

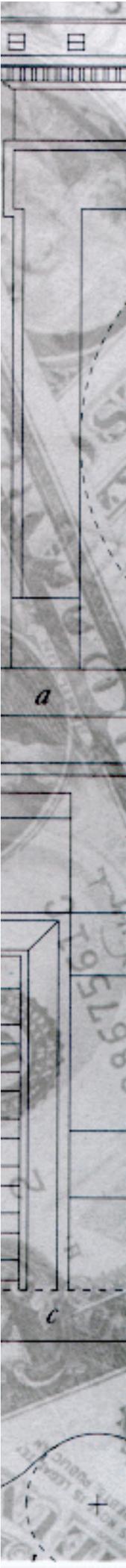
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*Political Relationships, Global  
Financing and Corporate Transparency*

by  
**Christian Leuz**  
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# Political Relationships, Global Financing and Corporate Transparency

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## Abstract

This study examines the financing choices of firms operating in a weak institutional environment. We argue that in relationship-based systems, global financing and strong political connections are alternative means to create firm value. Well-connected firms might be less inclined to access global capital markets because (state-owned) domestic banks provide capital at low cost. Moreover, the expanded disclosures and additional scrutiny that come with issuing foreign securities might be at odds with close political ties at home because these ties can best be exploited when little is disclosed about the firm. Using data from Indonesia, we provide strong support for the hypothesis that global financing and political connections are substitutes: Firms with close political ties to former President Soeharto are significantly less likely than non-connected firms to have publicly traded foreign securities. To study performance effects, we examine how returns during the Asian financial crisis differ between firms with and without foreign securities. Consistent with prior work, we find that firms with foreign securities exhibit higher returns during the crisis. However, our data indicate that politically well-connected firms also received considerable support during this period. These results suggest that previous estimates of cross-listing benefits are considerably biased if domestic opportunities such as political connections are ignored.

*JEL classification:* P16, G32, G38, K22, K42, M41, G18

*Key Words:* Disclosure; Cross listing; Financing choices; Emerging market economies; Asian financial crisis; Indonesia; Cost of capital

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## **1. Introduction**

In designing their corporate strategies, firms systematically seek to anticipate and exploit opportunities in their business environment. While many of these opportunities present themselves in markets, firms can also create value by investing in political relationships (Stigler, 1971; Krueger, 1974; Peltzman, 1976; Baron, 2001). This latter possibility is particularly attractive in economies that are based on personal connections rather than arms-length transactions in markets (Rajan and Zingales, 1998). In this paper, we explore the link between a firm's domestic opportunities and its foreign financing decisions. In particular, we ask if the pursuit of political connections changes the likelihood that firms operating in a weak institutional environment access global capital markets.

We study this question for two reasons. Ever since the liberalization of capital markets, foreign capital has become an increasingly important source of finance for these firms (Karolyi, 1998). In the mid 1990s, Asian firms raised \$1 in foreign equity markets for every \$3 they raised domestically (Bekaert, Harvey and Lumsdaine, 2002). Thus, it is important to understand which firms are likely to take advantage of this new opportunity. More importantly, the decision to issue securities that are traded on foreign markets often forces firms to adapt to the rules and institutions of these markets. Firms that issue foreign securities come under the scrutiny of foreign regulators, financial analysts and foreign institutional investors. Thus, the decision to finance the firm globally carries important implications for the availability of information and perhaps the quality of corporate governance, two important determinants of financial market development (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997 and 2000). These informational consequences of global financing are the second reason for our interest in emerging-market firms' decision to access foreign capital markets.

In this paper, we argue that firms' domestic opportunities such as political connections are likely to interact with their foreign financing decisions. However, it is a priori not obvious whether firms with strong political connections are more or less likely to access global capital markets. There are good theoretical reasons to believe that firms with stronger political relationships are less likely to finance themselves globally. In emerging economies, close political ties often offer access to low-cost financing from (state-owned) banks. The lower the costs of domestic capital, the weaker are the incentives to access foreign markets. Moreover, the greater disclosure that comes with issuing foreign securities may be particularly costly for firms with close political ties because higher levels of transparency are difficult to reconcile with the benefits that good political connections can confer. For instance, in many weakly regulated markets, firms are free to engage in undisclosed related-party transactions benefiting controlling insiders and political backers. But transactions of this type have to be reported once the firm's securities are traded on a major U.S. exchange. These arguments suggest that political connections and global financing are substitutes.

On the other hand, there are equally valid arguments that well-connected firms are more likely to have foreign securities. Close political ties afford more attractive business opportunities and increase firm value (Fisman, 2001; Faccio, 2002). Hence, closely connected, fast growing firms with a high demand for capital might find it particularly attractive to tap into foreign markets. From the perspective of foreign investors, valuable well-connected firms might be the most interesting investment opportunities an emerging-market economy has to offer. These arguments suggest that close political ties and access to foreign capital markets are complements.

In view of the conflicting arguments, the relation between firms' financing strategies and their political connections is ultimately an empirical question. In this paper, we examine this

relation using data from Indonesia. Indonesia's crony capitalism under former President Soeharto provides a particularly suitable setting to examine firms' transparency choices. First, Indonesia has low levels of mandatory disclosure, providing more discretion to firms and increasing cross-sectional variation in transparency. Second, there is ample evidence that the Soeharto regime provided substantial economic benefits to politically well-connected firms (Fisman, 2001). Third, Indonesia's relatively centralized power structure during the Soeharto era facilitates the measurement of political connections. And finally, the Asian financial crisis towards the end of the Soeharto era provides an economic shock that we can exploit to assess the performance consequences of transparency and political connections (Mitton, 2002).

