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Emerging Financial Markets

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EMERGING FINANCIAL MARKETS

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Professor Calomiris received a BA in economics from Yale University in 1979 and a PhD in economics from Stanford University in 1985.

In 1997, **Professors Beim and Calomiris** designed a new course in emerging financial markets, which they have both subsequently taught and which provided the genesis for this book. This course won the 1997–1998 Chazen International Innovation Prize at Columbia Business School.

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Preface

Purpose of This Book

We believe that this is the first textbook to be written on emerging financial markets (EFMs), a subject that is very new, yet one with roots reaching back into history. In a narrow sense, the book grew out of a grant given by Citibank to Columbia Business School in 1996 for the purpose of designing a new course in emerging financial markets for our MBA program. This funding was used primarily to create seven original cases. These cases, described in greater detail below, are a complement to this textbook and are specifically designed to illustrate its themes. We use the book and all seven cases in our course.

In a larger sense, however, this book is made possible by the outpouring of research in recent years that seeks to explain the startling financial crises in Latin America and Asia during 1995–1998 and related issues such as capital flows, currency regimes, legal and regulatory matters, corporate governance, and the functions and structure of financial systems. Just as the optimism of the first half of the 1990s stimulated a wave of investment activity on Wall Street, so the crises of the second half of the 1990s stimulated a wave of academic activity. The hundreds of creative and thoughtful papers written to explain aspects of EFMs provide the intellectual foundation for this book.

We try to represent all sides of the relevant debates, so that the text can be used with confidence regardless of any professor's personal position on the key issues. On the other hand, we show what we believe to be central to the subject by the very titles of our chapters. Simply put, this is a book about the institutional foundations of all financial markets. It emphasizes three fundamental elements that any financial market needs to function well: sound law and regulation, reliable systems of information and control, and thoughtful management of the national government's fiscal balance and the value of its currency.

Why Study Emerging Financial Markets?

We understand "emergence" to mean the separation of financial systems from state domination through a process of liberalization that we examine in detail. We believe

that liberalization is highly beneficial to sustained economic growth, but that it can be fraught with danger. The EFMs can be thought of as some 50 experiments in privatizing economies and building financial systems, none perfect, with different emphases and different problems. If we can penetrate from the surface phenomena to the foundations, we can learn which foundations are important, and what goes wrong when some foundational element is missing or flawed. It does not require any great leap of faith to believe that if the foundations are weak, the structure can be knocked down by any number of passing storms. It is, we think, the differences in foundational institutions that make EFMs behave so differently from developed financial markets and from each other.

There are at least three good reasons to study emerging financial markets. The first is their role in global portfolio management. While investments in EFMs must be viewed as the high-risk component of a global investment portfolio, no money management firm can afford to ignore them. Every serious investor needs to understand the unique mix of rewards and risks that these markets offer.

Second, financial institutions are being built all over the developing world. Students from Africa, Latin America, Asia, and Central and Eastern Europe are flocking to the universities of the developed world to learn more about how modern market institutions work so they can apply that knowledge to the task of building their own countries' financial systems. These students need to gain a clear understanding of the problems in EFMs to better understand the specific gaps that need to be filled to build stronger institutions in their own countries.

But there is a third and deeper reason to study emerging financial markets. By looking carefully at the patterns of what works and does not work, all of us can gain a richer understanding of the foundations of all financial markets. In other words, this subject is much larger than it seems. The EFM perspective takes one back to basics, to the foundations on which all financial markets rest, and this perspective enriches our understanding of financial markets everywhere.

Intended Audience

Emerging Financial Markets is designed primarily for use in postgraduate study, particularly but not exclusively at business schools. It should be read by students whose careers will take them into direct contact with emerging financial markets, who will be living and working in one or more developing countries or working for a firm with important operations in developing countries. It is also intended to help those who plan careers in investment management. Also, because bank management figures prominently in the performance and risk of EFMs, the book will be of interest to students planning a career in international banking. We trust it will be of interest to public officials charged with the often frustrating task of developing and dealing with financial markets in an era of globalism and financial fragility. Finally, it should be read by all those who seek a richer understanding of what a financial market is, who want to see at a deeper level why some financial markets function so well and others so disappointingly.

