# Study finds treaties help developing economies spur investment

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Developing economies suffer from a paradox: they don't receive investment flows from developed economies because they lack stability and high-quality financial and lawmaking institutions, but they can't develop those institutions without foreign funds.

A recent study co-authored by Brandon Julio, a professor in the Department of Finance at the University of Oregon's Lundquist College of Business, found that bilateral investment treaties, commonly known as BITs, can help developing economies overcome this paradox, but only as long as those countries can demonstrate a commitment to property and contract rights.

Julio published the research, "A BIT Goes a Long Way: Bilateral Investment Treaties and Cross-border Mergers," in a paper that appeared online Dec. 11 ahead of print in the *Journal of Financial Economics* with co-authors Vineet Bhagwat of the George Washington University School of Business and Jonathan Brogaard of the Eccles School of Business at the University of Utah.

Controlling for various economic effect, the authors found that "the probability of a cross-border merger taking place in a country's economy more than doubles, increasing from 1.6 percent before the treaty to 4.5 percent after the treaty is signed," the researchers stated.

The researchers argue that even in an era of globalization with global capital flows continuing to gain velocity, developing economies should not overlook the value of bilateral investment treaties to overcome what is known as the Lucas paradox.

The paradox was named for Nobel Laureate Robert Lucas, a University of Chicago economist who articulated it in his seminal paper published in 1990 in the journal *American Economic Review*. It highlighted the fact that funds do not flow to poorer countries despite the fact that returns to capital are higher in the developing world.

By looking at mergers and acquisitions, Julio and his co-authors set out to assess whether bilateral investment treaties help spur investment in developing economies.

Using data from Securities Data Co."s database on mergers and acquisitions, the researchers analyzed merger data for all countries between 1980 and 2014. They then correlated that data with 1,057 BITs from 139 countries.

The analysis found that both the number and size, in terms of dollars, of cross-border deals increased after a treaty was signed. BITs also made mergers more likely between asset-rich companies or those in asset-intensive industries, like mining or airlines because they decrease the risk of government expropriation of property.

"The basic idea is to provide clear and enforceable rules to protect foreign investment and reduce country or political risks, which should encourage investment," the researchers noted.

But BITs are no panacea, according to Julio, Bhagwat and Brogaard.

If a country has a bad reputation for upholding property rights, or seems politically unstable, corporations will not attempt to do business there even if a BIT is in place. Similarly, if a country is already deemed low risk, then a BIT makes a deal no more likely. Countries with median-level political risk benefit the most from these agreements, the researchers said.

"While the results do not completely resolve the Lucas paradox, and most cross-border capital remains within the borders of developed countries, the proportion of cross-border deals flowing from the developed to the developing world has increased significantly as more and more countries sign BITs," they concluded.

As bilateral investment treaties are difficult and time consuming to negotiate and are often struck between nations with more mature economies, the findings from the research encourages leaders of developing nations to look to BITs as a faster way to attract foreign investments from companies in Europe, America and Japan.

So long as a country can demonstrate a commitment to property and contract rights, these agreements can be effective and can support both local economies and equities markets, the researchers concluded.

**More information:** Vineet Bhagwat. A Bit Goes a Long Way: Bilateral Investment Treaties and Cross-Border Mergers, *SSRN Electronic Journal* (2016). DOI: 10.2139/ssrn.2872989

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