CHAPTER-III

Global Financial Markets

Incentives and Impediments to Foreign Flow of Fund

3.1 INTRODUCTION

At the outset we desire to introduce in brief the effectiveness of sample countries policy, practice, and market operation to entice foreign flow of funds in the sample countries. Descriptive analysis will be followed by objective measure to answer following two questions: i] what is the pattern of growth of financial integration of the sample countries. It will help to answer the query - do the developed countries are more integrated than less developed economy? Trade or financial integration which one is most prominent for the countries under study? ii] We will try to relate the growth in interconnectedness of financial market to potential drivers of integration often referred as 'environment'. The major drivers are institutional development, improved market operation, privatization, lifting of policy restriction etc. This will help to understand what prevent markets to attract foreign capital, compel it to function independently; finally market fails to enjoy the status of developed markets.

3.2 EMERGING AND DEVELOPED MARKETS

Until now, no universally accepted definition of an 'emerging market' exists, nor there do any consensus about which markets merit the 'emerging' status. Composition of the universe of emerging market is in a continuous state of flux. Today's emerging market may tomorrow qualify for developed markets.

World Bank defines emerging markets that simply belong to low or middle income countries. It is an insufficient definition as in the year 2007 nearly 144 economies fall in to the developing category but only a handful of markets of these countries merit the emerging market title. Hence, scholars find it difficult to depend on this inadequate definition.

Standard and Poor/International Financial Corporation [IFC] identified some elementary features to recognize the status of emerging markets. Usually the markets are ill nourished where pervasive restrictions on foreign portfolio investment exists due to insufficient opening up of the economy leading to the fact that the markets mostly depend on limited domestic flow of fund and looks anaemic. S&P/IFC

classifies an equity market as 'emerging' if it meets at least one of the following two criteria:

- Its domiciled in a low or middle income economy as defined by the World Bank.
- Its investible market capitalization (i.e., portfolio open to foreign investors) is lower than its recent gross national income figure.

S&P/IFC added that equity markets which impose investment restrictions such as foreign ownership limits, capital controls, extensive government interest in listed stocks and other legal and political restrains on trading activity, particularly for foreign investors, are generally considered emerging markets. Morgan Stanley Corporation International [MSCI] relying on a more elaborate classification suggests that world markets follow a step wise path from-Frontier to Emerging and then to Developed market (Appendix-ii). A new market accessible to international investors would logically start as a frontier market and evolve over time when warranted to emerging market status first, then to developed market category. Commonality, if any, in above two definitions most relevant for present analysis is the scope for foreign portfolio investment or alternatively interconnectivity with other markets is the single most important element to influence the status of the market-the emerging or developed. Thus integration or segmentation, the central theme of the present thesis is an important parameter to influence the stages of development of the market. Underlying assumption is only an integrated market can attract both domestic and foreign investors, minimize risk, increase liquidity; supply necessary funds for the development, at least initially to private sector and finally can help the market enjoy the status of developed market. As the countries gradually move from frontier to developed markets, gradually, they perform more investor's friendly role and their co movement with other markets also changes. Modern economists even argue that, in a well integrated market correlation between national savings and investment vastly declines because world economy favours efficiency (Bordo et. al 1998).

In addition to our sample, 'quality' of a large number of countries of different regions of the globe has been shown [table (2.2) in chapter-ii]. It is simply based on well accepted assumption that superior investment performance is achievable by spreading

capital across a number of geographical sectors and carefully re-balancing back the proportions of shock on a regular basis [Goetzmann et. al (2005) Solnik and Michenand (2005)]. A priori investment constraint to an extent almost common for all economies leads to sub-optimal investment solution.

