

EMERGING CAPITAL MARKETS

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Summary

Emerging economies are developing economies that have adopted market-oriented policies and have established stock markets in order to obtain foreign capital to increase economic growth. This is a marked change on previous attitudes towards economic growth, which had been seen as a larger role for government planning. The changes in emerging economies policies reflects the development of international financial markets that has seen substantial and increasing flows of private finance around the world.

There has also been a global consensus that conservative fiscal and monetary policies, large-scale privatizations, and reductions in the size of government are a necessary basis for sound economic management. Emerging economies have adopted these policies in line with their dominance in advanced countries. While there is no final evidence, a tentative conclusion is that emerging economies that rely on private capital inflows achieved higher economic growth in the last decade of the twentieth century than those dependent on official foreign aid.

Two important issues arising from the involvement of emerging economies in global financial markets are (a) whether capital flows generate instability for emerging economies, and (b) whether financial crises affecting emerging countries create financial turmoil for the global economy. Analysis of financial crises in Mexico, Asia, and Brazil suggest that financial crises are caused by inadequate preparation for engagement in global financial markets and that emerging economies have to strengthen their domestic financial sectors.

1. Introduction

The issue of how the undeveloped or less developed economies could increase their economic activity, raise living standards in order to alleviate poverty, and place themselves on a path of sustained economic growth was one of the most critical problems facing the world economies in the period after the end of World War II.

Issues in development economics mirrored the concerns of mainstream economics in the industrialized world. That there are developed countries that have initiated many innovations in the process of economic growth provides both a model for, and a source of assistance to, developing countries. One critical issue was whether economic development is best achieved through the untrammled operation of market forces or whether active intervention of the government is a positive and helpful force for development. The experience of the United States and European economies in the depression of the 1930s had led some economists to question whether a market economy allowed for effective *ex-ante* coordination of economic decisions. The rivalries of the Cold War led to serious attention being given to the role of planning, modeled on the USSR command-economy style, in the development process.

The process of development planning required an explicit statement of the long-term goals of the economy over a long period (following the USSR approach, development plans were for a five-year period), a detailed specification of what outputs were to be produced, and procedures to ensure that the goals of the plan were actually achieved. The major strategy of such plans was to mobilize resources efficiently and effectively in order to raise output quickly to effect sustained growth. In command economies, such as those of the USSR and its satellites, such development planning faced many problems. The overall problem was to achieve a balance between different types of production such as defense and civilian goods, investment goods and consumer goods, industry and agriculture, between different regions of the economy, and between central and local authorities. Planning in command economies was unable to resolve the difficulties over the long term; the longer term economic development of the command economies saw the institutionalization of inefficiencies and the inability to reconcile the various balance requirements. The result was that the command economies disintegrated and attempted in the 1990s to transform themselves into market economies.

In developing economies, various attempts to implement a planning approach to economic growth were implemented, although non-command economies found it very difficult to increase the rate of savings in the economy and even more difficult to reconcile the demands of different regions, groups, and aspirations of the people. An important constraint on economic growth that was more fundamental than increasing savings was the difficulties many developing economies experienced in creating the necessary preconditions for a modern economy. Some of these preconditions are establishing a system of enforceable property rights or, even more fundamentally, respect for the rule of law, effective land tenure systems, and the general legal and social infrastructure taken as a given in advanced economies.

By the 1980s the consensus among economists of different schools of thought was that development planning was not possible in the developing economies. However, the

1980s and 1990s saw the rapid growth of economies in East Asia because of policies that emphasized reliance on export-led growth and the government involvement in determining industry strategy. So successful was this prolonged episode of economic growth that it was dubbed “the Asian miracle” and held up as an exemplar to other countries. The Asian economies of Thailand, South Korea, Taiwan, Hong Kong, Malaysia, Singapore, and, to a lesser extent, the Philippines and Indonesia had been transformed by sustained high growth rates of economic output. The development of these Asian economies was marked by very high domestic saving rates enhanced by foreign borrowings leading to high rates of capital formation. The economies had been transformed by productivity gains in agriculture that allowed the transfer of labor resources to the industrial sector. The per capita incomes in these economies increased remarkably over a 20-year period, creating living standards comparable to, if not surpassing, those of developed economies. The Asian financial crisis of 1997 came as a shock both to these economies and to the champions of the new economic strategy embodied in the Asian miracle. The most seriously affected economies in the Asian financial crisis were Thailand, South Korea, and Indonesia, which required extensive support from the International Monetary Fund (IMF) and multinational consortia to stabilize their economies. These economies experienced sharp economic recessions and considerable dislocation to their financial sectors. By contagion, the other Asian economies of Singapore, Hong Kong, and the Philippines experienced contractions and a shock requiring domestic remedial action. Malaysia, which was relatively seriously affected, eschewed assistance from the IMF, placing blame for the economic downturn and financial disruption on speculators in international financial markets and imposing controls on capital flows and foreign investment. Although the exact nature of the Asian financial crisis is still being debated, the consensus of official views is that the rapid economic growth in production and incomes was not matched by improvements in bank supervision, corporate governance, and deregulation of the financial sector.

