



# Financial Markets & Development

*The Crisis  
in Emerging  
Markets*

Alison Harwood, Robert E. Litan  
& Michael Pomerleano, **Editors**

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DEVELOPMENT

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*The Crisis in  
Emerging Markets*

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*This book is based on a conference entitled "Preventing Crises in Emerging Markets," held on March 26–27, 1999, in Palisades, New York. The conference was jointly sponsored by the World Bank Group and the Brookings Institution.*

## *Foreword*

**T**HIS BOOK IS the product of a conference sponsored jointly by the World Bank and the Brookings Institution, with the participation of the International Monetary Fund, the Bank for International Settlements, and representatives from many investment and commercial banks.

The conference began by looking back at the causes of the Asian financial crisis—as well as at issues involving supervision, transparency, control, banking markets, and the capital markets themselves—and then moved to a discussion of how to avert such crises in the future.

Reflected in this volume is a rich agenda including broad treatment of the growth of the Asian markets, a look at how equity markets function in the region, a closer look at East Asian corporations, and corporate governance. The book then moves to supply-side issues: foreign investment in Asia, the future of emerging market investing, lessons learned from East Asia and Latin America, the role of the World Bank in this crisis, and, finally, a fascinating paper on prospects for the future.

The conference, and this book, was not designed to undertake a theoretical analysis of the crisis. Instead it offered a chance for practitioners, members of supervisory agencies, and persons from governments to come together to examine lessons learned and what we can do about it.

Many people contributed to the success of the conference and this volume, and we would like to acknowledge their support here, including all

of the formal discussants and speakers at the conference shown in the following pages. Many others also participated as moderators or as informal discussants: Charles Adams, Walter Arnheim, Joyce Chang, Uri B. Dadush, Richard H. Frank, David Gill, Jack Glen, Luis Guisti, Guillermo Harteneck, Isaac Hunt Jr., Desmond Lachman, Kenneth G. Lay, Paulo Leme, Walter Molano, Claudia Morgenstern, John D. Rea, Walter Stern, Prasarn Trairatvorakul, Konstantinos Tsatsaronis, Philip Turner, Antoine W. van Agtmael, Douglas Alan Webb.

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# 1

## *Introduction*

FOR MANY INVESTORS, the 1990s has been the decade of the “emerging market” in both a positive and a negative sense. The good news is that this is the decade that set records for capital inflows into developing countries and transition economies, since dubbed the emerging markets. The bad news, of course, is that emerging markets were rocked twice with crisis, first following the devaluation of the Mexican peso in 1994–95 and then in 1997–98 following a series of financial crises in Southeast Asia and Russia. Only now, as this volume is appearing in the fall of 1999, does it look as though the countries most adversely affected by the latest crises are finally recovering from what, for most of them, has been the most significant economic downturn in the postwar era.

Emerging markets are important not only because their precipitous downfall sent a shudder through the economies of the rest of the world but also because they have most of the world’s population and, over the next several decades, should account for most of the world’s growth in economic output. As this occurs, financial flows and institutions within those markets, and between those markets and markets in the rest of the world, inevitably will become more important.

The time is ripe, therefore, for systematically and consistently monitoring the continued development of finance in emerging markets. Toward that end, the World Bank and the Brookings Institution have collaborated

in producing this volume, which may become the first of an annual series on emerging market finance designed to be of interest to investors, analysts, and policymakers throughout the world.<sup>1</sup>

The papers in this volume were originally presented at a conference in Palisades, New York, before an audience consisting of representatives from all of these constituencies. The conference occurred only six months after the market instability in the fall of 1998, following the Russian default and devaluation, which in turn followed on the heels of the currency and economic crises in Asia during 1997 and 1998. It should not be surprising, therefore, that this initial conference and the papers in this volume concentrate so heavily on aspects of these crises.

We are acutely aware that much already has been written on this subject. But we believe that this conference and the papers presented at it were unique in focusing on the characteristics of the *financial and corporate systems* that arguably contributed to the severity of the crisis in each of the affected countries. Accordingly, virtually all of the chapters that follow deal with these subjects. To provide a broad perspective, the volume begins (following this introduction) in chapter 2 with an overview of the Asian crises provided by one of the world's leading international economists, Richard Cooper.

As Cooper explains, although the details differed from country to country—and those details matter—the common element among all of them was the rapid outflow of funds akin to a deposit run on a bank. The outflows triggered collapses in the values of each currency on world markets and, in turn, steep declines in real output in each of the affected countries. The crises were especially dramatic because each of the countries (with the exception of Russia) had been following sound macroeconomic policies by contemporary standards: government budgets were not unbalanced, while monetary policy was not generating disturbing rates of inflation.