This book and the related cases should provide a full set of materials with which a semester course in emerging financial markets can be taught. We have found at Columbia that the travails of the late 1990s by no means dampened interest in this subject. On the contrary, the need to penetrate the complexity of financial problems in developing markets has become increasingly clear and urgent, creating a fascinating

curriculum of study. We offer this book in the hope of making such a curriculum more accessible. We also offer substantial data in the appendixes to the various chapters, in the hope that this will stimulate students and professional researchers as well to explore quantitatively the world of EFMs.

Outline of the Book

In the introductory chapter we survey the trends of finance in developing economies. We take a brief look at history, both the longer history of investment in developing countries and the more recent events, beginning with the great debt crisis of the 1980s, its reasons, and its aftermath. We then look at the capital flows into the emerging markets during the 1990s in more detail, examining them by region, by type of user, by type of capital inflow, and by type of investor. We note the connection between the development of external capital sources and the development of local financial institutions, and we pause to emphasize the importance of local institution building. We then take a more detailed look at the instruments and the performance. We examine the unique characteristics of risk and return patterns in EFMs, summarizing the aspects in which EFM portfolio risks differ from or mirror traditional risks borne in developed economies.

In Chapter 2 we begin the process of looking behind this financial performance to the underlying realities of developing countries' financial systems. Since many of these realities are political, we start with a description of the role of government generally and an account of the financial system's relationship to government. We describe a set of policies that have been called *financial repression*, which is a form of state domination of the financial process. We then characterize the functions of the financial system, emphasizing particularly its role in channeling capital to highest-return uses. We describe indicators of the extent of financial development (or its opposite, repression) and build a country-by-country index of financial repression and financial development. Finally, we connect this measure to the capital flows of Chapter 1 and to economic growth generally.

Chapter 3 is devoted to privatization, the key element in emergence and the most distinctive feature of EFMs in the 1990s. We develop a framework to explain why privatization has been such a powerful engine of economic growth, and why it is essential to the proper functioning of financial markets and intermediaries. After discussing the origins of state ownership, we focus particularly on the mass privatizations of Central and Eastern Europe, contrasting the approaches taken by different countries and asking which worked well and which worked badly. We then turn to financial liberalization. We define the phenomenon and consider pitfalls in the transition from financial repression to liberalization. We take a close look at two examples of financial liberalization: Chile in the 1970s and Korea in the 1980s. Lessons for successful liberalization are drawn from those and other recent experiences.

Chapter 4 is about the legal foundations of financial markets. We start with the rule of law itself: What does it mean and how can it be measured? We look particularly at the problem of corruption, which plagues all countries but which has particularly burdened many of the EFMs. We look at property rights and contracts, without which it is hard to imagine any financial market functioning well. We then turn to securities law and the prevention of securities fraud, which also plagues every financial market, but some disastrously. We examine the legal bases for shareholder and creditor rights, and consider in particular detail the need for good bankruptcy law and the various forms it can take.

Chapter 5 discusses information and control. We start with the academic understanding of asymmetric information and its impact on financial markets. We then discuss two types of information-related functions that effective financial systems provide: screening and monitoring. We explain adverse selection and the problems associated with risk monitoring, including principal–agent problems. We then consider the role of banks, institutions uniquely able to deal with screening and monitoring functions. This leads to a broader discussion of corporate governance, its goals, and various forms. We close the chapter with a discussion of the various institutions of information creation: accounting firms, credit rating agencies, security analysts, and the financial press, emphasizing the role that such institutions play in well-functioning capital markets.