Developing economies, unlike the command economies, had further avenues for economic growth: foreign aid, foreign investment, and trade. The need to restructure the economies of war-torn countries after World War II had led to the creation of international institutions to provide such support. The IMF was to provide short-term support to economies experiencing balance of payments problems and the International Bank for Reconstruction and Development (IBRD), now called the World Bank (WB), for medium- to long-term loans to developing economies. The International Development Association (IDA) was established in the late 1950s as a related institution of the WB to provide non-commercial loans to developing economies while, in 1956, the International Finance Corporation (IFC) was established as a member of the WB Group as a source of financing for private enterprise in developing member countries. Regional development banks in Asia, Africa, and Latin America were also established.

Foreign aid is effective if it allows for the transformation of the domestic economy of the recipient country, allowing for shifts in production and trade. There occurred a heightened focus on development aid to alleviate poverty in the developing economics. In the aggregate economic view, foreign development aid seeks to increase the total resources available to a developing economy, thus removing the constraint of limited local resources, and to increase the availability of foreign exchange to it. Shortage of foreign exchange through an inability of developing economies to export on a large

scale had imposed a constraint on the purchase of investment and consumer goods from abroad. The question of the most appropriate form of foreign aid gave rise to two answers. One was concerned that aid agencies or aid donors would impose, explicitly or implicitly, their own economic values on the developing economy and that the developing economy's reliance on foreign aid would lead to the adoption of conservative economic and social policies. The other was that foreign aid would not allow the free operation of market forces and would perpetuate inefficiencies in economic operations.

The importance of foreign aid to developing economies is evident; what is not as clear are the incentives for developed economies to provide foreign aid. While developed economies may be motivated by altruism, they have both public and private interest reasons for supplying aid. The public interest arises from foreign policy considerations under which they seek to advance their national interests in the international sphere. National interests may be the desire to create a sphere of influence in developing economies for defense or diplomatic reasons, such as seeking the support of aid recipients in international organizations by way of votes in policy deliberations, or election of aid donor countries' candidates for international office. Private interests arise from purely commercial reasons by providing contingent aid, such as requiring aid funds to be expended on products from the aid donor. Public interest reasons dominate in multinational aid programs.

In general, in the 1980s the volume of foreign aid for development failed to expand and from the 1980s the greater part of the flow of foreign resources to developing countries was private capital directed towards foreign investment, both direct and portfolio investment. Influential in this change were the activities of the IFC, which became the world's largest multilateral source of financing private sector activity in developing economies. Up to 1997, the IFC had committed more than US\$36 billion, either on its own account or through arranged syndications and underwriting to nearly 2000 businesses in approximately 130 developing economies. Since 1984 the IFC has sponsored more than 30 collective investment vehicles such as country mutual funds.

From the point of view of the domestic economy, foreign investment is the acquisition of assets domiciled abroad. Assets include real assets such as factories, buildings, mines, and farms while financial assets include shares, bonds, bank deposits, and other financial claims. Direct foreign investment occurs when real assets or a controlling interest in real assets are acquired. Portfolio investment is the acquisition of financial assets, particularly the acquisition of shares in commercial enterprises and holdings that do not provide for control of the entity issuing the shares. Foreign investment occurs because investors want to obtain a higher rate of return on their funds than is obtainable at home. A further and much more important motive in recent times has been the desire to diversify portfolios internationally. The general principle of portfolio diversification is that a mixture of assets whose returns are not completely correlated will increase the average return to the portfolio and will reduce the risk of loss on the portfolio. Even if the rate of return on assets in foreign countries is not higher than the rate in the domestic economy, the interests of domestic investors will be well served by acquiring assets whose returns do not vary in the same way as domestic assets do. Investors from mature countries where the range of investment opportunities is restricted will find it

worthwhile to invest in developing economies, which offer investment projects that are potentially more rewarding. Foreign direct investment has increased due to the activities of transnational corporations, which produce and market consumer and producer commodities internationally.

