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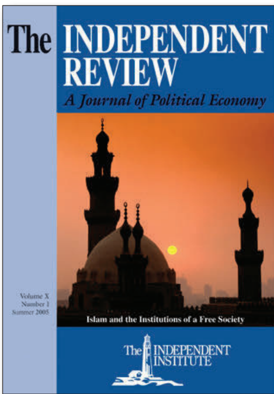

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# Enterprise Capital in Emerging Markets

ROY C. SMITH

Economic growth in developing economies has long been considered dependent on trade, direct and portfolio investment, and foreign aid, including loans from the World Bank and the International Monetary Fund (IMF), which were set up after World War II to fund reconstruction and development and to maintain an orderly international financial system. The postwar reconstruction of the European and Japanese economies proved successful, and it was hoped that similar approaches would enable the countries of the Third World to bring their economies up to Western standards, thereby reducing the likelihood that they would seek economic success by aligning themselves with the Communist countries. Aside from the rapid economic progress of a few, relatively small Asian countries (the so-called "Asian Tigers"—Hong Kong, Singapore, Taiwan, and South Korea—all of which had strong incentives to stay closely allied to the United States), however, the postwar period until the 1990s produced few cases of developing countries that greatly improved their economic conditions relative to the developed world.

Until the 1990s, trade in developing countries was still largely in commodities, foreign direct investment was limited, and foreign portfolio investment was scarce, although banks were beginning to make significant loans to affiliates of Western companies located in developing countries and to the governments of these countries. Foreign aid and technical assistance were regarded as essential to economic development, although they came with political strings or financing conditions that were sometimes hard to live with. It was evident that economic development in the Third

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World was extremely hard to achieve, despite considerable efforts. This difficulty was attributed in part to the prevalence of corrupt, authoritarian governments, whose retention of power depended on their maintenance of the economic status quo, and in part to the distortions of political and economic relations caused by the struggle between East and West in the Cold War. In that struggle, most developing countries preferred to be in the middle, where they could play one side against the other. Although doing so brought in financial and military aid, it did little or nothing to speed economic growth. For the most part, the lack of substantial economic development reflected an inadequate system of private enterprise and an absence of the conditions needed to attract foreign capital. Since 1990, however, great progress has been achieved in attracting *enterprise capital* to the private sectors of a number of developing countries, whose economic growth rates have soared as a result. Ironically, several of these countries are former socialist societies that have adopted market-driven economic systems that are incentive compatible and lubricated by fluid capital flows from abroad.

## The New World Order

Changes began after the removal of the Berlin Wall in 1989, which symbolized the end of Soviet-style communism. That system essentially imploded under the weight of economic mismanagement, Cold War arms-race pressures, and the obvious, contrasting economic success of the market economies in the West. After the wall came down, the rest of Soviet eastern Europe and the Soviet Union itself dissolved bloodlessly into a cluster of independent states seeking economic development and willing to try Western measures to achieve it. Meanwhile, India, whose government had struggled to resist any aspects of foreign "imperialism" and to remain neutral in the Cold War, began in the early 1990s to adopt similar policy changes to enable its economy to exceed the "Hindu rate of growth" (an average annual growth rate of 3.5 percent from 1950 to 1990) to which its socialistic political system had confined it since the country's independence in 1947. A decade earlier in Communist China, Premier Deng Xiaoping, beginning with his "Four Modernizations" policy, had introduced measures to create a "socialist market economy" (or "socialism with Chinese characteristics") that brought about fundamental market-opening reforms to decommunize the economy and to permit and encourage private enterprise, foreign direct investment, and private investment in stock markets.

