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Guest editorial

Emerging markets finance: Overview of the special issue

1. Introduction

Capital flows to developing countries have gone through cycles in the last 30 years. Having reached high levels during the 1970s they practically stopped in the aftermath of the 1982 foreign debt crisis. In the early 1990s developing countries regained access to foreign capital following major restructuring of their economies and adoption of more liberal policies. As a result net private capital flows exceeded $230 billion in 1996, nearly six times greater than what they were at the start of the decade, and almost four times more than the peak reached during the 1978–1982 commercial bank lending boom.[1] The composition of capital flows changed also from bank lending to bonds, foreign direct investment and portfolio investment, while the private sector instead of the public sector did most of the external borrowing. During the late 1990s there was another reversal of capital flows following the Asian and Russian crises in 1997 and 1998, respectively. However, in recent years the interest by foreign investors in emerging markets has once again picked up.

This cyclical behavior of capital flows to developing countries raises a number of interesting questions relating on the one hand to investors in developed countries and their motives for seeking diversification benefits from investing in these emerging markets, and on the other hand it raises questions relating to the developing countries themselves and the potential effects of increased capital on their domestic financial markets, currency markets and real economy.

Providing answers to such questions has been the motivation of the First International Conference on ‘‘Emerging Markets Finance’’ at Cass Business School in London, which was organized by the Emerging Markets Group (EMG) in May 2005. One hundred and fifty papers were submitted to the conference, seven of which have been selected to be included in this Special Issue following the usual refereeing process. The conference was sponsored by the Economic and Social Research Council (ESRC), by *JIMF* in conjunction with The Frank J. Petrilli Centre for Research in International Finance at Fordham University, by the European Bank of Reconstruction and Development (EBRD) and by Cass Business School. Two additional papers have been included, for their relevance to the central topic of this issue: ‘‘Stock market liberalization and the informational environment’’, by Kee-Hong Bae, Warren Bailey and Connie X. Mao and ‘‘Currency crises: Are they all the same?’’ by Graciela Kaminsky.

[1] International Bank for Reconstruction and Development (1997).

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However, before proceeding I would like to thank all those, who have contributed to the success of the conference. I would like to thank the Programme Committee, discussants and referees, who helped with the selection of papers. However, my greatest thanks go to James Lothian, the Editor of *JIMF*, whose advice was most valuable throughout the process and to Cornelia McCarthy, the Associate Editor, who oversaw the production of the Special Issue.

2. Issues in emerging markets finance

The nine contributions focus on some of the key issues in emerging markets finance − market integration, corporate finance, international asset management and contagion.

2.1. Financial market integration

Financial market integration has been a key area in emerging markets finance. As Emerging markets have started to liberalize their markets a great many issues have become relevant in research. These include the measurement of financial market integration,[2] its impact on stock returns,[3] international capital flows,[4] political risk,[5] the real economy[6] and its relation to financial liberalization and economic integration.[7] The Bekaert et al. paper in this issue contributes to this area by examining the effect on the volatility of economic growth. James Lothian on the other hand, examines the interaction between capital flows, financial integration and the quality of legal institutions. I will take each paper in turn.

Lothian in his keynote address on ''Institutions, capital flows and financial integration'' examines why capital flows from the developed to the less developed countries have not been larger. This question has puzzled economists for the past four decades and in particular more recently when the degree of financial integration has been much greater. This is more of a puzzle considering that at the start of the last century such flows were substantial when measured either as a percentage of the total or relative to the incomes of the receiving countries. Lothian turns to the theory on economic development, which over the past decade and a half has shifted its focus from technology and capital accumulation to the underlying factors affecting the returns to investment including policies pursued by various government agencies and central banks and the institutions like property rights that affect the basic business environment. Using the Frazer Institute's Economic Freedom of the World Index (EFW) to capture changes in the size of the government, legal system, property rights, sound money, freedom to trade internationally and regulation, Lothian tests whether these factors can explain capital flows from rich to poor countries. He uses foreign investment to GDP and foreign investment scaled by

