

## **The New Landscape for Investment in Emerging Markets**

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**Mansoor Dailami**

In talking about the new landscape for investment in emerging market economies, we seem to assume that the old landscape, however defined, will no longer prevail as the global financial crisis inflicts enduring impacts on cross-border investment and financial flows.

In other words, the post-crisis environment will in some fundamental and transformative ways be different from the past, and we will enter a new era, a new normal. While I remain skeptical of commentaries such as “the end of history,” “the end of capitalism,” and “the end of Anglo-Saxon finance,” I believe that we find ourselves at a significant inflection point in global economic relations, and that this shift will have major implications for cross-border investment. In fact, markets are already trading on the view that this transition—the transition of economic power from developed to developing markets—is underway.

### **The balance of global economic power is shifting**

*The economic rise of developing countries in recent years is undeniable.* We estimate that since 2000, developing economies have grown by an average of 5.4% per year, more than three times higher than the 1.7% experienced by high-income countries. China has grown a whopping 9.8% per year over that same period, and India 7.1%. In

2007, 86 developing countries grew at a rate higher than 5 percent. Of total foreign exchange reserves of \$7.5 trillion as of September 2009, developing countries account for more than half.

*More conspicuously, vast asset accumulation by emerging markets and oil exporters in recent years has turned these countries into major investors on the global stage.* In turn, even amid the global economic maelstrom of the past year, investors around the world seem to be operating under the belief that improved fundamentals in EM economies are of a structural nature, and as such, are positioning themselves to capitalize on the shift in the balance of global economic power from mature to EM economies.

*In terms of policy, one striking difference between the current episode and those of the past is that developing countries now have much greater scope for monetary adjustment by virtue of their more flexible exchange rate regimes.* This has changed the nature of currency risk facing foreign investors in many emerging economies. Currently more than half of developing countries operate under some type of floating regime. Since October 2008, many developing countries have lowered interest rates and expanded their monetary base in concert with the developed world—complementing, in many cases, substantial fiscal expansion.

*In terms of cross-border investment, an important implication of the expanding financial clout of developing countries is that they are a growing source of global*

Between 2003 and 2008, FDI outflows from developing countries increased more than seven fold, reaching an estimated \$[187] billion in 2008. Developing countries are also

expected to become an increasingly popular destination of global financial flows in the coming years. In the 1980s, FDI inflows to developing countries accounted, on average, for 12 percent of global total. In the 1990s, that share increased to approximately 25 percent. Between 2000 and 2009, it rose to an average of [29] percent, a trajectory that is expected to continue. Cross-border M&A deals involving corporations based in developing countries will drive this trend.

### **Several medium-term concerns regarding emerging markets linger**

*International bank lending to developing countries continues to decline.* Syndicated bank lending to developing countries thus far in 2009 totals only \$62.8 billion, about a quarter of the already-depressed 2008 level of \$257 billion. The decline in bank lending has been particularly sharp with regard to cross-border activities. Thus, while US banks lent \$502 billion in 2006 and \$644 billion in 2007 to foreign borrowers, they repatriated \$433 billion in 2008. UK-resident banks reduced their foreign lending even more sharply, repatriating \$590 billion from abroad in the fourth quarter of 2008 and a further \$70 billion in the first quarter of 2009. The decline in bank lending is likely to disproportionately affect project finance deals in core infrastructure and low-income countries with limited or no access to global capital markets.

*FDI in financial services will remain depressed.* Our current estimates indicate that nearly 1,000 foreign banks have a majority-ownership stake in developing countries. Foreign-owned lenders represent a particularly high proportion of the local banking industry in Eastern Europe and Latin America, where they account for 70 percent and 40 percent, respectively. Some international banks, however, are in the process of asset

repatriation and liquidation as a way of allocating capital to home countries.

*Markets are pricing in high corporate default rates.* Having built up a large volume of foreign currency debt during the boom years of 2002-2007, emerging market-based corporations now face the challenge of servicing their debt obligations in an environment of sluggish global growth, high currency volatility, shrinking bank credit, and discriminating bond market investors.

Between 2002 and mid-2007, total foreign capital raised through bonds and syndicated loans by emerging market corporations amounted to \$1.6 trillion, compared to \$351 billion between 1999 and 2001. Much of this debt will come due for repayment over the next few years. Judging from the current level of emerging market corporate bond spreads, the market is pricing in default rates well above the pre-crisis levels but significantly lower than at the depth of the crisis. Based on current spreads, the implied probability of default is 9.8% for BB rated borrowers and 4.7% for investment-grade borrowers.

*By and large, countries have resisted the introduction of explicit capital controls and cross-border flow restrictions since the start of the financial crisis.* To date, only two emerging markets have taken policy action in introducing some degree of restrictions. The first, Brazil, imposed a 2% tax on portfolio inflows, ostensibly designed to slow the appreciation of the real, on October 20 of this year. This followed a 1.5% tax on fixed income inflows in March 2008, which was subsequently lifted in October 2008. The second, Taiwan, introduced limited capital controls on November 10th banning foreign inflows into local time deposits.

## **Implications for political risk insurance**

*First, associated with big shift will be big risk of the world economy moving toward a multi-polar order.* The fact that the United States faces a decline in its relative economic power means that it will have to brace for greater policy interdependency and external influences on its domestic and foreign economic policies. In the immediate years after the Second World War, the United States had the luxury of promoting multilateralism and the reduction of trade barriers because of its position as the world's strongest economy, at the same time making it beneficial for other countries to follow its lead by providing generous financial assistance. The United States is no longer in that fortunate position. In order to mitigate an abrupt loss of power, the United States is likely to be selective in its support for multilateral institutions, and will concentrate instead on the bilateral relationships in which it can best project and maintain its economic power. This may take the form of bilateral trade deals, mutual security pacts, or currency swap arrangements with other central banks—as the Federal Reserve has done with Brazil, Mexico, South Korea and a number of other countries over the course of the crisis.

*Second, risk premiums will remain at higher levels than pre-crisis.* With all of the regulatory and monitoring efforts to safeguard financial stability currently underway at the national and international levels, it seems unlikely that sovereign emerging-market debt spreads will migrate down to the level of 150 to 200 basis points seen in 2006 and early 2007. The new equilibrium in the post-crisis era will feature higher market volatility, higher liquidity premiums, and possibly more conservative investment sentiment than prevailed during the pre-crisis period. Bearing in mind such factors, our

statistical analysis suggests that a further tightening of 80 to 100 basis points is all that can conceivably be expected over the next year or two.

*Third, as banks continue to repair their balance sheets, the corporate capital structure will favor bond market funding over bank lending.* Compared to bank loan markets, bond markets are more transparent and provide information on spreads that can be incorporated in the financing design and better incorporation of political risk insurance as an integral part of risk management schemes.

*Fourth, markets need to successfully navigate the pullback from official policy support ahead.* Markets' reaction to the unwinding of the safety net that accommodative official policy has provided since late 2008 will be important. At present emerging-market assets—and indeed all risky assets, are benefiting from the dollar-funded carry trade, which itself is being facilitated in part by extremely loose US monetary policy.