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Plenary 3

Global Portfolio Investments - Opportunities and Barriers in Emerging Markets

17. Speech by Dr. Zhou Xiaochuan

Chairman of the China Securities Regulatory Commission

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Mr. Chairman, Ladies and Gentlemen,

It is my pleasure to attend the IOSCO annual meeting and to speak at today's panel. Global portfolio investments in emerging markets have increased substantially in the past decade. They have brought in capital needed for emerging economies and provided higher returns for investors. In the meantime, however, portfolio investments can also increase the vu1nerability of recipient countries with weak financial systems and thus bring risks to investors. Discussions about obstacles to portfolio investments and their policy implications are important not only to emerging economies, but also to the stability of international financial system.

Opportunities

Since the beginning of 1990s many emerging economies have liberalized their capital markets. In the same time, some emerging economies with sound development and reform strategies have in general been growing faster than industrialized economies. Attracted by higher returns and the opportunity to diversify risks, portfolio investments have accordingly increased in emerging markets. In 2000 total portfolio investments flowed into emerging markets was three times that in 1990, and equity in flows went up by nine folds.

In recent years, portfolio investors have been selective and showed discrimination towards emerging economies with different growth prospects. This year, despite the Argentina crisis, the prospects for portfolio investments in emerging markets had brightened. Emerging equity and bond markets have outperformed those in industrialized countries in the first quarter, and emerging market portfolio equity investment is expected to more than double to $21 billion by the end of the year.

The turnaround of global economy is no doubt a significant factor for the improvement in emerging equity and bond markets. Learning from the lessons of recent financial crises, many emerging economies have since then reduced fiscal deficits, lowered inflation, and increased foreign exchange reserves. Efforts are also being made on restructuring financial systems and improving prudential supervision and regulation.

On the investors' side, as global funds increasingly follow global benchmark index that has fixed allocations to emerging markets, we shall see a more stable allocation of funds to emerging markets. According to the UN, the total assets of institutional investors in the U.S. and Europe was about $14 trillion by the end of year 2000, out of which only 1% has been invested in emerging markets. In the next 10 years, up to 5% to 10% of these assets might be invested in emerging markets attracted by positive investment opportunities.

Furthermore, we should note that some emerging economies are endowed with a large population and vast potentials. As long as the government is committed to the strategy of opening-up and development, the economy will most possibly experience high growth, which implies good opportunities for portfolio investments.

In China, we have opened up part of our security market to foreign investors and listed over 60 companies at the international capital markets. Besides, we are preparing the qualified foreign institutional investors (QFII) scheme to accommodate greater portfolio investments. As China integrates further with the global financial economy, we are committed to a more open capital market and we believe that there are great opportunities for portfolio investments in China. The Chinese economy has been growing fast. Last year, China's GDP grew by 7.3%. Furthermore, the increased entry of private enterprises, joint ventures, and foreign companies will help improve the quality of listed companies and lead to better governance in general. Foreign investors will find China a highly desirable place for investments.

Obstacles

First, among factors affecting portfolio investments, emerging economies' potential in economic development is the fundamental one. Countries with high economic growth rates can bring higher returns for portfolio investments. Second, the standards of information disclosure and auditing in emerging markets are inadequate at the time being, but they are in the process of improving. Third, the competitiveness of domestic companies will increase as emerging countries open further and involve deeper with the financial globalization. Last, many emerging markets are in transition periods; policies and regu1ations are naturally often subject to changes. For most of them, however, policies are changing in the right direction. Investors often demand that the investment environment should be predicable and policies should be stable. The stability of policies, however, often comes at the cost of slower speed of economic reforms. Between stability and reforms, it is more important for emerging economies to push for reforms and institutional changes.

In conclusion, we should not look at the obstacles to portfolio investments in emerging markets from the traditional and standard point of view as we have taken for matured markets. While we try to understand better and take into account the trend of economic environment facing emerging markets, if the reform and development strategy moves into the right direction, we shall hold confidence in their futures and potentials. Countries with stable, high economic growth can often overshadow those difficulties and obstacles to portfolio investments. On the other hand, for countries without sound reform policies, if the uncertainties and difficulties are not dealt with properly, they tend to discourage foreign investments.

Besides the quality of listed companies, obstacles affecting portfolio investments in emerging markets also include limited market size, imperfect legal framework and accounting procedures, intransparency of information disclosures, weak corporate governance, absence of effective means for investor protection, low scale of participation of institutional investors, and pricing inefficiencies, etc.

Furthermore, macro economic environment in emerging markets has been unstable in recent years. In particular, economic and financial crises have troubled many emerging markets. Now unsure of the negative impacts on liberalization, many countries are cautious in opening up capital markets to foreign participants. Do the benefits justify the costs? What are the preconditions to open capital markets and to benefit from financial globalization? How to prevent and deal with these crises? Before satisfactory answers to these questions are found, the determination of emerging markets to participate in globalization will naturally be controversial, and the obstacles to investments will thus, to some extent, continue to exist. Therefore, once again we should seriously review the fundamental reasons of these crises so that we can build stronger courage in further globalization of emerging markets.

In China, as in other emerging economies, the development of capital market is constrained by factors such as unstable quality of listed companies, weak corporate governance, lack of sufficient financial products, and psychological shadow of the Asian Financial Crises. We are making efforts to change the situation by improving the overall investment environment and the quality of listed companies. Last year, we issued the "Principles of Corporate Governance for Listed Companies", pushing for listed companies to further improve their corporate governance.

Policy Implications

First, despite the uncertainties of opening up capital markets and the fears of inflicting with financial crises, emerging economies have no alternatives but to stick to the policy of opening up to meet the challenges of globalization. Competition at the international level will help to improve the quality of listed companies. Economic polices should be directed to lower restrictions on portfolio investments, remove policy obstacles such as tight control in capital account activities and unfair tax strategies which prohibit level-field competition.

The exchange rate regime and convertibility are certainly critical and in the meantime, difficult to mange. Besides, countries should strengthen the debts management system and improve government regulation of the financial sector. The common features of recent crises are shortcomings in external debt management.

Second, investors should adjust their views towards opportunities and difficulties in emerging markets. A long-term dynamic, comprehensive approach should be taken than a static one. Despite the current problems, most of the emerging economies are carrying out substantial reforms and moving towards a better future. Besides, economic situations in emerging markets vary among countries, and so do their opportunities and potentials of investments.

Last, initiatives at both the national and international level, from both developing and developed countries, should be taken to reduce volatility of emerging markets and increase the resilience of international financial systems. We are glad to see that the IOSCO has taken the initiatives in this direction. The ongoing work on multilateral MOUs will enhance the cooperation among members in information exchange and help to curb financial misconduct. Other international organizations such as the IMF and World Bank have also extended their efforts. For example, the Financial Sector Assessment Program has been set up to help member countries detect weaknesses in their domestic financial systems; internationally recognized standards and codes are being developed so as to guide institutional development; and the availability of economic date and the overall climate of transparency has been improved.

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Mr. Chairman, Ladies and Gentlemen,

In the past few years, a series of financial crises have occurred in emerging markets. These crises have, to certain extent, damaged investors' enthusiasm for emerging markets, and in the same time shakened the determination of emerging markets to further liberalize their markets. This is a temporary shadow over global portfolio investments. Developed countries and developing countries should work together to formulate new understandings and determination to meet the challenges of globalization.

Thank you.