So how could the series of crises have happened? To help answer this question, Cooper concentrates on the events in Thailand, where the sequence of events began, and uses the conditions in that country as a metaphor for explaining subsequent crises in other parts of the region. In brief, the problems in Thailand centered on excessive foreign currency bor-

1. Next year's volume is already being prepared, with papers to be presented at a conference in New York in the spring of 2000. In addition to the World Bank and the Brookings Institution, the International Monetary Fund will join as a cosponsor.

rowing by banks, which sought to arbitrage the low interest rates available on short-term foreign currency loans, using the funds to extend higher-interest loans in baht to domestic residents. All the while, Thailand was running a relatively large and growing current account deficit—the counterpart to the substantial capital flows into the country. Such a game can continue, Cooper points out, so long as foreigners continue to pour money into the country. When they stop—they need not actually withdraw their funds—sudden and sharp downward pressure is applied to the country's exchange rate.

In fact, investor sentiment about Thailand—not just among foreigners but within the domestic economy itself—began to change in 1996. Instead of recognizing that fact and allowing the exchange rate to decline, Thai leaders attempted to fight it by defending the currency: selling dollars as fast as investors offered baht in exchange.

We all know the end of the story. Eventually many of the borrowers whose debts depended on the stability of the baht, which events put seriously into question, rushed for the door, depleting the central bank's supply of foreign currency. The government had to obtain financing from the International Monetary Fund (IMF) to prevent a total collapse in trade. The financing came with conditions: not just tighter macroeconomic policies, but new, and some say more intrusive, requirements to change local banking supervision, abandon certain government projects, and change other domestic institutions that encouraged too much foreign currency borrowing in the first place.

Cooper describes how this sequence of events played out in other Asian countries. At the same time, he questions the simplistic view that the crises were “contagious.” There is relatively little trade among the countries, and their firms do not generally compete with one another in foreign markets. If there was contagion, it was more likely to be financial in nature—as Morris Goldstein has described, when one currency dropped like a stone, it was a “wake up call” among investors that others could too.

But which investors? Cooper believes that domestic residents put more selling pressure on their currencies than did foreign investors. This is contrary to the view held among many observers in Asia, of course. More broadly, Cooper concludes that the Asian crises teach us that a healthy financial system is integral to the proper “fundamentals” of any modern economy. When finance goes wrong, so does the real economy. This is important because, Cooper argues, financial systems are intrinsically unstable. Savers often want liquidity, while borrowers want assured finance over

long periods. Financial institutions and markets are supposed to bridge this gap in maturity preferences, but this process does not always occur smoothly. When it does not, financial crisis can be (and often is) the result.

### **What Went Wrong: A Financial View**

A broad theme running through many of the chapters in this volume is that, if anything, the development of western economies has demonstrated that financial systems will not function properly unless they contain some basic elements of an appropriate market infrastructure. Banks must be supervised effectively to ensure that they do not take excessive risks and that they maintain the resources to pay back depositors. Markets will not allocate funds to worthy borrowers unless investors have accurate and timely information about them and use that information effectively. Corporations must follow appropriate rules of governance to ensure that managers, as agents for shareholders, act responsibly and do not waste resources. When these elements of a financial system are not in place, it is more than likely that eventually too much money will be sent to the wrong destinations and that economies will become vulnerable to a sudden collapse of confidence among firms and investors. That, of course, is exactly what happened in Southeast Asia and Russia. Each country that experienced a crisis of confidence had significant shortcomings in its banking and financial markets, as well as in its systems of corporate governance.

Three papers presented at the conference and contained as chapters in this volume focus in particular on flaws in the equity markets in the affected region. Campbell Harvey and Andrew Roper in chapter 3 provide a multifaceted quantitative assessment of capital markets in the region and report some surprising results.

Harvey and Roper document that Asian equity markets, in particular, grew rapidly in the 1990s. Total dollar market capitalization across the major Asian stock market exchanges in China, Indonesia, Korea, the Philippines, Malaysia, Taiwan (China), and Thailand increased more than threefold between 1990 and 1996, from roughly \$300 billion to \$1.1 trillion. Over the same period, total stock market capitalization of Latin America grew even faster, reaching \$444 billion by 1996, more than five times its level in 1990.

The authors find that a significant proportion of the growth in market capitalization of Asian markets during the 1990s resulted from new capital mobilization (rather than growth in the value of existing equity). Unlike Latin America, where only about 100 initial public offerings (IPOs) found their way to the markets during the 1990–96 period, the number of IPOs in Southeast Asia jumped from roughly 1,600 to nearly 3,800. These new offerings totaled almost \$120 billion in market value. Flows of this magnitude helped to sustain high investment rates throughout the region during the decade.

