



## INTERNATIONAL CAPITAL MARKETS

In May 1995 the Board conducted its annual comprehensive assessment of developments in global capital markets, with a focus on the policy lessons that could be drawn from the events of the preceding year.<sup>4</sup> Directors discussed the turbulence in emerging markets in the wake of the Mexican crisis and reviewed issues related to regulation and supervision of financial markets in industrial countries. A second Board discussion on capital markets took place in December 1995. On that occasion, Directors reviewed a number of issues, including exchange rate fluctuations experienced by the major currencies, the performance of the industrial countries' bond and equity markets, challenges for banking systems in both industrial and developing countries, and the continuing impact of the Mexican crisis on other emerging markets. There was a broad consensus that the international capital markets had performed remarkably well during 1995 despite increased exchange rate volatility and the problems in emerging markets early in the year.

### Turbulence in Emerging Capital Markets

At the annual discussion in May 1995, Directors welcomed the greater integration of emerging markets into international capital markets; this had boosted investment and raised sustainable growth rates in many developing countries. They observed, however, that this integration also presented major policy challenges. Disturbances in any market could more quickly spread to other markets, and it had become easier for investors to switch between domestic and foreign currency assets. These developments highlighted the importance of sound macroeconomic and structural policies to foster an environment in which the benefits of integration of capital markets could be fully realized.

<sup>4</sup>The background paper prepared by the staff was subsequently published as *International Capital Markets: Developments, Prospects, and Policy Issues* (August 1995), in the Fund's series of World Economic and Financial Surveys.

### *Spillovers from the Mexican Crisis*

Directors noted that the Mexican crisis and subsequent liquidity problems in Mexico's short-term debt markets had triggered a broader re-evaluation of prospects in emerging markets. They observed that, although most emerging markets had been tested, those most affected by the spillovers of the Mexican crisis were those that also were perceived to have had one or more such weaknesses as low saving rates, misaligned exchange rates, large fiscal and current account deficits, fragile banking systems, and extensive foreign debt. Countries with stronger economic fundamentals had been affected less. Directors suggested that the international support provided to Mexico and the policy adjustments made by developing countries had been instrumental in containing contagion effects. Several Directors pointed out that the flow of funds to emerging markets was largely determined by economic fundamentals related to domestic policies in recipient countries. Directors also observed that net capital flows to developing countries would persist in the foreseeable future and could be sizable, as institutional investors in industrial countries continued to pursue international diversification of their portfolios.

Several Directors observed that data suggested that capital outflows from Mexico during 1994 had been caused largely by an increase in foreign claims by Mexican residents, rather than by sales of peso-denominated claims by foreign investors. Other Directors suggested that the data on capital outflows were not conclusive because of the difficulty in distinguishing between resident and nonresident transactions. Some Directors suggested that the staff examine the feasibility of monitoring portfolio adjustments of residents and nonresidents as an early warning signal of financial crisis.

### *Capital Flows to Developing Countries*

The shift, in recent years, in the composition of cross-border investments in emerging markets away from

syndicated bank loans toward tradable securities was seen by a number of Directors as allocating financial risks more widely. Directors recognized that losses during a financial crisis would be more broadly dispersed among institutional investors and, therefore, less likely to lead to systemic banking difficulties in the major international financial centers. In the event a country or group of countries experienced problems with debt servicing, however, this diffusion could make debt restructuring more difficult. Several Directors asked the staff to examine the possible role of the Fund in developing procedures for an orderly workout of international debt (see the section on the Debt Situation and the Role of the Fund).

Many Directors agreed that the best way for developing economies to safeguard themselves against the vagaries of international capital flows was to strengthen macroeconomic fundamentals and to build sound and efficient domestic financial systems. They emphasized that sterilized exchange market intervention was often the best first line of defense against surges in capital inflows, but they acknowledged that prolonged and fully sterilized intervention could be difficult to implement and sustain, especially in countries with shallow financial markets. Hence, some appreciation of the exchange rate appeared inevitable with sustained inflows, although a few Directors were of the view that appreciation was not an appropriate response to flows that were essentially transient in nature. Directors generally favored fiscal stringency and consolidation during periods of sustained capital inflows. They recognized, however, that no policy prescription would be universally valid; the policy response should take into account the specific characteristics of the recipient country and the nature of its capital inflows.

Although several Directors acknowledged that some controls—mainly prudential and monetary policy measures, including reserve requirements—might help to limit temporarily the potentially destabilizing effects of capital inflows, most emphasized that direct controls were distortionary and ineffective in the long run and should not be used as a substitute for prompt policy adjustment to ensure sound macroeconomic fundamentals. They also cautioned that controls on capital outflows were unlikely to be effective and could, in fact, aggravate a crisis of confidence.

