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***‘Emerging Markets Finance: Overview of the
Special Issue of the Journal of International
Money and Finance’***

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1. Introduction

The increasing importance of emerging economies in the world economy has given rise to profitable investment opportunities and has spurred academic interest to investigate the pricing of assets in those economies and the impact of the institutional and regulatory environment on the dynamics of raising capital and the behaviour of the real economy.

Contributing to the understanding of these issues in emerging economies has been the motivation of the second International Conference on “Emerging-Markets Finance” at Cass Business School in London, which was organized by the Emerging-Markets Group (EMG) in May 2008. One hundred and fifty papers were submitted to the conference, eight of which have been selected to be included in this Special Issue following the usual refereeing process. The selected papers cover four main areas: international money and finance, asset pricing, international investments and corporate finance. There are various issues however which permeate a number of the papers. For example, governance is the issue of many of the papers highlighting the severity of the problem in emerging markets and the concern of investors. It will also be noted that a number of the papers relate to China, which highlights its importance in the world economy and the urgency to understand how its markets operate. The purpose of this introduction is to bring out the connections of the papers and to provide a context for understanding the relevance and importance of each paper’s contribution.

However, before proceeding I would like to thank the sponsors of the conference, the Economic and Social Research Council (ESRC), JIMF in conjunction with The Frank J. Petrilli Centre for Research in International Finance at Fordham University, the International Monetary Fund and Cass Business School. Thanks also

are due to Marfin Laiki Bank, which generously funded the two Best Paper Awards. The paper, which was awarded the Best Paper Award in Banking, is included in this volume and is entitled “Does Bank Ownership Increase Firm Value? Evidence from China” co-authored by Ning Zhu (University of California, Davis) and Xiaochi Lin and Yi Zhang (Guanghua School of Management). Furthermore, I would like to thank all those, who have contributed to the success of the conference, the Programme Committee, discussants and referees, who helped with the selection of papers. However, my greatest thanks go to James R. Lothian, the Editor of *JIMF*, whose advice was most valuable throughout the process and to Cornelia H. McCarthy, the Associate Editor, who oversaw the production of the Special Issue.

2. International money and finance

The two papers selected in this area deal with two key issues in international finance. The first paper examines the controversial issue of the impact of globalization on the real economy, but tackles the debate by focusing on the impact of financial openness on productivity growth, rather than output growth; the second paper measures the economic value of macroeconomic fundamentals compared to technical trading rules for emerging-market currency investments and restores some faith in the usefulness of exchange rate models.

The impact of financial openness on economic growth has been studied extensively in the literature for recipient countries of capital flows are not assured of a positive impact on their economies. For example, there are two contrasting views of the effects of capital flows on consumption growth variability. One relates to international risk sharing and to reduction in the variability of consumption-growth; the other, to increased financial fragility and crises and to higher consumption-growth

variability. With the widespread openness of markets and the increased frequency of crises the issue has motivated substantial research. Ayhan Kose, Eswar Prasad and Marco Terrones in their paper “Does openness to international capital flows raise productivity growth” approach the issue from a different angle and examine whether financial openness enhances aggregate efficiency and total factor productivity growth (TFP). The benefits could come from “indirect” collateral benefits, which include development of the domestic financial sector, improvements in institutions, such as governance and the rule of law, better macroeconomic policies, all of which result in higher growth through gains in allocative efficiency. They apply a fixed-effects GMM approach to annual data for the period 1966-2005 for 67 countries, 46 of which are developing countries. The authors show that financial openness as measured by *de jure* capital openness has a robust positive effect on TFP growth. What is interesting, however, is that *de facto* financial integration, as measured by the stock of external liabilities to GDP, is not correlated with TFP growth. However, when they split up the stock of external liabilities they find a novel and interesting result. FDI and equity inflows contribute to TFP growth while debt inflows have the opposite effect. The negative effect of stocks of external liabilities on TFP is attenuated in economies with better-developed financial markets and better institutional quality.

