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**Global Financial Stability Report**  
Market Developments and 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  $\frac{1}{4}$  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

This is the second issue of the *Global Financial Stability Report*, a quarterly publication launched in March 2002 to provide a regular assessment of global financial markets and to identify potential systemic weaknesses that could lead to crises. By calling attention to potential fault lines in the global financial system, the report seeks to play a role in preventing crises before they erupt, thereby contributing to global financial stability and to the prosperity of the IMF's member countries.

The report was prepared by the International Capital Markets Department, under the direction of the Counsellor and Director, Gerd Häusler. It is managed by an Editorial Committee comprised of Hung Q. Tran (Chairman), Donald J. Mathieson, and Garry J. Schinasi, and benefits from comments and suggestions from William E. Alexander, Charles R. Blitzer, Peter Dattels, David Ordoobadi, and Effie L. Psalida. Other contributors to the report are Torbjorn Becker, Peter Breuer, Jorge Chan Lau, Martin Edmonds, Anna Ilyina, Kenneth Kang, Charles Kramer, Subir Lal, Gabrielle Lipworth, Chris Morris, Martin Mühleisen, Ramana Ramaswamy, Jorge Roldos, Calvin Schnure, Srikant Seshadri, R. Todd Smith, Mazen Soueid, and Amadou Sy. Anne Jansen, Oksana Khadarina, Yoon Sook Kim, Advin Pagtakhan, and Peter Tran provided research assistance. Caroline Bagworth, Vera Jasenovc, Ramanjeet Singh, Adriana Vohden, and Joan Wise provided expert word processing assistance. Jeff Hayden of the External Relations Department edited the manuscript and coordinated production of the publication.

This particular issue draws, in part, on a series of informal discussions with commercial and investment banks, securities firms, asset management companies, insurance companies, pension funds, stock and futures exchanges, and credit rating agencies in China, Germany, Hong Kong SAR, Hungary, Italy, Japan, Poland, Singapore, Switzerland, Thailand, the United Kingdom, and the United States. The report reflects mostly information available up to May 10, 2002.

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 *Global Financial Stability Report* on May 29, 2002. However, the analysis and policy considerations are those of the contributing staff and should not be attributed to the Executive Directors, their national authorities, or the IMF.

The economic recovery that began during the first quarter of 2002 has brought improvements in financial market conditions. Mature equity and bond markets have further stabilized. Most emerging market countries continue to have access to international capital markets, and their bond spreads have declined. The near-term outlook thus appears largely free of imminent threats to global financial stability.

However, one important source of uncertainty remains: the recovery and quality of corporate profits in mature markets. In fact, it is the main common theme shaping the major issues discussed in this report. In the period ahead, the level of corporate profitability will significantly influence capital expenditure, which so far is the missing component in the current recovery. Questions surrounding the quality of reported corporate profits, in the aftermath of Enron's failure, continue to have an adverse impact on international equity and corporate bond markets. Also, weak corporate profitability has had a negative effect on the quality of the balance sheet of some banks and, to a lesser degree, insurance companies. In the latter case, this highlights an emerging risk, as insurance companies have substantially expanded their financial market activities in recent years.

In the medium term, significant shifts in relative profitability between countries and regions may also give rise to changes in the pattern of international capital flows. Were this to occur abruptly or in a disorderly manner, it could represent a potential risk to financial stability.

### Corporate Profitability Impacts on Financial Markets

The risk of an equity price correction due to disappointing corporate earnings remains a possibility, not only for the United States but also in

### First Quarter Analysis—At a Glance

- ▶ The near-term outlook appears largely free of imminent threats, but one source of uncertainty remains: corporate profitability. See this page.
- ▶ Banks felt the pinch from sluggishness in the corporate sector, with those relying on wholesale banking performing rather poorly. Poor revenues, credit provisions, and the slow pace of cost reduction will likely prompt consolidation, especially in Europe. These developments translated into noticeably reduced syndicated bank lending to emerging markets. See page 25.
- ▶ Emerging bond markets rallied, outperforming most asset classes in mature markets. But because of a sharp decline in syndicated bank lending, gross financing flows to emerging markets totaled \$35.3 billion—less than that of the fourth quarter of 2001. See page 18.
- ▶ Insurance companies have expanded their financial market activities, becoming more exposed to market and credit risks. Thus, they are more vulnerable to financial shocks, and their own profitability and occasional failures are now a source of potential vulnerability for global financial markets. See page 30.

other regions. Moreover, the quality of corporate earnings has come under scrutiny in the wake of Enron and other high-profile bankruptcies (see Chapter II). Markets are still not sure what the unwinding of some measures used to drive up share prices will mean for reported earnings and equity valuations. Companies whose revenue and earnings' growth are seen as unsustainable, or are believed to derive from questionable accounting practices (particularly in the treatment of mergers and acquisitions), have had their share prices heavily discounted by the markets. Highly leveraged companies have also come under pressure either to deleverage or to extend the maturities of their liabilities to avoid refinancing risks, even at the expense of higher interest costs.