Lesson from the table is simple, straight forward and helpful to locate region and country most suitable for foreign investment. In terms of all the variables considered in the table quality of the market of developed economy is superior to others. Does it imply that, ignoring current fashion for emerging markets developed economies should be natural choice for portfolio investment? In fact, studies suggest that long run return of developed market is lower than developing economy, thus this faster growth of so called 'emerging' market is currently a lucrative destination of foreign funds. In addition, there are few developed markets such as Denmark, Austria, Belgium, Portugal (Number of listed companies in these markets say in Portugal is 49, in Austria is 101, in Denmark is 194 etc.) are so small and thin that the markets are incapable to support sizeable global investment. Many emerging markets, in fact a large in number, disqualifies on the same ground as an 'ideal' destination of foreign funds. Most of the Latin American countries save Brazil and Mexico suggest why there exist pervasive disillusionment of world's investing community about those economies .Markets are generally illiquid, foreign exchange and derivative markets are almost nonexistent, high brokerage cost and instability of macro - economy force both domestic and foreign investors to avoid these markets (Appendix-iii). In effect, simply, existence of these markets are at stake and most of the activities of the exchange such as listing, trading activities, capital rising have been swallowed by big markets. Most of the frontier markets namely Pakistan, Bangladesh, Srilanka are very close to India thus the benefit of low transaction costs, information cost, geographical proximity are there but due to numerous deficiencies and immaturity these markets are ignored. Asian markets such as Singapore, Malaysia, South Korea, Philippines, Thailand, Japan either belong to developed or emerging categories. These markets at the periphery, of course, are attractive destination of Indian capital. Thus, for ideal investment decision we note investors seeking high growth should not limit their analysis to the fascinating and breath-taking developments in emerging markets but

also scrutinize some of the well developed, industrialized countries that are also economically and politically more stable. Ignoring 'home biases, 'regional biases' or any 'bias for level of development' investors would diversify fund, that portfolio theory suggests optimal.

Original Washington consensus of 'stabilize, privatize and liberalize' has now been augmented by a long list of so called 'second generation reforms' that are heavily institutional in nature (Rodrik, 2006) and emphasize on 'governance related conditionality'. Ineffective institutional arrangement, unwillingness to comply with internationally accepted standard most importantly accounting standard, inefficient market operation, inadequate corporate governance, lack of transparency and accountability, unwarranted government intervention like threat of foreign exchange control, restriction on remittance of funds etc. that robs the freedom of competitive economy. All these along with other bad economic policies and practices like nationalization of business, loss of property right etc. that may be termed as 'unfavourable environment to restrict flow of capital in emerging economy and causes market isolation. Bordo et. al (1998) theorized adverse impact of the entire framework of 'asymmetric information' that influences both quantum and quality i.e., sectoral/functional composition of foreign investment. Non compliance with international accounting standard and ambiguous flow of information results in asymmetric and insufficient flow of information that not only discourages both domestic and foreign portfolio investment but also increases possibility of adverse selection. This leads to well known phenomenon 'lemons' problem. [Akerlof (1970), Stieglitz and Weiss (1981)]. Furthermore, inadequate corporate governance, lack of transparency those results from information asymmetry contribute in agency problem. Hence investors may feel it is risky to entrust funds to free standing management [Bordo (1998), Millo (2007)]. Thus a series of enlightened policies to be initiated to overcome the problem of informational inefficiency of the market so as to minimize the feeling – 'investment abroad is risky', 'it is hard to collect adequate and reliable information about firms from distant land', 'returns and volatilities are unpredictable'. Though the deliberation is mostly applicable for frontier/emerging markets, experiences of frequent market failure indicate developed markets are also victim of

this syndrome and a careful selection of country can allow foreign investors to minimize risk of portfolio. Pattern of development of 'governance related activities' of developed and developing economies are reported below.

In order to measure the investment environment of the nations we have taken recourse on Opacity Index provided by Milken Institute (Kurtzman & Yago, 2009). We can have a fair view of the investment risk of the countries with this index. The Opacity Index is a measure of five components that may be thought of as 'negative social capital'. These are Corruption, Legal system inadequacies, economic Enforcement policies, Accounting standards and corporate governance and Regulation. Together, these five factors spell CLEAR. A high score on the Index indicates higher levels of opacity in each of these areas. It is a broad measure of the effectiveness of a country's economic and financial institutions, as well as its overall risk. Opacity Index is based entirely on empirical observations. Higher the score of Opacity higher will be the risk of investment. Opacity Index mainly focuses on business and economic risks; actions taken on that level can change the relative attractiveness of a given country to outside investment. Over the years, research has shown that lowering opacity levels also lowers the cost of doing business. Decreasing corruption, for example, has the same effect as lowering business taxes. A decreasing opacity level is highly correlated with increased competitiveness (Hallett et. al, 2005).

