Encouraging the Longer Term: Institutional Investors and Emerging Markets

A Research Agenda

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Discussion Paper Series

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Graphs:

We thank Inge Kaul for valuable suggestions. We are also grateful to Bill Oliver, Hugh Peyman, Minh Pham, Krishnan Sharma and Almud Weitz for very useful comments on an earlier version.

Foreword

The continuing financial crisis in a growing number of so-called emerging-market economies has led to renewed interest in financial crisis management and prevention. After years of unlimited optimism and a seemingly ever-faster upward spiral of financial liberalization, record-breaking flows to developing countries, and rising investment fever, the plunge, started by Thailand's baht devaluation in the summer of 1997, was sudden and deep. Euphoric reports on emerging market investments becoming "mainstream" are being revised now that foreign investors—with the exception of foreign direct investors—are withdrawing from emerging markets.

The withdrawal of foreign money and the subsequent collapse of financial markets and economies as a whole in the region have dire consequences for the people in the affected countries. The ongoing recession threatens to reverse many of the development achievements of the last decades, particularly in reducing poverty and providing education and health services for all. Thousands of workers are being laid off, children are dropping out of school, and outright famine is hitting people in both urban and rural areas. In Indonesia alone, gross domestic product is expected to drop more than 15 percent this year, and the number of people in poverty is expected to rise to 100 million—or half the population.

Of course, there has been much debate and analysis about why the crisis happened, why it persists, and why the costs, economic and social, had to be so high. Although, as the saying goes, "there are always two to a Tango," in this case a borrower and a lender, the main focus of the analysis and debate has been on the emerging markets in crisis and their various inadequacies, such as: inadequate monitoring and supervision of financial markets; lack of information disclosure; or their inability to absorb financing flows adequately. Accordingly, most of the policy advice on how to prevent financial crises in the future is also addressed to developing countries. This, of course, rightly so—but only in part. While the developing countries can do a lot in order to strengthen their capacity to manage financial flows as well as to deal with episodes of speculative pressures and excessive volatility, the question remains whether the present nature and composition of financial flows must be taken as a "given." Would it not eventually be possible to encourage investors to prefer longer-term investments?

Suggestions on a reform agenda for the "source" countries, typically the industrial countries, have, so far, received only scant attention. There is considerable discussion about a new international financial architecture, including among other things, a statement by the G7 major industrial countries on this point. These suggestions foresee a more shared responsibility for both borrowers and investors. Yet, they, too, do not address the issue of the nature of the investment flows.

The 1998 Trade and Development Report by UNCTAD focuses on financial instability and, among other issues, lists a number of proposals to control and stabilize international lending and portfolio investment at the source country level. It is precisely under this umbrella that the authors have put their study.

The present Discussion Paper intends to act as a "curtain raiser" for further research and debate on this subject. The authors analyze the growing institutionalization of savings in industrial countries, particularly in the form of mutual funds and pension funds, and the implications of this trend for developing countries. As regards mutual fund investments in developing countries, they had grown considerably before the present crisis. However, they were highly volatile and biased towards the short-term. Asset allocation of pension funds in developing countries have, so far, been of a rather modest volume. But, as the authors argue, they could potentially provide the longer-term capital needed for investments in development. No doubt, in order to tap pension fund money, the emerging markets would have to work hard on reducing the risks they pose for foreign investors; and pension fund managers will, in this respect, be even more demanding than other investors.

Of course, attracting more long-term foreign money will not be the answer to all financing problems many developing countries face. International flows should always remain complementary to a country's local investment sources. A number of countries have quite successfully started to build up the domestic capital market, particularly through the introduction of national institutional investors such as pension funds. While these efforts have helped reduce the dependence on foreign inflows, the reality is that with the enormous infrastructure requirements for the next decades to come, many developing countries will still need to attract a considerable amount from beyond their borders in order to finance these investments. The trick is to attract those that are most beneficial to the country.

As the authors indicate, there is an urgent need to improve our understanding of how different groups of institutional investors manage the allocation of their assets to developing countries, whether the investments of different institutions could be ranked according to their volatility, and what could be done in order to enhance their interest in the longer-term. In order to clarify these issues, it is, of course, important to listen to the investors themselves. We will encourage such a follow-up dialogue.

However, policy-makers and financial experts in developing countries will certainly also have their views and suggestions on this topic. Developing countries, and particularly the poorer countries among them, cannot afford the level of financial volatility recently experienced.

The main purpose of this Discussion Paper is, therefore, to begin a discussion among experts in developing and developed countries on how to encourage longer-term investments on both ends. We are particularly interested in the experience of dealing with different types of portfolio investors in developing countries. Is there any difference in dealing with hedge funds, mutual funds or pension funds? How could longer-term investors be rewarded?

The current Discussion Paper is part of ODS' ongoing research on financing development. Earlier Discussion Papers on related research topics include those by Agosin and Ffrench-Davis, Pearce and Steele, Chichilnisky, Gentry, Eatwell, and Grunberg, all listed on the inside back-cover of this publication.

As with previous ODS Discussion Papers, we welcome the readers' comments on the topics presented here and intend to publish a synthesis of the follow-up research and comments we receive by the fall of 1999. Inquiries about contributions to the follow-up volume can be sent by mail to the address on the back cover of this Discussion Paper, by fax (212-906 3676), or by e-mail (*inge.kaul@undp.org* or *almud.weitz@undp.org*).

We look forward to hearing from you.

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January 1999

Executive Summary

This paper examines the recent underlying forces that have led to a large volume of capital inflows to emerging economies. An important part of these flows has originated in the institutionalisation of savings in industrialised countries and in the globalisation of financial markets throughout the world. We show that portfolio flows to emerging markets are mainly intermediated through European and American institutional investors, especially mutual funds. Pension funds, a potential source of long term finance to emerging economies, still appear to be fairly marginal investors in those countries. Although having important benefits for the recipient countries, these large capital flows have exhibited high degree of volatility in recent years, and this volatility has been very costly for development, as exemplified by the Mexican and Asian crises. External and domestic sources of volatility are analysed with particular attention paid to the phenomenon of herding among investors. Herding appears to result from the internal structure of incentives within the mutual fund industry. Policy implications are then studied to promote more long-term finance. The last section concludes with a research agenda.

I.
The Management of Financial Funds

1. THE DEVELOPMENT OF FINANCIAL MARKETS

Domestic and international capital markets have undergone profound changes in size and structure during the last ten years.

Deregulation, the dominant initial force that has driven these changes, has considerably enhanced the role of free market forces in determining choices open to economic agents. By the beginning of the 1980s, many of the restrictions which previously limited competition in financial markets, (such as restrictions on lines of business, geographical operation, quantitative restrictions on credit, interest rate and price restrictions, controls on foreign exchange transactions and international capital flows) had either been removed or had been undermined by market developments.

As a result, five trends have clearly emerged. The first is that capital markets have become increasingly globalised and integrated. Domestic markets have progressively become more integrated with each other and with off-shore markets. Capital flows across borders have intensified and the number of institutions operating in foreign centres increased. Furthermore, the global interlocking of national financial markets has far exceeded the global interlocking of national productive structures, as the very rapid