PART 4

PERSPECTIVES: HOPES AND HURDLES

Are Emerging Markets Now Shielded From Financial Crises?

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The 1990s was a decade of major financial crises in emerging markets: sovereign defaults, currency devaluations, plummeting assets markets, sudden halts in capital flows. In 2007 and 2008, ten years after the Asian and Russian crises, the situation appeared in a radically different light: appreciating currencies, net creditor countries, long-term local currency debt markets, rising asset prices and massive inflows of foreign investment.

According to IMF forecasts, emerging countries will grow at a rate of 6.7% in 2008 (after 7.9% in 2007), more than five times the rate of advanced economies (1.3%). The room for manœuvre created by such strong economic growth has been used in recent years to undertake major financial modernization efforts, which tends to bring the financial structures of emerging countries closer to those of advanced countries in various respects: improvement of the debt structure, a broader spectrum of financial markets, investor diversification.

Consequently, the emerging country asset class today is perceived as much less risky and less monolithic than in the 1990s. Investors seem to have taken note of the lowered credit risk in these countries, reflected in less financial market volatility, while maintaining a certain discrimination between them according to their economic fundamentals.

Emerging countries were relatively unaffected by the American subprime crisis. Some observers believed that they even appeared as a safe investment. Does that mean they will be shielded from major financial crises in the future? What is the share of actual progress as opposed to mere catching up, the share of remaining uncertainties and imbalances?

Development and convergence of emerging financial markets

The economic fundamentals of emerging market economies have considerably improved in recent years and their integration into the global economy and international financial markets has intensified. In 2006, net inflows of private foreign capital reached a record level of US$647 billion in these countries, according to the World Bank. Outstanding sovereign bonds issued by emerging countries on the international markets increased fourfold between 1994 and June 2007, from less than $110 billion to more than $407 billion. Bonds thus supplanted bank loans and other sources of capital such as development aid, as the primary source of financing for emerging markets.

This considerable surge in market-based financing has been underpinned by substantial financial efforts to modernize the financial sector, which has enabled emerging countries to offer investors an ever broader and more sophisticated range of financial instruments and thus attract new types of investor. Overall, emerging countries are tending to set up financial structures similar to those in advanced countries.

Improved public debt structure

The debt-to-GDP ratios have tended to decrease over the past 15 years, particularly as a result of more restrictive fiscal policies, at least for a few years, under pressure from the IMF or other multilateral institutions. In some cases, proceeds from privatization or commodity exports have been used primarily to repay the public debt.

At the same time, since the mid-1990s, the financing of emerging sovereigns has increasingly taken the form of securities issuance and less and less that of syndicated loans granted by banks. In the long run, the aim of these countries is to comply with OECD best practice. This institution recommends financing in the form of fixed-rate, long-term domestic debt denominated in local currency, underpinned by a broad base of domestic investors.

Lastly, public debt is generally issued in domestic currency, which reduces currency mismatches and makes States' risk less dependent on exchange rate fluctuations. Thus emerging countries have escaped the curse of original sin—the impossibility of borrowing in their own currency—that had made the crises of the 1990s so costly. In all, according to an IMF estimate in late 2004, the foreign currency debt was down to an average of 16% of the total negotiable public debt of emerging countries (compared with 6% in the OECD) and the short-term debt down to 11% (compared with 16% in the OECD).

With regard to these developments, Latin America appears as a case in point, given the extent of its early repayment of external debt and the use of innovative asset and liability management techniques such as the warrants issued by Mexico in November 2005, by which the dollar debt could be exchanged for a debt denominated in pesos. Thus Brazil, Colombia, Mexico and Venezuela repurchased nearly $30 billion of sovereign debt in 2006, $15 billion of which was for Brazil alone and represented 60% of its external debt in 2005. Other countries, especially among commodity producers (Russia, Algeria, Nigeria), have decided to repay in foreign currency all or part of their external debt to the Paris Club or the IMF, thus proportionally reducing their debt servicing.

