CHAPTER III

FOREIGN PORTFOLIO EQUITY INVESTMENT

Liberalization and globalization have stimulated the development of closer financial (as well as trade) relations between developed countries and emerging markets.[1] Foreign direct investment (FDI) has become an important source of capital inflows for emerging markets since the late 1980s. Another is foreign portfolio equity investment (FPEI), which has spread to emerging markets as regulatory barriers to capital movements have fallen. By contributing or participating in the equity capital of firms, both FDI and FPEI can enhance the development of the enterprise sector in host countries. This chapter addresses trends and issues relating to FPEI flows to emerging markets. In the first section, the linkages between FDI and FPEI are analysed. The second section discusses the trends in FPEI flows to emerging markets; and the third section provides an overview of the main mechanisms through which these flows are channelled (these are elaborated further in annex C at the end of this volume). The conclusions briefly raise a number of issues relating to FPEI that require further in-depth analysis.

A. Linkages between foreign direct and portfolio investment

In principle, FPEI is distinguished from FDI by the degree of management control that foreign investors exercise in a venture: portfolio equity investors usually provide only financial capital by purchasing shares of a company without any involvement in the company's management. Foreign portfolio equity investment typically has a shorter investment horizon than FDI, sometimes just a few weeks or months, although this horizon can extend to ten years or more. The type of investor is also different: while FDI investors are firms engaged in the production of goods and services, portfolio equity investors are more often either financial institutions, institutional investors (such as pension funds, insurance companies or investment trusts), or individuals, and are typically interested only in the financial returns of their investments.

In practice, these distinctions are often less than clear-cut and are subject to a number of qualifications:

- The ownership threshold commonly used to distinguish FDI and FPEI is somewhat arbitrary. An investment is normally counted as FDI when it involves an equity capital stake of 10 per cent or more of the ordinary shares in an incorporated enterprise, or its equivalent for an unincorporated enterprise. This is held to indicate a lasting interest in, or a degree of control over, the management of the enterprise (IMF, 1993). An equity stake of less than 10 per cent is categorised as foreign portfolio equity investment.

  However, minority-share purchases can in some circumstances involve direct management participation, and in some cases lasting management control can take place with a less than 10 per cent equity stake (as recognized by the IMF and OECD definitions of FDI). In the case of Japan, for example, Japanese companies sometimes hold less than 10 per cent of the shares of foreign suppliers of raw materials, but still have representation on the foreign company's board of directors and maintain a long-term business relationship with these companies.

- The role of venture capital investors. These provide equity capital for young unquoted companies, often at the start-up stage, and are often very closely involved in managing them, either directly or indirectly, by providing advisory services. Although their overriding motive is to achieve a capital gain, venture capital investors often wait several years before selling their equity stakes.

- Data constraints. Only a few countries (including major source countries, such as OECD members) have systematically recorded equity capital flows in their balance-of-payments accounts under categories that distinguish FDI from FPEI. The lack of accurate data on cross-border FPEI flows is a serious handicap for analysis. The recent nature of FPEI flows to emerging markets poses an additional challenge. A special effort is therefore made here to use data from a variety of sources: host countries,[2] home countries and international financial institutions (box III.1).

Flows of FPEI normally take place through transactions involving shares of companies quoted in stock markets, although some FPEI flows also take place in unquoted companies (for example, in the case of venture capital funds). The contribution of FPEI to the financing of domestic enterprises can be significant (box III.2) . It is most direct when the investment is made in the market for primary issues, in the local stock market, or in international markets through international equity offerings or issues of depositary receipts. Share purchases in the local secondary market contribute indirectly to the financing of local firms by pushing up equity prices and thus lowering the cost of raising capital in the stock market, thereby encouraging new equity issues. Furthermore, FPEI may increase the liquidity of the local stock exchange, bringing benefits to other segments of the capital market, such as the bond market, and increasing the volume of finance available for both local firms and foreign companies established in a country. Consequently, FPEI can help strengthen the local financial infrastructure, which can facilitate the operations of TNCs. An efficient financial system can also contribute to attracting FDI. At the same time, as FPEI finances in part the capital requirements of local companies, it can also increase the competitiveness of these companies. Although portfolio investors are attracted in the first place by "blue-chip" companies in emerging markets, investors also seek opportunities to take advantage of "price anomalies" by investing in companies that appear to be undervalued on the basis of, for example, the price-earnings ratio. These need not necessarily be blue-chip companies; they can be companies with high growth potential. Foreign investment can ease the access of these companies to capital markets and reduce their cost of capital investment.

Flows of FPEI are intimately linked to the development of stock markets in recipient countries. Many venture-capital fund investments in unquoted companies are made with the expectation of reaping capital gains subsequent to the listing of such companies on the stock market once they become mature. Likewise, some country funds are set up in developing countries in anticipation of the establishment of a local stock market. With regard to mergers and acquisitions, there is a close relationship between FDI and FPEI. In many cases, cross-border mergers and acquisitions are considered as FDI transactions because they confer a lasting and significant management interest in the merged or acquired company. However, it is possible for such transactions to take place with a minority equity interest, in which case the transaction would be recorded as a FPEI flow.

