EMERGING STOCK MARKETS AFTER THE CRISIS

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Contents

Introduction 7

1. Reassessing risk after the crisis 9
- 1.1 The impact of the crisis 9
- 1.2 Why were the crises not foreseen 14
- 1.3 Reassessing the risks of emerging markets 20

2. The rise in investment in emerging markets 25
- 2.1 The ebb and flow of capital 25
- 2.2 Why the enthusiasm for emerging markets? 28
- 2.3 The case for investing in emerging markets 29
- 2.4 A profile of emerging stockmarkets 33
- 2.5 The impact of emerging stocks investment on countries 38

3. Emerging markets long run performance 41

4. Matching market performance with economic performance 43
- 4.1 GDP growth and stock market performance 43
- 4.2 What makes for good economic perfomance? 47
- 4.3 International influences on emerging markets 50

5. The outlook for emerging markets 55
- 5.1 East Asia 55
- 5.2 Latin America 59
- 5.3 Emerging Europe, Middle East and Africa 63

6. Summary and conclusions 66

7. References 69

8. Appendix 1 70

9. Appendix 2 75

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EMERGING STOCK MARKETS AFTER THE CRISIS

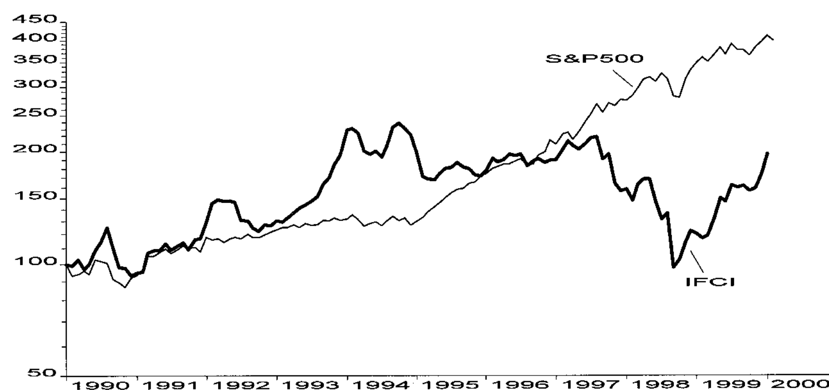
Introduction

In the 1980s and first part of the 1990s emerging markets were widely seen as the most exciting and promising area for investment. Individual country markets were recognised as volatile and risky but nevertheless, (or even partly because of this volatility), were expected to generate strong investment returns. This expectation was based both on a theoretical view that emerging markets ought to outperform since they were the dynamic economies and the welcome fact that they did outperform for much of the late1980s and early 1990s.

More and more brokers and fund managers, were drawn in, especially in the early 1990s. Pension managers were naturally cautious but nevertheless began to allocate a small percentage of their investment funds (typically around 1-2%) to emerging markets managers. Brokers were less cautious and rapidly built up large offices of analysts around the world, to help service these fund managers.

New areas of investment opened up as more and more countries liberalised access to their markets, both for domestic and foreign investors. With the fall of the Berlin wall in 1989, not only did a large new group of countries become available for investment but the risk of a radical Socialist government in an emerging country, supported by the old Soviet Union, seemed to vanish.

Chart 1: Emerging Stocks versus S&P500



In 1997 and 1998 enthusiasm turned to disillusion and pessimism. Stock markets crashed in nearly all emerging economies, starting in Asia and spreading to Latin America and parts of eastern Europe. Between August 1997 and September 1998 the IFCI index fell a massive 55%. Part of the poor performance was directly due to the huge falls in many exchange rates starting with the Thai devaluation on July 2nd 1997, the date conventionally taken as the start of the Asia crisis. Although currencies eventually recovered a long way from their lows, most still finished at 20-40% below previous levels. But stocks also fell dramatically in local currency terms due to the deep recessions and financial crises which ensued.

This study considers the prospects for emerging market stocks in the wake of the crisis. The first chapter looks at how investors are now reassessing risk after the crisis, surveying the market declines, and looking at why the crisis was not foreseen. Chapter two looks at the rise of emerging markets as an asset class over the last ten to twenty years and profiles the overall market. Chapter three looks at the long run performance of emerging markets as an asset class. Chapter four investigates the relationship between market performance and economic performance. Chapter five looks at the outlook for the major regions. Chapter 6 concludes.

This paper grew out of research into emerging stock markets over the last 15 years by the team at American Express Bank. The authors are grateful to Tapan Datta and Morton Balling for detailed and helpful comments and suggestions. Any remaining errors are of course the responsibility of the authors.

A note on the data

There is no single accepted benchmark for emerging stock market data though the MSCI indices have become the most widely used. Three are widely available: the IFC indices which started in 1985, Morgan Stanley Capital International Indices, starting in 1988, and ING Baring indices, starting in 1992. We use the IFC indices because of the longer run of historical data. The IFC publishes a Global index (IFCG) and an Investible index (IFCI), the latter confined to stocks where there is sufficient liquidity and availability for foreign investors. However, different indices give widely varying results due to differences in weighting and coverage. For example, the IFC builds its indices from companies with the greatest market capitalisation, MSCI stresses industry representation and Barings focuses on liquidity (Masters, 1998: 93).

Individual indices can also be relatively unstable over time because of large changes in composition as countries come and go. For example in 1995 the addition of South Africa to the IFCI index took its weight from 0% to 25% overnight and other countries were reduced accordingly (Masters, 1998: 97). Similarly the effective closure of the Malaysian market in 1998 had a dramatic effect on indices.

Despite these problems most fund managers do compare themselves with particular indices and there is no way of looking at the sector as a whole without using indices. The IFCI is clearly preferable to the IFCG for most purposes but data go back only to 1988. At the beginning of 2000 publication of the IFC indices was taken over by Standard and Poors.

This study includes Hong Kong and Singapore, though strictly speaking they are already outside the emerging market universe. We prefer to include them, however, because so many of the companies on the Hong Kong and Singapore exchanges are directly involved with emerging markets.

CHAPTER 1 Reassessing risk after the crisis

1.1 The impact of the crisis

The Asian crisis was a major shock and a severe blow to investors in emerging markets. Not only were there excruciating losses on investments, (see table below), but belief in both the Asian economic model and the attractions of emerging markets were called into question. Many investors had come to believe that rapid and relatively steady economic growth in the region was the norm and foresaw only mild market setbacks. Meanwhile the US economy and stock market performed staggeringly well through the period. Many investors turned away from emerging markets. Others began to ask whether a better way to access the economic growth potential of emerging markets might be to buy the shares of multinational companies with substantial operations in emerging markets, rather than buying local company stocks.

For the countries affected, the crisis was broad-based, affecting virtually the whole economy and financial system, bringing dramatic falls in asset prices and dominating the political scene. In the three worst-hit countries, Korea, Thailand and Indonesia, output dropped between 6-14%, the most severe contractions for almost 40 years. The economies least affected by the financial turmoil, Singapore, Taiwan and China, experienced a period of uncharacteristically low growth, whilst the cost of successfully defending Hong Kong's dollar peg was a sharp contraction in GDP. The crisis had its most severe impact on domestic demand, which collapsed in most countries. Investment plummeted in the face of excess capacity and as companies tried to rebuild balance sheets made unsustainable by high debt burdens. Consumers also cut back spending as unemployment rose and asset prices fell. In some cases car sales fell by 70-80% year-on-year.

Table 1: Changes in GDP in emerging countries
Real GDP, % pa

	1991-96	1997	1998	1999e
ASIA				
Indonesia	7.3	4.9	-13.7	0.2
Korea	7.4	5.0	-5.8	10.0
Thailand	7.9	-1.3	-8.0	4.0
China	11.6	8.8	7.8	7.1
Hong Kong	5.2	5.3	-5.1	1.8
India	5.5	5.1	6.0	6.3
Malaysia	8.6	7.8	-6.7	4.5
Philippines	2.8	5.1	-0.5	3.2
Singapore	8.3	8.0	0.3	5.6
Taiwan	6.5	6.8	4.8	5.7
LATIN AMERICA				
Brazil	3.8	3.6	0.2	0.8
Argentina	5.7	8.6	4.2	-3.0
Chile	8.5	7.6	3.4	0.0
Colombia	4.2	3.0	0.6	-2.0
Mexico	2.1	7.0	3.0	3.6

Peru	5.1	7.2	0.7	3.0
Venezuela	2.8	5.9	-0.7	-5.0
EUROPE/AFRICA				
Russia	-8.2	0.8	-4.6	2.0
Czech Republic	-0.3	1.0	-2.3	-0.5
Hungary	-1.8	4.6	5.1	4.3
Poland	2.8	6.9	4.8	4.1
South Africa	1.2	1.7	0.1	0.9

Source: IMF and national estimates

The sharp adjustments taking place on the domestic side showed through most vividly on the external accounts. Exports fell, due to the drop in trade financing, lower intra-regional trade, weak commodity prices and the squeeze on the price of manufactured goods caused by excess capacity. However, imports collapsed leading to large current account surpluses in countries where previously there had been sizeable external account deficits.

Recessions and the accompanying collapse of the asset price bubbles in the equity and property market led to the drying-up of credit to the private sector during the course of 1998 and into 1999. Credit collapsed most severely in Indonesia, Thailand and the Philippines, but also fell in Hong Kong and Korea. In many countries the scale of the devastation in the financial sector was severe, with the government forced to close or take over many finance companies and banks.

Market performance

The Thai stock market had been falling for over a year before the July 2nd devaluation and was already down more than 70% before the devaluation. Most other markets had been moving sideways in the year prior, while a few, including Indonesia and Hong Kong had a strong performance in the first half of 1997. But the declines between July 1997 and the lows of October 1998 (after the Russian crisis) were devastating, especially when measured in dollar terms.

Chart 1: Thailand: IFC Investable Index

Throughout the second half of 1997 and 1998 emerging markets were under pressure. Contagion effects threatened to cause a currency slide in Hong Kong and China, and attention also focussed on other countries where fixed exchange rates and weak financing positions might cause problems. The crisis reached its peak with the Russian devaluation and default in August 1998. This triggered a major retreat from risk positions among banks and hedge funds which saw risk spreads widen out dramatically across markets generally. There followed the bail-out of LTCM (a prominent hedge fund) in August 1998 and a subsequent 75 basis point cut in Federal funds rate to calm the financial markets' nerves. Brazil's devaluation in early 1999 was seen as the final global event in the crisis, though its impact proved less serious than expected.

Table 2: Equity markets in the crisis
Equity prices, End 1996 = 100, USD terms

	End 1997	**End 1998**	**End 1999**	**1990s peak**	**End 1999, % of '90s peak**
ASIA					
Indonesia	26	19	37	Jan-97	34
Korea	31	69	142	Oct-94	70
Thailand	21	29	41	Dec-93	19
China	75	36	72	Dec-93	35
Hong Kong	80	75	125	Dec-99	100
India	106	81	148	Sep-94	81
Malaysia	27	26	38	Feb-97	35
Philippines	38	42	42	Dec-93	36
Singapore	63	59	105	Feb-97	97
Taiwan	92	76	116	Jul-97	87
LATIN AMERICA					
Brazil	122	69	116	Jul-97	71
Argentina	117	84	112	Oct-97	85
Chile	104	73	99	Jun-95	66
Colombia	130	69	56	Mar-94	36
Mexico	149	91	162	Jan-94	78
Peru	113	68	82	May-97	60
Venezuela	80	62	55	Jan-92	30
EUROPE/AFRICA					
Russia*	145	23	90	Oct-97	43
Czech Republic	78	72	75	Jan-94	32
Hungary	160	143	164	Apr-98	89
Poland	81	72	87	Mar-94	50
South Africa	86	60	94	Jan-96	68

**03/02/1997 = 100*
Source: IMF

The Russian crisis
The Russian stock market was the best performing emerging market during 1997, with the RTS index rising from 372 at the end of 1996 to a peak of 1035 on 5th October. There was a perception that policy was on the right track and that Russian assets had been

undervalued. But, starting in the last quarter of 1997, confidence dwindled and foreign capital inflows weakened. Investors were influenced partly by the problems in Korea and Indonesia and partly by domestic policy weakness. In 1998 an adjustment programme designed to boost government revenues faced strong parliamentary opposition and in mid-year an IMF agreement failed to boost investor confidence. In August 1998 with domestic and external financing problems increasing, the authorities abandoned the rouble's exchange rate band, restructured domestic debt and announced a 90-day moratorium on foreign debt repayments.

By the end of 1998 the Russian stock market was worth only 23% of its end 1996 levels in dollar terms and less than 10% of its mid-1998 peak. Real GDP and inflation went in opposite directions with the economy contracting by 4.6% in 1998, whilst inflation soared to around 100% by early 1999. In 1999 Russia avoided the further economic disasters many had predicted at the beginning of the year and the stock market recovered to its end-1996 levels. But the fundamental structural problems which were at the core of the crisis- weak free market institutions, poor corporate governance, weak public finances and a poor banking system- still had to be addressed.

Chart 2: Russia: IFC Investable Index

The Russian crisis had a significant impact on financial markets elsewhere in Eastern Europe, but the effects were relatively short-lived. As the region's most developed and liquid capital market, Hungary suffered the most in the immediate impact of the crisis, but its equity market stabilised in 1999. Equity declines were less dramatic elsewhere mainly because foreign participation in the Polish market had always been small, and foreigners had already reduced their exposure in the Czech Republic well before the emerging market crises of 1997-98.

The Brazil crisis

The final leg of the emerging market crisis was in Latin America. Several currencies were forced to devalue sharply in 1999 including the Ecuadorian sucre and the Chilean and Colombian pesos but the key devaluation was Brazil's floating of the real. Just as in Russia, the government tried to defend an exchange rate, this time a crawling peg, despite very high domestic interest rates and large internal and external debt. IMF support was

forthcoming and for several months it looked as though the authorities might succeed. But, again as in Russia, the failure to move rapidly to reduce the fiscal deficit, due to the limited power of the Federal government, eventually wrecked the defence of the exchange rate. The real was floated on January 15th 1999 after a failed attempt at a limited devaluation two days earlier.

Chart 3: Brazil: IFC Investable Index

Brazilian stocks had lost half their value in the six months leading up to the float but then recovered sharply in local currency terms, though continuing to lag in dollar terms. However the overall impact of the Brazil crisis was much less than had been feared and, in a sense, marked the end of the emerging markets crisis as a global event. The real stabilised within three months, inflation stayed low and interest rates came down quickly. The recession proved relatively mild, with growth resuming by the middle of 1999. Following the devaluation the stock market quickly picked up in local currency terms and by end 1999 was at higher levels than before the crisis in dollar terms, though still well below its 1997 highs. The consequences of devaluation were not so bad in Brazil's case for four reasons.

1. *The private sector was in good shape*. Brazil's crisis was a public sector crisis rather than a private sector crisis. Compared to Asia's crisis economies, and Mexico in 1995, the Brazilian banking system was strong and, given the long build-up to the devaluation, most companies had already hedged their foreign currency exposure. The economic slowdown and devaluation undoubtedly caused severe problems for the Brazilian private sector, but there was no repeat of the credit crunches and systemic corporate sector distress which made Asia's recession so severe.

2. *Monetary policy was kept tight*. A revamped monetary policy regime, under new Central Bank Governor Fraga, was quickly put in place and interest rates were initially increased very sharply. The hike could not be sustained for long without destabilising the government's fiscal accounts, but was essential to bolster confidence and stabilize the real. The strategy worked, and exchange rate stability was restored more quickly than in Asia.

3. *IMF support was already in place*. Brazil still had substantial foreign reserves when it devalued and already had an IMF-led financial support package in place. The package had to be renegotiated, but this was easier than starting from scratch. As a result, a new policy framework was in place much more quickly than was the case in Mexico in 1995, and Asia in 1997-98, bolstering confidence and helping the real quickly to stabilize.

4. *The regional contagion was limited*. Countries in Latin America export different items, with commodities particularly important. This is very different to Asia where many countries export a similar mix of price-sensitive manufactured goods. Therefore, Brazil's devaluation did not produce the leapfrog devaluations which prolonged the crisis in Asia.

1.2 Why were the crises not foreseen

Many investors did expect a Brazilian crisis. Some foresaw a Russian crisis, though others were shocked by the Russian default. However virtually all investors were taken by surprise by the Asian crisis. Even those who realised that Thailand was in deep trouble prior to July 1997 did not anticipate the virulent contagion effect to the rest of the region. With the benefit of hindsight we can see a number of reasons why the Asian crisis was not foreseen.

First, many investors were complacent because they believed that the lack of a fiscal problem in Asia meant that crises would be avoided. This may be a case of short memories. The Chilean crisis of the early 1980s was caused by a private sector deficit, not a public deficit, while many of the problems in European countries at the end of the 1980's were due to private sector booms and overlending rather than government imbalances.

Secondly, the successful rescue of Mexico in 1994-5 may have led to the view that emerging country crises could be contained by swift IMF action. The unprecedented size and speed of the rescue package and the relatively quick turn-around in Mexico encouraged the view that there was little to be feared. This view may have glossed over the very deep economic and political crisis that Mexico did suffer at that time. It also did not allow for the devastation in the private sector in countries where bank financing, measured as a share of GDP, was much more pervasive than in Mexico.

Thirdly, the extent of the build-up of short term debt was not fully understood. Short term debt data for Thailand were available from the Bank for International Settlements as well as the central bank and the issue was well aired in 1995-6. Short term debt in Indonesia was less well noted since much was in the form of short term corporate paper and was only issued during 1997, too late to be included in BIS data before the crisis.

Fourthly, the extent of financial fragility was not fully appreciated. In some countries, for example Indonesia, the problems of government banks' weak loan portfolios had been known for a very long time. In others, for example Thailand, the proliferation of finance companies should have been a warning signal. But of course problem loans ballooned in the second half of 1997 and 1998 with the rise in interest rates and slump in the economy and asset prices.

Finally, and perhaps most importantly, investors were dazzled by the 'Asian miracle'. Growth had been so strong for so long that both local and foreign investors had come to

believe that it would go on for ever. Some slowdown might be expected from time to time but not a major crisis.

Thailand's leading role

Thailand had maintained a quasi-fixed exchange rate at around 25.5 baht per dollar from 1987 onwards. Also starting in 1987 Thailand experienced very high GDP growth rates, averaging 11.6% p.a. from 1987-90 and then subsiding to a still impressive 8-9% growth rate during 1991-5. This rate of growth came to be seen as a sustainable long-run rate so that the emerging bubble in the property sector was not fully recognised. Inflation remained at an acceptable 5% or so, but clear signs of overheating emerged in the economy during 1994-5 when the current account deficit doubled to reach over 8% of GDP.

Recognising the overheating problem, interest rates were raised to slow the economy. However this encouraged a further capital inflow, mainly through increased borrowing. With domestic lending rates at over 13% there was a strong incentive for companies to finance with dollar loans. Total debt rose from $43.6 billion in 1992 to $82.6 billion in 1995 but, crucially, short term debt surged from $18.9 billion to $41.1 billion over the same period. The problem of short term debt was widely recognised in Thailand (unlike Indonesia) and the government took action to stabilise it, but the level remained high.

Eventually higher interest rates combined with weaker exports, largely triggered by a down-turn in the electronics cycle (which affected the whole region), brought an economic slowdown. Investment started to decline as signs of overcapacity emerged. Then, with the current account deficit remaining large but interest rates falling, doubts over the sustainability of the exchange rate began to mount. There were several speculative attacks on the baht in the spring of 1997, which the central bank seemed to be able to fend off with only a small reduction in FX reserves. Indeed the baht actually appreciated in June as the central bank attempted to squeeze the speculators. But, unknown to everybody except the central bank, reserves were effectively down to zero by mid-year because of forward transactions.

