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Viewpoint

The World Bank February 1996

Note No. 70

Emerging Markets and Financial Volatility—Beyond Mexico

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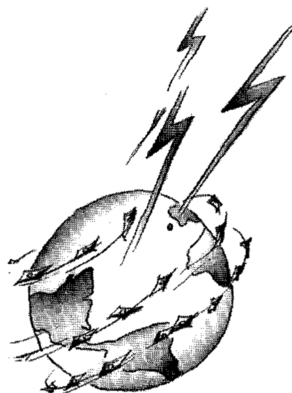

In the wake of the Mexican financial crisis, too much attention has been given to what was happening in emerging economies and too little to what was changing in financial markets. Easily forgotten now is that within weeks of the Mexican devaluation in December 1994, the unprecedented power of financial markets was twice demonstrated, and with equal drama, in the downfall of Orange County, California, and of the venerable Barings Bank. Such events suggest that emerging market investors and borrowers must derive lessons not only from their own experience but also from the broader changes in market structure and behavior.

What are these changes? First, much of the capital flowing to emerging markets is now in the form of bonds and portfolio equity investment. Second, investors managing these flows are attracted to high-risk, high-return opportunities and are less patient than the foreign direct investors or banks that emerging market governments may have been more used to dealing with. Third, these investors have no way of communicating their patience level to policymakers other than by exit. And fourth, high information costs tend to concentrate these flows in "hot" countries and lead investors to rely on a few knowledgeable observers to signal when their returns are at risk, adding to the potential volatility. These changes require a new perspective and new financial management capacity in both the public and the private sector.

Origins of volatility

"Putting the financial genie back in the bottle" by simply restricting the flow of capital, as some suggest, is not an option. Why? Because volatility predated the flows. It was, ironically, market volatility that in large part caused the globalization of financial markets in the first place. Until the 1970s, most international capital flows were fairly steady, passing through banks as a means of settling underlying trade in goods and services. Then oil price inflation, budget and trade deficits, and a variety of speculative bubbles appeared. The U.S. Federal Reserve abandoned its policy of targeting stable interest rates and announced that the best remedy for these ills was to steady growth in the supply of money. This policy shift set off unprecedented worldwide interest rate swings to accompany already volatile exchange rates. As interest rate targets dropped, economic volatility was transformed into financial asset volatility, and the markets responded.

Rather than following trade, growing pools of savings, increasingly managed by sophisticated, competitive institutions, began to flow across borders in search of much higher returns or, for the fainter of heart, portfolio diversification. These flows increased as nominal interest rates in the United States fell through the mid-1980s. Financial deregulation was embraced as a way to free institutions to deal with the volatility that threatened their access to funds or their ability to diversify into new businesses and markets. And new technologies allowed investors and intermediaries to complete transactions quickly and securely. Communications and information engineers made it possible to talk, trade, and settle across borders and time zones. Meanwhile, a new class of financial engineers developed security structures and derivatives that enabled investors to build international exposure—and to affect international market levels—without ever leaving their home market. Then it was only a matter of time before global capital discovered—and in

some senses created—the "emerging markets." And in the early 1990s, investors who had mastered the art of seeking out returns and diversification wherever they could were quick to recognize the opportunities in the newly liberalized economies in Latin America, East and Southeast Asia, the Middle East, and even Central Europe.

An unstoppable virtuous cycle had begun, or so the thinking went. Growing pools of savings in aging industrial countries would continue to find superior investment returns by building exposure to faster-growing developing countries. In turn, the integration of these countries with world financial markets would assure a level of connectivity and discipline that would prevent the kind of economic backsliding that had earlier soured such investments. It was presumed that newly powerful capital market forces would demand great discipline on the part of borrowers, with investors able to sell their holdings and refuse to invest again. After the loan failures of the 1970s and 1980s, when many commercial banks, trying to bail themselves out, threw good money after bad in lending to long-time customers, capital markets were expected to reduce volatility and its underlying conditions. But as things have turned out, the information content of the capital flows and the discipline they could instill in borrowers were both overestimated. And, as the Mexican experience shows, volatility was too often—and at great risk—simply assumed away.

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What has changed?

Capital need not always be crossing borders in record flows for it to be "global," nor can we expect investment flows to expand in an uninterrupted fashion. Still, capital flows now result from deliberate locational decisions by investors and borrowers who have considered global alternatives. Flows will slow from time to time. Indeed, after tripling from an average US$50 billion a year in 1989–91 to US$159 billion in 1993, investment flows to developing countries rose by only 5 percent to US$167 billion in 1994 and by some estimates fell by up to 20 percent in 1995.

The question now is, how does volatility affect emerging market investors, borrowers, and the market itself? To answer this, it is important to note the dramatic shifts in the composition of investment in developing countries since it exploded during the early 1990s. These flows are not "stodgy" old bank loans. Commercial bank loans have fallen sharply—from more than 20 percent of total capital flows to developing countries in the late 1980s to less than 4 percent in the past four years. Limited by balance sheet capacity and banks' new focus on fee-generating business, bank loans and syndications have given way to securities issues. Bonds reach a much broader range of investors, many of whose potentially longer-term and less-leveraged liabilities are well suited to bond assets. These investors are also willing to bear risks because of their ability to diversify portfolios and their perceived ability to trade assets actively when conditions appear to shift.

Capital flows to developing countries in the form of debt securities reached 25 percent (or US$42 billion) in 1993. But bonds are not the only financial market instrument being traded. Dynamic equity portfolio investments have grown from low levels to nearly another quarter of capital flows. These portfolios interact with increasingly well-developed stock markets. Or investors can trade them without ever leaving the comfort of their home market by using American or global depository receipts, which represent interests in emerging market companies.

