# Sukuk Reduces Risk of Corruption and Theft of Funds

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**Abstract**

*This paper aims to determine the importance of the The structure of Sukuk through the creation of Special Purpose Vehicles (SPVs) provides better transparency thereby reducing corruption and wastage as productive assets must be put to work in order to generate rental incomes for investors, rather than disappearing into off shore banking centres or participating in deliberately over priced projects.*

*The paper relies on The 2014 report makes interesting reading with Denmark, New Zealand and Finland ranked as the least corrupt countries and unfortunately a host of OIC countries coming out towards the wrong side of index, with the notable exception of the UAE and Qatar which rank 25 and 26 respectively, better than the likes of France, Portugal and Poland.*

*The results show that Corruption and abuse of state funds affects many countries and Organisation of Islamic Cooperation (OIC) countries are no exception. Corruption has a devastating impact for many reasons, one of which is whilst funds are siphoned off abroad, the debt remains on the countries balance sheet and accrues interest charges, compounding larger year after year.*

*The results In addition to the traditional benefits of sukuk, such as diversifying an investor base and accessing investors who do not invest in interest based bonds, a less discussed value add of sukuk is its structure, particularly the Ijara structure which to a greater deal over conventional bonds prevents the wastage of funds through corruption and theft.*

*This paper is a pioneer study undertaking about Sukuk Reduces Risk of Corruption and Theft of Funds*
***Keywords:*** *Sukuk, Risk, Corruption, Islam, Economics and Funds*

## Introduction

The Government of Indonesia conducted a regular sukuk auction last week and absorbed IDR1.98 trillion from incoming bid amounting IDR3.25 trillion, slightly lower than indicative target of IDR2 trillion. Average weighted yields were 18 bps higher for 6-months T-bills but 4 bps lower for PBS07 (maturing in 2040) respectively than prior auction result dated on 10 March. Government also issued IDR2.7 trillion PBS06 by private placement to Indonesia Deposit Insurance Corporation. At this moment, the government has issued a total of IDR170.16 trillion year-to-date out of annual gross target of IDR452 trillion (budget revision).

Ras Al Khaimah Sukuk

This is Ras Al Khaimah's first sukuk issuance since October 2013, when the UAE emirate of Ras Al Khaimah sukuk was priced at 3.297% (MS+175bps) with a total of USD500m which garnered orders over USD5bn, which represents much stronger demand than the currently launched 10y sukuk.

Emirates Sukuk

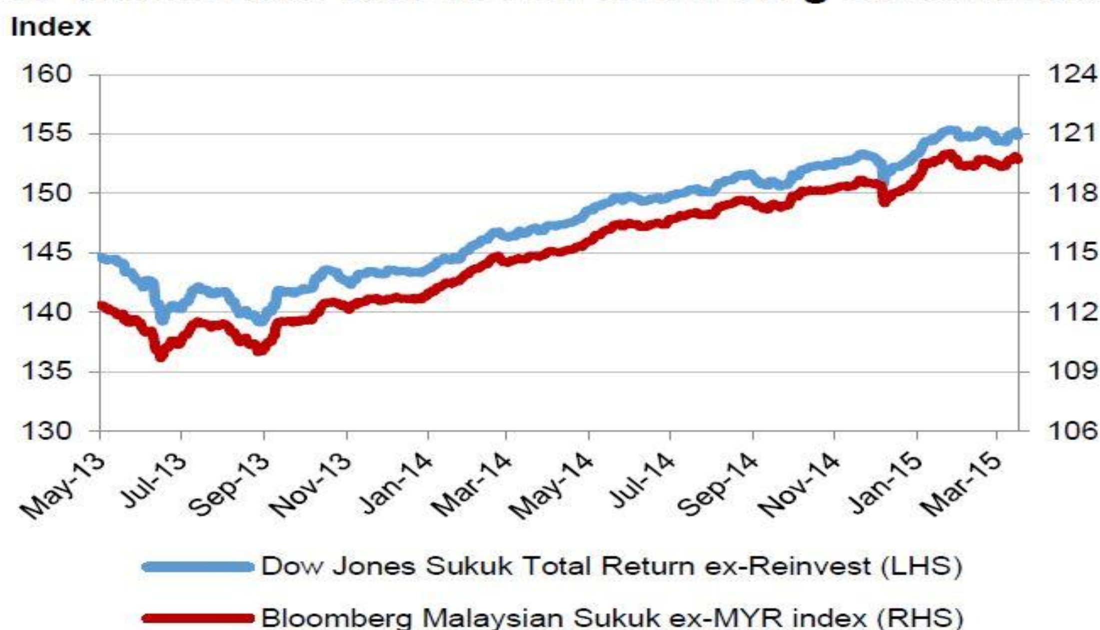
Also launching this week was the Emirates airlines sukukwhich is to fund the orders for A380-800, as Emirates seeks USD107.5bn worth of aircrafts from Boeing and Airbus. This is the first time for UK Export Finance (UKEF) to guarantee a sukuk.

This weeks Germanwings crash as well as subdued demand, intense competition (from low cost carriers), and overcapacity issues may dampening market's sentiment for the airline sector.