Chapter 6 discusses the third foundational element of any financial market: currency stability. We discuss the causes of inflation and its impact on both debt markets and foreign exchange markets. This discussion has a technical side, which places inflation in the broader context of government fiscal and monetary policy, and which examines the desirability and risks of currency pegging and currency boards as devices to control inflation and stabilize currencies. We show that, in some cases, banks actually benefit from inflation, and examine what happens to banks in such instances when inflation subsides.

Because banks are the primary financial institutions in most EFMs, we devote Chapter 7 to a close look at the banking industry. The most obvious issue here is the stunning frequency and depth of banking crises that have erupted around the world during the past two decades. We examine the reasons for banking problems, including connected lending, moral hazard, and the decline of franchise value during liberalization. Finally, we turn to the resolution of bad loans and bankrupt banks—how best to resolve banking failures when they occur and what goes wrong when banks are bailed out inappropriately.

Chapter 8 describes the anatomy of a modern EFM crisis, a joint collapse of financial prices and financial institutions. We classify the explanations for these crises into three groups: those that focus on fixed exchange rates as the culprit, those that emphasize short-term debt and liquidity problems, and those that emphasize weak fundamentals. We chronicle the "tequila" crisis of 1994–1995 and the Asian crisis of 1997–1998 in some detail, trying to find both common themes and special cases. We show the various linkages among the three explanations for these crises and consider lessons for government policy.

Finally, Chapter 9 is about building financial institutions. This provides a summary of the learning in the entire book, with a particular emphasis on the micro or institutional perspective. We emphasize that a country will not have strong financial institutions unless the government sets out to support them, and offer examples of what good governments do when they are so motivated. We then consider the managerial problems of building a financial institution, emphasizing particularly the role of strategy, of a sustainable growth rate, of risk management, and of compensation contracts. As an antidote to the collapses studied in Chapters 7 and 8, we focus on some success stories and suggest reasons for optimism about the future.

At the back of the book is a glossary of technical terms and acronyms. When the text first mentions or first defines a term listed in the glossary, that term is often set in italics. We hope that the glossary will provide a useful way to refresh readers' understanding of the numerous technical words and phrases.

Throughout, we hope to reflect the large amount of recent academic research, as well as practical experience in emerging financial markets. We often quantify characteristics of countries so that our comparisons and conclusions can be as well grounded as possible. We not only report some of the research results of recent academic studies, but

also show some of the country-level data that underlie those studies. Thus, our chapters often have appendixes that list or quantify various attributes country by country.

It is not often that a fundamentally new subject comes along, but EFMs are in many ways a new and fascinating subject. Because the field is so new, our book certainly does not contain all the answers to the problems of successful investing or successful policy design. However, we trust that we will at least help our readers to formulate the right questions.

A Note on Cases

The seven original cases that have been written as complements to this book are summarized below. All of these cases have been refined based on our classroom experience with them, and comprehensive teaching notes are available for each. Next to each title is the chapter subject that the case is designed to illuminate:

Hungarian Telephone and Cable Corporation (Privatization)

A small American company has established a position in Hungary's telecommunications market during privatization. Having organized an advantageous dollar bond issue to finance its capital program, it shifts at the last minute to what seems to be a less attractive local loan from a weak Hungarian bank. Why?

Champacoal (Information and Control)

An American banker arrives in Hanoi to open an office for a large international bank in Vietnam. What clients should the banker pursue? The local state coal mining company looks potentially attractive as a business, and wants to borrow, but the only financial statements it can provide appear to be utter nonsense. Can this loan be made? How can one proceed?

Gazprom (Information and Control)

An international oil company is selected by Russia's largest enterprise to be its partner in field development, but the price is a large equity-linked investment. The stock has two prices, a local price and an external (ADR) price. The two prices appear wholly uncorrelated and of quite different magnitudes. Discounted cash flow analysis seems to produce a valuation lower than either stock price. Are the laws of finance suspended? What is the value of Gazprom?

