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In Search of Anchors

By

Mohamed A. El-Erian, Managing Director, Fixed Income, PIMCO

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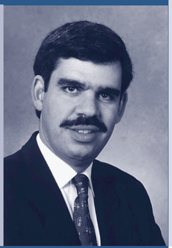
Mohamed
A. El-Erian



Emerging Markets Watch

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In Search of Anchors

The calendar says it has been two weeks since the September 11 Tragedy but my heart says otherwise, fed by vivid mental images depicting the enormity of the human losses. Judging from my own prior experience with the sudden and unexpected loss of loved ones, I doubt that the combined feeling of intense sadness and shock will dissipate quickly in the months ahead. My thoughts and prayers go out to the many people who are suffering from this terrible event.

Like others, our market is nothing more than the collective behavior of individuals, the majority of whom have been touched deeply by this terrible Tragedy. This market, too, is trying to pick itself up and march on. But it is undeniable that certain things have changed. And these changes extend well beyond short-term disruptions to price discovery, liquidity and trading volumes. For emerging economies, these changes entail a one-time reduction in income and wealth, as well as longer-term qualifications to some of the underpinnings of the asset class.

At the most basic level, EM has temporarily lost many of its fundamental and technical anchors – domestic and external. Price action is highly tentative, with investors lacking conviction and enthusiasm. Accordingly, the market is at the mercy of volatile moves in equities in industrial countries.

As we look forward, it is highly likely that EM as a whole will re-establish many, if not all, of its dislodged anchors. But the process will take time and will involve some degree of re-definition. The challenge for investors, PIMCO included, is to anticipate the nature, sequence and speed of the process. This is key to our continued ability to out-perform in EM.

Reacting to a National and International Tragedy

Consistent with other financial markets, the immediate impact of the terrorist attacks was to disrupt the basic functioning of EM. Trading was halted as the market tried to come to grips with the enormity of the human losses and technical breakdowns. Reflecting the hard work of many people in New York, systems were gradually restored and liquidity increased, albeit not to the pre-September 11 levels.

In terms of credit fundamentals, the Tragedy accelerated a process that had been initiated by growing market recognition of the synchronized nature of the global economic slowdown. In effect, it fast forwarded the deterioration in the demand, price and financing outlook for many emerging economies.

With concerns now spreading about the health of the hither-to remarkably robust U.S. consumer spending, emerging markets can no longer count on a consistent increase in the volumes of their exports. The outlook for their exports unit values has also dimmed, with commodity prices being adversely impacted, and competition growing in third markets due to sharp currency depreciations. Even oil prices have fallen as market participants recognize that, post-Tragedy, there is little that OPEC members can do on the supply front to offset the unavoidable fall in demand. Meanwhile, tourism flows have been disrupted, undermining yet another important source of foreign exchange earning for many emerging economies.

To their credit, several countries have already taken policy measures in response to the income and wealth losses resulting from the deterioration in their external environment. Rightly, the emphasis has been on macro policies and, to the extent possible, attempting to press ahead with structural reforms. The old habit of just relying on international reserves and hoping for the best is scarcely in evidence. And in countries with flexible exchange rate regimes (i.e., the majority with the notable exception of Argentina, Bulgaria, and Hong Kong), the currency has been allowed to play its role of shock absorber. But, much to the disappointment of policy makers, market reaction has been muted as investors continue to be driven by more global developments.

The immediate adverse effects on emerging economies are not limited to the loss of (a) the external anchor associated with trade in goods and services, and (b) the domestic policy anchor. The Tragedy has also increased global risk aversion. This is being felt in virtually every financial market around the world. For emerging economies, the likely outcome includes a decline in capital inflows and an increase in borrowing costs.

With U.S. and European corporates coping with disruptions in their home markets (namely, more uncertain demand and funding conditions), their appetite for overseas activities is being curtailed. It is not surprising, therefore, that the Institute for International Finance is now projecting a 4.5% decline in foreign direct investment flows for this year and a further 13.2% for 2002. It also expects net private capital flows to emerging economies to fall from $167 billion last year to $106 billion this year.

These economic and financial changes are rightly leading Wall Street analysts to cut their growth projections for emerging nations. And the revisions are not minor. UBS for example has just cut its 2001 growth rate for Latin America from 1.1% to 0.5%; the revision for 2002 is from 3.4% to 1.9%.

