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The Instability of the Emerging-Market Assets Demand Schedule*

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Introduction
The expansion and contraction of portfolio capital flows and short-term bank lending from OECD countries in emerging markets during the past decade has generated a large and controversial body of literature. Most of the debate has focused on the effect of these flows on emerging markets themselves, and on the effect of host country policies on the attraction or retention of the flows. However the process by which credit providers and portfolio investors make their decisions is much more than simply deciding to supply a specific amount of capital to emerging markets at a given average risk and price, and then to allocate this between individual emerging markets according to local risk and return characteristics – the so-called ‘fundamentals’.

In any market, changes in the level of transaction flows and the prices at which they take place must reflect shifts in either the demand schedule or the supply schedule (or both simultaneously), and both these schedules will be affected by agents’ expectations about the future evolution of the market. Fortunately increasing attention is being paid to two dimensions of what this chapter logically terms ‘the demand for emerging-market assets’.

The first strand in the recent literature relates to what are frequently but somewhat misleadingly called the ‘push’ and ‘pull’ factors that determine capital flows at the macroeconomic level. The aggregate level of capital flows to emerging markets is held to be determined by the push factors, which include market conditions in the source country and the return on emerging markets as a whole. The pull factors are the conditions in the destination countries, which determine the allocation of the aggregate flow across the emerging markets. The second strand relates to the determinants of investors’ decisions to purchase (or sell) emerging-market assets at the microeconomic level. Portfolio choice models thus include source-country conditions as determining the opportunity cost of capital (that is, the risk-free portion of the portfolio) and the overall asset stock; while

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destination-country conditions determine the yield and risk of emerging-market assets.

From the first strand it is apparent that shifts in aggregate asset demand (that is, changes in the push factors), such as OECD interest rate changes and G3 exchange rate fluctuations, account for at least half of the observed changes in capital flows, independently of the asset supply (that is, ‘pull’) conditions: the so-called ‘fundamentals’ in emerging markets themselves. From the second strand it is clear that what matters to individual investors’ decisions is not only information about fundamentals but also the way in which the information is used, endogenous cycles in risk appetite and the effect of regulatory incentives – all of which are determined by conditions in the source country.

In effect the demand schedule for emerging-market assets is three-dimensional. As well as price (or yield) on one axis, so to speak, and the quantity of assets on another axis, there exists a third dimension that can be broadly termed ‘quality’ on another. This is no different in principle from the market for, say, cars – except that, as we shall see, quality is not a stable or exogenous factor. Nor, as we shall see, is it a ‘market in lemons’ where quality is unknown to the buyer alone. The supply schedule (that is, emission or resale by government, company or bank concerned) has the same three dimensions. Ideally, quality is the given risk of debt default, dividend collapse or major devaluation, as determined by the fundamentals of the country and its companies, so that the interaction between stable demand and supply schedules will determine the price and quantity at which the market in assets clears. The changes in this equilibrium over time are the observed capital flows. Variations in asset quality when fundamentals alter due to external shocks or domestic politics will be reflected in changing prices and flows as markets adjust to the changed circumstances. Then the objective of emerging-market governments (and their international advisors) is to improve asset quality by sound (or sounder) management so that either asset prices improve (that is, yield spreads fall) or more assets can be supplied (that is, capital inflows are attracted) at the going price.

Asset prices can be seen as information that is directly available to the market, but only in the form of past and current values and yields. However future prices (or indeed the appropriate long-term price trend) are an essential aspect of price and are a matter of investors’ expectations rather than measurable data. Moreover the quantity dimension is ambiguous for two reasons. First, what is recorded (for example in balance of payments statistics) is the value of flows made up of innumerable transactions (price multiplied by quantity), and while the number of securities transactions could in principle be counted there is no clear definition of the volume index to be used to aggregate them. Second, changes in the stocks of financial assets (which are what is recorded at the firm level) reflect not only new flows but