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Risks and Rewards in Emerging Market Investment

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Risks and Rewards in Emerging Market Investments

by

Roy C Smith and Ingo Walter¹

For the better part of two centuries, countries with shortages of internally generated capital have relied on foreign investment to augment their growth and development. These principally took the form of bank loans, corporate bonds and stocks, and direct investments. In the 19th Century, the capital flows originated mainly in Britain, Germany and France to the then-emerging markets of the United States and Latin America.² In the 20th Century, the United States became a major capital exporter and joined the Europeans in lending and investing in the developing countries of the Americas and Asia.

The financing usually came in waves. Periods of cautious optimism that attracted capital at relatively high rates of return were followed by periods of "irrational exuberance" in which others sought to duplicate the seemingly easy successes of the early investors only to see—as money rushed in—returns dramatically eroded. Next came periods of financial distress, defaults, reschedulings and other events that ignited an attitude of pessimism, which in turn caused the

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² See D.C.M. Platt, *Foreign Finance in Continental Europe and the USA, 1815-1870*, (London: George Allen & Unwin, 1984) for a useful analysis of the investment cycles and quantities in the 19th Century.

inflows to cease and even reverse. Time would pass, and another cycle would begin.

In this century, there have been two major periods of default on emerging market debt instruments. In the 1930s, large numbers of bonds issued by Latin American governments and others (many solicited, underwritten and sold by the securities affiliates of American banks) defaulted. And in the 1980s, a host of developing countries entered into massive bank debt rescheduling exercises, the results of which are well known.

In the early 1990s, following a number of important economic policy changes in developing countries that encouraged the creation of relatively free markets, a new wave of investment unfolded. The policy drivers have come to constitute a new model of economic development loosely known as the "Washington Consensus." This time, the investment wave was accompanied by a surge of privatizations made available to the investing public shares of large-capitalization companies that promised to be actively traded. Between 1991 and 1994, not only did foreign portfolio investment into emerging market countries soar, but—encouraged by the new free-market policies—so did foreign direct investment (see Exhibit 1). The collapse of the Mexican peso in late 1994 and early 1995 stopped the euphoria. Emerging market equity securities crashed in a simultaneous pattern all over the world. The IFC Emerging Markets Investible Composite index measured in U.S. dollars dropped by 12% in calendar 1994 (having risen by 79.6% in 1993, 3.3% in 1992 and 39.5% in 1991).

³ A term coined by John Williamson of the Institute for International Economics as the conventional wisdom among opinion-leaders that free markets and macroeconomic (notably price) stability are preconditions for viable economic development.

By the end of January 1995 (compared to January 1, 1994) the damage had become far greater. The stock market in Turkey was down 57%, Mexico 56%, China 54%, Poland 50% and Hong Kong 41%, with plunges of 20% to 30% common in most countries.⁴

The aftermath revealed that large foreign institutional investors, especially dedicated country-fund managers, were shocked to discover politically motivated, deceptive and misleading reports of apparently wrong-headed financial practices in Mexico, and decided it was time to get out. These fund managers had rushed into emerging markets all over the world on behalf of their investor clients, and suddenly appeared to lose confidence in all of them at once, regardless of important differences in country fundamentals. Mutual fund shareholders began to demand redemptions, and multiple-country liquidations were often necessary to retain portfolio balancing.

Panic sales by both foreign and local investors overwhelmed the relatively illiquid markets in most parts of Latin American, Eastern Europe, and Asia. These markets, which were seen to offer low-correlation investments (and therefore attractive in accordance with modern portfolio theory) ended-up highly correlated after all—they all had the same large and volatile investors, the big American and European fund managers.

This lesson has now been learned too. Emerging market investors have been more cautious, and market returns have reflected it. Exhibit 2 shows the effects on aggregate returns on a portfolio of emerging market securities during this period. The

 $^{^4}$ The principal exceptions were Chile, where the market was up 42%, Brazil, 39%, South Africa 10% and South Korea 9% over the same period.

IFC Composite lost 8.4% in 1995 and gained 9.4% in 1996, but these returns were meager indeed compared to returns of 37.5% in 1995 on the S&P 500 index and 23% in 1996. The relatively low returns came in spite of the recovery of aggregate emerging market equity portfolio inflows in 1996 to the \$45 billion level achieved in 1993.⁵

Still, there is now some evidence to suggest another turn in the foreign investment patterns of emerging markets. Banks and bond market investors have taken up where the equity investors left off—JP Morgan's Emerging Market Bond Index rose 39.3% in 1996, having nearly doubled from its low point in early 1995 (see Exhibit 3). Emerging market borrowers issued \$74 billion of investment grade bonds (now called "zunks") in 1996, and \$20 billion more were sold by over 50 different issuers in the first quarter of 1997. A record \$3 billion uncollateralized 30-year Brazilian sovereign Eurobond was issued in June 1997 at 395 basis points over U.S. Treasuries. Three-quarters of these bonds were exchanged for higher-yielding Brady bonds issued by the debtor governments as part of their debt restructuring plans. Indeed, during the preceding year more than \$9 billion of similar bond exchanges to reduce outstanding Brady bonds were offered by Latin American governments.