This prompt reaction by markets is proving to be harsh discipline for corporations and an incentive to enhance the transparency of their financial accounts, strengthen their balance sheets, and refrain from undue risk taking. Many corporations have begun to respond to this signal, demonstrating the strong self-correcting elements inherent in well-functioning financial markets. In addition, regulatory changes are now under way in the United States and Europe to further strengthen the operation and supervision of capital markets (see Box 2.1). These responses are likely to permit investors to evaluate and price risks more accurately in the future.

Increased uncertainties in the outlook for corporate earnings also may have contributed to the weakening of the U.S. dollar in recent weeks. In the context of declines in foreign capital flows into U.S. securities since December 2001, concerns have revived about the potential for and implications of a significant rebalancing of global capital flows. (The potential implications for financial markets will be examined in a

forthcoming issue of the *Global Financial Stability Report*.)

## Corporate Profitability and the Banking Sector

Corporate financial performance has affected the banking sector, through both the revenue and the cost side. Financial reports so far have suggested that banks that are not well-diversified but rely primarily on wholesale banking have performed rather poorly in the first quarter. The position of some weak banks, in Europe and elsewhere, has deteriorated further. The unsustainable situation of such institutions, squeezed by poor revenues, credit provisions, and the slow pace of cost reduction, will likely prompt cross-border consolidation, especially in Europe. Any serious impediments to this necessary adjustment should be of concern to bank supervisors. These developments, as well as the general retrenchment in risk taking, have noticeably reduced net banking flows to emerging market countries.

The weakening financial situation of Japanese banks continues to be a source of vulnerability for international financial markets. Japan's prolonged economic stagnation and deflation have significantly reduced corporate profits and generated successive waves of nonperforming loans (see Chapter II). Caught

between diminishing profitable business opportunities and loan-loss provisioning, Japanese banks have posted net losses in most of the past eight years, and will likely continue to do so for the time being.

The weakness of Japanese banks has already curtailed capital exports from Japan to emerging market countries. Further, international spillovers could occur through three possible channels: a disorderly repatriation of Japan's as-

**The near-term outlook appears largely free of imminent threats . . . but one source of uncertainty remains: corporate profits in mature markets.**

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sets held in mature markets; further sharp falls in financing flows to emerging markets; and risks to international financial institutions with exposures to Japan. These effects could lead to volatile adjustments in international financial markets, as well as in countries facing the resulting shifts in capital flows. However, the lack of profitable investment opportunities at home argues against large-scale liquidation of assets held in the United States and Europe. Moreover, many Asian countries are in better economic shape than in 1997–98, enjoying in particular stronger current account positions, higher official reserves, better debt structure, and more flexible exchange rates. Consequently, they are in a better position to cope with the adjustment problems that might arise from financial disruptions in Japan. Finally, many international financial institutions have reduced and tightly managed their Japan market exposures and counterparty risks. Consequently, adverse effects from the international spillovers appear to be manageable.

### Financial Market Activities of Insurance Companies

Reflecting pressure on the profitability of their underwriting business, insurance companies have relied increasingly on their investment and other financial market activities to generate sufficient returns (see Chapter III). In the process, insurance companies are becoming more exposed to market and credit risks, notably those transferred from banks through capital market instruments, which have become riskier and more complex. Thus, insurance companies are becoming more vulnerable to financial shocks through their linkages to the major financial markets and institutions, and their own profitability and occasional failures are now a source of potential vulnerability for global financial markets.

Stronger disclosure and regulation of the financial activities of insurance and reinsurance companies are needed. While there are national differences, the regulatory approach to insur-

ance companies tends to focus on solvency relative to insurance claims and not sufficiently on exposure in financial markets. Absent sufficient disclosure, and despite the absence of any market sense of impending crisis, there is a widely felt need for more information on the financial market activities of insurance companies to help market participants better understand the magnitude and profile of risks taken on their books. There is an even stronger case for enhanced disclosure of the financial activities of the reinsurance companies, which in many countries face even lighter regulation—especially in cases where companies operate from offshore financial centers.

### Developments in Emerging Markets

Emerging bond and equity markets rallied strongly in the first quarter of 2002, outperforming most asset classes in mature markets (see Chapter II). The spread compression of the EMBI+ to levels not seen since the Russian crisis was supported by inflows into the asset class, including from crossover investors. Bond issuance, particularly in the dollar segment, remained in line with historic levels. However, due to a sharp decline in syndicated bank lending, gross financing flows to emerging markets totaled \$35.3 billion, lower than in the first and fourth quarter of 2001.

The emerging bond markets remain vulnerable to corrections, in part due to the growing involvement of crossover investors, who may withdraw funds rapidly in the event risk appetite declines or other asset classes become relatively more attractive. The main risks going forward stem from domestic political factors that might cast doubt on the direction of economic policy, disappointment with the economic recovery in individual countries, or geopolitical developments.

### Local Equity Markets

As the first installment of a three-part analysis of local securities markets, Chapter IV looks at

the development of the emerging equity markets and their linkages with international capital markets. Future chapters will look at the local fixed income and derivatives markets and conclude with an analysis of policy implications and recommendations.

While financial systems in emerging market economies have traditionally been dominated by commercial banks, the experience of the late

1990s (especially with the Asian crisis) has suggested that it would be desirable to develop local securities markets to provide alternative and more stable sources of domestic funding. With proper underpinnings, local securities markets could enhance the stability of domestic financing flows and might also have an “insurance value” with regard to reliance on international capital flows.