All of these once-socialist states—the former Soviet bloc, China, and India together represented about half of the world's population—knew that without economic growth, they would be unable to create or attract the resources necessary to meet the rising expectations of their large populations. Rapid, sustained economic growth had not been feasible under their old systems, which the revolutionary regimes had adopted for ideological reasons. The process of economic change in these transitional economies during the 1990s was disorderly, inefficient, and somewhat

erratic, but the effort to adopt open-market economic policies succeeded in raising the rate of economic growth and creating foreign investment opportunities that attracted overseas capital. Correspondingly, foreign aid and development loans began to decline. Indeed, net official payments to emerging-market economies have been negative since 2003.[1] In the eight-year period from 1999 to 2006, the average economic growth rate of emerging-market economies as a whole was 5.9 percent (Russia, India, and China averaged 6.5 percent, 6.6 percent, and 9.0 percent, respectively), compared to an average growth rate for the same period of 1.5 percent in Japan, 1.9 percent in the European Union, and 2.8 percent in the United States (IMF 2005; Norris 2006).

The convergence of these political and economic developments in the former Soviet Union, India, and China coincided with another important series of events in global capital markets: the restructuring of large amounts of defaulted debt owed by Latin American and other Third World countries to banks and other private investors in the developed world. The debt had accumulated over more than a decade of optimistic, aggressive expansion by the banks, fueled in part by the sudden rise of oil prices in 1973 and the ensuing flow into the Middle East of billions of "petrodollars." The money coming in had to be rechanneled, and the oil-country governments, inexperienced in finance, chose to deposit it in a handful of large international banks. The banks had to relend the money, and they identified a number of developing countries with substantial borrowing needs (owing to the oil-price rises and other reasons) that would happily take it from them in the form of term loans. The banks believed they were being well paid for the credit risk over the long term, although by the early 1980s regulators and credit analysts expressed concerns about the mounting exposure to Third World debt that the banks had accumulated. Before long, because of difficult Third World economic conditions, political pressures, irresponsible promises, mismanagement, and corruption, many of the countries could not meet their debt-service obligations. U.S. banks in particular experienced a series of moratoria, standoffs, defaults, and, finally, in the late 1980s, a variety of forced debt rescheduling.

## Recovery Through Rescheduling

The rescheduling of the defaulted debt of the 1980s contained the seeds of reform, restructuring, and invigoration that restored and expanded access to capital markets by emerging-market countries. These elements involved essentially the exchange of bank loans carried at historical cost for bonds with a market price set daily by supply

1. The term *emerging markets* appeared in the 1980s. It now refers to the Third World countries that are seeking to open their economies to competition from free-market forces through deregulation and reforms. Most data for emerging-market economies, however, include all Third World economies, whether they are trying to open up or not.

and demand. An inducement offered by the U.S. Treasury primed the pump for the exchanges. The governments whose bank debt was being restructured were offered the opportunity to purchase, at deep discounts, long-term zero-coupon U.S. Treasury securities to serve as collateral for the new bonds to be issued. These new bonds (called "Brady Bonds" in honor of U.S. Treasury secretary Nicholas Brady) would mature at the same time as the zero-coupon U.S. Treasury bonds, so the Treasury bonds would supply the cash to redeem the maturing Brady bonds. The inducement succeeded in persuading banks to accept the exchange even though their loans, to be exchanged, had to be written down substantially in value, a concession most of them had been unwilling to make previously. In the end, about $250 billion of Brady Bonds came onto the Eurobond and other international bond markets, where trading became active, and investors willing to speculate on the recovery of developing-country economies replaced bankers and other investors who had become discouraged. The active trading of Brady Bonds made it possible to price developing-country credit risk regularly and accurately in the market, thus permitting additional new issues to appear. By the early 1990s, these issues underpinned a substantial improvement in the depth and efficiency of international markets for developing-country credit.

