount of control these institutional investors have over the resources flowing to developing countries, their preferences now serve as guideposts for those countries wanting to attract private capital. This book explores whether the frequently expressed criteria, that is stability and growth, for selecting a country in which to invest, adversely affects political democracy. This combination, the distortion of fair market principles allowing institutional investors to accrue considerable power, plus the subsequent potency of their preferences due to this power, suggests that within this most recent wave of democratization lies a countervailing force. This force is a financial market that empowers money managers who value stability and growth over political democracy.

By examining the new regime in which private investors increasingly exercise the power attached to the control of capital, we arrive at an analysis that probes the relationship between capital sourcing,

and political and economic transformations. The scope of this book is not to explore all the political and economic phenomena resulting from financial globalization, but rather to focus on institutional investors' norms and practices, and how these can influence developing countries. The central question is how institutional investors impact democratization in developing countries. Through testing for coordination and other violations of fair market principles, the analysis first establishes the viability of institutional investors as political actors. If institutional investor action is coordinated, then they are an organized unit within the international system, and their objectives and practices should perhaps be held to a scrutiny similar to the International Monetary Fund (IMF), World Bank, or other financial development institutions. Therefore, a first step in showing linkage between private investment and domestic political and economic changes in developing countries is to demonstrate investor coordination – their capacity to function as a system within the international system. Once coordination has been established, the next task is to investigate their preferences and to explore how these are expressed in the system of international finance. If institutional investors are influencing the politics in developing countries, as foreign aid donors and other international entities have done in the past, what type of organization, norms, and methods of communication do they utilize to achieve this? Are there signaling devices and/or codes of ethics which structure and reproduce the systems in which they operate? If there is imperfect competition in the international markets for developing country equities, what are the potential effects on democracy? What are the channels in which investors communicate and what are the norms, categories, and results produced by this organizational system? In addition, in what ways can individual investors influence policies in emerging market countries? These questions will be addressed in the following format.

The book is divided into six chapters. Chapter 1 begins by reviewing some of the literature, which helps inform the question of a connection between institutional investor capital and politics in developing countries. The second half of Chapter 1 describes the shift from official development assistance to private finance; it differentiates forms of investment and discusses the growing importance of finance capital and the role of institutional investors in the emerging markets. Chapter 2 establishes institutional investors as

political actors in the international system by answering two questions. First, do large investors possess undue influence over other investors and the market? Secondly, do emerging market investors act independently of one another in response to certain political and economic phenomena in developing countries, or; is there a departure from efficient and fair market distribution? Here, the international market for developing country equities is investigated for violations of fair market practices. If institutional investors are to be considered political actors in the international system, it is first necessary to determine if their actions are coordinated, or if they are responding independently to macroeconomic and risk data. This section does not differentiate between intentional or unintentional coordination nor does it explore the signals around which investors may coordinate. Rather, it seeks only to uncover the existence of a violation of the widespread neo-liberal premise that financial markets will allocate capital fairly. Once it is shown that institutional investors do coordinate and have influence over pricing, then the focus turns towards shared investor preferences for emerging market countries and the types of coordination that take place.

Chapter 3 explores the criteria used by investors to choose a country for their portfolios. In this chapter, the preferences of institutional investors are uncovered through a survey of various mediums in which investors have made known what they think to be the most important determinants of a worthy emerging market investment. Chapter 4 shows how institutional investors help produce the norms of the global financial system that ultimately benefits them. This chapter focuses exclusively on structural factors that are external to developing countries. The chapter is organized into levels of coordination that take place among investors when common goals and outcomes result from varying degrees of cohesion over policy direction in developing countries. Chapter 5 outlines how institutional investors attempt to exercise their power as political actors in developing countries. By drawing parallels between domestic and international investor activism, this chapter illustrates the growing trend of institutional investors' governance in emerging markets. Chapter 6 focuses on the political impact that occurs as a result of coordination and activism on the part of institutional investors. It questions whether the emergence of financial markets, a staple of late twentieth century economic reform, has a positive effect on



civil liberties and/or political rights in developing countries. It examines the impact institutional investors may have on democracy, either as a group or as individual investors working according to the rules of thumb which guide international finance.

## **Theoretical perspectives on development and global finance**

Key to economic development in developing countries has been the ability to maintain a flow of capital into the infrastructures and industries targeted for expansion. However, the sources and method by which capital flows into developing countries is not often found in political science inquiries. More specifically, few theories about political and economic development have included international finance in their equations of freedom and growth. Theories about advanced capitalism most often conceive the international flow of capital as an abstract process in which rational actors seek to maximize returns for investments within a global marketplace. The abstract market and the reduction of investors to rational actors with homogenized preferences obfuscate the power and specific preferences of the individuals at the source of international financial flows. However, a few scholars of capitalism have contributed to the understanding of these *large money managers'* potential impact on developing countries' politics. For instance, the spread of liberalism today is often compared with the economic system that preceded the two world wars (Arrighi, 1994: 71; Lash and Urry, 1994; Wachtel, 1988). At the end of World War II many scholars sought to uncover the systemic causes of World Wars I and II. Two schools of thought emerged representing the liberal and socialist politics of the time. Scholars such as F.A. Hayek defended free market liberalism and blamed the demise of nineteenth century peace on the anti-democratic strains he perceived embedded in socialism. Critics of the free market system, such as Karl Polyani, blamed *laissez-faire* ideology as the underlying cause of war. Polyani, in particular, provides reference points about past practices of international financiers in developing countries, particularly during the century before World War I.

Giovanni Arrighi presents another image of advanced capitalism by extending the historical insights of Ferdinand Braudel's observations on the mechanisms of capitalism and market economies.