A considerable portion of the financing for Asian corporations came from international equity and debt markets. The latter proved far more important than the former. International equity placements totaled about \$18 billion during the 1990–97 period, compared with more than \$120 billion financed through international bond markets. Significantly, almost three-quarters of this amount, roughly \$90 billion, was denominated in dollars.

Undoubtedly, the liberalization of Asian capital markets during the 1990s facilitated the flow of funds from international investors and contributed to the significant amount of new capital mobilization documented previously. The liberalization process was a gradual one, however.<sup>2</sup> Typically, governments would begin by relaxing restrictions on direct investment in specific industries, while raising the generic limits on foreign investment of all types. Still, until the various crises occurred, governments throughout East Asia maintained investment limits that were low enough to prevent foreign control of domestic industries. Asian governments especially were reluctant to relax foreign ownership limits in certain industries, notably finance and telecommunications.

The foreign investment limits undoubtedly helped to explain why Asian capital markets concentrated most of their funds among particular industries, indeed even more so than Latin American markets. As a result, equity returns on Asian exchanges tended to move together to a much greater

2. For example, Korea outlined a liberalization plan for financial markets as early as 1987. Initial foreign ownership limits were set at 10 percent of market capitalization, with a 3 percent limit for individual foreign investors. Between December 1991 and December 1997 the foreign ownership limit in Korea was raised on seven separate occasions; each time, it was ratcheted up by no more than 3 percent. Finally, in June 1998, Korean officials broke with the traditional policy of gradualism and increased foreign ownership levels from 26 to 55 percent. Under the new foreign investment limits, foreigners were permitted to own a controlling interest of domestic firms.

extent than would be expected in more diversified stock markets. Moreover, although the returns varied across countries, they failed to exceed returns on less risky securities in more developed markets, while deteriorating well before the breakout of the crises in 1997–98.

One of the more disturbing findings reported in the paper by Harvey and Roper is that Asian corporate managers increasingly leveraged their companies despite their declining profitability. Why? The authors suggest that the managers “bet” their companies, hoping that added leverage could offset declining profit ratios. The bets, which were made by borrowing in foreign currency, assumed that exchange rates would remain stable. It turned out, of course, that these bets turned sour, aggravating each crisis as it hit. Harvey and Roper conclude that a real and significant failure in corporate governance throughout Asia permitted these bets to be made.

In chapter 4 Michael Pomerleano and Xin Zhang expand on and essentially confirm many of the findings of Harvey and Roper. The Pomerleano and Zhang study benchmarks the Asian economies against Latin American and industrial countries and explicitly links internal financial performance (reflected in corporate profitability) to the implied cost of capital. Among other things, the authors find that the real weighted average cost of capital, as well as nominal returns on investment, during the 1990s varied considerably across developing and developed countries, casting doubt on the view that capital markets are well integrated across national borders. More significant, their calculations, based on the best available data, reveal that the return on invested capital exceeded the opportunity cost of capital in only a few economies. This disturbing result suggests that there was much wasted investment in the region.<sup>3</sup>

The authors also examine the relationship between past and future stock prices in Asia, seeking to determine which types of stocks appealed most to investors. They find that in Asia so-called “glamour stocks” systematically outperformed value stocks (or those with low ratios of price to book value). Indeed, value stocks actually sold at a discount in Asia. Furthermore, with the exception of Korean stocks, market fundamentals—profitability, relative value, and ownership concentration—played virtually no role in the market during the Asian financial crises. Indeed, high levels of corporate leverage—widely considered a source of vulnerability in the crises—did not affect stock prices (again, excepting Republic of Korea).

3. The authors acknowledge that their results must be treated with caution, because many firms (especially financial firms that were highly leveraged) were not included in their database.

Pomerleano and Zhang conclude from their analytical work that emerging markets in Asia did not price risk adequately and thus did not exert effective financial discipline on corporations in the region. Why would Asian markets differ so markedly in this regard from those in western economies? The authors speculate that Asian markets lacked the high standards of transparency, including disclosure, research, and dissemination of relevant financial information, that are routinely found in the west. In the absence of transparency, speculation and volatility become much more dominant characteristics of markets. If this is right, then measures that bring Asian and other emerging markets up to western legal, regulatory, accounting, and information dissemination standards should help to insulate those markets in the future against a repeat of the 1997–98 crises.

Nonetheless, the authors also note that in several Latin American and Asian developing countries, the returns on invested capital are quite reasonable, although the cost of capital is surprisingly high in countries with high savings rates. They conclude that the cost of capital is high because of ineffective and costly intermediation of savings. One key challenge for developing countries in the future is to improve the process of financial intermediation so that investors and savers can be matched more efficiently and at lower cost.

