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# Non-financial corporations and maximizing shareholder value: an approach on macroeconomic instability in emerging economies

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# Presentation structure

- Objective;
- Introduction;
- Maximizing shareholder value and the corporate dynamics;
- Macroeconomic instability in emerging economies;
- Concluding remarks.

# Objective

- The aim of this paper is to address the behavior of non-financial corporations under the intensification of the regime of maximizing shareholder value, highlighting aspects of macroeconomic instability arising from this process in emerging economies.

# Introduction

- End of the Bretton Woods system;

- Especially since the 1970s: trend towards the expansion of financial flows and stocks;

- Maximizing shareholder value;

- Growing dominance of the financial sphere over the productive one;

- Instabilities in emerging economies / contagion effect.

# Maximizing shareholder value and the corporate dynamics

- Seeking a growing shareholder value through higher asset prices on the Stock Exchange;
- Focus on core business investments;
- Financial dimension in corporations' decisions;

$$\Downarrow$$

- Objective function for a large capitalist enterprise:

$$F = f\,(Fi, Ipt, X)$$

# Maximizing shareholder value and the corporate dynamics

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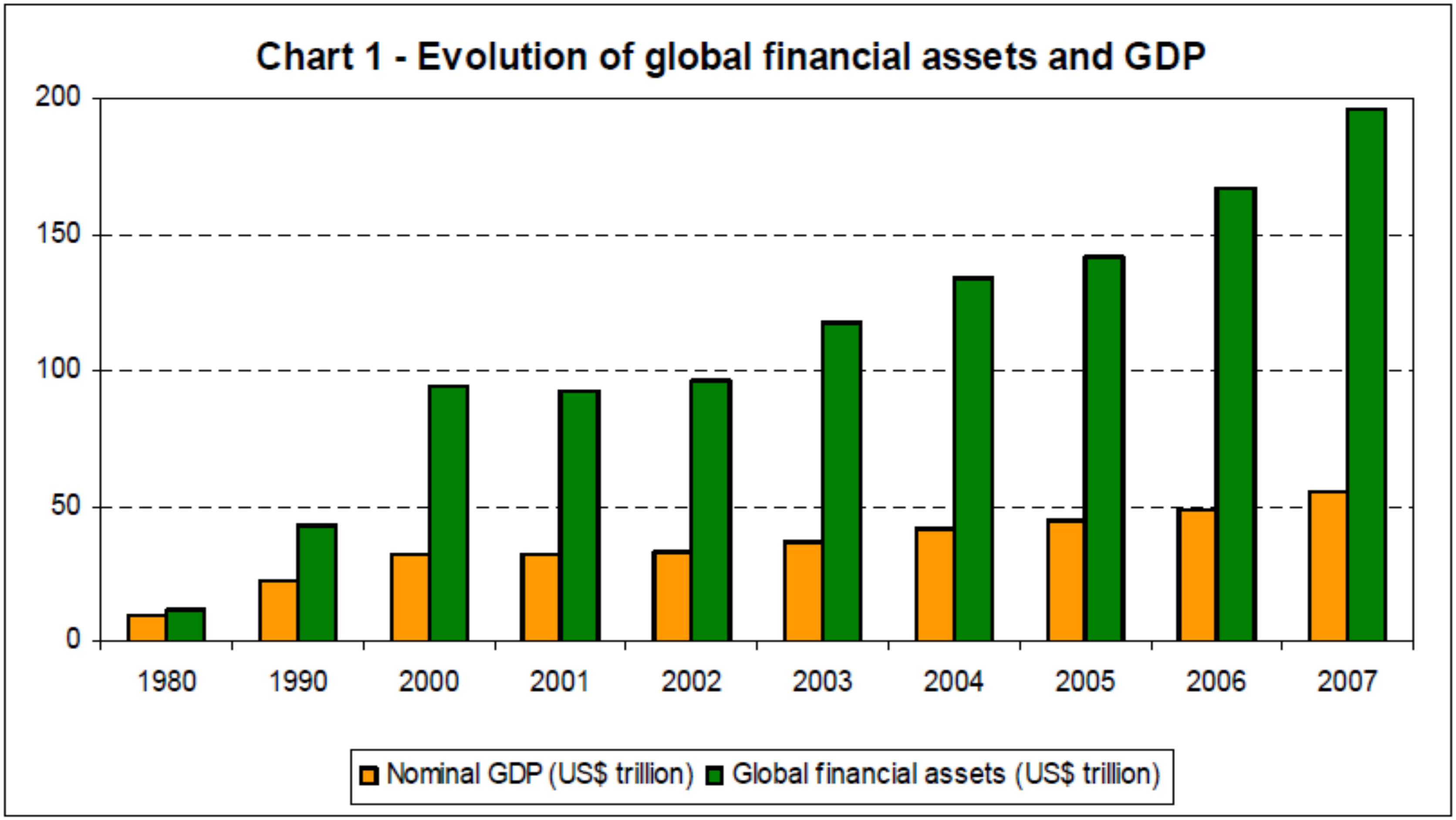


**Source**: McKinsey Global Institute, in: Bresser-Pereira (2010, p.57).

# Maximizing shareholder value and the corporate dynamics

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- Microeconomic financial logic does not differ significantly between the economies;
- High executive's remuneration;
- Sources of instability arising from this new regime:
  - Bad credit assessments;
  - Uncontrolled degrees of leverage;
  - Financial innovations;
  - Flawed system of risk rating;
  - Payment practices (bonus).