Once the central bank left the market the baht abruptly depreciated by about 15% then continued to slide for the rest of the year reaching a low of 55.5/US$ in early January 1998, slightly more than a 50% overall depreciation. Foreign bank lenders tried to reduce lines, though they were restrained by the IMF and G7 governments. Local borrowers moved to hedge their positions. The baht came back to around the 38-40 level in late March 1998 and stabilised not far from that level, but the damage had been done. The combination of higher domestic interest rates to try to stabilise the baht, a fiscal contraction recommended by the IMF and a collapse of business and consumer confidence sent the economy into a severe recession. GDP fell 8% in 1998.

How far structural factors were to blame remains controversial. Inadequate regulation and supervision of the banking sector was perhaps the most significant structural weakness. The introduction of offshore international banking facilities (IBFs) in 1992 had allowed a sharp run-up in short term debt, though this problem started to be addressed well before the crisis. Also the authorities permitted a proliferation of finance companies, which helped to finance the property boom, and did little to restrain them. Linked to this was the so-called 'crony capitalism' where business owners, bankers and government ministers cooperated closely to ensure the flow of licences and lending, though this issue was of greater importance in Indonesia and Malaysia than in Thailand. Finally, exchange

rate targetting was certainly one of the main causes of the crisis and this must be regarded as a structural factor.

Contagion to the rest of Asia

The spread to the rest of the region took place through two main channels. First, investors looked for other countries in the same situation as Thailand, ie with a large current account deficit, a fixed exchange rate, substantial short term debt, weak banks and a slowing economy. Since business and consumer confidence quickly weakened everywhere, this combination soon applied to most countries in the region. Secondly, there was a view that, since Thailand competed with many countries in the region, other currencies would need to depreciate simply to maintain trade competitiveness.

Table 3: Exchange rate per USD
End 1996 = 100

	End 1997	**End 1998**	**End 1999**
ASIA			
Indonesia	51	30	33
Korea	50	70	75
Thailand	54	70	68
China	100	100	100
Hong Kong	100	100	100
India	91	85	82
Malaysia	65	67	67
Philippines	66	67	65
Singapore	84	84	84
Taiwan	84	85	88
LATIN AMERICA			
Brazil	93	86	58
Argentina	100	100	100
Chile	97	90	80
Colombia	78	67	54
Mexico	97	80	83
Peru	95	83	74
Venezuela	94	85	73
EUROPE/AFRICA			
Russia	93	27	20
Czech Republic	79	91	76
Hungary	81	75	64
Poland	82	82	69
South Africa	96	80	76

Source: IMF

The two other countries with the largest short term debt problem, Korea and Indonesia, gradually followed Thailand into severe difficulties. Banks tried to withdraw short term lines, local borrowers tried to hedge their dollar loans and speculators took aim. Reserves eroded and attempts to control the fall in exchange rates with higher interest rates failed when political pressures became too great. Korea's elections took place in December

1997 but the crisis intensified during the weeks just before, in a climate of policy uncertainty. Indonesians turned on President Suharto when the crisis erupted and there followed a drawn-out succession crisis, during which economic policy-making suffered. A key turning point in Indonesia was the decision to close several banks at the IMF's instigation, which triggered a run on other banks, as Indonesians questioned whether the government would, or indeed could, guarantee deposits.

Malaysia suffered significantly too. Although it did not have the short term debt problem of the others, it did have a huge property overbuild and subtantial excess capacity. Taiwan allowed its currency to slip in October 1997 despite huge FX reserves, mainly because it wanted to remain competitive. But this put pressure on the Hong Kong dollar because investors reasoned that, if Taiwan could devalue, then Hong Kong might too. The Hong Kong authorities decided not to devalue but the high interest rates needed to defend the currency triggered a major fall in stock and property prices which brought on a major recession. In the absence of devaluation the result was price deflation, worsening the downturn. The Philippines had not enjoyed the 1990s boom like most of the other countries and correspondingly suffered less. Nevertheless the peso declined and the economy suffered a mild recession.

The Russian crisis

Fiscal problems lay at the heart of the Russian crisis, combined with political upheaval and capital flight. Perhaps the reason why some investors were surprised by the crisis was that they persistented in the expectation that the Russian government would do enough to satisfy the IMF and that the IMF could not 'give up' on Russia. This is a recurrent pattern in crises. Investors are well paid (in the form of interest differentials) to take the risk that governments will fail in 'last-ditch' crisis management and so are often willing to do so. It was the shock of the failure of that high risk calculation which led to the reassessment of a variety of risks around the world in the summer of 1998 and the consequent problems for Long Term Capital Management.

The Russian fiscal deficit was financed primarily by short-term domestic debt, which rose to some 14% of GDP in 1997. The 1996 liberalisation of the financial markets for foreign participation, combined with high interest rates and a stable exchange rate policy made Russian T-bills (GKOs) attractive to foreign investors. At the same time, Russian banks were borrowing abroad to finance their investment in GKOs (and later, in the Russian stock market). Interest rates on state bonds fell dramatically as foreigners' holdings of GKOs reached $19bn at the end of October 1997, more than the level of FX reserves at that time. By the summer of 1997, Russian banks were turning their attention to the stock market because returns on domestic T-bills were slowing.

The stock market saw the first collapse of several in the last week in October 1997 as the Asian crisis intensified and political conflicts in the Russian government worsened. Pressure began to build on the rouble in the final quarter of 1997 and first half of 1998 as foreign investors, anxious about high short term debt, poor government revenues and weakening current account receipts began to sell GKOs and capital flowed out of the country. FX reserves fell from a peak of $20.4bn in June 1997 to $10.5bn at end-January 1998, and interest rates jumped. The servicing burden of domestic debt started to rise as a result of higher borrowing costs, while the sharp fall in oil prices cut budget revenues, and planned privatisations failed to deliver required receipts. Political conflicts in the government worsened with the sacking of the Chernomyrdin government and the appointment of the virtually unknown Sergei Kiryenko as Prime Minister in April 1998.

In the background, capital flight was accelerating: net resident capital outflows were around $42bn in 1997, equivalent to 9% of GDP, but the effect on reserves was masked by large non-resident capital inflows until the final quarter of 1997. The current account surplus shrank to 0.8% of GDP in 1997 as a result of falling energy receipts.

Large capital outflows in May 1998 resulted in a financing crisis, with the government unable to raise the $1-1.5bn weekly requirement to repay short-term domestic debt coming due. Reserves, having been rebuilt in March-April, fell to $9.5bn and the rouble tested the low end of its 6.1/US$ +/-15% trading band. Struggling to contain the rouble within its band, the central bank raised interest rates to 150% and the government announced significant expenditure cuts and revenue raising measures.

In July 1998 the IMF agreed a $4.8bn loan to Russia as part of an international aid package worth $22bn, but by mid-August the flight from the GKO market had become a stampede. Purchases of government and corporate securities had been financed by short-term dollar borrowing, which made the banking sector highly vulnerable to the unstable rouble. The rapid decline in the value of these securities threw Russia's largest banks into distress. Liquidity suffered, forcing default on interbank payments and delay in the return of deposits to customers.

When RUB 4bn of short-term government debt came due on 17th August 1998, the government, unable to meet payments, froze the local debt market, aiming for conversion into longer-term debt instruments. A 90-day moratorium was declared on rouble-denominated GKO and OFZ treasury bills, worth just under $31bn, of which around one-third was held by foreigners. The rouble's crawling peg was abandoned and the currency fell from Rub 6.24/US$ at the end of July to Rub16.1/US$ at the end of September, eventually stabilising at Rub 24.2/US$ in March 1999. The Russian Traded Index, which had peaked at 1032 in October 1997, touched 49 a year later. The aftermath of the moratorium on GKO debt led to the government's effective default, with little prospect for western investors of recovering more than a small fraction of the value of the debt.

The crisis had to a certain extent been foreseen, at least by some investors. Many foreign investors in GKOs believed that, although the situation was unstable, they would be able to quit the market before the crisis hit. For others, stock market valuations were justified by Russia's huge natural resources potential. Finally, there had been a belief that, with successive governments, the reform programme would deliver on budget revenues and on structural adjustment.

The Brazil crisis

The Brazil devaluation crisis in early 1999 was to a large extent anticipated, and partly for this reason was not as serious as the 1997-98 Asia crisis. Brazil continued to attract sizeable inflows of capital even in the wake of the Asian crisis but three problems always pointed to the country being vulnerable to financial turmoil. Firstly, the current account deficit had been growing since the mid-1990s. A second area of vulnerability was Brazil's heavy reliance on foreign financing. Finally, Brazil failed to tackle its budget deficit.

The confidence crisis in international markets after Russia's mid-1998 devaluation and debt default aggravated these problems. To maintain access to world capital markets in

difficult times countries must follow policy regimes that command market respect. In the final quarter of 1998 and early part of 1999, Brazil lost the confidence of international investors.

1. *Weak external accounts*. Brazil's current account deficit widened to the equivalent of 4% of GDP in 1997 and 1998. Weak commodity prices and lower Asian demand did not help, but the main reason for the deteriorating trend was the political decision to favor a firm exchange rate to keep inflation low, rather than a weaker exchange rate to help export competitiveness. The Brazilian real was allowed to depreciate in nominal terms by more than the difference between local and international inflation. But in 1998 the real was probably 25% overvalued, and only 6% of this was being clawed back each year under the existing exchange rate regime. Brazil was gambling that markets would allow the further 2-3 years leeway needed to fully correct the real's overvaluation.

2. *Dependence on foreign finance*. Brazil was consuming more than it saved and depended on foreign finance to bridge the gap. Foreign debt was very large and the Brazilian private sector, like its equivalent in South Korea, came to depend very heavily on short term foreign debt. Total short term debt rose from US$35bn in the mid-1990s to US$65bn by mid-1998. This made Brazil vulnerable to a loss of market access, and put a premium on pursuing policies that commanded market confidence.

3. *Budget deficit problems*. Macro economic policy in Brazil improved dramatically with the introduction of the Real plan in 1994, and inflation fell sharply. But most of this improvement came on the back of very tight monetary policies. Brazil struggled to tackle its budget deficit which climbed to 8% of GDP in 1998. Domestic debt climbed to 45-50% of GDP, levels last seen in Brazil in the mid-1980s. On top of the deteriorating trend, the short duration of the debt was also a major problem, with the average maturity only seven months. In the 1980s the debt burden was inflated away. In the 1990s, with the government committed to keeping inflation low, fiscal adjustment was essential to keep down the risk of domestic debt default.

President Cardoso tried to come to grips with fiscal reform, but progress was very patchy. The problem was politics; the opposition to reform of powerful pressure groups whose interests are institutionalized in Brazil's 1988 constitution (adopted in the flush of populism after the end of military rule). In addition, in an unfortunate parallel with Mexico in 1994, President Cardoso's resolve on fiscal reform weakened in 1998 ahead of the October presidential election. Brazil's fiscal credibility was hurt further by the government's loss of key Congressional votes on social security reform in December 1998, and the January 1999 moratorium on debt payments to the Federal government by the state of Minas Gerais.

Confidence plummeted, capital outflow increased, and interest rates were hiked, making the fiscal position even worse as most domestic debt was at floating rates. With virtually no progress on the fiscal side, an attempt to manage a small controlled devaluation on January 13th 1999 failed. Rather than bolstering confidence, the move had the opposite effect, and the floating of the currency was forced two days later. But the move caused no great surprise, many private sector borrowers had already hedged and there was no threat to the financial system.

1.3 Reassessing the risks of emerging markets

The severity of the economic recessions in Asia and Russia and the size of the market declines have brought a major reassessment of the risks in emerging markets. We look first at currency risk and then at six other factors which have received renewed attention.

Currency risk

A dominant factor in the Asian crisis as well as in Russia and Brazil was the dramatic fall in currencies. This is not a new phenomenon; the Chilean crisis of 1981 was similar in many respects, with an unexpected currency collapse having a devastating effect on the private sector (Kamin, 1999). More recently the Mexican crisis of 1994-5 was triggered by a sudden devaluation.

In the Latin American debt crisis of 1982, however, currencies had a supporting role in the drama rather than taking the lead. In that crisis there was a sudden cessation of inflows due to a loss of confidence in Mexico's (and other countries') ability to pay and there was a withdrawal of short term lines, but the crisis was triggered by the government's default, which shattered domestic and international confidence. Devaluation came as part of the adjustment process. The big difference was that most lenders had foreign currency obligations and the risk was (primarily) sovereign. Another difference worth noting is that the IMF's role then was usually to urge the necessity of devaluing when currencies were clearly overvalued. In contrast, during the Russian and Brazilian crises the IMF found itself trying to support a particular parity.

Since the Asian crisis investors have regarded fixed exchange rate systems with suspicion. Stock market investors are vulnerable to the market decline if the central bank raises interest rates to defend the currency. They are also vulnerable if a devaluation follows which triggers an economic slowdown and asset price collapse as in Asia. However devaluation is often good news for stock market investors because it stimulates the economy and therefore profits and also, after a time may allow for lower interest rates. The Brazilian experience for example was much less damaging for stocks than the Asian experience. In dollar terms the market was higher within four months of the devaluation.

The crisis has set off a major new chapter in the debate over which is the best system of exchange rates. The general conclusion has been that if countries want to allow free capital movements they must choose between the extremes of a floating currency at one end of the spectrum and a currency board or dollarisation at the other end. It is more difficult to be in the middle of the spectrum trying to maintain a fixed exchange rate. The success of the Hong Kong and Argentinian currency boards and the decision by Ecuador to dollarise underline the importance of credibility if a fixed rate is to be maintained, though when the exchange rate is too high there can be plenty of pain. The floating rate option has now been adopted by most countries in Asia, together with Russia and Brazil.

Arguably, if economic policy is sound and political stability is reasonably assured, it may not matter very much which system is chosen. Fixed systems should be relatively easy to sustain while floating rate systems will not be very volatile. In practice many countries use fixed exchange rate systems to try to compensate for political uncertainty or unstable government finances, which is a recipe for periodic instability. Also the world economy is likely to continue to generate unforeseen shocks which suggests that some form of floating or adjustable system may be superior.

One effect of the Asian crisis has been to reduce markedly inflation rates in most countries. The disinflationary effects of the recession and good monetary policy outweighed the inflationary impact of devaluation. If low inflation is maintained, the risks of investing in these countries should be reduced. In Brazil and even Russia, the inflationary impact of the devaluations has also been contained better than feared.

Assessing currency vulnerability

Since 1997 there has been a considerable literature on the causes of currency crises and whether they can be predicted. Some studies have found patterns in the data and have argued that forecasting is indeed possible. One study, for example, used logit analysis and found that the most important explanatory variables were foreign exchange reserves, exports and real GDP and, to a lesser extent, portfolio capital flows (Kumar, Moorthy and Perraudin, 1998).

However other researchers have emphasised that crises seem to vary enough over time that such models cannot be relied upon for future forecasting. A study by researchers at the IMF looked at three forecasting models estimated before 1997 to see if they predicted the crisis and found that two out of three failed (Berg and Pattillo, 1999: 107). One approach to assessing the extent of vulnerability is to look at various risk factors. These can be summarised in terms of three questions. Is a currency overvalued? Can it be defended? And, is the 'financing gap' sustainable?

Deciding whether a currency is competitively valued is very difficult in practice. An attempt can be made to calculate the purchasing power parity (PPP) level but this is fraught with difficulties. Perhaps the best approach is to identify a year in the recent past when the currency looks as though it might have been in equilibrium. It should be a year when the current account deficit was low, but not a recession year because that would be a distortion. Then the PPP level needs to be extrapolated to the present by comparing inflation rates. The best measure is the wholesale price index but this is not always available or reliable.

It is doubtful whether such an approach can exclude a potential error of at least 10% in the result, which means it will only identify grossly overvalued currencies. Another approach is to look at the recent export performance and the current account deficit. If export growth is poor and the current account deficit is large in relation to GDP, e.g. 4% or more, then the currency may be overvalued.

Whether the currency can be defended depends on two main factors: the level of foreign exchange reserves and whether interest rates can be held high for long enough. The ability to hold interest rates high depends on the strength of the economy and the political situation facing the government. A strong economy and a government far from elections may be able to absorb a rise in interest rates relatively easily. In contrast a very weak economy or a government soon facing elections is likely to try to avoid raising interest rates. In addition, raising interest rates has more of an impact the greater the credit outstanding in the economy.

Of course reserves need to be measured against the overall financing position, which is where the sustainability of the financing gap comes in. We define this 'financing gap' as the current account deficit plus the medium and long term debt amortisation due plus short term debt outstanding. Strictly speaking this is mixing up stocks and flows since the short term debt has to be continuously refinanced. Nevertheless the financing gap does indicate the size of the problem if lenders became reluctant to roll over any debt.

Other risk factors

As well as currency risks the Asian crisis also highlighted several other risks affecting emerging market investments:

1. *Excess foreign currency debt accumulation by the private sector*. The upward trend in short term debt in the mid-1990s was noted by many observers and there was some nervousness about the implications. The Bank of Thailand, for instance, addressed this problem very actively in 1995-6 and took steps to slow the pace of increase. In mid-1996 it produced a paper for foreign investors explaining the background to the increase and the measures it had taken (Bank of Thailand, 1996). Short-term debt owed to banks started to fall from mid-1996, though remained high, at about the same level as reserves.
   After the crisis there was much discussion of the problem of short term debt, though it is certainly not a new problem. Mexico's default in 1982 followed a huge accumulation of short term debt, mainly by the public sector, when the medium term borrowing markets closed up. Its 1994 crisis was also largely due to excess short term borrowing. One problem with short term debt is that it can be accumulated very quickly and does not always show up in official debt data in time. However it is hard to argue this for Thailand and Korea because the data were available and were widely discussed. It took a fall in confidence following economic slowdown to trigger the crisis. In the aftermath of the crisis governments everywhere are being more careful about the accumulation of short term debts while investors are also paying more attention. For stock market investors the presence of a large short-term debt is both more likely to lead to a threat of devaluation, implying the risk of a sharp hike in interest rates, and to make any devaluation more painful.

2. *Excess leverage in the corporate sector*. For stock market investors leverage can be a useful way to boost earnings per share. Providing the return on capital is greater than the cost of borrowing, stock-holders gain. However, in Asia this may not have been the rationale for the debt-financed growth of many companies. It seems more likely that companies were focussed on growth rather than return on capital and may have preferred debt to equity in order to maintain control. However the return on capital was already falling in most Asian countries well before the crisis, and the currency collapse raised domestic interest rates as well as the cost of servicing foreign currency loans.
   Korea generally has the highest debt/equity ratios and the consequent leverage effect on share prices was considerable when the recession struck. A broader issue is concerning investors now though, which is whether companies will be able to achieve strong growth in the next few years, given that there remains a need to reduce leverage further.

3. *Bubble risks*. It has often been said that bubbles can only be recognised after the event. It appears also to be true that some investors recognise bubbles but nevertheless participate, planning to exit before the bubble bursts. Certainly, with the benefit of hindsight we can see the bubble element in several of the Asian countries. The rapid rise in property prices, the frenetic pace of new business openings and the rapid rise in real earnings were all symptoms. Stock prices were not rising much after 1993, except in Hong Kong. In Russia, too, the rise in the stock market in 1996-7 looks like a bubble.
   However, the debate is still on as to whether the view that Asian countries could grow at 7-8% p.a. or more should be regarded as part of the bubble or whether countries will

be able to return to these rates of growth. This issue will be addressed below in the concluding section.

4. *Recession risks*. Mild slowdowns or recessions are not necessarily too bad for stock markets but the huge declines in GDP seen in many countries in 1997-8 had a similarly huge effect on stocks. The risk of such a devastating recession was presumably not sufficiently discounted in advance. Going forward, investors are more likely to include that risk in their thinking.
   Several factors worsened the impact of the recession. First, some of the ‘bubble’ elements mentioned above had artificially inflated stock markets. Many companies were directly or indirectly dependent on gains on property. Secondly, the sharp change in the terms of trade hit certain companies very hard, often those which had benefited from an overvalued exchange rate. Thirdly, the need to maintain high domestic interest rates for some time to stabilise exchange rates and prevent a major inflation hit hard on companies with high leverage. Of course, whether the IMF pushed for keeping interest rates too high for too long, or did not allow enough fiscal ease remains a hotly debated subject.