Following the FTSE country classification (Appendix-ii) we have chosen five countries from each stage of development (Developed: UK, USA, Singapore, Hong Kong, Japan; Advanced emerging: Taiwan, South Africa, Brazil, Mexico, Hungary; Secondary Emerging: India, Indonesia, Malaysia, Argentina, Phillipines; Frontier: Srilanka, Kenya, Bangladesh, Nigeria, Croatia) and calculated their average score in each aspect.

Figure 3.1

Average Opacity Scores of the Countries

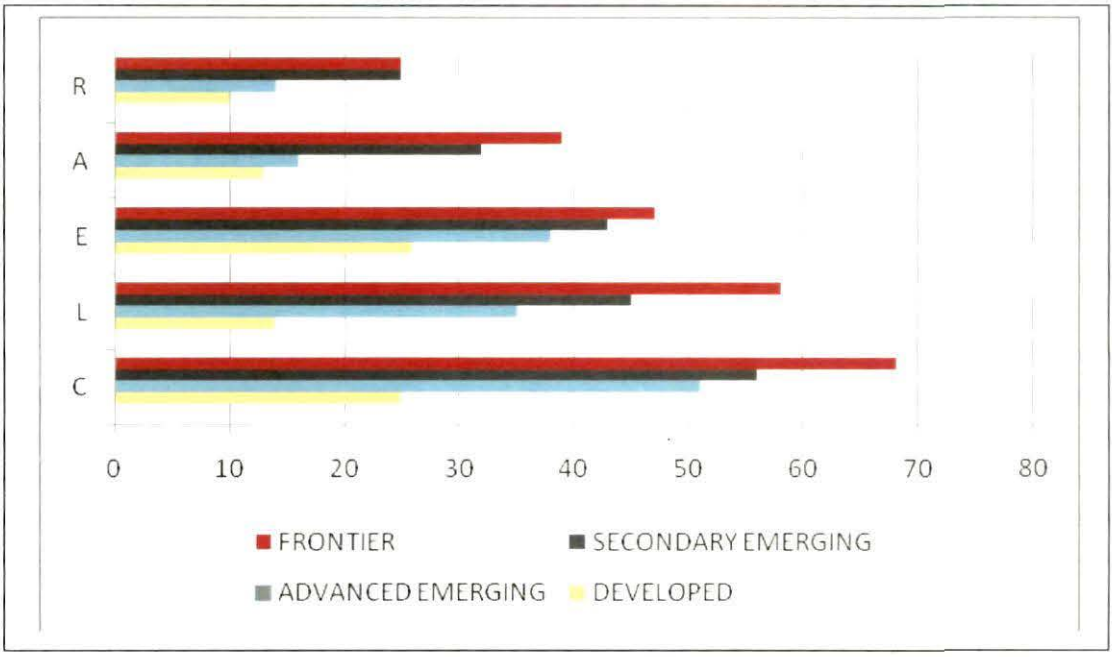


Figure compiled by the author

Above chart (Fig. 3.1) 'CLEAR'ly shows that frontier markets are risky in all respect. Level of corruption is on a sky rising high. So, are the legal inadequacies? Condition of the accounting standard and corporate governance is quite the same. Regulatory bodies are also not strong enough to curb the wrong doings. Secondary emerging markets like India, Indonesia, and Malaysia are in a slightly better position but still far away from the standard set by Developed countries like USA, UK, HongKong, Japan etc. Very low scores in each aspect clearly show the investor friendly atmosphere of those countries.

Firm regulatory bodies, good corporate governance, fairly low level of corruption are some of the pivotal factors behind the risk free nature of their capital markets. These attract more and more investors and markets become integrated to rest of the world. Advanced emerging markets like Taiwan, Mexico are in a better position than our country but the gap from developed ones are quite high.