Gerben de Zwart, Thijs Markwat, Laurens Swinkels and Dick van Dijk in their paper “The economic value of fundamental and technical information in emerging markets” begin by revisiting the pertinent literature on exchange-rate behavior in developed markets. This includes Meese and Rogoff’s (1983) findings that structural models cannot outperform naïve random walk forecast at short horizons, the later evidence on the usefulness of macroeconomic information in forecasts of exchange rates at longer horizons (see e.g. Mark, 1995, Killian, 2001 and Berkowitz and

Giorgianni, 2002), the evidence on the superior performance of trading rules relative to fundamentals at short horizons (see e.g. Menkhoff and Taylor, 2007), as well as the evidence in recent studies that suggests a weakening of such performance over time (see e.g. Olson, 2004, Pukthuanthong-Le et al., 2007, and Neely et al., 2008).

De Zwart, Markwat, Swinkels and van Dijk bring together the two basic types of information and show that both of are relevant for assessing exchange-rate movements in emerging markets. Using 21 freely floating emerging-market currencies relative to the US dollar over the period 1997-2007, they find that naively combining chartist and fundamentalist trading strategies not only generates positive risk-adjusted returns that are both economically and statistically significant, but also performance, which is much more consistent and stable across currencies than the individual fundamentalist and chartist strategies. The authors thus provide convincing evidence for the complementary value of technical and fundamental information as suggested by questionnaires among currency traders.

3. International Investments

A key factor influencing international investments in emerging markets is the extent of corruption in the host country. If one looks at corruption indices, such as Index of Economic Freedom compiled by the Heritage Foundation and the *Wall Street Journal*, one notices that the majority of emerging markets score very low. A high level of corruption is likely to exacerbate information asymmetries as well as increase the cost of doing business. Furthermore, it has been found that cross-border direct investment is more sensitive to information frictions than investment in portfolio equity and debt securities (see Daude and Fratzscher, 2008). Javorcik and Wei in their paper “Corruption and Cross-border Investment in Emerging Markets: Firm-

Level Evidence” examine both the impact of corruption to the foreign investor’s decision to undertake FDI and the choice of entry mode e.g. joint ventures or wholly owned investments. They use a unique firm-level data set based on a survey by the EBRD, in which companies listed in the Worldscope dataset are asked about investment projects in the transition economies of Central and Eastern Europe. They thus extend earlier work by Heinsz (2000), which was restricted to US multinational firms and which examined market entry and ownership separately rather than simultaneously. They find a negative relationship between the probability of investment and the extent of corruption in the host country. They find further that, conditional on FDI taking place, foreign investors are more likely to take on a local joint venture partner in a corrupt host country than to set up a wholly owned subsidiary. The reason, they opine, is to save the transaction costs of dealing with local government officials. They find in addition that foreign investors with more sophisticated technologies are more likely to retain full ownership of their project rather than engage in joint ventures.

In their paper, Groh and Liechtenstein ask a complementary question regarding other types of investment into Central Eastern Europe (CEE). The objects of their concern are venture capital and private equity (VC/PE), both of which are different to FDI in many respects. For example, capital for VC/PE investments is provided by institutional investors as portfolio investments and not by corporations that follow a strategic rationale as in FDI. VC/PE also is provided via intermediate agents – the venture-capital and private-equity funds – rather than directly. Furthermore, VC/PE investments have to be liquidated after some time, to return the proceeds to the investors. Additionally, there is no knowledge transfer from a parent company to a subsidiary with VC/PE, unlike FDI.

Groh and Liechtenstein compile their data using a survey in which they ask institutional investors about the importance of a number of emerging-market allocation criteria. They then transform these rankings of criteria into a weighted index that they use to assess the attractiveness of VC/PE for 10 CEE countries and the 15 member countries of the EU prior to May 1, 2004. They identify six tier groups of countries ranked by degree of attractiveness. The best ranked CEE country is Hungary, which actually ranks ahead of France. The CEE countries as a whole, however, rank below the EU-15 average. Groh and Liechtenstein's index is highly correlated with fundraising activity and, therefore, has quite good tracking power. Their exercise thus provides guidelines for policy improvements to attract more risk capital funding.

4. Asset Pricing

Despite the substantial liberalization of capital markets in recent years (see Edison and Warnock, 2003), markets, especially of emerging economies, have not been fully integrated. This segmentation has been attributed to poor institutions, political uncertainty, lack of transparency and poor corporate governance (see e.g. Nishiotis, 2004, Stulz, 2005 and Bekaert, Harvey, Lundblad, and Siegal, 2008). Depicting the role of these institutions in the pricing of assets in emerging markets has been a challenge. Bekaert, Harvey, Lundblad, and Siegal (2008) propose a country-level measure based on industry-level earnings yield differentials, aggregated across all industries in a given country.