*(Reproduced with permission from RHB Global Sukuk Markets Research, Kuala Lumpur, Malaysia)*

In a research note, RHB Research reported the Bloomberg Sukuk Market Return Index (BMSSUTR) rose marginally 0.07% W-o-W (vs. +0.13% in week prior) to 119.71, bringing YTD return to 1.23% (vs. 1.23% in week prior). The Dow Jones Sukuk Total Return Index (DJSUKTXR) rose 0.06% W-o-W (vs. +0.24% in week prior) to 154.87, with YTD returns to 1.56% (vs. 1.50% in week prior).

The expanding Yemen civil war and Iran's disputes with UN added geopolitical risk premiums back to oil (Brent +8.7% W-o-W to USD59.2/bbl) and the Middle East markets, overall reversing sukuk gains out of FOMC's dovishness last week. Similarly, 10y UST ended at 1.99%, returning to last week's levels after touching 1-month lows of 1.87% on Tuesday. The top 5 gainers in the BMSSUTR during the week were QATAR 23, SECO 22, ISDB 19, SECO 24 and SECO 23 adding market value by USD3.1bn.




Sukuk primary market should be supported as UAE forms federal Shariah Board by 3Q15, where the board will assess standards of Islamic financial products; whether it conforms with Islamic creeds. As a comparison, Malaysia established its board in 1997, therefore we think the Sharia Board formation is overdue, but is a positive step towards building confidence in sukuk products and should support sukuk issuance toward end of 2H15. Nevertheless, it still depends on the US Fed rate hike decision. Risks loom in the

region, where Saudi Arabia led air strikes in Yemen and pressured oil prices by c. 9% W-o-W (week prior -5%) to USD59/bbl.

***(Source: RHB Global Sukuk Markets Research, Kuala Lumpur, Malaysia)***

Moody's affirms Pakistan US dollar Trust Certificates issued by The Second Pakistan International Sukuk Company Limited with Caa1 rating, whilst revising the outlook on Pakistan's foreign currency government bond rating to positive from stable.

**A stronger external liquidity position**

Net foreign reserves with the State Bank of Pakistan climbed to $11.2 billion as of 13 March 2015, from $3.2 billion at the end of January 2014. The cushion provided by foreign reserves coupled with dwindling external debt repayments to the IMF has reduced external vulnerabilities. This has in large part resulted from a lower current account deficit, which was easily financed by the issuance of a Eurobond in April 2014, a Sukuk issuance in December, continued disbursements under the IMF program, and privatization proceeds.

**Efforts towards fiscal consolidation**

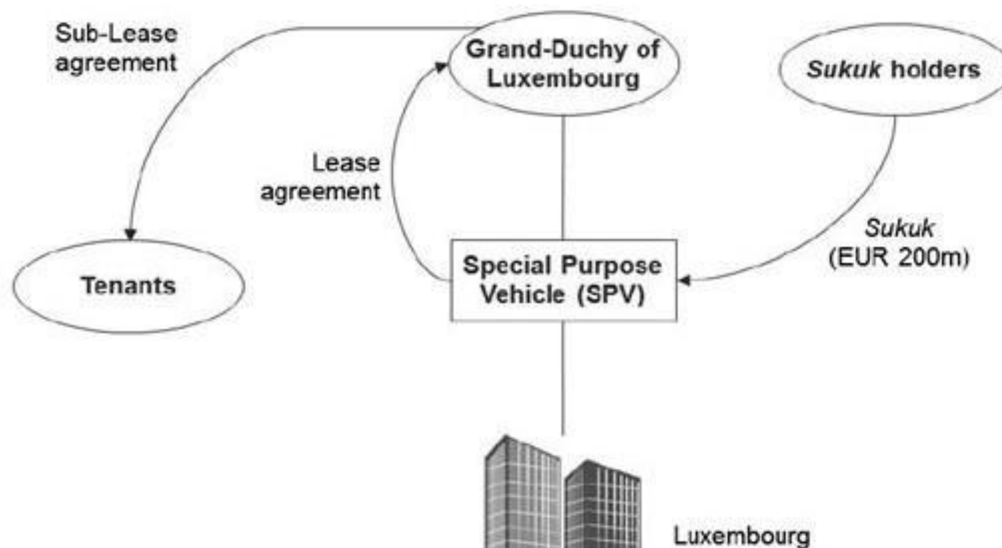
The government has relied on the banking system for deficit financing, but such borrowing is gradually declining as privatization proceeds, and the Eurobond and Sukuk issuances, have helped it to diversify funding. Moreover, the maturity of domestic public debt is lengthening as the government substitutes shorter-term treasury bills with Pakistan Investment Bonds that carry a longer tenure. This will reduce roll-over risks and volatility in debt issuance prices.

In its annual report, Transparency International ranks countries based on expert opinions of public sector corruption. Countries scores can be helped by open government where the public can hold leaders to account, while a poor score is a sign of prevalent bribery, lack of punishment for corruption and public institutions that don't respond to citizens needs.

Taking the example of the sukuk issued by the Government of Luxembourg in 2014, three government properties – two towers of the Gate of Europe in Kirchberg and the Gutenberg building in Strassen were sold to a Luxembourg SPV for which the Luxembourg Government was the single shareholder.

The SPV was securitised by means of the sukuk holders investing €200 million who whilst receiving this value back at maturity (when the Government buys back the properties from the SPV), would receive a benchmark linked profit rate of 0.436% to be generated from the rental income received by the SPV from the tenants of the three properties securitised.