In our analysis, we find strong support for the view that foreign securities and close political connections are substitutes, i.e., two alternative means to increase firm value. Firms that are close to the Soeharto regime are significantly less likely to have publicly traded securities abroad. They are also less likely to have debt or equity securities traded on US exchanges. These findings hold after controlling for firm size, financial leverage, firm profitability, and industry characteristics.

There are at least three explanations for our results. First, it is well known that Indonesian firms with close ties to the regime had preferential access to financing, typically from state-owned banks (Backman, 2001). Once such funds become available, the benefits of foreign securities are simply smaller. Second, foreign securities require greater transparency, which is likely to impede politically arranged financing via covert operations with state-owned banks. And third, low transparency facilitates the extraction of private benefits of control, which has been suggested as another reason why firms from countries with weak institutional structures do

not cross list in the US despite evidence of substantial cross listing benefits (Doidge, Karolyi and Stulz, 2001; Reese and Weisbach, 2002).

These three explanations are not mutually exclusive, and it appears likely that all of them influence firms' financing strategies. While our data do not allow us to distinguish between these various mechanisms, our main finding that firms trade off political connections and access to global capital alone has important empirical implications. A key question in the recent literature on cross listing is whether or not foreign securities are effective legal bonding devices which commit firms operating in weak institutional environments to better corporate governance (Fan and Wong, 2001; Doidge et al., 2001; Reese and Weisbach, 2002; Siegel, 2002). In support of this view, Mitton (2002) reports that Asian firms with higher-quality disclosures have significantly higher returns during the Asian financial crisis. However, if domestic sources of firm value – for instance President Soeharto's attempts to save firms close to the regime – are omitted from these analyses, the resulting estimates are likely to be biased.

There is some anecdotal evidence that Soeharto tried to protect well-connected firms. The Texmaco group for example received loans in excess of US\$ 1 billion from Bank Negara Indonesia, one of Indonesia's largest state banks. The loans far exceeded the bank's legal lending limit, but were approved by Soeharto "as a means to prop up the conglomerate after the Asian financial crisis" (Solomon, 1999). Texmaco's founder, Marimutu Sinivasan, is said to be a long-time friend of President Soeharto. Consistent with such examples, our analysis shows that the performance effects associated with foreign securities increase considerably once we control for a firm's closeness to the Soeharto regime, indicating that both greater disclosure and political connections contributed to firm value during the crisis. This result is consistent with and complements recent evidence by Johnson and Mitton (2003) showing that politically well-

connected firms in Malaysia benefited from the imposition of capital controls during the Asian crisis.

While our study suggests that political favors of dubious legality could be one of the *reasons* why well-connected firms are reluctant to issue foreign securities that come with additional disclosures, the link between political ties and global financing has *consequences* for corporate transparency even if the increased disclosure does not *cause* firms to stay at home. Because strong political ties discourage firms from issuing publicly traded foreign securities – the main insight of this study – corporate transparency is less likely to improve in countries where political connections play an important part in economic activity.

The paper is organized as follows. Section 2 describes the institutional setting and explains our research design. Section 3 describes the sample and the data. Section 4 presents the results for firms' transparency choices and Section 5 reports the performance tests. Section 6 concludes the paper.

## **2. Institutional Setting and Research Design**

A key premise of our approach is the idea that political connections constitute a source of firm value. There is empirical evidence supporting this view, both for Indonesia (Fisman, 2001) and for a larger set of economies. For instance, connected firms pay fewer taxes and have larger market shares (Faccio, 2002). In Indonesia, the Soeharto regime often arranged preferential financing for well-connected firms (so-called “memo-lending”). An example of the early 1990s is Golden Key, a little-known chemical and manufacturing group, which received an unsecured loan of \$430 million from the state-owned Bank Pembangunan Indonesia. Court proceedings subsequently revealed that Hutomo Mandala Putra, the youngest son of President Soeharto, was

an early investor in Golden Key and had introduced the firm to bank officials who approved the loan at “neck-breaking speed” (McBeth, 1994). Similarly, the Barito Pacific group received huge loans from state banks prior to the crisis. Political connections are widely cited as the reason behind the state banks’ generosity (Borsuk, 1993).

The benefits of political connections are not confined to debt financing. Barito Pacific’s 1993 public stock offering, for instance, was greatly helped by the state civil-service pension fund acquiring a 20% stake. Barito denied allegations that it needed the pension fund’s entry to “shore up the company before it could go public,” but analysts noted that the fund’s investment substantially boosted the company’s capital (Borsuk, 1993). A further source of value for politically well-connected firms is the granting of important licenses. The Salim Group, one of the largest Indonesian conglomerates, had very close ties with President Soeharto and was awarded lucrative franchises in banking, flour milling and telecoms (Shari, 1998).

These anecdotes illustrate that political connections are one way to obtain low-cost financing and other economic advantages. An alternative strategy for emerging-market firms to increase value is to access foreign capital markets. The issuance of foreign securities can lower the cost of capital, help to overcome the obstacles of segmented markets (Stulz, 1981; Erunza and Miller, 2000), and increase the firm’s value by fostering its recognition among analysts and investors (Merton, 1987; Lang, Lins and Miller, 2002). Some authors have also argued that cross-listings improve corporate transparency and investor protection and hence the value of the firm to outsiders. This claim is the subject of an ongoing debate. Cheung and Lee (1995), Coffee (2002), Mitton (2002) and Reese and Weisbach (2002) provide evidence in favor of the hypothesis. Fanto (1996), La Porta, Lopez-de-Silanes and Shleifer (1999), Licht (2001), McNeil (2001) and Siegel (2002) are more skeptical.

To better understand the performance and governance effects of global financing strategies, it is important to understand why firms choose to issue foreign securities. The incentives to do so depend in part on the relation between the value of access to foreign capital markets and firms' domestic business opportunities. If cross-listed firms were equally able to exploit political connections, we would expect firms to simultaneously invest in domestic relationships and access foreign capital markets. However, if the issue of publicly traded foreign securities forces firms to give up domestic business opportunities, those with good opportunities might be reluctant to access foreign markets.