[2] See e.g. Gagnon and Karolyi (2004) for comparing the prices of ADRs to the underlying securities; Edison and Warnock (2003) for proposing the use of the ratio of market capitalization represented by the IFC Investable Indices, which correct for foreign ownership, to the market capitalization represented by the IFC Global Indices; Bekaert et al. (2002b) for using statistical techniques to find breaks in the variables; and Bekaert and Harvey (1995) for estimating and comparing ex ante returns in various markets having specified an asset pricing model and Phylaktis and Ravazzolo (2004) for incorporating exchange risk in the analysis.

[3] See e.g. Bekaert and Harvey (2000) and Henry (2000).

[4] See e.g. Bekaert et al. (2002a).

[5] See e.g. Bekaert and Harvey (2000).

[6] See e.g. Levine (2005) for a survey on the relationship between finance and growth including the effects of financial liberalization on economic growth.

[7] See e.g. Phylaktis and Ravazzolo (2002).

population for a sample of 64 developed and less developed countries in the year 1997 and finds that the EFW index has a positive and highly significant impact. He concludes that capital flows to developing countries are relatively small because of the institutions that have been in place and the policies that have been pursued by most poor countries for most of the time.

Recipient countries of capital flows are not, however, 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 a reduction in the variability of consumption growth. The other relates to increased financial fragility and crises and higher consumption growth variability. Geert Bekaert, Campbell Harvey and Christian Lundblad in their paper "Growth volatility and financial liberalization" examine whether countries, which have opened their capital account and liberalized their equity markets, have experienced a change in real consumption growth variability. They run panel regressions of consumption growth volatility on the liberalization measures over the period 1980–2000 for the 95 countries for which all the main macroeconomic variables are available, and for 40 countries that have experienced an equity market liberalization. The authors show that financial liberalization is mostly associated with lower consumption growth volatility. Their results are robust to controlling for business-cycle effects, economic and financial development, the quality of institutions and other variables. The maximum decrease in consumption growth volatility is found for countries that liberalize their equity markets at a time when their capital account is relatively open. They also check for potential endogeneity problems for liberalization could be strategically timed when volatility is expected to change. Past volatility is not, however, found to predict liberalization. Thus, they find overwhelming evidence that liberalizing equity markets does not lead to excessive economic volatility. However, the findings suggest that countries, which are economically fragile, have low quality institutions and poorly developed financial sectors, equity market liberalization may not reduce real variability at all.

2.2. *Corporate finance*

The quality of legal institutions in relation to corporations in emerging markets has been a fruitful ground for research. As La Porta et al. (1998) have noted shareholder rights are not always present and when they do the legal enforcement of those rights is weak. Research has concentrated at the firm level and examined the relationship between corporate governance, firm performance and corporate valuation. For example, Black (2001) examines governance practices of Russian corporations and finds that they are strongly related to implied value ratios, while Black et al. (2004) find that governance of Korean firms is strongly related to firm performance. Similarly, Klapper and Love (2004) use firm-level corporate governance rankings across 14 emerging markets and find that this corporate governance index is related to firm's performance and valuation. On the other hand, Doidge et al. (2005) have used firm-level corporate governance scores (generated by an investment bank or a rating agency) and found them to be related with country and firm characteristics.

Other studies have looked at specific corporate governance provisions, such as the effect of management ownership structure and large non-management blockholders on firm value (see e.g. Lins, 2003), the relation between CEOs turnover and firm performance (see e.g. Gibson, 2003) and the effect of corporate diversification on firm value (see e.g. Lins and Servaes, 2002).

