

Emerging Financial Markets

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*“What is an emerging market? A market that will never be developed.”
-Anonymous Trader at an Investment Bank in London, September 2007*

What separates an emerging market from a developed one? Are “emerging markets” destined to develop or will their path be unsteady and peripheral? The answer to these questions is more convoluted, contentious, and relevant than ever. With more than 50% of the global GDP and almost two thirds of its growth now produced by the emerging world, global investors will likely continue allocating an increasing fraction of their portfolios to EM. A nuanced understanding of institutional differences, risks, and specificities of the emerging world are key to untap the potential of these markets.

This course dives into the **institutional, economic, and financial fundamentals of emerging market economics**. We will explore the main risk factors in EM financial systems over the past three decades and build on country characteristics to predict corporate and government asset performance. The first goal is to challenge you to think critically about the place EM countries occupy in the international financial system. The second goal is to equip you with analytical tools to prepare you for successful development of investment strategies in emerging markets. To that end, we will draw on **historical examples, economic theory and empirical techniques** to analyze how emerging markets have performed, what underlying fundamentals drive development and how current political turmoil influences **opportunities for investment and business development**.

Readings: The main textbook is Emerging Financial Markets, by David Beim and Charles Calomiris, 2001 (**EFM**). Other readings (including **EFM**) and the case studies are found in the electronic course packet.

Students are expected to prepare for class by reviewing the assigned readings and preparing case-debate presentations and written case solutions as a group. Groups consist of a team of **three or four** students. Students are responsible for forming groups **immediately after the first class**. Team lists must be submitted in hard copy form to the instructor at the **beginning of the second class**.

Grading is based on 4 cases- team written case solutions (50%), 4 team presentations of mini-cases (30%) and a take-home final exam consisting of longer-answer questions (20%). **The take-home final exam will be distributed on the second to last class and will be due by the end of the last class of the term**. The final exam will test comprehension of the material in the required readings, class discussions and guest speakers’ presentations. The final exam should take no more than 3 hours to complete. Case solutions should be no more than **four pages of text** (double-spaced, Times Roman 12 font with normal margins), which follow a **one-page executive summary**. Up to five pages of charts and tables may be attached. Finally, there is a bonus (optative) individual Essay, representing 10% of the total class grading.

The following is a list of readings and assignments for each class meeting. Additional readings with contemporaneous information will be added in a timely fashion.

COURSE SCHEDULE AND READINGS

Readings with asterisks (*) are required. All required readings are available in the readings packet.

Theme 1: How do *institutions* affect *development* in Emerging Markets? Is *economic convergence* a reality or a dream? How do institutional risks impact strategies for investment in EM?

- ***EFM, Chapters 1-3.**
- ***Rene Stulz, "The Limits of Financial Globalization," NBER, January 2005.**
- ***Rodrik, Dany, Institutions Rule: The primacy of Institutions over Geography and Integration in Economic Development. Journal of Economic Growth 9, 2004.**
- ***Patel, D., Sandefur, J. and Subramanian, A., 2018. Everything you know about cross country convergence is (now) wrong. PIIE Real Time Economic Issues.**
- ***Aidt, T., Eterovic, D., 2011. Political Competition, Electoral Participation and Public Finance in 20th Century Latin America. European Journal of Political Economy 27(1), 181-200.**
- Daron Acemoglu, Simon Johnson, and James A. Robinson, "An African Success Story: Botswana," In Search of Prosperity: Analytical Narratives on Economic Growth.
- Eterovic, D., Sweet, C., 2014. "Democracy and Education in 20th Century Latin America". Economics and Politics 26 (2) 237-262.
- Peter Henry, "Capital Account Liberalization, the Cost of Capital, and Economic Growth," NBER, February 2003.
- Stanley Engerman and Kenneth Sokoloff, "Factor Endowments, Inequality, and Paths of Development among New World Economies," NBER Working Paper 9259, October 2002.
- Geert Bekaert and Campbell Harvey, "Equity Market Liberalization in Emerging Markets," *The Journal of Financial Research*, 2003.

Theme 2: What are the economic and social benefits of *financial development*? Why do countries rely on *financial repression*? Which kind of investment opportunities are created by this government intervention?