This asset linked profit generation means investors get to understand the underlying asset and are more involved in the project. All money raised has to be accounted for as it is used by the SPV to purchase the properties, the funds cannot go missing, or be wasted.




**Transparency will Increase Investors Confidence to Fund Big Infrastructure Projects**

Increased transparency can be used to inspire investor confidence and trust thus leading to increased foreign direct investment (FDI). For countries which face the challenges of corruption as well as those seeking to avoid the injustices of interest based bond borrowing, sukuk represent an opportunity to tap a new investor base, one that is ethical and provides the borrower more rights and prevents abusive interest charges in case of default.

At a recent Islamic finance conference in Nigeria, Usman Hassan, CEO of Jaiz Bank, a Nigerian based Islamic Bank set up in 2003, urged the Nigerian government to take a closer look at sovereign sukuk issuances to fund infrastructure projects. He stated "Sukuk are very apt for Nigeria, as you cannot have failed projects…for every project you have, you are raising government money and it has to be accounted for, the financier (investor) will not allow abuse". He urged to government to look at the structure of sukuk to see how it can be of benefit to the economy as a source of FDI from a new diverse investor base.

**Creating Transparency and Growth in Project and Infrastructure Finance**

Growth in project and infrastructure finance is not being held up by a lack of appetite from banks, explained opening speaker Michael Wilkins, Managing Director of Infrastructure Ratings at Standard & Poor's Rating Services. Pointing out that global project finance volumes have reached their highest level since the crisis, he said: "Rumours of the death of project finance have been exaggerated. Lending is very healthy."

Unfortunately, however, there continues to be a noticeable disparity between the surplus liquidity that is available to invest and the lack of infrastructure projects to invest in. Management consultancy McKinsey has estimated this investment gap as being $20 trillion through to 2030 in the G20alone. While the money is out there, we

will only see growth in project and infrastructure finance once the shortage of projects being procured by governments has been addressed.

The paper examine show Sub-Saharan African governments can reduce real and perceived corruption risks of transport and energy infrastructure projects. On one hand, there is rising interest by investors in projects co-financed by governments and development finance institutions (DFI). On the other hand, such complex contracting models increase the possibilities of concealing misconduct. Meanwhile, there is growing scrutiny around the world of issues relating to anti-bribery and corruptionand an increasing risk of prosecution or debarment even for third-party misconduct. Consequently, real and perceived corruption risks discourage the mutually beneficial match of high return projects for private investors and closing Africa's infrastructure gap.

Desk research and expert interviews with key project stakeholders helped identify what they perceive as major corruption risks. These were categorised andillustrated by case examples. The overall key finding is somewhat counterintuitive. Potential private investors in public-private infrastructure projects in Sub-Saharan Africa do not regard the tender process as the highest corruption risk. Rather, they are highly concerned about the transparency environment of the project origination (project appraisal, selection, design and budgeting), because misconduct at this initial phase gives leeway for corruption at later project stages.

This carries an important message for DFIs and other donors, who traditionally focus on promoting procurement reform. Together with host governments, they should instead award more attention to improving governance at the project preparation phase, as in most Sub-Saharan African countries these are carried out either poorly, or not at all. By recommending to reduce information asymmetry with investors on the project preparation, the paper urges policy-makers to better consider the perspective of investors in planning infrastructure projects.

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The opinions expressed and arguments employed herein are solely those of the author and do not necessarily reflect the official views of Kroll, the Blavatnik School of Government. The author thanks Mr. Oliver Stern and Mr. Chris Ives of Kroll for their support during the writing of this paper.

The analysis relies on combining evidence from existing literature (academic papers, policy reports by DFIs, NGOs and companies, etc.) with real-world view points gathered through sixteen expert interviews. These were conducted with key stakeholders, such as investors, contractors, corruption and fraud investigators and

representatives of DFIs and civil society organisations (for an anonymous list of the interviewees see the Sources). The aim of the interviews was to collect valuable first-hand observation sand there is no intention to generalise these experiences. Admittedly, such expert interviews are subjective and provide unsystematic information. At the same time, they deliver invaluable insights on sensitive matters, which arerarely documented or mediatised, such as the real reasonsfor project failure.

The risk areas identified are illustrated through case examples. Such aselection of projects could be affected by confirmatory bias, so the issues raised are not claimed to be representative for all infrastructure projects. The aim of the case boxes is solely to highlight the existence of certain types of risks that seem to be recurrent. While some of the casespresent wrongdoings which were publicly prosecuted, others are hypothetical examples or sanitised versions of projects discussed duringthe interviews. Such caution was dictated by the lack of evidence, but also for the protection of the anonymity of the sources. More over, while the paper seeks to build on past experience, its purpose is entirely forward-looking: identifying risks, instead of bringing accusations.

Corruption risk among the main obstacles One of the reasons investors are hesitant about capitalising on such opportunities is the high corruption risk of infrastructure projects. According to the OECD, half of bribes paid are in industries with the largest spending on infrastructure, namely the extractive (19%), construction (15%) and transportation (15%) sectors(OECD, 2014, 8). Among the main causes ofsuch a high occurrence of corruption are the complexity of the project cycle, the uniqueness of projects, direct control by agovernment with often poor management practices, and a deep-seated "culture of secrecy" (Stansbury, 2005, 38). The effects of corruption on the project can be inappropriate project choice, high prices, poor quality, excessive time and cost overruns, in adequate maintenance and low returns. These impede the infrastructure's contribution to economic growth and translate into reputational and commercial losses for the private investor.