Overall, Brady Bonds (special bonds created in 1989 to replace defaulted loans in Latin America), once a symbol of the financial crises in emerging countries, have virtually disappeared. Only $6 billion remained outstanding at the end of 2006, whereas this outstanding debt amounted to $150 billion in the mid-1990s. Conversely, the loans granted by the IMF to emerging countries amounted only to $8 billion in March 2007, as opposed to $100 billion in 2003.

Broadening the spectrum of financial markets

In response to the banking crises in the 1997-2001 period, the structural reforms carried out enabled the banking sectors to restructure and consolidate, financial systems to be opened up to foreign investors, and supervision of financial institutions to be strengthened. At the same time, the share of market-based financing increased with the emergence of new financial instruments.

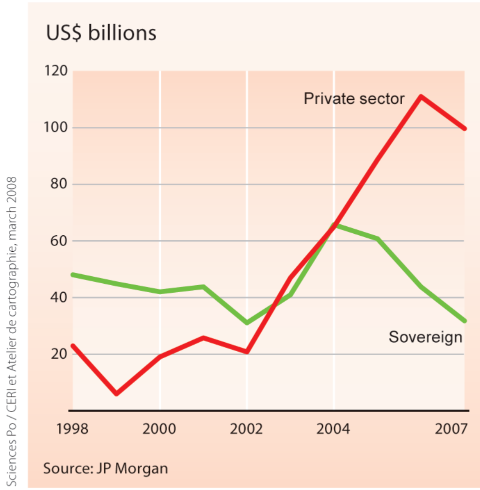
First there has been a growth in local currency-denominated sovereign bond issuance (see above), as shown by the high capitalization of the new leading index GBI-EM[1] devised by JP Morgan, started in June 2005 ($693 billion), which now represents more than double the capitalization of the former EMBIG[2] benchmark index for foreign currency sovereign bonds ($367 billion).

More recently, private companies in emerging countries have been issuing heavily on the international debt market (bonds and syndicated loans) in a context of abundant liquidity and low risk premia. For instance, in 2006, bonds issued by the private sector in emerging countries ($111 billion) exceeded those of sovereign bonds ($44 billion), a significant change with respect to the early 2000s when private issuance barely represented half the sovereign issuance. This trend was facilitated by the fiscal discipline of States, which borrowed less, thus leaving the field open to the private sector, as well as by a new methodology of rating

1 GBI-EM : Global Bond Index – Emerging Markets; index calculated by JP Morgan representing negotiable debt issued in local currency by sovereign emerging countries, including long-term and sufficiently liquid bonds. That is available back to 2002.

2 EMBIG, Emerging Market Bond Index Global, the index calculated by JP Morgan representing assignable debt issued in dollars or euros by sovereign emerging states, including bonds and long-term syndicated and sufficiently liquid films. Data are available as far back as 1993.

figure 89: **Sovereign and private sector bond issuance in emerging countries, 1998-2007**



agencies, which now authorizes a corporate rating in emerging countries to exceed that of the sovereign State. Likewise, syndicated loans granted to companies in emerging countries in dollars and in euros reached a record $315 billion in 2006, according to JP Morgan.

Furthermore, domestic stock exchanges in emerging countries have gained increasing importance in the financing of local businesses. The intense flow of equity portfolio investment from non-residents reached a record level of $94 billion in 2006, compared with not even $6 billion in 2001-02, according to the World Bank. In the front line of the development of emerging stock exchanges is a small group of highly attractive countries, the BRICs (acronym for Brazil, Russia, India and China), characterized by their heavy economic weight, high growth, the size of their private companies and for some their considerable openness to foreign investment, making them a preferred destination for international investment. The share capital market value of the BRICs (including continental China, but excluding the Hong Kong stock exchange) represents nearly three-quarters of that of all emerging countries.