Dong Wook Lee, Chan Shik Jung, Kyung-Suh Park in their paper in this volume develop a different approach to emerging-markets asset pricing, however, and examine the role of investor heterogeneity to explain the cross-section of average

stock returns in an emerging market. Investor heterogeneity has an asset-pricing implication and contributes to a wedge between the market portfolio and the tangency portfolio. As a result, risk-sharing within the market is limited, and an extra risk premium arises, one not associated with covariance with the market portfolio. Lee, Jung and Park augment the one-factor CAPM model by including a measure of investor heterogeneity using foreign or institutional ownership and test the explanatory power on Korean stock-market data. They find that the heterogeneity-augmented two-factor model outperforms the CAPM one-factor and the Fama-French three-factor models.

Sandro Andrale in his paper “A model of asset pricing under country risk” follows yet a different route to value emerging-market assets and develops the first structural model of sovereign default that allows for simultaneous pricing of emerging-market sovereign bonds and stocks. In his model, the price of an emerging-market stock is the appropriately discounted present value of a stochastically growing perpetuity whose trend and volatility may undergo a negative regime change – country risk - such as a hostile renegotiation of foreign debt. Because of the country risk, emerging-market stocks are valued at a discount, i.e. lower P/E ratios, than otherwise identical stocks that are not subject to country risk. The model provides closed-form formulas relating emerging-market stock prices (and expected returns) to the corresponding average yield spread in sovereign bonds. Thus, sovereign spreads used by practitioners to value emerging-market assets are useful measures of country risk because they contain relevant information about the timing of the negative regime change. Using data from nine emerging markets, Andrale is able to confirm the model’s quantitative and qualitative predictions. His regressions show that as sovereign yield spreads increase, emerging-market stocks tend to become more

volatile in absolute terms, less volatile relative to sovereign bonds, and more highly correlated with sovereign bonds.

5. Corporate Finance

Both papers in this section explore the impact on firm value of two distinct characteristics of the Chinese economy: political connections and direct bank ownership of companies, both of which are extensive in China. Iftekhar Hasan, Bill Francis and Xian Sun in their paper “Political connections and the process of going public: evidence from China” take advantage of clear quantitative restrictions imposed by the government on firms going public, such as the fact that the offer price is restricted by the firm’s profitability and by an assigned multiplier (P/E ratio), which is decreed by the government. This restriction is an important determinant of the offer price and, therefore, the amount of proceeds that can be raised. Such government imposed restrictions on the going-public process invite firms to seek values through political connections. The study uses 423 domestic IPOs during 1994-1999 and finds that political connections are valuable to firms. Firms with greater political connections have higher offering price, lower underpricing, and lower fixed costs during the going-public process.

Direct bank ownership is believed to benefit borrowing companies in developed markets. Ning Zhu, Xiaochi Lin and Yi Zhang examine this issue in the case of China and highlight the fact that the relative costs and benefits of such practices might be different in emerging markets with relatively weak monitoring mechanisms and relatively underdeveloped banking systems. They use novel data on bank equity ownership and board structure of listed companies and find that banks hold a considerable number of listed company shares, which in turn allows bank

managers to appoint board directors and vote on important corporate matters. Furthermore, the companies with bank ownership have significantly higher debt than those without bank ownership. However, this enhanced access to bank lending does not seem to improve corporate performance in China. Using various proxies for operating performance, growth opportunities, and valuation, Zhu, Lin and Zhang find that companies with bank ownership perform worse than those without bank ownership. These results are robust to controlling for state ownership and other important firm characteristics, alternative proxies for performance, and to subsamples of different sectors and time periods.

6. Conclusions

The papers in this Special Issue have discussed some of the key areas in Emerging-Markets Finance. Since the publication of the previous *JIMF* Special Issue on Emerging-Market Finance in May 2006, the focus of papers has shifted from investigating the impact of liberalization on financial decisions and the economy to the impact of poor institutions, political uncertainty, lack of transparency and poor corporate governance. That reflects market participants' sensitivity to these issues in the increasing uncertain economic environment. It is hoped that the topics in this volume will prove of interest not only to researchers, but also to practitioners and regulators.

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