Stijn Claessens, Simeon Djankov, and Larry H. P. Lang take yet another look at corporations in Asia in chapter 5, concentrating on the characteristics of ownership of Asian companies and their connections to the valuation of those firms. The authors find extensive family control of East Asian corporations. Ten families in Indonesia and the Philippines control more than *half* of the corporate sector. In Thailand, families control almost half of corporations, and in Hong Kong (China) and Korea, families control about one-third of corporations. This contrasts with Japan, where family control is insignificant.

Claessens, Djankov, and Lang argue that such heavy concentration of ownership strongly shaped the legal and regulatory institutions in East Asia—and not for the better, at least by western standards. Where families dominate, it is not surprising to find weak systems of corporate governance or close connections with banks and government sources of finance—the essence of what has been called “crony capitalism”—that many observers have asserted played an important role in contributing to the severity of the crises in the region.

In their empirical analysis, the authors find that family-controlled corporations are not valued as highly by the markets as firms where control is

held more widely. Their analysis confirms earlier work, suggesting that large owners have a tendency to direct the gains earned by their corporations toward private uses rather than toward enhancing the future value of the corporation itself. This makes the protection of minority shareholders all the more important a subject of reform in Asian economies, a subject explored in depth by Kenneth Scott in chapter 10 and discussed in more detail below.

## The Role of Foreign Investment

The Asian crisis has spawned many controversies. One of them is about the role played by foreign investment. Critics, many of them in the affected region, charge that foreign investors were too fickle, pouring too much money in too rapidly and then taking it out at an even faster pace. In our opening discussion, we briefly summarized Richard Cooper's views rejecting this simplistic view. But several of the chapters in the book, in part or in whole, explore the issue in greater depth.

Michael Barth and Xin Zhang concentrate their attention in chapter 6 on the behavior of foreign *portfolio* investors in particular—investors whose stake in the companies they buy is not sufficient to give them control or influence in the running of the corporations. The authors distinguish three types of foreign investors (mutual funds, pension funds, and hedge funds) and three means by which foreign institutions invest in local stock (through local markets, international placements of publicly traded depository receipts and private equity, and local private equity).

Barth and Zhang document that, in fact, equity flows were more resilient in the face of crisis than is generally understood. When account is taken of the decline in market values during the crises, there is no evidence that mutual funds withdrew funds from Asia in a major way. Furthermore, international placements and private equity investments were stable sources of finance during the Asian crises, and the evidence suggests that foreign investors did not destabilize Asian stock prices. The authors further document that foreign equity investors account for a very high share of the “free float”—shares traded in the open market—in Asian emerging markets, that foreign investors have investment horizons longer than those of domestic investors, and that they suffered significant losses during the crises. The paper infers that foreign investors in local markets appear to be motivated by economic fundamentals, not by “herd” behavior.



Barth and Zhang also find that mutual funds in particular have not been and are not likely to be a source of short-term volatility in emerging markets. Indeed, emerging market mutual funds experienced *inflows* throughout 1997, except for the month of December. The inflows continued into 1998, before turning into very small outflows at mid-year. Those emerging market funds that invest primarily in Asian economies outside Japan experienced steady but small outflows in 1997. These outflows began early in the year, well before the devaluation of the baht in July. In 1998, the outflows moderated considerably.

Actually, while portfolio equity was coming into Southeast Asia at the rate of about \$10 billion a year in both 1997 and 1998, foreign direct investment (FDI) also was remarkably resilient during the crisis period. In contrast, there was a significant withdrawal of short-term loans by international banks (evidenced by a very large increase in the errors and omissions entered in the balance of payments data for the affected Asian countries), which clearly contributed to the severity of the crises.<sup>4</sup>

Barth and Zhang believe that portfolio equity will be needed in a big way to help the Asian countries out of their difficulties in the years ahead. For example, recapitalizing the banks and restructuring heavily indebted corporations in the region may require an injection of at least \$200 billion in equity, or about ten times the total FDI and portfolio equity investment in these countries in 1998. In a situation of systemic distress in the domestic private sector, governments are the only other possible source of domestic equity. But the government has no special skill in corporate restructuring, so the case for increased equity investment by foreigners—whether FDI or portfolio equity—becomes even more compelling.

Ian Giddy in chapter 7 analyzes one particular way in which more and more foreign companies are attracting capital: rather than issuing stock in their own countries, they are issuing depository receipts, an instrument issued in a foreign country that is backed by securities in the home market. The most popular depository receipts are those issued in America by U.S. commercial banks.

Using data on American depository receipts (ADRs), Giddy finds that during the 1990–98 period returns on ADRs issued on behalf of Latin American firms were more highly correlated with returns earned in the U.S. market than was the case with Asian ADRs. At the same time, returns within each region were very highly correlated. These results lead Giddy to

4. World Bank. (1998).