Finally, derivative markets have shown a considerable boom in emerging countries, enabling investors to better manage their exchange, interest-rate or market risk. Thus foreign exchange futures and currency options, which are very useful to international investors to protect their investments from fluctuations in exchange rates, are now available for most of the major emerging currencies. Securitization has appeared on credit markets. In Latin America it represents nearly 3% of the bond market.

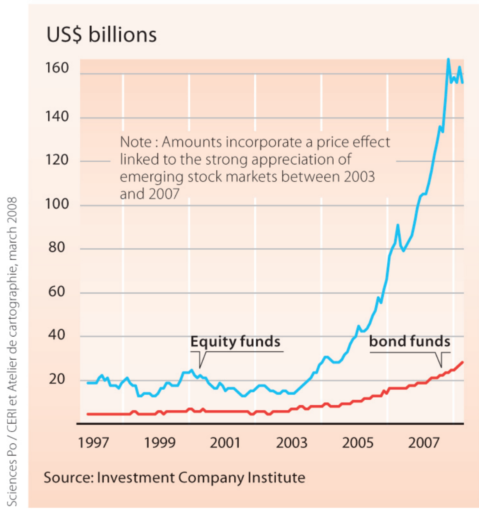
Investor diversification

In this favourable context, since 2002, international investors have turned again to emerging assets in order to diversify their global portfolios. The low level of interest rates over the past four years has also encouraged institutional investors in developed countries (insurance companies, pension funds, mutual funds, etc.) to position themselves on emerging markets with a view to extracting additional yield enabling them to meet their commitments.

All of these factors have fostered the appearance on emerging financial markets of players whose behaviour is more stable and who are likely to hold securities for longer periods. For instance, CalPERS, the largest American public pension fund, increased its share of emerging assets in the funds under its management from

0.6% to 2.4% between 2002 and mid-2007. The Swedish public pension fund AP2 increased its allocation of emerging equities from 3% in 2004 to 5% in 2007. Reputed to be more volatile, the investment flows of mutual funds specializing in emerging countries also recorded very high growth between 2002 and 2007, even if their cumulative outstanding amount accounts for less than 2% of the total assets under management in US mutual funds. Lastly, participation of hedge funds specializing in emerging markets has apparently increased both in numerical terms and in the amounts invested. According to Hedge Fund Research, quoted by JP Morgan (2007), the assets under management of hedge funds specialized in emerging markets have grown twice as fast as total hedge fund outstandings, rising from 2% of the total assets in 2002 to more than 4% in 2006.

figure 90: **Net assets of US mutual funds specialising in emerging markets, 1997-2008**



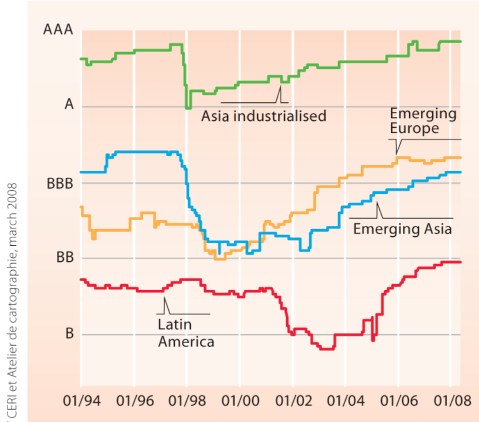
However, to cover their long-term financing needs, emerging countries still need to develop a broad enough base of national institutional investors (mutual funds, insurance companies, pension funds) to reduce their external vulnerability significantly and durably. In some countries, such development is already under way with the introduction of pension systems based on capitalization, as in Chile, where pension fund assets represented nearly 60% of GDP, or Mexico where private pension funds, which were introduced in 1997, hold the equivalent of $50 billion in peso-denominated government bonds.