There is a partial overlap in the motivations underlying FDI and FPEI. For both types of investment, the rate of economic growth (as well as potential rate of growth) of the host country are an important influence on decisions on where to invest. For efficiency- or asset-seeking FDI, however, this element may be of lesser importance. For instance, in the case of FDI made with the intention of

Box III.1. Data on FPEI

There is no single perfect source of data on FPEI flows. Because of the variety of instruments through which such investments can be made, and their increasingly global nature, few individual countries have reliable and accurate statistics on FPEI flows. At the global level, in particular, the accurate tracking of these flows remains a challenge.

There are several commonly utilized sources of data on regional and global FPEI flows. The World Bank reports its estimates annually in *Global Development Finance* (formerly entitled the *World Debt Tables*), and the IMF does likewise in its *Balance of Payments Statistics Yearbook*. The World Bank publishes only FPEI data on emerging markets, while the IMF also includes data on FPEI in developed countries. The report on cross-border capital flows produced in the past by Baring Securities has also been a frequently referenced data source; this report will in future be published by Cross Border Capital. The World Bank defines FPEI as the sum of country funds, depositary receipts (American and Global) and direct purchases of shares by foreign investors. The data on these three sources of FPEI are based on information from a number of sources, including Euromoney databases and publications; Micropal Inc.; Lipper Analytical Services; published reports of private investment houses, central banks, national securities commissions and national stock exchanges; and the World Bank's Debtor Reporting System. The IMF reports balance-of-payments data received from its member countries. The magnitudes published by these three sources are different due to the differences in methodologies utilized in producing the data.

In light of the limitations in utilizing balance-of-payments data, the data used here are from the World Bank, which appear to be the most comprehensive available at this time. Inputs from actual market sources of data give some assurance that these data represent reasonably reliable and comprehensive estimates of actual FPEI flows.

An alternative method of producing estimates for FPEI flows is to use consolidated data from home (as opposed to host) countries. The most important sources of this type of investment are the United States, Japan and the United Kingdom. This, however, has proven difficult because Japanese authorities have only recently begun to record geographically disaggregated FPEI data, while authorities in the United Kingdom do not provide disaggregated data at all. The United States Treasury Department, however, maintains a detailed data set, which is used in this chapter. Five major recipient countries have also provided relatively detailed information, which is also used here.

Source: UNCTAD, based on World Bank, 1997b and IMF, 1996b.

Box III. 2. Financing of domestic enterprises in Malaysia and Thailand

Information on new capital raised by domestic enterprises and FPEI flows into two emerging markets, Malaysia and Thailand, has shown that FPEI has played an important role in the financing of enterprises through the local stock market (box table).

Box table. New equity issues and FPEI inflows in Malaysia and Thailand, 1993-1995
(Millions of dollars)

Country	1993	1994	1995
Malaysia			
New equity issues	1566.4	3383.6	5237.5
FPEI flows	8938.7	4289.6	1150.0
Thailand			
New equity issues	..	4905.8	5294.8
FPEI flows	2681.8	408.1	2118.8

Source: UNCTAD, based on International Federation of Stock Exchanges, 1994 and 1995.

In Malaysia, FPEI exceeded the amount of capital raised through new equity issues in 1993 and 1994, implying that part of that investment was made in the secondary market. In 1995, however, FPEI was about a fifth of the total amount of capital raised. In Malaysia, FPEI flows exceeded FDI flows in 1993. In Thailand, such flows have been lower than capital raised from new equity issues and represented about 40 per cent of all capital raised in 1995. In Thailand, FPEI flows have exceeded FDI flows in 1993 and 1995.

Market capitalization and growth potential are important factors in determining the overall magnitude of FPEI. Not surprisingly, countries with high ratios of market capitalization to GDP have attracted stable FPEI inflows. Indeed, such inflows have been an important source of financing of domestic enterprises in these emerging markets.

Source: UNCTAD, based on International Federation of Stock Exchanges, 1994 and 1995.

rationalizing production or establishing an export base, the cost and skill level of the labour force, the state of physical and communications infrastructure, the host country's geographical location (distance to target markets), as well as the existence of free trade agreements between the host country and target markets that facilitate market access, may be of greater importance than the host country's growth rate (UNCTAD, 1993a). For market-seeking FDI, the size and economic growth of the market are particularly important determinants (UNCTAD, 1993a). Host-country market size, however, does not appear to be the most important determinant of FPEI flows. In a survey of international equity investment funds recently conducted by UNCTAD,[3] the potential rate of economic growth was identified most frequently as being highly important in investment decisions. Market size can have, however, an indirect influence in so far as the size of stock market capitalization, and hence its degree of liquidity, is in many cases related to the size of the economy.[4] Political stability is also important for both FPEI and FDI; the same is true for the degree of volatility of exchange rates. For portfolio equity investors, the level of ease of capital repatriation and disclosure standards for companies operating in the local market appear to be very important. Typically, FDI does not attach an equally high degree of importance to the latter.