To examine the relation between political ties and corporate transparency, we analyze the likelihood of Indonesian firms having publicly traded foreign securities. Firms that issue publicly traded securities abroad come under the scrutiny of foreign regulators, financial analysts and foreign institutional investors, which is likely to increase the availability of information. We also examine which firms have debt or equity securities traded on major US exchanges. In this case, firms have to file Form 20-F with the SEC, which requires extensive disclosures (e.g., on related-party transactions) as well as reconciliations of net income and shareholders' equity under foreign GAAP to U.S. GAAP. In addition, the filing exposes firms to SEC enforcement and shareholder litigation, and makes them subject to the record keeping and accounting provisions of the Foreign Corrupt Practices Act (Coffee, 2002).

### **3. Sample and Data**

Our tests require financial statement and share price data. We obtain financial data from the Worldscope database. In 1997, the database comprises 151 Indonesian firms. We lose 13 firms because we are unable to find share price data on Datastream. In addition, we drop 8 firms that

are not traded over our sample period. Thus, the final sample consists of 130 firms, representing over 80% of the Indonesian market capitalization in December 1996.

Next, we search for foreign securities of Indonesian firms using the SDC database, Datastream, the Global Access database, SEC filings on Edgar, and the Bank of New York's ADR list. We identify 22 firms with publicly traded debt and equity securities on 6/30/1997, shortly before the beginning of the Asian crisis. We do not include private debt agreements or private equity placements because these arrangements allow investors to be informed via private channels rather than public disclosure. Our research design appeals to the notion that foreign securities imply greater transparency and public disclosure. As the most stringent requirements apply to firms with debt or equity securities traded on major US exchanges, we also present our analyses using firms filing Form 20-F with the SEC. We identify 8 firms.

Our measure of political connections is based on Fisman (2001). His study shows that firms that are close to the Soeharto suffer negative returns when bad news about the President's health hit the market. Based on this result, we compute for each firm a cumulative stock return over the 6 health-related events identified by Fisman (2001).<sup>1</sup> The cumulative return over the 6 events is on average -4.6% and exhibits considerable cross-sectional variation. Some firms lose more than 20% of their value over these 6 events. We multiply the cumulative returns by -1 so that larger realizations indicate greater closeness to Soeharto. This variable is our proxy for political connections.

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<sup>1</sup> The event days are January 30 – February 1, 1995; April 27, 1995; April 29, 1996; July 4 – 9, 1996; July 26, 1996; April 1-3, 1997. For further details on the events see Fisman (2001). There are 7 firms, for which we do not have return data for all 6 events. Dropping these firms does not materially alter our results or inferences. The results are also very similar using the average rather than the cumulative return over the 6 events.

Table 1 reports descriptive statistics for all firms and for two subsamples. All financial statement data is measured as of the fiscal year end in 1996.

#### 4. The Choice of Foreign Securities

We begin our analysis by studying firms' decisions to have publicly traded foreign securities. In our empirical model, the net benefit of foreign securities  $y_i^*$  depends on a vector of firm characteristics  $X_i$ , a firm's closeness to the Soeharto regime  $C_i$ , and industry fixed effects  $\mu_s$ :

$$(1) \quad y_i^* = X_i\beta + \gamma C_i + \mu_s + \varepsilon_i$$

If firms with closer connections to the Soeharto regime are less likely to have foreign securities, we observe that  $\gamma < 0$ . Prior studies identify firm size and the export level of a firm's industry as important factors influencing the decision to cross list shares abroad (e.g., Saudagaran, 1988; Saudagaran and Biddle, 1995; Karolyi, 1998).<sup>2</sup> We control for industry effects and firm size, measured by total assets, in all models.<sup>3</sup> As having publicly traded foreign securities generally requires firms to increase transparency, we expand our base model to control for firms' financing needs and profitability as both factors have been shown to influence corporate disclosure choices (Healy and Palepu, 2001). We use capital intensity as a proxy for financing needs and the return on assets as our measure for profitability (model 2). The former is computed as the ratio of fixed assets to total assets. The latter is measured as the ratio of operating income to total assets. Finally, we take into account that, in emerging market economies, business groups often provide financing to other members of the group (Khanna and

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<sup>2</sup> It would be desirable to include the percentage of sales abroad as a firm-specific control, but this data is not available for most sample firms in the Worldscope database.

<sup>3</sup> Using the market value of equity as a proxy for firm size yields even stronger results. We nevertheless use total assets because market capitalization could be affected by firms' choices of foreign securities.

Palepu, 2000). If financing strategies within a business group are correlated, estimates ignoring group affiliation overstate the number of independent observations. To avoid this problem, we cluster standard errors on group affiliation using data from Claessens et al. (2000) and Fisman (2001).

The net benefit of foreign securities  $y_i^*$  is unobserved, but we know which firms have foreign securities:

$$(2) \quad y_i = \begin{cases} 1 & \text{if } y_i^* > 0 \\ 0 & \text{if } y_i^* \leq 0 \end{cases}$$

Given the binary nature of our dependent variable, we report probit estimates in Tables 2 and 3. The models for foreign securities (Table 2) as well as the models for the 20-F filings (Table 3) explain a substantial fraction of the cross-sectional variation. The key result in these tables is that firms with strong political connections are less likely to have foreign securities and US securities requiring a 20-F filing. Gauging the magnitude of the effect, the estimated coefficient in the first specification of Table 2 implies that an increase in closeness by one standard deviation reduces the likelihood of a firm having foreign securities by 5.8 percentage points.