⁵ In 1993 the total equity inflow to emerging market countries was \$45 billion, but it fell sharply to \$32.7 billion in 1994 and \$32.1 billion in 1995, before recovering to \$45.7 billion in 1996. Of the 1996 total, \$34 billion were secondary market flows into outstanding shares traded on domestic markets, mainly in Latin America and Eastern Europe. The volume of new issues of equity securities in 1996, however, was well below the peak year of 1994, but higher than 1995. Data: World Bank Debtor Reporting System, April 1997.

^{6 &}quot;Can't Get Enough of That Zunk," The Economist, April 19, 1997.

However, the Brazil issue, rated B1 and BB-, was the most aggressively priced. Bond market rallys also occurred in other emerging market countries, particularly in Eastern Europe, where Russian bonds received much support in the market.

The renewing enthusiasm for Third World debt was not limited to bond investors, banks were jumping in again as well. In 1996, syndicated banks loans to Latin American borrowers exceeded \$250 billion, an increase of nearly 50% over 1995. Major American banks doubled or tripled their Latin American exposures during this time, during which lending spreads over LIBOR were, on average, 50% less than the preceding year.⁸

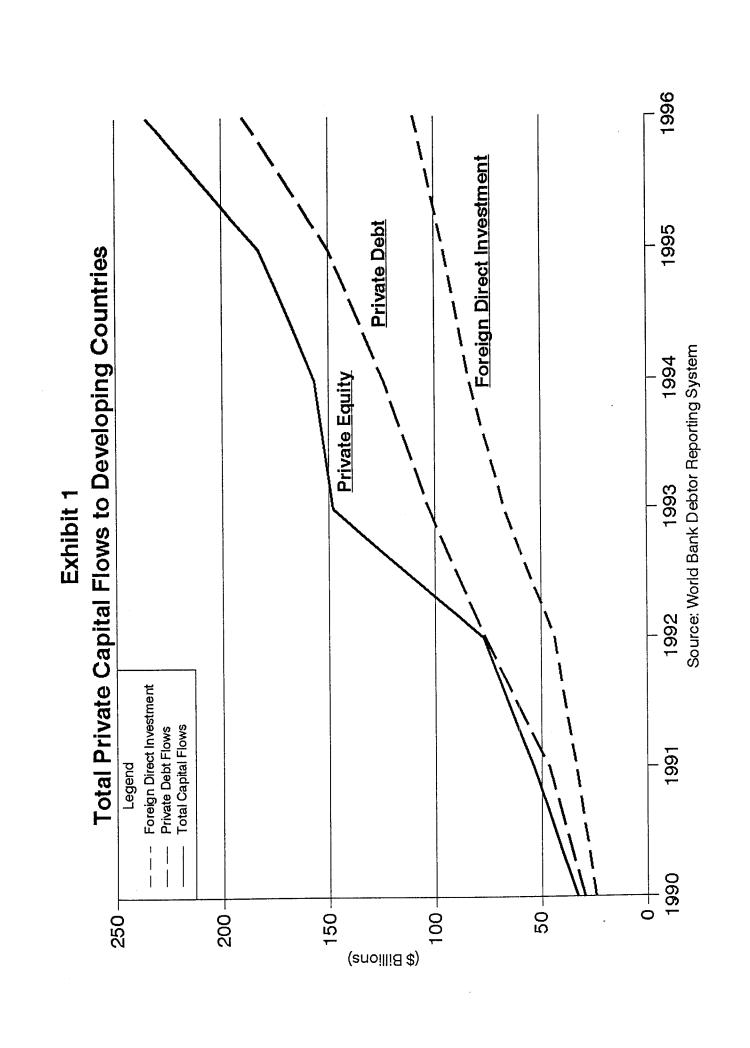
Insert Exhibit 1 (private capital flows to e-m countries)
Insert Exhibit 2 (returns on portfolio of e-m securities 1990-96)
Insert Exhibit 3 (returns from emerging market bonds, 1994-1997)

