

**MANAGING PORTFOLIO EQUITY FLOWS**  
**In**  
**EMERGING MARKET COUNTRIES**

**A Discussion Paper**  
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**Managing Portfolio Equity Flows in Emerging Markets**  
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## EXECUTIVE SUMMARY

### *Key stylised facts regarding portfolio equity capital flows*

Portfolio equity capital flows have grown significantly and have raised their share of total capital flows of all kinds to EMCs. Such portfolio equity flows have been marked by substantial volatility and a great degree of concentration. Indeed the pattern of winners and losers in capturing shares of global flows into EMCs changes markedly from period to period. There is also evidence of growing competition for such portfolio equity capital flows among EMCs.

### *Determinants of the volume and direction of portfolio equity flows are complex and vary from time to time.*

Cyclical factors such as global liquidity levels interact with other conjunctural factors as well as structural factors to determine how portfolio equity capital flows grow and which EMCs they head towards.

### *Key policy questions are therefore raised*

Macro-economic management faces dilemmas as a result of the size and volatility of such portfolio equity flows. Other important questions that policy makers have to address include the balance between portfolio equity capital flows and other types of flows as well as how to manage the risks that appear inherent in the nature of such capital flows.

### *Policy prescriptions*

In essence, this paper concludes that the following broad areas of policy action need to be considered:

1. **Macro-economic policies need to be vigilant:** Sound macroeconomic management (dealing with the “trilemma”) should be combined with effective macro prudential surveillance to monitor the potential unwinding of global imbalances and their consequences for the domestic financial system and domestic policy mix of the EMCs and to the portfolio strategies of international investors;
2. **Financial markets need to be developed further:** Development of deep, transparent and liquid domestic stock markets in parallel with steps to foster debt markets are essential parts of reforms to the institutional framework and to a systematic reduction of risks to private investors;
3. **Well-planned capital account liberalization:** Capital account opening needs to be structured in a manner that will support and reinforce financial market development policies; and
4. **A strengthened framework for financial policy transparency** should help inform global investors of the quality of domestic markets and regulatory governance and thus help better align investor perceptions of risk with the actual risks.

# MANAGING PORTFOLIO EQUITY CAPITAL FLOWS IN EMERGING MARKETS<sup>1</sup>

## Section 1: Introduction

This paper studies trends in the flows of portfolio equity capital to Emerging Market Countries (EMCs) and assesses implications for policy makers.

### *Definitions*

There is no single, universally accepted definition of EMCs. We have chosen a broad definition that is used by major investors and their supporting agencies such those who construct stock indices for various categories of countries. A full list and explanation of EMCs is given in Annex 1.

### *Motivation for the paper*

Net inward portfolio capital flows to emerging market countries (EMCs) have fluctuated significantly in recent years. Just before the onset of the Asian financial crisis in 1996, net inward portfolio *equity flows of USD32.9bn were recorded flowing to all developing countries. This fell sharply to USD6.7bn in 1998, rebounded somewhat to around USD12bn during the global equity boom in 1999–2000, fell again in 2001–02 as this equity boom turned into bust and then rose sharply to around USD25bn in 2003–04.*

The size and volatility of these flows have created substantial problems for policy makers in EMCs besides raising important questions for private investors as well. In the past two decades, EMCs have witnessed a series of financial crises some of which many analysts trace to the abrupt manner in which capital flows generally, including portfolio equity flows can shift pace and direction. The Asian financial crisis of 1997–98 resulted in substantial contraction of output and incomes in a range of countries including Indonesia, Thailand, Korea and Malaysia, countries which had otherwise been successful in economic development. The rapidity with which a crisis that started in Southeast Asia with the devaluation of the Thai Baht in July 1997 spread to countries in other regions (Korea in December 1997 and Russia in August 1998) raised the issue of whether policy makers had been too quick to open their capital accounts without putting in place appropriate other policy measures to manage the potential negative effects of capital flows and their volatility

In particular, policy makers have been concerned by a number of issues which are addressed in this paper:

- First, sizeable capital flows have compounded policy dilemmas. A key reason for the crisis in Southeast Asia was the attempt by policy makers there to maintain an exchange rate regime that was not consistent with separately managed monetary policy while also opening their capital accounts. In the presence of large capital

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<sup>1</sup> Paper prepared by Manu Bhaskaran, V Sundararajan and Harinder Kohli, directors of the Centennial Group for the Emerging Markets Forum for its inaugural meeting at Templeton College, Oxford 9–11 December 2005. We are grateful to our research assistants, Daniel Soh and Harpaul Kohli, for their help in putting together the data analysis in this paper.

inflows, Southeast Asian policy makers in 1995-97 had great difficulty containing the overheating of their economies (reflected in rising inflation rates and deteriorating current account deficits) through tight monetary policies while also trying to keep their exchange rates within target ranges. Speculative capital flows – a good part of it in the form of equity flows – overwhelmed their efforts.

- Second, the abruptness and speed of reversal of capital flows has also compounded economic problems in EMCs. In 1997-98, the sudden loss of confidence in Southeast Asian economies after the Thai Baht devaluation led to highly disruptive outflows of capital including portfolio equity, depressing the value of equity holdings and leading to abrupt monetary tightening. These factors compounded an emerging slowdown, converting it into a massive crisis.

This paper aims to understand as best as possible the underlying forces determining the pattern of inward portfolio equity flows to EMCs, surveys recent studies and analyses of the subject and concludes with a review of the implications for policy and strategy.

### ***Organisation of the paper***

The paper is organised as follows. After this brief introduction:

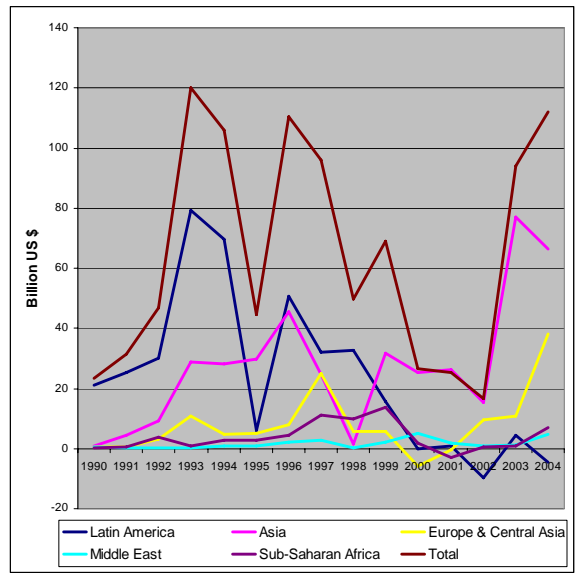
- Section 2 will present data on capital flows and will sketch out important features of portfolio flows—their growth, volatility and how they stand in relation to other forms of capital flows.
- Section 3 will then assess and review some of the determinants of portfolio equity flows.
- Section 4 will review several recent studies on the consequences and implications of portfolio capital flows in order to identify the critical issues facing EMCs.
- We will then review the literature on appropriate policy towards portfolio equity flows and survey actual policy responses by EMCs in different circumstances. Selected case studies will be reviewed briefly on actual country experiences.
- Finally, the paper presents a series of conclusions on areas for policy action and further research.

## Section 2: Trends in Portfolio Flows

Before discussing individual components of portfolio inflows, it is useful to review the evolution of the overall size and regional trends in private capital inflows during the recent past. Charts 1 and 2 below show total portfolio inflows (portfolio equity and portfolio debt) by region (Americas, Asia, Middle East, Europe and Central Asia and Sub Sahara Africa) during the past 10 years in billions of US Dollar as well as percent of GDP. A breakdown of regional inflows total flows (equity, debt, FDI and bank loans) is shown in **Annexes 2-5** at the end of the report. Overall, between 1994 and 2004, US\$740 billion flowed into EMC. Of this, \$360 billion or over half went to Asia and about US\$200 billion or a third to the Americas.

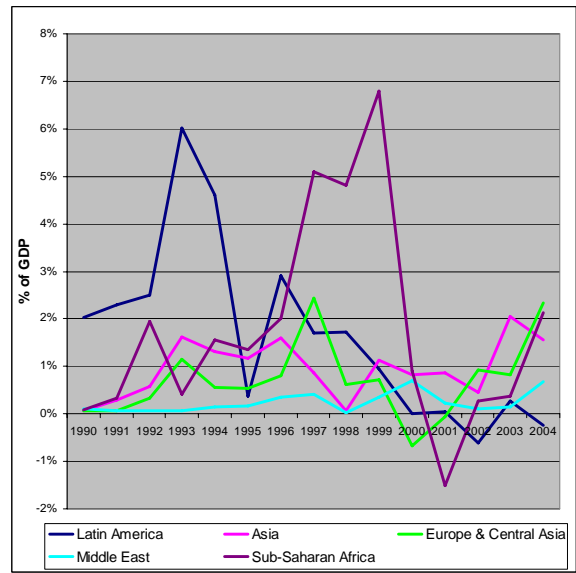
**Chart 1**

**Portfolio Investment into EMC, by Region**



**Chart 2**

**Portfolio Investment into EMC as %GDP**

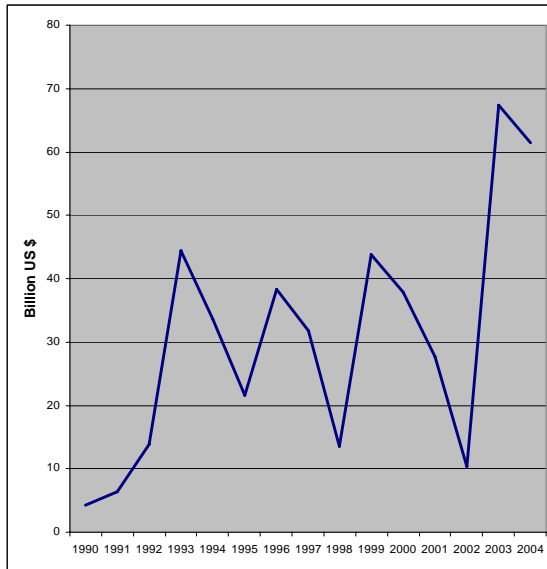


Sources: Collated by Centennial Group from the IMF's IFS, the World Bank, and Taiwan's Central Bank; also, to fill in missing data, CEIC Data and calculations based on the India's and Indonesia's central banks.