Another control variable, which is frequently used in the disclosure literature, is financial leverage (e.g., Healy and Palepu, 2001). However, we are concerned that, in our setting, leverage partly reflects firms' demand for foreign securities. For instance, firms with close ties to Soeharto and privileged access to loans from state banks are likely to have more short- to medium-term debt than firms with foreign bonds or equity. For this reason, we introduce financial leverage separately (model 3). Our main result that political connections and foreign

securities are negatively associated is essentially unaffected if we control for firm profitability (ROA), financing needs (capital intensity) and financial leverage.

As the trade-off between domestic political benefits and global financing could be different for the subsidiaries and affiliates of foreign firms, we drop the 11 foreign firms in our sample to test the robustness of our results (model 4). As before, we find that firms that are close to the regime are less likely to have foreign securities. We also check whether we obtain similar results using an alternative measure of closeness to the regime, i.e., the stock returns during the days leading up to Soeharto's resignation in 1998. The idea is again that firms close to Soeharto are likely to experience negative returns when he resigns. As it is not clear at which point the market expected Soeharto to step down, we accumulate returns over the period from May 12<sup>th</sup> through May 21<sup>st</sup> 1998.<sup>4</sup> We use this cumulative return, again multiplied by -1, instead of the health-based Soeharto variable. When we include this alternative measure along with all our controls in model 5, we continue to find that more closely connected firms are less likely to have foreign securities. The same conclusion holds when we use the resignation-based returns in the other specifications presented in Tables 2 and 3.

#### *Additional Robustness Checks*

We perform a number of additional robustness checks to validate our findings. First, we use alternative proxies for firms' financing needs, namely average sales and asset growth, and for firm profitability, namely EBITDA over total assets. The resulting estimates are very similar to those reported in Tables 2 and 3. Second, we control for a firm's average trading volume over

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<sup>4</sup> On May 12<sup>th</sup>, student protests calling for Suharto's resignation gained momentum and widespread support. On May 15<sup>th</sup>, a wing of the ruling Golkar party called for his resignation. The upper house of the Parliament joined these calls on May 18<sup>th</sup> (Cohen, 1998; DJ Newswire, 5/18/1998). Suharto finally resigned on May 21<sup>st</sup>.

the event days. This robustness check addresses the concern that infrequent trading of some stocks could affect our results and, in particular, could bias the Soeharto measure towards zero. However, including trading volume leaves our results virtually unchanged.

Third, another potential concern is that our closeness captures how strongly a firm reacts to negative market news, rather than political connections.<sup>5</sup> Addressing this issue, we compute cumulative returns over alternative event days with extreme negative market news. To obtain events with negative market news that are unrelated to news about the Soeharto regime, we identify the worst five non-adjacent trading days for the Hang Seng Index (Hong Kong) and, separately, for the Strait Times Index (Singapore) between January 1995 and April 1997, which is the same time period during which the health events occurred.<sup>6</sup> We construct three alternative proxies from these event days capturing how strongly a firm's return reacts to bad market news. For each sample firm, we compute its cumulative return over (a) the Hong Kong events, (b) the Singapore events, and (c) those days that register as worst days both in Hong Kong and Singapore. The latter days appear to be Asia-wide bad news. The average cumulative return for our sample firms is -3.8%, -7.4%, and -8.0%, respectively. Using any of these three proxies instead of the closeness variable in any our models results in insignificant results. Thus, firms' responsiveness to negative news does not predict their decision to have foreign securities and, hence, does not drive our results for the health-based closeness measure.

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<sup>5</sup> This concern is particularly relevant for the performance tests presented in Section 4, which is why we explicitly control for historical volatility in these regressions. Note that introducing volatility as an additional control variable in the choice models does not alter the results presented in Tables 2 and 3.

<sup>6</sup> Adjacent trading days are combined into one event. We make sure that the event windows do not overlap with the Suharto health events. We also examine news reports for these days. We find that the negative returns on these days primarily reflect worldwide market movements, interest rate or dollar exchange rate changes.

Fourth, we re-estimate our models using a different securities variable. We code a binary indicator for the six firms with *private* foreign securities, such as private placements in the US under Rule 144a and private foreign debt. These securities allow firms to access foreign capital markets, but they do not require extensive *public* disclosure of information. Thus, if transparency issues are critical for the decision to have publicly traded foreign securities, closely connected firms might be as likely or even more likely to have private foreign securities. Although the results for the private securities are based on a small number of observations and should thus be interpreted with care, it is interesting that more closely connected firms are significantly *more* likely to have private securities in all models.<sup>7</sup> These findings suggest that transparency issues play a role for the documented tradeoff between political connections and global financing.

Finally, we address the concern that our closeness measure could be endogenously determined. The models in Table 2 and 3 as well as our robustness checks assume that firms' political connections are predetermined. This assumption is not unreasonable. While President Soeharto came to power in 1966, the first Indonesian ADR was not issued until 1991 (Bekaert, Harvey and Lundblad, 2002). Thus, the key political alliances in Indonesia may have been forged largely prior to financial market liberalization and the issuance of foreign securities. In addition, many important political connections appear to be family related, which is another exogenous factor (Backman, 2001). Similarly, Johnson and Mitton (2002) argue that political connections in Malaysia are based on chance and have long personal histories. But as the

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<sup>7</sup> Controlling for size, ROA, capital intensity and financial leverage (model 3), the estimated coefficient on closeness is 6.208 with a robust standard error of 2.842.

endogeneity concern appears to be equally valid, we explicitly test whether closeness to Soeharto is exogenous to firms' global financing decisions.

