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DEVELOPMENT BRIEF

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Rising portfolio flows: Short-lived or sustainable?

Portfolio investments reduce the cost of capital in developing countries, making it important to sustain their recent fivefold expansion

Private portfolio flows, both bonds and equity, have grown explosively in the past four years. These flows, which averaged less than US$6 billion a year during 1982–88, were estimated at US$34 billion in 1992.*

The revival of portfolio flows to developing countries was led initially by a sharp expansion in bond financing (see the chart). Several countries that had previously been absent from international capital markets reentered this market in 1989. Equity flows through closed-end country and regional funds, which until recently had been the main vehicle for participation in developing country stock markets, were fairly modest during 1989–90. In the past two years, the use of international share offerings by several major middle-income countries to privatize public sector firms and the opening of many developing country stock markets to direct participation by foreign investors have boosted equity portfolio flows.

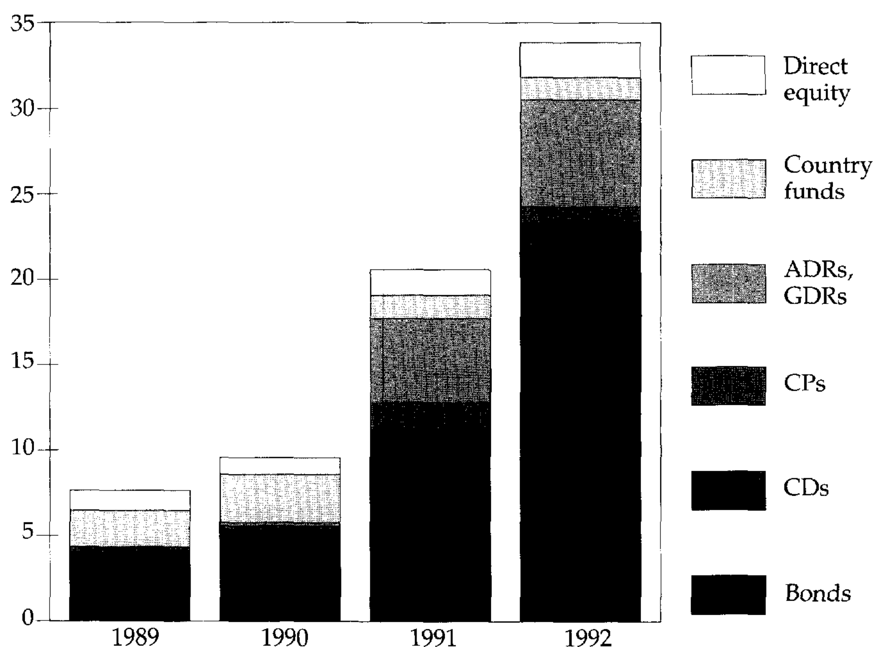
The increase has gone largely to a few countries in Latin America, where gross equity portfolio flows have grown more than tenfold in four years—from US$434 million in 1989 to an estimated US$5.6 billion in 1992. Much of these flows have represented repatriated flight capital, some high risk and high return funds, and a small part institutional investment. Since these flows grew at a time of falling U.S. dollar interest rates and recession in the United States, an issue is whether access to these flows will be sustained.

The potentially huge supply of portfolio equity flows to developing countries is motivated not only by source country conditions but by host country creditworthiness, a desire for diversification, host and source country regulations, and investor information. Changes in all these factors suggest that access to these flows should prove to be sustainable to a reasonable degree.

Benefits of portfolio flows

The primary benefit conferred by equity portfolio flows on a host country is a reduction in its cost of capital (in addition to the presumed benefit of efficient employment of resources by the most creditworthy corporations in the private sector). Prices in developing country stock markets typically have jumped higher upon opening to foreign investors, indicating that removal of market segmentation has permitted the domestic rate of return to fall. But the benefit is not realized by all types of these flows. International stock trading (through American depository receipts—ADRs) and di-

Gross portfolio flows to developing countries, 1989–92



Source: World Bank staff estimates.

