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Emerging Markets and the Virgin Investor

Emerging markets have to be prepared for some home truths on the road to creditworthiness

The weekend prior to Easter I was invited to speak at a mutual banks conference in Salzburg. Although my topic was the value of retail finance to banks and clients, one of the participants chose me to ask how one could ever trust the international financial system again after the latest Argentinean debacle.

The issue touched him deeply, not only because some of his clients had unadvisedly, of their volition, invested in Argentinean bonds, but more particularly because this default shook his very catholic belief in the orthodoxy and orthopraxis of the international financial system, that elusive concept probably going back to a Bretton Woods world.

I was both astonished and moved by the fact that an experienced local banker could have kept such faith intact in the face of contrary historical evidence. Who has not read about the emerging countries' wholesale failure to meet their commitments in the 1890s, 1930s, 1980s, and 1990s?

I had mentally filed away Argentina as an issue for the IMF, lawyers and distressed debt traders and of no remaining interest for mainstream investors.

What lies at the other end of emails from central African bank officials

A more topical and relevant issue in the spring of 2004 seemed to me the central bankers' concern with too tight emerging markets' credit spreads.

Even more worrying to me was the fact that every private banker, particularly those who have access to a Bloomberg only when they visit a wealthy client, was busy peddling emerging markets funds on the back of their Q4 2003 performance.

How quaint it seemed my old economics professor teaching us that perfect markets are those where price is shaped by the choices of rational investors. Here was the proof, if any was needed, that the perfect market is one where the fools and the professionals balance each other out.

The fools however deserve some partial excuses, the inherent optimism in emerging markets' economies and the deficit of reliable information.

Let me attempt to lay the foundations of some basic understanding with some general observations.

I am convinced that every reader visiting for the first time a given emerging country will have returned with a more positive view of it than he/she held before.

He/she may have flown the national airline and found it very acceptable, may have stayed in 5-star hotels of equal or better standing and quality of service than in G7 countries, may have seen vibrant economic activity, may have met educated and polite young people and may have even spotted incredible business opportunities.

Even if he/she may have been partially exposed to some example of bureaucracy, corruption or poverty, he/she may have condoned them in the spirit of holiday, filed them away as

"exotic" or forgiven them as something likely to be encountered also in the developed countries.

Obviously the worst time to make a sensible emerging markets investment decision is in the period immediately after a holiday.

Availability of credit has been the engine of economic development in the entire developed world. Periodic credit squeezes have halted progress and excessive credit has fuelled inflationary periods and cyclicality.

There is no reason why this should be different for emerging countries. Let us see how credit is created.

First of all there is government or government-guaranteed debt and debt incurred by regional or local authorities with or without central government guarantee.

There are several problems for the investor. Borrowing statistics are often incomplete and one can grasp the full picture only when some appointed investment banker or creditor group's representative starts working with the government to prepare a full picture in anticipation of a rescheduling. The system of national accounts may also be deliberately stunted in order to hide borrowings by local authorities or government controlled corporations. Not all covenants may be known or crystal-clear. The magnitude of the debt service burden may be deliberately hidden or simply unknown even at highest levels of the financial bureaucracy.

The ability to raise tax revenue to meet debt obligations may be constrained by tax evasion opportunities, corruption or simply by social and political limitations.

In many post-colonial or post-Marxist regimes the government sector may be as large and inefficient as to represent a black hole, into which any amount of credit will disappear without trace. Governments may feel compelled, for political reasons, to back huge uneconomic, debt-financed projects that have no chance of pay-back.

It is often the case that even in the most favorable circumstances; the level of growth demanded by demographic circumstances cannot be self-funded and will need to be financed by external debt. Only if the investments made will be so effective as to yield an overall return, net of failures, expressed in the currency of funding, higher than the cost of debt will there be a chance to keep one's credit-worthiness and not to fall into the trap of periodic debt-rescheduling or debt-renegotiation or abandonment.

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To hope in such continuous effectiveness is showing remarkable faith in human performance.

Public borrowing has been sourced over the decades alternatively through bank loan financing and/or capital markets according to the cycle. For instance in the 1950s and part of the 1960s the securities markets claimed the lion's share, in the 1970s the banks, awash with cash originating in the oil-rich countries, took the baton.

This has caused not only discrete jumps in costs of borrowing, but also in covenants, creditors' attitude and behaviour and modalities of renegotiating the debt, when necessary.

The second main source of funds for emerging markets has been trade finance. It has been historically the experience of many banks that both the capacity as well as the willingness of the borrower to repay trade finance is higher than the ability and readiness to repay sovereign or quasi-sovereign debt.

Against this encouraging scenario, many universal banks have abandoned trade finance due to capital requirements and to the volatility impact on bank provisioning due to automatic minimum country provisioning requirements.

Basel II is unlikely to improve this, more likely it will aggravate the situation substantially.

The net result is that only a handful of banks, with long experience in emerging markets and trade finance and a solid, unused capital base are prepared to compete in this field.

The third main source of funds is through self-support inside the various ethnic diasporas, the Lebanese in Africa and Brazil, the Chinese and Indians in South East Asia, etc.

These groups seem able to leverage their family connections in other countries or assets held offshore as collateral for financing facilities.

It is not a modern phenomenon, it happened throughout the centuries and it is a well trodden road to development.

The big risk for such minorities is the backlash that the wealth they acquire through such activities may, as it has, lead to social unrest and violence aimed directly at them. At the extreme it may lead to the exodus of the concerned minority and the consequent impoverishment of the emerging country affected.