These differences highlight a major contrast between the investment motivations for FDI and FPEI. The overriding motivation for investment by portfolio equity investors is their participation in the earnings of local enterprises through capital gains and dividends. Hence, it is more important for them that capital be easily transferable and that disclosure standards be high. Transnational corporations tend to be more interested in accessing markets and resources and, more generally, in the contribution that the investment can make to the competitiveness of the transnational corporate system as a whole (UNCTAD, 1995a). The latter concern is particularly important for firms that have integrated international production structures and have an intra-firm specialization in production. In general, TNCs tend to have a longer-term investment horizon than portfolio equity investors, especially when their investment involves a capital outlay (in the case of greenfield investment, for example).

The contrast in motives between TNCs and portfolio equity investors is not, however, always so stark. In particular, the investment horizon of venture capital investment tends to be somewhat longer than for FPEI in general, and the existence of significant (and perhaps also long-term) management control is not unusual. In that case, it is very difficult to differentiate between FDI and FPEI. However, the principal underlying motives remain different. For venture capitalists, the foremost motivation is to share in the capital gains of the equity of a local enterprise when it is listed eventually on the stock exchange. The stock exchange acts as a mechanism through which venture capitalists "exit" the investment. Thus, venture capitalists, while closely affiliated with the management of the enterprise in question, are also focused for the duration of their investment on their eventual exit. Venture-capital investments, therefore, represent a case in which the linkage between FDI and FPEI can be quite strong.

The discussion above helps to illustrate why FPEI flows are more volatile than FDI flows. Since the prime motivations behind the two types of investment are mostly different, so are the investment horizons. Typically, it is easier for portfolio equity investors to liquidate their investments by selling their equity positions in the secondary securities market than for TNCs to sell their foreign affiliates, especially if these are intertwined in international production networks or "sunk" costs are high. The volatility of FPEI flows may, however, vary with the type of mechanism through which an investment is made. In particular, venture-capital portfolio investment is less volatile than some other types of FPEI flows. Similarly, investments placed through large institutional investors (e.g., via country funds) appear to be less volatile than portfolio investments made directly in the local market; portfolio equity investments through closed-end investment funds[5] appear to be less volatile than investments placed by open-end investment funds (for reasons examined below).[6] Investment flows in the secondary market for depositary receipts do not affect the flow of funds in or out of the local stock market because trading activity is conducted on foreign stock exchanges. Thus the issue of volatility of FPEI flows does not arise in this case. Direct portfolio equity investment in the local stock market is probably the most volatile form of FPEI, particularly when such investments are managed by retail investors, who tend to invest more speculatively, and do not have access to the sophisticated investment methods or the extensive information and resources for research typically available to large institutional investors.

Overall, total FPEI flows to emerging markets have fluctuated more widely than total FDI flows during the period 1986-1995 (annex table A.11). This is indicated by the greater relative variance of FPEI flows compared with FDI flows - - four times that of FDI flows.[7] Evidence at the country level also shows that FPEI flows are more volatile than FDI flows, although the degree of volatility may be influenced by the extent of domestic macroeconomic instability (box III.3). For example, in

the five emerging markets for which fairly detailed data on FPEI flows have been obtained, the relative variance of these flows is many times higher than that of FDI flows (annex tables A.12 through A.16).

Box III.3. Volatility of FPEI flows and macroeconomic instability in Malaysia, South Africa, Thailand, Turkey and Venezuela

The volatility of FPEI flows tends to be higher in countries with high levels of macroeconomic instability. (Although causality could operate in either direction, it appears that, in general, the variability of FPEI flows reflects actual or expected macroeconomic instability.) Ranking Malaysia, South Africa, Thailand, Turkey and Venezuela according to the degree of domestic macroeconomic instability (based on the level of inflation and the variability in exchange rates) (annex table A.17), and comparing that ranking with a ranking of the degree of volatility in capital flows in general, and in FPEI in particular, shows a correspondence between the two rankings. Turkey, Venezuela and South Africa have experienced high volatility in these macroeconomic indicators (in descending order of degree of volatility), while Thailand and Malaysia have experienced relatively low levels of volatility in these indicators. Turkey and South Africa, followed by Venezuela, have also experienced higher volatility in capital flows in general, and in FPEI flows in particular (South Africa first, followed by Turkey and Venezuela).

Source: UNCTAD.

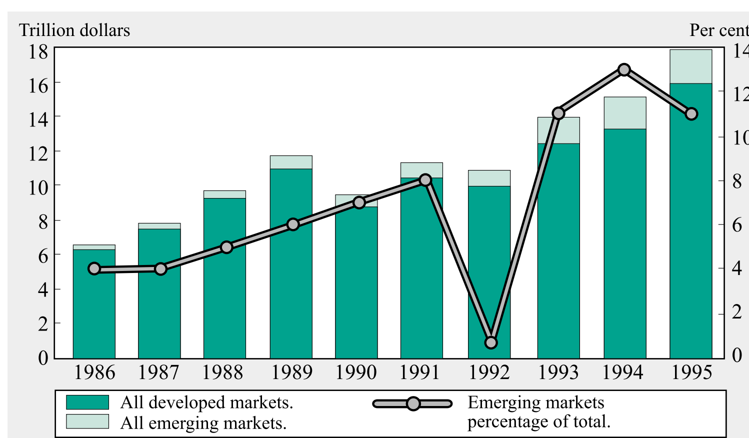
B. Trends

1. General trends

Substantial FPEI flows into emerging markets is a relatively recent phenomenon, dating from the early 1990s. A watershed was reached in 1993, when the level of FPEI trebled, compared with a year earlier (annex table A.11). Flows declined in 1994 and 1995, partly in response to the financial crisis in Mexico in December 1994. However, they recovered in 1996: the volume of new equity raised on international capital markets in 1996 by emerging markets increased by 34 per cent over 1995, reaching some $15 billion (World Bank, 1997b, p. 18).