Directors stressed that, in moving toward capital account liberalization, the development of a strong banking system and an adequate prudential and regulatory framework as well as proper sequencing were of the utmost importance. They also underscored the importance of appropriate debt-management practices in the emerging markets, noting, in particular, the risks of relying on short-term capital to finance long-term development.

### *Recovery of Some Emerging Markets*

During the discussion in December, Directors noted that financial activity and asset prices had begun a sustained recovery in some of the emerging markets affected earlier in the year by the Mexican crisis and that capital inflows had recovered to some extent from declines in 1994 and early 1995. Directors also observed that there were significant differences among emerging economies with respect to access to the international markets, and they attributed this to variations in economic fundamentals and to greater discrimination on the part of investors. Directors believed it would be premature to say that all emerging markets—particularly those outside Asia—had recovered. Several important, lingering effects of the Mexican crisis were still being felt as the year closed. First, in the largest Latin American countries, interest rate spreads were still wider than before the crisis. Second, credit guarantees had become more prevalent since the crisis, and sovereign bond issues accounted for more than three fourths of all international bond issues by developing countries. Third, maturities had shortened considerably. Fourth, investor interest in securities in emerging markets had not recovered to pre-crisis levels across a broad spectrum of countries in Asia and Latin America.

Concern was expressed about the weakness in banking systems in a number of countries. It was noted that many banking systems had impaired capital positions and substantial nonperforming loans and would likely be vulnerable for some time. Directors stressed that transparent, sound financial systems and comprehensive supervision were essential for maintaining stable macroeconomic policies. Some Directors commented that, in certain emerging markets, the effective enforcement of prudential regulations was becoming more difficult owing to the use of offshore derivative transactions by domestic financial institutions. In light of increased use of these instruments, some Directors noted that the regulatory authorities should require improved financial reporting, supervision, and risk management. Other Directors, while agreeing that such transactions make domestic regulations less effective, nevertheless emphasized the benefits—primarily the ability to hedge against asset price and exchange rate volatility—that can be derived from the use of cross-border derivative transactions.

### *Major International Capital Markets*

The growing use of derivatives was also an object of concern for the industrial countries, and the discussion in May 1995 focused on these countries' efforts to improve the regulation and supervision of banks in light of increased activity in derivative markets. In December 1995, Directors' further consideration of supervisory and regulatory issues was prompted by

signs of a possible increase in competitive pressures on banks. Directors also reviewed trends in the industrial countries' foreign exchange and securities markets and discussed steps taken by the Japanese authorities to resolve the problems of Japan's banking system.

### *Regulatory and Supervisory Issues*

At the discussion in May, Directors observed that industrial countries had been largely successful in strengthening the regulatory and supervisory infrastructure for derivative markets, but some noted that further improvement was needed. They welcomed the proposal by the Basle Committee on Banking Supervision to redesign the capital requirement regime for international banks' off-balance-sheet and trading activities. Directors noted that important challenges remained with respect to international cooperation and coordination of regulatory and supervisory requirements. They generally agreed that, despite the globalization of capital markets, rules applying to markets and institutions were still national. Some Directors urged the staff to consider further the potential contribution that the Fund could make to the Basle Committee's endeavors to strengthen supervisory and regulatory arrangements, particularly in view of the universality of the Fund's membership.

In considering these issues again in December, several Board members observed that intermediation margins on both domestic and international bank loans—as measured by spreads between loan and deposit rates—had declined to their lowest level in recent years, suggesting a high degree of competition among banks both within and between the major

banking centers. Some bank regulators had, however, expressed concern that lending standards and loan covenants may have been relaxed too much, recalling that competitive pressures in the past had driven banks into unfamiliar and riskier lines of business. Directors stressed that supervisory authorities should remain vigilant in their efforts to guard against undue risk taking by financial intermediaries.

### *Problems in Japan's Financial Sector*

In their December discussion, Directors generally agreed that the monetary authorities in Japan had reached a critical juncture with respect to resolution of Japan's long-standing banking problems. Many welcomed the more aggressive stance of the authorities in allowing some banking institutions to fail. However, it was broadly felt that other measures might be necessary—for example, the view was expressed that early resolution of the problem of bad debts would require faster write-offs of nonperforming loans, greater use of public funds, and increased efforts to sell bank assets. Several Directors also recommended improved transparency and more stringent disclosure requirements. Many Directors considered that the premium paid by Japanese banks in the interbank market reflected concerns in the international markets about slow progress in resolving loan losses. More generally, Directors noted the large differences between countries with respect to financial disclosure, accounting standards, bank supervision, and management practices, and they called for greater harmonization, cooperation, and sharing of information among the major industrial countries.