The major growth in financial flows to developing economies in the last 20 years of the twentieth century came from portfolio investment; developed economies, especially the United States, have aging populations who save for the provision of retirement income through the agency of pension funds and mutual funds. Such funds hold internationally diversified portfolios.

In contrast with the problems of planning faced by the command economies, problems that eventually resulted in their downfall, the development of the global economy saw a movement towards increased reliance on the private sector. The end of World War II had seen widespread controls of the free passage of finance between countries. However, these controls were gradually eased during the 1950s and 1960s. The 1970s saw the float of major currencies and the movement towards financial sector liberalization. The general movement in Western economies was towards greater reliance on market forces following the acceptance of the view that “markets work best.”

The movement culminated in the acceptance of the “Washington consensus,” the general policy prescriptions of the IMF (and the WB) that favored fiscal conservatism and emphasis on market process as economic organizing arrangements in devising economic strategy for economies accepting assistance from the IMF.

The collapse of the USSR in the late 1980s removed the empirical underpinnings of the theoretical view that planned economies were viable and saw the triumphant emergence of the liberal democratic capitalist market economy. Privatization has since proved less successful in Russia than in other countries in transition and in other developing economies. From 1992 to 1994 privatization by a voucher scheme saw 15 000 firms transferred to insiders (former management of the state-owned enterprises) while the post-1994 privatizations under which the State-owned assets were sold for cash has led to what has been described as “a fraudulent shambles.” The general agreement is that Russian privatizations have been a principal cause of the country’s economic decline because the requisite institution building was not carried out; the major deficiencies are an inadequate capital market framework and minimal shareholder information and protection systems.

The model for economic development was now the adoption of the market model. The former command economies attempted to transform themselves into market economies and were referred to as the transitional economies. The developing economies also adopted the strategy for development recommended by the international monetary institutions derived from the Washington consensus and these countries were referred to as emerging market economies.

At the same time, in the 1980s and 1990s the growth of international financial markets was substantial and rapid. The growth of the international financial markets stemmed

from the following factors:

- The float of major currencies and the abolition of exchange control in developed economies;
- The substantial volatility in asset prices, which created the demand for hedging facilities, which was met by the establishment of new financial products such as futures and options and the establishment of new financial exchanges and the extension of existing ones;
- The increase in world trade, which itself was the result of the liberalization of trade;
- The growth of large surpluses and deficits on the current account of the balance of payments that saw large flows of accommodating and financing capital. The early impact occurred in the 1970s with the oil price crises and the need to recycle the large current account surplus of the oil-producing nations;
- Improvements in computer and communications technology that made access to financial markets much easier and supported extensive global trading in financial markets.

The result of this development was the maintenance of a global integrated set of private financial markets capable of seeking out profitable opportunities throughout the world and mobilizing capital on a large scale to exploit such opportunities. Coupled with this global development was the trend for developing economies to become emerging market economies. While the definition of emerging markets is not simple and clear, the generally accepted elements of the concept is that developing economies have moved to rely on private sector forces to accelerate economic progress. Emerging market economies have sought to obtain private capital to boost economic development.

The issues in emerging market economies are:

1. Does reliance on market-oriented policies and strategies lead to increased economic activity?
2. Does reliance on market-oriented policies and strategies lead to sustained economic growth and development?
3. What are the necessary preconditions for such reliance?
4. What are the economic infrastructure elements required to support market-oriented policies?
5. Does the reliance on private foreign capital generate instability in the emerging market economies?
6. Does the emergence and expansion of emerging market economies lead to financial turbulence in international financial markets?

The issues are examined through considering the role of finance in economic development and the role of financial markets in allocating economic resources. Light is also shed on some of these issues from considering global developments, but more particular information is given by the following:

- Experience of the former command economies in transition to market economies and in particular the economic instability of the Russian economy.
- The financial crisis in the Latin American economies of Mexico and Brazil.

- The lessons to be learned from the Asian financial crisis of 1997 that saw the long and successful economic development of the Asian miracle brought to a sudden, generally unexpected, and shuddering halt.