Emerging Market Investment Cycles

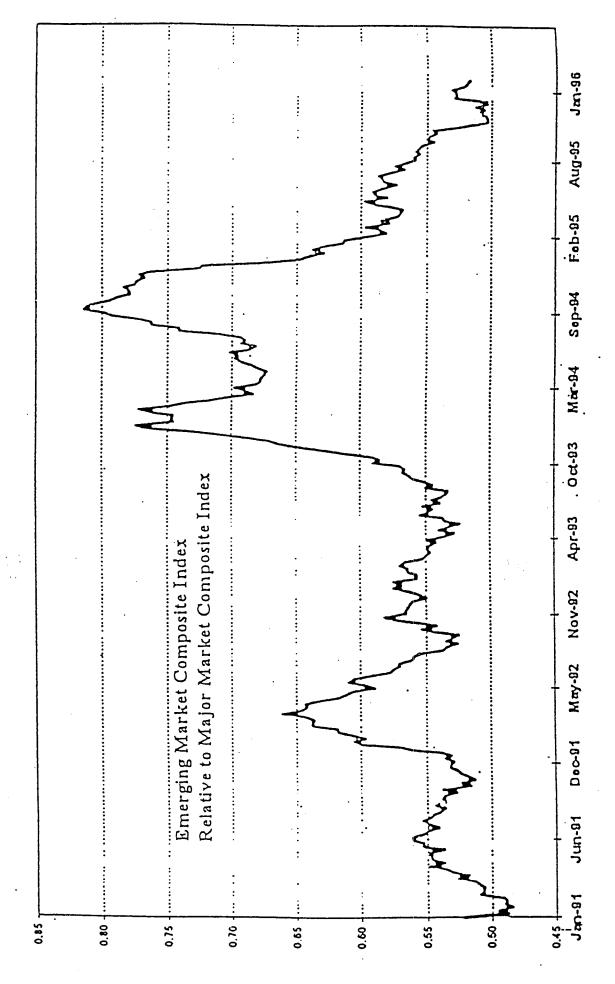
What appears in these patterns is that the basic cycle of investment into emerging market loans and securities seems to have become compressed, and its amplitude accentuated, by factors related not to the conditions in the emerging market countries but to the behavior of the investors themselves. These investors have their own problems—they must compete to attract and retain funds under management by

⁷ Thomas Vogel, "Brazil's Offering of Dollar Denominated Bonds Totaling \$3 billion is Snapped Up by Investors," *The Wall Street Journal*, June 5, 1997.

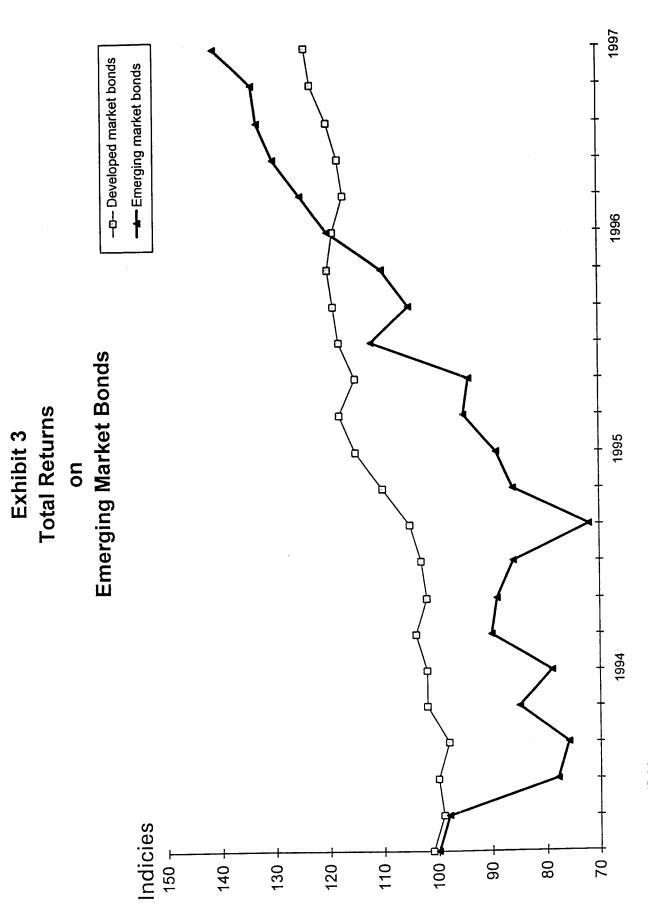
⁸ Thomas Vogel, "Ecuador Woes Rattle Foreign Lenders," *The Wall Street Journal*, February 11, 1997 and Samuel Iskander, "Banks Agree \$275 million Brazil Loan," *The Financial Times*, April 23, 1997.



Comparative Emerging-Market Equity Performance (Jan. 1991 - Feb. 1996) Exhibit 2



Source: Merrill Lynch



Source: JP Morgan

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demonstrating outstanding results in total returns. They are competing with hundreds if not thousands of other fund managers—in the U.S. and Britain there are more investment funds than there are stocks to invest in. All are trying to beat their benchmarks, and yet the vast majority fail to do so. All attempt to increase returns for the same degree of risk by shifting into new and different asset classes. The record shows that adding a modest amount of high-risk/high-return investment to a well-diversified portfolio will, up to a point, serve to enhance risk-adjusted portfolio returns. Emerging market securities are thought to be good examples of high-risk/high-return investments, so portfolio managers seek to include them among their assets in modest quantities.

Invariably, however, investors move in herds. Globally, there were more than \$35 trillion (market value) in stocks and bonds outstanding at the end of 1995, of which in excess of \$22 trillion were funds under management by institutional investors around the world. Given the pressure to perform against their market indices, they must move into whichever asset class seems to be the most promising at the time. As their investments in the chosen asset class accumulate and prices are bid up, expected returns erode. Then, as the sector deteriorates in appeal, they begin to withdraw at the same time in search of the next fashionable sector. This is not the irrational behavior of crowds infected by investment euphoria, but the rational behavior (however volatile) of a large number of institutional investors with huge stakes in the market, each trying to outperform or at least keep up with the others.