An asset class perceived by investors as less risky and more diversified

Lower credit risk

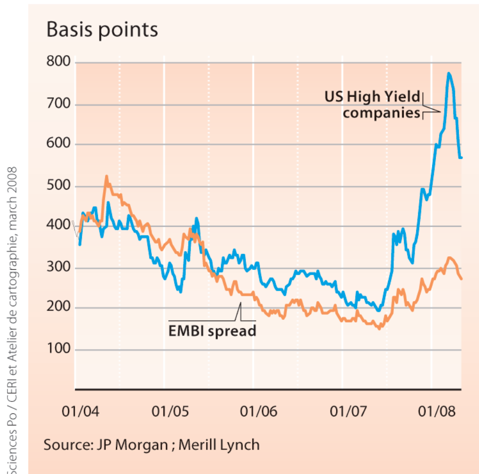
Combined with the often very large-scale accumulation of currency reserves, efforts to consolidate public finances have resulted in an improvement in the ratings of emerging countries, enabling them to recover levels prior to the 1997 financial crisis. The passage of emerging countries from an aggregate situation of current account deficit in the 1990s to a high surplus, and rising rather than depreciating currency trends, have also fostered an improvement in sovereign ratings.

Several emerging countries are thus reaching the “investment grade” category which now represents 40% of the EMBIG index, as opposed to 3% when the index figure 91: **Rating of foreign currency denominated sovereign debt**



Source: Bloomberg; composite rating computed as an average of Moody's and S&P ratings

figure 92: **EMBI spreads (emerging countries) and US High Yield corporate spreads, 2004-2008**



Source: JP Morgan ; Merill Lynch

was created in 1993. This trend has continued recently, as in 2006 rating upgrades have significantly exceeded rating downgrades.

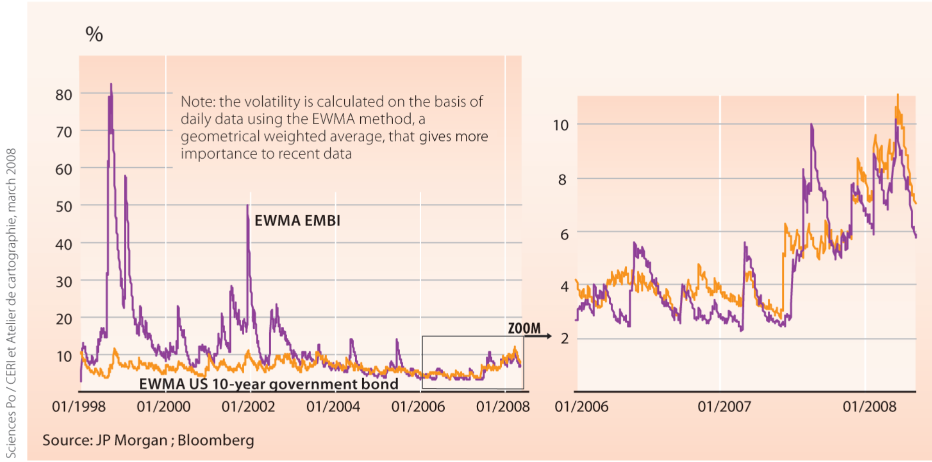
As a reflection of this improvement in the quality of credit, risk premia on emerging bonds have been spectacularly reduced since 2003, reaching historic lows in 2007. Thus, whereas the cost of financing Latin American countries exceeded that of the United States by 10% in 2002, today this gap averages a mere 2%.

Emerging countries are now considered as less risky than American companies in the speculative (high-yield) category, judging by the level of their risk premia. This inversion took place in 2005. This observation holds true if ratings are adjusted: B-rated countries have a lower credit risk premium than American companies with the same rating. Lastly, during recent episodes of financial tensions on global markets, whether in May-June 2006 or in July-August 2007, the re-appreciation of risk premia by investors was lesser and of shorter duration in emerging countries than for risky companies in advanced countries. This tends to accredit the idea that lower risk premia in emerging countries are due more to an improvement in their economic fundamentals than to exogenous factors such as an abundance of liquidity on a world scale and a lowering of international investors' risk aversion.