Between 1986 and 1995, emerging stock market capitalization grew more than tenfold -- from $171 billion to $1.9 trillion -- a much faster pace than that in developed markets (figure III.1). As a result, emerging markets' share of world stock market capitalization increased from nearly 4 per cent as of end-1986 to nearly 11 per cent as of end-1995. By the end of 1995, over 17,000 companies were listed and

Figure III.1. Emerging markets share of world market capitalization, 1986-1995
(Trillions of dollars and percentage)



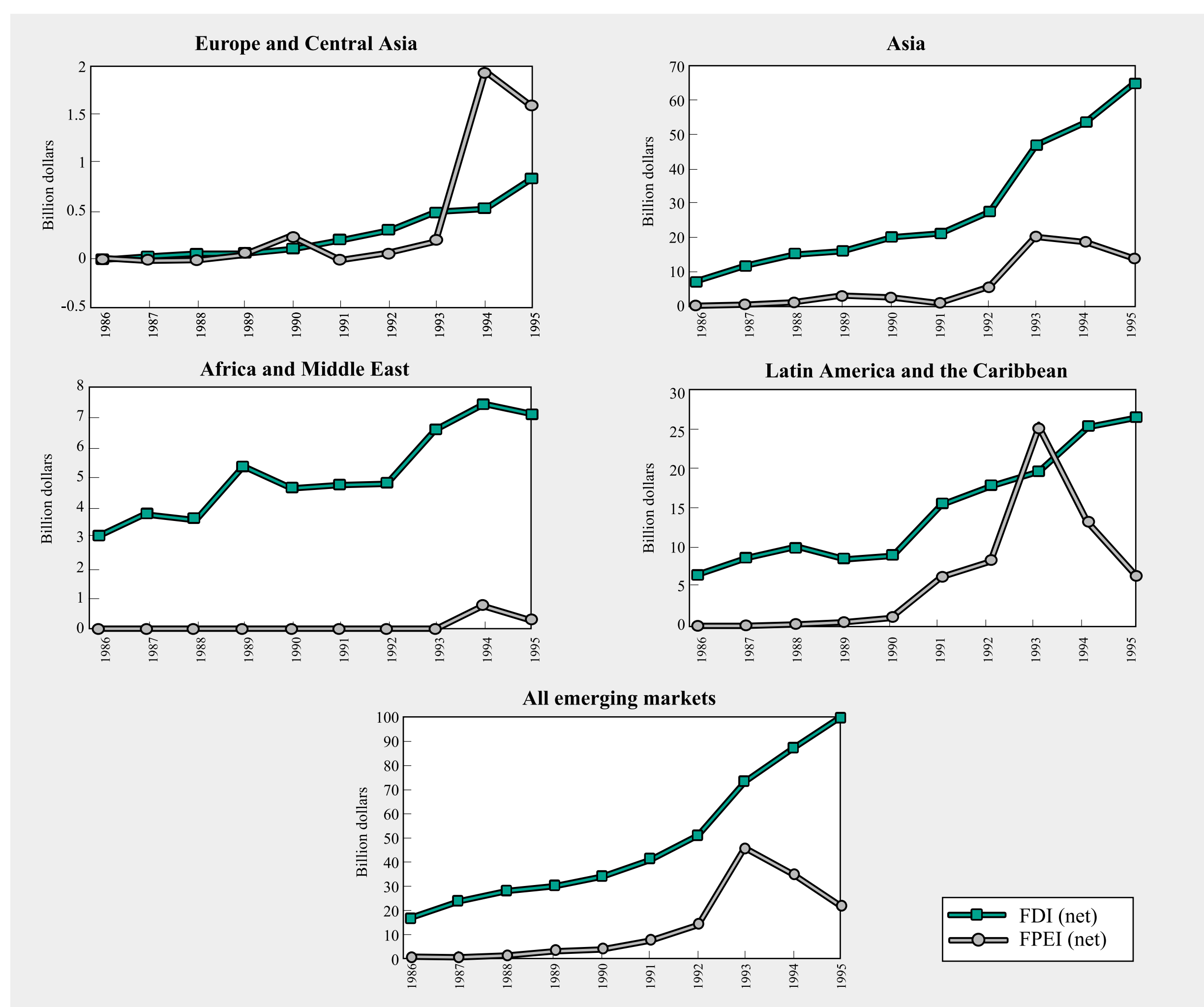
Source: International Finance Corporation, 1996.

traded in emerging capital markets - - the equivalent of about 90 per cent of the number of companies listed in developed-country markets.