# Maximizing shareholder value and the corporate dynamics

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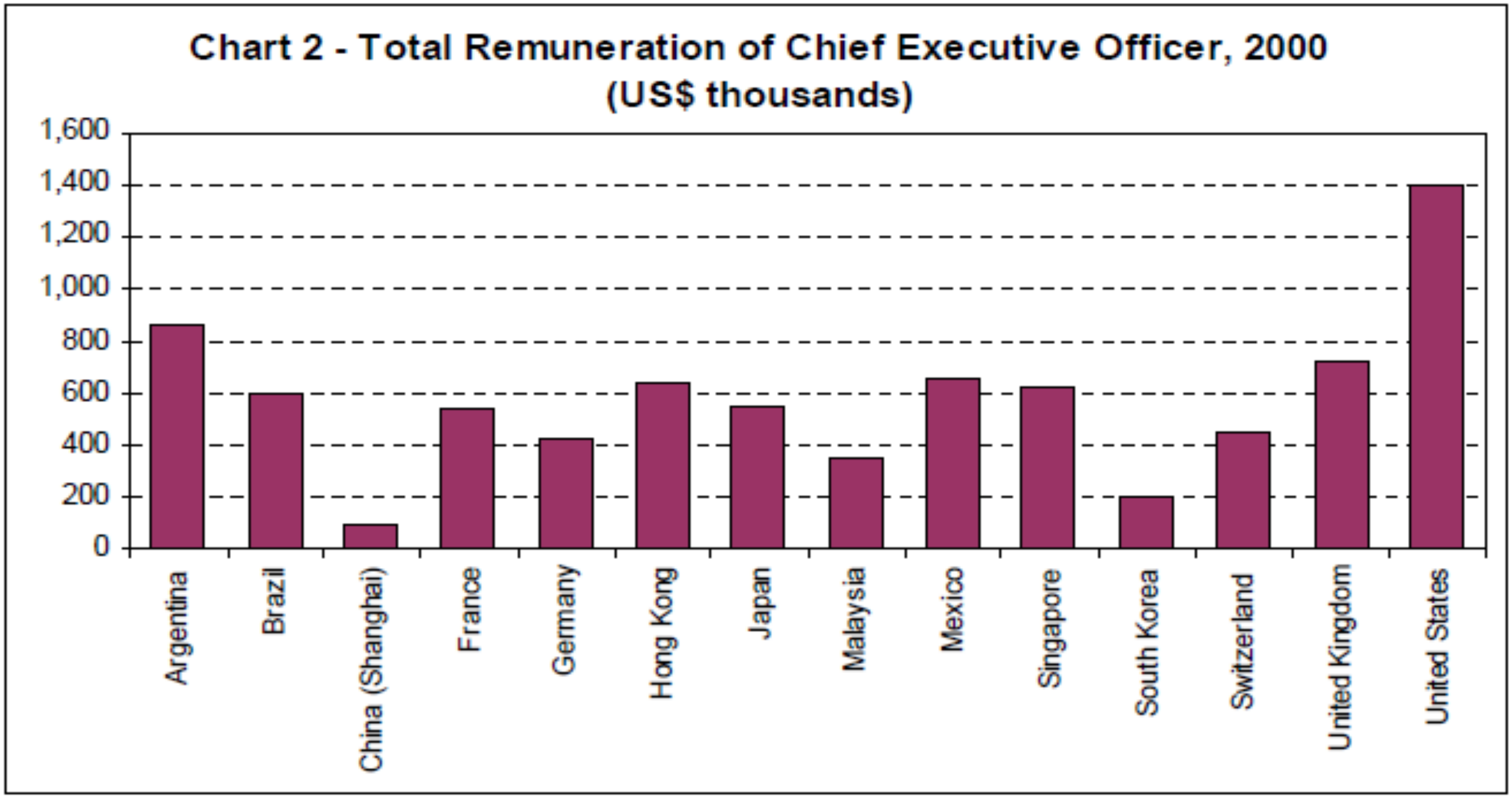


**Source**: Own elaboration based on *Tower Perrins Worldwide Total Remuneration Survey 2000*, in: BECHT *et al*. (2005, p.59).

# Maximizing shareholder value and the corporate dynamics

- Decisive participation of banks and institutional investors in the creation of shareholder value:
  - They themselves are shareholders of the companies;
  - Injection of liquidity into the system by banks could become a speculation channel;
  - Financial institutions have become huge conglomerates that integrate different services, instruments and markets, used by non-financial corporations.