Lastly, this decrease in perceived risk enables countries that had no access to international borrowing markets to diversify their sources of financing. For example, Ghana became one of the first countries of sub-Saharan Africa to be able to issue bonds on international markets in September 2007, and this despite a market context that was highly affected by the American subprime crisis.

Lower volatility

The decrease in financial risk goes hand-in-hand with a considerable drop in asset volatility across the board in emerging countries in both bonds and shares. A typical figure 93: **Historical volatility of the EMBI spread and of US government securities, 1998-2008**



gap in the EMBIG index of emerging sovereign bonds has for instance fallen from 200 base points in the 2000-05 period to 15 base points in 2006 and 7.5 base points in the first quarter of 2007. Similarly, the volatility of the emerging MSCI equity index fell from about 30% in 2002 to 24% at the end of 2003 and nearly 16% in mid-2007.

This drop in volatility is not specific to emerging countries, all financial markets having experienced a period of very low volatility between 2004 and early 2007. But it was larger in scale in emerging markets, to such an extent that in certain cases emerging assets have proven to be less volatile than those in advanced countries—a paradox if one considers that investments in emerging countries remain more uncertain that those made in developed countries. Thus, in 2006, the volatility of the EMBIG index remained constantly lower than that of the US 10-year rate, except for the short episode of May-June 2006.

Besides the drop in risk, lower volatility can be explained by the reduction of macroeconomic volatility in recent years. In fact, GDP fluctuations in emerging countries in these past years have been lower than in preceding decades, a global phenomenon that certain observers dubbed the "great moderation". It could also be that the longer investment horizon in emerging countries (see above), with the appearance of more stable and longer-term investors, has contributed to reducing financial market volatility.

Better discrimination?

The overall improvement in emerging country economic fundamentals conceals a great disparity among most benchmark indicators (particularly growth in GDP, inflation, current account balances, currency reserves, public finances). Thus in order to assess risk in emerging markets, the specific situation of each emerging area, even each country, must be taken into account.

As the percentage of emerging assets increases in their portfolios, investors are encouraged to develop and refine their analysis of factors specific to each market and each country. In this respect, the correction that occurred in May-June 2006 and the subprime crisis since July-August 2007 have, unlike what happened in the 1990s, revealed a certain degree of discrimination among investors. In May-June 2006 the correction affected most emerging stock markets negatively, but to varying degrees depending on their fundamentals. Indeed, the correction affected countries that are most fragile from a macroeconomic standpoint, particularly those suffering from significant public and current account imbalances (especially Turkey and Hungary). The subprime crisis that began in July-August 2007 had very diverse impacts on emerging countries. Some countries which enjoyed good fundamentals and a solid financial sector, such as Brazil, were affected only briefly. On the other hand, countries characterized by strong leverage effects in the financial sector, or by a lack of transparency or weak modes of governance, were noticeably and durably affected. This happened in Kazakhstan and to a lesser extent in the Baltic States and Russia.

All in all, enhanced emerging market transparency, by allowing investors to better manage their risks, has probably fostered this differentiated reaction. This diagnosis was not called into question by the American subprime crisis. Quite the contrary, emerging markets seem to have appeared as a safe haven in the second half of 2007 even though during prior financial crises, foreign investors had immediately withdrawn their capital from the same markets. This lack of contagion is noteworthy. For instance, mutual funds dedicated to emerging equities recorded significant inflows in September and October 2007, after a halt in the month of August. The MSCI emerging equity index also rose nearly by 40% between January and October 2007.

Is this favourable configuration bound to last?

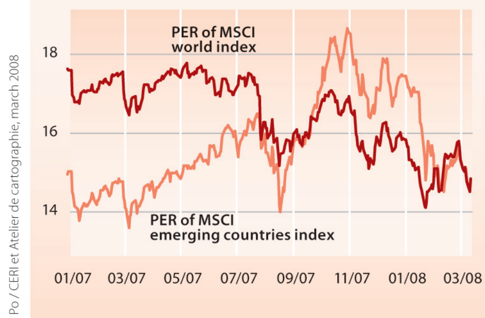
The difficulty of assessing risk

Despite the progress made in recent years, financial markets in emerging countries still have certain deficiencies related to a variety of factors.