In contrast, Leora Klapper, Luc Laeven and Inessa Love in their paper in this Special Issue, "Corporate governance provisions and firm ownership: Firm-level evidence from Eastern Europe", focus on a different aspect of corporate governance than earlier studies. They analyze what type of firms is more likely to use specific corporate governance provisions such as "cumulative voting", which allows shareholders to cast all their votes for one candidate standing for election to the Board of Directors, and "proxy by mail", which allows shareholders to submit their votes by postal or electronic mail. These provisions are two of the six provisions in the anti-director rights index constructed by La Porta et al. (1998) and are not mandatory by national law in any of the four Eastern European countries they examine. In particular, they test whether the use of these provisions relates to the ownership structure of the 220 firms located in four Eastern European countries.

After controlling for other firm characteristics, they find that firms that have a large, minority blockholder are more likely to allow cumulative voting. They do not find any significant relationship between the use of these corporate governance provisions and foreign ownership. They conclude that the use of cumulative voting is associated with the presence of large, minority shareholders.

In another paper in this Special Issue, Jana Fidrmuc and Jan Fidrmuc examine whether firm performance can be improved by appointing new managers and/or by introducing better incentives as suggested by contract theory. McAfee and McMillan (1987), however, argue that these two instruments are in fact complementary so that new managers and better incentives reinforce each other. Using data on privatized firms in the Czech Republic, this paper presents results that suggest complementarity between the appointment of new managers and introduction of incentives in a transition economy. The results show that the relationship between past performance and managerial turnover strengthens after the appointment of the first post-privatization managing director. Before the first managerial change, past performance has no bearing on the probability of managerial turnover, indicating weak disciplining role of CEO replacements. After the change, however, past firm performance turns out to be negatively and significantly correlated with the probability of managerial change. Moreover, their data show that firms without a change of the managing director over the six years after the privatization perform worse than the firms that replaced their managing directors. They interpret these findings as evidence suggesting that the appointment of new managers and introduction of incentives are strongly complementary changes.

Another potential channel to improve corporate governance at the firm level has been the decision of a firm to issue a cross-listed security such as an ADR. By listing overseas and adopting foreign standards of reporting, regulation, and law, a company can benefit by submitting to what Admati and Pfleiderer (2000) call "voluntary disclosure". At the same time, there is increased analyst coverage, forecast accuracy, and news stories after individual firms cross list (see e.g. Lang et al., 2003).

The relationship between equity market liberalization and changes in the information environment based on market disclosure and analyst activity is examined by Kee-Hong Bae, Warren Bailey and Connie Mao in their paper "Stock market liberalization and the information environment". Their paper uses a range of openness measures and information indicators and offers a comprehensive view of the importance of foreign portfolio flows to improving disclosure, information production, and other facets of the information environment in emerging economies compared to previous studies.

They use three measures of openness of the stock market to foreign investors: explicit official liberalization and equity cross-listings, the fraction of the local stock market available to foreigners, and the flow of US equity investment in and out of the local stock market. They use the component firms of the Standard and Poor's Emerging Markets Database (EMDB) over the period 1986–2002. Their results show that increased openness is associated with increases in firm-specific information, analyst coverage, and analyst value-added, and decreases in earnings management. In particular, foreign analysts increase their presence, activity, and contribution to the information environment after openness increases. Using a detailed sample of Korean firms, however, these effects are dampened for firms that rate poorly on governance.

2.3. International asset management

Two papers in the Special Issue relate to investment decisions. The first by Kate Phylaktis and Lichuan Xia entitled ''Sources of firms' industry and country effects in emerging markets'' examines whether the traditional asset allocation strategy based on the country-oriented approach of diversifying across countries continues to be appropriate given that stock markets now move much closer together than before, compared to the alternative approach of diversifying across industries. In a sense, the authors examine in their research how much of the movement of Honda equity return is due to the fact that Honda is in the automobile industry and how much is due to the fact that Honda is a Japanese firm. This is what has been termed the industry versus the country effect. If the industry effect is found to dominate the country effect then diversification across industries should be preferred. Despite the importance of the issue for investment decisions little is known about the structure of industry and country effects in Emerging markets. The paper contributes to the literature by examining the different behaviors of emerging markets relative to developed markets by comparing the dynamics of their global, country and industry effects at the firm level. The paper examines the sources driving these factor effects by exploring the cross-sectional differences in the factor effects across firms using information on their characteristics. In particular, it examines the impact of firms' foreign sale ratios used as a proxy for the firms' business globalization and the role of firms' ADR listings used as a proxy for financial market integration.