Not all equity investments are held in trading portfolios, of course. In fact, nearly half the capital flows to developing countries represent direct foreign investment (like that in plant and equipment) by strategically minded global corporations. Still, some US$65 billion of capital—about 30 percent more than the total annual investment flows just five years ago—has flowed in each of the past few years to developing countries in the form of bonds and portfolio equity investments.

The profile of these investments is decidedly less patient than that of the direct foreign investment whose presence in part attracts them. The new investors appreciate volatility. Their often highly quantitative managers intentionally create exposure—typically representing a small share of assets—to high-risk, high-return classes of investments. Taken together, such investments can make up a large share of lightly capitalized markets, reinforcing the markets' volatility. And emerging markets are well suited to the new investors. Newly opened economies present opportunities for windfall gains at the same time that they are steering through the uncharted waters of adjustment (which occasionally turn windfalls into waterfalls). Moreover, the performance of many firms in the emerging economies is tied to the fate of their market. This phenomenon, along with the high information and transaction costs of dealing in a wide variety of equity and debt instruments, can lead to holdings concentrated in a few countries or companies, again adding to volatility. For example, during the 1990s, 84 percent of private capital flows to developing countries have gone to just twelve countries, with nearly 30 percent going to China and about 13 percent to Mexico. Trouble in one of these countries cannot but have a major impact on the market as a whole.

Financial market investors compensate for their lack of intimate knowledge of—and long-term relationships with—the countries and companies in which they invest with hair triggers on their investments. They count on other, more knowledgeable observers to signal when returns are in jeopardy. They expect such signals to be reflected quickly in market prices, which are in turn affected by the relatively large number of investors whose decisions are linked to price performance. Prices are therefore more likely to rise or fall precipitously. The trouble is that the markets have no easy way to transmit their time-bound expectations and their ongoing judgments to borrowers. As long as prices are high, both investors and borrowers tend to presume that all is on track. Neither pays enough attention to fundamentals. Investors believe that others will want to buy their stakes when it is time to take profits. And borrowers draw from the price charts and their success stories a sense that their job is done. By the time it becomes clear that not enough has been done to support long-term investments, there is little or no margin left for completing the task.

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Economic management implications

In view of the benefits of financial integration—increased trade, more uniform market rates (adjusted for risk and inflation), and a higher potential for growth—investors and developing country capital importers both must understand how the other responds to financial volatility.

So how should investors adapt? Recent experience suggests that investors might be well served to ignore traditional counsel against "fighting the tape" and begin to rely less on market trends as a guide to investment strategy. Developed markets in which trend analysis is used enjoy relatively complete information flows and are populated by a wide variety of investors with different objectives and time horizons. In thinner and more crisis-prone emerging markets,

investors should consider the underlying fundamentals for the countries and companies—not only policies and the commitment and ability to implement them, but also the ability to manage in the wake of financial volatility.

There is already broad agreement on the importance of better-quality information on the fundamental condition of economies into which global funds are flowing. But this is not a panacea, nor will it improve the situation immediately. It might even slow capital flows down for a while. Some investors will be deterred by the information they receive or by the difficulty of determining how others in the market will respond to such data. And it might take time for existing or prospective investors to reclassify their emerging market assets away from the most high-risk, high-return categories, while in the short run they could choose to reduce their portfolio exposure to all developing country securities.

The countries on the receiving end of global capital flows, meanwhile, face substantial risk along with high opportunity. The cost of avoiding financial integration is unacceptably high. But integration is not costless; in the early stages of economic and financial reform, it can introduce a potential for higher financial volatility. That is why some countries have deliberately curbed investment inflows during long periods of adjustment. But not all have found this tradeoff attractive. Some attempt to integrate quickly into global financial markets even if their local markets are not yet developed to global standards. This leads to a pattern of events that by now has been repeated in several countries, notably in Latin America but also in such countries as Turkey. In the typical scenario, economic adjustment is led by tight-money policies aimed at reducing chronic inflation. This generates substantial inflows of foreign funds and heavy repatriation of overseas holdings. Success in this phase, however, does not necessarily signal a capacity in the economy to absorb investment flows. Countries that have "suffered" such a surfeit of capital inflows relative to their ability to deploy them in a fully productive way find that international markets continue investing even when trade deficits balloon, growth remains anemic, banking weakness reflects poor investment performance, and the political will to complete the reform is lacking.

Investors' reaction to conditions in Mexico throughout 1994 and 1995 was, of course, the extreme case. As the markets there began to plateau, competitive investment yields rose and investors became wary. Outflows were stemmed by offering higher returns and through financial engineering that lowered investors' risks. But the message from investors was not that all was well. It was simply that they would give Mexico another chance—as long as it absorbed more of the market risk. Even if this was recognized in Mexico as well as outside, it was not clear that the Mexicans were granted enough time or room to fix the economy to meet market expectations, nor could they easily change those expectations. Clearly, officials must learn to manage the economic fundamentals that it is in their power to affect, to inform investors of their progress, and to listen carefully to the feedback that the market offers. Market jitters do not necessarily require fundamental rethinking, nor does market euphoria suggest that necessary reforms can be postponed. But the stakes are rising, and the window of opportunity for action is shrinking.

Like other international financial institutions, the World Bank too must reconsider its role in the wake of volatile global capital flows. Strategic advice and financial support can no longer be offered in a market vacuum. The message of market flows must feed into Bank operations, and the Bank must try to improve the information content of its advice to client countries. Finally, while the Bank's need to address long-run fundamentals is increasingly important, so too is the need to help client countries improve their capacity to anticipate, avoid, and manage the crises of volatility that can accompany economic liberalization and financial integration.

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