CHAPTER IV EMERGING EQUITY MARKETS

The experience with banking crises and the loss of access to international capital markets during the Asian crisis of the late 1990s led some observers to argue that emerging markets should develop local securities markets in order to provide a more stable source of funding for the sovereign and corporates. This chapter is the first of three studies that the *Global Financial Stability Report* will provide on the potential contribution that local securities markets could make to ensuring greater financial system stability. This chapter examines the factors that have influenced the contribution of emerging equity markets to financial sector stability—forthcoming issues will analyze local bond markets, which have played a relatively important role in recent years, and the emergence of derivative markets in selected countries, as well as the main policy issues associated with the development of local securities markets as a complementary source of funding to banks and international capital markets.

One of the key issues in developing local securities markets as a stable source of funding for corporates is the development of an adequate domestic and international investor base. The scale and stability of that investor base will be influenced fundamentally by the nature of the returns and portfolio diversification benefits associated with holding local securities. This chapter therefore analyzes emerging market equities from two perspectives. First, it looks at the performance of this asset class from the perspective of global investors and considers how this performance may affect the scale and volatility of equity-related capital flows. Second, it examines emerging market equities as an alternative source of finance for the corporate sector, and analyzes how equity issuance in emerging markets has fared in relation to bank financing.

Emerging Market Equities as an Asset Class for Foreign Investors

The global investor base for emerging market equities includes dedicated emerging market funds, global or international funds that allocate a portion of their assets to emerging market equities in order to track either a world or regional equity index, and tactical investors, such as hedge funds. While the emerging market allocations of global equity funds are typically small—around 5 percent of total assets—the absolute amounts of these allocations can be sizable in relation to the market capitalization of emerging stock markets; for instance, the emerging market exposure of global equity funds (both dedicated and nondedicated) is estimated to have reached about $108 billion last year (about the size of total market capitalization in Korea). For tactical investors in emerging markets, the objective is to achieve high absolute returns through market timing, given the high volatility of this asset class. For global equity funds, emerging market equities could provide a diversification play. Adding emerging market equities to portfolios dominated by mature market equities can at times provide a more favorable risk-return profile than investing exclusively in mature market equities, particularly when returns between the two assets are not closely correlated.

The global investor's perspective on emerging market equities is somewhat different from that of the local investor, in part because the alternative investment opportunities facing the two are often rather different. The international investor is typically interested in the foreign currency returns available from investing in emerging market equities, and has access to several other classes of equities as alternatives; dedicated international emerging market funds, in particular, expect to obtain an equity premium on this asset class over longer periods. Local equity investors

Table 4.1. Equity and Bond Returns

	2001–2002:Q1			1990–1994			1995–2001			1990–2001		
	Returns	Standard dev.	Sharpe ratio	Returns	Standard dev.	Sharpe ratio	Returns	Standard dev.	Sharpe ratio	Returns	Standard dev.	Sharpe ratio
S&P/IFCI Composite[1]	11.13	28.4	0.21	16.02	20.6	0.42	–3.68	26.3	–0.36	4.53	24.2	–0.08
Asia	22.99	33.1	0.54	12.35	24.2	0.21	–9.81	32.7	–0.48	–0.58	29.5	–0.24
EMEA	–4.80	26.7	–0.37	–2.57	35.2	–0.28	1.78	25.0	–0.16	–0.03	29.6	–0.22
Latin America	5.34	28.1	0.01	27.40	29.2	0.69	1.35	31.8	–0.14	12.20	30.9	0.19
MSCI EAFE	–21.93	18.3	–1.47	0.31	19.4	–0.36	1.42	16.0	–0.28	0.95	17.4	–0.32
S&P 500	–9.90	18.3	–0.82	8.34	12.4	0.09	14.77	16.0	0.56	12.09	14.6	0.39
NASDAQ	–23.34	43.2	–0.66	10.06	17.6	0.16	13.62	31.9	0.24	12.13	26.8	0.21
EMBI+ Brady Broad[2]	17.14	9.4	1.29	14.43	14.0	0.51	14.84	17.8	0.50	14.69	16.4	0.50
Merrill Lynch U.S. High Yield	6.37	10.0	0.13	11.32	6.4	0.63	6.86	6.0	0.16	8.72	6.2	0.36

Sources: Bloomberg L.P.; and Datastream.
[1]Asia: China, India, Indonesia, Korea, Malaysia, Pakistan, The Philippines, Sri Lanka, Taiwan Province of China, and Thailand.
EMEA: Czech Republic, Greece, Hungary, Poland, Russia, Slovakia, Turkey, Egypt, Israel, Jordan, Morocco, South Africa, and Zimbabwe.
Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
[2]EMBI+ Brady Broad started in 1991.

are mainly interested in local currency returns and risks, and for many of them the assets available for investment are much more restricted than for the global investor. Until recently, for example, retail investors in many emerging markets have had little access to fixed income instruments; the alternatives in practice have involved the decision of whether to place money in a bank, to buy government bonds, or to invest it in stocks. As local fixed income instruments become a more viable asset class in emerging markets in the future, the existence or otherwise of an equity premium that compensates for the additional risk is likely to become an important issue for the investment strategy of local investors.