Based on 1893 firms in MSCI global index from 1990 to 2002 from 37 countries out of which 14 are emerging markets, the results show that the global and industry effects are still dominated by the country effects in emerging markets in contrast to developed markets. However, the ratio of country to industry effects drops significantly after 2000. The results are robust to controlling for variables which might have significant impact on firms' factor effects, such as the firm's business globalization, financial market integration and TMT sector affiliation.

In the second paper related to international investments entitled ''What drives credit risk in emerging markets? The roles of country fundamentals and market co-movements'', Diana Diaz Weigel and Gordon Gemmill use an extended structural model based on Cathcart and El-Jahel (2003) with a Kalman filter and data on prices of Brady bonds to extract a measure of creditworthiness for four emerging economies, Argentina, Brazil, Mexico and Venezuela. Their estimated distance-to-default measure provides a continuous indicator of the perception of credit risk across time. They relate this distance-to-default measure to global, regional and country-specific variables. Country-specific variables are found to account for only 8% of the explained variance, while regional factors, which relate to joint stock-market returns, volatility and market sentiment account for 45%. Global conditions, related mainly to US stock-market returns, explain another 25% of the variance. Of the 20% of the variance that remains unexplained, more than half is due to another common (but unidentified) factor. The authors conclude that the creditworthiness of these four emerging markets is mainly driven by a common set of factors that are related closely to stock markets in the region and the United States.

The results of both papers have implications for investors. The first one suggests that the traditional cross-country diversification remains valid for emerging markets despite the increasing correlations in those markets following the substantial capital market liberalizations in the 1990s. However, as the ratio of country to industry effects drops significantly in recent years, it implies that cross-industry diversification will become more important in the future. In selecting individual stocks, the findings suggest that various firm characteristics, such as their extent of international business and ADR listing status should be taken into account. An efficient way to do so would be to choose equities that are cross-listed as ADRs, and that are issued by firms with less international business exposure and that are primarily from emerging markets.

The second paper suggests that investors should treat the credit risk of emerging markets and more specifically of Latin American markets as non-diversifiable. The high level of contagion across Latin American bonds has important implications for the pricing and risk management of bond portfolios. Credit ratings for these emerging markets should be based more strongly on global and regional economic factors than on local factors, such as local inflation or currency reserves.

2.4. Contagion

Following the various crises in the last 30 years, a substantial literature has been written on why crises occur and how they spread.[8] The theoretical literature has evolved with each of the crises. We have the first-generation models, which focus on the fiscal and monetary causes of crises, second-generation models, which emphasize countercyclical policies and self-fulfilling crises and the third-generation models, which focus on moral hazard and imperfect information with "excessive" booms and busts in international lending and asset price bubbles. The empirical literature has assumed, however, that all the crises are the same. Graciela Kaminsky in her paper "Currency crises: Are they all the same?" challenges the "one size fits all" models.

To identify the various classes of crises, Kaminsky examines crisis episodes for 20 industrial and developing countries over the period 1970–2002, with a total of 96 currency crises. To gauge whether crises are all of the same nature or whether groups of crises show unique features, she uses a variety of macroeconomic and financial indicators suggested by the previous literature and a multiple-regime variant of the signals' approach, which allows her to endogenously identify the existence of various classes of crises. Once crises are classified, she examines whether the nature of crises varies across emerging and mature economies and investigates the degree of severity of each type of crisis.

The key finding is that crises are found to be of six varieties. Four of these varieties are associated with domestic economic fragility, with vulnerabilities related to current account deterioration, fiscal imbalances, financial excesses, or foreign debt unsustainability. But crises can also be provoked simply by adverse world market conditions, such as the reversal of international capital flows. The so-called sudden-stop phenomenon identifies the fifth variety of crises. Finally, as emphasized by the second-generation models, crises also happen in economies with solid fundamentals. Thus, the last variety of crises is labeled self-fulfilling crises.

