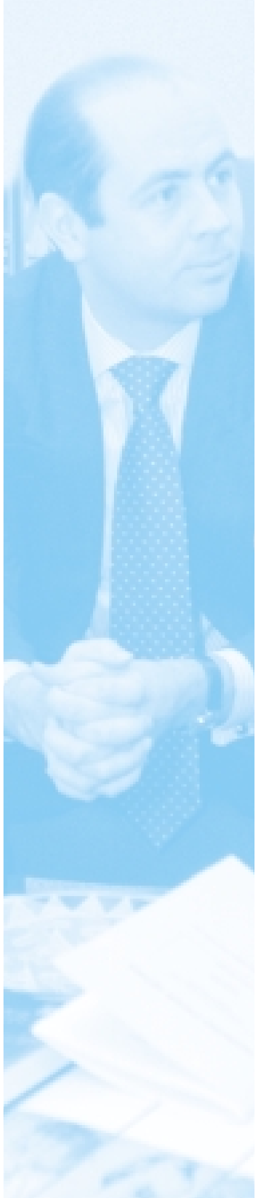
In a crisis, investment managers tend to flee less transparent countries to a greater degree than more transparent ones
—R. Gaston Gelos



Interview with R. Gaston Gelos and Shang-Jin Wei

Transparency may help in countering extreme volatility in emerging markets

The economies of developing countries can be destabilized by the abrupt withdrawal of capital from their markets. How can emerging markets stanch such volatile outflows? Two IMF economists think they have part of the answer. R. Gaston Gelos and Shang-Jin Wei argue that greater transparency can reassure portfolio investors and make them more likely to ride out market downturns. The IMF Survey *spoke to them.*

IMF Survey: Why did you take up the question of transparency and investor behavior?

GELOS: There has been a lot of talk at the IMF, starting with the Mexico crisis and particularly after the Asian crisis, about the importance of transparency in preventing crises in emerging markets. The general view is that transparency should be promoted among member countries, and the IMF has also become more transparent itself. Surprisingly, there is hardly any empirical work that documents the relationship between financial market volatility, the incidence of crises, and the behavior of international investors on the one hand, and transparency on the other.

WEI: The IMF has been doing a lot of work in promoting more transparency in member countries, particularly through its Reports on the Observance of Standards and Codes (ROSCs). One of the measures of transparency in our project is based largely on information collected from the ROSCs. Our project suggests that greater transparency, as partly measured by ROSCs, has a significant impact on a country's ability to attract international investment.

IMF Survey: What types of transparency did you examine?

WEI: Our paper talks about three types of transparency: transparency of corporate operations, and two aspects of government transparency—the way macroeconomic information is collected and released, and the way monetary and fiscal policies are conducted. Our research findings suggest that fund managers obviously care about all three dimensions, as indicated by the fact that they seem to allocate more investment to countries that score high on transparency in each of those three dimensions.

IMF Survey: What is preventing countries from becoming more transparent, if it is in their own interest?

WEI: Sometimes a country may not realize the benefits of being more transparent. The IMF's work on standards and codes tries to help countries understand the value of transparency and develop the technical capacity to be more transparent. Our work shows that it is good for a country to be more transparent. This does not necessarily mean that people who are in the privileged positions of government would benefit from greater transparency. In general, countries with better governance, better institutional setups, are more likely to pursue greater transparency.

IMF Survey: Is there a distinction between transparency and the accuracy or credibility of information?

WEI: Transparency includes accuracy and comprehensiveness. Timely release of false information won't make a country more transparent, though it might seem to be so. It's very difficult, however, to measure the quality of information. Investors have to disentangle true information from noise. In less transparent countries, a particular piece of news would have a higher noise-to-information ratio, and people would tend to discount a given announcement.

IMF Survey: Why should fund managers favor transparency? Don't they gain an advantage in a nontransparent country if they have good contacts?