In any event, the global investor's decision to invest in emerging equities is driven by risk-adjusted returns, and the potential portfolio diversification benefits associated with the extent of the correlation of these returns with the rest of his/her portfolio. In the next sections, the performance of emerging equity markets is reviewed, with a view to inferring how this performance affected the investment behavior of global investors as the asset class matured during the past decade.

Emerging Equity Market Performance

After languishing for a protracted period, equity prices in emerging markets have witnessed a sharp rebound over the last six months. Indeed, the return on the S&P/IFCI Composite,[1] a benchmark dollar-based index for emerging market equities, has been about 11 percent in the 12 months to the first quarter of this year, in contrast to a negative return of 10 percent for the S&P 500 and a negative return of 23 percent for the NASDAQ during the same period (Table 4.1).[2] The driving force of the recent spurt in emerging market equity prices has been Asia—the IFCI Composite's Asia index increased by about 23 percent in the year to the first quarter of this year. The Latin America index, in contrast, increased by only about 5 percent, and the EMEA index, which covers emerging markets in Europe and the Middle East, declined by about 5 percent in the same period (Table 4.1). Unlike

[1]For many global investors, the benchmark used to measure emerging equity markets returns is the S&P/IFCI composite index. It is U.S. dollar based, excludes stocks that foreign investors are restricted from buying in emerging markets, and adjusts for float, liquidity, and market capitalization.

[2]Not all investors follow this benchmark and thus performances will vary between individual funds. However, the average performance of 189 funds labeled emerging market funds by Morningstar have not outperformed the S&P/IFCI index over the last 5–10 years.

in past episodes, when emerging market equity prices tended to exhibit a high degree of comovement, particularly within regions, there has been a greater divergence of equity price movements across countries during the recent upturn. Equity prices in Korea, for instance, increased by 55 percent in the 12 months to the first quarter of this year, while equity prices in China declined by about 16 percent. This divergence in U.S. dollar returns is apparent in other regions as well—while equity prices in Mexico picked up sharply, Brazil and Argentina have witnessed slumps in stock prices. In the EMEA region, Russian stock prices are up by 57 percent in the last 12 months—making it the best performing emerging equity market in this period;[3] Turkey, in contrast, witnessed a 33 percent decline, and Poland a 19 percent decline in stock prices.

Despite this strong recent performance, emerging equity returns have been relatively poor—both in absolute and relative terms—during the past decade. While investors in emerging market equities should, a priori, expect higher relative rates of return (because of relatively higher potential growth rates), between 1990 and 2001, the average annual return on the IFCI Composite was about 4.5 percent—just about one-third of the returns available from investing in the S&P 500 index or the NASDAQ. The returns on the Asia component of the IFCI Composite have, in fact, been in borderline negative territory; Latin America accounts for the bulk of the positive returns that this asset class has provided during the decade. In contrast to emerging market equities, emerging market international bonds have provided high returns. Indeed, investors tracking JP Morgan's emerging bond index, EMBI+, could have obtained average annual returns of almost 15 percent between 1990 and 2001. Comparisons with other "riskier" asset classes provides much the same story—U.S. high-yield instruments generated twice the return of emerging market equities in this period.

Not only have returns on emerging market equities been low, but volatility has been high, with Sharpe ratios for emerging market equity returns being significantly lower than those for both the S&P 500 and for EMBI+ (Table 4.1). The cumulative impact of the underperformance of emerging market equities over the decade is illustrated starkly in Figure 4.1. One-hundred dollars invested in January 1990 in a fund tracking the IFCI Composite would have grown to $180 at the end of the first quarter of this year. The same investment tracking the S&P 500 index, in contrast, would have grown to $440. Investors tracking the EMBI+, however, would have been rewarded by asset growth of more than five times over the decade.

Splitting the last 10 years into the pre- and post-Mexican crisis phases—a benchmark often used to delineate the start of the increasing internationalization of emerging market crises—offers interesting insights. Between 1990 and 1994, the average annual returns on the benchmark emerging market equity index was about 16 percent—twice that of the returns available from tracking the S&P 500, and even somewhat higher than that of EMBI+. The Sharpe ratio for the IFCI Composite was also higher than that for the S&P 500, associated with a relatively lower volatility of returns for emerging market equities in this period. All that changed dramatically during 1995–2001. The returns on the IFCI Composite averaged a negative 3½ percent, in contrast to about 15 percent returns on both the S&P 500 and EMBI+. Volatility of equity returns also increased significantly in emerging markets in the post-Mexican crisis period.