In 2004, private equity flows accounted for US\$248 billion out of US\$340 billion total portfolio flows. An analysis of the long-term trend in equity portfolio capital inflows brings out the following patterns as shown in Charts 3 and 4:

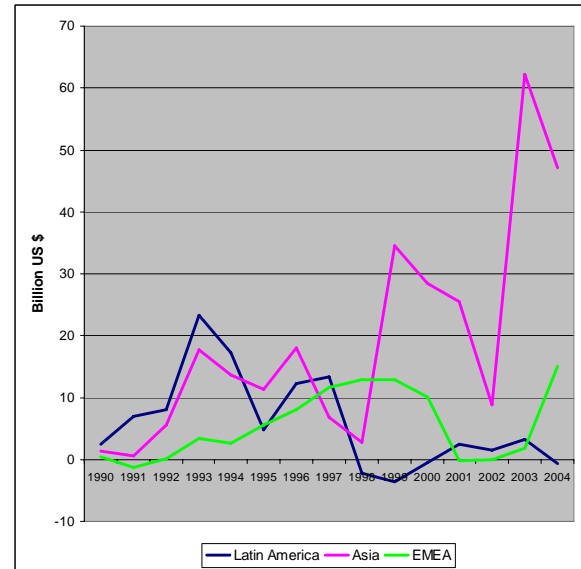
**Chart 3**

**Portfolio Equity Flows into EMC rising**



**Chart 4**

**Asia sees the most volatility**



Sources: Collated by Centennial Group from the IMF's IFS, the Central Bank of Taiwan; CEIC Data and calculations based on the Reserve Bank of India and Indonesia's Central Bank.

We now look at a number of stylised facts regarding portfolio equity capital flows into EMCs. In much of the discussion to follow, we have found it useful to differentiate different sub-periods in this long period. Before 1990, we had a period of limited openness where only a few emerging markets were open to foreign investment—such as Malaysia. The next few years, roughly from 1991 to 1996 saw a progressive opening of equity markets by EMCs, resulting in large inflows during that period. There followed a period of crisis in 1997–98 in the aftermath of the devaluation of the Thai Baht. Finally, there is the current period of substantial opening and large capital flows in all regions.

**2.1 Significant changes in pattern of winners and losers**

First, the top ten recipients of total portfolio inflows between 1994 and 2004 (Table 1) have changed significantly, with Brazil, Argentina, Thailand and Indonesia dropping out and Taiwan, Poland, South Africa and Czech Republic making the latest top ten. Mexico in the Americas, Korea, China and India in Asia, and Hungary and Turkey in Europe made the list in both periods. Taiwan rose from 11<sup>th</sup> rank to 1<sup>st</sup> rank in the latest period. Reflecting the changing relative economic prospects of the two regions, while in 1993/4 the top three recipient countries were from Latin America, last year the top four countries were from Asia and their combined inflows twice the amount received by the next six countries.

**Table 1: Top Ten Countries: Total Portfolio Investment into Emerging Markets**

		Average Between 1993-1994	Average Between 2003-2004	
1.	Brazil	30.3	Taiwan (China)	23.5
2.	Argentina	22.5	Korea	20.8
3.	Mexico	18.5	China	10.8
4.	Korea	9.9	India	9.2
5.	Thailand	3.9	Poland	7.3
6.	China	3.7	Turkey	6.7
7.	India	3.4	Hungary	5.1
8.	Hungary	3.1	Mexico	5.0
9.	Indonesia	2.8	South Africa	4.0
10.	Turkey	2.8	Czech Republic	3.3

Sources: Collated by Centennial Group from the IMF's IFS and the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on the Reserve Bank of India and Indonesia's Central Bank.

## 2.2 Portfolio equity flows have grown hugely in volume

Second, there has been significant *growth in the volume* of portfolio equity inflows (Charts 3 and 4 and Table 2) during the past twenty years. But, this has not been true for all regions in the EMC universe. Asia and Emerging Europe/Africa saw significant growth while Latin America received rising flows until 1996, since when flows have been very modest.

**Table 2: Long-Term Trends in Portfolio Equity Investment into EMC Region**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
<b>Emerging Market Region</b>	<b>USD Billions</b>				
Asia <sup>(1)</sup>	287.6	4.5	66.9	9.6	206.6
EMEA <sup>(2)</sup>	81.2	-1.4	18.7	24.6	39.3
Latin America	89.4	3.2	72.6	11.1	2.4
Emerging Market Total	458.3	6.3	158.2	45.4	248.4

Sources: Collated by Centennial Group from the IMF's IFS, the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on the Reserve Bank of India and Indonesia's Central Bank.

Notes:

(1) China and Malaysia 2004 values estimated from 2003 data; No Malaysia data before 2002; No Philippines data before 1996.

(2) EMEA = Europe, Middle East and Africa. Large outflows in 1985–90 mainly due to outflows from South Africa during the late apartheid period.

## 2.3 Portfolio equity flows are highly volatile

Third, portfolio equity flows have been marked by substantial *volatility*. There were even some years of negative flows when such capital was actually flowing out of some regions. Tables 2 and 3, and Chart 6 show the long term accumulated portfolio equity capital inflows, broken down by different sub-periods as explained above. For instance, Asian EMCs saw an explosion of portfolio equity inflows in 1991–96, followed by a collapse in



the crisis years of 1997-98 after which there was another explosion of portfolio equity inflows in recent years.

Chart 6 plotted the volatilities of the various types of global capital inflows to EMCs over the last 2 decades. The volatilities were computed using the 5 year trailing standardised standard deviations of different types of capital inflows.

- FDI inflows, being most stable, exhibited consistently low and steady volatility over the years.
- Similarly, volatility of equity portfolio inflows has declined steadily since 1989 and remained moderate since the mid nineties..
- On the other hand, *debt inflows*, being most volatile, showed a plunge in volatility during 1989-1996, but volatility surged at an exploding pace soon after the Asian crisis. Volatility of debt inflows remained the highest among the three types of inflows for most of the years in the last 2 decades.

Table 3 examines the volatilities of capital inflows into EMCs for different sub periods.

- In the initial period of limited openness (1985–90), capital inflows from other investments recorded the highest volatility among all other inflows. Volatilities of both equity and debt inflows in this early stage are significantly high and topped that for all subsequent sub-periods.
- Since the early liberalisation stage in 1991, the volatility of equity portfolio inflows has shrunk to less than a third of that in 1985–90. Likewise, the volatility of debt inflows remained fairly low during the 1990s.
- However, the recent period(1999-2004) saw a sharp rebound in the volatility of debt inflows after the crisis. Volatility of foreign direct investment inflows, on the contrary, has remained fairly stable and low over the last 2 decades.

**Table 3: Standardised Standard Deviations of Global Capital Inflows**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
Type of Capital Inflow	Standardised Standard Deviation				
Equity Portfolio Inflows	0.91	1.57	0.52	0.43	0.47
Debt Inflows	1.03	1.82	0.47	0.27	1.20
Foreign Direct Investment	0.71	0.35	0.44	0.01	0.13
Other Investment Inflows	2.01	-2.02	0.74	2.09	2.76
Total Investment Inflows	0.72	0.74	0.38	0.28	0.33

Source: Collated by Centennial Group from International Monetary Fund's International Financial Statistics Databases, Taiwan's Central Bank, Malaysia's Department of Statistics, the Reserve Bank of India, Indonesia's Central Bank and the Wall Street Journal.

## 2.4 Portfolio equity capital tends to be concentrated

Fourth, portfolio equity inflows have been marked by their *concentration*. Asia has tended to dominate these flows into EMCs in several though not all periods. Recently, this Asian domination has been increasing. Latin America's share has been in a secular decline after peaking after the initial period of opening up in Latin America in the late 1980s.

**Table 4: Regional Shares of Portfolio Equity Capital into EMC Region**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
Emerging Market Region	Percentage of total portfolio equity inflows to EMCs				
Asia <sup>(1)</sup>	62.8%	71.0%	42.3%	21.1%	83.2%
EMEA <sup>(2)</sup>	17.7%	-22.3%	11.8%	54.3%	15.8%
Latin America	19.5%	51.3%	45.9%	24.6%	1.0%

Sources: Collated by Centennial Group from the IMF's IFS, the Central Bank of Taiwan; CEIC Data and calculations based on the Reserve Bank of India and Indonesia's Central Bank.

Notes:

(1) China and Malaysia 2004 values estimated from 2003 data; No Malaysia data before 2002; No Philippines data before 1996.

(2) EMEA = Europe, Middle East and Africa. Large disinvestment in 1985-90 mainly due to disinvestment from South Africa during the late apartheid period.

Many emerging countries in Asia also competing for international capital implemented intensive reforms in their capital markets after the crisis, supported by policy makers' growing interest in developing their capital markets. Together with Asia's reviving economic climate, huge inflows of global opportunistic equity capital were thus drawn into Asia. In other words, the figures indicated the success of emerging countries in Asia in taking a progressively larger slice of global equity portfolio capital funds from other regions.