Smith and Blundell (1986) devise a simple exogeneity test for models with limited dependent variables. The test involves the estimation of a first stage with closeness as the dependent variable. The residuals from the first stage are then included as an additional covariate in the models in Table 2 and 3. As the standard order condition for identification applies, we need an instrument for a firm's closeness to the regime. We use the ethnicity of a firm's president director<sup>8</sup> as an instrument in the first stage.<sup>9</sup> Given the delicate state of race relations in Indonesia, it is likely that Chinese managers view close political connections with former President Soeharto in a different light than indigenous Indonesians (Pribumis). A priori, it is difficult to predict whether good political relations are more or less important for Chinese managers. Given anti-Chinese sentiments, one could argue that political protection is more valuable for the Chinese than for Pribumis. However, there are also arguments to the contrary. Political favors of often-dubious legality typically need to be repaid by kickbacks and side payments of equally dubious nature. This practice is risky for any manager, but particularly risky for Chinese executives. Criminal wrongdoing in combination with SARA – an Indonesian acronym for the hot-button issues, suku (tribe), agama (religion), ras (race), and antar golongan (ethnicity) – tend to stir emotions. The trial of Golden Key owner Tan Tjoe Hong provides an illustrative example. Accused of having fraudulently secured a \$430 million letter of credit,

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<sup>8</sup> Indonesian firms have a two-tiered board structure. The president director heads the managing board of directors. Hence, the role of the president director broadly corresponds to the role of the CEO.

<sup>9</sup> Information on the ethnicity of the president director and the dominant owner, which we use as an alternative instrument, comes from a large number of publicly available sources such as press reports and company websites. We crosschecked information with an Indonesian accounting firm, an Indonesian stockbroker, and with Indonesian students at the Wharton School. Michael Backman also kindly shared his expertise in these matters. A complete list of all sources is available upon request.

Hong was subject to a vocal anti-Chinese campaign throughout his trial. The *Far Eastern Economic Review* reports that Indonesians holding anti-Chinese views were paid to attend the court hearings (McBeth, 1994). While it is difficult to know the extent to which judges are impressed by such public pressure, it is possible that Chinese managers are more reluctant to engage in corrupt behavior in a country where their ethnicity can be used against them. Ultimately, however, the relationship between Chinese ethnicity and political closeness to the regime is an empirical matter.

To be a valid instrument, the ethnicity of the president director should be correlated with political closeness and uncorrelated with the choice of foreign securities. Consistent with this requirement, we do not find evidence that the ethnicity of the president director influences firms' choices of foreign securities other than through the channel of political connections. When included in the models in Table 2 and 3, the ethnicity variable remains economically small and statistically insignificant, while the closeness variable remains largely unchanged. In our first-stage regressions, we find that president directors of Chinese ethnicity are significantly less close to the Soeharto regime.<sup>10</sup> We report  $p$ -values for the Smith-Blundell exogeneity test for all models in Tables 2 and 3. Under the null hypothesis of exogeneity, the first-stage residuals have no explanatory power. As shown, we cannot reject the null for any of our specifications. Thus, there is no evidence that our closeness measure is endogenous to the choice of foreign securities.

In summary, the results lend reasonable support to our hypothesis that domestic opportunities influence firms' foreign financing choices. In particular, we find that political connections and publicly traded foreign securities appear to be substitutes.

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<sup>10</sup> For instance, using the covariates of model 3 in Table 2, the estimated coefficient of the ethnicity indicator on closeness is -0.056 with a robust standard error of 0.023. The ethnicity of the dominant owner turns out to be the weaker instrument.

## **5. Returns to Foreign Securities Before and During the Asian Financial Crisis**

An alternative approach to testing our hypothesis that political relationships and foreign securities are alternative means to increase firm value is to explicitly study the performance consequences of the two strategies. This analysis also demonstrates the importance of our findings in the previous section for empirical analyses of the performance effects of cross listings.

We analyze the stock returns of our sample firms one year prior to and during the financial crisis of 1997 and 1998. In a financial market equilibrium, it would be surprising if firms with foreign securities consistently outperformed firms with strong political relationships. In contrast, unexpected shocks such as the financial crisis in Asia are likely to result in significant differences in performance, allowing us to tease out the benefits of political connections and foreign securities. The Asian crisis, which many believe was in part the result of weak corporate governance and low levels of transparency (Stiglitz, 1998; Harvey and Roper, 1999), may have created a premium for more transparent firms with foreign securities. Mitton (2002) provides evidence of this effect. In a sample of firms from five Asian countries, he finds that high-transparency firms with US cross listings significantly outperform low-transparency firms during the crisis.

However, as the results in the previous section suggest, global financing and corporate transparency are only half the story. In measuring the performance effects of foreign securities, it is important to take into account firms' political connections and how the regime responds to the economic turmoil. Suppose President Soeharto lost much of his ability to support politically well-connected firms during the crisis. In this case, return regressions that ignore political connections overestimate the value of foreign listings. In contrast, if Soeharto supported "his"

firms during the crisis – as the Texmaco example suggests – the benefits of foreign securities during the crisis might be larger than previously estimated.

To investigate these issues, we estimate a series of models explaining the stock price performance of our sample firms prior to and during the Asian financial crisis. In particular, we compare models that treat the presence of foreign securities as exogenous with models that explicitly take into account that foreign securities are chosen depending on prior political investments. We investigate three different time periods. The year prior to the crisis (7/1/96-6/30/97), the crisis period up to President Soeharto's resignation (6/30/97-5/21/98), and an extended window (6/30/97-8/31/98), which corresponds to the analysis in Mitton (2002) for comparison purposes. We use firms' log returns  $r_i$  over these periods as dependent variables in our models. Returns are annualized so that we can compare the magnitude of the estimated coefficients across the three time periods. We control for firm size (measured as the log of total assets), financial leverage (ratio of long-term debt to total assets), and the historical volatility of the stock (standard deviation of weekly returns in 1996).

$$(3) \quad r_i = X_i \beta + \phi y_i^* + \mu_s + \varepsilon_i.$$

The results in Mitton (2002) predict that firms with foreign securities outperform other firms during the crisis, i.e.,  $\phi > 0$ . The performance effects of foreign financing are reported in Table 4. In simple OLS regressions, we find positive and significant effects throughout the crisis (columns 4 and 7), consistent with Mitton (2002). In contrast, firms with foreign securities did not outperform other firms in the year prior to the crisis (column 1), which is consistent with our expectations for returns in financial market equilibrium. Furthermore, adding our measure of closeness to these OLS regressions, we find that the coefficient on foreign securities changes

little and our closeness measure has no significant relation with stock returns. Thus, to the extent that these estimates are biased, the bias is not the result of an omitted variable problem.