The Opacity Index uncovers India's poor condition regarding institutional development to curb the corruption and ensure good corporate governance [it is ranking 37th among 48 countries, 2009 (Kurtzman & Yago, 2009)]. The lesson is that only by opening up the market, without a proper institutional development a country can never create investor friendly atmosphere. Absence of regulation and high level of corruption can harm the investors' confidence and this hinders the integration process as a whole.

Unlike neoclassical economics, it is not assumed that institutional frame work is given. Instead it is believed that it has to be researched; designed, arranged and constituted properly that will influence economic behavior (Rudolf, 2005). Both economic and political freedom helps to develop a competitive economy that allows market players to enjoy the benefit of being 'right', encourages free flow of capital to earn higher return thus helps unification of global financial system that ensures best uses of world resources. Hence, research on causes of segmentation is essentially an interdisciplinary study that includes work in property right, economic analysis of the law, public choice theory, constitutional economics, the theory of collective action, transaction cost economics, the principal-agent approach, the theory of relational contract, principles of comparative economic system and market efficiency paradigm. We explicitly treat that an appropriate blending of all these variables are important to decide upon the flow of capital in an economy [Rudolf 2005, Xuan and Daly 2007].

3.3 ISOLATION OF CAPITAL MARKET: SOME SYMPTOMS AND SUGGESTIONS

Frontier and emerging markets are more or less isolated. The fact is clearly evident in their lower degree of financial openness in comparison with the other developed countries.

a) TRADE INTEGRATION AND FINANCIAL INTEGRATION

We measured the ratio of trade and financial integration or openness of 9 developed and 9 developing countries (Developed: USA, UK, Germany, France, South Africa, Australia, Hong Kong, Korea, Japan Developing: India, Indonesia, Malaysia, Singapore, Philipines, Argentina, Chili, Brazil, Mexico) for the period of 14 years (1995-2008). The period after 2009 is deliberately spared as because global meltdown abnormally affected trade and capital movement of the select countries badly during that period. It is not surprising to see that average trade integration as a percentage of GDP is much higher than that of financial integration in case of developing nations like India. This indicates developing nations are not quite financially integrated as FDI and FPI flows from and within the economy are not sufficient enough despite good bilateral trade relations with the other countries. The picture is completely reverse in case of developed nations. Average financial openness as a percentage of GDP curve is moving well above the trade openness curve. This is exactly what observed by Lane & Ferretti (2003). For the industrially developed nations, both the ratios show substantial increase over the period: in the aggregate, international asset trade has grown far more rapidly than goods trade by this measure. We have also compared trade as well as financial openness, of developing countries with that of the developed countries separately (figure 3.2). In case of trade openness both the curve are moving at par during 1998-2004 period. After that developed nations' trade openness curve jumped substantially and moving quite higher than that of the developing nations. We can observe significant increase in the financial integration ratio over period of our study especially in case of developing nations, though the rate is much lesser than that of the developed countries. FIR (financial integration ratio) curve of developed nations are gradually rising throughout the period and it is always

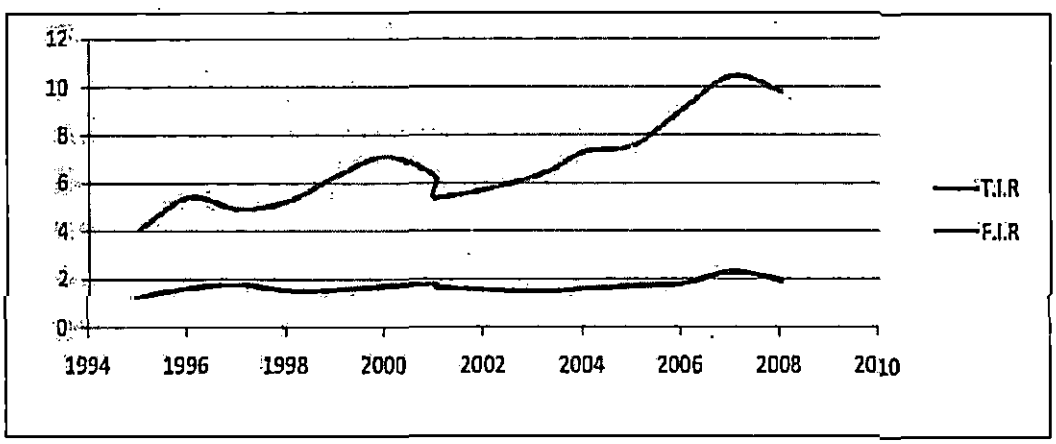
moving well above the developing nations' FIR curve. All these figures clearly explaining that developed countries are much more financially integrated than that of the developing nations and the degree of integration is increasing day by day. Emerging countries like ours are gradually moving more in the path of liberalization to reduce gap between trade integration and financial integration.

