2005 IOSCO Emerging Markets Regional Training Seminar Taipei

"Attracting Global Investors to Emerging Markets"

Keynote Speech

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President Chiu,
Distinguished Guests,
Ladies and gentlemen,

I am honoured today to address fellow IOSCO regulators on the subject of attracting global investors to emerging markets.

In the tradition of securities regulators, I should begin by saying that all opinions expressed here are my own and not necessarily those of the Securities and Futures Commission of Hong Kong, nor that of the IOSCO Technical Committee, which I currently chair.

Emerging Markets – A historical overview

The term "emerging market" was first coined by Antoine van Agtmael of the International Finance Corporation (IFC), World Bank in 1981[1], as an economy with low-to-middle per capita income, which has embarked on capital market reforms. It excludes the highly developed and mature capital markets of the US, Canada, Australia and Europe, as well as the Japanese and Hong Kong market, which happen to be members of the Technical Committee of IOSCO. In recent years, large markets of big developing economies, such as Brazil, China, India, Turkey, South Korea and South Africa are still classified as emerging markets even though they are fairly substantial in market capitalization and product sophistication.

The emerging markets were traditionally subdivided into four geographical groups, Asia, Latin America, Eastern and Central Asia and Middle East and Africa. After the fall of the Berlin Wall, Eastern and Central Europe also emerged as another group. The emerging markets

[1] Source: Investopedia Online

as an asset class was considered attractive for two fundamental reasons:-

> Firstly, higher growth potential and higher returns on the upside, offset by higher risks and volatility (including lower liquidity) on the downside; and
> Secondly, a natural hedge or diversification of risks against concentration of investments in developed markets.

As developed markets began to age in terms of population demographics, the higher savings in their pension and social security funds sought to diversify out of their markets into emerging markets, precisely in search of higher yield or total return potential, whilst diversifying some risks. This brought about the creation of the fashion of investing in emerging markets, which caused the international financial institutions (IFIs) (led by the IFC) to champion the cause of developing emerging capital markets. Efficient domestic capital markets would not only help resource mobilization at the domestic level, but also help global resource allocation.

As you all know, capital flows comprise two principal types: Foreign Direct Investments (FDI) and Foreign Portfolio Investments (FPI). Prior to the 1980s, the principal flow to emerging markets was through FDI and official aid, supplemented by bank lending. After the Latin American debt crisis of the 1980s, FPI comprised mostly investments in equity and perhaps, some bonds. Today, the nature of foreign portfolio flows comprises not only traditional bank lending, equity, bonds, but also derivatives, structured products, venture capital and private equity.

In the last two decades, Latin America and Asia markets have been the major beneficiaries of capital flows, partly because of high growth, but also because their political development has been more stable than Africa and the Middle East. Prior to the Asian crisis, the so-called Asian Miracle attracted huge inflows of capital, and it was the massive withdrawal of both FDI and FPI after 1997 that caused the painful reforms in Asia. In 1999, Latin America markets took up about US$107 billion of FDI, exceeding the Asian share of US$102 billion.

When the Argentinian crisis broke, the position again reversed, with FDI flows to Asia standing at US$107 billion in 2003, or 62% of the total FDIs into emerging markets, while FDI flows to Latin American markets declined to US$48 billion[2].

Indeed, the Institute of International Finance (IIF) has recently estimated that flows to emerging markets are now rising to almost pre-1997 levels. In 2004, flow of private money to 29 “emerging market” economies rose to US$279 billion, close to the US$287 billion in 1997

[2] Source: United Nations Conference on Trade and Development Annual Report 2004

and just below the peak of 1996, when US$322 billion flowed to emerging markets[3].

The surge of money into emerging markets partly stemmed from improved policies and economic fundamentals, but it was also because of excessive liquidity growth worldwide, as fiscal prime pumping and low interest rates to combat deflation resulted in high liquidity in the major markets. Funds from these markets therefore moved to emerging markets in search of higher yields. The average spread (interest rate differential) between emerging market bonds and US Treasuries declined to a seven-year low of 346 basis points by the end of 2004.