The EMEA region's share of equity portfolio inflows rose steadily over the initial sub-periods of limited openness and early liberalisation, hitting its peak during the Asian crisis before the share took a deep plunge in the recent post-crisis period.

Likewise, Latin America's share of equity portfolio inflows surged over the initial sub-periods since the mid-1980s and most of the 1990s. Its share then took a deep plunge during the Asian crisis. In contrast to Asia's rebound, Latin America's share of equity portfolio inflows continued to fall to less than 1% in the recent period of increased openness.

EMCs in Asia have thus been absorbing most of the global equity portfolio inflows, resulting in the rapid boom in the relative share of equity portfolio capital in Asia's overall capital inflows in the aftermath of the Asian crisis. Equity portfolio inflows in EMEA and Latin America, on the other hand, have been losing their importance in their overall share of capital inflows since the post crisis period. Over the last two decades, equity portfolio inflows in Asia constituted a significant amount of 15.6% of Asia's overall capital inflows, close to 50% higher as compared to relative shares of 10.74% and 10.59% from EMEA and Latin America respectively.

Concentration of portfolio equity flows is evident not only among regions but also within regions. Table 5 shows that Asian EMCs' shares of equity portfolio capital into Asia have fluctuated significantly over the years. Major recipients of equity portfolio capital in Asia include China, India, Korea and Taiwan, claiming a total share of 96.9%, 84.4% and 90.1% in 2001, 2002 and 2003 respectively. Among these main recipients, Taiwan embraced a huge slice of total Asia's equity portfolio capital, claiming over 40% of total equity portfolio inflows to Asia since 2000. Nonetheless, reasonably high portions of total equity portfolio inflows to Asia have also been drawn into China, Korea and India as well.

**Table 5: Relative Shares of Equity Portfolio Investment into Asian EMCs**

Year	1997	2001	2002	2003	2004
<b>Emerging Market Country</b>	<b>Relative Shares of Asia's Equity Portfolio Inflows</b>				
<b>China</b>	82.50%	3.34%	25.24%	12.41%	
<b>India</b>	37.27%	8.68%	13.91%	14.09%	20.22%
<b>Indonesia</b>	-72.73%	1.74%	9.84%	1.82%	4.34%
<b>Korea, Rep of.</b>	36.83%	40.39%	4.44%	23.15%	20.13%
<b>Malaysia</b>			-0.62%	2.15%	
<b>Philippines</b>	-5.92%	1.51%	4.53%	0.74%	0.89%
<b>Singapore</b>	-6.48%	-0.84%	-4.48%	2.38%	6.18%
<b>Taiwan (China)</b>	-32.55%	44.46%	40.81%	40.46%	29.91%
<b>Thailand</b>	56.41%	1.38%	6.05%	2.87%	-1.01%

Sources: Collated by Centennial Group from the IMF's IFS, the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on the Reserve Bank of India and Indonesia's Central Bank. Notes: For 2004 total, China and Malaysia 2004 values estimated from 2003 data.

Asia's share of equity portfolio capital relative to its overall capital inflows has changed significantly over the last two decades, ranging from a trough of 2.3% in 1985-90 to a peak

of 23.84% in 1999–2004. (See Table 6) The liberalisation reforms in many developing capital markets in Asia in turn have sparked higher economic growth, enhanced creditworthiness and rising corporate profits and market value and thus have undoubtedly drawn in equity portfolio capital. As shown earlier, EMCs in Asia, among all the other regions, received the highest concentration of global equity portfolio flows.

**Table 6: Relative Share of Portfolio Equity in Overall Capital Inflows by Region**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
EMC Region	Relative Shares of equity portfolio inflows in overall inflows				
Asia	14.7%	2.3%	9.3%	5.24%	23.84%
EMEA	10.7%	11.12%	12.1%	14.1%	9.0%
Latin America	10.6%	-7.3%	17.9%	5.5%	0.9%

Sources: Collated by Centennial Group from the IMF's IFS, Taiwan's Central Bank; also, to fill in missing data, CEIC Data and calculations based on Malaysia's Dept. of Statistics, India's and Indonesia's central banks, and the Wall Street Journal.

Note: 1985-90 Latin America equity inflows were actually positive but all other Latin America investments summed negative; hence the negative sign for a positive number.

## 2.5 Increased competition for portfolio equity capital

Despite this past concentration of portfolio equity inflows to just a few countries, it is important to note that many more EMCs are now opening up their capital markets and striving to receive a greater share of global flows of portfolio capital. In the past decade, we have seen:

- **Countries opening up their capital account:** Malaysia has removed virtually all the controls it placed on capital flows in September 1998 in response to the Asian financial crisis. China and India have gradually eased restrictions on their capital accounts.
- **Countries easing restrictions on foreign ownership:** For instance, ownership ceilings have been eased in countries as divergent as Taiwan, India and Malaysia. In addition, such EMCs as China have devised new licensing and other regulations that allow approved foreign institutional investors to participate in domestic capital markets—where before they were not allowed to participate at all.

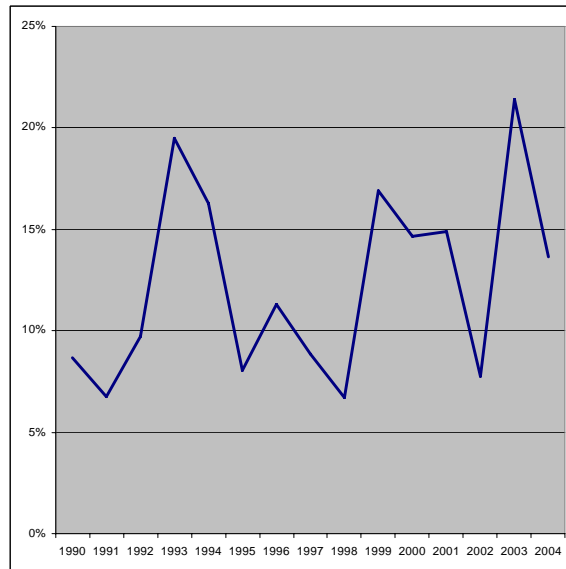
Consequently, there has been *increased competition* for capital among EMCs, and new favourites have emerged in recent years. As mentioned above, there has been a significant change in the list of top ten recipient countries during the past decade.

## 2.6 Equity portfolio flows have become more important compared to other forms of capital.

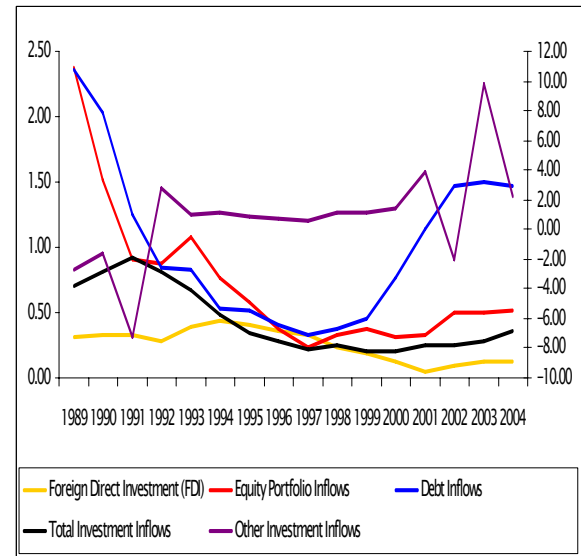
Sixth, the relative importance of equity portfolio flows in the overall flows of capital has tended to fluctuate significantly. The last two decades have seen sharp fluctuations in the

share of equity portfolio inflows in total capital inflow.(Chart 5). Despite these fluctuations, the relative share of equity portfolio flows in overall flows of capital has climbed since the 1990s.

**Chart 5**  
**Portfolio Equity Inflows Share of Total Capital Inflows**



**Chart 6**  
**Volatilities of Global Capital Inflows into EMCs**



Source: Collated by Centennial Group from the IMF's IFS, the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on Malaysia's Department of Statistics, the Reserve Bank of India, Indonesia's Central Bank and the Wall Street Journal.

In Tables 7 and 8, we can observe that the relative share of equity portfolio flows has multiplied nearly three times since the initial stage of limited openness to the recent period of increased openness. Though the relative share fell during the Asian crisis, it was quick to pick up pace and rebounded sharply right after the crisis, embracing an even higher share as compared to its initial growing share in the early liberalisation period before the crisis.

In contrast, net inward debt flows fell significantly after the Asian crisis, but have rebounded since 2002, Both the share of domestically raised external debt, as well as that of portfolio debt inflows, have risen recently, reflecting enhanced creditworthiness of most EMCs particularly in Asia, improvements in domestic debt market infrastructure, strengthening of public debt management, liberalization of capital accounts that facilitated deepening of domestic financial markets, continuing substitution of bank loans by market debt, and better investment climate. Nevertheless the share of foreign investors in domestic debt markets remain small and spotty, although domestic market debt is emerging as an important foreign investment destination (See World Bank's *Global Development Finance*, September 2005, Chapter 4).

With rapid global financial integration, especially after the Asian Crisis, many developing capital markets in Asia have gone through substantial reforms leading to increased liberalisation and openness to the global market. As a result, equity flows have emerged as

a more popular choice of global investors in EMCs compared to traditional debt counterparts in the past. However, on the whole, foreign direct investment flows still comprise by far the largest share—about two-third-- of overall capital flows to EMCs.