⁹ Securities Industry Association, 1996 Fact Book, and Barry Riley, "Growth on a Grand Scale," The Financial Times, April 24, 1997.

Two things make this confluence of investor behavior distressing news to emerging market countries. First is the fact that these investors manage such large asset pools relative to the market capitalization of the emerging financial markets that their relative impact can be enormous. In 1996, as against the \$1.9 trillion aggregate market capitalization of 100 or so emerging stock markets, global institutional fund managers controlled more than \$8 trillion in equity investments alone, of which perhaps as much as \$1 trillion was available for investment in international stocks. A sudden interest in Chile (1996 market capitalization, \$40 billion) or Taiwan (\$54 billion) could result in a huge inflow of capital to the relatively small equity markets in those countries. Equally, a loss of global investor interest in Thailand (\$17 billion) or Poland (\$6 billion) could initiate a sudden market collapse.

Second is the fact that the institutional herd tends to look for new investment areas rather than to revisit former, once discredited, ideas. After the herd has left, it can be much more difficult—because of the trailing disappointment—to re-attract foreign portfolio investment in significant amounts. To some countries (China for example) it must seem that, when the herd is running, the country can attract overseas capital without any effort to improve investment conditions beyond making shares available. But once the boom has subsided, interest in local investments can become extremely difficult to restart.

Understanding Emerging Market Risks

Informed investors generally measure risk in terms of the standard deviation of returns, or volatility, of specific assets or asset-classes in comparison to the

corresponding volatility of a base or market standard such as the S&P 500. So observed volatility over a particular time period should reflect the amount of risk that the investors have actually assumed. The rewards, of course, should be commensurate. But sometimes they are not. For example, the annual volatility of the IFC Composite for the three years ended 1996 was 17.7%; the volatility of Mexican stocks (in dollar terms) for the same period was 23.5%, and for the S&P 500 it was 10.3%.¹⁰ However, the IFC Composite and the Mexican market returns for the three years ended 1996 (-3.4% and -16.0%, respectively) were not at all adequate to cover the higher risk exposure that was associated with them. So one could argue that, in retrospect, these were not at all successful investments in those years. But at the time that the investments were made, the forward-looking, risk-adjusted returns from these same markets based on 1991-1994 data looked very attractive indeed. Obviously, forecasting future returns and the risks by which to adjust them is itself risky business in the case of emerging market securities. So institutional investors buy some of these securities for their portfolios on the basis of their very unpredictability itself, and on the assumption that in the long run the appropriate returns will be realized. In other words, they make the investment and hope for the best.

The risks in emerging market investments, however, are identifiable and to an increasing degree quantifiable in terms of factors other than conventional volatility measures. Thus, selection of investments in particular countries may be possible on a basis that is more likely to succeed than either buying the indexes or in making

¹⁰ Data: International Finance Corporation, Emerging Market Statistics.

random security selections.

In standard capital asset pricing models, the investor looks for a return that represents a risk-free rate plus a premium to account for the particular risk being taken, either a credit risk or market risk. There are three special risks we can identify in emerging market investments: (1) country risk, (2) risks of market imperfections and illiquidity, and (3) correlation risks. These risks apply to all types of exposures —equities, bonds, bank debt and direct investments. By attempting to calibrate these risks, it is possible to obtain useful information affecting investment selections.

Country Risk. This is the risk of macroeconomic underperformance due to policy errors, political intervention or other causes. The investment losses experienced in the Mexican peso crisis of late 1994 was an example of country risk materializing. This risk is within the purview of sovereign credit analysts and is reflected, inter alia, in government debt ratings. Yield differentials for various country debt instruments relative to U.S. Treasuries or LIBOR are observable daily in the market. These differentials may be the best indications of country risk that is available. If Brazilian sovereign debt trades at 330 basis points above a comparable-maturity U.S. treasury security yielding 6.5% (i.e., a Brazil risk-free rate of 9.8%), then that differential represents the return necessary to compensate investors for the Brazilian country risk that has been assumed. There are active markets today for many emerging-market sovereign and other debt issues, covering a range of credit ratings from BBB to B, and these can provide a useful proxy for country risk. Indeed such indicators of country risk are available even for untraded bonds by extrapolation from a table showing rating

vs. risk premium and/or by estimating the probable ratings for an unrated country by using country risk ranking tables or benchmarking against non-investment-grade corporate debt.

Market Imperfections. Emerging market economies are often plagued by substantial financial-market imperfections, such as poorly defined or enforced legal rights of investors, inadequate investment information, poor custody or clearance and settlement arrangements, inefficient secondary markets, as well as corruption and fraudulent trading activities. These imperfections appear to affect equity investments considerably more than they affect debt investments, but for domestic debt traded mainly inside the country, the imperfections can be comparable to the risks experienced by equity investors.