- ***Charles Calomiris and Stephen Haber, *Fragile By Design: Banking Crises, Scarce Credit and Political Bargains*, Princeton University Press, 2014, Presentation.**
- ***Levine, Ross (2005) "Finance and Growth: Theory and Evidence." in Handbook of Economic Growth, ed. Philippe Aghion and Steven N. Durlauf, 865–934. Amsterdam: Elsevier.**
- ***Reinhart, C., Kirkegaard, J., Sbrancia, B., 2011. Financial Repression redux. Finance and Development.**
- ***Díaz-Alejandro, Carlos F. (1983): Good-Bye Financial Repression, Hello Financial Crash, Center Discussion Paper, No. 441, Yale University, Economic Growth Center, New Haven, CT**
- Graciela Kaminsky and Sergio Schmukler, "Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization," NBER, June 2003.
- Peter Rousseau and Richard Sylla, "Financial Systems, Economic Growth, and Globalization," in *Globalization: An Historical Perspective*, 373ff.
- B. Courne de, O. Denk, and P. Hoeller, "Finance and Inclusive Growth," OECD, 2015.
- Francisco Buera, Joseph Kaboski, and Yongseok Shin, "Finance and Development: A Tale of Two Sectors," *American Economic Review*, 2011.
- Graciela Kaminsky, "Crises and Sudden Stops: Evidence from International Bond and Syndicated-Loan Markets," NBER, August 2008.
- Joshua Aizenman and Gurnain K. Pasricha, "Why Do Emerging Markets Liberalize Capital Outflow Controls? Fiscal versus Net Capital Flow Concerns," NBER 18879, March 2013.
- Barry Eichengreen and Andrew Rose, "Capital Controls in the 21st Century," CEPR, June 2014.

- Michael Klein and Jay Shambaugh, "Rounding the Corners of the Policy Trilemma," *American Economic Journal: Macroeconomics*, 2015.

Theme 3: How should you assess *Sovereign and Corporate Risk* in Emerging Markets? *What happens with domestic financial assets when a country opens its capital market?*

- ***Ashvin Ahuja; Kevin Wiseman; Murtaza H Syed, Assessing Country Risk: Selected Approaches, IMF 2017.**
- ***Geert Bekaert, and Campbell Harvey, "Emerging market finance," *Journal of Empirical Finance*, 1998.**
- ***Carmen Reinhart and Kenneth Rogoff, "From Financial Crash to Debt Crisis," *American Economic Review*, 2011.**
- ***Bellas, D., Papaioannou, M., Petrova, I., 2010. Determinants of Emerging Market Sovereign Bond Spreads: Fundamentals vs Financial Stress. IMF Working Paper.**
- ***Eterovic, D., 2008. "Modeling Spreads in EM EXD: SECM v.2," (with P. Goldberg and A. Prakash). External Debt Strategy Working Paper No. 2, Merrill Lynch.**
- Richard Cantor and Frank Packer, "Determinants and Impact of Sovereign Credit Ratings," *Quarterly Review*, Federal Reserve Bank of New York, 1997.
- Juan Cruces and Christoph Trebesch, "Sovereign Defaults: The Price of Haircuts," *American Economic Journal*, 2011.
- Suk Hun Lee, Hyun Mo Sung, and Jorge L. Urrutia, "The Impact of the Persian Gulf Crisis on the Prices of LDCs' Loans," *Journal of Financial Services Research*, 1996.
- Geert Bekaert, C. Erb, C. Harvey, C. and T. Viskanta, T. "Distributional Characteristics of Emerging Market Returns and Asset Allocation," *Journal of Portfolio Management*, 1998.

Theme 4: How do the *legal foundations of finance and corporate governance* shape innovation and private equity investment in Emerging Markets?

- ***EFM, Chapters 4-5.**
- ***Charles Calomiris, Mauricio Larrain, Jose Liberti, Jason Sturgess, "How Collateral Laws Shape Lending and Sectoral Activity," *Journal of Financial Economics*, 2016.**
- ***Tarun Khanna, Krishna G. Palepu, and Jayant Sinha, 2005. Strategies that fit emerging markets. Harvard Business Review.**
- ***Alexander Peter Groh, 2009. Private equity in emerging markets. IESE working paper.**
- *** Sweet, C., Eterovic, D., 2015. "Do Stronger Intellectual Property Rights Increase Innovation?". *World Development* 66, 665-677.**
- Gledson Carvalho and George Pennacchi, "Can Voluntary Market Reforms Promote Efficient Corporate Governance? Evidence from Firms' Migration to Premium Markets in Brazil," Working Paper 2007.
- Yan-Leung Cheung, In-Mu Haw, Weiqiang Tan and Wenming Wang, "Board Structure and Intragroup Propping: Evidence from Family Business Groups in Hong Kong," *Financial Management*, Fall 2014, 569-601.
- Nuno Fernandes and Mariassunta Giannetti, "On the Fortunes of Stock Exchanges and Their Reversals: Evidence from Foreign Listings," *Journal of Financial Intermediation*, 2014.
- Bernard Black and Vikramaditya Khanna, "Can Corporate Governance Reforms Increase Firms' Market Values: Evidence from India," 2007.
- Laura Alfaro and Maggie Xiaoyang Chen, "Surviving the Global Financial Crisis: Foreign Ownership and Establishment Performance," *American Economic Journal: Economic Policy*, 2012.
- Kee-Hong Bae and Vidhan Goyal, "Creditor Rights, Enforcement, and Bank Loans," *Journal of Finance*, 2009.
- Asim Ijaz Khwaja, Atif Mian, and Bilal Zia, "Dollars Dollars Everywhere, Not a Dime to Lend," Working Paper, March 2007.