**Table 7: Long-term Trends in Global Capital Investment into EMCs**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
<b>Type of Capital Inflow</b>	<b>USD Millions</b>				
Equity Portfolio Inflows	458.3	6.3	158.2	45.4	248.4
Debt Inflows	518.1	23.3	300.9	100.4	93.6
Foreign Direct Investment	2039.9	114.8	499.1	355.1	1070.8
Other Investment Inflows	558.3	-8.4	320.2	60.1	186.4
Total Investment Inflows	3576.2	1136.0	1278.5	560.9	1600.8

Sources: Collated by Centennial Group from the IMF's IFS, Taiwan's Central Bank; also, to fill in missing data, CEIC Data and calculations based on Malaysia's Dept. of Statistics, India's and Indonesia's central banks, and the Wall Street Journal.

**Table 8: Relative Shares of Capital Investment into EMC's**

Period	1985-2004	1985-90	1991-96	1997-98	1999-2004
		Limited Openness	Early Liberalisation	Crisis	Increased Openness
<b>Type of Capital Inflow</b>	<b>Relative Shares of Total Capital Inflows to EMCs</b>				
Equity Portfolio Inflows	12.81%	4.64%	12.37%	8.09%	15.52%
Debt Inflows	14.49%	17.11%	23.54%	17.89%	5.85%
Foreign Direct Investment	57.04%	84.42%	39.04%	63.31%	66.89%
Other Investment Inflows	15.61%	-6.17%	25.05%	10.71%	11.64%

Source: Collated by Centennial Group from the IMF's IFS, Taiwan's Central Bank; also, to fill in missing data, CEIC Data and calculations based on Malaysia's Dept. of Statistics, India's and Indonesia's central banks, and the Wall Street Journal.

In short, portfolio equity flows have been characterised by:

- A changing pattern of winners and losers.
- Massive growth in volumes
- Significant volatility
- Substantial concentration – both among regions (favouring Asian EMCs) as well as within regions.
- Equity portfolio flows are growing in importance relative to other types of capital flows.

### **Section 3: Determinants of Portfolio Equity Flows**

Portfolio equity flows are influenced by conjunctural and cyclical factors as well as structural factors and the institutional environment. Conjunctural factors include: expected returns as well as volatility of returns in the destination country relative to mature economies. Both are generally influenced by the relative developments in economic growth and monetary conditions; developments in return and volatility in the emerging markets as a group can also impact on individual countries in so far as EMC equity is treated as an asset class in the portfolio allocation decisions of foreign investors. Further, portfolio equity flows also depend on structural factors such as the expected diversification benefits reflected in the correlation among returns, the state of development and institutional quality of capital markets in the destination countries, and the degree of openness to capital flows.

#### **3.1 Cyclical factors affecting flows and country/regional shares of portfolio capital**

Economic growth and related monetary policy cycles in developed countries, especially the United States, appear to have a disproportionately powerful influence over net flows of portfolio equity capital to EMCs. There are two basic issues to consider here.

First, easy monetary conditions in the US and other OECD countries tend to create conditions of excess liquidity, that in turn may be channelled into investments primarily into financial assets in the developed countries in the first instance. However, some part of this will tend to flow into EMCs as portfolio capital.

Second, as easy monetary conditions are prolonged in developed economies, market-determined yields on financial assets will tend to fall, spurring global investors to search for higher-yielding assets elsewhere. If, at the same time, the global economy is growing well, global investors' risk tolerance tends to improve. This often causes these global investors to price risk less rigorously—leading to an inflow of portfolio capital into riskier assets such as EMCs bonds and equities, and so depressing yields or raising equity valuations.

#### **3.2 Expected rates of return appear to be heavily influenced by relative economic growth prospects:**

Global investors are actively searching for areas and instruments offering attractive returns. In analysing the expected rates of return for foreign equities, investors tend to look for prospects in the countries' economic growth and also assess the level of currency risk involved. Booming economic growth may not actually produce high equity returns but investors do look at relative economic growth rates as a guide to relative returns so long as this is likely to be accompanied by a stable or rising exchange rate. So long as the overall macro-level indicators are promising, the issue will be more one of the profitability of the actual companies they invest in. Thus, corporate profitability is the key. Factors like earnings growth, return on equity, and other measures of value creation such as economic value-added are all becoming key considerations for global investors.

Over the 1991–2004 horizon, notable growth was observed among the Asian economies compared to both the EMEA and Latin America regions.

- Indeed, EMCs in Asia reaped the highest share of global equity portfolio capital over this period (Table 3 in Section 2). Despite the declining momentum of growth in Asian economies over subsequent periods, Asia’s share of equity portfolio funds continued to be high. Such a phenomenon can probably be explained by Asia’s sustained growth differential above the other regions over the years. Moreover, most of the portfolio capital flows were concentrated in India, China and Korea (Table 7), where average growth was significantly higher than most other EMCs.
- Likewise, equity funds were drawn into EMEA when its average regional growth jumped from a negative to a positive during the Asian Crisis, resulting in a substantial surge in EMEA’s share of global equity capital (Table 3).
- Unfortunately, Latin America’s share of equity portfolio capital fell sharply, in part due to the relatively slower pace of economic growth there.

**Table 9: Weighted Real GDP Growth by Regions**

Period	1991-2004	1991-96	1997-98	1999-2004
		Early Liberalisation	Crisis	Increased Openness
Region	Weighted Real GDP Growth			
Latin America	2.8	3.5	3.5	1.8
Asia	10.2	11.0	10.0	9.4
Europe & Central Asia	-0.2	-9.0	7.7	6.0
Middle East	10.4	13.6	8.7	7.8
Sub-Saharan Africa	4.7	4.3	4.9	5.1
Emerging Markets Total	7.2	6.8	8.2	7.3

\*Weighted 3 years moving average of the economies listed, based on 2000 GDP and PPP exchange rates.

\*Brunei’s figures are not included.

Source: Collated by Centennial Group from Economic Intelligent Unit (EIU) Database.

### 3.3 Exchange rate expectations

Especially after sharp exchange rate devaluations in EMCs in 1997-2001, global investors became substantially concerned with currency risk. They tend to look carefully at any risk of an EMC currency being misaligned. They will also assess longer-term factors that affect the sustainability of an EMC’s exchange rate regime—such as the consistency of monetary and fiscal policies, current account balances, financial sector sustainability issues such as the growth of consumer and corporate debt, etc.

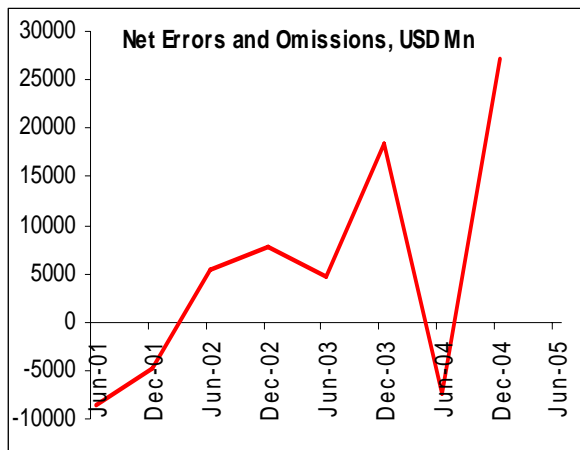
Currency changes have clearly played a role in recent flows into China and Malaysia. Both countries saw a surge of flows into equity, bond and real estate markets as expectations that their currency pegs would be replaced by a floating currency regime intensified—their



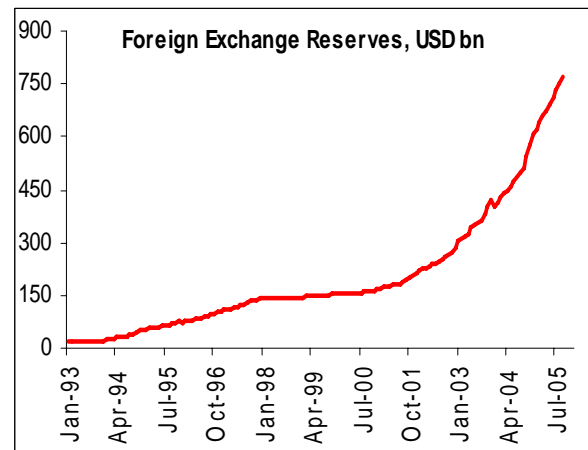
currencies were seen as under-valued and therefore likely to appreciate. In China’s case, strict capital controls meant that much of the capital that flowed in was hot, unrecorded money—which is why the errors and omissions item in the balance of payments turned sharply up. This capital flow was also seen to be sensitive to expectations of the currency—when fears of the overheating of the economy caused investors to revise downwards their expectations of currency appreciation, such flows turned negative briefly (Chart 8).

The currency pegs that were followed by these two countries until 21<sup>st</sup> July 2005 led to sustained central bank interventions over an extended periods to prevent the currency from appreciating. These in turn caused a surge in foreign exchange reserves in the past few years (Chart 9).

**Chart 8**  
**Speculative flows to China currency expectations**



**Chart 9**  
**Causing foreign exchange reserves to rise**



Source: Collated by Centennial Group using CEIC Database

### 3.4 Sovereign credit ratings

The recent BIS annual report 2004 showed that sovereign credit ratings for both Asia and EMEA have been following an improving trend since the end of 1990s, when ratings plunged during the Asian Crisis before picking up in the recent years. Not surprisingly, equity portfolio flows into Asia fell over subsequent periods in the 1990s and then soared in the post-Crisis period (Table 1). Similarly, a rise in the equity flows to EMEA was noted following the improvement in its sovereign credit ratings in recent years. On the contrary, sovereign credit ratings for Latin America reported all time lows since the 1990s, leading to the drastic shrinkage in its equity capital flows since 1991.