The conventional capital asset pricing model requires the addition to the risk-free rate of a premium to reflect the risks inherent in a particular equity investment. In the United States the equity risk premium today is about 3%, a rate that compensates investors for the economic uncertainties of owning the stock and the imperfections of the market in which it trades. An emerging-market equity risk premium should similarly compensate the investor. One way to calculate the emerging market equity risk premium is to multiply (a) the U.S. equity premium by (b) the ratio of (i) the volatility of the emerging market stock market index to (ii) the volatility of the S&P 500, both defined in terms of standard deviations. But forecasting volatility ratios is always difficult, and perhaps more unreliable in emerging-market situations, especially those which involve substantial market imperfections.

The effect on investors of deficiencies in market structure is to impair liquidity, that is, to interfere with the investors' right to buy or sell securities at a fair market price at any time. Either the interference shows up in the ability to transact at all, or in the ability to transact at fair prices. We know that the market applies a penalty to investments that are illiquid in the form of a price discount, or yield premium. William Silber, among other academic observers, has estimated that the amount of the discount in cases involving equity investments that were restricted from trading, or "locked up," for approximately two years has often been more than 30%. 11 Depending upon the degree of illiquidity that appears to be threatened through market imperfections, one could project a required increase in the expected return to investors that would be equivalent to a discount from 0% to perhaps as much as 40%. Examples of markets with low levels of structural illiquidity might include Chile, Hong Kong and Taiwan, and those with high levels would include Russia, China and Viet Nam.

Correlation Risk. Central to the principal of diversification is that the different investments selected for a portfolio not have returns that are highly correlated with the returns on the rest of the portfolio. Low correlation is as important to asset-allocation as any other factor under the control of the investor. But as discussed earlier, in the aftermath of the Mexican peso crisis, an investor does not know whether investment choices are going to be highly correlated in the future. Not

¹¹ William L. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," *Financial Analysts Journal*, July/August 1991. Silber relates the amount of the discount on the restricted stock sales he studied to how much of the total stock outstanding was restricted and the credit worthiness of the company.

knowing is a risk, one that to some degree can be estimated.

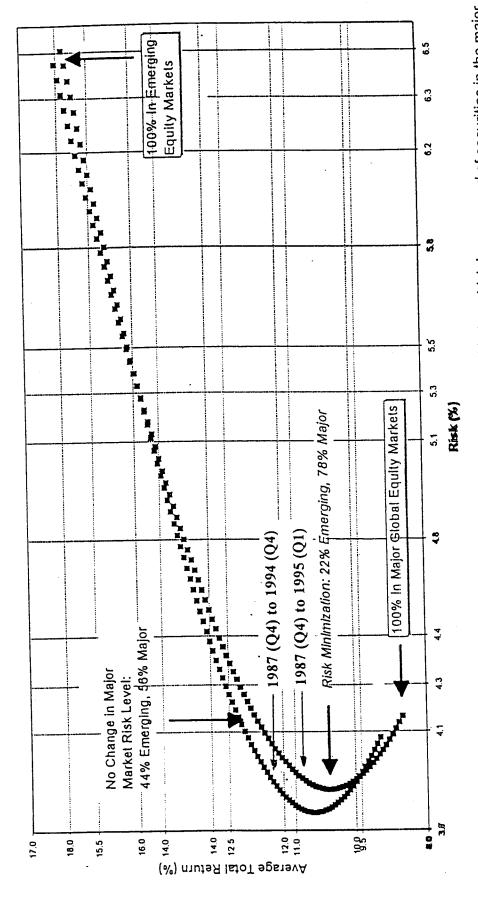
Before the 1994-95 Mexican problem began, an investor seeking an optimum portfolio consisting of major global equity markets and emerging equity markets would have found evidence only of low correlation across the various emerging markets and between them and the major markets. As little as three months later, after the shocks in one emerging market had been transferred to virtually all the others, it was clear that the earlier assumption of low correlation across those markets was erroneous. The efficient frontier was not where it had been thought to be. Indeed the new optimum portfolio required significantly fewer investments in emerging market securities than before. To achieve the same expected return, after taking the correlation spike into account three months after the event, additional risk would have to be accepted in the amount of a higher standard deviation of about 1.0% on a base of approximately 3.9%, or an increase in volatility of nearly 25%. See Exhibit 4.

Insert Exhibit 4 [Efficient Frontier Charts Before and After Peso Crisis)

The experience with the high correlation among emerging market returns following the Mexican Peso crisis may be unusual, but that does not mean that it could not be repeated. As long as large U.S. and European investors are among the most significant traders in these small-capitalization markets, some form of correlation instability must be assumed, and that this distortion could involve an increase in portfolio volatility of as much as 25%—which in the example cited in Exhibit 4 could

Exhibit 4

Investor Gains from Emerging Market Portfolio Allocations 1987 (Q4) to 1995 (Q1) Against 1987 (Q4) to 1994 (Q4)



month total returns. Average return is the annualized total return performance over the designated period. We assume no adjustment markets worldwide, including the US. For emerging markets, we use the US dollar-based IFC Emerging Markets Composite Index, an Our proxy for the major global equity markets is the US dollar-based MSCI World Index which is composed of securities in the major aggregate of activity in emerging markets globally. Risk is defined as absolute volatility using the standard deviation of month-tofor withholding taxes. involve a reduction of risk-adjusted total portfolio return of 0.5% - 0.75%.