The analysis in the paper implies that early-warning systems should allow for multiple regimes. This next generation of early-warning systems should, therefore, incorporate methodologies such as regression tree analysis or parametric multiple-regime models à la Hamilton (1989) to capture a broad spectrum of crises.

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[8] For a survey of the literature see Claessens and Forbes (2001).

The second paper on contagion in the Special Issue relates to the spread of crises across markets. Most existing studies, in contrast, look at crises in currency and stock markets separately. However, theory emphasizes the link between crises in the two markets. In countries with open, relatively small and undeveloped domestic capital markets, portfolio flows of foreign investors can exert a strong influence on local stock markets (Bekaert et al., 2002a, b). If such investors substantially increase their assessment of risk, drastic portfolio outflows and a depreciation of the currency are both likely to occur. Hence, in emerging and small developed markets, one would expect extreme stock market declines to be linked to an increased probability of extreme currency depreciation through foreign investor portfolio flows. Phornchanok Cumperayot, Tjeert Keijzer and Roy Kouwenberg in their paper "Linkages between extreme stock market and currency returns" investigate the link between extreme events on the currency and stock markets and the pattern of spillover within and across regions. By focusing on extreme events, they aim to isolate the effect of true market shocks from the "normal" pattern of returns, in order to gain insight into the mechanics of possible cross-market spillover effects in extraordinary market environments. Previous work has focused on extreme value theory to study spillover behavior of extreme stock-market returns, or extreme returns in stock and bond markets. The authors' model extreme linkages based on limited dependent variable models (see Bae et al., 2003) for 26 countries by estimating a simultaneous equations probit model, using a sample of 2500 daily returns over the period from 1996 to 2005.

Their results show that in a number of emerging markets that went through a period of crisis an extreme stock market decline increased the probability of extreme currency depreciation on the same day. For currency markets they find evidence of spillover of extreme events within regions, but limited influence outside the region. Extreme events on stock markets are much more interrelated globally, particularly when they originate from the US.

3. Conclusions

The great scholar and finance practitioner Walter Bagehot (1880) noted in the late nineteenth century the trend towards financial integration when he wrote "the same instruments which diffused capital through a nation are gradually diffusing it among nations". He went on to warn that "while the effect of this will be in the end to simplify the problems of international trade … for the present, as is commonly the case with incipient causes whose effect is incomplete, it complicates all it touches".[9] It seems that the issues relating to international capital flows and market integration are still with us today. They have, however, become both more global in scope, encompassing emerging markets as well as developed markets, and more complicated by the extent and depth of integration and the speed with which markets can react.

The papers in this Special Issue have discussed some of the key areas in emerging markets finance. They have highlighted the importance of quality of institutions for attracting capital and for enjoying the benefits of capital market liberalization. For example, in Lothian's paper the quality of institutions affect the amount of capital flows to developing countries. In Bekaert et al., equity market liberalization may not reduce real variability when countries have low quality institutions and poorly developed financial sectors. Similarly, Bailey et al.'s finding of an increase in foreign analysts' presence, activity and contribution to the information environment after openness increases is dampened for firms that rate poorly on governance.

[9] See Bagehot, 1880.

Many of the papers have also pointed out potential problems of endogeneity. For example, Klapper et al. find that large minority shareholders prefer stronger voting rights. It may be that firms may enact these voting provisions in response to pressure from existing, large minority shareholders. Bae et al. show that openness may actually follow changes in the information environment, rather than triggering changes in the information environment as they had theorized. As more information about firms in an emerging market becomes available, foreign demand for local stocks increases and puts pressure on local authorities to loosen access.

The challenge for future research will be to explore ways of solving the endogeneity problems in studying the effects of changes in policies in emerging markets by applying more powerful econometric techniques and seeking more imaginative instruments.

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