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INTERNATIONAL CAPITAL MARKETS

Developments, Prospects, and Key Policy Issues

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The following symbols have been used throughout this volume:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 1997–99 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 1998/99) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

“n.a.” means not applicable.

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this volume the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

PREFACE

The *International Capital Markets* report is an integral element of the IMF's surveillance of developments in international financial markets. The IMF has published the *International Capital Markets* report annually since 1980. The report draws, in part, on a series of informal discussions with commercial and investment banks, securities firms, stock and futures exchanges, regulatory and monetary authorities, credit rating agencies, and the staffs of the Bank for International Settlements and the International Swaps and Derivatives Association. The discussions leading up to the present report took place in Brazil, Chile, France, Germany, Hong Kong SAR, India, Japan, Singapore, South Africa, Switzerland, the United Kingdom, and the United States, in early 2000. The report reflects information available up to the end of June 2000.

The *International Capital Markets* report is prepared in the Research Department, under the general direction of the Economic Counsellor, Michael Mussa. The *International Capital Markets* project is co-directed by Donald J. Mathieson, Chief of the Emerging Markets Studies Division, and Garry J. Schinasi, Chief of the Capital Markets and Financial Studies Division. Co-authors of the report from the Research Department are Torbjorn Becker, Bankim Chadha, Jorge Chan-Lau, R. Sean Craig, Burkhard Drees, Ronald Johannes, Charles Kramer, William Lee, Gabrielle Lipworth, Jens Nystedt, Anthony Richards, Jorge Roldos, R. Todd Smith, Amadou Sy, and Caroline Van Rijckeghem. Silvia Iorgova, Anne Jansen, Oksana Khadarina, Subramanian Sriram, and Peter Tran provided research assistance. Contributors from other departments are Paula De Masi, Western Hemisphere Department; Peter Hayward, Monetary and Exchange Affairs Department; and James Morsink, Asia and Pacific Department. Caroline Bagworth, Sheila Kinsella, Rosalind Oliver, Ramanjeet Singh, and Adriana Vohden provided expert word processing assistance. Marina Primorac of the External Relations Department edited the manuscript and coordinated production of the publication.

The study has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors following their discussions of the *International Capital Markets* report on August 2, 2000. However, the analysis and policy considerations are those of the contributing staff and should not be attributed to Executive Directors, their national authorities, or the IMF.

LIST OF ABBREVIATIONS

ADRs	American Depository Receipts
BBVA	Banco Bilbao Vizcaya Argentaria
BCCI	Bank of Credit and Commerce International
BIBF	Bangkok International Bank Facility
BIS	Bank for International Settlements
BSCH	Banco Santander Central Hispano
CACs	Collective Action Clauses
CFTC	Commodity Futures Trading Commission
ECB	European Central Bank
ECU	European Currency Unit
EMBI	Emerging Markets Bond Index
EMF	Emerging Markets Free
EMTA	Emerging Markets Traders Association
EMU	European Monetary Union
EONIA	euro overnight index average
ESCB	European System of Central Banks
EU	European Union
FDI	foreign direct investment
FSA	Financial Supervisory Agency
FOMC	Federal Open Market Committee
GDRs	Global Depository Receipts
G-7	Group of Seven
G-10	Group of Ten
HIPC	heavily indebted poor countries
HLI	highly leveraged institution
IFC	International Finance Corporation
IIF	Institute of International Finance
IMFC	International Monetary and Financial Committee
ISDA	International Swaps and Derivatives Association
JGB	Japanese government bonds
LCBO	large, complex, banking organization
LIBOR	London interbank offered rate
LTCB	Long-Term Credit Bank
LTCM	Long-Term Capital Management
MRO	main refinancing operations
NAFTA	North American Free Trade Agreement
NCB	Nippon Credit Bank
NPV	net present value
OECD	Organization for Economic Cooperation and Development
OTC	over-the-counter
PFE	potential future exposure
PSI	private sector involvement
SAR	Special Administrative Region
SDDS	Special Data Dissemination Standard
SEC	Securities and Exchange Commission
VaR	value at risk
Y2K	Year 2000

CHAPTER I INTRODUCTION

During 1999 and into the first half of 2000, global financial conditions generally improved in tandem with the strong rebound in the global economy. Following the most severe market turbulence—especially for emerging markets in the postwar period—entailing a succession of regional crises that enveloped the major financial markets, credit concerns have eased and global investors became more willing to engage in risk taking. This was especially evident in their rush to invest in technology-related companies that underpinned the "new economy."