5. *Weak banking systems*. In some countries, perhaps most notably Indonesia, the weakness of many banks was known well in advance of the crisis. In others, the full extent only came to light, or was only created, in the crisis. The root of the problem was that in many countries, deregulation of the financial sector was too rapid and poorly sequenced. Non-bank financial companies, often owned by banks were at the forefront of the problems in some countries. Weak banks, of course, made the crisis worse. For investors, a key problem was that the financial sector was a large part of the investor universe. To take an extreme example, in 1994 the finance, insurance and real estate sectors in just two countries, Malaysia and Thailand, accounted for 6.7% of the entire IFCI index (all emerging countries). Since the crisis, one of the factors holding back performance in some stock markets has been that many finance companies and banks have been nationalised or merged, while other banks have needed to issue new stock in order to recapitalize.

6. *Political Risks*. The Asian crisis very much reinforced the view that democratic systems are best able to deal with economic disaster. Korea and Thailand are generally credited with the best response to the crisis and this was much facilitated by their ability to change government. In Korea’s case the timing of the election was relatively fortuitous, although the delay in economic policy measures just before the crisis made things worse initially. Thailand’s shifting coalitions and frequent elections also stood it in good stead. In Indonesia, by contrast, the crisis destroyed the legitimacy of the Suharto Presidency and the absence of a democratic system meant that popular unrest created a violent political crisis, exacerbating the economic crisis. In Malaysia there was no change in government and there are different views about the effectiveness of the government’s response. However, from the investor’s view-point, it is clear that the imposition of exchange controls, the freezing of some share trading and the new tax on investors’ exiting the stock market were very negative developments.
   Early in the crisis there were fears that the crisis would spark a general retreat from liberalisation. However, with the exception of the measures taken in Malaysia, that has not happened. Governments have generally stuck with open markets and in most cases improved the environment for foreign investors. The introduction of bankruptcy

courts (Indonesia and Thailand), albeit operating imperfectly, the opening up of stocks to more foreign ownership (Korea) and the increasing percentage allowed for foreign direct ownership in several countries are all positive developments.

Conclusion

The experience of the Asian crisis changed attitudes to risk. Investors are now much more conscious of the potential downside risk for markets, the risk of fixed or quasi-fixed exchange rates, the risk that even very successful countries can suffer major recessions and finally the risk of contagion.

The crisis has also raised questions over the extent to which the success of Asian countries in achieving high economic growth was in fact misleading because too much of that growth was in excessive and wasteful investment. The debate led by Paul Krugman and others, which started well before the crisis, centred on questioning the Asian miracle on the grounds that it was not really a miracle at all, just the successful application of a high level of inputs (capital, labour and education, essentially). To resume rapid growth in the future countries will either have to restore the conditions which created strong investment, or achieve an improved performance in total factor productivity. With many countries still suffering from excess capacity and businesses much more cautious about future demand prospects and reluctant to build up leverage, the easier option, the first one, may not be achievable in the near future. We return to this issue in chapter 5.

CHAPTER 2: The rise in investment in emerging markets

2.1 The ebb and flow of capital

Private capital flows to emerging markets surged in the 1990's compared with the 1980s and the fastest growing area was portfolio investment. For full details by country see the appendix. Total net capital flows rose from an annual average of $15.2 billion in 1984-9 to nearly ten times that level in the 1990s. Portfolio investment grew rapidly in the early 1990's, peaking (net) at $113.6 billion in 1993, but has since been very volatile. Foreign direct investment rose steadily until 1998, when investment flows to Asia (in particular) fell back, albeit to a limited extent.

Table 1: Net Capital Flows to Emerging Countries

Total flows	**1984-89**	**1990-96**
US$ billion	**Annual average**	**Annual average**
Net private capital flows	15.2	148.1
Net direct investment	12.9	63.1
Net portfolio investment	4.7	54.1
Other net investment	-2.5	30.9
Net official flows	23.9	15.3
Change in reserves("-"=increase)	-13.8	-81.2

Source: IMF Annual Report 1998

Between 1990 and 1996 total private capital flows to developing countries rose nearly five-fold to $222 billion, only to fall back by over one-quarter at the onset of the Asian crisis in 1997. However, the pattern was far from uniform across countries and some categories of capital flows were significantly more volatile than others. Official flows averaged around $20 billion over 1984-97. This average masks sharp volatility in the 1990s, when governments and multilateral institutions received net inflows of capital in 1994 and 1996 and made sizeable loans in response to the Mexican crisis of 1995 and then the Asian crisis in 1997.

Private flows

Direct investment rose steadily through the 1980s and 1990s, with average annual flows of $12.9bn in 1984-89 rising fourfold to $54.5bn in 1990-95 and by 20% a year in 1996 and 1997. Portfolio investment was more volatile. In 1984-9 net portfolio flows amounted to $4.7 billion annually, only one-third of average annual direct investment flows. In 1990-95, average net portfolio investment had risen to equal direct investment and in fact dwarfed FDI flows in 1990-93, the years before the Mexican crisis. The Mexican crisis of 1995 resulted in a sharp drop in portfolio flows to only 42% of FDI flows in 1995.

Table 2: Breakdown of Private Investment Flows

Net Portfolio Investment US$billion	**1991-95 annual average**	**1996**	**1997**	**1998**
Emerging markets:	69.7	80.8	66.8	36.7
Africa	0.2	-0.2	2.9	3.5
Asia - crisis countries	10.1	20.0	12.6	-6.5
- other Asia	0.02	-7.5	-11.8	-8.8
Middle East & Europe	16.1	4.1	4.3	8.8
Western Hemisphere	33.7	40.0	39.7	33.0
Countries in transition	9.5	24.4	19.0	6.7
Net Direct Investment	**1991-95 annual average**	**1996**	**1997**	**1998**
Emerging markets:	60.7	115.9	142.7	131.0
Africa	2.6	5.5	7.6	6.8
Asia - crisis countries	6.9	9.5	12.1	4.9
- other Asia	24.6	45.6	50.5	45.1
Middle East & Europe	2.7	2.4	3.3	2.9
Western Hemisphere	17.6	39.3	50.7	54.0
Countries in transition	6.3	13.5	18.5	17.4

Source: IMF

Bank lending rose sharply in 1995 and 1996, particularly to Asia which saw an 'unprecedented volume of loans', according to the BIS, especially to Thailand, while Indonesia, South Korea and Taiwan were the main recipients of syndicated loan facilities. BIS reporting banks' claims on outside area countries rose from $36.6bn in 1994 to $108bn in 1995 and $141.4bn in 1996, and in the first half of 1997 lending was running at a $152bn annualised rate. Banks' exposure shrank sharply in the final quarter of 1997 and first quarter of 1998, with a shift away from Asia in favour of Latin America and Eastern Europe, mainly to Brazil and Russia. The third quarter of 1998 saw a sharp reduction in net assets to Eastern Europe as banks pulled back from Russia, and, to a lesser extent, from Poland. At the same time, nervousness over Brazil led to a reduction of assets in Latin America between the third quarter of 1998 and second quarter of 1999.

Table 3: Change in net assets of BIS-reporting banks

US$billion	**1994**	**1995**	**1996**	**1997**	**1998**	**1999q1**
Latin America	-19.0	-27.7	1.6	11.8	9.9	-13.3
Asia	25.0	66.2	51.0	-18.0	-94.6	-21.6
Eastern Europe	-15.0	-6.2	7.9	9.2	11.3	-9.5
Middle East	0.2	-15.2	-17.2	16.9	6.5	17.1
Africa	-5.4	-2.1	-3.2	-5.2	0.8	0.0

Source: Bank for International Settlements

Portfolio flows by bonds and equity

Flows into bonds have averaged two to three times those into equities, according to IMF data, (see detailed country data in appendix). The preponderance of bonds is more marked in Latin America. In Asia bonds were only slightly ahead as a form of financing.

Bonds showed a rapid build-up during 1991-4, then dipped sharply in 1995, following the Mexico crisis, reaching new records in 1996-7. Investment in stocks soared in 1993, which is reflected in the indices, particularly for Asia, before dipping in 1994, the year that the Federal Reserve raised interest rates sharply. After a further fall in 1995 flows climbed again, but not surpassing the 1993 record.

Looking at bonds there are no great surprises in the countries which saw the main inflows, but the size of inflows in some individual years are extraordinary in some cases. For example the $28.7 billion inflow to Argentina in 1993, the $46 billion into Brazil in 1994 and most remarkable of course the $44.3 billion into Russia in 1997. Flows into stocks are more widely dispersed, with 15 countries receiving an inflow of $1 billion or more in at least one year compared with only 9 countries receiving the same inflow into bonds. But the amounts overall are much smaller.

Latin America
The Mexican crisis had a significant impact on flows to Latin America in 1995, with a net portfolio investment inflow of $61billion in 1994 virtually eliminated in 1995, with an outflow of some $10.9bn in debt securities from Mexico alone. Nevertheless some $26bn of IMF and exceptional financing for Mexico brought a speedy recovery, with capital inflows of $11.2bn into Mexican debt securities in 1996, and a recovery to $40bn of total net portfolio investment to the region. Nervousness over the devaluation in Brazil in early 1998 led to net outflows of equity investment in Latin America in 1998, but the impact on total flows was more muted. Net foreign direct investment flows overtook portfolio flows in 1997-98, and accounted for as much as 5% of GDP in countries such as Chile, Colombia, Peru and Venezuela in 1996-97.

Asia
Net portfolio investment flows to Asia peaked at $21billion in 1993. Flows to the ‘crisis’ countries alone- Indonesia, Korea, Malaysia, the Philippines and Thailand- reached $20 billion in 1996 but there were portfolio outflows in other Asian emerging markets from 1995. Nevertheless, portfolio flows were dwarfed by bank lending in 1995-6 of over $30bn in each year. Foreign direct investment stayed firm in the non-crisis countries, rising to $50.8 billion in 1996 before dropping only slightly to $54.5 billion in 1998. Net portfolio investment continued to decline in 1998, but the recovery of Asian markets since the beginning of 1999 suggests that the data will show a strong recovery.

Middle East and Europe
The countries in this region have had diverse experiences, from the oil-producing middle-eastern countries to the fast growing southern European countries (including Greece, Portugal and Turkey) and the transition economies of central and eastern Europe and Russia. Portfolio investment flows peaked in the early 1990s in the Middle-East and Europe region, while growing from virtually nothing in 1991-92 to $21 billion in 1994 in the transition economies. However the transition economies experienced a sharp fall in flows in 1997-8 after the crisis began.

Portfolio investment was particularly sluggish to the Middle-East, with Israel and Egypt the main recipients in 1997 to the tune of respectively 2% and 1% of GDP, though both suffered a sharp decline in flows in 1998. Turkey suffered a particularly sharp net outflow of bond portfolio investment in 1998, equivalent to 3% of GDP. The single European currency encouraged portfolio flows into Portugal and, more recently, Greece, while the impressive portfolio (primarily bonds) inflows into Russia, peaking at 4% of GDP in

1997 and the first half of 1998, reversed sharply in the final quarter of 1998. The central European economies attracted large FDI inflows and portfolio flows in 1994-5, but suffered a loss of enthusiasm in 1996-7 during the onset of the Czech crisis. In the first half of 1998 the markets became more attractive to investors looking for alternatives to the Asian markets, but the Russian crisis cut short the recovery.

Africa

Portfolio flows to African countries have been limited, with South Africa receiving the lion's share of portfolio investment, with inflows of $13bn a year in 1997 and 1998, and net portfolio investment equivalent to 6.4-6.5% of GDP in each year. Direct investment flows have been rising, but are a fraction of the flows to Asia and Latin America. Official flows continue to be an important source of finance, accounting for 59% of total flows in 1990-97.

2.2 Why the enthusiasm for emerging markets?

Several factors were key in driving the sharp rise in capital flows in the early and mid1990s.

1. *Low interest rates and high industrial country liquidity*. Investors were 'reaching for yield'. Studies suggest that the rise in capital flows in the early 1990s was primarily due to the decline in global, and especially US, interest rates and the cyclical downturn in industrial countries (Calvo, Leiderman and Reinhart, 1993: 108). Low international interest rates were particularly important in encouraging inflows into emerging market bonds and high-yielding currencies. Foreign direct investment, by contrast, was less susceptible to low international interest rates, and grew at a slower pace in the early 1990s. The supply of liquidity was also boosted by the renewed health of the US banking system.

2. *Market opening*. Financial sector deregulation allowed broader and deeper capital markets, while liberalised capital controls in many countries allowed increased access to foreign investors. In fixed income markets the issuance of Brady bonds by many Latin American countries starting in the late 1980s, replacing old commercial bank debt at a discount, was crucial in encouraging new investor interest in emerging markets. This debt carried no currency risk and appeared to have limited country risk, given its explicit and implicit US backing, which was then reinforced by the marked improvement in Latin American countries' performance in the 1990s. The end of Communism in eastern Europe and the Soviet Union brought about economic reform. The opening of stockmarkets and international bond issuance, allowed foreigners to participate in fledgling markets.

3. *Portfolio diversification*. A key attraction of emerging markets is that they are generally relatively uncorrelated with major markets and with each other.

4. *Globalisation*. Falling trade barriers and more efficient communications encouraged increased internationalisation, while intensified competition (particularly among large companies) and the strength of the yen and the Deutschmark in the early-1990s encouraged companies to relocate production to lower-wage countries. These trends have resulted in steady and sustained rises in foreign direct investment.

5. *Improved country risk perceptions*. Improved investor perceptions of country creditworthiness in the early-1990s became evident with the falling spreads on

emerging market bonds. Strong growth rates among the Asian 'tiger' economies, the opening up of Eastern Europe and the re-emergence of Latin America after the debt crisis of the early 1980s contributed to renewed confidence in emerging markets. Between September 1994 and July 1997 the ratings agencies upgraded 16 countries and gave ratings to 11 previously unrated countries, although these changes came *after* the peak in portfolio flows, in 1993. The largest flows of capital tended to go to countries with apparently strong economic fundamentals and relatively stable real exchange rates.

6. *Herd instinct.* The rise in some emerging markets became self-fulfilling as investors rushed to participate in the upswing. When other market participants are accepting a certain risk and it is paying off in terms of returns, new participants continue to come forward.

The World Bank concluded that portfolio flows were driven primarily by US interest rates during 1990-93, but after 1993 country specific factors became more important (World Bank, 1997: 82-84). Another study found that whereas flows to Latin America were influenced primarily by US interest rates, flows to Asia on the other hand have tended to respond more to Japanese rates (Montiel and Reinhart, 2000). Casual observation suggests that one of the outcomes of the Asian crisis, as well as the starkly diverging behaviour of different emerging market regions in the last few years, is that investors are increasingly taking note of country factors.

Chapter 2.3 The case for investing in emerging markets

Until 1997, whatever the theoretical case for investing in emerging markets, the practical results spoke for themselves. Although there had been plenty of disappointments, for example Asia's indifferent results post 1993 or some spectacular busts like Taiwan in 1990, the overall market performance indicators were impressive. Moreover many individual markets went through periods of doubling in just two or three years. If investors could ride these spurts, returns could be very impressive indeed.

Chart 1: Emerging Markets: The Long-Term Picture (IFCG Index)

Source: DATASTREAM

Now, after the abysmal performance of 1997-8, especially compared with the spectacular gains in US and European markets, the historical record no longer provides so much encouragement. Investors therefore have been revisiting the theoretical case for investing in emerging markets to see if it is still valid, and if so where the case went wrong in practice.

Five propositions

The case for investing in emerging markets rests on five key propositions.

1. Emerging countries can grow faster than developed markets, provided that they adopt market-oriented policies.
2. Countries will increasingly adopt market-oriented policies in the current world environment.
3. Companies in fast growing emerging markets will be able to generate matching profit growth.
4. Emerging markets have acceptable risks.
5. Emerging markets have relatively low correlations with major countries.

1. Fast economic growth

Given good economic policies, emerging markets are expected to grow relatively fast for several reasons. First, they are catching up with the industrial countries so they are not limited by technical progress. The first industrial country, the UK is estimated to have grown at around 2.25-2.5% p.a. ever since the industrial revolution in the late 18th century. Germany and the United States, catching up in the 19th century managed growth rates of 4-5% p.a. for long periods. In the 20th century Japan and Korea and others have enjoyed long periods of growth of 8% p.a. or more. The key is to be able to mobilise sufficient capital for investment, by generating a high domestic savings rate and then to use those savings efficiently.

However some countries in Asia seem to have invested too much in the 1990's, creating an unsustainable boom, so savings that are too high can be a problem too. The best performing emerging market of all, Hong Kong, has always had a lower savings rate than many other Asian countries, 25-30% instead of 35-40%, but has used those savings particularly efficiently.

A second reason for expecting emerging countries to grow fast is that they should be able to attract capital, management and technology from the developed countries. Foreign direct investment brings all three, while foreign purchases of stocks and bonds brings capital. Increasing globalisation, powered by the end of the Cold War and progress on world trade liberalisation is expected to reinforce this trend.

Finally, emerging countries mostly have fast growing populations and even faster growing labour forces. Growth rates are in stark contrast to Europe and Japan (where both populations and workforces are growing very slowly) and are also faster than in the US. This can permit faster economic growth, by helping to provide a continuing labour supply and home market.

2. Countries will adopt market-oriented policies

There has been a steady increase in the number of countries adopting more market-oriented economic policies over the last twenty years. This has been driven partly by the success of certain countries, which then became development models for others. In Asia it was the four original tigers, Hong Kong, Singapore, Taiwan and Korea, though they

also looked to Japan for inspiration too. In Latin America the success of Chile has been crucial in the 1990's. In Europe the European Union countries are the inspiration for surrounding countries.

Another major factor has been the discrediting of Socialist models of development following the failures in the Soviet Union and Yugoslavia (where a worker-ownership model was tried in the 1960s and 1970s). The remaining communist regimes, like China and Vietnam are moving towards more market-centred forms of organisation.

A supporting factor here may be the increased knowledge of what is going on outside their country, through the greater penetration of TV and increased travel. Whether a government is democratic or not, the political pressure to deliver the good life, in the form of material comfort, is more intense than ever. Only a few governments, for example in Iraq or North Korea, seem to be able to ignore this, although even then not completely.

However politics can be a short-term business, with irreconcilable pressures preventing progress on structural change. To tackle this problem the IMF and World Bank use loan programmes to compensate governments for the short-term political pain of implementing structural changes. Without such compensation governments may be unwilling to tackle change rapidly. Emerging stock markets tend to rise when IMF and/or World Bank programmes are announced.

Another important area is privatisation. Annual privatisation revenues in developing countries climbed from $2.6 bn. in 1988 to $25.4 bn. in 1996, (Perotti and Oijen, CEPR 1999) The same study suggested that privatisation has played a crucial role in emerging market development and is associated with excess returns in stock markets. Privatisation of course adds to the stocks available on local equity markets but also tends to boost the whole market. The CEPR authors argue that 'the process of privatisation itself, whenever implemented rigorously and consistently, leads to a progressive resolution of regulatory and legal uncertainty and thus to a resolution of uncertainty over future policy'.

Sometimes major structural reform is pushed through by undemocratic governments, for example in Korea in the 1960s, Chile in the 1980s or China today. However there are also plenty of recent examples of democracies achieving radical change too, e.g. Argentina and Peru in the 1990s. Newly-elected governments usually have 4-5 years to prove themselves before the next election, which can often be enough to reap the benefits of change. In contrast a weak, undemocratic government may not be able to risk political unpopularity for that long.

A final factor which needs to be remembered, particularly in taking a long term view is the role of the international environment. Reasonably strong growth in the industrial countries and an openness to trade are crucial supports for emerging market success. The problems in east Asian countries in the late-1990s, though partly self-generated, are also linked to Japan's chronic recession and the consequent weak yen. If all the industrial countries were in recession at the same time, as occurred in the 1930s, the prospects for emerging markets would be much more uncertain.