**Project origination scenarios signalling corruption risk**

Most of these corrupt practices take place around the tender process. Indeed, this is what donor-led reforms put most pressure on.Their efforts are usually concentrated around improving project implementation, particularly procurement.For instance, the so-called Public Financial Management and New Public Management reforms promoted by the DFIs in the 1980s and 1990s included reforming public procurement systems and introduced outsourcing to private companies. However,the roots of corruption in the tender areoften to be found in earlier project phases. As Figure 2 shows, the project cycle has many stages, and corruption affects each of them. Moreover, corruption during the early stages of project appraisal, design and budgeting may open doors for wrong doings later on. The problem is that in states with weak governance system, such as the discussed Sub-Saharan African countries, it is exactly these phases that are either poorly executed or missing altogether (Wells, 2015, 5).

The need to devote more attention to project origination is pioneered by some civil society activistsand was also confirmed by the expert interviews. Many respondents agreed that verifying how the contract was awarded by no means guarantees that the project was "clean" [I1][I2][I7][I9][I11][I16]. Instead, it also needs to be checked, whether the project preparation that took place prior to the investor's

involvement was in line with international best practices of transparency. More over, the wider project context has to be thoroughly analysed to detect threats tothe project's transparency and success prospects. Desk research paired with the valuable first-hand experience of interviewees helped identify a series of initial project characteristics, which are typically indicative of corruption risks at further project stages. These are usually scenarios, where the project was launched in spite of its questionable feasibility or economic necessity (so-called "white elephant projects"), or where the project's smooth execution is vulnerable to its high political sensitivity. In thesecases, the project is exposed to increased risks of delays, suspension, lack of operational capacity, etc. Moreover, such projects are particularly conducive to wrong doing through out the project cycle, because in order to mask such defects, there is a high chance that further bribes will be paid (e.g. to obtain positive progress reports or audits).

**Real vs. (mis)-percieved risks**

While there are many scenarios in which investors failed to identify early indicators of misconduct, an exaggerated reliance on perceptions can be atrap at the opposite extreme. Lack of information and/or careful analysis of the project origination environment and the parties involved can produce a costly misjudgement of the corruption-risk level of the project by either under-or overestimating it. There is a great deal governments and DFIs can do to help potential investors navigate perceptions and rightly assess corruption-related risks.

**Transparency Is Assurance**

The word "transparent" can be used to describe high-quality financial statements. The term has quickly become a part of business vocabulary. Dictionaries offer many definitions for the word, but those synonyms relevant to financial reporting are: "easily understood," "very clear," "frank" and "candid."

Consider two companies with the same market capitalization, overall market-risk exposure and financial leverage. Assume that both also have the same earnings, earnings growth rate and similar returns on capital. The difference is that Company X is a single-business company with easy-to-understand financial statements. Company Y, by contrast, has numerous businesses and subsidiaries with complex financials.

Which one will have more value? Odds are good the market will value Company X more highly. Because of its complex and opaque financial statements, Company Y's value will be discounted.

The reason is simple: less information means less certainty for investors. When financial statements are not transparent, investors can never be sure about a company's real fundamentals and true risk. For instance, a firm's growth prospects are related to how it invests. It's difficult, if not impossible, to evaluate a company's investment performance if its investments are funneled through holding companies, hiding from view. Lack of transparency may also obscure the company's debt level. If a company hides its debt, investors can't estimate their exposure to bankruptcy risk.

High-profile cases of financial shenanigans, such as those at Enron and Tyco, showed everyone that managers employ fuzzy financials and complex business structures to hide unpleasant news. Lack of transparency can mean nasty surprises to come.

**Transparency Pays**

Mounting evidence suggests that the market gives a higher value to firms that are up front with investors and analysts. Transparency pays, according to Robert Eccles, author of "The Value Reporting Revolution" (2001). Eccles shows that companies with fuller disclosure win more trust from investors. Relevant and reliable information means less risk to investors and thus a lower cost of capital, which naturally translates into higher valuations. The key finding is that companies that share the key metrics and performance indicators that investors consider important are more valuable than those companies that keep information to themselves.

Of course, there are two ways to interpret this evidence. One is that the market rewards more transparent companies with higher valuations because the risk of unpleasant surprises is believed to be lower. The other interpretation is that companies with good results usually release their earnings earlier. Companies that are doing well have nothing to hide and are eager to publicize their good performance as widely as possible. It is in their interest to be transparent and forth coming with information, so that the market can upgrade their fair value.

Further evidence suggests that the tendency among investors to mark down complexity explains the conglomerate discount. Relative to single-market or pure play firms, conglomerates could be discounted. The positive reaction associated with spin-offs and divestment can be viewed as evidence that the market rewards transparency. Naturally, there could be other reasons for the conglomerate discount. It could be the lack of focus of these companies and the inefficiencies that follow. Or it could be that the absence of market prices for the separate businesses makes it harder for investors to assess value.