As part of the general restructuring effort, developing countries were provided incentives to conform to a new set of liberalizing economic principles that encouraged the creation of free markets and more open local economies (Claessens and Rhee 1994). Policy changes supportive of these principles quickly increased capital inflows of foreign direct investment, portfolio investment in corporate securities (often facilitated by new issues in the Eurobond market), and wealthy local residents' repatriation of capital previously transferred abroad.[2] The capital flow stimulated economic growth in the private sector, which encouraged emerging-market governments to undertake large-scale privatization of important state-owned enterprises. The sale overseas of large amounts of stock in former state-owned enterprises (for example, telecom, energy, and other public utilities) attracted additional portfolio inflows, which stimulated an emerging-economies stock-market "bubble" from 1992 to 1994, when the unexpected, sudden collapse of the Mexican peso brought an end to the euphoria.

The peso's collapse triggered an almost simultaneous crash of developing-country equity markets all over the world. By the end of January 1995, the Mexican stock market had dropped 56 percent from its level a year earlier, and the markets in Turkey, China, Poland, and Hong Kong went down by similar amounts, with declines of 20–30 percent being common in most emerging-market countries (a few countries with capital controls in place were not affected by the contagion). The aftermath revealed that when large, foreign, institutional investors—pension and mutual

2. The open-market principles led to policy changes such as eliminating price and investment controls, deconstructing state-owned enterprises, encouraging the establishment of financial markets, and providing for institutional and regulatory developments to keep pace with the changes.

funds—discovered politically motivated, deceptive, and fraudulent actions of government officials in Mexico, they decided en masse that it was time to get out of all similar investments. Panic sales in illiquid markets ensued, leading to a collapse in market prices. The hot money, previously attracted by the sudden discovery of an emerging-market investment play, pulled out as quickly as it had arrived (Smith and Walter 1997).

Or so it seemed at the time. However, only the emerging-country stock-market bubble burst (while a new one, the Internet bubble, was forming in the United States), not the rationale for emerging-market investment. This rationale was that private capital, through the forces of globalization, would substantially reward economies that modernized their private sectors and built the necessary institutional infrastructure to support free-market enterprise. Many countries attempted to do so, and, in them, investors could find securities that justified revaluation as free-market reforms reduced country risk. Over the years, the Asian Tigers had benefited enormously from both foreign capital and internal reforms, and so now were China and countries in Latin America, Southeast Asia, and eastern Europe.

Sovereign-debt markets for emerging-market countries continued to be active and to permit many new Eurobond and syndicated bank issues despite further defaults and restructurings (Mexico 1994; Thailand, Korea, and Indonesia 1997–98; Russia 1998; Argentina 2003). Financial-market participants recognized that emerging markets had developed a permanent place among asset classes appropriate for institutional investment. The assets were risky, but the returns were expected to exceed those of ordinary assets; when failures occurred, losses were taken, and the market moved on to attract a new group of investors buying in at lower prices and looking for subsequent improvements. The debt rescheduling that occurred after the mid-1990s was largely forced by excessive borrowing, not by fundamentally backward economic policies.

## Enterprise Capital

Foreign direct investment continued to expand in the 1990s with the improving prospects for private enterprise, especially in the large, formerly socialist economies of Russia, India, and China. Stock markets in emerging-market countries, spurred by privatizations (which reached a peak of nearly $60 billion in 1997), continued to attract the attention of hedge funds and country-specific investment funds. New issues of emerging-market common stocks peaked again in 2000 at $73 billion, returning to the levels experienced during the emerging-markets bubble of 1992–94. Total private capital flows to emerging-market countries, including foreign direct investment and debt and equity portfolio investments (which peaked during the bubble at $150 billion) leveled off for a year or two, then increased again to reach $230 billion in 1996, before more than doubling to $509 billion in 2000 (Institute of International Finance 2007). In both 1996 and 2000, approximately half of the capital flows

represented foreign direct investment, but the other half consisted of a record inflow of portfolio investments. Most important, almost all of the funds coming into these countries were directed to the private sector, which after privatizations and market reforms was more unrestrained and robust than ever. The influx of capital, increasing year by year in volume and in the sophistication of the financial instruments employed, was being used to expand private enterprise.