Figure 3.2

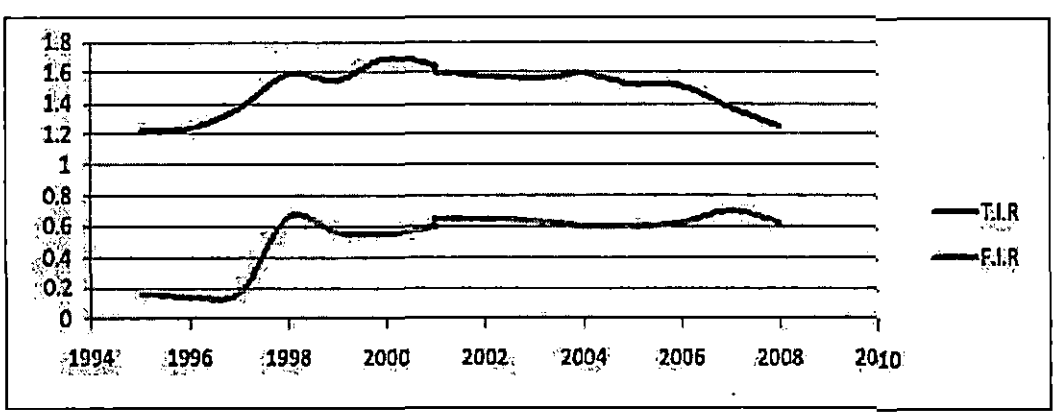
Comparative Trade Openness and Financial Openness

(1995-2008)

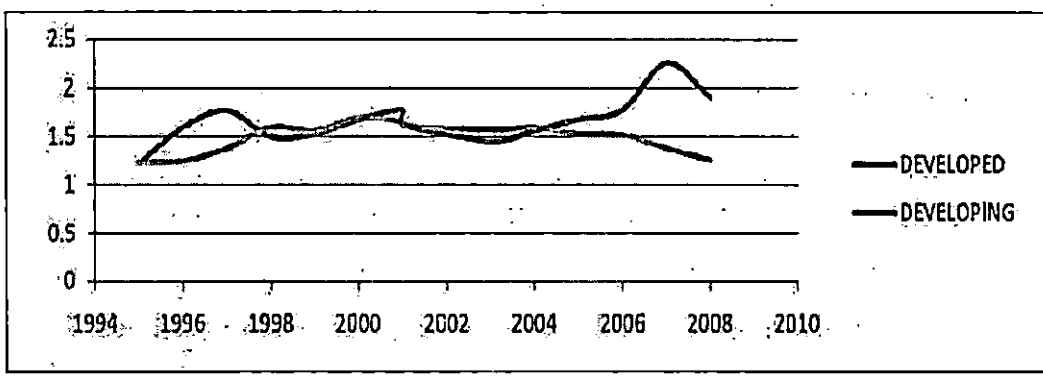
a. T.I.R and F.I.R of Developed Countries