The aftermath of the financial crisis that hit Mexico at the end of 1994 and spread for a short period to other emerging markets illustrates the resilience of emerging markets. Countries with a large domestic financial sector and a broad domestic savings base recovered especially quickly from the crisis. Thus, an analysis of the impact of the Mexican crisis on the performance of 26 emerging stock markets other than Mexico shows that it has been significant beyond December 1994 for only four countries (Atlan *et al.*, 1996).[8] Of these four countries, two are in the same region (Brazil and Colombia) and two have gone through domestic turbulence that has weakened their domestic financial sectors (Pakistan and Hungary).

A closer look at recent trends in FPEI flows in the two main recipient regions, Asia and Latin America (flows to Africa and to the emerging markets of Europe and Central Asia are relatively small) (figure III.2), reveals some similarities in the movements of these flows. Between 1992 and

Figure III.2. Evolution of FDI and foreign portfolio equity investment in emerging markets, 1986-1995



Source: data from annex table A.11.

1993, flows to both regions increased substantially -- by 560 per cent in Asia and 230 per cent in Latin America. In 1994, they decreased by 2 per cent in Asia and 51 per cent in Latin America. In 1995, however, FPEI flows increased slightly (by 4 per cent) in Asia, and decreased (by 45 per cent) in Latin America.

The two major factors behind the increase in FPEI flows to emerging markets are the liberalization and globalization of financial markets and the concentration of substantial financial resources in the hands of institutional investors. The globalization of financial markets implies that financial capital can move more freely and at lower cost between countries. This has been facilitated by financial-market liberalization and by the rapid flow of market information made possible by improvements in communications technology. Investors are thus in possession of the tools and information that allow them to move funds quickly between different countries and regions of the world. They have also been willing to take more risk because they expect higher returns in new and fast-growing emerging markets. Between 1988 and 1995, there was a significant increase in the number of emerging markets establishing liberal regimes towards foreign investment. In 1988, only three emerging stock markets were classified by the International Finance Corporation as "free" with respect to foreign investment in stocks listed locally; eleven markets were categorized as relatively free (annex table A.18). By 1995, 26 emerging markets were classified as free, 11 markets as relatively free, and only one market was closed to foreign investment.

The second major factor responsible for the surge in FPEI flows to emerging markets is the institutionalization of savings and investments in developed countries. It has been estimated that insurance companies, pension funds and mutual funds in developed countries (and some emerging markets) had an identifiable pool of savings worth nearly $21 trillion in 1993 (Howell *et al.*, 1995, p. 58).[9] It is also estimated that the six largest developed countries are holding around $38 trillion in savings. These figures, although not strictly comparable, provide a very rough indication of the heavy concentration of developed-country savings under the management of institutional investors. In comparison, global equity market capitalization in the same year was $14 trillion. Investment by developed-country mutual funds in emerging markets has been particularly important (annex table A.19). However, by one estimate, the average share of emerging market securities in institutional investors' portfolios is only around 1 per cent (IMF, 1995, p. 172). In general, institutional investors in developed countries are biased in favour of investments in domestic assets, mainly because they are risk averse or lack familiarity with foreign economies and financial markets, although this is beginning to change. Hence, a very small shift (in percentage terms) in their investment portfolios in favour of emerging markets would result in a substantial increase in the volume of FPEI flows to these markets. There is a high correlation between FPEI flows in emerging markets and interest rates in developed countries (for example, interest rates of United States Treasury Bills).[10] Indeed, low returns on financial investments in developed markets during 1993 induced a surge in FPEI flows into emerging markets in that year.

The trend of rising FPEI flows during the 1990s (compared with the 1980s) appears to be a longer-term structural phenomenon, rather than a cyclical one. This can be explained by the fact that growth remains higher in emerging markets than in developed ones, with the former offering good opportunities for diversification of portfolio-investment risks. Even though there has recently been a strong upturn in developed-country capital market performances, especially in the United States in 1996, FPEI flows to emerging markets have remained strong. There are indications that investors are exploring new frontiers of investment,[11] and that the volume of international equity offerings by companies from emerging markets is increasing.

2. Trends in outflows to emerging markets from the principal source countries

It is estimated that, over the period 1992-1994, more than 35 per cent of FPEI flows to emerging markets originated in the United States, 15 per cent in Japan and 11 per cent in the United Kingdom (Howell *et al.*, 1995). In recent years, investors from Hong Kong and Singapore have also invested in emerging markets.

For the most important of these source countries, the United States, FPEI flows to emerging markets increased substantially in 1993, but decreased in 1994 and 1995 (annex table A.20). They rose again in 1996, despite a clear upturn in stock-market returns in the United States.[12] Overall, FPEI flows from the United States were hosted by over 39 emerging markets.[13] However, the majority of funds (89 per cent of the total in 1995) have been placed in a handful of countries with large equity markets: Argentina, Brazil, Chile and Mexico in Latin America; China, India, Indonesia, the Republic of Korea, Malaysia and the Philippines in Asia; and South Africa. The same group of countries accounted for 69 per cent of United States FDI outflows to emerging markets in 1995. The degree of concentration of FPEI flows in a few emerging markets is therefore higher than that in FDI outflows, at least for the United States.