Theme 5: How has *the emergence of China* changed the Emerging Markets landscape and its opportunity set? Which are the Chinese engines of growth and how are they evolving? What are the financial market and macroeconomic impacts of Chinese spillovers to the rest of EMs?

- ***Lee Branstetter, “China’s Financial Markets: An Overview,”** in Charles Calomiris, editor, *China’s Financial Transition*, Chapter 1.
- ***Tri Vi Dang, Honglin Wang, and Aidan Yao, “Chinese Shadow Banking: Bank-Centric Misperceptions,”** Working paper, 2014.
- ***Raphael Lam and Jingsen Wang, China’s Local Government Bond Market.** IMF working paper, 2018.
- ***Ashvin Ahuja and Malhar Nabar, 2012. Investment-led growth in china: global spillovers.** IMF working paper.
- ***Jennie Bai, Michael Fleming, and Casidhe Horan, The Microstructure of China’s Government Bond Market.** Federal Reserve Bank of New York Staff Reports, no. 622 May 2013
- ***Yasheng Huang, 2012. How did china take off? Journal of Economic Perspectives—Volume 26, Number 4—Fall 2012—Pages 147–170.**
- ***Dennis Tao Yang, 2012. Aggregate Savings and External Imbalances in China. Journal of Economic Perspectives—Volume 26, Number 4—Fall 2012—Pages 125–146.**
- ***Xiaodong Zhu, 2012. Understanding China’s Growth: Past, Present, and Future. Journal of Economic Perspectives—Volume 26, Number 4—Fall 2012—Pages 103–124.**
- **Il Houg Lee, Xu Qingjun, and Murtaza Syed, 2013. China’s Demography and its Implications.** IMF working paper.
- **Hongbin Li, Lei Li, Binzhen Wu, and Yanyan Xiong, 2012. The End of Cheap Chinese Labor.** Journal of Economic Perspectives—Volume 26, Number 4—Fall 2012—Pages 57–74.
- **Malhar Nabar and Papa N’Diaye, 2013. Enhancing China’s Medium-Term Growth Prospects: The Path to a High-Income Economy.** IMF working paper.
- **Christina Kolerus, Papa N’Diaye, and Christian Saborowski, 2013. China’s footprint in global commodity markets.** IMF Spillover notes.
- **Nkunde Mwase, Papa N’Diaye, Hiroko Oura, Frantisek Ricka, Katsiaryna Svirydzenka, and Yuanyan Zhang, 2013. Spillovers from china: Financial channels.** IMF Spillover notes.
- **Davide Furceri, João Tovar Jalles, and Aleksandra Zdzienicka, 2013. CHINA SPILLOVERS New Evidence from Time-Varying Estimates.** IMF Spillover notes.
- **Zheng Song, Kjetil Storesletten, and Fabrizio Zilibotti, “Growing Like China,”** *American Economic Review*, 2011.
- **Asim Khwaja and Atif Mian, “Do Lenders Favor Politically Connected Firms?”** *Quarterly Journal of Economics*, 2005.
- **T.T. Chong, L. Lu, and S. Ongena, “Does Banking Competition Alleviate or Worsen Credit Constraints Faced by Small and Medium Enterprises?”** *Journal of Banking and Finance* 2013.
- **Meghana Ayyagari, Asli Demirguc-Kunt, and Vojislav Maksimovic, “Formal versus Informal Finance: Evidence from China,”** *Review of Financial Studies*, 2010.
- **Warren Bailey, Wei Huang, and Shishu Yang, “Bank Loans with Chinese Characteristics: Some Evidence on Inside Debt in a State-Controlled Banking System,”** *Journal of Financial and Quantitative Analysis*, 2011.
- **Di Guo, Kun Jiang, B-Y Kim, and Chenggang Xu, “Political Economy of Private Firms in China,”** *Journal of Comparative Economics*, May 2014, pp. 286-303.
- **C.C. Curtis, S. Lugauer and N.C. Mark, “Demographic Patterns and Household Savings in China,”** *American Economic Journal: Macroeconomics*, 2015.