The performance of emerging equity markets during the 1990s stands in sharp contrast to that in mature markets. On the one hand, for advanced economies, the existence of an ex post equity premium—that is, higher returns available over the long run from holding stocks compared to the yields on a risk-free rate, usually a benchmark treasury bond—is generally accepted

[3]The RTS dollar index in Russia increased by over 100 percent in this period. The different weighting of individual stocks in the RTS and IFCI Russia indices accounts for the differences in measured returns.

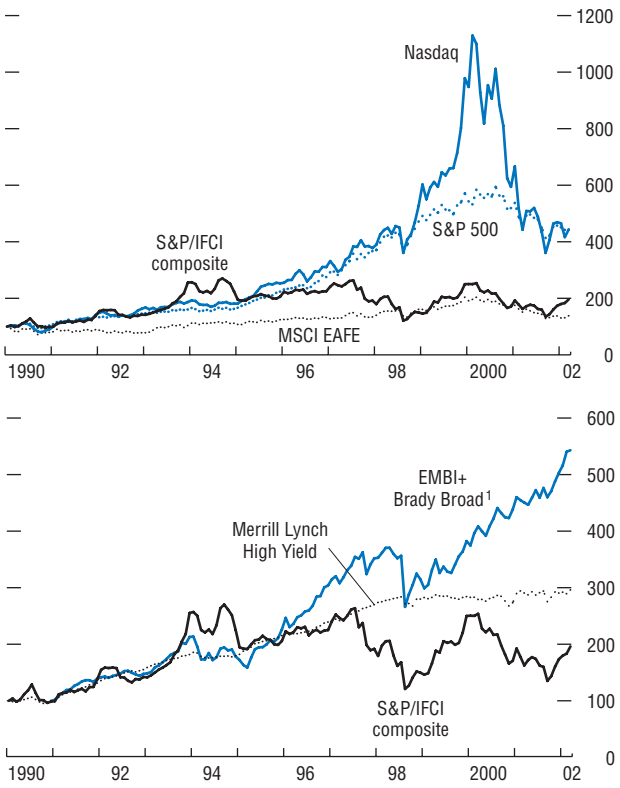
as a stylized fact; the premium is perceived as the higher compensation required for holding the riskier asset. The debate on the equity premium has essentially centered on whether it is "rational" for the premium to be as high as the realized 6–7 percent for holding stocks rather than bonds. Some have argued that the equity premium in the United States indeed has been historically high, but that the run-up in U.S. stock prices in the latter half of the 1990s, and the accompanying higher valuations and lower implied expected returns, has reduced the equilibrium equity premium, as investors have gradually adapted to the idea of holding stocks as a longer-term asset.[4] In emerging markets, however, the equity premium has been *negative* over the period 1990–2001—the return on the IFCI Composite being almost 2 percentage points lower on average than that from holding the 10-year U.S. treasury bond.

Portfolio Diversification and Emerging Equity Markets

The negative equity premium on emerging market equities raises the issue of why a global investor ought to have an exposure to this asset class, and of its future viability. As noted above, another determinant of foreign investor interest in emerging market stocks is their potential return enhancing and/or risk reducing function in broader equity portfolios. How much of that has materialized?

Figure 4.2 illustrates the historic risk-return trade-offs available for different portfolio combinations of emerging market and U.S. stocks, with a focus on international investors willing to allocate up to 10 percent of their assets to emerging market equities. During the period from January 1990 to March 2002, a portfolio consisting only of emerging market stocks was ex post inefficient, as it returned the lowest possible

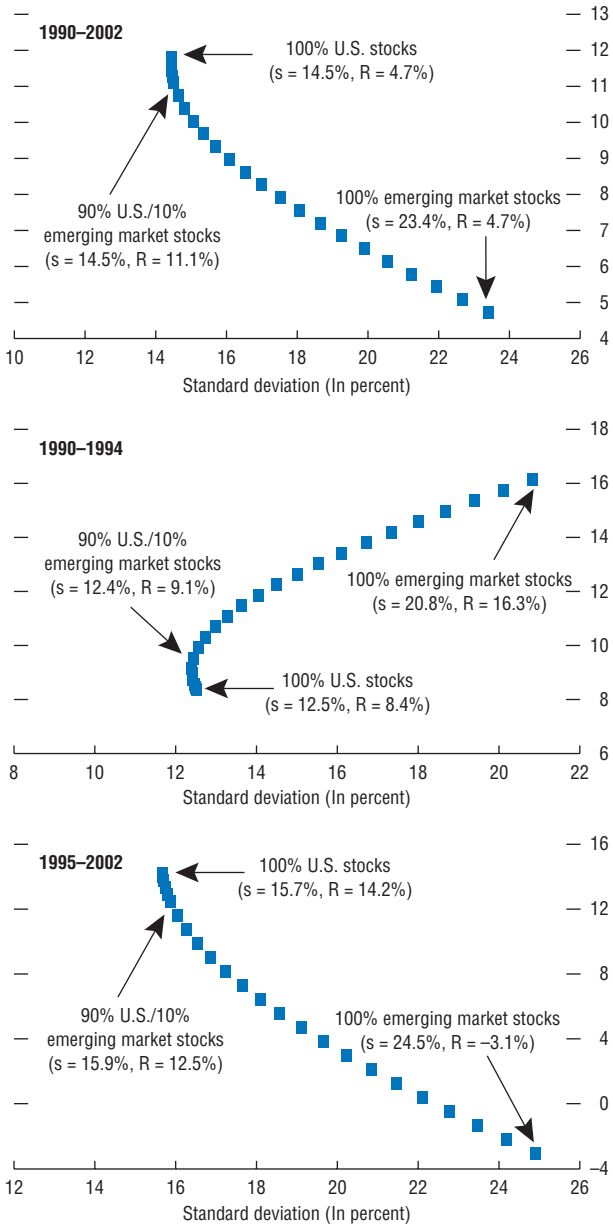
Figure 4.1. Equity and Bond Performances
(January 1990 = 100)