By comparison, the distribution of the total net assets of international emerging equity funds indicates that country equity funds have been established for only 35 emerging markets (annex table A.19). This does not, however, imply that only 35 emerging markets have hosted international equity fund investments. The actual number could be significantly higher if investments placed via regional and global equity funds are included. Nevertheless, almost the same group of emerging markets (Brazil, Chile, China, India, Indonesia, the Republic of Korea, Malaysia, Mexico, the Philippines, the Russian Federation, Taiwan Province of China and Thailand) has attracted the lion's share of equity funds.

It is not surprising that the distribution of FPEI is skewed towards upper-middle income and large low-income countries with a high growth potential. These countries have dynamic securities markets that offer a broad base for investment. Investors often claim that, besides the level of risk-adjusted returns, the degree of market liquidity is a crucial element in the decision to invest in emerging markets. In this respect, an adequate market infrastructure and the availability of exit mechanisms (through stock exchanges) contribute to greater liquidity. More mature markets also tend to offer a superior level of regulation regarding information-disclosure and accounting standards.

C. Investment mechanisms

There is a large variety of mechanisms through which FPEI flows are channelled. The principal mechanisms are venture capital funds, country funds, American depositary receipts and global depositary receipts, convertible bonds and bonds with equity warrants. Some mechanisms are more suitable to a particular stage of development of an emerging market than others. Furthermore, the credit standing of companies issuing equity shares also influences the level of their access to particular segments of the international capital markets. Countries may prefer to channel FPEI inflows through specific mechanisms in order to protect their markets from externally induced turbulence.

1. Venture capital funds

Since the late 1980s, many specialized venture capital institutions have been formed to invest in emerging markets. Many are structured as two-tier investment funds, with management provided by professional fund managers from international capital centres (see annex C for technical details). While venture-capital institutions have been established in many countries, including several least developed countries (e.g., Bangladesh, Madagascar, Mozambique and Uganda), they have expanded fastest in the newly industrializing economies of Asia and the transition economies of Central and Eastern Europe. The major trends in venture-capital funds are:

- The pool of investable venture capital funds in South and East Asia outside infrastructure has increased rapidly over the past ten years, from an estimated $500 million to $6 billion. Several major regional and international financial institutions, including the Hongkong and Shanghai Banking Corporation, the Development Bank of Singapore and AIG Investment Corporation (Asia), have established venture capital or private equity funds.

- There has been a similarly rapid expansion of venture capital financing in Central and Eastern Europe. The number of venture capital funds investing there is estimated to have reached 72 by 1995, with a total committed capital of about $4.5 billion. The European Bank for Reconstruction and Development has supported actively the creation of equity funds in the region.

Over the past two decades, the International Finance Corporation has promoted venture capital funds in developing countries in an effort to improve the access of small and medium-sized firms to equity finance and management expertise. The International Finance Corporation has worked with institutional investors, investment banks and fund managers in structuring funds, identifying fund managers and placing funds. By 1996, it had invested $196 million in 49 venture capital funds, with a total initial capital of $1.5 billion.[14]

The Commonwealth Development Corporation has also expanded its venture capital activities in developing countries, in particular by promoting venture capital funds, in order to provide start-up capital to companies in eight African countries (Ghana, Kenya, Mozambique, South Africa, Tanzania, Uganda, Zambia and Zimbabwe). These funds are generally smaller ($10-$15 million) than those in which the International Finance Corporation has invested, and are managed directly by the Commonwealth Development Corporation.

However, the experience of venture capital investors in developing countries to date has been mixed. It is clear that their success, and willingness to continue investing in emerging markets, depends on a number of basic conditions being met. These include: finding enough firms with business management skills and offering prospects of high returns on investment; attractive tax regimes in host countries; and the availability of "exit" options for disposing of investments.

2. International equity investment funds

By pooling the investable funds of a large number of small investors, international investment funds provide economies of scale that can lead to lower average transaction costs of entering foreign markets directly (such costs can be prohibitive for small investors). They offer investors both

professional portfolio services and diversification of risks. These funds can invest on a global, regional, subregional or individual country basis. They can also be structured either as closed-ended or open-ended (see annex C for technical details).

From 1986 to 1996, the total number of international emerging equity market funds grew from 28 to 1,435, while the net asset value of these funds increased from $2 billion to $135 billion (annex table A.19). Of the total number of international equity funds as of September 1996, 298 were global funds; 775 were dedicated to Asia; 239 to Latin America; 88 to emerging Europe; and 35 to Africa and the Middle East. Asian funds accounted for the largest share of total net asset value of emerging market equity funds (48 per cent), followed by Latin America (11 per cent).