Next, we estimate treatment effects models. They explicitly account for the substitutive relation between political connections and global financing, thereby isolating the marginal effect of foreign securities. The first stage of these models is the corresponding probit model from Table 2. At the second stage, we estimate equation (3), adding the inverse Mills ratio  $\lambda$  to account for firms' financing choices. The second-stage results are presented in columns 2, 5 and 8 of Table 4. In the two-stage models, the performance effects of foreign securities are considerably larger than in the simple OLS regressions. Conceptually, the difference in the coefficients on foreign securities is an estimate of the benefits Soeharto provided to well-connected firms during the crisis. Controlling for political relationships, we now also find a small positive performance effect of foreign securities for the year prior to the Asian crisis, which again underscores that both political connections and foreign securities contribute to firm value.

To address the concern that our results simply reflect long-run differences in performance across firms, a second set of models controls for firm profitability prior to the crisis (ROA) and firms' financing needs (capital intensity). Although these controls reduce the magnitude of the estimated performance effects to some extent, we continue to find positive and statistically significant effects in all three time periods.

We repeat our analyses examining the performance effects of 20-F filings in Table 5. The results exhibit a similar pattern. Taking a firm's closeness to the regime into account, we find much larger performance effects. When we control for past profitability and financing needs, there is no performance effect of 20-F filings prior to the crisis.

In summary, the estimates presented in Tables 4 and 5 suggest that President Soeharto lent considerable financial support to politically well-connected firms during the financial crisis, which is consistent with anecdotal evidence for Indonesia (Solomon, 1999) and the findings in Johnson and Mitton (2003) for Malaysia. Our findings indicate that both foreign securities and political connections contribute to firm value before and during the Asian financial crisis. As a result, conventionally measured cross listing effects are downward biased if political relationships are ignored.

## 6. Conclusions

In this study, we examine the link between firms' political connections and their foreign financing decisions. Using Indonesia as an example, we show that well-connected firms are less likely to have publicly traded debt or equity securities abroad. Our results indicate that firms in Indonesia view connections and global financing as substitutes. Consistent with this interpretation, we also provide return-based evidence that firms derive significant benefits from *both* foreign securities and political connections during the Asian crisis.

These findings also shed light on the link between political connections and corporate transparency. This link is twofold: As this paper suggests, political ties are likely to be one reason why few Indonesian firms have foreign securities. A greater number of foreign securities, however, would make it easier for domestic and foreign investors to learn about Indonesian firms. Thus, in discouraging firms from issuing foreign securities, political ties indirectly lead to lower transparency. Poor corporate transparency is a *consequence* of the strength of political ties. In addition, transparency concerns could be one of the *reasons* why well-connected firms are reluctant to access global capital markets. Our finding that firms with political ties are less

likely to have publicly traded securities but *more likely* to have private securities is consistent with this view, but it is based on a small number of observations.

One potential implication of our findings is that if closely-connected firms need to give up some of the benefits that come with good domestic relationships when they tap into foreign capital markets, and if, as our results show, firms are reluctant to do so, then they are also likely to resist changes in domestic institutions, which make domestic markets more like foreign capital markets. Thus, our results shed light on one of the reasons why it is difficult to undertake institutional reform in emerging markets.

A second conclusion of our work relates to research on firms operating in relationship-based economic systems in general. A growing literature investigates the performance effects of adopting corporate strategies that are more consistent with the Anglo-Saxon model of market-based, arms-length financing. In these analyses, it is important to recognize that these decisions are likely to be endogenously determined. In a relationship-based economy, firms with weak political connections have the strongest incentives to improve transparency and corporate governance. Unless this is taken into account, the debate surrounding the performance or valuation effects of greater corporate transparency and improved governance is likely to be misinformed.

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Table 1 – Summary Statistics

The table reports means and standard deviations (in parentheses) for a sample of 130 Indonesian firms. A subsample of 22 firms has publicly traded foreign securities, and 8 firms have US securities requiring a 20-F filing, as of June 1997. “Closeness to Soeharto” is the log stock return over five news events indicating that President Soeharto is in bad health, multiplied by –1 to increase in closeness. “Closeness to Soeharto (resignation)” is the log stock return prior to and at Soeharto’s resignation (5/12/1998-5/21/1998), multiplied by –1. Firm characteristics are measured at the end of the fiscal year 1996. “ROA” is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “President Director” indicates whether the head (CEO) of the managing board of directors is Chinese (=1). “Log returns” are annualized log stock returns for the periods indicated in the table. “Volatility” is the standard deviation of the weekly stock returns during 1996.