Private enterprises have flourished in many emerging-market countries since the resumption of capital-market activity in the mid-1990s. Not only were funds made available to expand and develop businesses as a result of foreign direct investment, but these investments in local businesses were usually accompanied by transfers of foreign management, technology, and access to overseas markets. Government efforts to open and deregulate national markets led to greater competition and efficiency. National capital markets, also subject to deregulation or reforms and fortified by international investments, gave rise to financing opportunities previously available to only a few companies. Local-currency corporate bond markets developed in response to declining interest rates, greater transparency, and a rise in purchasing power of local financial institutions. An example of this development is the recent appearance in Mexico of local-currency-denominated collateralized-debt issues sold to newly activated pension funds.

In many emerging-market economies, privatization of state-owned enterprises resulted in major transformations of local markets, owing to the large size of the issues. Privatization issues were often directed as much as possible toward local individual investors, who would thereby become shareholders in a revitalized private sector and therefore supporters of it. Increasing activity in the capital markets created opportunities to transact corporate mergers in them, which began to expand the range of strategies available to publicly traded corporations.

## Enterprise Capital Activity Since 2000

Table 1 shows the increasing capital-market activity in several categories in emerging markets for the six years from 2001 through 2006. The activity consists of new issues of debt (including public and private issues of bonds and bank loans by local corporations, joint ventures, and others), new issues of equity securities (including public offerings and private equity transactions), and merger and acquisition transactions done in local and overseas markets. The transactions include some investments by foreign corporations in their subsidiaries done through the issuance of loans or securities. These investments are included as capital-market activity involving corporate restructuring and control changes that lead to better asset utilization.

Total enterprise capital raised or deployed in emerging-market economies increased from $517 billion in 2001 to $1.57 trillion in 2006. These essentially private transactions greatly exceed sovereign-government financing totals for the years indicated. Over this six-year period, emerging-market economies cumulatively raised $4.9

**Table 1**
**Emerging-Market Enterprise-Capital Market Activity, 2001–2006 (billions of dollars)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Cumulative Total |
|---|---|---|---|---|---|---|---|
| Sovereign Government Issues | 67.1 | 66.5 | 77.8 | 103.0 | 108.3 | 122.9 | 545.6 |
| Corporate Debt Market Issues* | 211.2 | 175.8 | 228.5 | 327.0 | 489.6 | 866.5 | 2,298.6 |
| Corporate, JV, and Subsidiary Issues** | 166.7 | 191.7 | 177.9 | 181.2 | 233.7 | 342.2 | 1,293.4 |
| **Total Corporate Debt Issues** | **377.9** | **367.5** | **406.4** | **508.2** | **723.3** | **1208.7** | **3,592.0** |
| Common Stock Issues | 25.4 | 35.7 | 57.9 | 108.2 | 124.8 | 237.5 | 589.5 |
| Mergers & Acquisitions | 113.3 | 106.3 | 131.3 | 87.1 | 127.3 | 123.4 | 688.7 |
| **Total Enterprise Capital Activity** | **516.6** | **509.5** | **595.6** | **703.5** | **975.4** | **1569.6** | **4,870.2** |

* Corporate debt issuers are public, private, and mutually owned firms.
** All other corporate debt issuers are nongovernment issuers (public, private, mutually owned, investor, joint venture [JV], subsidiary, and unknown).
*Source:* Author's compilations based on data from Thomson Financial, SDC Platinum Mergers and Acquisitions Database. Available at: http://www.thomson.com/content/financial/brand_overviews/SDC_Platinum.

trillion for private purposes, as compared to $546 billion raised by the governments of these developing countries. The largest expansion of capital-raising activity was the issuance of corporate debt ($2.3 trillion), the smallest in new issues of common stock ($590 billion). Despite this activity and the recent history of rapid economic growth in many emerging-market countries, foreign investors have only recently rediscovered emerging-market securities. Net portfolio investment flows into emerging markets, for example, increased from $39 billion in 2004 (after several years when these flows were modest) to approximately $70 billion in 2006 (Institute of International Finance 2007).