3. Fast growth of profits

This is the weakest proposition of the five. In some countries profits have performed well but in others results are poor. There are several reasons why profits may not grow as fast as expected. First, there is some evidence that many emerging country companies have

followed growth strategies rather than profit strategies. The emphasis has been on growing in size rather than in earnings. This has long been the Japanese approach to development and companies in many other Asian countries, in particular, seem to have followed the same path.

Secondly, there is concern that, in some cases, publicly quoted companies are run in parallel with privately-held companies, often with inadequate transparency in the relations between them. This may mean that profits are limited in the public company. Worries about these two points have made some fund managers argue that it is better to participate in the faster growth of emerging markets by buying multi-nationals with a large emerging market involvement.

There is a further problem with investing in emerging markets which is that the mix of stocks may not reflect the economy very much. The fastest growing areas of the economy may not be well represented. If that is the case then it becomes much more difficult to argue that investors can tap into fast country growth by buying a portfolio of the country's stocks.

4. Emerging markets have acceptable risks
This proposition is examined in more detail in section 1.3 above. Until the Asian crisis there was a general perception that risks had receded. Broad country risks seemed to be less after the collapse of the Soviet Union and with the spread of globalisation and the widespread adoption of market-friendly policies. More specific risks of investing in emerging markets seemed to be dwindling as liquidity increased, settlement improved and moves were made to increase transparency in many countries. There was also a view that by investing in a wide range of emerging countries investors could diversify away much of the risk.

Emerging markets were recognised as a high risk investment of course. But in investment theory high risk implies that you can expect high returns, so especially for the longer term investor, this appeared to be an attractive proposition. The decline in interest rates in the industrial countries added to that attraction in the 1990s. However, the actual returns in recent years have dented that expectation. Not only has a 'buy and hold' strategy of emerging markets proved unrewarding, but the general decline in emerging markets in 1997-8 left little scope for even an active manager to make money in this asset class.

5. Low correlations with major markets
In practice this proposition is broadly born out by the data (see section 3.1 below). The theoretical proposition rests on the idea that emerging markets are influenced by domestic issues to a considerable degree, particularly broad issues of economic policy and country risk. However emerging markets are also influenced by world economic growth, world trade and US liquidity, for example, which does link returns in emerging markets with major markets (see chapter 4 below and also Michaud, Bergstrom, Frashure and Wolahan, 1996: 9).

Conclusion: The theoretical case now
Their poor performance in the mid-1990s has focussed attention once again on whether the case for emerging markets is really sound. This book investigates in further depth propositions one, two and four outlined above. As we shall see, the evidence for the first

two propositions is sound. Emerging economies do grow faster. Moreover, despite the trauma of the Asian crisis, so far policy has improved as a result, rather than deteriorating into a general retreat from globalisation as had been feared.

The third proposition, linking country growth to individual company profit performance looks much weaker. Overall, emerging markets do not have an impressive profit growth performance, though there are plenty of exceptions by country and among companies. Worries over this issue have recently made many investors prefer emerging market sovereign bonds, which are investments in country risk rather than private sector profit growth. However, the shock of the Asia crisis and the emphasis that has been placed on improved corporate governance could mean that there is more focus on achieving profit growth in the future.

Risks in emerging markets have been starkly exposed in recent years. Country risk of course, but also contagion between countries and the lack of liquidity in markets. However only Malaysia imposed new costs on investors through controls and later extra taxes. Otherwise markets have remained open. A positive view of this re-evaluation of risk is that markets are going to be priced more conservatively for some time to come and therefore rewards should be higher in the long-term. Nevertheless, for all investors, recent experience underlines the importance of understanding and recognising the risks and ensuring that their investments in this area fit in with their overall willingness to take risks.

2.4 A profile of emerging stockmarkets

Market capitalisation vs developed markets

The capitalisation of emerging stockmarkets rose from $614bn at the end of 1990 to $2272bn at the end of 1996, a 270% rise in the six-year period. The previous six years had seen a fourfold increase. This compares with an increase in developed market capitalisation of 106% between end-1990 and end-1996. Nevertheless, emerging market capitalisation was only some 12.5% of developed market capitalisation at end-1996.

Market capitalisation peaked at $2712bn in July 1997, but in the aftermath of the Asian crisis dropped 27% to $1985bn by the end of January 1998. The impact of the Russian crisis was equally severe: market capitalisation, which had recovered to $2329bn by the end of April 1998, fell 31% to $1612bn by the end of August 1998. The recovery in 1999 was equally impressive, rising to $2994bn, by end-year, about 10% above the pre-crisis peak.

Of the regions, Latin America saw the greatest decline in market capitalisation after the July 1997 peak, down 36% by mid-1999 before recovering. Asia was 9.2% above its June 1997 peak by end-1999. Europe, MidEast and Africa (EMEA) region's peak in market capitalisation came slightly later, in September 1997. By the end of 1999 market capitalisation was 29% above its previous peak. Asia dominates emerging market capitalisations, and is twice the size of the EMEA markets and more than three times the size of the Latin American markets.

Table 4: World Market Capitalisation

$bn	**end-1990**	**end-1996**	**end-1997**	**end-1999**
Argentina	3.3	44.7	59.3	83.9
Brazil	16.4	217	255.5	408.9
Chile	13.6	65.9	72	68.2
Colombia	1.4	17.1	19.5	11.6
Mexico	32.7	106.5	156.6	154.0
Peru	0.8	12.3	17.6	13.4
Venezuela	8.4	10.1	14.6	7.5
China	2.0	113.8	206.4	330.7
Hong Kong*	59.5	380.5	332.2	539.6
India	38.6	122.6	128.5	184.6
Indonesia	8.1	91	29.1	64.1
South Korea	110.6	138.8	41.9	308.5
Malaysia	48.6	307.2	93.6	145.4
Pakistan	2.9	10.6	11	7.0
Philippines	5.9	80.6	31.4	48.1
Singapore*	29.3	128.7	93.4	162.9
Taiwan	100.7	273.6	287.8	376.0
Thailand	23.9	99.8	23.5	58.4
Czech Rep.	-	18.1	12.8	11.8
Egypt	1.8	14.2	20.8	32.8
Greece	15.2	24.2	34.2	204.2
Hungary	-	5.3	15	16.3
Jordan	2	4.6	5.4	5.8
Poland	-	8.4	12.1	29.6
Portugal*	3.1	16.8	43.8	67.6
Russia	-	37.2	128.2	72.2
South Africa	137.5	241.6	232.1	262.5
Turkey	19.1	30	61.1	112.7
Emerging markets	613.6	2272.2	2200.6	2994.5
Developed markets	8784.8	18140	21317.9	
USA*	2046.0	5933.0	8240.0.8	13875.0
Japan*	2521.0	2931.0	2232.0	4665.0

** Datastream / Source: IFC*

Market capitalisation weightings and the crisis

Market weights in the IFC investable composite index shifted dramatically over the crisis period. At the end of 1996 Malaysia and Taiwan carried the heaviest weightings, respectively 16.1% and 14.4%. The Asia composite weighting was substantially higher than the Latin American and EMEA composite weightings, at 61.2% compared with respectively 24% and 14.8% (see table). By the end of 1998 the composite weightings had evened out, shifting in favour of EMEA, with Asia's weighting only 28.4%, compared with 38% for EMEA and 34% for Latin America. South Africa, Mexico and Brazil each carried more than 10% of the IFCI weighting. Greece and Portugal's weightings had risen from around 1-2% to respectively 7.2% and 5.5%. By contrast Malaysia's weighting fell to 7.4% and Taiwan fell to 8.4%.

Table 5: Market weights in the IFCI Composite Index

end-1998 ranking	**%**	**end-1996 ranking**	**%**
S.Africa	12.03	Malaysia	16.1
Mexico	10.86	Taiwan	14.4
Brazil	10.64	Brazil	9
South Korea	9.78	South Africa	8.2
Taiwan	8.39	South Korea	6.9
Malaysia	7.4	Mexico	6.8
Greece	7.15	Thailand	5.5
Portugal	5.51	India	4.8
Chile	5.32	Indonesia	4.7
Argentina	4.36	Philippines	4.6
Turkey	2.97	China	3.7
India	2.31	Chile	3.4
China	2.26	Argentina	2.5
Hungary	1.9	Portugal	1.6
Philippines	1.84	Turkey	1.5
Indonesia	1.83	Greece	1
Thailand	1.58	Colombia	0.9
Poland	1.42	Czech Rep.	0.9
Peru	0.95	Peru	0.7
Russia	0.89	Venezuela	0.7
Colombia	0.86	Poland	0.5
Egypt	0.84	Pakistan	0.4
Venezuela	0.81	Hungary	0.3
Czech Rep.	0.52	Jordan	0.3
Pakistan	0.35	Hong Kong	-
Jordan	0.26	Singapore	-
Hong Kong	-	Russia	-
Singapore	28.53	Egypt	-
Composite, IFC	100		
Composite, IFC	100	Latin America, IFC	33.79
Latin America, IFC	24	Asia, IFC	28.38
Asia, IFC	61.2	EMEA, IFC	37.83
EMEA, IFC	14.8		

Source: IFC

Market capitalisation comparing the IFCI with IFCG

The table shows the share of the IFC's investable index in the IFC's global index, for each country. The global index represents the broad market, and incorporates some 60-75% of the total capitalisation of all listed shares on the local stock exchange. The investable index represents stocks which are available to foreign institutional investors, in practice meeting adequate size and liquidity requirements. Of the regions, Europe and Latin America have the largest share of investable stocks in the global index, while Asia has the lowest share. Asian stocks in general carry greater restrictions on foreign participation in the form of ceilings on foreign investment in local listed stocks.

Table 6: Market capitalisation, end-1999

US$mn	**IFCG**	**IFCI**	**IFCI as % of IFCG**
Argentina	23959	23850	99.5
Brazil	102853	96392	93.7
Chile	45558	43303	95.1
Colombia	5800	4342	74.9
Mexico	108846	107861	99.1
Peru	8391	8153	97.2
Venezuela	4004	3918	97.9
China	89132	32244	36.2
Hong Kong			
India	94744	26891	28.4
Indonesia	21193	19337	91.2
South Korea	173865	163771	94.2
Malaysia	79244	75827	95.7
Pakistan	3853	3139	81.5
Philippines	24037	11376	47.3
Taiwan	270433	149191	55.2
Thailand	29058	15265	52.5
Czech Rep.	4621	3793	82.1
Egypt	12275	11544	94.0
Greece	80220	80220	100.0
Hungary	14036	13959	99.5
Jordan	4002	2006	50.1
Poland	12460	12451	99.9
Portugal			
Russia	23685	17528	74.0
South Africa	106533	106533	100.0
Turkey	60228	59468	98.7
Composite, IFC	1479800	1128209	76.2
Latin America, IFC	299410	287820	96.1
Asia, IFC	786457	497338	63.2
EMEA, IFC	393933	343051	87.1

Source: IFC

Correlations and p/e ratios

One of the attractions of investing in emerging markets is that stock markets generally have low correlations with the US stock market. The table below shows that the IFCI markets have a lower correlation that the FT EuroPac, although the regions are above the Nikkei's correlation. Some large emerging stock markets, for example Turkey and Korea, have extremely low correlations, which make them attractive diversification investments.

Table 7: End-1999 Correlation with:

	US S&P 500	Japan Nikkei	FT Europe
Argentina	0.52	0.40	0.52
Brazil	0.48	0.35	0.53
Chile	0.46	0.31	0.46
Colombia	0.14	0.02	0.15
Mexico	0.60	0.37	0.54
Peru	0.25	0.27	0.34
Venezuela	0.26	0.09	0.23
China	0.32	0.08	0.18
Hong Kong			
India	0.10	0.07	0.12
Indonesia	0.44	0.34	0.46
South Korea	0.29	0.59	0.50
Malaysia	0.46	0.27	0.37
Pakistan	0.11	0.01	0.01
Philippines	0.56	0.42	0.56
Singapore			
Taiwan	0.36	0.31	0.37
Thailand	0.53	0.46	0.52
Czech Rep.	0.22	0.12	0.23
Egypt	0.23	-0.06	0.09
Greece	0.30	0.03	0.30
Hungary	0.49	0.12	0.35
Jordan	0.15	-0.14	0.12
Poland	0.42	0.25	0.37
Portugal			
Russia	0.50	0.37	0.62
South Africa	0.55	0.45	0.58
Turkey	0.21	0.05	0.27
Composite, IFC	0.67	0.48	0.69
Latin America, IFC	0.59	0.40	0.59
Asia, IFC	0.54	0.49	0.57
EMEA, IFC	0.55	0.34	0.61

Source: IFC

Price-earnings ratios have tended to be higher in Asia than in other regions, and the recovery in markets, which started in 1998, led to a sharp rise in the PE ratio. Earnings remain weak in the region, keeping the p/e ratio at extremely high levels. In the EMEA region emerging Europe ratios are higher than those of the Mideast/Africa region. Latin American PE ratios peaked in 1995, but fell to low points in 1998 before recovering to more normal levels once again.

Table 8: P/E Ratios

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
IFC Composite	20.3	18.5	25.9	22.9	20.1	18.1	16	18.0	31.3
IFC Latin America	17.4	17.9	18.4	16.0	23.3	16.2	15.1	11.6	16.3
IFC Asia	21.4	19.5	33.3	29.3	20.6	19.9	20.3	38.3	-78.5
IFC EMEA	na	na	21.9	18.0	16.2	14.9	15.3	14.4	19.2

Source: IFC

Practical issues for investors
Emerging markets are at the frontier of stock market investing and present greater risks and costs than investing in major markets. There are three broad areas of risk (this section draws heavily on World Bank, 1996: 310-11):

1. *Settlement and operational risks and costs*. There are considerable risks that a party will default on payment or delivery obligations. If trades fail and the settlement system does not ensure that shares are only delivered versus payment (DVP), then investors are exposed to counterparty risk. According to the World Bank, most emerging markets do not conform to DVP. Delays in trades and erratic payments of dividends are common.

2. *Legal and custodial risks and costs*. A key problem is fraud, for example that securities are not recorded in the legal registry or that certificates are counterfeit (the World Bank cites instances in India, Indonesia, Malaysia and Turkey). Another major problem has been investors' rights as minority shareholders. Many emerging market firms are closely held and managed by majority shareholders and there may not be sufficient protection in the legal system or in effective enforcement for minority shareholders.

3. *Informational and regulatory risks and costs*. Information is scarce due to lack of good accounting information. Regulatory systems are generally weak, which contributes to the unreliability of the information and can also allow substantial insider trading.

Taken together these risks translate into extra costs for investors because of the expense of counteracting and dealing with them, and also because of periodic losses. Linked to this is the low liquidity in many markets (i.e. relatively low turnover) which means that investors may not be able to change their positions quickly to take advantage of market conditions or new information. This becomes a particular problem for large funds.

In all these areas progress has been made over the last twenty years, partly at IFC and World Bank instigation. But changing laws does not always change practices, especially in countries where enforcement of property rights is often difficult. And these issues remain a major concern to investors, particularly now that the perception of likely returns in emerging markets is less positive. For most investors collective funds are likely to continue to be the best way to invest in emerging markets. An alternative is the American Depositary Receipts, ADRs which are offered for many of the larger emerging market stocks and trade in the US.

2.5 The impact of emerging stocks investment on countries

It is worth pausing briefly to ask whether foreign investment in emerging stock markets is 'a good thing' or not for emerging countries, though full consideration of the issue is outside the scope of this paper. The benefits may be identified in the inflow itself, which increases the resources available to the country or by the way foreign ownership of stocks deepens and strengthens the stock market through a variety of routes. On the negative side, there is a concern that money flowing into stock markets may be 'hot money', which flows out again at the first sign of trouble. Whether it can flow out again so easily depends on the liquidity of the stock market and the availability of currency hedging and also of course on any capital controls in place.

The size of the flows has been documented above and, for a number of countries, sufficiently large to be significant in overall resource availability (see appendix for detailed data). However one study found that portfolio investment (in contrast to foreign direct investment) had no discernible impact on domestic investment, (Bosworth and Collins, 1999).

The World Bank and IFC place more emphasis on the role that foreign investment in stock markets is playing in developing the local capital market (Levine, 1996). The effect works partly through increasing liquidity in the markets, which then enables the stock market to perform better both in financing new issues and in pricing companies. It may also work by increasing the focus of both domestic investors and governments on improving the operation and transparency of stock markets, again helping with development.

CHAPTER 3 Emerging markets long run performance

The table below summarises the performance of the IFCG index 1985-99. The key conclusions are as follows:

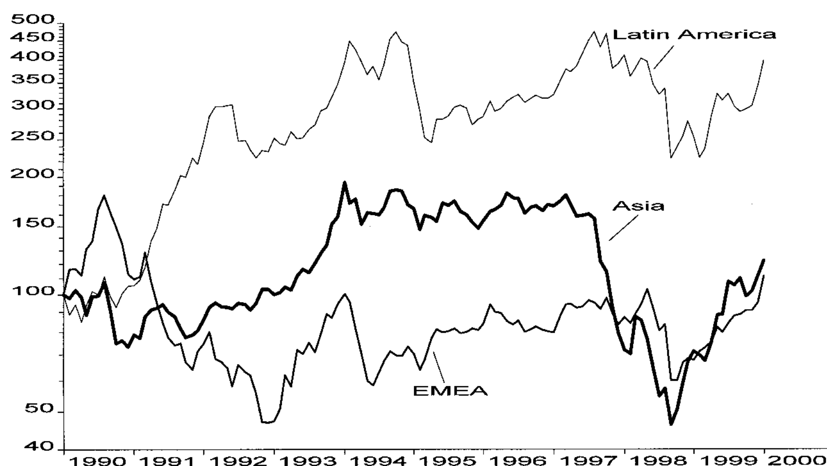
1. The performance of the composite index of 12.3% p.a. was markedly inferior to the US S&P500 at 16.6% p.a. and MSCI Europe at 20.1% p.a. However, the performance of Europe and the US was exceptional over this period and may not be repeated. Very long run evidence for the US and UK suggests that equities provide a real return of about 6-7% over the long run, which would translate to 8-9% at current inflation rates.

2. Latin America substantially outperformed Asia over this period, with annual average returns of 19.1% versus 10.3%. Asia provided good returns from 1985-93 but has fallen on average since then despite the recovery in 1999. Latin America enjoyed explosive returns of 54.8% p.a. each year during 1991-3, which accounts for its out-performance.

3. Chile, Mexico and Argentina were the best performing markets over the whole period. In Asia the Philippines was the best performer with Hong Kong and Taiwan not far behind.

4. Indonesia, Malaysia and China were the worst performers overall. But many other countries showed very poor performances over three year periods.