As I have pointed out elsewhere[4], there is a symbiotic relationship between capital flows between emerging and developed markets. The classical relationship is that between Asia and the US. Asian central banks and retirement funds tend to put most of their reserves into US Treasuries, bonds and equities to diversify their risks into "blue chip" assets, which also serves to finance the current account deficit of their major trading partner. In return, the major capital markets in US recycle their funds back to emerging markets in the form of FDI and FPI in the search of higher yield and spread, enhanced through leverage and structured financing.

Hence, capital flows are two sides of the same coin. Like free trade, it is mutually beneficial and helps to diversify risks on both sides. However, it carries its risks, because history has shown that investment trends can reverse overnight and capital can flow out of an emerging market rapidly. These "flow shocks" can be triggered either by problems emanating from the emerging market, or are sometimes due to problems from the developed markets itself. Nevertheless, these sharp fund withdrawals rapidly expose weaknesses in the emerging market structure, such as overleveraged borrowers and frail financial institutions. In the Asian crisis, it left behind a devastation of the domestic financial systems, with large devaluations, bankruptcies and wiping out domestic wealth that was built up prior to the crisis.

The topic of this morning's lecture is to have an overview of what would attract and keep global investors to emerging markets, noting that sharp reversals of flows can have high costs for the domestic economy.

[3] Institute of International Finance, Inc, "Capital Flows to Emerging Market Economies", January 2005

[4] Andrew Sheng, "Optimal Financial Structure for Economic Growth: Lessons from Other East Asian Economies", China Centre for Economic Research 16-17 September 2004, Beijing

After the Asian crisis, the IFIs developed a common view on what makes a successful market economy. The preconditions (as articulated by the IMF[5]) are:-

- Sound and sustainable macroeconomic policies;
- A well-developed public infrastructure, such as a functioning judiciary, and effective regulatory elements relating to asset valuation, supervisory powers, enforcement, exercising rights against collateral, licensing and accounting powers; and
- Procedures for resolving problem institutions.

The author of the term "Washington Consensus[6]" set out 10 reforms for emerging markets that was needed:-

1. Fiscal discipline
2. Re-ordering public expenditure priorities
3. Tax reform
4. Liberalization of interest rates
5. A competitive exchange rate
6. Trade liberalization
7. Liberalization of inward foreign direct investment
8. Privatization
9. Deregulation
10. Property rights

Without getting into the rights and wrongs of the Washington Consensus, it is important to understand that in order to attract capital into your market, one must understand very clearly what benefits such capital brings. A capital market has four major functions:-

1. Efficient resource allocation
2. Price discovery
3. Risk Management and
4. Corporate Governance

Many emerging markets in fact are not short of resources or savings. Indeed, because they have inefficient or incomplete banking and capital markets, savings leak out through capital flight while foreign capital cannot or does not want to come in. Indeed, it is always legitimate to ask the question: why should a foreigner come to invest when the domestic investor is reluctant to do so? After all, a domestic investor should know local conditions better than the foreigner.

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[5] International Monetary Fund, "Financial Sector Regulation: Issues and Gaps", 2004
http://www.imf.org/external/np/mfd/2004/eng/080404.pdf

[6] John Williamson, "From Reform Agenda to Damaged Brand Name: A short history of the Washington Consensus and suggestions for what next to do", Finance and Development, September 2003

Consequently, I believe that it is not necessary to go down the laundry list of macro-economic policies, the quality of the public infrastructure and the institutional framework. The principles of investing in a market are identical to the principles of investing in a company. When an investor looks at the quality of a company, he or she looks at the quality of corporate governance: what is the performance and the conformance? In other words: -

- Does the company deliver superior performance, with risks properly disclosed and measured/audited according to international standards?
- Does the company conform with the law and internationally accepted ethical standards with respect to transparency and fair treatment of all shareholders, employees and other stakeholders?