Emerging-market stock-market capitalization totaled $7.1 trillion in 2005, or 16.3 percent of global equity-market capitalization. This capitalization reflected a twelvefold increase over its 1990 amount, when it represented 6.4 percent of global equity-market capitalization, and compared favorably to a fourfold increase in market capitalization for developed countries as a whole (Securities Industry Association 2006). Emerging-market stock-market capitalization in 2005 was somewhat greater than total U.S. equity-market capitalization in 1995. Indeed, the average annualized three-year return of six emerging-market stock index funds through June 1, 2006, was 42.2 percent ("Emerging Markets" 2006; Lauricella and Gullapalli 2006).

Table 2 shows the enterprise-capital transactions for the three largest formerly socialist economies (Russia, India, and China) for the period from 2001 to 2006. It seems fitting, in light of the earlier success of the Asian Tigers, to refer to these newly rapidly growing economies as something equally formidable, such as the "Formerly Socialist *Lions*"!

Enterprise capital increased in the Lions from $57 billion in 2001 to $371 billion in 2006, greatly exceeding government financings. These countries have cumulatively raised more than $1.2 trillion for private purposes during the past six years. These issues have been distributed in various international markets, but most of the securities have been sold in national markets, which have gained experience, volume, and sophistication in the process.[3]

Table 3 shows the percentage of emerging-market enterprise-capital transactions accounted for by the Formerly Socialist Lions. Russia, India, and China together accounted for an average of 21 percent of these private financing transactions in 2006, as their economies set the standard for high economic-growth rates among all countries. Together they also accounted in 2006 for 31.6 percent of all emerging-market debt issuances, 52.0 percent of new stock issues, and 38.8 percent of merger-and-acquisition transactions, compared to only 6.1 percent of all emerging-market sovereign debt issued. These proportions are very large parts of global emerging-market

3. Sales outside national markets are generally accomplished by placements in the unregulated Euromarket or in the United States through unregistered private placements to institutional investors under Securities and Exchange Commission Rule 144a. A substantial portion of large, seemingly local privatization issues from China and Russia have been distributed through such international placements.

**Table 2**
**"Formerly Socialist Lions" Enterprise-Capital Market Activity, 2001–2006 (in billions of dollars)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Cumulative Total |
|---|---|---|---|---|---|---|---|
| Lion Sovereign Government Issues | 6.2 | 4.4 | 6.7 | 9.1 | 19.9 | 20.8 | 67.1 |
| Russia | 1.7 | 0.7 | 1.6 | 2.8 | 2.3 | 3.3 | 12.4 |
| India | 0.8 | 1.5 | 2.6 | 3.2 | 5.9 | 5.9 | 19.9 |
| China | 3.7 | 2.2 | 2.5 | 3.1 | 11.7 | 11.6 | 34.8 |
| Lion Corporate Debt Market Issues* | 14.9 | 19.9 | 32.8 | 58.9 | 82.5 | 150.2 | 359.2 |
| Russia | 2.2 | 9.4 | 19.1 | 35.5 | 45.1 | 70.1 | 181.4 |
| India | 3.7 | 5.1 | 6.0 | 14.8 | 30.2 | 59.1 | 118.9 |
| China | 9.0 | 5.4 | 7.7 | 8.6 | 7.2 | 21.0 | 58.9 |
| Lion Corporate, JV, and Subsidiary Issues** | 16.7 | 33.1 | 51.4 | 77.8 | 107.9 | 49.0 | 335.9 |
| Russia | 3.4 | 10.3 | 29.6 | 46.3 | 61.5 | 29.6 | 180.7 |
| India | 4.0 | 6.4 | 10.6 | 18.0 | 35.6 | 10.6 | 85.2 |
| China | 9.3 | 16.4 | 11.2 | 13.5 | 10.8 | 8.8 | 70.0 |
| Total Lion Corporate Debt Issues | 31.6 | 53.0 | 84.2 | 136.7 | 190.4 | 199.2 | 695.1 |
| Russia | 5.6 | 19.7 | 48.7 | 81.8 | 106.6 | 99.7 | 362.1 |
| India | 7.7 | 11.5 | 16.6 | 32.8 | 65.8 | 69.7 | 204.1 |
| China | 18.3 | 21.8 | 18.9 | 22.1 | 18.0 | 29.8 | 128.9 |