Meanwhile, outstanding EM financial instruments have come under pressure as a result of the generalized flight to quality occasioned by rising risk aversion. Both dedicated and cross-over investors have been selling. The fact that the Tragedy is also unfavorably impacting other spread products involves a double dose of bad news for EM: The higher quality segment of the market is being pressured by sales from high grade funds while the lower quality segment is facing tough competition from the high yield market.

Short- and Medium-term Implications

All this has affected the bottom line for EM investors through a drop in valuations and an interruption in the pattern of credit differentiation that had been driven by growing differences in individual countries' domestic economic conditions.

Not surprisingly, equity valuations have been hit more than bonds. Since September 11, EM equities have lost 10.7% of their value (as measured by the MSCI – EM Free) while EM bond have returned a negative 3.6% (as measured by JP Morgan's EMBI+).

This differentiation in performance among EM bonds and equities is consistent with an asymmetrical characterization of the influences on each of the private and public sectors that was already evident before September 11 (Figure 1). This asymmetry is now being amplified in light of the large differences, within individual economies, in balance sheet strength and direct sensitivity to global income and price effects.

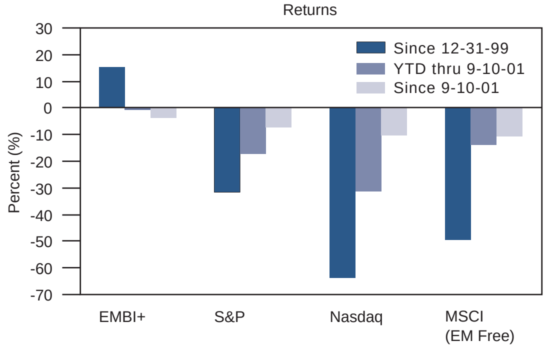

Figure 1

Source: Bloomberg

By contrast, the differentiation between emerging economies has been sharply reduced. Most country betas have converged notwithstanding stark differences in countries' ability and willingness to deal with the more fluid and difficult international environment. One consequence of this, as discussed in a recent report by Deutsche Bank, is to alter the risk characteristics of most EM portfolios.[1]

Part of the dissipation in credit differentiation is temporary and reversible as it reflects the "market for lemons" effect discussed in a previous *EMW*.[2] This effect causes valuations to be driven by a common systemic effect rather than determinants of relative value within the asset class. Today, the driver is the major economic and financial shock and uncertainties occasioned by the terrorist attacks; it has been accentuated by redemptions forcing broad-based sales by EM fund managers.

But not all of the collapse in credit differentiation is attributable to the "market for lemons" phenomenon. Some of it also reflects the fact that the world has changed; or at least is much more uncertain. At the extremity of this argument is the view that there has been a radical reordering of the attributes that determine EM creditworthiness.

Consider two variants of this view, both of which de facto compress credit differentials:

- In the "weak" variant, EM investors benefit from increased "bail out" protection — especially if they focus on the "intensive care" countries that are deemed political allies of the U.S. Under this scenario, countries closest to default and financial disruptions are the most likely to benefit from extra-ordinary assistance from a U.S.-led effort aimed at ensuring financial calm during the pursuit of terrorists.
- Under the "strong" variant, the post-September 11 world order reverses globalization forces, thereby penalizing those emerging countries that, through sound policy implementation, have made the most progress in integrating their economies with the advanced ones.

It certainly would be a peculiar turn of event if the longer-term redefinition of the EM anchors were to downplay good policies in favor of moral hazard and anti-openness measures. Fortunately this is not the central scenario though it warrants monitoring.

The Road Ahead

While the asset class has lost temporarily many of its anchors, our investment approach continues to be based on the combined assessment of economic, external and technical factors.

On the economic and external fronts, the road that emerging economies take from here depends mainly on two issues: First, the extent to which they can benefit from the coordinated easing of macro policies in mature economies (led by the U.S.); and second, the manner in which they can adjust their internal policies to the new global realities.

Recognizing the downside risks facing the global economy, policy makers in industrial countries are taking steps to reliquify their economies. The initial emphasis has been on a (de facto coordinated) easing of monetary policy, led by aggressive Fed action. There is now talk of a loosening of fiscal policy (both tax cuts and higher spending).