As markets recovered during 1999, mature market credit spreads receded from their crisis peaks and have remained appropriately above precrisis levels, given the decline in highly leveraged activities that had compressed spreads before the crisis. The remarkable, continued rapid growth of U.S. productivity—largely related to the new economy—helped sustain the low inflation expansion in the United States, and spurred U.S. and worldwide investment. Despite the upturn in global interest rates, equity markets rose to record highs during the second half of 1999 and into early 2000 on increasingly optimistic expectations of future earnings growth for investments in dynamic technology-related sectors. The deepening and broadening of credit markets in the euro area helped boost global debt issuance, especially euro-denominated debt, reflecting too the increased pace of corporate restructuring (especially merger and acquisition activity) and the gathering strength of the global expansion. Even in Japan, equity markets recovered on initial signs that the decline in output may have bottomed.

Emerging market asset prices saw strong increases in 1999 as fundamentals in many countries improved, and the domestic and external financing situation of most emerging markets continued to recover from the rolling crises that affected Asia, Russia, and Brazil between mid-1997 and early 1999. Reflecting these improvements, the credit ratings of a number of emerging markets improved. Emerging market bonds posted strong returns in 1999, significantly outperforming the low or negative returns for most alternative fixed income asset classes in mature markets. Emerging equity markets also had a stellar year, driven by the performance of technology-related stocks. Other favorable developments include a widening of the investor base for emerging market assets, a diversification of funding sources by borrowers, and a shift toward longer-term funding.

Since March 2000, however, participants in mature and emerging markets have become less at ease with the uneven growth patterns among the major currency areas, signs of inflationary pressures, and increasing external imbalances. These have produced a growing list of questions and risks. In particular, the sustainability of technology-based productivity gains, which fueled the robust low inflation expansion in the United States, was repeatedly tested by investors as they faced these and other uncertainties. This is clear in the increasing volatility in global equity markets. Emerging market currencies and debt markets were also affected by the sharp correction in technology sectors of equity markets, especially the Nasdaq, as investors identified both these classes of investments with the riskiest of financial assets that would benefit or suffer as risk appetites changed. Additional tensions arose from technical factors related to repurchases of U.S. and U.K. government debt, which impaired traditional hedging and pricing practices associated with government yield curve benchmarks and the interpretation of credit and swap spreads in the mature and emerging markets.

Increased volatility and declines in mature equity and bond markets also adversely affected their counterparts in the emerging markets over

March–May 2000. It became apparent that the rally in emerging markets also had been helped in part by the forces that drove the "new economy" paradigm. Further, the rally had relied on expectations of only modest increases in official interest rates in the United States and Europe. Thus, emerging market assets were hit hard when global stock markets fell and the monetary policy tightening in mature markets threatened to be larger than had earlier been expected.

This increased market volatility has heightened once again the recognition of risks in global financial markets, including those associated with the rapid integration of national financial markets into the global arena, the ongoing lack of transparency, and increased competitive pressures on financial institutions. Indeed, reflecting on the lessons from the crises and contagion that spawned earlier global turbulence, investors question the effectiveness of the existing international architecture, including the role of the IMF, to realize the potential to generate growth in increasingly integrated and securitized international capital markets. Private and public sector initiatives have begun to address some of these and related issues, for example with specific measures to improve risk management practices and bolster regulatory and supervisory capabilities. The proposed revision of the 1988 Basel Accord on Capital Adequacy is a key element in bringing prudential regulations up to date. Other public and private groupings have also explored ways to ensure the smooth functioning of the financial system, particularly how to improve banks' liquidity management, the safety of payment systems, the reliability of stress testing, and the effectiveness of portfolio credit management systems.

This year's *International Capital Markets* report reviews and assesses recent developments in the mature and emerging financial markets and continues the analysis of key structural changes in global financial markets that has been presented in recent reports. Global financial markets are inherently information-, communication-, and computation-intensive, and advances in telecommunications and computer technologies during the past two decades have dramatically lowered the cost of undertaking many financial activities. The potential economies of scale and scope created by these declining costs have led to intense competition to gain market share both within and across national and international financial markets. This intense competition has been characterized by the development of new financial instruments and services and the use of these financial innovations to enter new markets or to attract new customers. This year's report examines two aspects of this process of financial innovation and market penetration: the global development of the over-the-counter (OTC) derivatives market and the expansion of foreign-owned banks into emerging markets. The report also examines another issue, namely market participants' assessments of proposals for private sector involvement in the prevention and resolution of crises, that is likely to affect the future terms and conditions of market access for many emerging markets.