But not all emerging market countries were equally affected by the Mexican experience. Many countries with large domestic investor bases, such as Singapore, Hong Kong, Chile and Argentina, suffered far less from the Peso collapse than countries with large foreign investor participation such as Peru, Pakistan, Hungary, the Philippines and China. Moreover, countries which had imposed restrictions on capital inflow to avoid various distortive effects of capital inflows on the domestic economy and money supply, such as Chile, South Africa and South Korea, had less capital to be abruptly pulled out by frightened investors abroad. Correlation risk thus may be reduced by more careful asset selection.

Portfolio Selection

It thus appears that investors can benefit by more careful selection among emerging-market countries. They can do this by estimating the aggregate emerging market risk more carefully, and by converting this risk to minimum returns needed to justify a given portfolio allocation. The expected risk of the investments can be reduced by selecting countries with less imperfect market structures and those which appear to be less exposed to correlation risk. And careful assessment of whether the minimum returns are likely to be reached, based on current asset price comparisons, may also improve investment results.

As an example, assume an investor in late 1996 was considering an investment in a Brazil fund with a five-year time horizon. He hoped to be able to significantly outperform the S&P 500 index because of the emerging market risk that is involved

in the fund. Using the capital asset pricing model, the return needed to balance the Brazil market risk would be 16.2%, comprised of a country risk-free rate of 9.8% (based on a Brazil country risk premium of 3.3%), and an equity risk premium of 6.5% (the US risk premium multiplied by the ratio of the Brazilian market volatility to the S&P 500 volatility). On this basis, a Goldman Sachs study calculated that an equivalent "fair value" price-earnings ratio for Brazil was 11.6x. At the time the Brazilian market was trading at a p/e ratio of 13.4x, or a 15% premium over the risk-adjusted level. The study, which looked at the largest seven markets in Latin America, concluded that whereas some markets, like Brazil, might be overvalued, other markets were up to 15% undervalued based on this particular model. 12

The predicted 16.2% return was derived by taking into account country risk, through the debt premium, and the market imperfection risk, through the equity premium, although the risk premium so determined might be understated as compared to the liquidity-discount approach. The estimated return does not, however, account for the correlation effect, which could add another 3.0% or so of required return. ¹³ On this basis, investors would be looking at an expected return of 20% or more to justify participation in Brazilian equities.

Investors, of course, can shop around. As they become more knowledgeable about emerging market investments they will select some and reject others more on

¹² Jorge O. Mariscal and Emanuel Dura, "The Valuation of Latin American Stocks: Part III," Goldman, Sachs & Co., November 29, 1996.

¹³ To raise the total return on a portfolio 80% invested in the S&P 500 and 20% in a selection of emerging market countries by 0.5% in order to adjust for correlation risk would require the emerging market portion to return an additional 3%.

the basis of careful country and market risk evaluation than before. Consequently, there will have to emerge a greater amount of competition for capital investments on the part of emerging market countries. Indeed, based on recent returns, it is evident that this competition has already begun. High-risk markets like Russia will continue to attract investors with long-shot, "casino" mentalities, but the bulk of the assets to be invested in emerging markets are likely to follow more cautious lines.

Cross-Border Investment and Capital Formation

Countries have plenty of incentives to pursue policies that deal with both the country and market risk elements facing foreign investors. Recent World Bank evidence¹⁴ suggests that the development of local equity markets plays a critical role in the economic growth process:

- Countries that had more-liquid stock markets in 1976 tended to grow much faster over the next 18 years than those which did not.
- High levels of stock market liquidity, measured by the turnover ratio (trading volume divided by market capitalization) tends to be associated with more rapid growth over the same period.
- Countries with high trading-to-volatility ratios likewise tended to grow faster, after controlling for conventional economic, political and policy variables associated with growth differentials for various periods and country samples. Volatility per se does not seem to be related to growth, but rather the ease with which stocks can be traded.
- Stock market development seems to complement—rather than substitute for—bank finance, both of which seem to promote growth independent of each other. Higher levels of development of the banking system are associated with faster growth no matter what the state of development of the stock market,

¹⁴ Ross Levine, "Stock Markets: A Spur to Economic Growth," *Finance and Development,* March 1996. A Summary of twelve papers presented at a World Bank conference on *Stock Markets, Corporate Finance and Economic Growth.*

and vice-versa, for reasons that are not yet well understood. Although most corporate investment in developing countries is financed through bank loans and retained earnings, both (along with the debt-equity ratio) are positively associated with stock market liquidity.