### 3.5 Real interest rate differentials

EMCs have generally provided higher real interest rates than the US or other developed economies (see Table 10). However, given the higher risk associated with EMCs, the key issue has been the quantum of risk premium required to maintain flows of capital into EMCs. But the countries are now also vulnerable to sudden changes in global investors' risk appetite. This was seen clearly in April 2004: when expectations of the degree and speed of likely tightening of monetary policy in the US changed suddenly, EMC sovereign bond spreads over US Treasuries rose suddenly. This was accompanied by a substantial increase in financial market volatility, reflecting rapid changes in global asset allocation by large investors who reduced their allocation to riskier EMCs as their risk appetite waned.

**Table 10: Real Interest Rate Differentials By Regions**

Period	1991-2004	1991-96	1997-98	1999-2004
		Early Liberalisation	Crisis	Increased Openness
<b>Emerging Market Region</b>	<b>Real Interest Rate Differential</b>			
Latin America	59.2	143.3	3.0	-6.2
Asia	2.2	11.7	3.3	-7.7
Europe & Central Asia	-41.6	-73.9	-48.4	-7.0
Middle East	3.0	12.2	3.7	-6.5
Sub-Saharan Africa	0.9	4.4	8.0	-5.0
Emerging Markets Total	4.1	18.9	-7.9	-6.7

\*Money market rates deflated by consumer prices minus U.S. real rates. \*Brunei's figures are not included.  
Source: Collated by Centennial Group from Economic Intelligent Unit (EIU) Database.

### 3.6 Structural Changes that impact on portfolio equity flows

#### (a) Capital Account Opening in EMCs

A country's decision to open up and enhance the access of foreign investors to the equity and debt of its companies will attract global investors seeking diversification and new opportunities for returns.

There are opportunistic capital flows—e.g., if countries privatize aggressively, that will lead to temporary surges in portfolio capital inflows, as well as more longer-lasting improvements in flows driven by fundamental reforms in the capital account regime. Country experiences in liberalizing capital flows and in using capital controls to insulate the domestic economy from external vulnerabilities raise a host of issues that include the following:

- Are controls effective in limiting particular forms of capital flows?
- Do controls facilitate better macroeconomic policy mix and outcomes?.
- Do controls have long-term effects on investor confidence and level of flows?
- Does the effectiveness of controls depend upon the type (indirect and market based versus direct and administrative) and target of controls?, and
- Do capital controls serve a prudential purpose and are prudential policies effective in minimizing the risks in cross-border capital flows?

In addressing these issues, Arriyoshi et al<sup>2</sup> show that the effectiveness of controls and the benefits of liberalization depend upon a host of factors, including the seriousness of macro-economic imbalances, administrative capacity to manage the controls and its liberalization, the level of financial market development, and the nature of controls. While the effectiveness seems to depend upon country-specific circumstances, properly managed, transparent and market-based controls can temporarily help to insulate pressures on monetary conditions, and provide the breathing space needed to undertake more basic policy and structural adjustments. In addition, well-sequenced domestic financial sector development strategy with proper prudential safeguards can provide a basis for an orderly process of capital account liberalization.

### ***b) Investibility Issue: Developing Markets and Market Infrastructure***

There is some evidence, though not a whole lot, that foreign mutual funds investments in emerging markets are significantly linked to security-market infrastructure, shareholder rights, and quality of accounting standards (see Aggarwal, Klappen and Wysocki (2003)<sup>3</sup>. Also, there is evidence that equity-market liberalization, involving an opening up to foreign shareholders, is associated with significant increase in share prices and reduction in cost of capital (Henry and Lorentzen (2003))<sup>4</sup>. Also, more protection of shareholders is strongly associated with the size, efficiency and stability of equity markets (see Garibaldi, Mora, Sahay, and Zettlemeger(2002))<sup>5</sup>. However, much work remains to be done on the linkages between market and institutional structures and the pace of market development. In particular additional work on the impact of observance of global regulatory standards on the pace and volatility of inflows could provide valuable insights for policy.

Several structural factors play a key role in shaping the perceived returns and riskiness of investing in EMC equity securities. These include:

- First, corporate governance and transparency: The Asian financial crisis highlighted the crucial importance of good corporate governance, transparency of management and majority shareholders actions affecting companies that foreigners invest in and the accuracy of financial accounts presented to the investment community. The creation of effective regulatory and supervisory institutions and the formulation of appropriate policy frame work for good governance in EMCs have thus become important.

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<sup>2</sup> Arriyoshi Akira, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Ivan Canales-Kriljenko, and Andrei Kirilenko, 2000, "Capital Controls: Country Experiences with their Use and Liberalization, Occasional Paper No. 190, Washington DC, International Monetary Fund).

<sup>3</sup> Aggarwal, Rena, Leora Klappen and Peter D. Wysocki 2003 "Portfolio Preferences of Foreign Institutional Investors" Policy Research Working Paper 3101, WB, Washington, D.C. July.

<sup>4</sup> Peter Blair Henry and Peter Lombund Lorentzen. "Domestic Capital Market Reform and Access to Global Finance: Making Markets Work." The Future of Domestic Capital Markets in Development Countries ed. By Robert E. Litan, Michael Pomerleane, and V. Sundararajan (editors) Brookings Institution Press(2003 Washington D.C.).

<sup>5</sup> Pietro Garibaldi, Nada Mora, Ratra Sahay, and Jeromin Zettlemeger, What Moves Capital to Transition Economies? In IMF Staff Papers May 2002, vol 48, Special Issue (IMF, Washington, D.C.).

- Second, market liquidity has also become an important determinant of flows of portfolio capital into EMC equities. Global investors typically seek investments in which there are significant amounts of daily trading enabling them to buy and sell these assets without moving the price against them and also ensuring that they can enter and exit these investments easily as and when they desire to. Market liquidity is influenced by both the size and pattern of ownership of listed securities, and the micro-structure of the markets, including the trading systems. The creation of a liquid security market with efficient trading arrangements is thus important to attract both domestic and foreign investment.
- Third, several broad structural features that affect the macroeconomic and financial stability policy frameworks, such as the sustainability of exchange rate regime, the perceptions of financial system stability, including the debt-equity ratio of companies, public debt sustainability, efficiency and soundness of financial intermediation etc. will also shape the overall perceptions of costs, risks and returns of investing in EMCs.

*(c) Structural Changes in Sources of Portfolio Capital*

Developments in developed economies can also play a role. According to evidence discussed in the IMF's Global Financial Stability Report (GFSR), September 2005 (Chapter III on Global Asset Allocation), the degree of "Home Bias" in institutional investors has declined, with foreign assets often reflecting a range of investment objectives. Pension assets, often a very conservative investment group, are increasingly placing mandates with broader guidelines, including alternative investments. For all types of institutional investors in industrial countries, the share of foreign assets rose between 1997 and 2003 to an average of 12%, driven by several factors: 1) Greater focus on Asset and Liability Management (ALM) by institutional investors; 2) Changes in accounting and financial reporting standards; 3). Influence of rating agencies on asset allocation decisions of institutional investors such as Insurance companies; and 4) Governance arrangements of institutional investors for asset-allocation decisions.

These factors, combined with the growing availability of investment vehicles and liquid markets in many developing and emerging markets, have contributed to a surge in foreign capital flows. For instance:

- World pension assets rose from less than \$7 trillion in 1993 to \$11 trillion in 1998, and are expected to exceed \$15 trillion by 2003. In 2003, approximately \$655 billion of the \$15 trillion in pension assets is likely to flock to emerging markets. The scope and impact of such increased flow of capital on the Latin American region is analyzed in Savitsky and Burki (Paper #5)
- Insurance companies' assets in the OECD surged from close to US\$7 trillion in 1993 to over US\$11 trillion in 2001. Likewise, assets in OECD-based investment companies which included closed-end and managed investment companies, mutual funds and unit investment trusts exploded from slightly over US\$4 trillion to over

US\$11 trillion during the same period. An immense part of these mounting institutional assets are expected to be drawn into emerging markets given their rapid development and reforms in their capital markets over the recent past.<sup>6</sup>

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<sup>6</sup> Source: OECD Statistical Databases

## Section 4: Key Issues arising from Large Portfolio Flows

Our review of trends and determinants of flows of portfolio equity capital raise several key policy questions.

### 4.1 Macro-economy level

First, at the macro-economic level, some fundamental issues arise with regard to the relationship between degree of openness of the capital account, the appropriate exchange rate regime, and the capacity to insulate domestic monetary conditions, including interest rates, from external shocks. The impossibility of controlling all three variables—level of capital flows, interest rates and exchange rates—using only two instruments, monetary policy and the use of capital controls, raises a host of issues relating to the effectiveness of capital controls in insulating domestic monetary conditions, as discussed earlier.

With surges in inflows, the immediate policy response has typically been sterilization, but this entails costs and hence some countries have used controls on capital inflows to reduce reliance on sterilization, and in some cases to allow time to effect other policy adjustments (or in some cases to postpone adjustments). Such controls were typically accompanied by other policies, such as liberalization of outflows (Chile, Columbia), increased flexibility of exchange rate (India), further strengthening prudential framework and soundness of financial systems (Malaysia, Chile and India) and adjustments in fiscal policies (which has varied considerably across countries). In some countries, outflow controls were used temporarily to prevent downward pressure on exchange rates in times of crisis, while pursuing other policy adjustments to cope with the more basic imbalances that might have triggered the outflows (e.g. Malaysia). The tax on short-term capital inflows (using unremunerated Reserve Requirements) used by Chile is the most well known example of inflow control that has been studied in the literature extensively (for a survey, see Williamson (2005)<sup>8</sup>. There is evidence that, with the use of such market-based capital controls, the authorities obtained some freedom to vary the mix between raising interest rates and reducing the inflow of capital, as needed.