**Table 2**
**(continued)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | Cumulative Total |
|---|---|---|---|---|---|---|---|
| Common Stock Issues | 12.0 | 10.6 | 18.0 | 39.9 | 54.6 | 123.4 | 258.5 |
| Russia | 0.2 | 1.2 | 0.1 | 2.1 | 3.6 | 6.6 | 13.8 |
| India | 0.4 | 1.0 | 3.1 | 7.6 | 12.9 | 23.1 | 48.1 |
| China | 11.4 | 8.4 | 14.8 | 29.2 | 38.1 | 93.7 | 195.6 |
| Lion Mergers and Acquisitions | 13.6 | 31.0 | 50.3 | 28.4 | 45.2 | 48.0 | 216.5 |
| Russia | 2.0 | 5.8 | 30.3 | 16.3 | 31.6 | 14.1 | 100.1 |
| India | 4.5 | 5.0 | 2.8 | 2.8 | 7.8 | 16.7 | 39.6 |
| China | 7.1 | 20.2 | 17.2 | 9.3 | 5.8 | 17.2 | 76.8 |
| **Total Lion Enterprise-Capital Activity** | **57.2** | **94.6** | **152.5** | **204.0** | **290.2** | **370.6** | **1,169.1** |
| Russia | 7.8 | 26.7 | 79.1 | 100.2 | 141.8 | 120.4 | 476.0 |
| India | 12.6 | 17.5 | 22.5 | 43.2 | 86.5 | 109.5 | 291.8 |
| China | 36.8 | 50.4 | 50.9 | 60.6 | 61.9 | 140.7 | 401.3 |

* Corporate debt issuers are public, private, and mutually owned firms.
** All other corporate debt issuers are nongovernment issuers (public, private, mutually owned, investor, and joint-venture [JV]).
*Source:* Author's compilations based on data from Thomson Financial, SDC Platinum Mergers and Acquisitions Database. Available at: http://www.thomson.com/content/financial/brand_overviews/SDC_Platinum.