Sources: Bloomberg L.P.; and Standard and Poor's.
[1]December 1990 = 100.

[4]See, for instance, Clement (2001) and Constantinides, Donaldson, and Mehra (2002). For an up-to-date discussion of the equity premium in the mature markets, see Chapter II, Box 2.2.

Figure 4.2. Risk-Return Trade-Off for Emerging Market and U.S. Stock Market Portfolios[1]
(Rate of return; in percent)



Sources: Bloomberg L.P.; Standard and Poor's; and IMF staff calculations.
[1]IFCI Composite total return index is used for emerging market stocks and S&P 500 total return index for U.S. stocks. Risk (in percent) is calculated as the annualized standard deviation of monthly returns and return (in percent) as the annualized geometric average of monthly returns.

annual average return (4.7 percent) for the highest possible risk (23.4 percent). In contrast, a portfolio that included only U.S. stocks would have provided a return of about 12 percent, the highest possible portfolio return. Hence, U.S. stocks were clearly more attractive than emerging market stocks from a tactical perspective—that is, when the focus is exclusively on returns. Moreover, emerging market stocks did not offer much in the way of diversification benefits in this period, as a 10 percent allocation to emerging markets did little to change portfolio risk, while providing a lower annual return of about 11 percent.

In contrast to the experience of the decade as a whole, the first five years of the 1990s proved rewarding for global funds willing to hold emerging market stocks. A portfolio fully allocated to emerging market stocks not only experienced the highest return (about 16 percent annually), but also offered diversification benefits to international investors. A portfolio of exclusively U.S. stocks was ex post inefficient, returning 8.4 percent for a risk of 12.5 percent, whereas a 10 percent allocation to emerging markets would have provided about a 9 percent annual return for a marginal risk reduction. Such an allocation would have also been the minimum variance portfolio. The post-Mexican crisis period has been a troubling one for emerging market equities. Between 1995 and 2002, a portfolio composed exclusively of emerging market stocks would have been inefficient—negative 3 percent return for the highest portfolio risk (24.5 percent). In contrast, U.S. stocks experienced the highest portfolio return for the lowest risk. Portfolio diversification by inclusion of emerging market stocks offered no benefits to global investors in this period.

Explanatory Factors

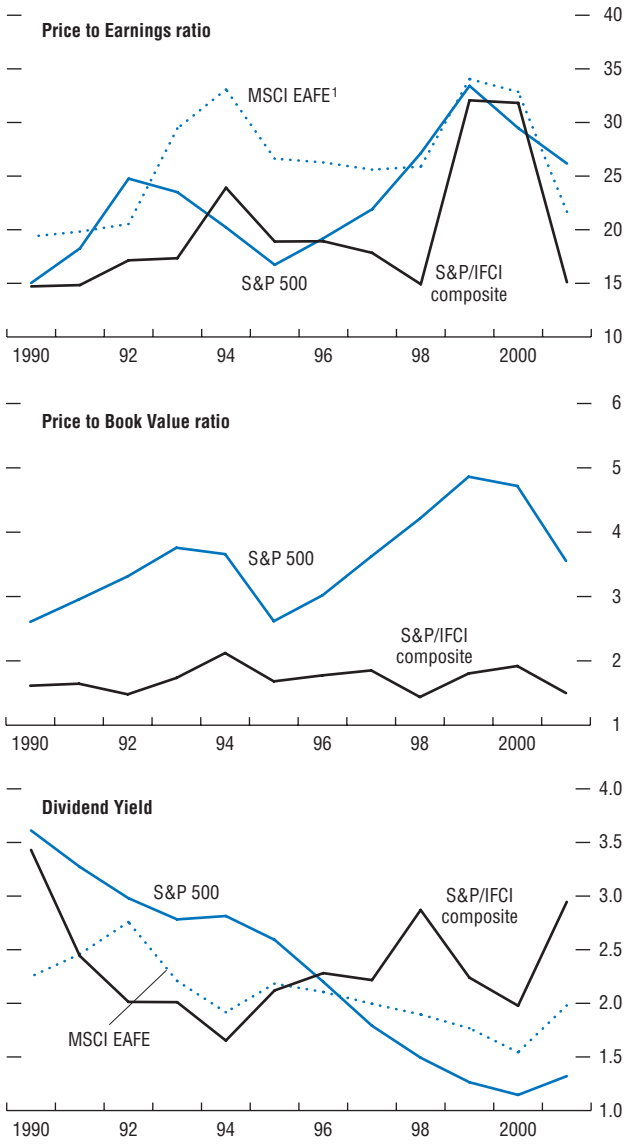
The trends in emerging market equity performance noted earlier warrant an analysis at two levels. The first is to identify the driving forces of the recent run-up in equity prices in emerging markets. And the second is to arrive at an under-