With an open capital account, however, the authorities have to build sufficient resilience in the financial system and in other economic segments, and sufficient flexibility in the choice of macroeconomic policy mix, in order to cope with the inevitable volatility in capital flows, while setting in place contingency plans, and reserve cushions to cope with extreme volatility that might occur occasionally. Thus careful institutional preparations for an effective macroeconomic and financial stability policy framework will be key to managing the macro policy consequences of capital account opening. For an analysis of policy responses by EMCs to the recent surges in capital inflows, see the 2004 Annual Report of the Bank for International settlements (summarized in Box 1), and GFSR (September, 2005).

<sup>8</sup>John Williamson, "Curbing the Boom-Bust Cycle: Stabilizing Capital Flows To Emerging Markets" July 2005, Institute For International Economics, Washington DC.

**Box 1: Recent Policy Responses towards Surging Equity Portfolio Inflows**

The 2004 Annual Report of the Bank for International Settlements reviewed the policy responses of several EMCs in response to large capital inflows.

Various policy actions were carried out by countries in response to soaring capital inflows. Through 2003, many emerging countries including Brazil, Chile, Russia and South Africa allowed their currencies to recover sharply from immense depreciations. Consequently, their nominal effective exchange rates appreciated over the year to an extent consistent with inflation targets.

Alternatively, actions targeted at dampening exchange rate appreciation encouraged outflows and reduced inflows simultaneously as seen in China for example. In response to these flows, China acted to lessen exchange restrictions on individual overseas travel, encouraged certain types of domestic firms to invest abroad, and initiated a scheme to induce domestic institutional investors to increase their outward investment. In order to curb inflows, the authorities temporarily suspended approvals of new investment under the Qualified Foreign Institutional Investors scheme and placed daily limits on the conversion of dollars into domestic currency by individuals. Similarly, India liberalised investment by domestic companies and financial institutions in overseas assets, allowed the prepayment of foreign currency debt by firms, and permitted residents to hold foreign currency accounts.

In addition, some countries shifted their attention to depress exchange rate appreciation through exchange rate intervention. Emerging Asia has seen a surge in the total reserves since 2003 and early 2004. Though motives for accumulating reserves among Asian economies varied, foreign currency intervention by central banks' to resist appreciation stemming from surging speculative capital inflows played a crucial stabilizing role. Even countries with reasonably flexible exchange rate regimes like India, Korea and Thailand also intervened through the foreign currency markets to slow appreciation.

Efforts to limit speculative moves on currency were also practised to tackle exchange rate appreciation. Two popular examples are policy responses by Thailand and Korea where Thailand limited non-residents' short-term baht lending in September 2003 and subsequently set limits on the amount and maturity of their baht deposits. Korea, on the other hand, imposed restrictions on non-deliverable forward markets to dampen currency speculation.

## **4.2 Dependence on different Types of Portfolio Capital: Portfolio Capital vs. Other Forms of Capital Inflow**

Once it is accepted that large amounts of foreign capital will be flowing into the country, the question of appropriate balance between different forms of capital flows becomes an issue. First, it is desirable to foster a balanced inflow of debt and equity capital in order to avoid possible distortions in financial structure of firms and banks that might raise vulnerabilities to interest rate and exchange rate shocks. Second, historically portfolio flows have been much less stable than FDI and subject to greater influence from global factors than FDI flows. In addition, some negative correlation between FDI and portfolio equity flows has been observed historically for technical reasons of substitutability among these two forms of capital. While continued gains in both portfolio equity and FDI are desirable, inflows of debt through domestic debt markets would be preferable over debt through external markets, as the former reduces currency risks.

Although in principle, countries should favour less volatile forms of capital, such as FDI, while maintaining some balance among other forms of flows, in practice, it is not feasible to influence the composition with any precision. In discussing as to why capital inflows into China have been primarily in the form of FDI, a recent IMF Working Paper has argued<sup>7</sup> that the tax and legal incentives for FDI combined with limited development of domestic capital markets serving as a barrier to other forms of capital may have caused the observed outcome.

Recent major shifts in composition of capital flows to EMCs toward more volatile portfolio capital and loans raises major questions of vulnerability to capital flow reversals (see 2004 Annual Report of BIS for an analysis). The policy frame work to moderate the impact of such risks assumes particular importance in the current conjuncture, requiring strong macro prudential surveillance and flexible macro policy response as emphasized below in Section 5.

## **4.3 Micro-level Issues-Managing risks in Cross Border Capital Flows**

As already mentioned, the development of domestic financial markets, strong risk management capacity at the individual institutions level, and an effective supervision of financial markets and institutions, are some of the components needed to bring about orderly liberalization of capital account. Identification of additional risks due to cross border capital flows and preparing the institutional capacity to deal with those risks should go hand in hand with the use of such liberalization as a tool to strengthen the depth and liquidity of domestic financial markets. These considerations call for careful sequencing and coordination of domestic and external liberalization policies, and complementing the policy package with proper macro prudential surveillance.

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<sup>9</sup>Prasad and Wei (IMF Working Paper /05/79, April 2005)



**Box 2: Case Study of Malaysia**  
**Effectiveness of Capital Controls in Malaysia**

In September 1998, in response to strong pressures on Malaysian Ringgit the authorities imposed a wide range of controls on capital outflows designed to eliminate the off-shore Ringgit market and thereby choking off speculative activity against the Ringgit, while pegging the exchange rate, easing fiscal policies to raise capital spending, and strengthening prudential framework and financial sector restructuring. A study by Arriyoshi, et al (2001) shows that the wide ranging nature of the measures, and their strict and effective enforcement by the authorities and commercial banks, seem to have been instrumental in effectively eliminating the offshore Ringgit market and thus contributing to containing speculative pressures. The acceptability of measures was strengthened by efforts to disseminate information to increase transparency of the controls and their efforts to accelerate the financial sector restructuring. Kaminsky and Schmulker (2000) find that the controls were successful in lowering interest rates, stabilizing the exchange rate, and reducing the co movement of Malaysian overnight interest rates with regional interest rates.

Kaplan and Rodrik (2001) provide econometric evidence that the controls and the associated policy package allowed a faster recovery from economic crisis and better performance than would have been possible in their absence.

## Section 5: Conclusions and Policy and Strategy Implications

The above analysis and assessment raises key policy questions:

- Regulatory — corporate governance rules (international accounting standards, requirements for proper disclosure, etc.);
- Surveillance — regular assessment of corporate and financial sector vulnerabilities needed;
- Macro-economic — exchange rate regime, capital account.

Since 2001, emerging market equities have generated higher risk-adjusted returns than mature equity markets, while emerging market bonds have been one of the best performing asset classes. In response, both portfolio equity and debt inflows to emerging markets have rebounded from the declines experienced in earlier years. Also, increasing attention to local currency bond markets by foreign investors, particularly for sovereign issues, has contributed to overall portfolio capital inflows.

However, the levels of portfolio equity inflows, though rising, remain modest in most countries, and are concentrated in a few countries like India, Malaysia and China, relative to portfolio debt. Flows of portfolio equity have also been volatile, driven by various conjunctural factors; while the volatility of equity returns has been high historically relative to mature markets. It is true that this volatility seems to have declined in recent years; the decline in volatility of mature markets has been more pronounced. In addition, the small size and weak infrastructure of many emerging markets have restrained the pace of inflows.

The key issue, therefore, is: What should the strategy be, to promote greater interest from foreign investors in emerging equity markets, and to diversify the range of countries that benefit from portfolio equity flows?

The strategy can be presented in terms of four policy messages.

- 1. Sound macroeconomic management (dealing with the “trilemma”), and effective macro prudential surveillance (to monitor the potential unwinding of global imbalances and their consequences for domestic financial system);**

Flexibility to manage the mix of interest rate, exchange rate, and fiscal policies within a framework of a flexible exchange rate regime and liberalized interest rate environment is key to coping with the normal or expected volatility in foreign capital flows. Dealing with unexpected volatility, however, will require proper level of international reserves, complimented by appropriate financial safety nets. Market-based controls on capital flows may provide some flexibility to the authorities in some countries to alter the interest rate–exchange rate mix temporarily (Williamson (2005)). Ultimately, however, flexible use of all macroeconomic policy instruments would be necessary to achieve non-inflationary growth, while smoothing the impact of global shocks.

The desirable macroeconomic policy mix would, however, depend upon macro-prudential environment (for example, the relative vulnerability of the financial system soundness to exchange rate or interest rate or other shocks) as well as the nature of stocks. No a priori prescription is feasible. In particular, the potential unwinding of global imbalances and the associated shifts in exchange rates, interest rates, and other asset prices, could have significant impact on the soundness of banks, other financial intermediates, and market volatility. Effective monitoring of this impact—macro prudential surveillance— would help to guide macroeconomic policy mix and develop complementary prudential policies. In particular, the application of financial supervision policies can benefit from the better distinction between the impact of common macroeconomic and global shocks affecting the financial system, and the institution specific shocks linked to its specific balance-sheet and risk characteristics.

The current conjuncture of increases in more volatile portfolio flows and the potential risks on account of unwinding of global imbalances calls for strengthened macro-prudential surveillance to complement a prompt macro policy response.

**2. Development of deep, transparent and liquid domestic stock markets in parallel with steps to foster debt markets.**

Development of domestic stock markets should be pursued jointly with corporate debt market development to foster a balanced access to both debt and equity finance and thereby promote both financial stability and efficient allocation of capital. Market development policies should be combined with appropriate risk mitigation policies. The specific institutional components of a market development program would include:

- Improvements in market micro-structure, and in the transparency and governance of issuers; and
- Improvements in market integrity, including the effectiveness of security market regulations and regulatory governance.

Development of domestic capital markets would, however, require a strengthening of legal infrastructure, including putting in place a robust insolvency and creditor rights regime, which serves as a precondition of effective regulatory framework for both banking and capital markets.