**The Role of Transparency**

Transparency – in the form of risk and data analysis – will be key in enabling growth in the project and infrastructure market. This is because the more information that market participants have; the more confident they will feel about making decisions to invest in infrastructure.

With this in mind, Arnold Gevero, Associate Director at S&P Capital IQ, gave an update on global project finance performance, based on the S&P Capital IQ Project Finance default and recovery study. The study, which was started by a small group of global banks in 2001, represents the historical compilation of performance information – including default rates – from the project finance portfolios of 35 lending institutions.

Describing the study as "one of the largest sources of aggregated global project finance recovery information", Gevero revealed that as of 2014 the study covered 7,959 projects, of which 624 had defaulted on their debt.

Gevero explained that over the past five years there had been steady project finance growth across all regions, but projects were largely concentrated in the three most popular sectors – power, transportation and oil and gas. He also noted that the number of defaults was higher in these sectors due to their dominance in the market.

Transparency matters greatly to the $40-trillion global pension fund industry, revealed Jon Winslade, Vice President of EMEA Asset Owners Channel Management at S&P Dow Jones Indices. As a result, indices have a role to play from an equity perspective.

While global pension funds in aggregate have less than 1% of their assets invested in infrastructure in aggregate, they are increasingly looking to infrastructure as a means to hedge against inflation and achieve growth. This is provided that they can find the right assets, however. Between 2004 and 2014, $215bn in institutional money was committed to infrastructure investment. Typically the investment is made into large funds that are around $6 bn in size on average.

"There is a spending gap and a target investment gap, so the challenge is to put these together, and pensions are trying to do this whatever way they can," Winslade said. "They're starting to do this through listed securities and index investing can provide a low cost solution to that."Nevertheless the lack of objective, high-quality data on infrastructure projects continues to be an issue. Winslade highlighted that it can be very hard for pension funds to find appropriate benchmarks to use when assessing infrastructure investment. "It's difficult to advocate using a listed benchmark with unlisted," he said, "because you are comparing apples with automobiles, but there is merit in thinking about such indices as a means to measure the opportunity cost of not investing in highly transparent, and generally cheaper, investment approaches which still enable access to infrastructure returns."

And the other explain about The strive for more transparency presupposes that destabilizing behavior by individual investors can be avoided or attenuated by improved provision of information. For example, international investment funds may be more likely to engage in herding in less transparent countries (where herding is defined as funds taking investment decisions which they would not take if they did not observe other funds taking them). As a result, investors may rush in and out of countries even in the absence of substantial news about fundamentals.

As far as we know, there has been no systematic examination on the relationship between transparency, especially the transparency of government policies, on the pattern of international investment. The objective of this paper is to provide an evaluation of this relationship. Specifically, we will first document whether transparency of a country has any effect on the level of international investment. We will then examine whether transparency affects the herding tendency of international investment funds.

Transparency could affect the level of international portfolio investment. In the corporate finance context, Diamond and Verrechia (1991), among others, have argued that a reduction in informational asymmetry can increase the investment from large investors and hence reduce the cost of capital for the firm (see Healy and Palepu, 2001, and Core, 2001, for reviews of the empirical literature on corporate disclosure). So far, there is no theoretical paper that has modeled explicitly the effect of a country's transparency on the level of international portfolio investment. However, it seems reasonable to extrapolate from the corporate finance literature that an improvement in a country's transparency can be expected to lead to an increase in the level of investment by international mutual funds.

In terms of the effect of transparency on herding behavior, the relationship in theory is more complex. On the one hand, one set of theoretical explanations of herding behavior relies on asymmetric information (e.g., Bikhchandani et al., 1992; Banerjee, 1992; Devenow and Welch, 1996; Bikhchandani and Sharma, 2000). We would note that there is a natural linkage between low transparency and asymmetry of information.

Low transparency typically does not mean that no one knows anything. Rather, lower transparency means that less information is made publicly available, which in turn implies that the gap between those who know and those who do not becomes larger. Such higher informational asymmetry should therefore result in more herding.

On the other hand, herding by institutional investors can be rationalized without an appeal to informational asymmetry at all, but instead by the incentives faced by fund managers that result from the need to have their performances compared periodically with a common benchmark (Scharfstein and Stein, 1990; and Chevalier and Ellison, 1999). In this case, an improvement in a country's transparency would not imply a reduction in international investors' herding behavior.

Related to this discussion, the theoretical link between availability of information and market volatility is ambiguous, as pointed out, among others, by Furman and Stiglitz (1998). While their argument is not specifically about herding behavior, it is about investors' trading behavior in different information environments. In particular, they suggest that if more transparency means a higher frequency of information release (holding the true value of the fundamental constant), price volatility could increase rather than decline. The notion that transparency may not necessarily reduce volatility is reflected in the recent literature on corporate transparency. In particular, Bushee and Noe (2000) report a positive association between corporate transparency and the volatility of the firm's stock price. Firms with higher levels of disclosure tend to attract certain types of institutional investors which use aggressive, short-term trading strategies which in turn can raise the volatility of the firm's stock price. It is not clear whether this investor self-selection story can be generalized to international context. Ultimately, the effect of transparency on the behavior of international investors is an empirical question.