standing of why this asset class has underperformed over the longer run. As some of the issues pertaining to the recent run-up in emerging market equity prices have been discussed in previous chapters, the focus of this chapter is primarily on explaining longer term trends. A few key points on recent developments are, however, noted as a precursor to the structural explanation of this asset class's performance.

The recent pickup in emerging equity markets has been associated with attractive valuations in aggregate for this asset class. The price-earnings ratio for the IFCI Composite was about 15 at the end of last year, compared to about 26 for the S&P 500. Moreover, the price-to-book ratio for emerging market equities is just over 1—about one-third of that on the S&P 500—and dividend yields, about 3 percent—almost three times larger than that for the S&P 500 (Figure 4.3). As noted earlier, unlike in the past, when equity prices in different emerging markets tended to move together, there appears to be much greater diversity recently in the equity market performance of the different countries. While the macroeconomic story is no doubt part of the explanation—that is, countries likely to benefit to a greater extent from the expected recovery in the United States, such as Korea, Taiwan Province of China, and Mexico, have had sharper spurts in equity prices than those that are less closely tied in with the U.S. cycle—there also appears to be a microeconomic basis for the recent divergence. Equity markets with attractive fundamentals appear to have done well, while countries with high stock valuations, such as China, have witnessed depressed equity markets, despite having the potential to reap the benefits of a prospective U.S. recovery.

What accounts for the underperformance of this asset class from a longer-term perspective? The general inclination when seeking explanations of stock market weakness is to search for indicators of overvaluation. But unlike Japan, where long-term stock market weakness has been tied to the overvaluation associated with the bubble in equity prices in the late 1980s, valuations do not appear to be the key factor for

Figure 4.3. Valuation Indicators in Emerging Equity Markets



Sources: Bloomberg L.P.; Standard and Poor's.
[1]EAFE stands for Europe, Australia, and Far East.

explaining the longer-term performance of emerging equity markets. Figure 4.3 indicates that while the price/earnings ratio for the IFCI Composite has been high during certain episodes, it has on the whole been significantly lower than that of the S&P 500 for much of 1990–2002. Other valuation indicators such as the price-to-book ratio and dividend yields also do not indicate the picture of a structurally overvalued emerging equity market for the entire period.

Market participants argue that the key factor generating both the poor returns on emerging market equities and the reduced diversification benefits has been the experience with financial crises during the second half of the 1990s. A string of financial crises, starting with Mexico in 1995, Asia in 1997–98, Russia in 1998, Brazil in 1999, and, more recently, in Turkey and Argentina, culminated in prominent currency depreciations and severe contractions in the level of economic activity in emerging markets. The downturn in economic activity and currency depreciations that accompanied these crises severely weakened both the income and balance sheet position of local corporates, especially in situations where the corporate sector had large foreign currency exposures. Moreover, the restructuring of corporate balance sheets at times involved lengthy negotiations and legal complications that further affected corporate performance. Such poor corporate performance was readily reflected in sharp declines in equity prices, over and above the decline in the value of many emerging market currencies.[5]

The large depreciations associated with these crises also had a strong impact on the returns earned by foreign investors, especially for many emerging equity market funds that tended not to fully hedge their currency exposures. As a result of this experience, foreign investors, whose holdings account for between ¼ and ½ of the market capitalization of some of the largest emerging equity markets, appear to have become more averse to currency risks.

As noted earlier, the second half of the 1990s witnessed a decline in the diversification benefits associated with holding emerging market equities. In part, this reflected the higher correlations between the equity returns in the various countries affected by the emerging markets crises. However, this period also saw a trend increase in the correlation between emerging and mature stock returns (Figure 4.4). This higher correlation related in part to the global effects of some mature market crises (such as associated with the failure of Long-Term Capital Management) and the sectoral investment strategies adopted by many global equity investors in connection with the sharp rise and subsequent decline of equity prices in the technology, media, and telecommunications (TMT) sector in the latter part of the 1990s (see Brooks and Catão, 2001).