Theme 6: how do *inflation and exchange rate policies* affect invest strategies for Emerging Markets? How should you analyze inflation and exchange rate risks?

- *Romer, David., 2013. **Short run fluctuations.**
- *EFM, Chapters 6.
- *Charles Calomiris, "Devaluation with Contract Redenomination in Argentina, *Annals of Finance*, January 2007.
- *Mishkin, F., Schmidt-Hebbel, K., 2001. One decade of inflation targeting in the world: what do we know and what do we need to know. NBER WP.
- *Fischer, S., 2001. Exchange rate regimes: Is the bipolar view correct? *Journal of economic literature*.
- *Calvo, G., Mishkin, F., 2003. The mirage of Exchange rate regimes for Emerging Markets. *Journal of economic perspectives*.
- *Devereux, M., Lane, P., Xu, J., 2005. Exchange rates and monetary policy in emerging market economies. *Economic Journal*.
- *Alvero, A., Eterovic, D., 2020. What do US dollar peaks look like, how quick are they, and what can be expected in their wake? <https://www.rohatyngroup.com/acm/trgmdownload.php?file=TRG%20Report%20on%20US%20Dollar%20Peaks%20-%20July%202020.pdf>
- Eterovic, D., Illanes, F., 2008. "Passing the buck: FX pass-through in LatAm," LatAm Economics paper No. 1, Merrill Lynch.
- Mishkin, F., Schmidt-Hebbel, K., 2007. Does inflation targeting make a difference. NBER WP.
- Charles Calomiris and Ian Domowitz, "Asset Substitution, Money, and Inflation in Brazil," *Journal of Money, Credit and Banking*, February 1989.
- Charles Calomiris, "Institutional Failure, Monetary Scarcity, and the Depreciation of the Continental," *Journal of Economic History*, 1988.

Theme 7: What are the macroeconomic and financial indicators most useful in identifying sovereigns at risk of default? What are the factors that determine the size of "haircuts" or a forced reduction in the value of a bond--in a sovereign restructuring? *Taxonomy, Causes and Social Costs of EM financial crises, historically and in the present era.*

- *EFM, Chapters 7 and 8.
- *Campbell Harvey and Andrew Roper, "The Asian Bet," Working Paper, March 1999
- *Moritz Schularick and Alan Taylor, "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870–2008," *American Economic Review*, 2012.
- *Fisher, I. (1939), "The Debt Deflation Theory of Great Depressions." *Econometrica*.
- *Minsky, H. (1992), "The Financial Instability Hypothesis." The Jerome Levy Economics Institute of Bard College WP.
- *Reinhart, C., Rogoff, K., 2008a. This Time is Different: A Panoramic View of 8 Centuries of Financial Crisis. NBER wp 13882.
- *Dornbusch, R., and S. Edwards. 1989. Macroeconomic Populism in Latin America. NBER Working Paper no. 2986. Cambridge, Mass.
- *Alvero, A., Eterovic, D., 2020. An Empirical Framework for Analyzing EM Sovereign Debt Restructurings. <https://www.rohatyngroup.com/incontent/TRG%20Report%20on%20Sovereign%20Debt%20Restructurings%20-%20October%202020.pdf>.
- Charles Calomiris and Stephen Haber, *Fragile By Design*, Chapters 10-11, 14-15.
- Stephen Haber, "Mexico's Experiments with Bank Privatization and Liberalization, 1991-2003," *Journal of Banking and Finance*, 2005.
- Enrica Detragiache, Thierry Tresselt and Poonam Gupta, "Foreign Banks in Poor Countries: Theory and Evidence," *Journal of Finance*, 2008.
- Charles Calomiris, "Banking Crises and the Rules of the Game," November 2009.
- Nicola Cetorelli and Linda Goldberg, "Banking Globalization and Monetary Transmission," *Journal of Finance*, 2014.

- Serkan Arslanalp and Peter Henry, "Debt Relief: What Do the Markets Think?" NBER, December 2002.

Theme 8: What is *macro-prudential regulation* and how does it affect international capital flows to EMs? Why could too much capital inflows be a bad thing?