WEI: Transparency is a mechanism for being fair. Individual investors might have access to some privileged information, so a particular person would probably prefer to keep that information privileged, but that's bad for the country as a whole. Investors collec-

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 17	1.82	1.82	2.33
February 24	1.81	1.81	2.32

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the euro, the Japanese yen, the pound sterling, and the U.S. dollar, which constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

tively suffer from not having information. So what transparency does, essentially, is address the fairness question by making information available equally to all investors. By definition, only a very small number of people can have access to privileged information in an opaque environment. Most investors will choose to stay away, and the consequence for that country is that the prices of its assets will fall.

GELOS: It depends on the exact nature of the information asymmetry—what's known to whom. You could think that these fund managers are professionals in overcoming such informational barriers, and they might, in fact, benefit from them because they might be better placed than others to overcome these issues. Thus, if we find any effect of transparency on this class of international investors, it is most likely to represent the lower bound of the effect. If these fund managers dislike opacity in emerging markets, individual investors will dislike it even more. And what we find is that emerging market equity funds hold fewer assets in less transparent countries.

IMF SURVEY: Do fund managers focus more on the reporting of individual companies that they invest in or on the overall macroeconomic data of a country?

GELOS: They are interested in both. Particularly in emerging markets, country factors—the general macroeconomic situation and policies—are a big determinant of returns. A fund manager might know 100 percent about all the companies, but if the government, out of the blue, pursues some distorting policies, it will adversely affect companies' returns.

IMF SURVEY: In what way does greater transparency help during a crisis?

GELOS: Investment managers tend to flee less transparent countries to a greater degree than more transparent ones. Typically, funds are reallocated across countries.

WEI: Countries with lower transparency appear to induce international investment funds to engage in herding behavior—when funds imitate each other's trading patterns—which has been alleged to contribute to greater volatility in the market. So this suggests that greater transparency would moderate herding behavior, which, in turn, would contribute to more stable domestic financial markets.

IMF SURVEY: Herding behavior implies some irrationality in the mind of the investor, doesn't it?

GELOS: Herding can be very rational, depending on how the market first learns about some information. If every investor receives unclear information, it might be rational for individual investors to rely merely on what other investors are doing and, in the extreme, to completely disregard their own information.

WEI: Herding could be individually rational, but it is socially inefficient. Some of our work shows that herding in emerging markets, such as in Korea during the Asian crisis, goes beyond just responding to common fundamental information. This suggests that at least part of the correlated trades are likely to be due to reasons other than common information. Correlation in trading, which is a necessary condition for herding, seems to be systemically related to those countries' level of opacity.

IMF SURVEY: What should governments focus on to become more transparent for international investors?

WEI: Corporate and macropolicy transparency probably have the biggest impact on international investment behavior.

GELOS: More specifically, governments can try to follow some of the IMF's guidelines on how to make the fiscal process and the conduct of monetary policy more transparent. On the corporate side, the government can set the rules of the game for a wider range of measures—from accounting standards to the implementation of regulations for stock markets.

IMF SURVEY: What are your key conclusions?

WEI: Since the Asian crisis, many people have commented that international capital flows are very volatile, and international investors, including mutual funds and pension funds, often engage in herding and other activities. That seems to portray emerging markets as helpless, innocent bystanders who just got sucked into these volatile international capital flows. One important message of our project is that different emerging markets may very well experience different degrees of volatility of capital flows. These differences are systematically related to the countries' own characteristics, such as transparency. That has important policy implications. A developing country cannot simply say "the world outside my door is so messy that if I open up I will get into trouble." The capacity to minimize such trouble is related to a country's transparency and other policies. Therefore, we should be thinking of domestic reform to improve transparency as a crucial element in a strategy to embrace financial globalization. ■

Copies of IMF Working Paper 02/174, "Transparency and International Investor Behavior," by R. Gaston Gelos and Shang-Jin Wei, are available for $15.00 each from IMF Publication Services. See page 55 for ordering information. The full text is also available on the IMF's website (www.imf.org).

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