These events have provided a greater understanding of the necessary preconditions for successful economic development and of the necessity to construct a legal and social infrastructure that can support basic market transactions.

2. Financial Markets in Emerging Market Economies

Economic development occurs through the accumulation of capital, both physical and human, and the acquisition and use of advanced technology. Central to the accumulation of capital is the savings investment process in which savings are channeled into investment or gross capital formation. The role of financial markets in the savings investment process is to facilitate that transfer of funds from surplus units to deficit units. Savings in an economy occur by reducing current consumption and is a lowering of current living standards. It is thus critical that current sacrifices are rewarded by higher levels of consumption in the future. The process has to ensure that savings are allocated to the most productive and profitable capital projects. Investment in new productive capital projects leads to immediately higher levels of economic activity and to higher levels of sustainable economic growth. Failure to direct savings to the most productive investment imposes substantial real costs on the economy.

Banks play a special role in the savings investment process in selecting from loan applications from deficit units those propositions that lead to successful investment. Banks have special skills in dealing with small and medium-sized deficit units that are unable to access financial markets directly to sell securities. While banks play a critical and often predominant role in the savings investment process, the nature of banking leads to financial and economic problems. The history of economic development is marked by a large number of bank failures and banking panics that have frozen economic activity and led to large costs of resolution. The question of how best to regulate banks in order to achieve the undoubted benefits of their operations without episodic disruption has been discussed long and hard but without an easy resolution. The general issues of bank regulation are that strict regulation by governments leads to dynamic inefficiency, as banks are unable to cope successfully with changing financial and economic circumstances, which leads to distortions in the savings investment process and ultimately in economic activity. Unregulated banking, on the other hand, is prone to episodic large-scale failures that create inefficiencies and disruptions to economic activity. The role of bank supervision was brought into central focus by the Asian financial crisis of 1997 but the incidence of banking failures and panics was high in both developed and developing economies in the 1990s.

In general, there are two ways savings can be allocated to investment:

1. an interventionist approach under which savings are allocated in response to a government plan or by government direction under some guidelines; or
2. a market-oriented approach under which decisions to allocate savings are left to private markets and private institutions that seek to maximize private profit.

As discussed, this division is sharply polar and it has to be said that even in highly advanced capitalist economies such as the U.S. there has been a significant intervention in the market process.

In the 1950s and 1960s, policy generally veered towards the interventionist end of the spectrum. However, the 1970s saw a sea change whereby official policy moved away from intervention to a more “hands-off” approach central to which was the floating of exchange rates, reduction of the size of the government sector, and financial sector deregulation. In developed economies the role of financial markets increased in importance for various financial and economic reasons, one of the more important being a movement towards disintermediation (i.e. the process of deficit units seeking to raise external finance direct from the financial markets and thus bypass banks and other sources of intermediated credit). The movement to market-oriented processes was not without its problems, especially in relation to stability and banking failures and crises. A number of European economies, the Nordic nations, Spain, and the U.S. saw serious problems emerge in the banking sector and, in the case of the U.S., in the nonbank deposit-taking financial institutions. International action to develop effective standards for bank regulation came through the work of the Basel Committee on Banking Supervision (BCBS) under the auspices of the Bank for International Settlements (BIS) and led to the enunciation of basic standards that achieved general acceptance throughout the developed world.

The changes in the developed world affected developing economies. The fashion for market-oriented policies found favor in developing economies with at least tacit and often overt support from the official international financial agencies, the IMF and the WB. Developing economies moved to create private financial markets that could attract funds from abroad. This source of funds was potentially important for developing economies that could draw on a much greater pool of funds, so that the scope for increased investment and economic growth was considerably enhanced. Moreover, it was generally thought that market-oriented processes would be more efficient and effective in allocating savings to investment.

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Biographical Sketch

Jon Stanford has a Ph.D. from the University of Leicester, England. He is a Fellow of the Securities Institute of Australia. A specialist in monetary and financial economics, he has published *Money, Banking and Economic Activity*, John Wiley, 1973, which has also been published in Spanish and Portuguese-language editions; (with T.G. Beale) *The Law and Economics of Financial Institutions in Australia*, Butterworths, 1995, and *Financial Institutions* in Halsburys Laws of Australia, 1997. He is currently Senior Lecturer at the University of Queensland, Brisbane, Australia.