	Full Sample (N=130)	Firms with Foreign Securities (N=22)	Firms with 20F Filings (N=8)
Foreign Securities	0.169 (0.376)		
20F Filing	0.062 (0.241)	0.364 (0.492)	
Closeness to Soeharto	0.072 (0.107)	0.053 (0.044)	0.055 (0.040)
Closeness to Soeharto (resignation)	0.109 (0.208)	0.004 (0.120)	-0.014 (0.136)
Total assets (millions of Rupiah)	2,390 (4,990)	7,360 (9,080)	5,110 (5,670)
ROA	0.068 (0.069)	0.062 (0.060)	0.082 (0.062)
Capital intensity	0.340 (0.237)	0.382 (0.265)	0.593 (0.168)
Financial leverage	0.190 (0.168)	0.293 (0.149)	0.341 (0.170)
President Director is Chinese	0.585 (0.495)	0.636 (0.492)	0.625 (0.518)
Industry classification			
Agriculture	0.038	0.045	0
Mining	0.015	0	0
Manufacturing	0.508	0.455	0.625
Transport	0.062	0.091	0.250
Trade	0.092	0.091	0.125
Finance	0.238	0.318	0
Services	0.046	0	0
Log returns Pre-crisis 7/1/96-6/30/97	-0.325 (0.574)	-0.238 (0.538)	-0.437 (0.582)
Log returns Soeharto period 7/1/97-5/21/98	-1.253 (1.192)	-0.972 (0.989)	-0.156 (0.527)
Log returns Mitton (2002) 7/1/97-8/31/98	-1.160 (0.988)	-0.928 (0.872)	-0.337 (0.608)
Volatility	0.062 (0.026)	0.062 (0.036)	0.049 (0.015)

Table 2 – Foreign Securities and Political Connections

The table reports probit estimates of the likelihood that the 130 Indonesian firms in our sample have publicly traded foreign securities. The dependent variable takes on a value of 1 if the firm has foreign securities and 0 otherwise. “Closeness to Soeharto” is the log stock return over five news events indicating that President Soeharto is in bad health, multiplied by  $-1$  to increase in closeness. “Closeness to Soeharto (resignation)” is the log stock return prior to and at Soeharto’s resignation (5/12/1998-5/21/1998), multiplied by  $-1$ . Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is the log of total assets in million Rupiah. “ROA” is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Industry” indicators are included for agriculture, manufacturing, transport, trade, and finance. Standard errors (in parentheses) are robust and clustered on group affiliations reported by Fisman (2001) and Claessens et al. (2000). Models 4 and 5 drop firms that are affiliates or subsidiaries of foreign firms. We report  $p$ -values for the Smith-Blundell (1986) exogeneity test. The null hypothesis is that our closeness measures are exogenous. We denote (two-sided) levels of statistical significance as follows: † significant at 10% \* significant at 5% \*\* significant at 1%

	(1)	(2)	(3)	(4)	(5)
Closeness to Soeharto	-5.578 (1.814)**	-5.471 (1.830)**	-6.566 (2.002)**	-6.636 (1.973)**	
Closeness to Soeharto (resignation returns)					-2.043 (1.053)*
Firm size	0.899 (0.176)**	0.886 (0.176)**	0.882 (0.186)**	0.863 (0.180)**	0.677 (0.137)**
ROA		-0.862 (3.170)	-0.247 (3.775)	0.297 (4.411)	-2.304 (3.527)
Capital intensity		0.848 (0.920)	0.064 (0.876)	0.217 (0.869)	0.681 (0.814)
Financial leverage			2.613 (1.021)**	2.272 (1.000)*	1.692 (0.960)†
Industry	Included	included	included	included	Included
Constant	-19.937 (3.711)**	-19.902 (3.726)**	-20.360 (4.011)**	-19.702 (3.844)**	-15.887 (2.923)**
Observations	130	130	130	119	119
Pseudo $R^2$	0.41	0.42	0.45	0.44	0.41
Smith-Blundell exogeneity test	0.16	0.17	0.23	0.30	0.18

Table 3 – US securities with 20-F Filings and Political Connections

The table reports probit estimates of the likelihood that the 130 Indonesian firms in our sample have US securities that require a 20-F filing. The dependent variable takes on a value of 1 if the firm has this type of security and 0 otherwise. “Closeness to Soeharto” is the log stock return over five news events indicating that President Soeharto is in bad health, multiplied by  $-1$  to increase in closeness. “Closeness to Soeharto (resignation)” is the log stock return prior to and at Soeharto’s resignation (5/12/1998-5/21/1998), multiplied by  $-1$ . Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is the log of total assets in million Rupiah. “ROA” is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Industry” indicators are included for manufacturing, transport and trade. Standard errors (in parentheses) are robust and clustered on group affiliations reported by Fisman (2001) and Claessens et al. (2000). Models 4 and 5 drop firms that are affiliates or subsidiaries of foreign firms. We report  $p$ -values for the Smith-Blundell (1986) exogeneity test. The null hypothesis is that our closeness measures are exogenous. We denote (two-sided) levels of statistical significance as follows: † significant at 10% \* significant at 5% \*\* significant at 1%

	(1)	(2)	(3)	(4)	(5)
Closeness to Soeharto	-3.126 (1.554)*	-5.311 (2.400)*	-6.791 (2.734)*	-6.827 (2.649)**	
Closeness to Soeharto (resignation returns)					-3.379 (1.070)**
Firm size	0.414 (0.086)**	0.647 (0.174)**	0.590 (0.168)**	0.559 (0.160)**	0.496 (0.185)**
ROA		0.889 (3.401)	2.070 (4.203)	2.993 (4.790)	-1.701 (3.879)
Capital intensity		4.003 (1.187)**	3.251 (1.036)**	3.347 (1.017)**	4.305 (1.375)**
Financial leverage			2.439 (1.393)†	2.079 (1.389)	0.356 (1.449)
Industry	included	included	included	included	Included
Constant	-10.245 (1.883)**	-17.048 (4.312)**	-16.213 (4.128)**	-15.484 (3.905)**	-13.979 (4.413)**
Observations	130	130	130	119	119
Pseudo $R^2$	0.23	0.45	0.47	0.48	0.47
Smith-Blundell exogeneity test	0.38	0.18	0.18	0.21	0.17