First of all, some of these markets are very recent and this makes risk difficult to assess. This is particularly true of bonds issued by private companies. Both rating agencies and investors encountered difficulties assessing and monitoring the risk associated with these debts, due to the lack of reliable historical data on the default of these companies, which display very different characteristics from those of developed countries. Rating agencies thus find themselves undergoing a learning process. As for investors, they often have neither the expertise nor sufficient information in terms of quantity and quality (problems of corporate governance and reporting) to assess risk with any great precision, all the more so since many issuers are not rated by those agencies. The robustness of investor expectations remains to be proven regarding this type of investment, particularly in situations of economic downturn.

Next, the narrowness of emerging markets and their low degree of liquidity (measured by the ratio between transaction flows and assets outstanding) can imply large price fluctuations in the event of even slight portfolio reallocations by international investors. This is all the more true since there is still a significant gap between the size of international investors and the size of emerging markets in which they invest, leaving the possibility of an overly optimistic appreciation of their capacity to exit their positions at reasonable prices

figure 94: **Valuation multiples of emerging stock markets (PER, Price Earning Ratio)**



Source: JP Morgan ; Bloomberg

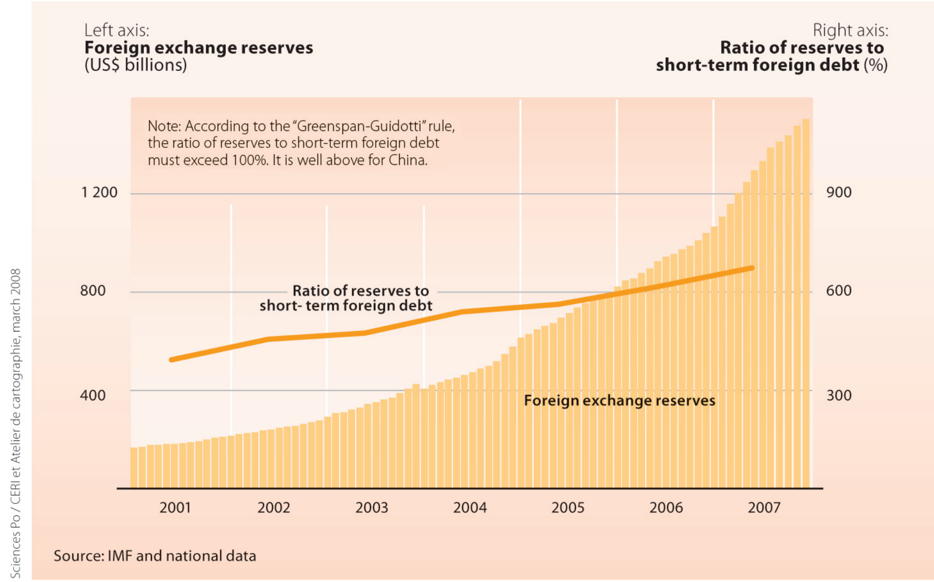
Lastly, given the palpable optimistic mood today on emerging markets, it is likely that investors will be led to overestimate growth potential and so underestimate risk in certain compartments. This could be the case particularly on emerging stock markets, where valuation levels are now higher than those of developed markets. Even if this valuation premium is justifiable by the "growth value" status of emerging companies, it does not take into account the possible sources of fragility of companies in these countries where the structure of governance, sources of financing, international diversification and the experience of competition are probably less established than for a multinational in a developed country.

Accumulation of foreign exchange reserves

World foreign exchange reserves have surged from US$2 trillion in 2001 to an unprecedented $5 trillion in early 2007. Asian emerging countries (notably China) and oil exporting countries were responsible for most of this accumulation.