Chart 1: Emerging stocks, Regional Performance



Source: DATASTREAM

Table 1: Total returns from Emerging Market equities

All in US$ terms	**1985-87 %pa**	**1988-90 %pa**	**1991-93 %pa**	**1994-96 %pa**	**1997-99 %pa**	**Best 3-yr Period**	**Worst 3-yr Period**	**1985-99 an average,%**
Argentina	12.2	34.4	85.0	1.9	6.9	1989-91	1992-94	24.8
Brazil	-18.5	2.7	75.7	22.1	10.3	1991-93	1985-87	14.6
Chile	70.4	42.8	45.9	7.7	2.7	1985-87	1996-98	31.4
Colombia	58.2	10.6	76.3	2.0	-13.5	1990-92	1997-99	22.1
Mexico	30.5	67.3	55.6	-19.7	19.7	1988-90	1994-96	26.6
Peru	-	-	-	20.7	-3.6	1993-95	1996-98	11.6
Venezuela	20.8	52.7	-8.1	7.8	-16.1	1989-91	1992-94	8.9
China	-	-	-	4.0	12.8	1996-98	1993-95	5.9
Hong Kong	24.6	9.3	58.2	7.0	12.4	1991-93	1996-98	19.3
India	18.9	19.4	20.1	-11.6	19.6	1991-93	1995-97	12.5
Indonesia	-	-	8.2	2.7	-27.9	1993-95	1996-98	-6.5
South Korea	51.9	19.3	1.7	-11.8	14.0	1986-88	1996-98	13.1
Malaysia	-1.1	17.8	42.9	0.4	-25.2	1991-93	1996-98	4.6
Pakistan	15.1	10.4	51.5	-20.3	-6.0	1991-93	1996-98	7.6
Philippines	120.8	0.5	64.2	0.9	-22.7	1985-87	1996-98	23.2
Singapore	4.2	16.2	33.9	4.7	4.7	1991-93	1996-98	10.1
Taiwan	53.8	23.8	11.3	5.3	4.3	1987-89	1990-92	18.4
Thailand	34.0	30.8	50.4	-17.9	-26.0	1987-89	1996-98	9.9
Czech Rep.	-	-	-	-	-12.9	-	-	-
Egypt	-	-	-	-	4.6	-	-	-
Greece	60.7	33.1	-10.4	5.8	65.7	1997-99	1991-93	26.8
Hungary	-	-	-	6.9	19.8	1996-98	1993-95	-
Jordan	11.3	-2.6	21.3	0.1	7.2	1991-93	1986-88	7.1
Israel	-	-	-	-	20.1	-	-	-
Morooco	-	-	-	-	18.6	-	-	-
Nigeria	-27.4	22.8	-7.4	55.5	-9.7	1994-96	1985-87	3.1
Poland	-	-	-	-2.3	-3.0	1993-95	1997-99	-
Russia	-	-	-	-	2.4	-	-	-
South Africa	-	-	-	8.6	0.7	1993-95	1996-98	-
Turkey	-	32.8	-2.8	-7.6	-56.8	1987-89	1990-92	27.3
Zimbabwe	83.6	52.8	-22.4	35.7	-20.1	1985-87	1996-98	18.0
Composite, IFC	18.5	20.4	25.6	-2.0	3.2	1987-89	1996-98	12.3
Latin America, IFC	4.1	36.8	54.8	0.0	10.3	1991-93	1994-96	19.1
IFC Asia,	23.4	20.1	20.2	-2.9	-4.4	1987-89	1995-97	10.3
US, S&P,500	19.8	14.1	16.7	20.6	27.1	1995-97	1992-94	16.6
Nikkei, Japan	57.3	0.3	-4.4	3.0	26.6	1985-87	1990-92	9.1
Europe, MSCI	40.8	13.7	12.2	15.1	23.1	1985-87	1990-92	20.1

Total returns, in US$, based on the emerging market global indices produced by the International Finance Corporation.

CHAPTER 4 Matching market performance with economic performance

4.1 GDP growth and stock market performance

In macro-economic terms the period from 1985-1996 was an extraordinarily successful one for many emerging countries. Latin America emerged from the depths of recession and despair following the 1982 debt crisis. In Asia more and more countries emulated the success of the original four tigers, Hong Kong, Singapore, Korea and Taiwan, and achieved very rapid growth rates. China liberalised from the early 1980s, India from the early-1990s and in both countries economic growth accelerated. Finally, freed from communism, central and eastern Europe began to shake off the torpor of the planned economy, though only a few countries have yet achieved impressive growth.

GDP growth and returns

It might be expected that the countries which grew fastest would have provided the best market returns. The table below shows emerging countries ranked by the returns on investing in the IFC Global index from 1985-99, together with the average GDP growth over the same period. Intriguingly, there is no direct relationship, as can be seen from the scatter chart below. Some countries with very good economic growth records provided poor returns, e.g. Malaysia and China, while others with only weak growth records provided stellar returns, e.g. Mexico and Greece.

Table 1: Market performance vs GDP

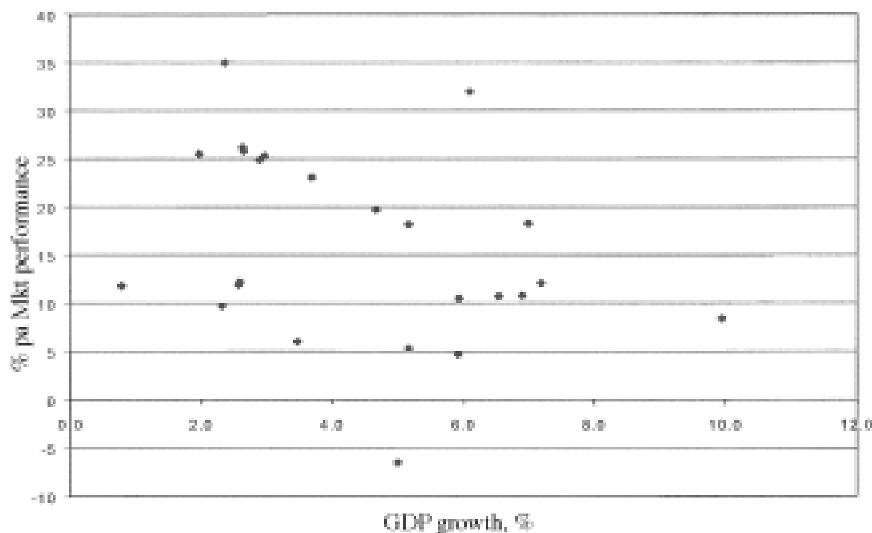
% Country	Market Performance, 1985-1999	AveGDP growth, 1985-99
Chile	31.4	6.8
Turkey**	27.3	3.4
Greece	26.8	2.3
Mexico	26.6	2.9
Argentina	24.8	3.2
Philippines	23.2	3.4
Colombia	22.1	3.3
Hong Kong	19.3	5.0
Taiwan	18.4	6.6
Zimbabwe	18.0	2.9
Brazil	14.6	2.6
South Korea	13.1	7.3
India	12.5	5.9
Peru*	11.6	4.2
Singapore	10.1	7.3
Thailand	9.9	6.5
Venezuela	8.9	2.0
Pakistan	7.6	4.9
Jordan	7.1	3.0

China*	5.9	8.8
Malaysia	4.6	6.5
Nigeria	3.1	3.5
Indonesia***	-6.5	3.2

* *over time period 1994-99*
** *over time period 1988-99*
*** *over time period 1991-99*

Source IMF, IFC

Chart 1: Market Performance vs GDP



Is this result caused mainly by the Asia crisis, depressing returns from investment over this period? The answer is no. If the exercise is performed from 1985-96 only, i.e. ending before the Asia crisis, there is still no strong correlation between GDP growth and market returns. Asian countries of course provided better average returns over that period, mostly in the 10-20% pa range, but a number of countries, particularly in Latin America, provided even better returns than when 1997-9 are included, while recording a much slower average rate of GDP growth.

It does not take much investigation to reveal that many of the best performing markets were those which achieved a major turnaround in economic prospects over the period. The table below shows which countries saw a substantial improvement in GDP over the period 1985-99 compared with the preceding three years, 1983-5. Many Asian markets had already been growing healthily in the early-1980s and saw little change. However a group of mainly Latin countries (including Peru, Chile, Argentina, Mexico, Portugal and the Philippines) saw significant improvements in GDP growth which probably account for their above average market returns. Starting from the mid-1980s many of these countries moved to democracy, made major progress in liberalising their economies and opened up to foreign investment. In the 1990s central and eastern Europe showed the same promise and some markets there did very well too.

Table 2: Change in average GDP growth rate

1985-99 vs 1983-5	
Philippines	6.9
Peru	3.9
Chile	3.4
Argentina	3.2
Portugal	2.6
Singapore	1.9
Mexico	1.9
Hong Kong	1.6
Malaysia	1.5
Thailand	1.2
Colombia	1
India	0.4
Indonesia	0.4
Greece	-0.1
Turkey	-0.2
Pakistan	-1
Taiwan	-1
Korea	-2.2
China	-3.8

Source: IMF

This phenomenon helps to explain why some markets show extraordinary gains following good news. Investors know that the market will react favourably to positive news on the economy, even when there is little to show for it yet in terms of economic growth (or profits). Russia is perhaps the most dramatic example. On good news in 1995-7 this market showed a more than 500% rise, only to lose all of that and more in 1998. In 1999 it achieved another three digit percentage gain. One calculation, (reported in the Financial Times, 16/8/99 page 17), is that Gazprom, (the Russian oil company), is at a 95% discount to Exxon of the US. Investors therefore reason that if Russia becomes a more reliable, successful economy there is huge room for a re-rating.

GDP growth and PE ratios

There is a better correlation between GDP growth and PE ratios (see scatter chart below). This makes good sense. Countries with higher average GDP growth over an extended period (15 years here) are rewarded with higher average PE ratios. Some countries still depart from the average range. For example Russia and the Czech Republic have enjoyed higher PE ratios than would appear to be justified by their GDP growth, but this again may represent hope value. Three other countries, Egypt, Chile and Thailand seem to have enjoyed lower PE ratios than their performance would justify. However their PE ratios are much higher in the 1990s than the 1980s.

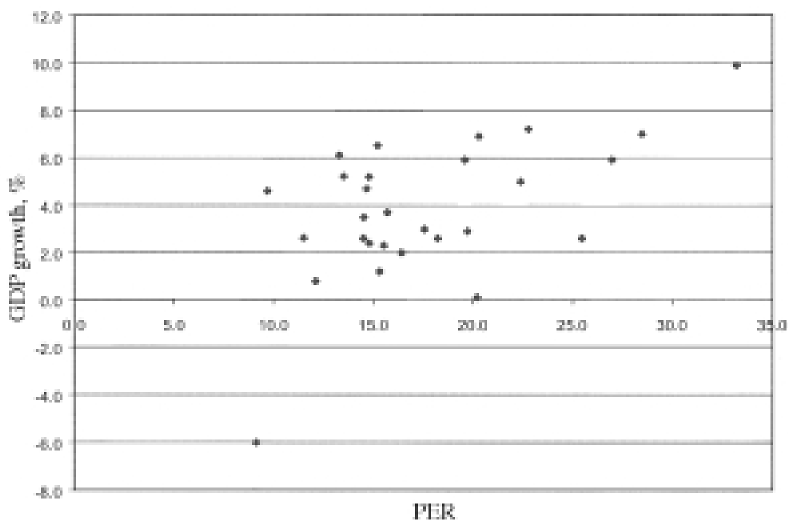
Table 3: PERs and GDP growth 1985-99

	AVG PER*	GDP growth, %
China	33.2	9.9
Taiwan	28.5	7.0
Malaysia	27.0	5.9
Peru	25.5	2.6
Korea	22.8	7.2
Indonesia	22.4	5.0
Singapore	20.3	6.9
Czech Rep.	20.2	0.1
Argentina	19.7	2.9
India	19.6	5.9
Philippines	18.2	2.6
Portugal	17.5	3.0
Greece	16.4	2.0
Colombia	15.7	3.7
Venezuela	15.5	2.3
South Africa	15.3	1.2
Thailand	15.2	6.5
Hong Kong	14.8	5.2
Poland	14.8	2.4
Turkey	14.7	4.7
Mexico	14.5	2.6
Jordan	14.5	3.5
Pakistan	13.5	5.2
Chile	13.3	6.1
Hungary	12.1	0.8
Brazil	11.5	2.6
Egypt	9.7	4.6
Russia	9.1	-6.0

** Years of negative earnings (i.e. losses) are excluded from the calculation of average PER.*

Source: IMF, IFC

Chart 2: GDP growth vs PER



GDP growth and earnings
The link between GDP growth and market performance should be expected to run via corporate earnings. In other words, strong GDP growth should mean strong corporate earnings growth and therefore a high PE ratio, and even with a stable PE ratio returns equal to earnings growth. However corporate earnings series (derived from IFC data) are extremely volatile and so this is very difficult to test. Earnings growth depends crucially on the years chosen. It might seem reasonable, for example, to exclude 1998-99 on the grounds that the Asian crisis has depressed earnings. But it could also be argued that earnings were artificially inflated in the mid-1990s by the economic boom and by earnings on property, which could not be sustained. Overall, earnings in most markets have made surprisingly little progress in many countries over the last 15 years. See table below.

4.2 What makes for good economic performance?

In March 1997 the authors first published a study on the characteristics of a "tiger economy", ironically just as the Asian economies stumbled (American Express Bank, 1997). The aim was to take the factors generally held to be behind the success of the original four tigers, Hong Kong, Singapore, Taiwan and South Korea, and to see to what extent they were being introduced in other emerging countries. Of course there is considerable disagreement over the relative importance of different factors in the tigers' success. Our analysis took a simple approach, providing equal weights to five different areas: macro-economic stability, human capital, market-orientation, export-orientation and the investment/GDP ratio. Each of these areas was then scored for 1987 and 1997 using a number of key ratios and indicators. (See Appendix 2 for full details)

Five key factors in success

1. *Macro-economic stability.* Asia's inflation rates have generally been considerably lower than other emerging market regions and are close to OECD levels, whilst low government deficits or surpluses have helped reduce real interest rates. Low inflation encourages high savings and investment and makes better investment decisions possible, producing higher returns and thereby encouraging still higher savings/investment.

2. *Human capital.* Asia's tigers, with the possible exception of Thailand, score well on education, particularly at the primary and secondary level, whilst the stress on women's basic education has led to a larger pool of people qualified for more advanced/specialised training.

3. *Market orientation.* Although many countries have adopted pro-active industrial policies, the general pattern has been to encourage competition, limit the production role of the state and to keep regulation to a minimum.

4. *Outward orientation.* Tigers have skillfully utilised an outward-looking development strategy, with emphasis on keeping domestic prices in line with world prices and encouraging export growth. The rapid expansion of trade has helped to internationalise, liberalise and modernise Asian economies, by inducing inflows of foreign direct investment, advanced management skills and modern technologies.

5. *High investment ratio.* All the tigers have had a high savings rate and a high investment rate. Without doubt this has been a major contributor to growth and many analysts argue that it is this mobilisation of resources (to which human capital should

be added) that is the Asian "miracle". Of course, on its own, a high investment rate is not enough, as the Soviet Union clearly demonstrated. Investment has to be used efficiently as well which is where the first four factors come in.

The table below presents a full listing of the data for 46 countries showing the overall score in 1987 and in 2000 and comparing with economic growth on average in the 1990's. A number of conclusions can be drawn.

1. Even after the 1997-8 crisis the Asian tigers still stand out ahead with high scores and these scores still correlate with strong economic growth over the long term. However the scores have shown some deterioration, partly because of the poorer performance of exports and partly because of reduced macro-economic stability in some countries. It is worth noting that this particular scoring system, which was based on the "conventional wisdom" of the time, does not include some of the key factors now blamed for the crisis. For example short-term debt was not included in the ratios. Nor was corporate governance. A full assessment of the health of economies should now probably include these factors and others.
   It also seems likely that part of the reason for the rapid bounce-back in Asia from late-1998 onwards was due to some of the factors scored here. In particular the high savings ratio and low government deficit enabled governments to rescue the banking system without creating an over-burdensome public debt. And the good historical performance on inflation meant that the credibility of monetary policy in responding to the devaluations and avoiding hyper-inflation was high.

2. Secondly, most other countries throughout the range have been improving rapidly. A group of "near tigers" has emerged over the last 13 years with scores approaching the original tigers. Most lack the characteristic high savings ratios (although this does usually follow rather than lead). These countries are Indonesia, the Philippines, Czech Republic, Argentina, Chile and Vietnam. Also, with the exception of Vietnam, they have yet to prove that they can sustain fast growth. Taiwan, one of the original tigers, has slipped back to 'near-tiger' status due to a higher budget deficit and slow export growth.

3. The countries that have improved fastest in the last thirteen years are the Philippines, Argentina, Chile and Vietnam among the near-tigers. Lower down the spectrum Sri Lanka, Mexico, Peru and the Dominican Republic have shown strong improvements.

4. Latin America is generally still lagging, but has been improving particularly fast, probably spurred by the example of Chile. Economic policy-making in Latin America has improved significantly since the late-1980s. The region is now starting to gain the pay-off from economic reforms and growth in the second half of the 1990s had the tiger characteristic of being led by investment and exports and is therefore more sustainable.
   However, Latin America still falls short of the best in Asia in several key areas. Firstly, more should be done to boost export growth which probably needs to reach 20% p.a. for a sustained period to start making significant inroads into key debt indicators and so produce further improvements in the region's creditworthiness.

5. The second deficiency is Latin America's high real interest rates and low savings rate. The savings rate averages around 19% of GDP, compared to over 30% in east Asia. The launch of private pension funds in many countries in the region, following the

Chilean model, will stimulate savings but, again, only over the medium term. A third area where Latin America falls down is labour market reform. Centralised wage negotiations and high payroll taxes discourage formal employment in many countries. Finally, the reduced state in Latin America needs to become more efficient in controlling spending, particularly at local level, delivering public services, regulating finance and privatised industries, in infrastructure and social service provision and in curbing corruption in police forces/local judicial systems.

6. East Europe is difficult to assess at this stage. Eastern European countries scored comparatively well in the mid-1980s, notably on macro-economic stability, investment to GDP and investment in human capital. However, the quality of the investment was poor and not market-focused. The dismantling of command economies has inevitably lifted macro-economic instability whilst free market reforms have been implemented for too short a time period to lift scores on the market-orientation category. As a result, some scores have deteriorated over the last 10 years (Bulgaria, Slovakia and Ukraine). However, prospects for improved macro-stability and greater market orientation are good over the next few years, so scores should improve, helping the region to build on its very high level of human capital.

7. Africa has also shown some improvement, but still has a long way to go. No African country is close to achieving tiger status, with all the regional markets covered in our analysis scoring poorly on most criteria. Macro-economic policy improvements are occurring, particularly on the fiscal, monetary and exchange rate side in South Africa and in smaller countries such as Uganda, Ghana and Mauritius. In addition, many countries are opening up their foreign trade sectors and reducing taxation on agriculture. However, this is not enough, and there has been little progress in three other key areas: on privatisation, the encouragement of foreign investment and on financial sector reform, where the public sector crowds out private demand and keeps real interest rates high.

Table 4: Tiger Scores

	2000 score	**1997 score**	**1987 score**	**% change 2000/1987**
CONFIRMED TIGERS				
Hong Kong	80	85	75	7
Singapore	80	100	80	0
Czech Republic	75	75	60	25
Portugal	75	60	40	88
Philippines	70	80	35	100
South Korea	70	90	75	-7
NEAR TIGERS				
China	65	75	45	44
Malaysia	65	80	55	18
Thailand	65	80	55	18
Chile	65	70	40	63
Panama	65	60	40	63
Hungary	65	45	40	63
Slovakia	65	60	55	18
Israel	65	60	45	44

TIGER CUBS				
Taiwan	60	70	65	-8
Vietnam	60	70	45	33
Mexico	60	55	20	200
Greece	60	40	30	100
Sri Lanka	55	60	30	83
Argentina	55	70	30	83
Dominican Republic	55	40	25	120
Poland	55	65	50	10
EMERGING				
Bolivia	50	45	15	233
Peru	50	45	25	100
Uruguay	50	55	40	25
Jordan	50	60	40	25
Brazil	45	30	20	125
Colombia	45	60	45	0
Turkey	45	45	40	13
Morocco	45	35	30	50
Romania	40	50	60	-33
Ukraine	40	40	45	-11
Egypt	40	40	30	33
Kenya	40	50	25	60
South Africa	40	50	25	60
STRAGGLERS				
Venezuela	35	35	40	-13
India	35	40	20	75
Indonesia	35	65	45	-22
Russia	35	45	45	-22
Ecuador	30	40	25	20
Bangladesh	30	35	30	0
Bulgaria	30	35	45	-33
Ghana	30	40	20	50
Pakistan	25	25	25	0
Nigeria	25	15	10	150
Zimbabwe	25	30	15	67

Source: American Express Bank. See Appendix 2 for more details.