Table 4 – Returns to Foreign Securities

The table reports regression results with annualized log returns for 130 Indonesian firms as the dependent variable. “Foreign Securities” is an indicator, which is equal to 1 if a firm has publicly traded foreign securities and 0 otherwise. Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Volatility” is the standard deviation of the weekly stock returns during 1996. “ROA” is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. Industry indicators are included for agriculture, mining, manufacturing, transport, trade, finance and services. Standard errors (in parentheses) are clustered on group affiliation reported by Fisman (2001) and Claessens et al. (2000). In the two-stage treatment effects models, the first stage are the probit models reported in Table 2, and  $\lambda$  is the parameter estimate on the inverse Mills ratio. We denote (two-sided) levels of statistical significance as follows: † significant at 10% \* significant at 5% \*\* significant at 1%

	Log returns 7/1/96-6/30/97 Pre-crisis			Log returns 7/1/97-5/21/98 Soeharto period			Log returns 7/1/97-8/31/98 Mitton (2002)		
	(1) OLS	(2) 2-stage estimates	(3) 2-stage estimates	(4) OLS	(5) 2-stage estimates	(6) 2-stage estimates	(7) OLS	(8) 2-stage estimates	(9) 2-stage estimates
Foreign Securities	0.173 (0.161)	0.841 (0.395)*	0.678 (0.354)*	0.787 (0.273)**	1.905 (0.721)**	1.492 (0.626)*	0.699 (0.298)*	1.745 (0.605)**	1.510 (0.531)**
Firm size	-0.009 (0.044)	-0.104 (0.069)	-0.075 (0.060)	-0.096 (0.096)	-0.260 (0.130)*	-0.198 (0.109)†	-0.084 (0.085)	-0.238 (0.109)*	-0.199 (0.092)*
Financial leverage	-0.136 (0.313)	-0.010 (0.338)	-0.107 (0.368)	-0.864 (0.741)	-0.646 (0.645)	-1.369 (0.671)*	-1.120 (0.555)*	-0.917 (0.536)†	-1.431 (0.573)**
Volatility	1.399 (1.851)	1.101 (1.956)	1.594 (1.961)	-2.453 (3.708)	-2.868 (3.734)	-2.428 (3.632)	0.546 (3.141)	0.157 (3.088)	0.758 (3.010)
ROA			1.258 (0.789)			1.951 (1.440)			2.287 (1.228)†
Capital Intensity			-0.078 (0.266)			1.340 (0.482)**			0.852 (0.412)*
Industry dummies	yes	yes	Yes	yes	yes	yes	yes	yes	yes
Constant	0.242 (0.955)	0.993 (1.385)	0.417 (1.226)	3.016 (2.045)	3.644 (2.603)	1.933 (2.231)	2.119 (1.802)	2.813 (2.184)	1.691 (1.896)
Observations	129	129	129	130	130	130	130	130	130
$\lambda$		-0.448 (0.233)*	-0.354 (0.215)†		-0.759 (0.431)†	-0.533 (0.385)		-0.710 (0.359)*	-0.598 (0.322)†
R-squared	0.09			0.24			0.23		

Table 5 – Returns to US securities with 20-F Filings

The table reports regression results with annualized log returns for 130 Indonesian firms as the dependent variable. “US securities 20-F” is an indicator, which is equal to 1 if a firm has publicly traded US securities that require a 20-F filing and 0 otherwise. Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Volatility” is the standard deviation of the weekly stock returns during 1996. “ROA” is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. Industry indicators are included for agriculture, mining, manufacturing, transport, trade, finance and services. Standard errors (in parentheses) are clustered on group affiliation reported by Fisman (2001) and Claessens et al. (2000). In the two-stage treatment effects models, the first stage are the probit models reported in Table 2, and  $\lambda$  is the parameter estimate on the inverse Mills ratio. We denote (two-sided) levels of statistical significance as follows: † significant at 10% \* significant at 5% \*\* significant at 1%

	Log returns 7/1/96-6/30/97 Pre-crisis			Log returns 7/1/97-5/21/98 Soeharto period			Log returns 7/1/97-8/31/98 Mitton (2002)		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	OLS	2-stage estimates	2-stage estimates	OLS	2-stage estimates	2-stage estimates	OLS	2-stage estimates	2-stage estimates
US securities 20-F	-0.148 (0.212)	1.760 (0.870)*	0.452 (0.451)	1.282 (0.294)**	3.490 (1.480)*	1.306 (0.468)**	1.084 (0.354)**	3.151 (1.265)*	1.636 (0.695)*
Firm size	0.021 (0.042)	-0.065 (0.063)	-0.007 (0.044)	-0.046 (0.089)	-0.139 (0.100)	-0.047 (0.045)	-0.038 (0.077)	-0.124 (0.086)	-0.068 (0.066)
Financial leverage	-0.075 (0.320)	0.165 (0.405)	-0.057 (0.364)	-0.994 (0.736)	-0.748 (0.658)	-0.881 (0.378)*	-1.224 (0.547)*	-0.995 (0.562)†	-1.388 (0.555)*
Volatility	1.708 (1.744)	1.387 (2.353)	1.985 (1.935)	0.036 (4.050)	-0.200 (3.836)	2.961 (2.002)	2.725 (3.228)	2.504 (3.279)	2.983 (3.008)
ROA			1.138 (0.782)			1.179 (0.812)			2.142 (1.194)†
Capital Intensity			-0.142 (0.286)			0.471 (0.297)			0.584 (0.439)
Industry dummies	yes	yes	Yes	yes	yes	yes	yes	yes	yes
Constant	-0.398 (0.908)	0.184 (1.271)	-0.897 (0.934)	1.896 (1.896)	1.244 (2.043)	-0.586 (0.959)	1.074 (1.631)	0.564 (1.746)	-0.754 (1.419)
Observations	129	129	129	130	130	130	130	130	130
$\lambda$		-1.060 (0.446)*	-0.422 (0.258)†		-1.209 (0.752)†	-0.446 (0.267)†		-1.131 (0.643)†	-0.476 (0.407)
R-squared	0.09			0.25			0.24		