Such findings suggest that international portfolio capital flows may play a substantially more central role in the emerging-market growth process than previously thought. They can contribute disproportionately to market liquidity, especially in the presence of "noise traders" such as open-end mutual funds which *must* buy and sell in response to new client investments and redemptions and maintain portfolio weights. They can force securities prices into line with those prevailing on global markets. The portfolio flows can encourage upgrading of the legal infrastructure, trading systems, clearance and settlement utilities, information disclosure and accounting standards, and custody services. They can improve the process of corporate governance, perhaps in association with significant shareholdings by banks. And they can serve as a bellwether for local portfolio investors, who may find encouragement from a significant foreign presence in the marketplace.

Initiatives by Countries

But many governments have been reluctant to act to improve investment conditions in their capital markets. The "Big Bang" market reforms have been extremely slow in coming to most emerging-market countries, and when they have come they have often been gradual, irregular and often ineffective. On one hand, in may be that policy-making officials do not fully appreciate, relative to other matters of concern to them, the importance of financial market reform and re-regulation. On

the other hand, there may be a reluctance to change rules that have permitted powerful local insiders to amass great fortunes. However, as investors become more aware of the special risks of investing in emerging market securities they are likely to be more selective and choose countries that provide a higher-quality market environment. Market forces, in other words, will ultimately compel those countries seeking foreign capital to conform to world standards. There appear to be considerable advantages in being among the earliest converts to so conform. Some of the initiatives that can be taken by governments to do so are the following:

Sound macroeconomic policies. Providing an economic environment that holds out adequate prospects of good, long-term, risk-adjusted returns is a big job that includes many changes and reforms, and one that should by no means be shrugged-off with the notion that legislation is planned to take care of this or that. Investors care about what actually happens, not whether legislative bills are passed or not.

Reforms must begin with the basics: strong macroeconomic and structural policies that transform the country's economic system from the centralized, socialistic, import-substituting, foreign aid-dependent models of the past to the new "consensus" model of the open-market, low inflation, deregulated, private-sector oriented economy of the future. Many countries have moved in this direction in the past few years, notably several in Latin America and Eastern Europe, but much remains to be done. Privatization, the elimination of government subsidies and the removal of restrictions on foreign investment have been powerful tools to jump-start the transition. Once market forces begin to take hold and shape events, a great deal of progress can be observed.

Progress breeds an appetite for further progress. Progress in increased

transparency of government economic policies and market transactions, and increased toughness in dealing with failed institutions, especially financial institutions used to finance and prop-up inefficient state-owned enterprises in the past. Such levels of toughness, however, can be politically expensive, especially as they often result initially in high unemployment, as many countries have already experienced. Backsliding is an expected outcome when this occurs, and some amount of it may be tolerated for brief periods, but the long term requirement for the institutionalization of free market practices must have greater priority. No doubt, much of the separation of emerging market countries in the future into investment winners and losers will be determined by the degree of success experienced in making the free-market conversion and sticking to it.

Building financial infrastructure. Governments that want to attract international portfolio investment must be clear about the importance of creating some basic preconditions for viable capital markets—an obvious point honored as much in the breach as in practice. Fundamental is a functional financial system that embraces a viable banking industry, insurance and securities industries, pension and mutual funds. Banks in many emerging market countries are all too often large, subsidized bureaucratic institutions that possess few skills in finance and sometimes drive customers to transact in parallel (unofficial) markets. Many are loaded-down with nonperforming loans from state-owned enterprises or large domestic corporate combines deemed "too big to fail."

The worst of this debt ultimately will have to be separated from the banking

¹⁵ Ingo Walter, "Cross-Border Equity Flows: Tapping Into Global Markets," *ASEAN Economic Journal*, October 1993.

system and put into "bad banks," from which future recoveries might someday be paid. The "bad bank" in such a country, possibly a subsidiary of the central bank, can "purchase" impaired loans from commercial banks using government bonds. Thus recapitalized and solvent, banks can begin again to develop a viable lending business. Banks in some developing countries should be encouraged to develop close relationships with particular companies to improve information flows and monitoring their progress. ¹⁶

Countries also need to enact sensible securities laws in order to provide regulatory and enforcement authority against market fraud and other abuses—many emerging-market countries have done this in recent years, so that ample precedents are available—rules which should address the principles of fiduciary responsibility, full disclosure, fair markets, surveillance and enforcement, and require that minimum standards for training and certification of fiduciaries and intermediaries be met. This involves providing a central market place, a trading system that includes rules for price disclosure and settlements, and rules providing for the fitness and capitalization of securities firms dealing with the public.

The role of banks in the securities industry must also be determined, as well as the extent to which the participation of qualified foreign firms is to be permitted. Foreign securities firms (often through joint ventures) can contribute considerably to the training of employees and management of local firms, and to the general professionalism and efficiency of national financial systems. Some developing

¹⁶ Roy C. Smith and Ingo Walter, "Bank-Industry Linkages: Models for Eastern European Economic Restructuring," in Christian de Boissieu (Ed.), *The New Europe: Evolving Economic and Financial Systems in East and West* (Amsterdam: Kluwer, 1993); Ingo Walter, *The Battle of the Systems: Control of Enterprises in the Global Economy* (Kiel: Institut für Weltwirtschaft, 1993).

countries have also created short-term markets in government securities and commercial paper—in tandem with banking activities—as a competitive alternative borrowers and depositors. Countries like Korea, the Philippines and Colombia have had domestic commercial paper markets in operation for twenty years or more, while Poland has recently created one.