4.3 International influences on emerging markets

As might be expected, emerging market stocks are heavily influenced by international conditions including US economic growth, interest rates and other stock markets. We review these links here.

Emerging markets and US stocks

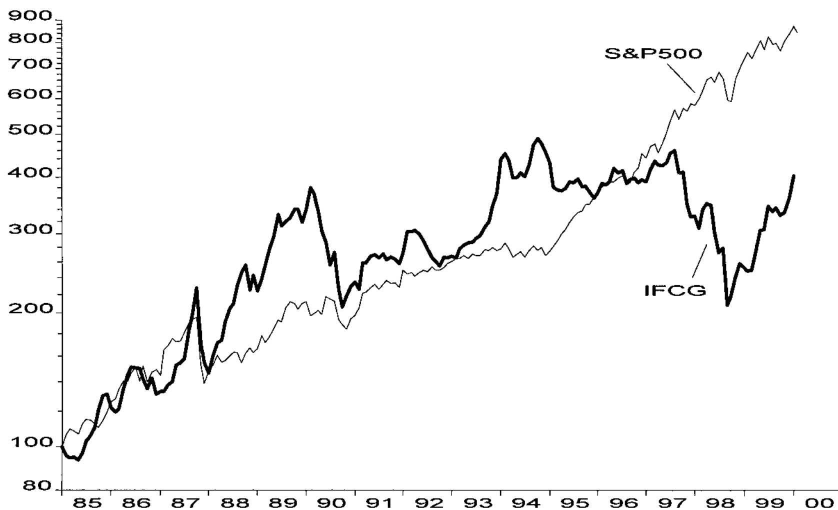
According to IFC data the correlation between emerging market stocks and the US Standard and Poor's Index has increased sharply in recent years. Taking the 5 years from December 1989 to December 1984 the correlation coefficient for the IFCI composite was

a comparatively low 0.49. In the 5 years to June 1999 it had risen to 0.68, slightly above the level for the UK's FT-SE 100 index. These correlations are based on monthly returns.

The increase in correlation may reflect increasing international investor interest in emerging markets, relative to local investors. It is possible, too, that it reflects the greater number of emerging markets with exchange rates which are fixed or more-or-less fixed to the US dollar, and thereby closely linked to US interest rates. However, over the last 2 years, the trend has been decisively away from fixed exchange rates.

The chart shows the two markets since 1985, using the IFC Global index. The pattern of short-term correlation can be seen, though the long-term divergences are equally clear. The IFCG substantially outperformed the S&P Composite during 1988-89 and again in 1993-4 but then dramatically under-performed in 1997-8.

Chart 3: IFCG Composite vs US S&P500

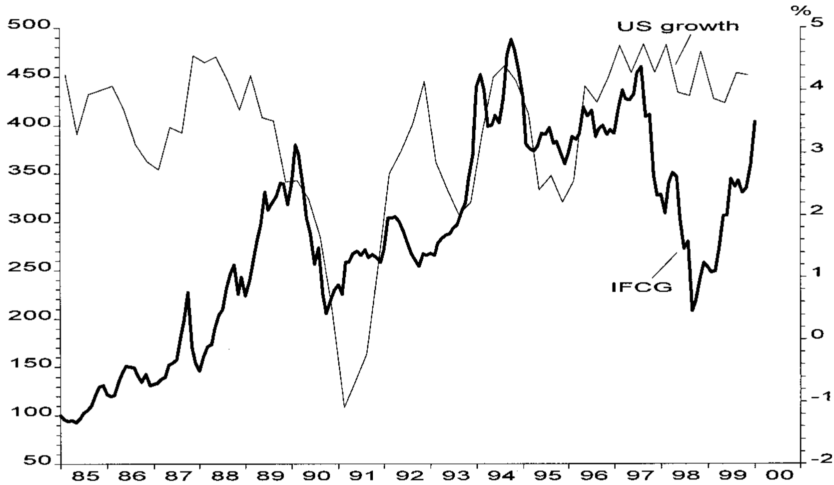


Source: DATASTREAM

Emerging markets and US GDP growth

US GDP growth supports emerging markets by providing a buoyant export market, which has been very important for many successful emerging countries over the last 15 years. The chart does broadly suggest that when US GDP growth has been stronger than trend emerging markets perform well. However the relationship broke down over the last 2 years. In fact it may have been working the other way round, with the crisis in the emerging markets lowering US interest rates, boosting the US stock market and therefore US consumer spending.

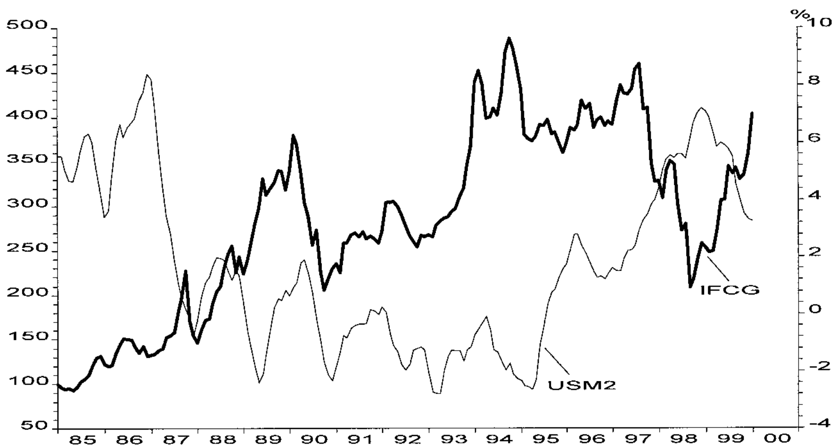
Chart 4: IFCG index versus US GDP growth



Emerging markets and US monetary policy

There appears to be no simple relationship between emerging market performance and US money supply growth. Real money supply growth fell dramatically after 1986, yet emerging markets performed well. And, after 1995, real money supply growth accelerated sharply but the S&P composite index, rather than emerging markets enjoyed the benefit.

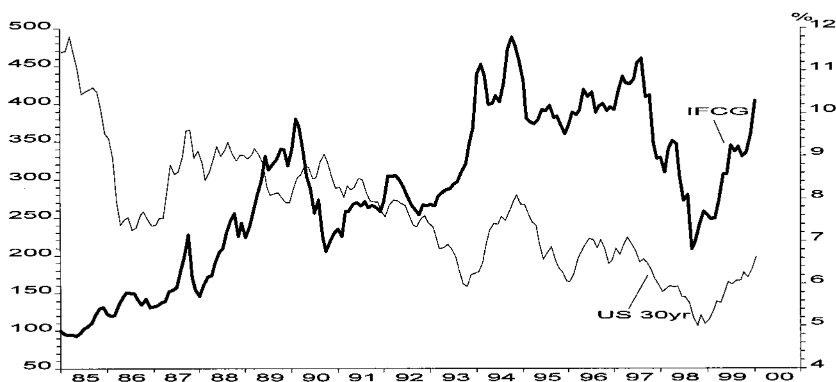
Chart 5: IFCG Index versus US real M2 growth



The declines in US bond yields in the mid-1980s, in 1992-3, 1995 and 1998 may have been supporting factors in the emerging market rallies at the same time. Certainly at times there has been a "reaching for yield" by investors. However this does not mean that

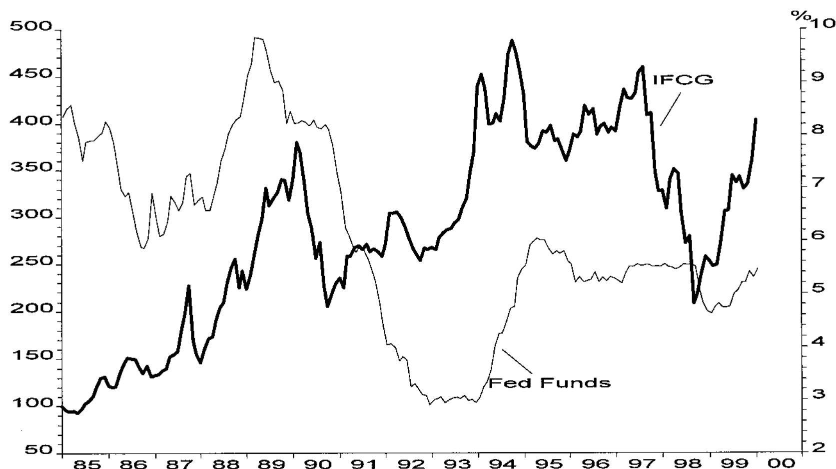
lower US yields "cause" stronger markets. They may both be a result of higher liquidity. In addition emerging markets performed very well in 1999 when US bond yields rose.

Chart 6: IFCG Composite vs US 30 Year Yield



There does not appear to be a simple relationship between the US federal funds rate and emerging stocks, either. The two major Federal Reserve tightening cycles, in 1988 and 1994, saw buoyant emerging markets. However the period of very low Federal funds rate in 1992-3 does seem to have been a big stimulus, particularly in Asia. The US Federal funds rate does of course have a very close impact on Hong Kong (not included in the IFC indices) because of the Hong Kong dollar link to the US currency.

Chart 7: IFCG Composite vs US Federal Funds Rate

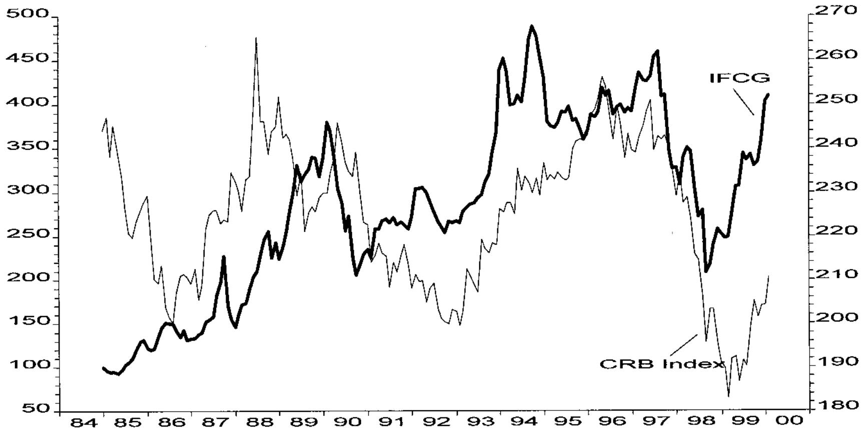


Emerging markets and commodity prices

Many emerging countries are dependent to some extent on commodity prices so it should not be too surprising that there is a relationship with equity prices. Higher commodity

prices should be expected to boost economic growth in many countries and also to boost liquidity. However commodity prices are also correlated with GDP growth in the industrial countries. Also, the fall in commodity prices in 1997-98 is widely seen as partly the result of the emerging market crisis.

Chart 8: IFCG Composite vs Commodity prices



Conclusion: international influences

There is no simple link between international factors such as interest rates, growth and other stock markets with the emerging markets. Part of the reason for this of course is that strong US growth is likely to be accompanied by rising interest rates and bond yields. So much depends on expectations. The data do support the idea that falling interest rates and strong GDP growth are supportive of stock markets, but it all depends on the exact circumstances.

Chapter 5: The outlook for emerging markets

In 1999 emerging markets were the best performing asset class. But now that the markets are no longer severely depressed there is a question as to whether they can continue to deliver good returns or whether the best is over. After the experience of the 1990s many institutional investors are suspicious of the asset class overall and remain much less enthusiastic than before. We approach the question by region.

Table 1: Market returns 1999, US$

Index	**1999, %**
IFC Gobal (weekly)	59.1
IFC Investibles (weekly)	63.4
Barings World	61.7
MSCI Emerging Markets	66.2
S&P 500	21.0
Europe	14.1
Japan	60.6

Source: Datastream

5.1 East Asia

The first signs of economic recovery in Asia started to emerge in the final quarter of 1998. Korea led the way, as decisive restructuring policies were put in place at a very early stage of its crisis at the beginning of 1998. During 1999 other countries in Asia also saw an economic rebound, and all bar Indonesia, which had its own acute political problems, and Hong Kong and China, the two countries which did not devalue, registered strong GDP growth in 1999. The IFCI Asia index rose x% and the Hang Seng Index for Hong Kong (not in the IFCI index) was up 69%. The Hang Seng Index just touched a new all-time high but the IFCI index finished 1999 x% below its earlier peak. To assess the medium-term outlook we start by identifying the positive and negative factors for stocks.

Positive factors for Asian stocks

1. Many countries may be able to return to relatively high sustained economic growth rates. Even if the 8-10% rates seen in the early-1990s are not restored, then at least a rapid 6-8% p.a. should be possible. There are a number of factors supporting this view:
   a. There is still plenty of “catch-up” space left to reach the GDP standards of Europe or the United States. This applies even to Hong Kong and Singapore where GDP per capita is comparatively high. If allowance is made for the high labour force participation in these countries and the long hours worked, productivity still lags. For example GDP per hour worked in 1996 in Hong Kong and Singapore was only 83% and 70% respectively of the average for the UK (Crafts, 1999). Moreover the level for a city such as London, which is a better comparison for these city-states, would be significantly higher than the UK average.
   b. All the elements that drove the successful tiger phenomenon discussed in section 4.2 are still in place, for example macro-economic stability, strong human capital and a market- and outward- orientation. In most cases the crisis has led to improved

policies, for example floating exchange rates, improved corporate governance and opening up to foreign investment. At the same time the corporate sector in many countries appears to have turned back to improving efficiency and performance and focussing on shareholder value. Taken together this should mean that total factor productivity is at least as good as in the past.

c. There is a good chance that high rates of investment will be restored. Savings rates have dropped from their peaks but are still relatively high so there is no constraint there, especially if governments succeed in reducing budget deficits, as seems likely. The main worry is whether memories of the slump or the legacy of bad debts will dampen business enthusiasm.

2. The lower level of domestic inflation now points to lower domestic interest rates than in the past, which should stimulate stock valuations. The development of a domestic bond market in many countries will make monitoring of yields easier.

3. Companies are likely to be more responsive to shareholder value than before. The failure of the "Japanese growth model" is now very plain. Companies and their shareholders are likely to focus much more on return on capital and therefore profits performance should be better. The increase in foreign investment supports this picture.

4. Asian economies and companies are well placed to benefit from the boom in spending on hardware for information technology. Some, particularly in the more advanced countries such as Hong Kong and Singapore, are also well-placed on the software side. In the early months of 2000, as we write, the bullish mood on this sector has already translated into huge stock market gains in these sectors.

5. Valuations still look modest in many countries. This is difficult to assess because profits are still depressed as a result of the downturn. The table below shows the result of a simple simulation based on assuming profits return to their average levels of the 1992-96 period and PE ratios stand at 20. On this simulation the overall index (as of end February 2000), has no room for further gains. The more developed economies, Hong Kong, Taiwan and Singapore are already well above the levels implied. However the less developed economies still have substantial potential gains.

Table 2: Simulating the potential gains

	Current IFCG level	**Current IFCG Level as % 1992-6 average**	**PE Ratio 1992-6 average**	**Potential Market Gain %**
IFCG Asia	339	86	24.5	-3
Korea	471	98	22.5	-4
Taiwan	1063	133	27.5	-45
Malaysia	141	46	29.3	48
Thailand	240	27	19.5	282
Indonesia	45	45	20.5	119
Philippines	1696	53	24.5	62
Hong Kong	16600	207	15.4	-38
Singapore	282	121	22.7	-25

Source: IFC, American Express Bank calculations

A simulation like this is a very rough technique and the results of course depend on the assumptions used, which may be too optimistic or too pessimistic. Also, it should be treated cautiously because the components of the index change over time and in some countries the effect of the crisis has been to substantially change the companies included. Nevertheless the assumptions used are surely on the conservative side. Compared with the average level of 1992-6, countries have enjoyed a significant rise in nominal GDP, even after allowing for currency depreciation. They should therefore be able to generate profits (even in dollar terms) which are significantly higher than during that period once the economic recovery matures. Also, the assumption of a PE ratio of 20 may be too conservative. It is true that markets are more cautious than before. But domestic interest rates are lower now, while international PE ratios are significantly higher now than in the early 1990's. PE ratios were frequently in the mid- to high 20s in the early 1990s and this may be achieved again.

One interpretation of the table may be that investors currently are expecting Hong Kong, Singapore and Taiwan to fully regain the strong economic and market performances of the early 1990's but are more doubtful about other countries, especially Thailand. Certainly many of the negative factors listed below apply more to these other countries and this view is in line with many brokers' current commentaries.

After a crisis and major market disappointment risk premia tend to be high at first. But there is a good chance that economic and market performance will surprise on the upside, helping to reduce risk premia over time. This points to higher valuations in other countries once they have proved they can grow fast again. If there is one single factor that matters the most it is restoring a healthy financial system.

Negative factors for Asian stocks

1. Internal and external private debt are still too high in many countries, which will constrain new investment. Banking systems remain burdened with bad debts which, again, will overhang business confidence for some years and constrain new spending. In some cases credit may be limited by the continuing weakness of banks, a so-called "credit crunch". There is frequently a reluctance to accept low valuations for property and so debts are rolled over or left on banks' books instead of being cleared out.

2. Following the boom there is excess capacity in many sectors, which may point to a slow pace of investment. Property is the worst affected but many other industries in countries such as Thailand and Malaysia also have excess capacity. On the plus side, Korea's sharp economic rebound has already significantly reduced the excess.

3. There will be a need for fiscal contraction in the next few years, which could limit economic growth. As a result of the deficits during the recession together with the assumption of substantial debts from the banking system, many governments now have non-negligible debt/GDP ratios, although only Indonesia has a serious problem here. On the plus side, a restrained fiscal policy is likely to mean continuing low interest rates and an exchange rate weaker than it might be otherwise, both of which are good for equity markets. Note that some appreciation of currencies is likely over time, however.

4. In some countries reforms to deal with the structural problems revealed by the crisis may not have gone far enough. For example, corporate governance appears to have been only partially reformed which may mean that "outside" shareholders continue to be disadvantaged or that companies continue to pursue growth at the expense of profits.

5. More fundamentally, there is a question as to whether the export growth model will continue to work for every country. Partly this depends on the performance of the US, Europe and Japan and whether trade rules continue to liberalise. But there is also a broad question as to whether countries can upgrade productivity fast enough to allow economic growth in the face of heavy competition from lower-wage countries. Some of the caution over Thailand for example is a fear that education standards will be a drag on productivity growth. China's accession to the WTO will further increase the pressure on many countries.

Conclusion: Outlook for Asian stocks

The analysis in section 4.2 argued that East Asian countries still have many of the characteristics of a "tiger economy" which points to a resumption of relatively fast economic growth over the next few years. Several factors will help to ensure this result, many of which apply also to the other regions:

1. A favourable international environment: Exports need to lead recovery, but for all the crisis countries, trade within Asia is large (see table below). A new Japanese recession or free-falling yen could provide another leg to the crisis, although the region is much less vulnerable now than in 1998. A crisis or major devaluation in China could also impact.

2. Financial sector reform: Japan's example in the 1990's highlights the cost of slow-paced banking reform. Bad debts should be quickly written down, and top priority given to downsizing and recapitalising local banking systems. In countries where banks have been nationalised governments need to move quickly to privatisation and greater foreign bank participation.

3. Moves towards "anglo-saxon" type governance: The over-close links between government, banks and corporates have produced severe governance and corruption problems (see table below), as well as over-investment and excessive debt. The opening up of capital markets to foreign investment should eventually see family ownership replaced with more 'anglo-saxon' type governance structures. Reforming highly indebted corporates is also crucial. Under the pressure of events, companies will be forced to use capital more efficiently and to lift returns. More flexibility and greater transparency should improve corporate sector efficiency.

4. Liberalise and deregulate services: Manufacturing and exports alone will not pull Asia out of recession. High cost service sectors need restructuring. The breaking up of monopolies and reduced regulation will boost productivity, cut prices and, ultimately, will lift employment and domestic demand.