**Transparency Encourages Foreign Investment**

*"Without exception, a country's lack of transparency is associated with lower exposure of emerging market funds."*

Whenever economic performance falters in emerging markets, analysts are frequently heard lamenting what they call a "lack of transparency." What they mean is that some countries-and the corporations that operate there-may contribute to their woes by failing to fully disclose information about financial and economic conditions while also being less than clear about the laws and regulations that govern their markets. For example, governments might be viewed as withholding information on (or being vague about) debt levels, fiscal policies, and regulatory requirements, while companies may be seen as stingy with financial disclosures.

In Transparency and International Investment Behavior, (NBER Working Paper No. 9260), coauthors R. Gaston Gelos and Shang-Jin Wei find that, at least when it comes to attracting much needed foreign capital, a lack of transparency indeed may affect economic performance by repelling international investors. "There is relatively clear evidence," they state, "that low transparency...tends to depress the level of international investment."

Gelos and Wei reach this conclusion after synthesizing data from various international surveys that assess government and corporate candor in addressing economic and financial conditions. For governments, the authors were interested in data

measuring the "transparency and predictability" of broad economic policies in addition to the "frequency and timeliness" of information releases. In seeking data on corporate transparency, Gelos and Wei hoped to "capture as accurately as possible the notion of information quality and availability."

They then took their ratings of corporate and government transparency and compared them to the monthly investment decisions of up to 90 global funds that invest in emerging economies between 1996 and 2000. What the data show, according to Gelos and Wei, is that "without exception" a country's lack of transparency "is associated with lower exposure of emerging market funds." For example, looking at a sample of emerging market funds, the authors find that Venezuela accounted for about 0.4 percent of the investment portfolio. But they state that it could "achieve an increase in weight in fund portfolios by 1.7 percentage points if it increased its transparency to Singapore's level." In other words, the international portfolio investment to Venezuela would have increased by 300 percent.

They also find a "moderate amount of evidence" that lack of transparency makes investors more likely to engage in herding behavior; that is, when dealing with less transparent countries, investment decisions are more likely to be determined by what other fund managers are doing as opposed to a rational, independent assessment of market fundamentals. This lemming-like activity, in which investors suddenly take their money and run en masse, often is cited as contributing to economic instability by exacerbating crises in emerging markets. Indeed, Gelos and Wei find that during economic crises, fund managers "flee non-transparent countries and invest in more transparent ones."

Finally, Gelos and Wei observe that a lack of transparency seems to make investors somewhat suspicious of economic news. While investors elsewhere routinely react to economic news by immediately reconfiguring their portfolios, in less transparent economies, the authors find, "fund managers may want to wait for further confirmation before engaging in a costly reallocation of assets."

**Transparency Matters**

*The more forthcoming countries are, the more they can resist the ups and downs of global financial conditions*

Over the past 20 years, emerging market economies have become increasingly integrated into world financial markets. For example, U.S. portfolio holdings of long-term securities (equities and long-term bonds) issued by entities from 27 key emerging market economies roughly tripled as a share of each country’s GDP between 1994 and 2012 (see Table 1).

This increase in financial integration has brought emerging market economies tremendous benefits. It has reduced their cost of capital (which has expanded investment opportunities), improved risk sharing and portfolio diversification, sped up the transfer of technology, and contributed to the spread of best practices in investor protection and governance.

But deepening financial integration has come at a price for many of these economies: it has increased their vulnerability to the ups and downs of international financial markets. However, that increased vulnerability varies significantly—it is higher for some countries, lower for others. To devise policies to reduce the volatility that can accompany increased global integration, governments must understand how country characteristics shape the way global financial markets affect emerging market economies.

Table 1

**Buying in**

U.S. investors own an increasing amount of long-term securities issued by entities in emerging market economies, measured as a percent of the issuing country's GDP.

(percent)

