B·O·E SECURITIES

POLITICAL & INDUSTRIAL RELATIONS FAX

REPORT ON WORLD BANK CONFERENCE

“Preventing crises in emerging markets”

OVERALL CONCLUSION

- The private, and not the public sector, was the main cause of the crises in Asia.
- Consequently, corporate governance has moved to the top of the agenda. Two aspects dominate corporate governance: disclosure of information and treatment of minority shareholders (pyramids and N-shares are OUT).
- The Washington consensus is still very much alive and well. Deviations from that policy framework could spark new crises. “People do not take their money out of boring economies.”
- Locals play a bigger role in capital flight than foreigners do. Retaining their confidence is more important than winning the confidence of the foreigners.

ORIGIN AND NATURE OF CRISIS in EMERGING MARKETS

Asia

- Asia’s crisis was mainly caused by the private sector, not the public sector or government.
- Generally the latter followed the Washington consensus by practising sound public finances. The one policy failure government was guilty of, was fixed exchange rates. This resulted in over-valued currencies and encouraged locals to “run for the door”.
- The private sector was over-borrowed.
- Foreign lenders exacerbated the problem by providing generous credit. Coming on top of high domestic savings rates, these foreign loans helped to fuel corporate debt.
- Corporate debt was in many cases used to finance poor investments. It also helped to finance cronyism.

(This analysis is also the foundation of the criticism against the IMF for its handling of the crises. The IMF prescribed reduction in demand as per economies spending too much, whilst the real issue was a liquidity crisis because of too much debt, borrowed too short).

Brazil

- Here the crisis had more of a political nature: desperately needed adjustments in public policy were simply not made. Budget deficits were too high (7,5% of GDP) and necessary corrections like pension, civil service, taxation and expenditure reforms were simply not approved by parliament.

- After the crisis broke and IMF help was conditional on political decisions, the politicians made the decisions quite quickly.

Conclusion

The Washington consensus is as alive and well as can be. In fact, the crises have underlined the need to stick to such policies. Deviation from the package could cause more crises. Capital controls are not back in vogue. However, the timing and sequencing of abolition are important. Post the crisis, SA's policy of incremental abolition is probably more in fashion than before.

CORPORATE GOVERNANCE

The role of the private sector in the crisis brought to the fore the question of a "Washington consensus" on corporate governance. Two issues have been identified as crucial:

- *Firstly,* disclosure - and specifically the quality of disclosure - has become much more important. The general consensus was that disclosure in Asia was simply not good enough. (Underlined by the continuing revelations of more debt and pension deficits at Nissan as the alliance with Renault gets consummated).

  Several fund managers I saw on my accompanying road show expressed the opinion that the quality of disclosure in SA was also not what it should be.

  The timing of disclosure is also critical – six month delays are not good enough for an assessment of a company's risk profile.

- *Secondly,* the treatment of minority shareholders is seen as the ultimate pre-requisite for good corporate governance. Any limits on shareholders' rights – e.g. pyramids and N-shares – are increasingly frowned upon as poor governance. It prevents optimal performance and is seen as promoting a form of "cronyism".

Conclusion

Globalisation implies that the standards of corporate governance must also be globalised. Therefore the standards of Wall Street and the LSE are the benchmarks.

FOREIGN AND LOCAL CAPITAL FLOWS

- Preliminary results from both World Bank and Harvard research suggest that the behaviour of local residents contributed to the crisis – in the opinion of some even more so than the behaviour of foreigners.

- Locals led the rush for the door in a sense and thus contributed to or, perhaps even triggered the crises. This is reminiscent of the Mexico experience when locals were also leading the rush that caused the crises in that country. As one World Bank analyst observed: "They know what is going on, better than the foreigners. They know when to run."!!

- A fixed currency regime encouraged the locals to "run for the door".

- Data has been published indicating that US mutual funds were net buyers of stocks throughout the crises in Asia.

Conclusion

Local investors play a big role in financial crises – perhaps even bigger than foreigners. It seems more important for governments to maintain credibility with its own markets and investors than with foreigners – the latter will follow the locals.

IMPACT OF CRISES

- Crises help to force restructuring, create better-performing institutions and develop more efficient regulatory frameworks. The USA experienced a financial crisis every ten years or so between 1830 and 1930. From these crises the fairly strong and efficient regulatory framework was developed which the US enjoys today.

- Emerging markets would have to develop the strong regulatory and institutional framework needed to participate in a global economy.

- The flow of capital to emerging markets has declined substantially as a result of the crises. It declined from $325bn in 1996 (about $81bn per quarter) to less than $15bn in the first quarter of 1999. This fits in with George Soros's big fear: that the countries on the periphery could be starved from necessary capital flows if the crises are not stabilised and settled down. A rise of interest rates in the US could be a spark that can aggravate the flow of money to emerging markets.

WHY INVEST IN EMERGING MARKETS AT ALL?

- Investment managers pointed out that emerging markets offer better value and higher growth prospects. RoE is much better than many of the stocks on Wall Street where there is "no E".

- Developed economies need return on assets to ensure that they can pay the pensions of the next generation of pensioners. These returns can better be achieved in emerging markets where the risks are higher, but the returns are higher as well.

- The question is whether enough investors agree, so that the critical mass will be created for the value in those markets to be realised. Critical mass is liquidity and that is essential for market success.

APPLICATION TO SOUTH AFRICA

- Fund managers will increasingly judge SA companies by international standards of corporate governance. It seems this process has already started: the recent experiences in the share prices of Firstrand (disclosure of information) and BOE (N-shares) illustrate the trend on the JSE.

- Structural adjustments in SA will have to continue, and at a quicker pace. Progress must be made with the variables discussed in our latest report (15 March 1999) or SA could again experience a crisis.

- The second half of the year will be critical for SA: if the actions we forecast in our latest report occur, the environment will stabilise; if not, another crisis could be developing. (Briefly, these are retrenchments in the civil service; seven privatisation transactions by year-end; reform in the labour market; and continued maintenance of strict fiscal policies.)

- A further risk area for policy is the level at which government will set inflation targets for the Reserve Bank. If these are too high and thus too lenient in respect of inflation, the currency could come under pressure.

- It is all about **growth**: SA will disappear off the radar screen if growth of 3% - 4%+ is not achieved from the 2000 onwards.

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