Through the traditional income and price effects, the macro-economic stimulus at the center of the global economy will have positive spill-over effects on emerging nations over time. Various technical factors will also be in play. Judging from historical experience and provided the deterioration in creditworthiness is not too pronounced, the reliquification will eventually serve to "push" institutional funds to EM in search of higher yields, while demand from local investors will continue to grow consistent with domestic financial sector reforms. These factors will interact with developments in complementary and competing asset classes.

While not providing an upfront compensation for the reduction in income and wealth, these developments would re-establish over time the external anchors for EM. Thus, given the conviction with which the U.S. authorities are pursuing macro policy easing, the question is more "when" than "if." And this depends on the U.S.'s ability to sustain consumption pending a recovery in business investment.

So, emerging economies can look forward to more favorable conditions pertaining to demand, price and risk appetite; but they are unlikely to materialize in the immediate period ahead given sequencing issues in the U.S. (and, by implications, the global economy). As discussed in Bill

Gross's recent *Investment Outlook*, "...a sharp recovery down the road is a possible scenario. The [U.S. economy] patient, however, is already in his recessionary bed sheets, and because of this fact, the economy is at risk of a substantial further downturn."[3]

An eventual recovery in the global economy can also serve to lessen the systemic risk to the globalization philosophy that has underpinned much of the policy deliberations at the national and international levels. But, as Paul McCulley has stated in a different context, reducing the depth of a river from 7 feet to 6 feet is not necessarily great news for everyone trying to walk across if their *average* height is just over 6 feet. Distribution counts as much as the average.

Here is where individual country policies come into play in a significant manner. The question boils down to whether countries have the willingness and ability to make the tough policy decisions needed to bridge to a better global environment. This question, which determines countries' ability to "pull" capital from abroad, assumes added importance given that international investors are particularly skittish given the quantum jump in uncertainty.

The September 11 tragic events call for an important qualification to our traditional "push/pull" analysis. Geo-political issues will matter more going forward as the international community looks to isolate countries that, inadvertently or otherwise, provide even a slight enabling environment for terrorism. Indeed, all emerging countries would be well advised to check, *in detail*, not only their political signals but also their financial regulatory regimes.

Geo-political considerations could also impact the willingness of the official community to provide exceptional financial assistance to help countries navigate the more difficult international environment. Having said this, we are very cautious towards investment strategies that take the geo-political argument to the moral hazard extreme – i.e., the argument that countries can have significant access to IMF/World Bank funding irrespective of the sustainability of their policy regime. First, history teaches us that external assistance, no matter how "strategic," can only have a meaningful medium-term impact if there is a conducive domestic policy regime. Holders of Russian bonds on August 17, 1998 would be the first to confirm this. Second, the international community has a range of instruments that can be used for strategic support. Some of them, such as bilateral official debt restructuring, give a political signal; others, such as enhanced IMF programs, also send a technical signal regarding policies. In choosing instruments, officials need to balance their response with the desire to preserve the credibility of the signaling process.

In Sum...

So while it is unlikely that we will return fully to the pre-September 11 world, there is a good chance that EM will re-establish its anchors consistent with attractive medium-term returns for investors. In the meantime, you will find us defensively positioned in terms of our different risk measures, spending a lot of time assessing how individual countries navigate the highly uncertain global environment.

With some luck, some of these countries could even use this time to make policy and institutional changes that could meaningfully improve their longer-term prospects for growth and financial stability. While this in no way would lessen the pain and sadness felt by the multitude of people being personally touched by the Tragedy, it would offer a very small ray of hope that some good, no matter how tiny, can come from this horrific adversity.

Mohamed A. El-Erian, Ph.D.
Managing Director
el-erian@pimco.com

September 25, 2001

[1] *"EM Technicals," Deutsche Bank, September 21, 2001.*

[2] *"Sound Economics, Noisy Politics, and the Market for Lemons," Emerging Markets Watch, June 2000.*

[3] *"The Bells," Investment Outlook, September 2001.*

PIMCO

840 Newport Center Drive
P.O. Box 6430
Newport Beach, CA
92658-6430
(949) 720-6000