While crises in emerging and mature markets affected the relative performance of emerging equity markets in the first and second halves of the 1990s, there are certain structural weaknesses that influenced equity market performance throughout the decade, although they became more evident to investors during periods of weak performance. In particular, liquidity, asymmetric information, and corporate governance considerations have had a dampening effect on the performance of emerging market equities. In many emerging markets, a few prominent companies constitute the bulk of the market capitalization of country indexes put out by the International Finance Corporation (IFC) and MSCI, and quite often the free float constitutes a small fraction of the companies' market capitalization. Firms included in these indices often tend to be privatized utilities, natural resource and transportation-related companies, or banks, which continue to maintain direct or indirect links to the state and have limited

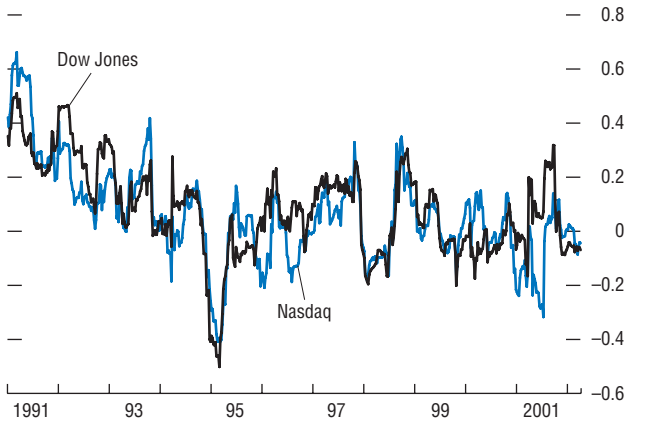
[5]For instance, while the Thai baht depreciated by 38 percent over the 12 months to May 1998, the stock market declined by 66 percent in U.S. dollar terms; similarly, the Indonesian rupiah depreciated by 78 percent over that same period, while the dollar value of the stock market fell by 88 percent.

opportunities for future growth. Also, foreign investors worry that adjustments in their holdings of these stocks will lead to large price movements, as the size of the free float is quite small relative to total market capitalization. Generating high returns in emerging equity markets therefore requires going beyond these companies, and picking out-of-index companies with good growth prospects. However, foreign investors do not generally invest in out-of-index stocks either because of liquidity considerations or simply because they are unaware of the potential of these stocks, since international investment banks do not include them in their research coverage.

Issues of transparency and corporate governance have also weighed negatively on emerging market equity performance. In many emerging markets, analysts have concerns about the accuracy and transparency of corporate earnings reports—especially for the case of closely held companies—and asset managers distrust analysts' research. Indeed, in a recent survey (Montagu-Pollock, 2001), a large majority of fund managers (76 percent of the sample) responded that they were not happy with the independence of the research they got from investment banks. Poor corporate governance has been identified as one of the causes of the recent Asian financial crises (see, for instance, Claessens, Djankov, and Lang, 1998), with ownership largely concentrated in the hands of families and the state, in part through the use of pyramid structures, deviations from one-share-one-vote rules, cross holdings, and the appointment of managers and directors who are related to the controlling family. Also, the need to attract strategic investors during the privatization processes of the 1990s in some European and Latin American countries was accompanied with weak minority rights that contributed to abuses from controlling shareholders. While the quality of corporate governance in emerging markets was also an issue in the first half of the 1990s, the Asian crisis in the latter half of the 1990s brought it to the fore.

The migration of the listings of top-quality emerging market corporates to major mature

Figure 4.4. Correlations Between Returns in Emerging and U.S. Equity Markets[1]



Sources: Bloomberg L.P.; and IMF staff calculations.
[1]Correlation between weekly returns on emerging and U.S. market indices computed according to the Riskmetric methodology with the exponetially declining weight equal to 0.95.

market financial centers has also taken a toll on the liquidity of emerging equity markets. A common way of raising equity capital in international markets is to issue depository receipts that trade in the United States (American Depository Receipts or ADRs) or in the rest of the world (Global Depository Receipts or GDRs).[6] In general, companies list on a local exchange initially and then offer part of their equity to international investors through depository receipts. During the 1990s emerging market issuers raised on average $7 billion a year through ADRs, but issuance levels in recent years have averaged around $22 billion—though that includes the peak year of 2000. Latin American entities were the most active issuers of ADRs in the early 1990, but more recently the focus has shifted to Asia. In the early 1990s, about 60 percent of international equity issues took the form of ADRs; this has risen to almost 80 percent in the past three years, with Latin American issues being almost exclusively in the form of depository receipt programs. Market participants argue that for some prominent Latin American stocks price discovery is done in New York rather than in the local markets.[7]

Along with ADRs, delisting of stocks from local stock exchanges in emerging markets has also had a negative impact on the asset class. Delisting has been a particularly significant problem in Central Europe, Latin America, and South Africa. In Hungary, for instance, a number of companies have delisted from the local stock exchanges because they have been taken over by multinationals—in 1999, FDI firms accounted for 50 percent of book value added in the nonfinancial business. Similarly, a large number of delistings by foreign companies of their Argentine subsidiaries accounts for a large fraction of the fall in the country's stock exchange market capitalization. In South Africa, some local companies decided to migrate and list abroad to take advantage of the larger investor base and overcome the size limitations of the local market. Delistings have been less of an issue in Asia.