**Table 3**
**"Formerly Socialist Lions" Enterprise-Capital Market Activity, 2001–2006 (Percentage of Emerging-Market Economies Total)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Lion Sovereign Government Issues | 2.9 | 1.7 | 2.8 | 4.0 | 4.7 | 6.1 |
| Russia | 1.7 | 0.7 | 1.6 | 2.8 | 2.3 | 1.0 |
| India | 0.2 | 0.4 | 0.6 | 0.6 | 0.8 | 1.7 |
| China | 1.0 | 0.6 | 0.6 | 0.6 | 1.6 | 3.4 |
| Lion Corporate Debt Market Issues* | 7.1 | 11.3 | 14.4 | 18.0 | 16.9 | 17.3 |
| Russia | 1.0 | 5.3 | 8.4 | 10.9 | 9.2 | 8.1 |
| India | 1.8 | 2.9 | 2.6 | 4.5 | 6.2 | 6.8 |
| China | 4.3 | 3.1 | 3.4 | 2.6 | 1.5 | 2.4 |
| Lion Corporate, JV, and Subsidiary Issues** | 4.5 | 9.0 | 12.7 | 15.3 | 14.9 | 14.3 |
| Russia | 0.9 | 2.8 | 7.3 | 9.1 | 8.5 | 8.6 |
| India | 1.1 | 1.7 | 2.6 | 3.5 | 4.9 | 3.1 |
| China | 2.5 | 4.5 | 2.8 | 2.7 | 1.5 | 2.6 |
| Total Lion Corporate Debt Issues | 11.6 | 20.3 | 27.1 | 33.3 | 31.8 | 31.6 |
| Russia | 1.9 | 8.1 | 15.7 | 20.0 | 17.7 | 16.7 |
| India | 2.9 | 4.6 | 5.2 | 8.0 | 11.1 | 9.9 |
| China | 6.8 | 7.6 | 6.2 | 5.3 | 3.0 | 5.0 |
| Common Stock Issues | 47.3 | 29.7 | 31.2 | 35.9 | 43.7 | 52.0 |
| Russia | 0.8 | 3.4 | 0.2 | 1.9 | 2.9 | 2.8 |
| India | 1.6 | 2.8 | 5.4 | 7.0 | 10.3 | 9.7 |
| China | 44.9 | 23.5 | 25.6 | 27.0 | 30.5 | 39.5 |
| Lion Mergers and Acquisitions | 13.4 | 30.7 | 50.3 | 28.4 | 45.2 | 38.8 |
| Russia | 1.8 | 5.5 | 30.3 | 16.3 | 31.6 | 11.4 |
| India | 4.5 | 5.0 | 2.8 | 2.8 | 7.8 | 13.5 |
| China | 7.1 | 20.2 | 17.2 | 9.3 | 5.8 | 13.9 |
| **Total Lion Enterprise-Capital Activity** | **8.2** | **14.6** | **20.2** | **20.6** | **21.3** | **23.7** |
| Russia | 1.1 | 3.4 | 10.1 | 9.2 | 9.9 | 7.7 |
| India | 1.7 | 2.4 | 2.8 | 4.0 | 5.8 | 7.0 |
| China | 5.4 | 8.8 | 7.3 | 7.4 | 5.6 | 9.0 |

* and ** See notes for table 2.

*Source:* Author's compilations based on data from Thomson Financial, SDC Platinum Mergers and Acquisitions Database. Available at: http://www.thomson.com/content/financial/brand_overviews/SDC_Platinum.

financing transactions for countries that began to discover international capital markets only around 1990. At that time, these countries were not in the game at all or were sitting quietly on the sidelines as the Asian Tigers set the world standards both in the development of their private sectors and in their economic-growth rates. The Asian Tigers were sometimes thought to have been so successful because they were small, comparatively easily governed countries that placed great importance on achieving economic development through encouragement of the private sector. The Lions, by contrast, were (until recently) very large, politically complex, hard-to-govern countries that did not place great political importance on achieving a rapid rate of economic growth and did not do much to encourage private enterprise.

Indeed, the Lions' success in attracting capital is somewhat surprising in light of their governments' controlling roles, the uncertain place of open markets and private enterprise in their evolving politicoeconomic systems, the rise and fall of oligarchs (or favored rich), corruption, and, especially in Russia and China, the uncertain commitment to private-property rights and the rule of law. Such anticapitalistic elements should surely cause rational new investors, especially long-term investors, to hesitate. Yet many have not hesitated; they have plunged ahead despite these concerns because of the apparent trends toward more liberal economic governance and the promise of future opportunities that the opening of large new markets and, in Russia, the access to large quantities of raw materials present. Investment markets do anticipate future events, often by many months, which may explain the actions of today's investors. Owing perhaps to naïveté or a more optimistic enthusiasm than the facts warrant, these investors may also be hoping to gain the "first mover" advantages that accrue to those who do not hesitate. Even if the investment flow into the Lions is greater than it should be, however, the important fact is that in these countries the private sector has attracted the influx, grown with it, and used it to promote the rapid absorption of advanced technology and a rapidly growing output of goods and services.