The economic success of individual countries will therefore depend both on external conditions and internal policy choices. Again, to quote from Crafts (ibid) "the experience of the United States in the 1930's offers considerable encouragement that even a very

severe crisis need not undermine long-term trend growth." The recovery from the previous crises in Korea in 1979-80 or in Hong Kong in 1983 very much support this view. Crafts blames the length and severity of the US downturn in the 1930's on the failure to deal quickly with the problems of the financial sector. Japan's poor economic performance in the 1990's is probably due to the same failure.

Perhaps the area of most worry to fund managers is whether economic success will be translated into market performance. With the benefit of hindsight, a key lesson of the 1990s was that macro-economic performance is not the same thing as profits performance. Returns on capital in Asia were falling even as the market rose strongly in the early-1990s. Asian companies will need to prove that they can perform.

5.2 Latin America

Latin stocks performed well in 1999 despite the economic problems in the region. For 1999 as a whole, Latin America's US$ return of 56% virtually matched that of the IFC composite (which climbed 57%), although a particularly strong final quarter's out-performance was not enough to overtake Asia for the year overall (IFC Asia was up 62%). The key question for the investor is whether the recent upturn is the start of a sustained rally.

Brazil's problems are far from over, but economic policies are better balanced now, and short-term debt has dropped. The downside of the fact that the crisis resulted from a public sector fiscal problem, is that Brazil's turnaround will be much more gradual than was the case in Asia during 1999. The Cardoso administration still faces a major political challenge in trying to push fiscal reforms through Congress. In addition, Brazil's external borrowing needs remain very high. But the floating, and still undervalued, exchange rate is now a major advantage and will act as a safety value if the politics stalls reform.

Positives for Latin stocks

1. Global economic trends and sound domestic policies should ensure that Latin American growth picks up substantially in 2000 after a small decline in regional GDP in 1999. But 3% growth is probably the best that the region can achieve in 2000, and the rebound will not be as strong as Asia's recovery in 1999. Longer term growth in the region should be able to exceed the 1990's average of 2.9% but is likely to remain lower than in East Asia.

2. Investor-friendly policies should stay the norm in all major countries. Tight monetary policies and free market reforms have brought down inflation, and boosted investment, savings and non-commodity exports. There is still much to do on the policy side, to reduce fiscal deficits and government debt, free up labour markets, boost infrastructure spending, and to better target social spending. But the political premium from keeping inflation low and attracting more investment is so great now that, outside the Andean sub-region, no significant political party advocates policies that are radically more populist. Pressure for further reforms will remain strong, though a key question is whether the political environment will be favourable, see below. Nevertheless the argument is over the pace and emphasis of reforms not the broad direction.

3. Commodity prices are probably now in a broad uptrend from the low levels seen at the beginning of 1999. Oil prices are already high currently but gains in other areas will be good for stock markets.

4. Valuations are still at reasonable levels. Stronger growth and sound policies should feed through into higher corporate earnings. Equity markets will also probably be lifted by an expansion of earnings multiples. P/E ratios have been lifted by the rebound in prices ahead of the rebound in earnings. But P/E ratios are still generally below five-year average levels and corporate earnings should rise strongly in 2000.

Negative factors for Latin stocks

1. Many Latin American countries have chronic fiscal problems. Not only does this mean that public spending cannot be an engine of growth but also continuing macro-economic and exchange rate instability are possible.

2. External positions are generally weaker than in Asia, although deficits have narrowed since 1998. Again this is a potential threat to macro-economic stability. But most major countries have already put in place IMF support programmes that should provide funds if a crisis threatens. Brazil, Mexico, Uruguay, Peru and Colombia have contingency financing agreed, and an enlarged IMF support package for Argentina came through in early 2000. In addition, direct foreign investment into Latin America has risen strongly and now finances a large proportion of the external deficits in most major countries

3. The political environment for further reforms may not be favourable. In Argentina the government faces a hostile Senate, in Brazil President Cardoso lost credibility due to the forced devaluation while in Mexico the PRI is in election mode in 2000. Venezuela's newly approved constitution is a step backwards in terms of economic reform, boosting state intervention and making extensive and permanent spending commitments on minimum wages, social security and pensions, on the basis of what may prove to be only temporarily higher oil prices.

4. Latin America is still less effective as a producer of manufactured goods than Asia and, in particular has relatively little exposure in the global electronics sector, which surged in 1999 and early-2000 on the back of the internet boom.

5. Latin America is still very dependent on the US economy and US interest rates. If the US boom does not last then Latin America will suffer.

Conclusion: Outlook for Latin stocks

Given the external risk posed to Latin America's recovery by US interest rates, it is probably best to focus on those countries with the strongest fundamentals and the lowest dependency on foreign financing. The best performers will probably be Chile and Mexico, where growth is likely to exceed the regional average (probably climbing to 5-6% in Chile in 2000, and close to 4% in Mexico). Brazil and Argentina have a greater risk profile. Economic recovery in both markets is likely to be sluggish (at best probably growth of 1-2% in Argentina, 2-3% in Brazil in 2000), but policies and politics should hold up reasonably well. Finally, the worst could now be over in Colombia, but the rest of the Andean sub-region looks too risky.

Table 3: Latin stock markets

	P/E ratio 1994-98 average	**P/E ratio 1999 average***	**Correlation with S&P****
Argentina	20.1	33.1	0.54
Brazil	16.7	12.4	0.45
Chile	16.6	15.7	0.50
Colombia1	3.7	10.0	0.21
Mexico	21.1	18.4	0.48
Peru	21.5	25.0	0.27
Venezuela	16.2	9.5	0.26

** January-October*
*** five year average to October 1999*

Source: IFC

To achieve and sustain higher growth Latin America needs to target four remaining problem areas.

1. *Low savings.* The region invests more than it saves, and foreigners cover the gap. The savings rate in Latin America is only 18% compared with 32% in Asia excluding Japan. Low savings put a low ceiling on the growth that can be achieved without hitting external problems. Relatively stable direct investment inflows have increased on the back of improved operating environments and extensive privatisation programmes. But a significant proportion of the savings gap is still funded by volatile portfolio inflows and external debt.
   Governments need to help reduce this vulnerability by pushing through fiscal reforms which boost tax receipts and cut sub-national spending. Pensions reform to encourage private savings and to control state social security burdens is also needed. These reforms are well advanced in many countries, but have still to be comprehensively tackled in Brazil.

2. *The overdependence on commodity exports*. Latin America exports less than Asia, and is more dependent on volatile primary products. Commodities account for about 45% of exports. This makes growth highly cyclical and can hold back diversification if, as in Chile, super-competitiveness in the primary sector leads to strong capital inflow and significant real exchange rate appreciation. Only Mexico has sharply reduced its commodity export dependence. The lesson here is that Latin America needs more flexible exchange rate regimes and regulatory and trade reforms which encourage exports of manufactured goods.

3. *Inflexible labour markets*. Surveys show only Peru, Chile and Mexico scoring well on labour flexibility indices. Governments need to do more to curb trade union power, cut payroll taxes and to deregulate labour markets which limit the flexibility of wages and hold down employment.

Table 4: Governance and Labour market flexibility

	Governance Index **1=poor, 10=good**	**Labour market flexibility index** **1=poor, 10=good**
Singapore	7.4	9.8
Hong Kong	6.4	9.5
Taiwan	6.2	5.5
Japan	6.1	8.4
China	5.9	6.9
Malaysia	5.0	8.5
India	3.4	1.9
Philippines	2.8	4.3
Vietnam	2.7	6.9
South Korea	2.3	3.4
Indonesia	2.2	7.5
Thailand	2.0	6.3
Chile	6.8	6.9
Brazil	3.7	4.0
Peru	3.1	7.4
Colombia	2.4	2.4
Mexico	2.2	5.9
Argentina	1.9	2.9
Venezuela	0.7	1.1

Governance index: based on survey data assessing corruption levels, judiciary independence and democracy. Labour market index based on hiring/firing practices and trade union strength.

Source: Based on Global Competitive Report, World Economic Forum

4. *Low quality government spending*. Growth is also held back by poor physical infrastructure, poor social services, a lack of confidence in judicial systems, and by poor education standards particularly at the primary and secondary level.
   If significant progress can be made in all the problem areas 5-6% pa growth in GDP would be sustainable over the long term. But only modest progress is likely, and 4-5% pa growth is probably the best that Latin America can achieve.

Table 5: Factors holding Latin America back

	Current account/ GDP,% **1998-99**	**Primary Products % of exports** **1997**	**Real fx rate 98 est.** **ppp=100**	**Gross savings % of GDP** **1997**
Argentina	-5	66	111	18
Brazil	-4	44	122	22
Chile	-6	80	127	28
Colombia	-5	61	145	16
Mexico	-4	22	106	19
Peru	-6	83	116	15
Venezuela	-2	85	140	20
China	1	20	105	42
Hong Kong	3	3	144	34

India	-2	25	105	21
Indonesia	1	47	50	36
Japan	3	3	89	31
Malaysia	1	34	72	37
Philippines	-1	22	87	16
Singapor	12	20	82	50
South Korea	3	7	75	36
Taiwan	1	5	79	25
Thailand	4	20	80	36
Vietnam	-7	55	125	17

ppp=purchasing power parity. Over 100=overvalued fx rate, below 100= undervalued.

Sources: AEB, IMF, ADB

5.3 Emerging Europe, Middle East and Africa

In 1999 the Russian economy performed much better than expected and showed signs of recovery. However the lack of serious reform effort is likely to hinder long-term recovery. The stock market surged a remarkable 259%, though at end-1999 was still only 62% of its end-1997 level in dollar terms. In other major markets, Greece reached new highs with investors optimistic of a successful entry to EMU. Turkey's new government unveiled an ambitious new reform programme and was officially included as a prospective EU member, encouraging a very sharp rally. Eastern European markets moved up too, encouraged by the faster pace of growth in the EU. South Africa, the largest component of the IFCI EMEA index rose 56% in 1999 on improved economic growth and lower interest rates.

Positives factors for emerging European stocks

1. Europe may be the most exciting region for policy change, which, as we have seen, is often a key driver of equity markets. In many countries change is necessary because the legacy of communism remains strong, or in the case of Turkey because the adjustment to low inflation has yet to be made. But a key catalyst too, is the prospect of EU entry, which should make it possible for countries to adopt more market-friendly policies. Some countries, such as Greece, have already made the transition to low inflation, low budget deficits and, to a certain extent, low current account deficits. For others, such as Hungary and Poland, inflation is coming down slowly and current account deficits remain high.

2. Entry into the European Union will also open up possibilities for trade, encourage more foreign investment and allow companies to fully exploit the comparative advantages of low labour costs and relatively high education levels. Some countries, notably Russia also have a substantial resource base.

3. Eventual membership of EMU should bring lower interest rates and more foreign interest in stock markets. The example of Greece, where the market soared during 1999 on excitement over EMU entry, is instructive. The goal of EMU membership will drive disciplined fiscal, monetary and exchange rate policy.

4. Faster economic growth is likely in the EU countries in coming years after a sluggish few years in the second half of the 1990's. This should help the emerging European countries, much of whose trade is with the EU.

5. Russia of course does not enjoy the prospect of EU membership in the foreseeable future. A positive view there relies on improved economic policy and institutional reform following the Presidential elections..

Negative factors for European stocks

1. Several markets have already reacted to hopes for improved policies. For example Russia, Turkey and Greece rose 259%, 221% and 67%, respectively, in dollar terms in 1999. Valuations now look expensive.

2. The transition from communism continues to be a long and difficult one. Privatisation has been achieved but often shareholders and managers are not operating in a free-market environment in the same way as the west, so that investment decisions are sub-optimal. Legal systems are embryonic. Russia is the extreme case of course, and although there are hopes for renewed reforms after the Presidential elections in March 2000, the outlook is uncertain.

3. Entry into the EU may be delayed and may prove disappointing. Even if central Europe joins in mid-decade there will be a lengthy transition before countries can enjoy the full benefits. There are also risks if exchange rates are fixed before economies are fully flexible.

4. Reform efforts in Turkey and Russia may fail. Turkey's budget deficit was 12% of GDP in 1999 and a substantial effort will be needed to bring it down. The Latin American experience of the 1980s included several false starts before inflation was finally tamed. Privatisation does look like accelerating finally, which will help with the fiscal situation as well as boosting the private sector, but again experience elsewhere shows that the privatisation process and its impact on an economy's efficiency can take a long time.

5. Morgan Stanley Capital International has now placed Greece in its global developed equity market list. The experience with Portugal was that interest waned once the market left the emerging markets categorisation. On the plus side foreign participation will be enhanced by the easing of restrictions on cross-border capital flows.

Middle East and Africa

The largest countries in the indices in this region are South Africa, Israel and Egypt, three very different economies about which it is impossible to generalise. South Africa has enjoyed only sluggish economic growth in the 1990s and this is reflected in the lack-lustre performance of the stock market. Slow growth has been due in part to tight macro-economic policies as inflation and interest rates have been brought down. But it also reflects a slow pace of structural change and the consequences of a gradual outflow of skilled labour. Israel has transformed its economy in recent years by controlling the budget deficit and reducing inflation. Now the emphasis is on further reform to privatise the state sector and reduce regulation. Egypt achieved macro-economic stability in the early-1990s and has been pursuing structural reforms at a rather leisurely pace, though there have been signs of an acceleration in recent years.

Conclusion: Outlook for EMEA stocks

The key issue for EMEA countries will be whether countries can pursue further economic reforms. This is the key to faster economic growth and improved stock market

performance. In Europe the prospect of EU membership should keep reforms in the right direction but the pace of change could be disappointing. In the Middle-East and Africa the pace of reform is still relatively slow now and much needs to be done. A second issue, particularly important for Europe but also to some extent for the whole EMEA region, will be whether western Europe can achieve a better economic growth performance, after relatively disappointing results for much of the 1990s.

Greece will lose its emerging stock market status shortly and there are concerns that this could lead to more stately progress for the index. There are also questions over how far structural problems remain to be tackled, notwithstanding the good progress on macro-indicators. The market has fallen from its peak last September (in contrast to the bullish trend in most other markets) and a further correction is likely to be needed unless the government can press ahead with reforms to the labour market and the public sector.

Turkey's potential is huge, but much depends on the success of the reform programme. In particular there are concerns about the durability of the current coalition government, the high level of short-term debt (now being boosted by sizeable portfolio capital inflows) and the risk of real lira appreciation. But an economic bounce-back, supported by booming investment and exports, looks promising for earnings growth, and a committed rejuvenation of the moribund privatisation programme would bolster the restructuring process.

In central Europe preparing for EU membership promises continued structural reform, with macro-policy driven partly by the desire to join EMU. In the Czech Republic the economic recovery is likely to be held back by weak investment and continued restructuring of the heavily-indebted corporate sector and banks. The restructuring process should bring value to the stockmarket over the longer-term, as will the prospect of EU membership, and, presumably, EMU.

In South Africa, the key for the long term will be the government's ability to maintain disciplined macro-economic policy and sustain the dynamic of reform and development without the driving force of a challenging parliamentary opposition. The long-term prospects for Israel are good if peace with Palestine and Syria can be secured. This would open up the prospect of much greater trade and investment with its neighbours. In Egypt maintaining political stability will be a key factor in encouraging foreign investor interest.

CHAPTER 6 Summary and Conclusions

Despite the shock and disappointment of the Asian crisis, foreign investors remain very interested in emerging stocks as an asset class. The sharp recovery in most markets in 1999, which continued into the first two months of 2000, is partly a result of this continuing interest, but is also likely to encourage some of the more cautious investors to return to the sector. Nevertheless markets are likely to maintain a higher risk premium for emerging stocks for some time to come and will be more wary of risk factors such as fixed exchange rates, low reserves, high short-term debt, high borrowing requirements and undemocratic governments.

Despite the crisis, foreign direct investment flows have remained strong, suggesting both that international companies are still optimistic about the prospects for emerging countries and that the trend to globalisation remains intact. Many of the structural factors driving international portfolio flows in the first half of the 1990's are also still in place. Overall, countries have opened further to portfolio investment and are making improvements in areas such as increasing transparency and liquidity, though much remains to be done. And the flow into investment institutions in the industrial countries will continue as more and more countries introduce private pension systems and populations age, bringing a boost to savings.

Overall the crisis seems to have improved economic policy-making. On the macro-economic side governments are more cautious over fixing exchange rates and are likely to be much more careful about allowing economic booms to develop unchecked. Meanwhile most countries have implemented significant structural changes including improved regulation of the financial system, more limitations on short-term foreign currency borrowing, greater openness to foreign investment and improved bankruptcy laws. Some of the fears expressed in 1997-98, that countries might retreat from globalisation, have not been borne out. There have also been political developments in a number of coutries towards greater democracy and stronger civic institutions. On the negative side, some countries have budget deficits for the first time for many years and a few have seen a sharp rise in government debt.

A further surprising aspect of the crisis was that higher inflation did not take hold, despite the size of the devaluations. Only in Indonesia was there a significant inflation (roughly a doubling of the price level) but even here monetary policy was quickly brought back under control. Similarly, in Brazil, fears that devaluation would set off the old inflation spiral proved unfounded. Very few developing countries now suffer from high inflation, in sharp contrast to 10-15 years ago.

The key to continuing solid recovery in the crisis countries will be resolving the problems of the financial sector. So far countries have a mixed performance. But the solid fundamentals of the Asian countries remain intact and indeed may have been improved. The evidence suggests that the best performing countries enjoy macro-economic stability, high human capital resources, a strong market- and outward- orientation and a high investment/GDP ratio. Latin America improved substantially in these areas in the 1990's but still has some catching up to do. Most countries in the EMEA region also have some way to go in most of these areas.

Overall, there seems to be a good chance that economic growth in Asia will be able to return to 'high single digit' rates over the coming years. Latin America should be able to grow faster than the 2.9% p.a. average of the 1990's but is likely to still fall short of Asian growth rates. The EMEA region is a mixed bag of countries, but in general this is the region with the most scope for market-oriented reforms and therefore the greatest potential to boost average growth rates. In Europe the role of the EU in fostering reforms by holding out the prospect of EU and eventually EMU membership, is crucial.

A further result of the crisis is that corporate managements are likely to pay more attention to shareholder value and to the interest of 'outside' shareholders. Evidence is anecdotal but managements do seem to be placing more emphasis on boosting returns on capital, rather than just maximising sales growth. Investment in property has receded as an easy way to make money and companies are turning back to their main business or trying to embrace the new technologies.

The core case for investing in emerging markets therefore remains intact. Emerging countries are likely to grow faster than developed economies over the coming years. More and more countries are adopting market-oriented policies, despite the shock of the crisis. And the evidence of the market recovery since October 1998 is that emerging markets are judged by investors to have acceptable risks. However the issues raised in the paragraph above, i.e. the correlation between economic growth and stock returns, remain the weakest link in the case. Fast economic growth in the past has not necessarily translated into fast growth of company profits and this is an area where investors are justifiably nervous. There appear to be an increasing number of fund managers using the 'bottom-up' approach, focussing on individual companies rather than a 'top-down' style. Another way to deal with this problem is to invest in multinational companies which are particularly active in emerging countries.

A related development is the trend towards industry-focussed fund management. Globalisation means that it may make less sense in future to start with countries and then choose companies within that country. A better approach may be to look at industries on a world-wide basis and then choose the best companies within that industry. This global approach cuts across both the top-down and bottom-up approach within emerging markets.

Emerging markets represent about 10% of world market capitalisation, although 55% of the total is accounted for by just 5 countries- Korea, Taiwan, Mexico, South Africa and Brazil. Part of the case for investing in emerging markets remains the benefits of diversification, since correlations with major markets remain only modest. But the historical evidence shows clearly that the best returns for emerging market investors follow positive policy 'shocks', e.g. when governments unexpectedly make a major shift towards more market-oriented policy. Russia is likely to continue to be a roller-coaster in this respect but the surge in the Turkish stock market over the last 9 months is a good example. Investors will also be watching the so-called 'frontier markets', mostly small emerging countries in the EMEA region.