Implications for Capital Flows

The sustained poor performance of local emerging market equities has sharply altered the global investor base for emerging market equities. For example, dedicated emerging market mutual funds have in some cases witnessed declines in assets under management of one-half. The role of crossover investors, such as pension funds and insurance companies, and tactical investors, such as hedge funds, has increased, and their focus is on opportunistic trading. As noted earlier, the robust performance of emerging equity markets in recent months has attracted investor focus on this asset class once again, with a number of global investment banks recommending their clients to go overweight on emerging market equities (see Salomon Smith Barney, 2002, and Goldman Sachs, 2002). As what market participants consider "tactical" investing in emerging equity markets gains in relative importance, it is likely to accentuate the already volatile net inflows into emerging equity markets (see Chapter II, Figure 2.14). And such a prospective increase in volatility is also likely to have spillover effects into other emerging asset markets, particularly to the currency markets.

Domestic Equity as an Alternative Source of Funding

In response to the emerging market crises of the late 1990s, a number of analysts and policymakers recommended the development of local securities markets as an alternative source of funding for the corporate sector to ameliorate the impact of a banking or external funding crisis. While the emphasis has been largely on the development of local bond markets, the need to

[6]See Box 3.6 in the *International Capital Markets* report (IMF, 2000) for a more extensive discussion of depository receipts programs.

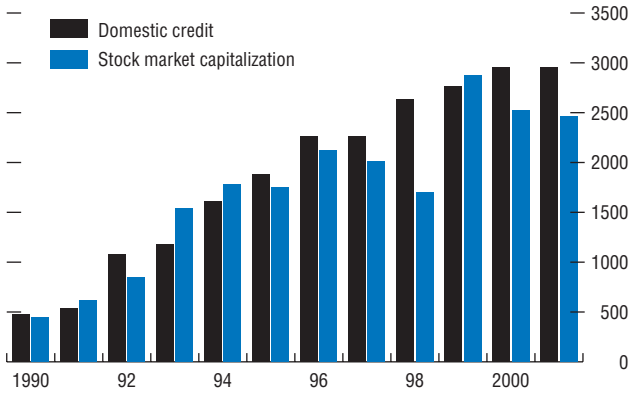
[7]Indeed, the typical risk-return profile of ADRs is not very different from that of locally listed stocks because of arbitrage.

reduce the leverage of several large corporates in Asia, combined with the desirability of having more flexible financial structures in volatile environments, has raised the issue of the stock market as a source of finance.

The value of stock market capitalization has been approximately equal, on average, to the value of outstanding bank credit over the last decade in emerging markets (Figure 4.5). Although this constitutes only a rough approximation of the pattern of corporate finance in emerging markets, it shows the relative importance of equity financing. There are significant differences, however, across time and regions. Bank credit is much larger than equity market capitalization in Asia, while the opposite applies to Latin America and Central Europe.[8] The collapse in equity prices in the former region in 1997 and 1998 accounts for a large share of the fall in market capitalization during these years, and the TMT-led rebound in valuations across the whole spectrum of emerging markets in 1999 explains the reverse phenomenon during that year. Outstanding bank credit grows steadily during the decade in Central Europe and Asia (with the exception of Asia only in 1997), while it flattens out in Latin America after 1994.

In contrast to the similar orders of magnitude in the stocks of debt and equity, bank lending has dominated domestic equity issuance in emerging markets. Between 1990 and 2001, the size of bank flows has been approximately 10 times the size of the equity flows (Figure 4.6). However, volatility has also been substantially greater. For example, an important increase in bank credit of around $400 billion in 1996 was followed by a contraction of $5 billion in 1997, while equity issuance was around $20 billion in both years. This is explained in part by the fact that bank lending is short term and hence needs to be rolled over, while equity is generally speaking a permanent source of finance. Nevertheless,

