Institutional Investors’ Liabilities and Emerging Markets

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abstract

This paper explores the determinants and implications of the growing allocation of foreign institutional investors to emerging markets assets. The key contention put forward is that the management of liabilities is at the core of the portfolio choice mechanism of institutional investors. Whereas existing literature highlights the importance of governance and hunt for yield in the era of financialisation, we argue that a key determinant of institutional investor flows into emerging markets has been the changes on the liability side of their balance sheets. The paper supports this contention with a Minskyan theoretical framework and the results from 14 semi-structured interviews with European pension funds. Moreover, the paper analyses the implications of the increasing participation of institutional investors in emerging market assets for external vulnerability in emerging economies, particularly with reference to our key focus on the liability side of their balance sheets. It argues that ultimately emerging market assets cannot be used to face institutional investors’ liabilities directly, which means they are bound to remain part of a return-seeking strategy. The stability of these allocations however depends fundamentally on the evolution of institutional investors’ liabilities, which are independent from emerging markets conditions. Despite the increasing presence of long-term financial investors, emerging markets remain therefore subject to considerable external vulnerability.