Investment in emerging markets really only took off in the 1990's and the sector has now been through a complete cycle of boom and bust. With at least the initial 'recovery' period in the market past, investors have to address the issue of relative valuations. The heady current multiples of US and to a lesser extent European stocks gives pause for thought. If the US and Europe can sustain market PE ratios of around 25 (Europe)

or 30 (the S&P500), where should valuations in emerging markets be? If the reason for high PE ratios is the low level of international interest rates and bond yields, emerging countries should benefit too.

In the late 1980's and 1990's many fast-growing countries had higher PE ratios than the US. Now, they are generally lower, after adjusting for the depressed level of profits. Either emerging stocks are undervalued or the markets are being much more cautious about the asset class than previously. The strong recent performance of Singapore and Hong Kong, which are not strictly emerging markets but are included in this study, suggests that the markets are more cautious than before. And, again, it may particularly be the link between economic performance and company performance, where investors are more confident about Singapore and Hong Kong.

At the beginning of 2000 technology stocks are rising strongly throughout the world. Some emerging markets are relatively strong in this area, notably countries in Asia such as Korea and Taiwan. But, as in the major markets, the non-technology stocks appear to be on much more modest valuations.

The international environment for emerging markets has been particularly favourable over the last 18 months. Strong economic growth in the US, combined with recovery in Europe and Japan has supported the economic recovery. Meanwhile short-term US interest rates have been low and commodity prices have been rising. All three factors are normally associated with strong emerging markets. Looking forward, emerging markets are at risk if the industrial country upswing is brought short, as some fear, by a sharp slowdown in the US economy, or if US interest rates need to rise substantially.

However a recession in the US or other industrial countries is not necessarily a major negative for emerging markets. Asian stocks did extremely well in the early 1990's despite Japan and Europe being in recession. And a US recession would bring significantly lower US interest rates and bond yields, which usually supports emerging markets.

A final thought. The remarkable rise in the US market since 1995, led by the technology sector, may or may not prove to be a bubble in the end. But the US market's dramatic outperformance of emerging markets and most other asset markets in the 1990s reflects a huge increase in US valuations. This cannot be repeated unless a few super-optimists are right in believing that the PE ratio could go up to 60 times, from the current 30. Hence US market performance is likely to return to closer to the long-run rate of growth of profits, of around 5-6% in nominal terms. Emerging markets therefore are likely to have a less challenging rival in the future, unless, of course, Japan is now set for a new leap forward.

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Appendix 1

Capital Flows by country $mn

	1994	1995	1996	1997	1998
ARGENTINA					
Net direct investment	2480	3756	4937	4924	3740
Net portfolio investment	8374	1882	9779	11115	10223
of which:equities	3103	1072	642	622	-922
bonds	5271	810	9137	10493	11145
GDP	257440	258032	272150	292859	298131
As % GDP					
Net direct investment	1.0%	1.5%	1.8%	1.7%	1.3%
Net portfolio investment	3.3%	0.7%	3.6%	3.8%	3.4%
of which:equities	1.2%	0.4%	0.2%	0.2%	-0.3%
bonds	2.0%	0.3%	3.4%	3.6%	3.7%
CHILE					
Net direct investment	1672	2220	3561	3467	1994
Net portfolio investment	908	36	1098	2370	-727
of which:equities	908	-261	529	1476	-789
bonds	0	297	569	894	62
GDP	50940	65210	68560	75780	72950
As % GDP					
Net direct investment	3.3%	3.4%	5.2%	4.6%	2.7%
Net portfolio investment	1.8%	0.1%	1.6%	3.1%	-1.0%
of which:equities	1.8%	-0.4%	0.8%	1.9%	-1.1%
bonds	0.0%	0.5%	0.8%	1.2%	0.1%
COLOMBIA					
Net direct investment	1296	713	2795	4892	2454
Net portfolio investment	87	1434	1606	925	1704
of which:equities	-671	1029	-210	-72	50
bonds	758	405	1816	997	1654
GDP	68633.99	80533.52	86354.77	96789.65	90920.75
As % GDP					
Net direct investment	1.9%	0.9%	3.2%	5.1%	2.7%
Net portfolio investment	0.1%	1.8%	1.9%	1.0%	1.9%
of which:equities	-1.0%	1.3%	-0.2%	-0.1%	0.1%
bonds	1.1%	0.5%	2.1%	1.0%	1.8%
MEXICO					
Net direct investment	10973	9526	9186	12831	10238
Net portfolio investment	7415	-10377	13961	4330	526
of which:equities	4084	519	2801	3215	-665
bonds	3332	-10896	11160	1115	1191
GDP	420165	286140	329449	402399	414791
As % GDP					
Net direct investment	2.6%	3.3%	2.8%	3.2%	2.5%
Net portfolio investment	1.8%	-3.6%	4.2%	1.1%	0.1%
of which:equities	1.0%	0.2%	0.9%	0.8%	-0.2%
bonds	0.8%	-3.8%	3.4%	0.3%	0.3%

VENEZUELA					
Net direct investment	455	894	1676	4611	3359
Net portfolio investment	253	-801	739	-1660	1551
of which:equities	595	267	1307	1426	257
bonds	-342	-1068	-568	-3086	1294
GDP	58418.85	77407.80	70543.25	88440.23	95015.15
As % GDP					
Net direct investment	0.8%	1.2%	2.4%	5.2%	3.5%
Net portfolio investment	0.4%	-1.0%	1.0%	-1.9%	1.6%
of which:equities	1.0%	0.3%	1.9%	1.6%	0.3%
bonds	-0.6%	-1.4%	-0.8%	-3.5%	1.4%

INDIA					
Net direct investment	890	2027	2187	3238	2239
Net portfolio investment	5491	1590	3958	2543	-603
of which:equities	5491	1590	3958	2543	-603
bonds	0				
GDP	330510	375580	398280	430740	445400
As % GDP					
Net direct investment	0.3%	0.5%	0.5%	0.8%	0.5%
Net portfolio investment	1.7%	0.4%	1.0%	0.6%	-0.1%
of which:equities	1.7%	0.4%	1.0%	0.6%	-0.1%
bonds	0.0%	0.0%	0.0%	0.0%	0.0%

INDONESIA					
Net direct investment	1500	3743	5594	4499	-400
Net portfolio investment	3877	4100	5005	-2632	-2002
of which:equities	1900	1493	1819	-4987	-4495
bonds	1977	2607	3186	2355	2493
GDP$mn	176888.1	202131.9	227369.6	214994.8	98822.90
As % GDP					
Net direct investment	0.8%	1.9%	2.5%	2.1%	-0.4%
Net portfolio investment	2.2%	2.0%	2.2%	-1.2%	-2.0%
of which:equities	1.1%	0.7%	0.8%	-2.3%	-4.5%
bonds	1.1%	1.3%	1.4%	1.1%	2.5%

SOUTH KOREA					
Net direct investment	-1651	-1776	-2345	-1605	629
Net portfolio investment	6121	11591	15185	14295	820
of which:equities	3232	3981	5301	2205	3706
bonds	2888	7610	9883	12090	2509
GDP$mn	380820.2	456357.6	484570.8	442543.2	320747.9
As % GDP					
Net direct investment	-0.4%	-0.4%	-0.5%	-0.4%	0.2%
Net portfolio investment	1.6%	2.5%	3.1%	3.2%	0.3%
of which:equities	0.8%	0.9%	1.1%	0.5%	1.2%
bonds	0.8%	1.7%	2.0%	2.7%	0.8%

PHILIPPINES					
Net direct investment	1289	1079	1335	1086	1553
Net portfolio investment	269	1190	5317	591	-880
of which:equities	0	0	2122	-376	184
bonds	269	1190	3195	967	-1064
GDP	64087.51	74123.04	82850.16	82250.34	65096.71
As % GDP					
Net direct investment	2.0%	1.5%	1.6%	1.3%	2.4%
Net portfolio investment	0.4%	1.6%	6.4%	0.7%	-1.4%
of which:equities	0.0%	0.0%	2.6%	-0.5%	0.3%
bonds	0.4%	1.6%	3.9%	1.2%	-1.6%

SINGAPORE					
Net direct investment	3973	925	1609	4988	4110
Net portfolio investment	-7726	-7359	-10283	-11464	-7483
of which:equities	-7245	-7510	-8671	-11559	-7193
bonds	-481	151	-1612	95	-290
GDP	70850.46	85158.74	100185.8	95107.75	84378.58
As % GDP					
Net direct investment	5.6%	1.1%	1.6%	5.2%	4.9%
Net portfolio investment	-10.9%	-8.6%	-10.3%	-12.1%	-8.9%
of which:equities	-10.2%	-8.8%	-8.7%	-12.2%	-8.5%
bonds	-0.7%	0.2%	-1.6%	0.1%	-0.3%

THAILAND					
Net direct investment	873	1182	1405	3356	6647
Net portfolio investment	2481	4081	3544	4352	-65
of which:equities	-394	2121	1123	3453	131
bonds	2875	1960	2421	899	-196
GDP	144524.8	168322.6	185067.0	153928.5	116779.4
As % GDP					
Net direct investment	0.6%	0.7%	0.8%	2.2%	5.7%
Net portfolio investment	1.7%	2.4%	1.9%	2.8%	-0.1%
of which:equities	-0.3%	1.3%	0.6%	2.2%	0.1%
bonds	2.0%	1.2%	1.3%	0.6%	-0.2%

CZECH REPUBLIC					
Net direct investment	762	2531	1394	1258	1592
Net portfolio investment	846	1370	721	993	314
of which:equities	450	911	551	381	738
bonds	396	460	170	612	-420
GDP	39902.72	50815.71	56459.75	52037.98	55016.41
As % GDP					
Net direct investment	1.9%	5.0%	2.5%	2.4%	2.9%
Net portfolio investment	2.1%	2.7%	1.3%	1.9%	0.6%
of which:equities	1.1%	1.8%	1.0%	0.7%	1.3%
bonds	1.0%	0.9%	0.3%	1.2%	-0.8%

EGYPT					
Net direct investment	1213	505	631	762	1031
Net portfolio investment	3	20	545	816	-571
of which:equities	-	-	-	515	-194
bonds	3	20	545	301	-377
GDP	51470.58	60294.11	67147.05	75367.64	82417.64
As % GDP					
Net direct investment	2.4%	0.8%	0.9%	1.0%	1.3%
Net portfolio investment	0.0%	0.0%	0.8%	1.1%	-0.7%
of which:equities				0.7%	-0.2%
bonds	0.0%	0.0%	0.8%	0.4%	-0.5%

HUNGARY					
Net direct investment	1095	4476	1986	1646	1458
Net portfolio investment	2464	2212	-869	-1040	1978
of which:equities	214	0	0	972	511
bonds	2250	2212	-869	-2012	1468
GDP	41508.17	44255.25	44844.07	45505.64	47574.62
As % GDP					
Net direct investment	2.6%	10.1%	4.4%	3.6%	3.1%
Net portfolio investment	5.9%	5.0%	-1.9%	-2.3%	4.2%
of which:equities	0.5%	0.0%	0.0%	2.1%	1.1%
bonds	5.4%	5.0%	-1.9%	-4.4%	3.1%

JORDAN					
Net direct investment	26	40.6	58.8	360.9	310
Net portfolio investment					

PORTUGAL					
Net direct investment	983	-3	590	608	-1164
Net portfolio investment	479	-1082	-1507	1934	273
of which:equities	496	-338	859	1719	1247
bonds	-18	-745	-2366	216	-975
GDP	88131.81	104678.7	108947.0	102133.3	103936.7
As % GDP					
Net direct investment	1.1%	-0.0%	0.5%	0.6%	-1.1%
Net portfolio investment	0.5%	-1.0%	-1.4%	1.9%	0.3%
of which:equities	0.6%	-0.3%	0.8%	1.7%	1.2%
bonds	-0.0%	-0.7%	-2.2%	0.2%	-0.9%

RUSSIA					
Net direct investment	537	1659	1708	3639	1158
Net portfolio investment	81	-1622	9744	17234	8482
of which:equities	25	4	2037	1298	703
bonds	56	-1626	7707	15936	7779
GDP	278893.5	347648.7	429620.3	435970.1	276658.6
As % GDP					
Net direct investment	0.2%	0.5%	0.4%	0.8%	0.4%
Net portfolio investment	0.0%	-0.5%	2.3%	4.0%	3.1%
of which:equities	0.0%	0.0%	0.5%	0.3%	0.3%
bonds	0.0%	-0.5%	1.8%	3.7%	2.8%

SOUTH AFRICA					
Net direct investment	188	726	702	-611	-1063
Net portfolio investment	2133	3076	2209	8218	7585
of which:equities	133	1325	485	4728	5628
bonds	1999	1751	1724	3489	1957
GDP	121405.8	133609.5	126248.1	129092.4	116735.5
As % GDP					
Net direct investment	0.2%	0.5%	0.6%	-0.5%	-0.9%
Net portfolio investment	1.8%	2.3%	1.7%	6.4%	6.5%
of which:equities	0.1%	1.0%	0.4%	3.7%	4.8%
bonds	1.6%	1.3%	1.4%	2.7%	1.7%

TURKEY					
Net direct investment	559	772	612	554	573
Net portfolio investment	1158	237	570	1634	-6386
of which:equities	903	120	198	-42	-347
bonds	164	117	372	1676	-6039
GDP	135972.1	172123.4	176217.6	189121.9	212454.5
As % GDP					
Net direct investment	0.4%	0.4%	0.3%	0.3%	0.3%
Net portfolio investment	0.9%	0.1%	0.3%	0.9%	-3.0%
of which:equities	0.7%	0.1%	0.1%	-0.0%	-0.2%
bonds	0.1%	0.1%	0.2%	0.9%	-2.8%

Appendix 2 The Tiger Analysis

Table 1: Raw data (Feb 2000)

	Macro Stability		Human Capital		Market Orientation	Export Orientation	Develop-ment state
	Inflation 96-99	*Budget balance an.av.% of GDP 96-99*	*Illiteracy % of total population 97*	*Secondary school enrolment % 96*	*Freedom index 97-98*	*Export growth an.av.% 96-99*	*Investment GDP an.av.% 96-99*
Argentina	0	-1.7	4	65	8.4	3	20
Bolivia	7	-3.0	16	23	8.0	5	19
Brazil	6	-7.5	16	20	6.0	5	22
Chile	5	0.0	5	58	8.2	0	25
Colombia	17	-3.3	9	50	5.6	5	22
Dominican Rep.	6	-1.1	17	25	7.0	11	23
Ecuador	40	-4.6	9	50	7.0	0	19
Mexico	19	-0.7	10	51	7.7	12	24
Panama	1	-1.0	9	60	8.3	0	26
Peru	7	-0.9	11	53	7.9	3	24
Uruguay	17	-1.6	3	85	7.4	5	12
Venezuela	48	-0.3	7	22	5.5	4	17
Bangladesh	6	-5.0	62	20	5.3	5	17
India	5	-5.8	47	40	5.8	7	25
Pakistan	8	-5.5	60	18	5.6	1	17
Sri Lanka	10	-8.8	9	80	6.5	3	26
China	2	-3.7	17	55	6.2	7	40
Hong Kong	2	0.6	9	75	9.4	0	32
Indonesia	24	-1.9	15	42	7.2	2	24
Malaysia	3	0.9	15	68	7.5	4	27
Philippines	7	-2.0	5	60	7.9	15	22
Singapore	1	10.8	9	85	9.4	-1	35
South Korea	4	-2.6	3	97	7.3	3	32
Taiwan	2	-2.2	9	90	7.1	2	22
Thailand	4	-1.8	5	40	8.2	0	31
Vietnam	5	-5.0	8	35	5.5	15	28
Bulgaria	224	-3.8	2	74	5.3	-8	12
Czech Republic	7	-2.6	3	87	7.1	6	32
Greece	5	-3.9	4	87	7.4	1	21
Hungary	15	-4.2	1	87	7.4	4	31
Poland	12	-2.6	0	85	6.0	3	23
Portugal	3	-2.5	9	78	8.0	10	25
Romania	74	-3.7	2	73	4.6	0	22
Russia	40	-5.6	0	88	5.4	-4	19
Slovakia	8	-4.5	3	89	6.1	2	36
Turkey	78	-9.0	17	55	6.6	9	25
Ukraine	36	-3.2	3	80	4.5	0	19
Egypt	5	-1.1	48	68	6.6	3	20
Ghana	27	-5.3	33	40	6.4	5	16

Israel	7	-3.2	5	87	6.5	5	22
Jordan	4	-5.6	13	60	6.1	2	29
Kenya	8	-2.6	21	30	6.8	1	18
Nigeria	17	-3.0	40	35	4.7	-3	8
Morocco	3	-3.2	54	40	6.0	4	21
South Africa	7	-9.1	16	51	7.3	2	19
Zimbabwe	32	-10.5	9	50	5.0	4	15

Source: IMF, World Bank, National sources

Table 2: Tiger scores - (Feb 2000)

	Macro Stability		**Human Capital**		**Market Orientation**	**Export Orientation**	**Develop-ment state**	**Total Score**
	Inflation an.av.% 96-99	*Budget balance an.av.% of GDP 96-99*	*Illiteracy % of total population 97*	*Secondary school enrolment % 96*	*Freedom index 97-98*	*Export growth an.av.% 96-99*	*Investment GDP an.av.% 96-99*	
Argentina	10	5	10	5	20	0	5	55
Bolivia	10	5	5	0	20	5	5	50
Brazil	10	0	5	0	15	5	10	45
Chile	10	10	10	5	20	0	10	65
Colombia	5	5	10	0	10	5	10	45
Dominican Rep.	10	5	5	0	15	10	10	55
Ecuador	0	0	10	0	15	0	5	30
Mexico	5	5	5	5	15	15	10	60
Panama	10	5	10	5	20	0	15	65
Peru	10	5	5	5	15	0	10	50
Uruguay	5	5	10	10	15	5	0	50
Venezuela	0	5	10	0	10	5	5	35
Bangladesh	10	0	0	0	10	5	5	30
India	10	0	0	0	10	5	10	35
Pakistan	10	0	0	0	10	0	5	25
Sri Lanka	5	0	10	10	15	0	15	55
China	10	5	5	5	15	5	20	65
Hong Kong	10	10	10	10	20	0	20	80
Indonesia	0	5	5	0	15	0	10	35
Malaysia	10	10	5	5	15	5	15	65
Philippines	10	5	10	5	15	15	10	70
Singapore	10	10	10	10	20	0	20	80
South Korea	10	5	10	10	15	0	20	70
Taiwan	10	5	10	10	15	0	10	60
Thailand	10	5	10	0	20	0	20	65
Vietnam	10	0	10	0	10	15	15	60
Bulgaria	0	5	10	5	10	0	0	30
Czech Republic	10	5	10	10	15	5	20	75
Greece	10	5	10	10	15	0	10	60
Hungary	5	0	10	10	15	5	20	65
Poland	5	5	10	10	15	0	10	55
Portugal	10	5	10	10	20	10	10	75
Romania	0	5	10	5	10	0	10	40
Russia	0	0	10	10	10	0	5	35
Slovakia	10	0	10	10	15	0	20	65
Turkey	0	0	5	5	15	10	10	45
Ukraine	0	5	10	10	10	0	5	40
Egypt	10	5	0	5	15	0	5	40
Ghana	0	0	5	0	15	5	5	30

Israel	10	5	10	10	15	5	10	65
Jordan	10	0	5	5	15	0	15	50
Kenya	10	5	5	0	15	0	5	40
NIgeria	5	5	5	0	10	0	0	25
Morocco	10	5	0	0	15	5	10	45
South Africa	10	0	5	5	15	0	5	40
Zimbabwe	0	0	10	0	10	5	0	25

Source: American Express Bank

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