Do stock exchange rallies enhance international relations?

The last quarter of 2009 delivered some fantastic results. Shares on the world's stock exchanges rallied, gold achieved record high prices, and oil prices continued to climb. The exchanges became a fundamental indicator of economic recovery around the world, and this optimism is expected to continue with caution throughout much of 2010

Europe is expected to show tepid growth, so investors would be wise to continue to focus on emerging markets. Their overall economic growth is expected to exceed that of their debt-ridden western counterparts.

So while not much has as yet changed from a regulatory standpoint since the G20 London Summit in April last year, there has been a seismic shift away from the previously considered 'safe' and more established economies of the West. The hegemony of the US, for example, is no longer guaranteed as the political and economic focus is shifting eastwards. China is now posing as the next political and economic superpower. Even the US has become very dependent on China as it is a key US Treasury bonds investor and an important trading partner with the US and the EU.

There's been no choice, but to treat China more equitably and seriously. However, while there is more fervour to work together to inspire global economic growth – which is in every nation's interest, the dominance of the US is being increasingly challenged. Not only has China tried to suggest that they should be allowed to develop an alternative reserve currency that would replace the hard-hit dollar, but it has also been working on developing economic and political ties with other countries, many of whom are fed-up with the US for one reason or another.

Yet, for example, while Barack Obama hasn't quite warmed up relations with Venezuela's Hugo Chávez and his government in spite of it remaining a major oil exporter to the US, relations with other countries like Syria have begun to warm. It's an important step because Syria was once part of President Bush's 'axis of evil' for its alleged support of terrorist groups like Hamas, Hezbollah and Islamic Jihad (which the Syrian government views as legitimate freedom fighters). So some tensions remain between the two countries, but Obama's open door policy approach is beginning to pay dividends.

Syria's economic liberalisation programme, the development of a social market economy and of its fledgling stock exchange are designed to not only attract much needed FDI, but also to improve relations with the US, the EU and many of its neighbours. In spite of the more open dialogue approach, US embargos against Syria remain in place. While this does have an impact on the country's economy, and without it there would be more FDI, the Syrian government is determined that it won't stall its reforms. Besides, countries like Syria and Venezuela have managed to get around such US actions as this by forming and improving their economic and political relationships with their neighours and more frequently with China too.

Emerging risks and significant gains

While investors are taking more risks than ever before by investing in emerging markets, nothing at the moment is quite that secure. Share prices on Pakistan's stock exchange rose by over 60 percent in 2009 after a dismal 2008. That year was characterised by political turmoil, the constant threat of the Islamic extremism of militant supporters of the Taliban and Al Qaeda, and the global recession. Yet Pakistan was then named as one of the most promising emerging markets.

Agence France Presse (AFP) reports that its 650 listed company KSE-100 index ended 2008 at 5,865.01, a 58 percent year-on-year drop on 2007. However, in spite of some fatal bombings by Taliban insurgents and military action against Islamic extremists, it closed 2009 on New Year's Eve at 9,386.92. Yet inflationary pressures remain a constant threat.

Although another leap is expected in 2010, yet much depends on the ability of the Pakistani government to maintain economic and political stability in order to inspire growth and attract investment. This fragility is shown by the events that occurred in February 2009 when Pakistan's Supreme Court disqualified the main opposition leader from contesting the elections. Its stock market faced its worst loss for two and a half years, but it later rallied when the ban was lifted.

Without the $8-9bn per year cost of the War on Terror, the Pakistani government could perhaps focus more of its resources on economic development. Ashfaq Hasan Khan, a former Pakistani government economic advisor says that his country is not receiving enough support from the US and its western partners. "Pakistan pays that much money on the war on terror and in return we just

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receive good words but no tangible money," he claims.

Even so, the performance of the country's stock exchange in Karachi has been largely unaffected. That's because most of the Islamic extremists' attacks have occurred in the north-west region of Pakistan. Although investors prefer to avoid countries with such conflicts as this, Pakistan remains an attractive proposition to investors.

Michel Tenaglia, a financial advisor at LPL Financial, says that an upward US, European or Japanese stock market trend creates economic stability for the less economically advanced nations. "So a comfort level is created when our markets move upward; and this implies that they can rely upon us for foreign aid, political aid and military help", he explains. As most of the emerging markets have more initial public offerings (IPOs) than the more advanced ones, this focus might shift completely. Will the West be looking to the emerging markets in the future to gauge their own comfort levels and for help? That's possible because the world's political, financial and economic structures and alliances are changing, and so their influence is growing.

Stock market growth can also lead to an increase in the mobility of funds

Stock market growth can also lead to an increase in the mobility of funds. Rajasimha Makaram, Engagement Manager at Fidelity Investments, talked to *World Finance* about the importance of cross-border capital flows which grew by 15 percent (CAGR) between 1990 and 2008. Green shoots are already showing, but the emerging economies will gain a larger share of them once they rebound and reach the heights of 2007 and 2008. "In India we have already recovered the foreign institutional investor (FII) and foreign direct investment (FDI) outward flows, but the Indian central bank is worried about how to contain the huge inflow of foreign funds", he says.

The biggest threat to India's own international relations would be if India were to follow Brazil's example and impose regulatory restrictions, which follow a protectionist agenda. Protectionism and restrictive regulatory frameworks can have a negative impact on international relations, but retaliatory action by the other nations would be counter-intuitive. Higher levies and taxes are nevertheless designed to restrict inwardly flowing foreign funds.

Given the current reversal of the economic order, the emerging economies need "some time to think and put in a more market, investor friendly regulations to control any imbalances that may be created by the sudden tsunami of fund flows", Makaram explains. After all protectionist policies could adversely affect their own economies and stock exchanges.

Chetan Ganatra – a student at Narsee Monji College of Management Studies in India, thinks that economic and stock market growth can unite two countries with disparate political ideologies. The US and China are two prime examples of this occurrence. Yet he's perhaps right to suggest that a growing stock market doesn't guarantee an improvement in international relations.

While US and Chinese relations have remarkably improved over the years, there has been no consensus between them about the yuan's devaluation. He thinks that "both parties will play more diplomatic games to strengthen their ties, so that the money their citizens have invested in the other country remains secure".

With 2010 being the year when the G20's much spoken about global financial regulatory framework really comes into force, and with hopes of ongoing economic recovery, there is still a need for international cooperation. Yet even the increased level of regulation could hamper the global economy, and the fortunes of the emerging markets' stock exchanges could end. Mark Mobious of Franklin Templeton Investment predicts a fall by up to 20 percent if any hiccups arise from their IPOs.

A reversal of the global economies recovery could also cause shares to fall. That's because stock exchanges tend to mirror what's happening politically and economically. Their performance can be maintained with the cooperation of the world's leaders and industry regulators, leading to better international relations and a healthier economic climate. This will inspire growth and investment, as indeed would more transparency and the development of more liberalised domestic economies in certain countries that have not been traditionally welcoming of foreign investment. ◇