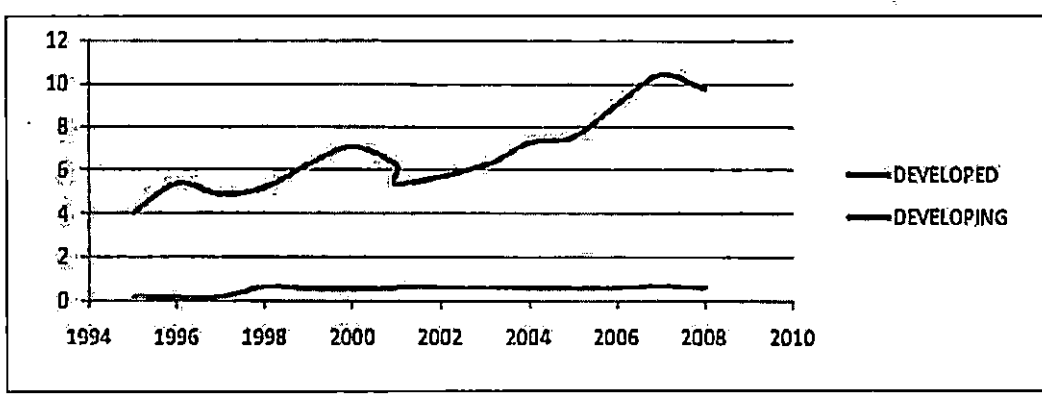
b. T.I.R and F.I.R of Developing Countries



c. T.I.R Developed Vs, Developing



d. F.I.R Developed, Vs Developing Countries



$$\text{T.I.R} = \frac{Export + import}{G.D.P}\ ;\ \text{F.I.R} = \frac{Foreign\ Asset + Foreign\ Liabilities}{G.D.P}$$

Data Source = I.F.S Statistics (2010)

Figures Compiled by the author

on the basis of the relation between the percentage change in the financial openness to GDP ratio and the percentage change in the trade openness in GDP ratio during the period 2002-2008 our findings holds good at the individual country level (Figure 3.3).

Figure 3.3

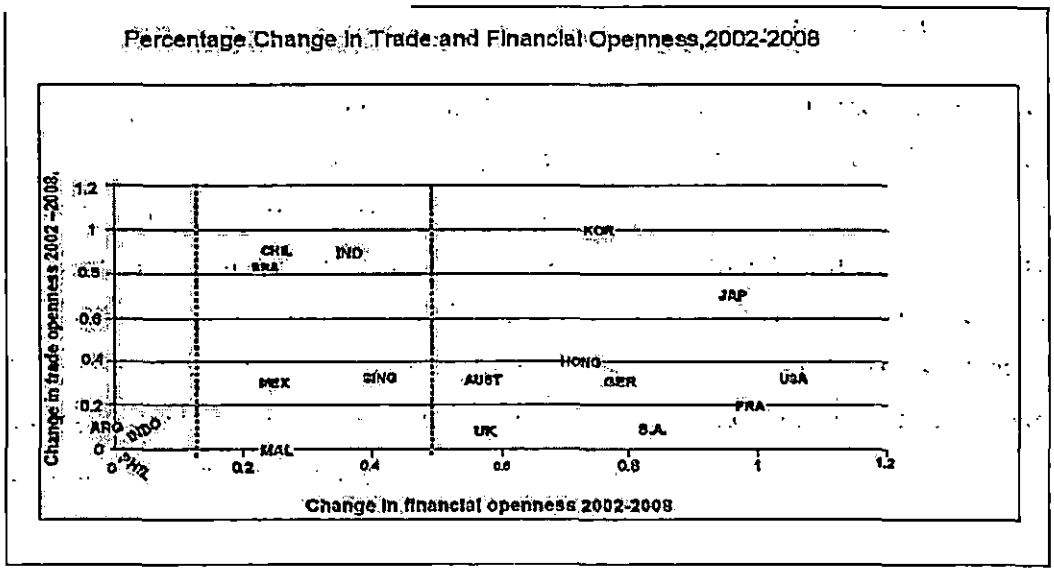
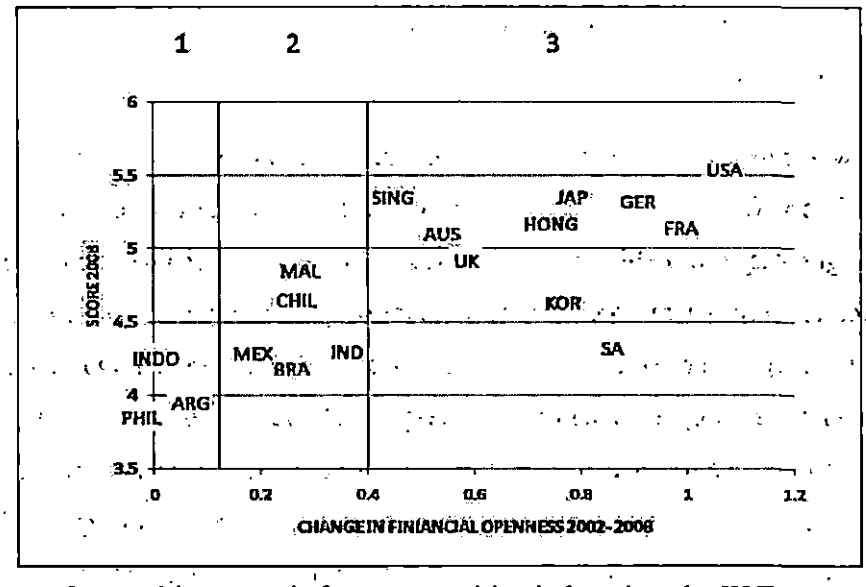