# Macroeconomic instability in emerging economies

- International monetary system characterized by a key-currency, like the dollar, by strong capital mobility and by a floating exchange rate regime: unstable and volatile macroeconomic prices (exchange and interest rates);

- Degree of an economy's exposure to external movements in this scenario depends on their forms of international insertion:
  - Productive and commercial dimension;
  - Financial dimension.

# Macroeconomic instability in emerging economies

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- Productive-commercial insertion:
  - FDI flows;
  - Degree of trade openness;
  - Emerging economies: lower technological dynamism, industrial structure based on lower value-added products and inferior degree of autonomy of economic policy.
- Change in the relations within corporations – more integrated pattern between headquarters and subsidiaries:
  - Movement of profits and dividends remmitances (in the absence of outflow restrictions, in moments of reversal in the international economic cycle, periods of domestic currency appreciation and during changes in the strategy of wealth allocation by the corporation around the world);
  - Currency fluctuations (revenues, costs, debts and derivatives operations).

# Macroeconomic instability in emerging economies

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- Monetary hierarchy:
  - The arrangement of the international monetary system is composed of different types of currencies, classified according to their degree of convertibility;
  - Ability of a currency to fulfill the three basic functions of money at the international level: means of exchange, unit of account / denominator of international contracts and store of value;
  - U.S. dollar; convertible currencies from central economies; inconvertible currencies (from emerging economies).

- Higher liquidity premium in emerging economies;

- Lack of a guarantee of continued capital flows to emerging economies.

# Maximizing shareholder value and the corporate dynamics

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- Asymmetries of the international financial system:
  - Exogenous dynamics of capital flows in relation to emerging economies;
  - Relatively low participation in global flows (but important participation of foreign investors in foreign exchange and financial markets of emerging economies).

- Economy's degree of financial openness;

- Emerging countries' integration in the international financial system:
  - Moments of reversal in the cycle and increase in risk aversion;
  - Economic growth.

# Non-financial corporations and foreign exchange derivatives

- Companies' bets (in a period of intense U.S. dollar devaluation, 1st Semester 2008): continuity of the process of appreciation of national currencies against the U.S. dollar;

- However, since mid-2008 ⇨ "flight to quality" and sudden stop of capital flows to emerging economies

⇩

International appreciation of the dollar

# Non-financial corporations and foreign exchange derivatives

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**Losses of derivatives incurred by companies as a result of the appreciation of the dollar**

| Company | Country | Sector | Losses (US$ million) |
|---|---|---|---|
| Citic Pacific | Hong Kong | Infrastructure | -2,400 |
| Controladora Comercial Mexicana | Mexico | Retail | -2,200 |
| Aracruz | Brazil | Paper/Cellulose | -2,130 |
| Votorantim Group | Brazil | Diversified | -1,040 |
| Cemex | Mexico | Cement | -711 |
| Gruma | Mexico | Foods made of corn | -684 |
| China Cosco Holdings Co. | China | Shipbuilding | -577 |
| Air China Ltd. | China | Airline | -450* |
| Sadia | Brazil | Processed food | -360 |
| Alfa | Mexico | Diversified | -273 |
| Vitro | Mexico | Glass | -227 |

**Source**: Prepared by the authors, based on Regalado and Lyons (Oct. 2008), Caminada and Price (Dec. 2008), Mavin (Dec. 2008), Randewich (Oct. 2008) and Diaz (Jan. 2009).
* Losses resulting from hedging contracts for fuel.
*Note*: not all losses are accounted for. Obviously, many companies are not listed and some derivatives positions are still open.

# Non-financial corporations and foreign exchange derivatives

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- Companies' losses ⟹ macroeconomic impacts:
  - Sudden increase of volatility and devaluation of national currencies, which were already suffering the effects of the international crisis;
  - Credit risk, restricting liquidity in interbank operations, drastic reduction in credit for firms in emerging economies and greater difficulties to refinance;
  - Process of losing credibility in companies as a result of little transparent operations on opaque markets: difficulty to get new loans or renew old ones (firms lost credibility in the banks' eyes for conducting "unknown" operations and jeopardized future profits, to be used to pay their debts).

# Non-financial corporations and foreign exchange derivatives

- Many companies have become Ponzi finance:
  - Losses with derivatives;
  - Debt in foreign currency;
  - Domestic credit crunch ⟹ Greater difficulties to refinance

    ⇓

    Liquidity risk

- Important transmission channel of the international crisis to emerging economies.

# Concluding remarks

- Financial microeconomic logic that guides corporations does not differ significantly between economies;

- However, given their different forms of international insertion (productive-commercial and financial) in a system of deregulated markets, the behavior of these corporations makes emerging economies more unstable;

- Need for regulatory mechanisms to mitigate financial and macroeconomic instability:
    - Control of volatile capital flows;
    - Derivatives: awareness by the regulators of the positions assumed by the agents and the volume traded in the different markets.

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