Banco Itaú and the Real *Plan (Inflation)*

Banco Itaú has made a fortune on float during Brazil's period of hyperinflation. But that era may be coming to an end with the advent of Cardoso's *Real* Plan. How should the bank handle the "threat" of an end to inflation? What strategies are available? What speculative opportunities beckon? Should these speculations be tried?

Yuval Ran and Israel Credit Lines (Building Financial Institutions)

Yuval Ran dominates the "gray market" of high-rate, high-risk lending to individuals in Israel in the early 1990s. He is the kind of figure Michael Milken was in the United

States—charismatic, very successful, and living on the edge of legitimacy. His company, Israel Credit Lines, is rapidly expanding into corporate loans, challenging the entrenched banks. Is he a genius or a crook?

BancoSol (Building Financial Institutions)

A lending officer at a large international bank receives an unusual proposal to securitize a portfolio of very small loans from some of the poorest people in one of the poorest countries in the world. The underlying bank is Bolivia's BancoSol, originally founded by eleemosynary foundations but rapidly becoming one of the most profitable banks in South America. Does this marriage of village-level microfinance with modern securitization make sense? Is BancoSol as good as it appears?

Peregrine Investments (Financial Crises and Building Financial Institutions)

The hottest securities firm in East Asia crashes abruptly in 1997, despite the fact that its base of operations, Hong Kong, has escaped major damage in the Asian financial crisis. How could such a well-regarded firm fall so quickly? Were there underlying weaknesses that should have been visible prior to 1997? How could its mistakes have been avoided?

These cases are available through Primis Online, a large and growing McGraw-Hill/Irwin database that provides you the flexibility of choosing only the material that matches your course. In addition to obtaining cases, you can easily build a custom version of this text at http://mhhe.com/primis/online.

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Emerging Financial Markets

CHAPTER

1 The Emerging Markets Phenomenon

Questions:

What has been the history of developing countries' engagement with global financial markets?

What happened in the debt crisis of the 1980s?

Why did capital flows resume so quickly after the losses of the debt crisis?

What have been the investment characteristics and performance of EFM securities?

In what ways is the risk of investing in EFMs unique?

Introduction

Developing countries have existed for a long time, and for much of their history they have attempted two related tasks: to build their local financial institutions and markets, and to attract international investment. Some have succeeded quite admirably while others have a great deal of work left to do. As time has gone by, the words we use to describe these countries and their markets have undergone considerable change. In the 1950s and 1960s it was common to speak of an "underdeveloped country." This soon gave way to the more polite "less developed country" (LDC) that was prevalent in the 1970s and 1980s. Then the phrase "emerging financial market" (EFM) caught on in the 1990s, as a worldwide change of ideas away from state-sponsored development and toward the opening of free markets brought a burst of progress and performance.

The International Finance Corporation (IFC), the private sector arm of the World Bank Group, began using the phrase "emerging financial markets" to describe a set of countries for which they kept and published standardized stock indexes starting in 1981. Their original list contained only nine countries whose stock markets looked particularly promising. This list was later expanded to 25 countries, for which the informal criterion was 30 to 50 listed companies with a market capitalization of $1 billion or more and annual trading volume of $100 million or more. The phrase "emerging financial markets" is now widely used to describe all developing countries.

The year 1993 will be long remembered as the year of miracles in emerging financial markets. Portfolio investors from developed countries, who in 1992 had supplied $10 billion of new debt capital and $11 billion of new equity capital to EFMs, raised those amounts almost fourfold to $36 billion and $45 billion, respectively, in 1993. The IFC reported that stock price indexes, measured in U.S. dollars, rose dramatically in almost all developing countries, led by the Philippines (+133 percent), Turkey (+214 percent), and Poland (+718 percent). The total market capitalization of all EFMs nearly doubled from $884 billion to $1,591 billion.

It was a year of boundless optimism. The recession in the United States had come to an end and U.S. stock markets were rising. Communism had been swept almost totally from the world stage during 1989–1991. Democracy had spread so widely that for the first time every government in Latin America except Cuba's was democratically

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