| | 1994 | 2001 | 2007 | 2012 | Change 1994-2012 | Average TGP 2002-12 |
|---|---|---|---|---|---|---|
| Hong Kong SAR | 13.38 | 18.92 | 57.34 | 49.86 | 36.48 | 5.71 |
| Taiwan POC | 0.21 | 6.76 | 20.66 | 18.66 | 18.45 | 5.17 |
| South Africa | 3.81 | 6.63 | 18.54 | 22.12 | 18.30 | 6.12 |
| Israel | 5.94 | 17.23 | 32.44 | 22.39 | 16.45 | 4.58 |
| Singapore | 9.88 | 25.03 | 38.33 | 24.99 | 15.11 | 4.80 |
| Korea | 1.64 | 6.83 | 13.26 | 15.23 | 13.60 | 3.97 |
| Turkey | 0.67 | 3.05 | 10.16 | 13.54 | 12.87 | 3.94 |
| Hungary | 1.34 | 3.84 | 6.68 | 10.14 | 8.80 | 3.75 |
| Brazil | 2.20 | 6.04 | 13.82 | 9.75 | 7.55 | 3.71 |
| Poland | 0.09 | 1.63 | 3.26 | 6.73 | 6.64 | 3.22 |
| Chile | 4.84 | 8.22 | 7.41 | 10.22 | 5.38 | 4.97 |
| Philippines | 3.89 | 5.26 | 9.69 | 8.65 | 4.77 | 3.71 |
| Colombia | 0.68 | 2.81 | 3.26 | 5.38 | 4.70 | 4.15 |
| Peru | 1.03 | 3.10 | 4.05 | 5.56 | 4.53 | 3.70 |
| Indonesia | 1.22 | 1.15 | 4.25 | 5.13 | 3.91 | 3.51 |
| India | 0.41 | 1.46 | 6.87 | 4.25 | 3.85 | 4.40 |
| Russia | 0.01 | 3.33 | 6.23 | 3.33 | 3.32 | 3.14 |
| Egypt | 0.00 | 0.62 | 8.14 | 1.68 | 1.68 | 3.73 |
| Czech Republic | 0.99 | 0.75 | 2.96 | 2.22 | 1.24 | 3.69 |
| China | 0.37 | 0.23 | 2.78 | 1.60 | 1.22 | 4.32 |
| Thailand | 3.67 | 1.38 | 2.60 | 4.60 | 0.93 | 4.29 |
| Mexico | 12.22 | 7.84 | 10.58 | 12.73 | 0.51 | 3.89 |
| Pakistan | 0.44 | 0.25 | 1.23 | 0.51 | 0.08 | 3.38 |
| Jordan | 0.63 | 1.09 | 0.65 | 0.63 | 0.01 | 4.22 |
| Morocco | 1.20 | 0.98 | 0.60 | 0.99 | -0.21 | 4.34 |
| Malaysia | 12.84 | 4.59 | 12.43 | 12.04 | -0.80 | 4.98 |
| Argentina | 6.34 | 1.63 | 3.77 | 1.57 | -4.77 | 2.80 |
| **Average** | **3.33** | **5.21** | **11.18** | **10.17** | **6.84** | **4.75** |

Sources: U.S. Treasury, International Capital System database; World Bank, World Development Indicators database; CEIC Asia database; and EMED Emerging EMEA database.

Note: The table records U.S. portfolio holdings of stocks and long-term bonds issued from 27 emerging market economies. TGP = Transparency of Government Policymaking index from the *Global Competitiveness Report*, produced by the World Economic Forum. The highest possible score is 7. POC = Province of China.

To that end, we examined the role that country transparency plays in the amplification of financial shocks emanating from global financial centers. We found that the more transparent economies—those that provide more data and in a more timely fashion and have better corporate disclosure standards, more predictable policies, and better governance-react less sharply to both improvements and deteriorations in global market conditions than do the more opaque emerging market economies that score worse on various dimensions of transparency.

***Country transparency and capital flows***

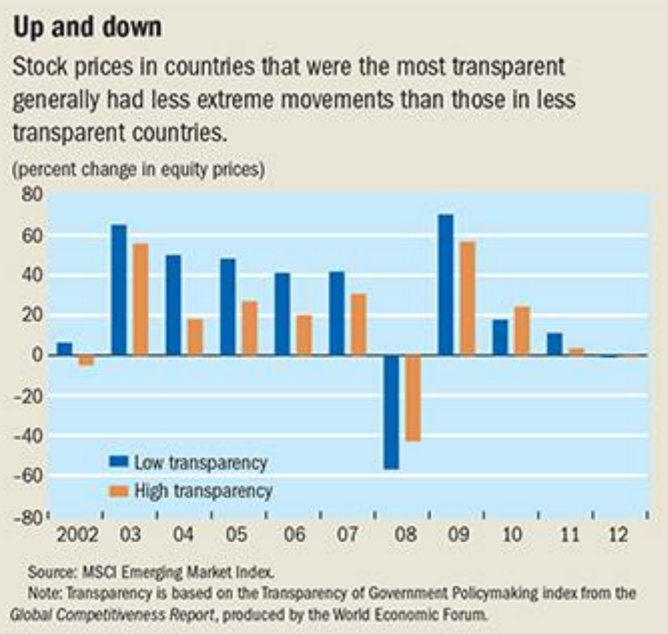
Many individual country factors influence the speed and intensity with which financial shocks propagate across economies. Financial linkages, such as common exposures by banks and mutual funds, play an important role in the transmission of common shocks and in financial contagion. It is also known that financial integration, the result of lower barriers to cross-border financial flows, generally facilitates the international propagation of financial shocks (Bekaert and others, 2011).

Less clear, however, is the role played by country-level transparency—that is, the availability of information that allows investors to properly assess risks and returns associated with investing in a country. It is often asserted that more transparency can be

beneficial both in attracting investment and in helping to avoid excessive volatility of capital flows. The argument is that more transparency enhances the orderly and efficient functioning of financial markets. Transparency reduces the occurrence of such phenomena as herding (where investors make certain decisions merely because they observe others making them), waves of investment flows driven by sentiment, and investor overreaction to news. The global financial crisis has drawn renewed attention to the role opacity plays in exacerbating financial shocks.

However, in principle, more transparency can actually result in higher volatility and, as a result, be destabilizing. For example, transparency might generate excessive provision of public information (through disclosures from governments or market participants), which could crowd out potentially more precise private information—reducing information efficiency and increasing volatility—especially when such information is confusing ("noisy," in financial parlance) or unrelated to fundamental conditions. For example, the timely publication of preliminary (and imprecise) official data may lead market participants to overreact to such news, causing too much price volatility in financial markets (Morris and Shin, 2002). More transparency also contributes to financial integration (by reducing information costs and asymmetries) and can augment the simultaneous movement of prices across markets (Carrieri, Chaieb, and Errunza, 2013).