## Implications

Enterprise-capital inflow into emerging-market economies has tripled in the past six years, and wherever it has gone, it has had an important effect on economic growth. Indeed, as shown by the experience of Russia, India, and China, the ability to attract relatively large quantities of capital for private investment has made possible exceptional economic-growth rates, despite the many difficulties and imperfections in these countries' investment climates. Enterprise capital now appears to be far more effective in generating growth in developing countries than foreign aid and loans from multinational development agencies or from individual countries' robust government-allocated national economic-development efforts, which for nearly fifty years were regarded as the world's best solutions for ending poverty and distress in the Third World. These "solutions," however, did little to generate the rates of economic growth needed in the Third World to alleviate the poverty and distress. Other ideas

have been offered—such as the "microlending" programs for which Muhammad Yunus was awarded the 2006 Nobel Peace Prize and the revision of property rights in the Third World to reflect de facto ownership of real and personal property developed by the poor, as urged by Hernando de Soto (2000)—but these efforts have lacked the access to investment capital necessary to create large-scale programs.

Driven almost entirely by market forces, enterprise capital is attracted by prospects for the future. It is not allocated by political considerations, government planning, quotas, or the aid programs, however well intended, of governments and supranational institutions. It is opportunistic, volatile, and somewhat wild—it can result in bubbles and add to local confusion over what is being financed, by whom, and why—but as long as the underlying conditions that attract it are unchanged, the access to the capital is maintained.

Many factors affect the underlying conditions that attract enterprise capital: the improvement in local business conditions by deregulation and market opening; the ability for competition to form in major market sectors; the creation (or improvement) of financial institutions, especially banks, insurance companies, stock exchanges, and retirement funds; and, most important, the credibility of government leaders' commitment to defend market openness against all special interests seeking to diminish it. Once that credibility has been established, market forces begin to work. First come the high-risk takers willing to bet that buying into a risky environment will be justified by the low price of entry, if things improve. As things do improve, other investors follow: local investors, expatriates with capital held outside the country, foreign institutional investors allocating funds to a new "alternative" asset class, and so on. Throughout the process, foreign direct investors also increase their bets that future conditions justify current commitments, and financial intermediaries begin to cruise for opportunities, deals to do, and techniques to import. Thus, markets for enterprise capital increase in activity and complexity as long as the fundamental commitment to open markets is sustained. The markets can endure losses, disappointments, and external shocks typical of risky investments anywhere, but should the commitment to open markets be lost or attenuated (as in Venezuela), the process reverses itself, and things go down even faster than they went up.

Sustaining the credibility is a matter of politics. Unfortunately, to gain votes, many politicians are tempted to take advantage of populist rhetoric that is antithetical to open markets. Some politicians are unable or unwilling to sell the idea of open markets if it means a journey through a "shock therapy" treatment of the economy. For those who can accomplish this task, however, the formula for attracting enterprise capital is relatively clear and well known. It has worked well in the poorer countries of Europe (Spain, Portugal, Ireland, and Greece), in small developing countries such as the Asian Tigers, Chile, and some eastern European emerging-market countries, and now it has taken root in larger countries, such as the Formerly Socialist Lions.

As relative newcomers to the process of raising enterprise capital, the Lions have set a good example for other emerging-market countries, some of which have

struggled for years to find ways to attract and retain capital for their private sectors. The Lions, despite their great size and political uncertainties, have effected significant market opening and allowed entrepreneurial forces to develop much more freely than they did previously. Other emerging-market countries, such as Poland, Turkey, Mexico, and Brazil, now appear to feel the need to compete with the Lions for the available capital before they fall too far behind—by opening markets wider; by developing new institutional investors (such as pension funds, as is now occurring in parts of Latin America); by encouraging innovation and the importation of financial devices and practices (such as securitization and the use of derivatives) that have existed for years in the developed world; by encouraging inward investment; by restructuring legacy, underperforming corporations; and by promoting entrepreneurial activity. Capital and the know-how to use it effectively have made a big difference in accelerating economic growth in the Lions, and they can have the same effect elsewhere. Indeed, if this process can take hold in Russia, India, and China, it can take hold almost anywhere.

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