Investors will certainly benchmark or compare investing in Emerging Market A with the Return, Risk and Liquidity of investing in a top quality developed market, in the same way that emerging market bonds and equity are benchmarked against the "yield spread" against US Treasury Bonds and total return on the Dow Jones Index. If the risk and return, plus lower liquidity, on Emerging Market A is lower or insufficient to compensate for investing in US Treasuries or Dow Jones, then a national investor will not invest in Emerging Market A.

There are therefore two aspects arising from this insight. First, in a global economy, the Emerging Markets are competing with each other and also with Benchmark Developed Markets for funds. Second, in order to retain or attract such funds, Emerging Markets have to demonstrate commitment in not only upholding international standards, including good corporate governance standards, but also develop a strong domestic financial system with the help of foreign participation.

The Global Market is a Sum Total of Domestic Financial Markets

Once we appreciate that the global financial system is a network of domestic financial systems, across which national savings flow in search of the highest return relative to the risks, there is every imperative to strengthen the domestic financial system to international standards.

A weak domestic financial system is a systemic threat to both domestic and global stability, especially if the more significant markets are vulnerable. Prior to globalization, it was possible to develop closed markets. But with WTO and under the pressure of the IFIs, it is almost impossible to develop domestic standards is isolation, as foreign financial institutions spread across markets, introducing new products, new technology and advanced systems of corporate governance.

As international standards of accounting, auditing, corporate governance, securities, banking, insurance and fund management regulation emerge and spread, fund managers will want to ensure that emerging markets which attract their funds meet international standards. A crucial question therefore arises whether Emerging Markets can achieve international standards in their domestic markets (banking or capital) without the assistance of foreign financial institutions. They have the expertise, technology, risk management and governance experience in finance that many domestic players lack in terms of critical mass or even exposure to such competition.

Key Challenges to Emerging Markets in Attracting Foreign Investments

In discussing the "How to" in "Developing Strong Domestic Financial Markets", the common challenges are less technical (such as technology in risk management models) but relate to the fundamental issue of public or corporate governance. Consequently, we can subsume the elements of macroeconomic policies, regulatory infrastructure and the existence or non-existence of markets under the broad umbrella of "governance".

To repeat, investors ultimately care about not the quality of assets, but the quality of governance, because ultimately, it is governance that delivers performance, rather than assets. In plain language, good management of gold mines produce profits; bad management produces pollution and losses.

Hence, the elements investors are concerned about relate to the following:-

- <u>The quality of transparency</u> – can investors have sufficient information to judge the quality of performance and conformance in the delivery of public goods that protect their property rights?
- The standards against which performance and conformance are benchmarked – in order to assess the <u>accountability of such governance</u>;
- The <u>incentive structure within the governance</u> that could bias performance one way or another. Experience shows that distorted incentives can lead to bad behaviour that result in incompetence, misleading disclosure, fraud or cheating minority shareholders.

The point I want to make is that many international studies have shown that FDIs and portfolio equity flows are positively correlated to economic growth.[7] But sustainable economic growth is dependent not just on foreign investments, but on the quality of domestic governance.

Corporate Governance

Most people tend to regard corporate governance as simply being the relationship between a corporation and its stakeholders, such as the corporation's shareholders and its directors. For an Emerging Market, good corporate governance extended to the national level may be more properly referred to as "domestic governance". At the corporation level, we often refer to the basic principles of good governance as transparency, accountability and a level playing field. Transforming these into the context of domestic governance, they appear in the form of transparency in government policies, anti-corruption policy and open competition in the market.

There are some revealing findings from research conducted on corporate and domestic transparency.[8] Based on the information in the Global Competitiveness Report produced by Harvard's University Centre for International Development and the World Economic Forum, research studies found that:

- International equity investment tends to avoid less transparent countries.
- The tendency for international funds to engage in "herding" (which is alleged to have contributed to instability in the developing countries' financial markets) is related to a country's transparency.
- It follows that capital flight during a financial crisis tends to be more severe in less transparent developing countries.
- Overall, research results showed that an improvement in transparency might very well reduce the so-called "sudden stop" phenomenon of "hot money" and hence increase the stability of domestic financial market in a developing country.