Although there is some evidence that supports the beneficial effects of country-level transparency (Gelos and Wei, 2005), the overall evidence is ambiguous. Moreover, existing empirical studies have focused largely on the transmission of financial shocks during crisis episodes.




We explored whether opacity at the country level amplifies the local impact of global market conditions over the business cycle by examining the behavior of bond and equity prices. The basic hypothesis is that when global financial conditions are benign, international investors become more prone to invest in markets whose underlying distribution of risks they understand less well ("ambiguous" markets) and then flee when global conditions deteriorate. Investors could behave this way for several reasons. They might become more comfortable with ambiguity when their other investments have performed well. Another possibility is that during difficult times fund managers face more scrutiny and more pressure to justify the asset composition of their portfolios and respond by reducing their exposure to assets whose risks are less well understood. Consequently, they are more prone to hold less transparent assets during good times than during bad

times. Alternatively, ambiguity may make it harder for investors to separate fundamental shocks from pure noise shocks, inducing them to associate benign signals in the financial centers with good fundamentals in the ambiguous markets.
Whatever the reason (and the possibilities are not mutually exclusive), more opaque markets experience larger booms when financial market conditions are favorable, whereas the opposite is true during bad times (see chart).

***Gauging transparency***

Measuring country transparency poses significant difficulties. First, we need measures that capture some notion of the inability to pin down precisely how likely different events are. We are therefore interested in indices of opacity that gauge the availability of all relevant information the investor can use to assess the risks associated with investing in a given country. Second, we need indices that cover many countries and go back a long time. Therefore, we focused on indices measuring corruption, governance, corporate disclosure practices, accounting standards, and the transparency of government policies and statistics.

To quantify the impact of global financial shocks on asset prices from emerging markets, we used, as a proxy for liquidity conditions and risk aversion in financial centers, the VIX, which measures investor expectations of stock market volatility over the next 30 days. In doing so, we controlled for several different measures of country opacity (ranging from the degree of corporate disclosure and transparency of government policies to broader measures of opacity, such as perceptions of corruption). Using data for both stock and bond markets over the period 1997–2011, we consistently found that emerging markets that score worse on various dimensions of opacity measures react more strongly to global market conditions than economies that are more transparent.

Table 2

**Transparency counts**

When investors anticipate volatility, bond spreads widen and equity prices decline in the emerging market economies that are least transparent and perform better in the most transparent economies.
(percent, 2002-12)

| | Least transparent | Most transparent | Transparency gains | Average weekly change |
|---|---|---|---|---|
| Change in bond spreads | 0.32 | -0.36 | -0.68 | -184 |
| Change in equity prices | -0.16 | 0.18 | 0.34 | 244 |

Sources: EMBIG, weekly percent changes in bond spreads; MSCI, weekly percent changes in equity prices.
Note: The table measures how much bond spreads increase and equity prices fall in response to a 10 percent increase in the VIX index, which measures expectations of stock market volatility over the next 30 days, in low-transparency countries and high-transparency countries relative to a hypothetical median-transparency country. The least transparent countries are in the bottom 10 percent of all countries measured by the Transparency of Government Policymaking index from the *Global Competitiveness Report* produced by the World Economic Forum from 2002-03 to 2011-12. The most transparent countries are in the top 10 percent.

It is significant that this result holds even when we controlled for a broad range of measures of risk, credit quality, and liquidity (Brandão-Marques, Gelos, and Melgar, 2013). In fact, according to our estimates, in response to a 10 percent increase in the VIX (considered a mildly negative shock), the countries with the most transparent government policies would experience an increase in sovereign bond spreads (the difference between the rate a country pays to borrow and the rate on U.S. Treasury securities) roughly 0.4 percentage point lower than that of the median country. By contrast, the least transparent country would have an increase in those spreads of 0.3 percentage point more than the median country. The “transparency gains” for more transparent countries amount to roughly twice the average weekly change in spreads measured by the J.P. Morgan Emerging Markets Bond Index Global (an index that

follows total returns of debt instruments issued to foreign buyers by emerging market economies). For equities, the gain is more significant and reaches almost two and a half times the average weekly increase in the MSCI Emerging Market Index, which measures the performance of about 1,600 stocks globally (see Table 2). This is roughly three times more than the increase in exposure that a country would get from doubling its international portfolio flows. Qualitatively, this result holds not only for government policies, but also for the other measures of transparency mentioned above.

***Policy challenge***

Our research implies that emerging markets are not helpless when it comes to responding to the ups and downs of global markets. Countries that wish to benefit from financial globalization can reduce its unpleasant side effects by becoming more transparent—that is, by providing more data and in a more timely fashion, improving corporate disclosure standards, increasing the predictability of policies, and, more generally, improving governance. In other words, increasing transparency may be an effective instrument for countries to consider before resorting to other measures aimed at reducing the adverse consequences of capital flows.

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**Conclusion**

Overall the event confirmed that there is a strong imperative to find ways to stimulate growth in the project and infrastructure market so that the financing potential of the private sector can be unleashed. Given the weight that investors put on transparency, the provision of high-quality information relating to default risk is likely to be a vital component of any solutions that are reached.

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