**3. Well-planned capital account opening process that will support and reinforce market development policies.**

Capital account opening policies starting from an initial situation of restrictions on inward and outward capital mobility should be managed to support the domestic market development strategy. Capital account opening can be used as a tool to reinforce market liquidity, while ensuring that risk mitigation measures take into account the specific additional financial risks arising from capital account policies. Sometimes institutional capacity may need to be strengthened first before cross border transactions

are opened up, while in other circumstances external liberalization can speed up domestic reforms. Thus the precise sequencing and coordination of capital account and domestic institutional reform measures will be country specific. Country experiences suggest that certain sound principles and practices can be identified for such sequencing of capital account opening and for the coordination of capital account measures with domestic financial sector reforms. (Robert Litan, Michael Pomerleano, and V.Sundararajan, (Editors) “Future of Domestic Capital Markets in Developing Countries”, 2003, Brookings Institutions Press, Washington DC).

**4. Strengthened framework for financial policy transparency to inform global investors of the quality of domestic markets and regulatory governance.**

The good practices in market infrastructure and market integrity are effectively captured in IOSCO Security Market Regulatory principles. Transparency of the authorities regarding their observance of these principles would be an effective means to inform global investors and derive the full benefits of domestic market development and capital account opening program. More generally, adoption of good practices in the transparency of monetary and financial policies, supported by good data dissemination practices, is a desirable component of overall market development. As markets develop, the scope and forms of transparency practices themselves should evolve.

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Centennial Group  
November 2005

## **Annex 1:List of Emerging Market Countries**

There is some debate as to how to define emerging market economies and therefore which countries should be included in any list of EMCs. For purposes of this paper, we have used a relatively broad definition to include countries which are both of most interest to international investors at this time and which compete with each other in attracting international private capital flows. The list we have chosen corresponds to the list and definitions of EMCs used by international investors and also by journals such as the Economist. While most of these countries are middle or upper middle countries developing countries in Asia, Europe and Latin America, we also include some low middle income and low income countries (e.g. China, India, Vietnam, Kenya, Nigeria, Bolivia etc.) which are capable of attracting significant capital flows as well as the so called “tiger” countries in Asia spawned the original club of the EMCs and whose economic policies are both emulated in and intertwined with rest of emerging Asia.

### **Sub-Sahara Africa**

Cote d'Ivoire  
Ghana  
Kenya  
Nigeria  
South Africa  
Uganda

### **Asia**

Bangladesh  
Brunei  
China  
India  
Indonesia  
Korea  
Malaysia  
Pakistan  
Philippines  
Singapore  
Sri Lanka  
Thailand  
Taiwan (China)  
Vietnam

### **Europe, and Middle East (EME)**

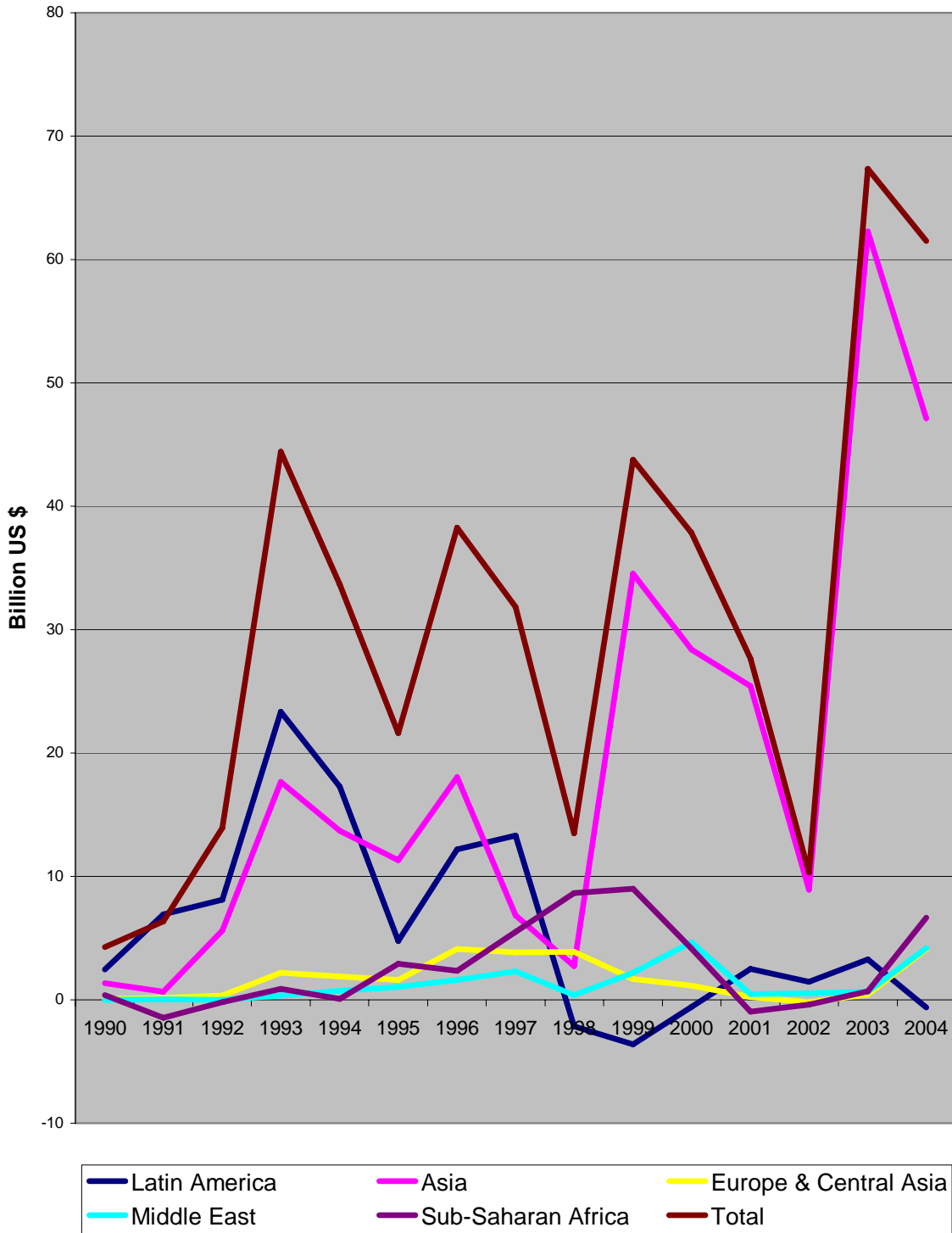
Algeria  
Bahrain  
Bulgaria  
Croatia

Czech Republic  
Egypt  
Kuwait  
Kazakhstan  
Hungary  
Iran  
Israel  
Jordan  
Morocco  
Poland  
Romania  
Saudi Arabia  
Serbia and Montenegro  
Slovak Republic  
Tunisia  
Turkey  
Russian Federation  
Ukraine  
United Arab Emirates

**Latin America**

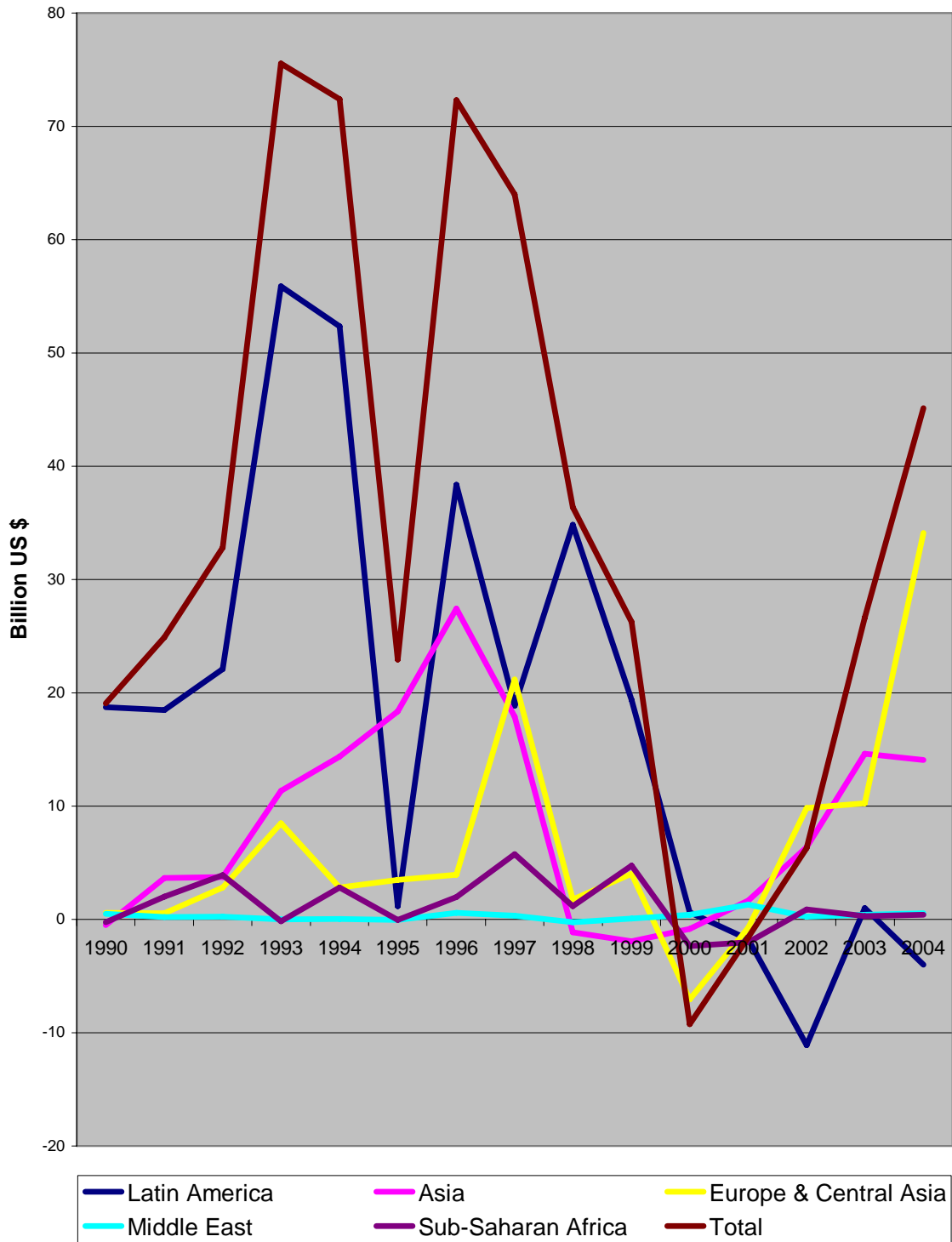
Argentina  
Bolivia  
Brazil  
Chile  
Colombia  
Costa Rica  
Ecuador  
Mexico  
Peru  
Venezuela  
Uruguay

## Annex 2: Portfolio Equity Investment into EMCs, by Region



Sources: Collated by Centennial Group from the IMF's IFS and the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on the Reserve Bank of India.