The fourth source of funding is credits obtained by native citizens of the emerging country through the assignment of flight-capital assets held offshore.

It is easy to take a moral stance on flight-capital, apart from the legal issues. It is equally easy to note that such capital expatriates when the times get tough and it returns in droves when the economic weather looks good again.

This is tantamount however to blaming the symptoms for the disease. The borrowing power derived from flight-capital reinforces good in-country decisions and penalizes bad ones. This must be economically right, no matter what the

moral or legal judgment on those exporting it. Had that capital been left onshore, it would have probably ended up in the same black hole that consumed the rest.

I have followed with great interest the debate between those who want to reform the IMF and allow emerging countries to use a less bitter medicine in treating development illnesses and the old school of fiscal and monetary probity, which advocates that a medicine is not effective unless it tastes revolting.

I doubt that either school of thought will advance an inch the resolution of the intractable problem: how do you maintain the credit-worthiness of an emerging country over an extended period of time, through economic and demographic cycles?

There will always be virgin investors, dissatisfied with available G7 returns, who find it easier to pick a country or a flag than to choose a sector, a stock or select a hedge fund. Problem is such investors are not enough in number and investable monies to keep the credit flowing. Moreover they tend to be fickle and to move in packs.

There will also always be banks willing to lend from time to time, under certain conditions, even to the most discouraging sovereign borrowers, but such banks are fewer and fewer and will be considerably fewer once more, when Basel II starts to bite.

I am afraid therefore that, no matter what the stance of the IMF will be in the future, waste, corruption, gigantic uneconomic projects, government interference in economic activity, defence spending, bureaucracy, too rich welfare schemes are luxuries that not even G7 countries can afford, leave alone emerging countries.

Credit worthiness is based on reputation and like reputation it becomes increasingly more difficult and costly to repair it, once dented.

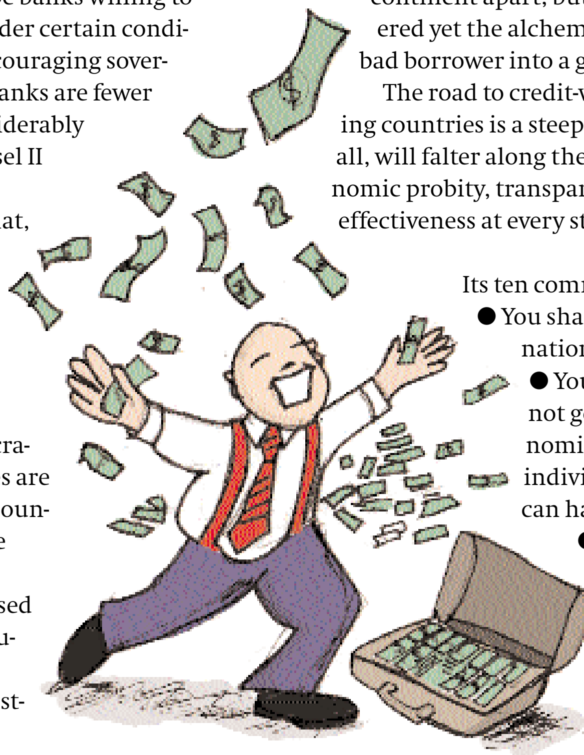
Emerging countries must stop dreaming that solutions to their problems lie elsewhere.

They do not. Even the marginal help they receive from the developed world is fundamentally inadequate and aimed not to restore their credit-worthiness, but to appease temporarily the conscience of the voters in those countries.

You think I am joking? Not a bit. You may say that G7 countries achieved their level of development more often ignoring or violating my ten commandments than not

Do you want to do a community water project in Uganda? Apply to the European Union in six copies under the heading “Equal Opportunities for Women”. Do you want to get UK backing for a school in Ethiopia? Apply under “Self Empowerment” projects. Politicians love to meddle with money which is not their own even a continent apart, but they have not discovered yet the alchemy which transforms a bad borrower into a good one.

The road to credit-worthiness for emerging countries is a steep one and many, if not all, will falter along the way. It calls for economic probity, transparency, harmony and effectiveness at every step of the way.



Its ten commandments are:

- You shall have reliable national statistics.
- Your Government shall not get involved into economic activities which the individuals or corporations can handle on their own.
- You shall record faithfully every sovereign or local authority debt incurred and you shall know and publish the debt-service burden at all times.
- You shall not borrow for projects unless you have at least an 85 per cent probability to cover more than adequately the cost of capital.
- You shall not borrow unless you have earmarked sufficient future revenue with at least 95 per cent probability to service the debt.
- You shall encourage social political harmony, so that your enterprising ethnic minorities will never feel threatened.
- You shall allow great freedom of capital movements for your citizens
- You shall encourage the free movement of your people, supporting them in their emigration, not taxing their home remittances, and encouraging them when they return home to start new businesses.
- You shall respect your citizens as citizens and not treat them only as subjects, whose only value is related to your ability to tax them
- You shall support a functioning judicial system and you shall hang all those in public office or in political activity found guilty of corruption.

You think I am joking? Not a bit. You may say that G7 countries achieved their level of development more often ignoring or violating my ten commandments than not.

You are right, but they are there and, short of major mismanagement, their credit-worthiness is established. That not only is not the case for emerging countries, but the investor, even the virgin investor, has a constant choice and the G7 risk/returns are a benchmark against which to judge them.

If you have wiser solutions, write to me. Actually do better, put your name forward to run the IMF. W