Figure compiled by the author

It is clearly evident from figure 3.3 that, for developed countries in the segment three (right hand segment in the figure 3.3), financial openness have increased more than trade openness, except Korea. In case of developing countries in the segment two (mid segment) trade integration is much higher than financial integration except Malaysia where increase in financial openness is very marginal while increase in the trade openness is zero. In case of segment one, countries which are very much emerging in nature, the increase is both direction is very nominal, next to zero, even in case of Philippines it is negative.

Figure 3.4

Competitive Score and Financial Integration



Competitive score is from competitive index given by W.E.F

Figure compiled by the author

We have compared the financial integration of the same set of countries with their competitive scores given by World Economic Forum 2008 (The World Economic Forum is an independent international organization committed to improving the state of the world by engaging business, political, academic and other leaders of society to shape global, regional and industry agendas). It is quite visible that (Figure 3.3) higher competitive score leads to greater degree of financial integration. This means, financial integration increases with the stages of development. In theory, international financial integration simply reflects financial deepening: in developed countries, financial assets and liabilities increased much faster than GDP over the past two decades, and the share of external assets and liabilities in total holdings remain unchanged. We observed that the developing nations are slowly but steadily moving towards the growth path.

3.4 CONCLUSION

Thanks to more speedy and quality of information that is available currently there is a trend of fabulous growth of both trade and financial service operations. More particularly flow of financial assets has outpaced the expansion of trade in goods and services; this trend was accompanied by some typical features below:

- Firstly, blessed with comparatively lesser informational asymmetry, investors now do not require 'the good housekeeping seal of approval' (Bordo et. al, 1998), no more prefer only rail road or government bond with assured return as it was earlier, instead preferences are tilting towards equity. Importance of government assurance 'to raise tax' and service its 'debts' is still there but popularity of equity is steadily increasing (Appendix-iv).

- Secondly, both the availability of investment alternatives and composition of portfolio have changed grossly than what it was earlier. Brilliant writings of Bordo et.al, (1998) may enrich our understanding about the dynamics of change process.

- Thirdly, ignoring geographical barrier cost of collecting information led to rise in inflow of fund in comparatively profitable emerging markets resulted increase in equity price of the countries and fall in cost of equity (Bekaert and Harvey, 2000).

- Fourthly, volatility of less efficient, disintegrated emerging market is much higher than developed markets. The extreme movement in the tail region ignoring central part of the distribution is basic attraction of foreign investors [Solnik et.al (1996)]. Targeting country and industry is the most difficult task in tactical global asset allocation to minimize risk exposure of international investment. Price to book, price to cash flow, price to earnings, momentum/ reversal indicators, long term interest rate, relative inflation growth, relative GDP, informational efficiency, rules, regulations, investment environment and quality of the market are few among many variables that are widely used to

asses expected risk and return from diversification. [Ferson et. al (1994), Frankel A.J, (1994), Millo (2007)]

- Lastly, a major precept of risk management is that risks do not add up; the risk of a portfolio is less than the risk of its individual component. Portfolio theory suggests that this risk reduction is only possible when markets are less correlated like many emerging markets.