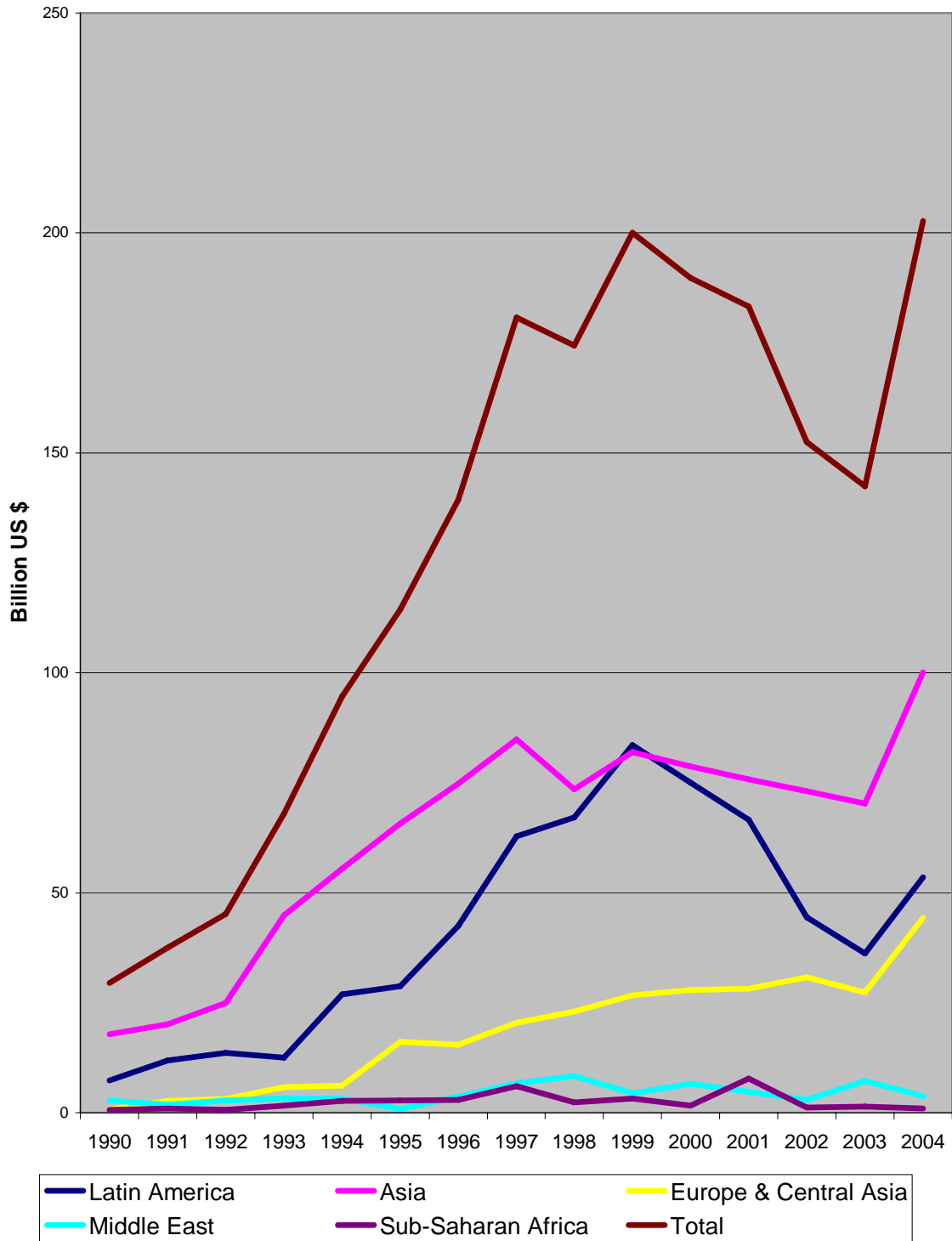
### Annex 3: Portfolio Debt Investment into EMCs, by Region



Sources: Collated by Centennial Group from the IMF's IFS and the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on Indonesia's central bank.

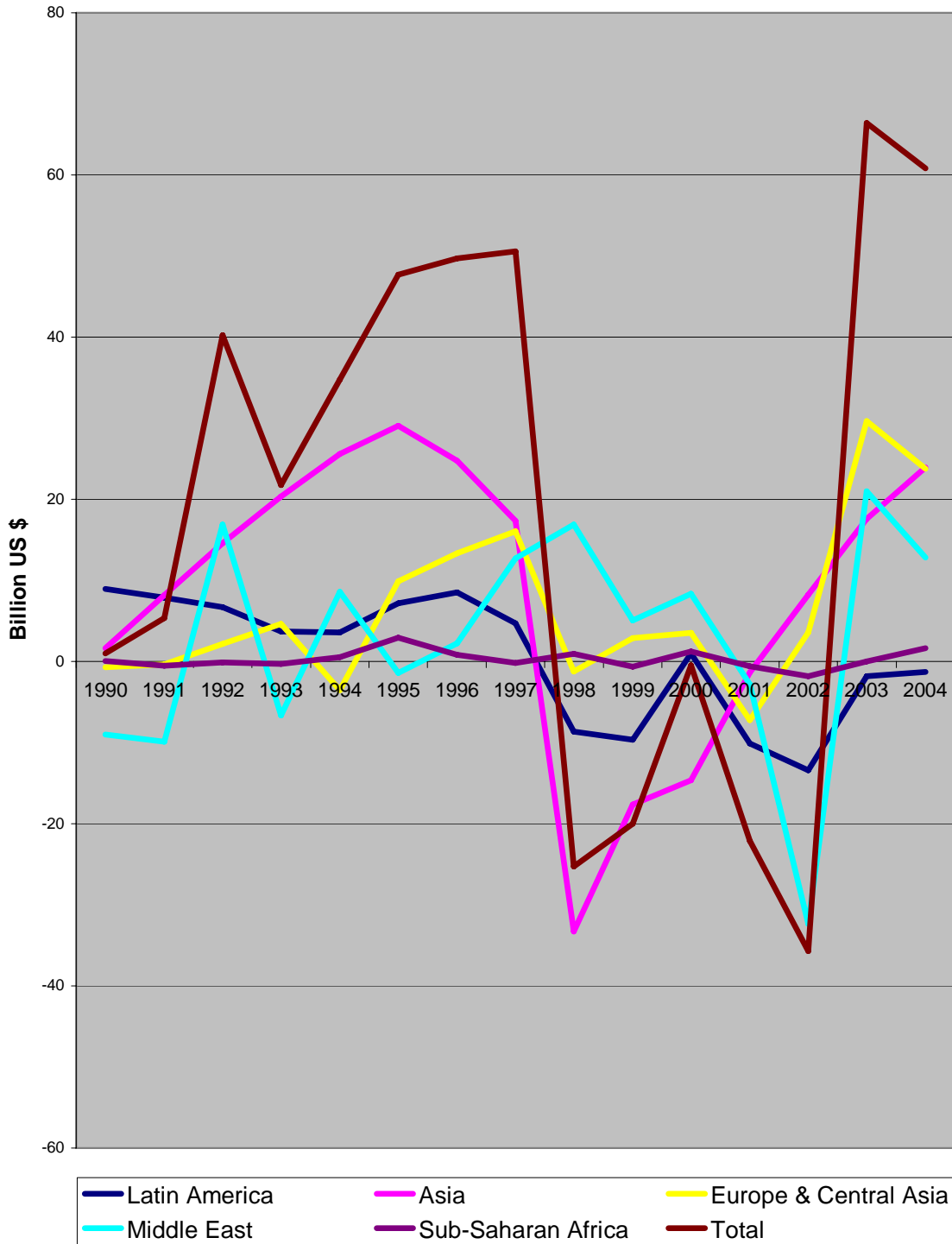


### Annex 4: Direct Investment into EMCs, by Region



Source: Collated by Centennial Group from the IMF's IFS and Taiwan's Central Bank; also, to complete data, CEIC, Malaysia's Statistics Dept, the Wall Street Journal, and India's and Indonesia's central banks.

### Annex 5: Bank Investment into EMCs, by Region



Sources: Collated by Centennial Group from the IMF's IFS and the Central Bank of Taiwan; also, to fill in missing data, CEIC Data and calculations based on the Reserve Bank of India.

Note: Some data missing for Mexico (1996-97), China (2004), Malaysia (1999, 2000, 2004) and the Slovak Republic (2004).