Overhauling corporations. Governments must also attach priority to making corporations fit for public ownership, which requires common financial accounting and auditing standards, a company law, and protection against exploitive concentrations of voting power by insiders. The largest source of shares in many countries will inevitably come from the privatization of state-owned enterprises intended to end such firms' operating inefficiencies, raise capital for the government, develop a public shareholder base, and establish a growing, profitable, market-oriented private sector. Some, especially in Latin America and Asia, have enjoyed great success with privatization programs, and have used the strong markets of the early 1990s to float as many issues as possible. Others, such as Russia and the former Czechoslovakia, rushed-through privatization programs in the interest of quick reform, but on a basis that may ultimately prove to be self-defeating. None of the foregoing conditions for public ownership were in place, few of the enterprises were economically viable in their own right-or depended on continued government subsidies or public procurement to continue in business-management was not substantially improved, and the process of ownership-distribution through vouchers was rife with fraud, corruption and racketeering. It is difficult to see how ordinary citizens will benefit from such privatization efforts if left with worthless shares while the valuable ones fall into the hands of the well-connected or corrupt.

Absent basic conditions for viable public ownership, governments should consider privatization through the sale of assets to corporate buyers, perhaps mostly foreign, who can inject new capital, knowhow and management, and contribute to the process of rebuilding the companies. Although there may be some political reasons to restrict foreign direct investment in developing economies, there are no good economic ones. Few sources of economic growth are more assured and quick-acting than direct investment by knowledgeable foreign corporations seeking long-term market opportunities.

The role of capital controls. Governments might consider certain techniques of limiting the form of portfolio investment inflows—a recommendation that goes against the grain of the Washington Consensus. Although at the end of 1995 all emerging equity markets combined represented only about 13% of global stock market capitalization, the effect of portfolio equity inflows on many countries has often been a glut of foreign exchange and liquidity, which can have severely adverse effects. Principal among these is inflationary pressure—caused by a sudden, substantial increase in the money supply-and appreciation of real exchange rates. Imports in some countries subjected to such inflows consequently increased, exports declined, so trade balances deteriorated and had to be financed by foreign borrowing. Some governments, such as Chile, South Africa and several Asian countries, have limited portfolio capital inflows in various ways to avoid the problem of excess liquidity and to maintain a competitive exchange rate. In Chile, such controls in effect seek to increase the cost of investment by imposing reserve requirements on loans, stamp taxes on securities transactions, and widening the bands within which the currency can fluctuate. Of the countries which experienced increased equity market prices in 1994, as against emerging market trends at the time, most maintained restrictions on capital inflows. Without such controls, the impact of massive portfolio flows is hard to counteract.

Interestingly, a 1997 report by the World Bank suggested that massive short-term capital inflows can trigger domestic inflation and real appreciation of exchange rates, as well as declining lending and investment standards, in emerging-market countries, with massive subsequent shocks possible if the is a reversal of investor sentiment.¹⁷ The analysis concludes—the Bank's strong advocacy of free-market economic policies notwithstanding—that capital-inflow controls can be useful techniques under appropriate circumstances in fostering macroeconomic stability, long-term capital formation and economic growth. Its recommendations are nevertheless heavily qualified in order to preempt justification of a reversion to traditional, highly distortive uses of cross-border capital controls.

As noted earlier, it may also be worth considering whether foreign portfolio equity investments via mutual funds should be tapped using closed-end rather than open-end funds. In closed-end funds, the shock of investor-demand shifts is taken by secondary-market prices of the funds in the *developed-country* stock markets rather than by massive, destabilizing, cross-border financial flows.

Where Next?

Perhaps few emerging market countries have the economic capacity or the political will to adopt far-reaching free-market policies all at once. Who does? Gradual

¹⁷ Amar Bhattacharya et al., *Private Capital Flows to Developing Countries* (Washington, D.C.: World Bank, 1997).

but steady approaches do work, however, perhaps best of all. Successfully rebuilt, former developing countries like Japan, Germany, South Korea, Taiwan, Singapore, Spain, Chile at no point adopted a totally free-market approach. They moved purposefully over decades in that direction, but only at a pace that could be accommodated by the accompanying political thinking and infrastructure-building. Other countries that have tried hard to accept the new policies (Mexico, Argentina, Brazil, perhaps India) have had considerable success despite some disappointments. They need more time for their efforts to bear the fruit that their more successful peers have enjoyed, and so far it appears there are few signs of a reversion to the pre-Washington Consensus era in any of these countries. The most powerful part of the new paradigm, however, is that countries must know that it all depends on them. A consistent barometer of their efforts, flawed as it may be from time to time, is in the capital they are able to attract.