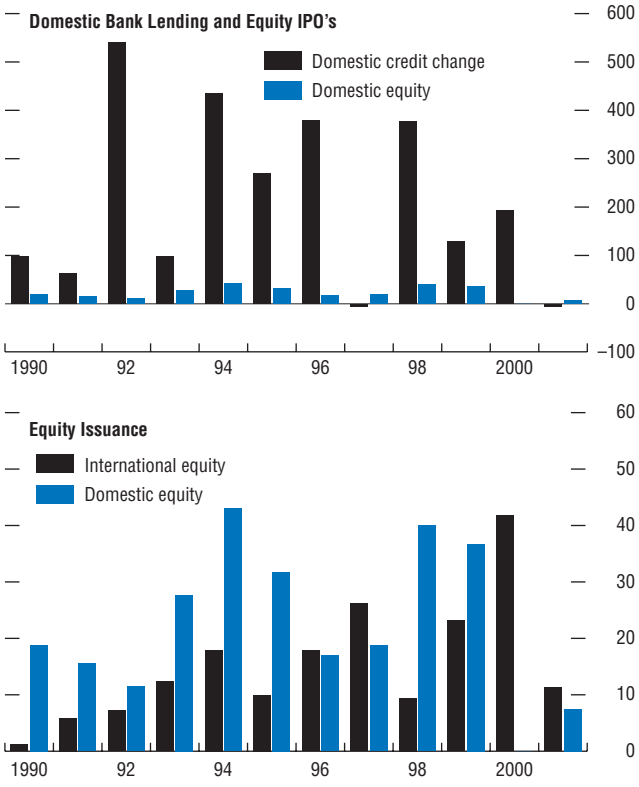
Figure 4.5. Stock Market Capitalization and Bank Credit
(In billions of U.S. dollars)



Sources: IMF, *International Financial Statistics*; and IMF staff estimates.

[8]This is due, in part, to the extensive privatization processes in these two regions, an issue that will be discussed in more depth in a forthcoming IMF Occasional Paper, *The Role of Local Securities Markets*.

Figure 4.6. Domestic and International Equity Issuance
(In billions of U.S. dollars)



Sources: IMF, *International Financial Statistics*; and IMF staff estimates.

the flow data show that, while relatively small in absolute size, equity finance was a relatively resilient source of finance during the Asian crisis. The sharp fall in domestic equity issuance in 2000 and 2001 raises doubts, however, about the long-term prospects of initial public offerings in local markets going forward, an issue that is related to the internationalization of equity markets. As Figure 4.6 (lower panel) shows, international equity issuance has dominated local equity issuance over the last two years.

While the internationalization of equity markets has helped top-quality emerging market corporates to raise capital at a lower cost, it may thwart efforts to develop local equity markets as an alternative source of finance. The trend toward the internationalization of equity markets is a result of the dramatic reduction in transaction costs associated with improvements in information and computation technologies.[9] The associated reduction in the cost of raising capital in the most advanced exchanges, combined with the integration of capital markets, has made evident the inefficiencies existent in several local emerging equity markets. Several of these markets are reducing listing requirements and other costs associated with initial public offerings, and they are establishing alliances with other exchanges to increase the investor base for local issues. It remains unclear if these local efforts could compensate global trends toward the consolidation of equity market activity in the most efficient financial centers. However, the poor performance of local emerging equity markets during the second half of the 1990s is not necessarily a harbinger of future performance. A more stable macroeconomic environment and improved corporate governance and transparency would nonetheless be key elements in furthering the development of these markets. In this regard, the ADRs and GDR programs of

[9]The trend toward internationalization of equity markets, which includes delistings, ADR issuance, dual listings and other phenomena, is discussed in IMF (2000); the shift of liquidity toward financial centers and consolidation of exchanges is described in IMF (2001).

emerging market corporates are also likely to play important roles in helping improve corporate transparency and governance.

Conclusions

Emerging market equities can provide global investors with attractive absolute returns as well as an avenue for diversifying their portfolios. The evidence indicates that investors reaped such benefits in the first half of the 1990s, but that the gains disappeared between 1995 and 2001. This deterioration in the performance of emerging market equities gave rise to tactical investors, whose opportunistic behavior is likely to increase volatility of capital inflows into emerging markets. The underperformance of emerging market equities from a longer-term perspective does not appear to be primarily due to overvaluation, though price/earnings ratios in emerging market equities have been high in some years. Some of the main factors in this underperformance are: (1) a string of financial crises, starting with Mexico in 1994, which has drastically pruned the U.S. dollar returns on emerging market equities; (2) concerns about corporate transparency and governance; and (3) the growing importance of American Depository Receipts (ADRs) and delistings, which has also reduced the universe of liquid stocks in emerging markets and has thinned both the domestic and global investor base. While the stocks of debt and equity are of similar sizes, bank lending has dominated domestic equity issuance in emerging markets. Between 1990–2001, the size of bank lending has been approximately 10 times the size of domestic equity issuance, but the volatility of bank lending has also been substantially greater. Moreover, while relatively small in absolute size, equity finance was a relatively resilient source of finance during the Asian crisis. The sharp fall in domestic equity issuance in 2000 and 2001 raises doubts, however, on the long-term prospects of initial public offerings in local markets as an alternative financing mechanism going forward, an issue that is largely related to the increasing internationalization of equity markets.

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