The International Finance Corporation has been a leading sponsor of many closed-end funds investing in emerging market securities. Closed-end funds are also established by investment banks, investment management firms, host-country governments, and groups of individual investors. There has been an evolution recently towards specialized funds, such as debt-equity conversion funds, index funds, corporate debt funds and sectoral funds (such as infrastructure funds). Closed-end country funds were initially set up to invest in countries that were largely closed to foreign investment (for example, the Korea fund, launched in 1984), or in countries in which foreign investors have found it difficult to invest for administrative reasons. Since the first emerging market fund, the Mexico fund, was launched with a listing on the New York Stock Exchange in 1981, closed-end funds have become the dominant form of vehicle for less-mature emerging market investments.

3. American depositary receipts and global depositary receipts

American depositary receipts are negotiable certificates issued by a commercial bank in the United States known as a depositary. They certify the ownership of non-United States companies' securities that have been deposited with either the depositary bank handling the issue (the depositary) or with the depositary's custodian bank abroad (see annex C for technical details).

The market for depositary receipts has grown rapidly during the 1990s, due in large part to increased emerging-market issuance activity. According to the Bank of New York, a total number of 10.7 billion depositary receipts with an overall value equivalent to $337 billion were traded in 1996 on United States securities exchanges; in addition, an estimated 1.5 billion depositary receipts with a value between $20 and $25 billion were traded on European exchanges, or on the "over-the-counter" market. Between 1990 and 1996, the compounded annual growth rate of trading in depositary-receipt shares was 30 per cent, while in value terms trading increased by 22 per cent. The total number of depositary-receipt programmes in existence at the end of 1996 exceeded 1,600 and included issues from 63 countries. Non-United States companies are reported to have raised $19.5 billion through depositary-receipt issues in 1996. This represents an increase of 63 per cent in the value raised and 50 per cent in the number of new issues over 1995. Emerging markets accounted for approximately 50 per cent of new issues in 1996, rising from 20 per cent in 1995.

4. Convertible bonds and bonds with equity warrants

Convertible bonds and bonds with equity warrants are hybrid debt securities that contain equity-related features (see annex C for technical details). For the issuing companies, the major advantage of issuing convertible debt may be that it enables them to attract financing which might otherwise be more difficult to attract, and that it may allow a better matching of cash flows in the

early growth period of the company when financing may be particularly crucial. Generally, the rights attached to these instruments will only be expected to be exercised in the event that the company is successful and its market value and share price rises.

Emerging market issues of equity-related bonds have risen quite quickly during the past ten years (annex table A.21). During that period, emerging-market issues grew at an annual average rate of 192 per cent, compared with 21 per cent for developed countries and 23 per cent for all markets. However, the size of emerging-market issues is small. During the past ten years, a total of $374 billion of these securities were issued, of which emerging markets accounted for only 4 per cent ($16 billion); developed countries accounted for the rest. Nevertheless, the growth in emerging market issues of these instruments coincides with the start of heavy institutional-investor interest in emerging markets.

Most emerging market equity-related bond issues (84 per cent of the total) have been floated in the Eurobond market. This has been the case especially with respect to issues of bonds with equity warrants. A relatively small volume of issues has been floated in the market for foreign bonds (bonds which are offered in one particular country and are denominated in the currency of that country). Emerging-market countries have been more active in the market for convertible bonds than in the market for bonds with equity warrants. The former accounted for 93 per cent of total emerging-market issues of equity-related debt instruments during the past ten years, whereas for developed economies convertible bond issues comprised only 32 per cent of the overall value of equity-related bond issues. The issuance of bonds with equity warrants is also a more recent trend in emerging markets than is the issue of convertible bonds (bonds with equity warrants were first issued in 1989 in emerging markets, while convertible bonds have been issued since 1985). On a regional basis, eight countries from Asia have dominated issuance activity (of equity-related bonds) among emerging markets. Asian issues of convertible bonds have, on average, accounted for 81 per cent of all emerging-market convertible bond issues, and for 85 per cent of emerging-market issues of bonds with equity warrants. Emerging markets in Latin America, on average, accounted for 4 per cent of all emerging-market convertible bond issues and 15 per cent of issues of bonds with equity warrants.

D. Some issues raised by FPEI

The policy implications of the growth of FPEI, especially for development, are not yet fully grasped. Although FPEI investors can provide a welcome source of external finance for domestic companies, their generally short-term investment horizon (especially when compared with FDI investors) raises concerns over the stability of such flows.

Flows of FPEI contribute most directly to the capital formation of companies in emerging markets through the subscription of primary issues. Even if a foreign investment is made in the secondary market, it can contribute to enterprise development through the reduction of the cost of capital by boosting the stock index and thus encouraging companies to go public, or to launch new equity issues. At the outset, there is some indication that a large part of FPEI flows to emerging markets is directed towards the secondary market (Howell *et al.*, 1995).[15]

Against this beneficial contribution, concerns have been raised with respect to the perceived volatility of such flows and its potential negative impact on domestic economies. Some unresolved issues that need to be addressed are:

- Does liberalization increase the exposure of emerging markets to potentially higher degrees of equity price instability or to speculative attacks, including potential contagion from disturbances originating in other markets?

- Are there policies or mechanisms that could be implemented in order to allow emerging markets to withstand better potential volatility in FPEI flows?

- Are the causes of stock market volatility in host emerging markets more the result of elements internal to the local market or of external events?