For an emerging market, the first step towards achieving better corporate governance is the development and transformation from a relationship-based economy to a regulation-based economy, and the administration of these rules in a fair and transparent manner.

Regulation-based economy

As regulators, we play an important role in shifting our markets from a relationship-based economy to a regulation-based economy. A

[7] Source: IMF Paper on "Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence, March 17 2003

[8] Source: Gelos and Wei, 2002 "Transparency and International Investor Behaviour", NBER Working Paper No.9260 (October)

relationship-based economy dominates where there are no clear rules of game nor transparency. In the past, emerging markets cannot develop to best international standards because they lack the know-how, the resources and the human skills to compete internationally. With a number of emerging markets, even if they had the resources and the access to such skills and knowledge, they missed the opportunity through bad or weak governance.

In other words, you can blame globalization for "exposing" your internal weaknesses when you are benchmarked to international standards of efficiency and market behaviour, but you have only yourself to blame if you do not achieve such standards.

With globalization and the arrival of the Internet, there is now no excuse. It is now possible to globalize regulation-based economies because the standards of transparency and regulation are now global. IOSCO, together with other standard setters, such as the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS), the International Accounting Standards Board (IASB), the OECD all provide the standards against which domestic economies will be assessed and benchmarked by the International Monetary Fund as part of their FSAP (financial sector assessment programme)[9]. Investors will look to these assessment, as well as credit rating agencies and other international analyst publications to judge for themselves on the quality of an emerging market's governance and regulatory framework to deliver transparent, efficient and fair markets.

Moreover, in partnership with international financial institutions (who have the skills, network and market access), emerging markets can build stronger domestic financial systems through competition and innovation. Many emerging markets fear too much foreign entry, but that is the natural consequence of free markets working to improve global and domestic efficiency.

With strong regulatory framework and clear rules, different parts of the market can be built, such as derivative markets, deep and liquid bond markets. Without the participation of foreign players, who can bring both the expertise and the competition, such markets cannot reach international levels of sophistication. Inefficient, closed and non-competitive domestic markets with non-transparent behaviour inevitably lead to large losses and often domestic financial crises.

Hence, I would argue that the process of building the public infrastructure of judiciary, regulation and accounting and auditing

[9] The Objectives and Principles of Securities Regulation (1998, updated October 2003) can be downloaded from IOSCO's On-line library at www.iosco.org/library (IOSCOPD154).

using international standards and with foreign financial participation is a necessary step towards good governance.

No one said that this is easy. In almost all markets, the political landscape can have significant influence over the process of financial reform or market liberalization. The process will inevitably face resistance from vested interests, or from others who refuse to change, or inertia from the bureaucracy, which stalls the progress. Nevertheless, the transformation to a regulation-based economy is necessary in order for an economy to achieve long-term, sustainable growth. Nearly most developed markets are regulation-based, and history has shown that very few relationship-based economies can achieve long, sustained productivity growth.

Conclusion

The development of financial markets and attracting foreign investors into the market is a long, challenging process of integrating domestic financial systems into the global network. No man is an island, and none of us is smarter than all of us. Just as free trade in goods proved to be mutually beneficial, free trade in financial services add to domestic and global welfare.

While short-term incentives will bring investors' attention to a market, foreign investments will flee the market when the incentives expire and investors are not sure about that market's long-term prospects. Emerging markets need to have long-term vision and persistence to overcome challenges during the development process, in order to achieve long term, sustainable growth. Today, no Emerging Market needs to do it alone. There are global standard setters, fellow regulators like IOSCO, which can help them in their task towards domestic strengthening. This is truly a global process with domestic and global winners.

Thank you.

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