*For more details, see *Global Economic Prospects and the Developing Countries, 1993*, Washington, DC, World Bank, April 1993.

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rect purchases on domestic stock markets appear to be much more beneficial than are country funds (comprising largely closed-end mutual funds), because they alter the way in which stocks are priced domestically.

The companies in developing countries that have listed ADRs have seen their costs of capital decline. For Teléfonos de México, the cost of capital has fallen by some 10 percentage points (relative to Mexican rates of return generally) since the offering of its ADRs in May 1991. Evidence from industrial countries also indicates that dual stock listings lead to a lower cost of capital—for Canadian firms by 0.71 percentage point and for Australian firms by close to 2 percentage points.

The issue of ADRs has lowered the costs not only for individual firms but also for other domestic firms through spillover effects. Contrast this with country funds, which are unlikely to have the same spillover benefits because there are not the same direct price linkages. Country funds can, however, be useful in promoting investor familiarity with an emerging stock market if direct purchases are difficult or if a country is concerned about large foreign ownership.

The cost of equity capital has also come down as a result of large capital inflows and associated increases in stock prices, in part driven by a perception of improved earnings prospects. After significant capital gains on most local stock markets, local price/earnings (P/E) ratios are now at their highest levels in most developing countries with a well-developed stock market, indicating lower required rates of return on equities. In India, the average P/E ratios at the end of 1992 were more than 30, up from 18 in 1986. Following the liberalization in Brazil, the P/E ratio increased 40% in 1991 alone, and direct foreign equity purchases in 1991 and 1992 exceeded $1 billion. For the group of emerging countries as a whole, the P/E ratio is now 17, up from 10 in 1986.

Despite considerable variation in returns across emerging stock markets, these markets have on average performed strongly in recent years, although less well in the second and third quarters of 1992. The International Finance Corporation's (IFC) composite index of total returns for 20 emerging markets rose 148% during 1987–92, exceeding returns on the U.S. stock market (Standard and Poor's 500) of 119%. The IFC's Latin America regional index rose 321% during this period, and its Asia regional index posted a gain of 153%.

Rates of return over the five-year period 1987–91 for the U.S. and emerging stock markets show that if U.S. investors had held up to 20% of their portfolio in emerging markets (compared with actual holdings of a fraction of 1%), they would have increased their average return by about 1% a year and decreased the variability of their returns.

Determinants of equity portfolio flows

Undoubtedly, a main factor determining the destination of equity portfolio capital is developing country creditworthiness. The recent experience in Latin America shows that markets are willing to recognize and reward improvements in creditworthiness quickly. *Institutional Investor's* average credit rating for the emerging market countries of Latin America rose impressively from 26.1 in September 1989 to 30.4 in September 1992.

A second factor is the array of regulatory and other impediments in the markets. Developing-country investment regulations vary from placing no significant restrictions on the purchase of stocks and repatriation of income and capital to severely restricting access. Nine emerging markets permit free entry, and a further 12 permit relatively free entry, while six others are restricted.

A third factor is source country regulation, both fiduciary and institutional. German institutional investors have the most stringent controls, while Japanese investors are subject to nonbinding ceilings on foreign asset size. If outward portfolio flows from all source countries behaved like those from the United States, portfolio flows to developing countries would increase by an estimated US$3 billion a year.

A fourth factor is the economic situation of the source country, such as low interest rates and poor growth prospects. These conditions are an important but by no means decisive determinant of equity portfolio flows. If U.S. dollar real interest rates rose by 100 basis points—a large rise—the net flow of portfolio equity to developing countries would decline by an estimated US$2 billion a year.

A fifth factor is the potential for diversification. Investing in emerging stock markets potentially lowers portfolio risk for the global investor. Emerging stock markets are weakly, and in some cases negatively, correlated with stock markets in industrial countries, so these markets provide substantial potential risk reduction benefits to international investors.

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