Chapter II provides a comprehensive assessment of recent developments and trends in the major financial markets and identifies key risks and uncertainties in the outlook. Of particular significance are the questions regarding the durability of the "new economy" and the underpinnings of the global rise in equity markets, the heightened potential for exchange rate volatility, and the risks associated with financial restructuring in the euro area.

Chapter III reviews developments in emerging markets over the past year, including trends in net and gross financing flows, and in primary and secondary markets for emerging market assets. As of mid-2000, emerging market asset prices were mostly modestly higher than a year earlier, reflecting some unwinding of the (probably excessive) pessimism toward emerging market economies that had grown out of the recent crises. Further, while emerging market assets remain among the more volatile asset classes, the continuing decline in the volatility of returns from recent crisis levels will enhance the attractiveness of emerging markets to investors. The chapter also notes some favorable developments in the investor base and the financing sources of emerging market borrowers. While the risk tolerance of some of these new investors is yet to be tested through a full cycle, a wider investor base—provided it has realistic expectations about the return and risk on its holdings—will help support the stability of financing to emerging markets. In addition, at the same time as the investor base is widening, emerging market borrowers are diversifying their financing sources, with greater recourse to domestic currency financing and longer-term funding. The chapter concludes that these developments offer the hope of greater stability in financing flows to emerging markets and greater prudence in the financing of borrowers in emerging markets.

Chapter IV focuses on OTC derivatives markets. The rapid growth, development, and widespread use of OTC derivatives transactions and markets has accompanied, and in many ways driven, the international integration of national financial markets and the globalization of finance. Much has been written about derivatives as financial instruments, and last year's *International Capital Markets* report discussed the role of highly leveraged institutions and their OTC derivatives positions in the mature market turbulence during the autumn of 1998. These markets comprise the internationally active financial institutions, and they are central to the functioning and efficiency of the major bond, equity, and foreign exchange markets. They are governed by private sector arrangements and are influenced indirectly by regulatory, supervisory, and legal systems. The smooth functioning of these systemically important markets relies heavily on market discipline, more so than in most other financial markets. Recent episodes of turbulence revealed the risks posed to market stability originating in features of OTC derivatives instruments and markets. The chapter identifies sources of risk to market stability as well as imperfections in the underlying infrastructure. Progress in addressing some of these risks and imperfections has been limited, and the chapter identifies areas where further efforts are necessary if the risks to instability are to be reduced and avoided in the future.

Following the crises in Asia, Russia, and Brazil, the international financial community has explored ways to enhance the international financial architecture with a view to preventing crises, where possible, and to mitigating their severity when they do occur. One cornerstone of the new international financial architecture initiative has been the official community's efforts to further the private sector's involvement in crisis prevention and resolution. Chapter V provides a systematic review of recent experiences with, and market views on, these efforts. Within the context of crisis prevention, the official sector has focused on how to improve data transparency, promote improved standards and codes, enhance debt management, facilitate information sharing and negotiation between debtors and creditors, support the introduction of collective action clauses in international bonds, study the feasibility of standstills and stays, and evaluate the usefulness of market-based capital controls. On the crisis resolution front, policies have had the objectives of limiting the size of official financing packages, reducing moral hazard, and restoring medium-term viability of the debtor country. This chapter assesses market views and discusses the extent to which the official community's objectives have been attained and how the initiative is likely to affect the terms and nature of international financing to emerging markets.

Chapter VI discusses the increasing role of foreign banks in emerging markets. The growing presence of foreign-owned institutions in the second half of the 1990s increased the share of assets under foreign control to more than half of total assets in several emerging markets in Central Europe and Latin America. The chapter analyzes the factors that have stimulated the rise of foreign participation, including those that drove global financial institutions to expand toward emerging markets, and the factors underlying the authorities' decisions to remove existing barriers to the entry of foreign institutions. The arguments that have been made in favor of and against greater foreign presence and the empirical evidence on the effects of foreign entry are also reviewed and assessed in this chapter. Finally, the main policy issues include the need to coordinate and upgrade prudential supervisory and regulatory policies across borders, bank concentration issues related to the merger of large international banks, and associated systemic issues.