- *Atish R. Ghosh, Jonathan D. Ostry, and Mahvash S. Qureshi, 2017. **Managing the Tide: How Do Emerging Markets Respond to Capital Flows?** IMF working paper.
- *Eugenio Cerutti, Stijn Claessens, and Luc Laeven, 2015. **The Use and Effectiveness of Macroprudential Policies: New Evidence.** IMF working paper.
- * Aisen, A., Eterovic, D., 2010. **Global imbalances: Are emerging markets the new guest at the party?** VOXEU. <https://voxeu.org/article/global-imbalances-are-emerging-markets-new-guest-party>.
- *Charles Calomiris and Andrew Powell, "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-99," in *Prudential Supervision: What Works and What Doesn't*, pp. 147-96.
- *Viral Acharya and Charles W. Calomiris, "A Macroprudential Policy Framework for the EU and Its Member States," in *Macroprudentialism*, edited by D. Shoenmaker December 2014.
- *Alvero, A., Eterovic, D., 2020. **EM Debt and the US Dollar Cycle.** <https://www.rohatyngroup.com/mcontent/EM%20Debt%20August%202020.pdf>
- Asli Demirguc-Kunt and Enrica Detragiache, "Basel Core Principles and Bank Soundness: Does Compliance Matter?" World Bank, March 2010.
- Samuel G. Hanson, Anil K Kashyap, and Jeremy C. Stein, 2011. A Macroprudential Approach to Financial Regulation. *Journal of Economic Perspectives*—Volume 25, Number 1—Winter 2011—Pages 3–28.
- James Barth, Gerard Caprio, and Ross Levine, *Rethinking Bank Regulation*, Cambridge University Press, 2006.
- Alexei Karas et al., "How Do Russian Depositors Discipline their Banks?" *Oxford Economic Papers* 62, 2010, 36-61.
- Craig Brown and Serdar Dinc, "Too Many to Fail? Evidence of Regulatory Forbearance When the Banking Sector Is Weak," *Review of Financial Studies*, May 2009.
- Pablo Federico, Carlos Vegh, and Guillermo Vuletin, "Effects and Role of Macroprudential Policy: Evidence from Reserve Requirements Based on a Narrative Approach," Working Paper, November 2013.
- S. Aiyar, C. Calomiris, and T. Wieladek, "How Does Credit Supply Respond to Monetary Policy and Bank Minimum Capital Requirements?" *European Economic Review*, 2016.
- S. Aiyar, C. Calomiris, J. Hooley, Y. Korniyenko, and T. Wieladek "The International Transmission of Bank Capital Requirements: Evidence from the UK," *Journal of Financial Economics*, September 2014, 113, 368-82.

Theme 9: Does *factor investing* work in Emerging Markets? How do portfolio construction, liquidity and transaction costs affect the way we invest in EM?

- **Cakici, Nusret, Frank J. Fabozzi, and Sinan Tan. "Size, value, and momentum in emerging market stock returns." *Emerging Markets Review* 16 (2013): 46-65.**
- **Rouwenhorst, K.G. (1999), Local Return Factors and Turnover in Emerging Stock Markets. *The Journal of Finance*, 54: 1439-1464. doi:10.1111/0022-1082.00151**
- **Griffin, John M., Patrick J. Kelly, and Federico Nardari. "Do market efficiency measures yield correct inferences? A comparison of developed and emerging markets." *The Review of Financial Studies* 23.8 (2010): 3225-3277.**
- Bekaert, Geert, Claude B. Erb, Campbell R. Harvey, and Tadas E. Viskanta. "The cross-sectional determinants of emerging equity market returns." *Quantitative investing for the global markets* (2015): 221-72.
- Bekaert, Geert, Campbell R. Harvey, and Christian Lundblad. "Liquidity and expected returns: Lessons from emerging markets." *The review of financial studies* 20.6 (2007): 1783-1831.

- Lesmond, David A. "Liquidity of emerging markets." *Journal of financial economics* 77.2 (2005): 411-452.
- Barra Risk Model Handbook, Global Equity, https://www.alacra.com/alacra/help/barra_handbook_GEM.pdf
- Van der Hart, Jaap, Erica Slagter, and Dick Van Dijk. "Stock selection strategies in emerging markets." *Journal of Empirical Finance* 10.1-2 (2003): 105-132.
- McLean, R. David, and Jeffrey Pontiff. "Does academic research destroy stock return predictability?." *The Journal of Finance* 71.1 (2016): 5-32.

Assignments

22-May: Mini Case 1

5-Jun: Case 1

12-June: Mini Case 2

26-Jun: Case 2

10-Jul: Mini Case 3

17-Jul: Case 3

31-Jul: Mini Case 4

14-Aug: Case 4