Initially, accumulation stemmed from an understandable self-insurance motive. In the wake of the financial crises of the late 1990s, when their official reserves rapidly diminished, emerging countries quickly reconstituted their reserve currency holdings to protect themselves against new speculation attacks and strengthen their capacity to cushion sudden stops in capital flows.

However, the academic literature shows that the level of currency reserves today in certain emerging countries is likely to be excessive. This is evident both figure 95: **Chinese foreign exchange reserves and ratio of reserves to short-term foreign debt, 2001-2008**



with respect to simple benchmarks such as the "Greenspan-Guidotti" rule that recommends that reserves should be able to cover the short-term foreign debt entirely, and using more elaborate frameworks of analysis that can compute an "optimal" level of reserves such as that designed by Jeanne and Rancière (2006).

Such hoarding can provoke domestic financial imbalances in countries that practice it (risk of inflation or high capital losses), as well as consequences on the world financial system, particularly in terms of excess liquidity (although this concept remains notoriously difficult to define) or asset price distortions.

Will emerging countries become a source of international financing?

In addition to official monetary reserves, a growing proportion of net external assets in emerging countries is currently invested in the form of sovereign wealth funds. The size of these funds is still limited, between $1.5 trillion and $2.5 trillion, but it is rapidly growing because of elevated commodity prices on one hand, and foreign exchange policies aimed at resisting currency appreciation on the other. In the long run, these funds will become larger than foreign exchange reserves.

The creation of these funds may appear legitimate, for those related to commodities in particular. These are non-renewable resources, and standard economic theory suggests that part of extraction revenue should be saved in order to face difficult periods in the future. The rationale is however somewhat different for non-commodity funds, in that they often result from economic distortions related to foreign exchange interventions and to a financial system whereby the State centralizes the national savings surplus.

In this context, a number of questions arise as to the role and modalities of action of these funds. Whereas official foreign exchange reserves were mainly invested in debt securities, particularly American ones, sovereign funds set their sights on riskier and more lucrative investments in equities as well as in alternative assets such as private equity or hedge funds.

The concentration of large amounts on a small number of funds, which are moreover opaque as regards their asset allocation and most of their positions, could have an influence on the proper functioning of financial markets. Moreover, these funds might have a tendency to make the price of certain assets rise, particularly if they are operating in narrow markets.

The debate is probably only beginning. The G7, in October 2007, for the first time recognized the importance of sovereign funds as international investors and urged that "best practices" should be identified for these funds in the areas of governance, risk management and transparency. The IMF, the World Bank and the OECD are in charge of looking into these questions. Nevertheless, there is a risk of a protectionist reaction in developed countries, all the more so since this issue involves sovereign states as opposed to private companies. The challenge probably involves creating a framework that would enable the emergence of actors in emerging countries, states and businesses as sources of cross-border financing and investment, making sure that they behave as responsible shareholders and investors.

Further financial development

Contrary to the 1990s crisis, the financial crisis of 2007 was not triggered by a currency devaluation or the sovereign default of an emerging country but rather by financial losses on risky housing loans within the very heart of the American financial system, reputed to be the most developed in the world.

This apparent paradox is the result of considerable structural and institutional reforms undertaken by emerging countries in recent years: improvement of the debt structure, broadening of the spectrum of financial markets, and investor diversification. Consequently, the emerging country asset class is perceived today as much less risky than in the 1990s.

However, buoyed by abundant liquidity, high global growth and rising commodity prices, the new strength of emerging countries has not yet been confronted with significant economic downturns in the developed world. This raises a series of challenges which emerging countries will confront in order to deepen their financial development: can emerging financial assets offer investors the necessary diversification if their economic cycles prove to be more dependent than expected on the US cycle? Could the financial imbalances created by their development model, such as the excessive accumulation of currency reserves, threaten their financial stability? Lastly, under what conditions can actors and businesses in emerging countries enter the financial scene as significant investors in developed financial markets, particularly in terms of international governance and international rules of investment?

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