- In view of the pressure on institutional investors to secure capital gains, what distortions might this introduce into investment choices in emerging markets?
- What measures can be taken to reduce stock market volatility? Does an enlargement of the domestic-investor base, notably through the strengthening of the role of institutional investors, help to reduce such volatility?

* * *

Foreign portfolio equity investors contribute to the equity financing of local companies and do not generally seek management control of these companies. This is perhaps the most distinctive feature of FPEI, as compared with FDI. Emerging markets have begun to host substantially increased FPEI inflows during this decade. In absolute terms, these flows now represent an important class of foreign capital in these countries in their own right. Such flows may rise further, given the continuing liberalization and globalization of financial markets and continued superior growth performance in emerging markets in comparison to developed countries, along with relatively fast rising market capitalization in the former group.

In light of this trend, it is important to identify the potential impact of FPEI flows on host countries' economies and the policy implications resulting therefrom. In particular, it would be useful to analyse the causes (and their direction) of volatility in these flows and their likely impact on the financial sector and the real economy in host countries, especially developing ones.

Notes

1 The term "emerging markets" is used here to denote developing countries and transition economies in Central and Eastern Europe. This chapter follows a methodology similar to that used by the International Finance Corporation in classifying as an emerging market any country with a 1994 GNP per capita level of $8,955 or less (this includes countries classified by the World Bank as low- and middle-income). The group of countries so defined includes several countries that in other chapters are considered as developed (such as Greece and Portugal) and excludes several economies that are considered as developing elsewhere in this volume (such as Hong Kong, China and Singapore). For a more complete listing of countries comprising emerging markets, see IFC, 1996.

2 Only a small number of countries have replied to UNCTAD's questionnaire on FPEI. Data for these countries are used here.

3 A survey of international emerging market equity fund managers was conducted by UNCTAD in January 1997 in order to determine what elements they considered to be most important in making investment decisions at the country level. The survey found the potential rate of economic growth to be the factor most frequently cited as being important to investment decisions. The degree of ease of

capital repatriation and the existence of a favourable environment for foreign investors were second most frequently mentioned, followed by disclosure standards. Other factors frequently identified as being important include political stability, the existence of a good settlement system, the comprehensiveness of securities market regulation, the degree of securities market liquidity and the soundness of the local currency (or the degree of volatility in the exchange rate).

4 Market size is perhaps also relevant indirectly because larger markets tend to have better developed capital markets, greater market capitalization and a wider array of investment opportunities. In less-developed emerging markets in which total capitalization is especially small, market size may become a constraint on FPEI by some large institutional investors that tend to invest in large blocks.

5 For a discussion of closed- and open-end funds, see annex C, section 2.

6 According for the IMF (IMF, 1995, p. 172) "Turnover ratios for open-end funds vary widely. Index funds, for instance, typically have low turnover ratios, whereas actively managed funds often have turnover ratios above 100 per cent, and many "aggressive" funds have turnover ratios of several hundred per cent. The average open-end fund has a turnover ratio of about 100 per cent. Closed end funds typically have turnover ratios below 50 per cent, and often in the neighbourhood of 20 per cent."

7 The relative variance, one measure of the degree of variation of a set of points around their average, is the square of the coefficient of variation. This measure of variability has been used for the purpose of comparing the degree of variability between flows of differing absolute magnitudes.

8 The study contains an econometric analysis of the performance of 26 emerging markets following the Mexican crisis of December 1994: seven in Latin America (Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela), six in Europe and Middle East (Greece, Hungary, Jordan, Poland, Portugal, Turkey), 11 in Asia (China, Hong Kong, China, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Philippines, Sri Lanka, Taiwan Province of China, Thailand) and two in Africa (South Africa, Zimbabwe). The Capital Asset Pricing Model was applied to calculate the betas of each market, also taking into account the regional impact (of Latin America and Asia) as well as the impact of the Mexican crisis.

9 The shifting demographic structure towards a larger proportion of the population into older age brackets in developed countries indicates that the volume of funds managed by pension funds in these countries will need to rise quickly in future if pension programmes there are to remain viable. The concentration of developed country funds under management by institutional investors is therefore likely to further increase.

10 On an annual basis over the period 1986-1995, the correlation coefficients between United States interest rates on Treasury bills and FPEI flows to all emerging markets, FPEI flows to Asia, and FPEI flows to Latin America were, respectively: -0.7, -0.6 and -0.8. These coefficients are statistically significant and indicate that FPEI flows to emerging markets are heavily influenced by developments in United States financial markets.

11 For example, a number of new investment funds for Africa, Eastern Europe and Central Asia were launched in 1996.

12 This may, in part, reflect the increasing acceptance among institutional investors in the United States of emerging markets and a concomitant rise in familiarity with these markets. It may, in addition, also indicate a more general desire among investors in the United States to diversify into foreign markets in response to anxiety over a possible reversal in rising returns in the United States markets.

13 The exact number of countries cannot be determined because some more marginal host countries are included in the data under the "other" category.

14 Information provided by the International Finance Corporation.

15 This report estimated, for example, that, over the period 1992-1994, more than 70 per cent of FPEI flows to emerging markets were made in the secondary markets for securities.