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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, 1998–99 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (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).

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, the Commission of the European Union, and the International Swaps and Derivatives Association. The discussions leading up to the present report took place in Argentina, Belgium, China, France, Germany, Hong Kong SAR, Hungary, Italy, Japan, Malaysia, Mexico, Poland, Singapore, Switzerland, Turkey, the United Kingdom, and the United States, in early 1999. The report reflects information available up to the end of June 1999.

The *International Capital Markets* report is prepared in the Research Department. The *International Capital Markets* project is directed by Charles Adams, Assistant Director, together with Donald Mathieson, Chief of the Emerging Markets Studies Division, and Garry Schinasi, Chief of the Capital Markets and Financial Studies Division. Coauthors of the report from the Research Department are Peter Breuer, Bankim Chadha, Nada Choueiri, Burkhard Drees, Anne Jansen, Charles Kramer, Subir Lall, William Lee, Joaquim Levy, Alessandro Prati, Anthony Richards, Jorge Roldos, Todd Smith (Visiting Scholar), Subramanian Sriram, Amadou Sy, Peter Tran, and Caroline Van Rijckeghem. Contributors from other departments are Martin Cerisola, Western Hemisphere Department; Cem Karacadag, Monetary and Exchange Affairs Department; and James Morsink, Asia and Pacific Department. Celia Burns, Sheila Kinsella, Rosalind Oliver, Ramanjeet Singh, and Adriana Vohden provided expert word processing assistance. Marina Primorac of the External Affairs 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 July 29, 1999. 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

BIS	Bank for International Settlements
BNL	Banca Nazionale del Lavoro
CAPM	Capital Asset Pricing Model
CAPS	Capital Augmented Preferred Securities
CCBM	correspondent central banking model
DJIA	Dow Jones Industrial Average
DCR	Duff & Phelps Credit Rating Agency
EAF	Euro Access Frankfurt
EBA	European Bankers' Association
ECB	European Central Bank
EFIL	Exchange Fund Investment Limited
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
EU	European Union
FBA	Federation of Bankers' Associations
FESCO	Forum of European Securities Commissions
FOBAPROA	Fondo Bancario de Protección al Ahorro
FOMC	Federal Open Market Committee
FRC	Financial Reconstruction Committee
FSA	Financial Supervisory Agency
G-7	Group of Seven
G-10	Group of Ten
GITIC	Guangdong International Trust and Investment Corporation
HKMA	Hong Kong Monetary Authority
HLI	highly leveraged institution
IFC	International Finance Corporation
IIF	Institute of International Finance
INDRA	Indonesia Debt Restructuring Agency
IOSCO	International Organization of Securities Commissions
IPAB	Instituto de Protección del Ahorro Bancario
ISD	Investment Services Directive
ISDA	International Swaps and Derivatives Association
ITIC	international trust and investment corporation
JGB	Japanese government bonds
KAMCO	Korea Management Corporation
LIBOR	London interbank offered rate
LTCM	Long-Term Capital Management
MRO	main refinancing operations
NCB	national central bank
NDF	nondeliverable forward

NPL	nonperforming loan
NRSRO	Nationally Recognized Statistical Rating Organization
OCC	Office of the Comptroller of the Currency
OTC	over-the-counter
PCA	Prompt Corrective Action
PNS	Paris Net Settlement
ROE	return on equity
RTGS	real-time gross settlement
S&P’s	Standard & Poor’s
SAR	Special Administrative Region
SDDS	Special Data Dissemination Standard
SEC	Securities and Exchange Commission
SLIPS	Stapled Limited Interest Preferred Securities
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer
VaR	value at risk
Y2K	Year 2000

I
Introduction and Overview

The period since last year's *International Capital Markets* report has witnessed some of the most severe financial market turbulence in the postwar period. The effects of the Asian financial crisis were initially felt mainly within the region, and the negative spillovers to other emerging markets and to most of the advanced countries outside the region were short lived.[1] Indeed, through mid-1998 other emerging markets, including in Latin America and Europe, generally maintained access to international capital markets at relatively favorable terms, and some of the Asian crisis countries saw a pickup in inflows.[2] At the same time, equity markets in most of the advanced countries continued to record strong gains—reaching record valuations; levels of leverage in advanced countries' financial systems remained high; and confidence was generally strong.

During 1998, however, the situation began to deteriorate as weakening commodity prices, deeper-than-expected output declines in the Asian crisis economies, and continued difficulties in Japan conspired to produce an increasingly negative perception of the global outlook. Russia's decision in August to unilaterally restructure its domestic debt and allow the ruble to depreciate triggered a far-reaching reassessment of risk. Reflecting the associated portfolio rebalancing and deleveraging, credit and liquidity spreads in key mature markets widened sharply—more than reversing the compression over the preceding several years; liquidity almost dried up in some of the deepest capital markets in the world following the near-collapse of the hedge fund Long-Term Capital Management (LTCM); and the dollar-yen exchange rate experienced its largest one-day movement since the collapse of the Bretton Woods system. The effects of the turbulence on the emerging markets were dramatic: spreads on external debt widened sharply, international lending effectively dried up, and the more vulnerable economies in Latin America began to be brought into the crisis.

Timely action by a number of central banks and the international community were successful in staving off the risk of a global crisis, and financial markets in the advanced countries began to stabilize toward the end of 1998. Moreover, even though sentiment began

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[1] The term "emerging markets" as used in this report is substantially broader than that used in other contexts and includes the IMF's *World Economic Outlook* classifications of "developing countries," "countries in transition," and the advanced economies of Hong Kong Special Administrative Region (SAR) of China, Israel, Korea, Singapore, and Taiwan Province of China.

[2] Here, and in what follows, Korea, Malaysia, the Philippines, Thailand, and Indonesia are characterized as the Asian crisis economies. In view of the large number of Asian countries seriously affected by the regional turmoil, the identification of crisis countries is necessarily somewhat arbitrary.

to deteriorate again early this year when Brazil gave up its defense of its currency after several months of pressure, the spillovers to other countries were surprisingly short lived and the negative effects on Brazil less than had been feared. These muted responses were pivotal in avoiding another round of international financial turmoil. In the event, the economic climate began to improve as it became clear that growth in the U.S. economy remained surprisingly robust, Japan began to take important measures to stabilize its economy and address its banking sector problems, and the Asian crisis economies showed signs of recovery. Notwithstanding these favorable developments, conditions in financial markets remain fragile, as evidenced by continued high levels of volatility, high spreads on emerging market external debt, and capital flows to the emerging markets that are running well below the rates during the boom years.

The turbulence over the last few years has raised questions about the market dynamics of the “new” increasingly integrated and securitized international capital markets, including the boom-bust swings in international capital flows, the speed and severity with which disturbances spill over across countries, and the market dynamics (magnification effects) associated with high levels of leverage. Recent *International Capital Markets* reports and *World Economic Outlooks* have extensively covered many of these issues, which are also being considered in the context of the IMF Executive Board’s work program. Following a review and assessment of recent developments in capital market and banking systems, this year’s *International Capital Markets* report addresses a number of specific features of international capital market dynamics, including the systemic and other issues posed by highly leveraged institutions and activities; the nonstandard policy responses some emerging markets have taken when faced with extreme external pressures; and the performance of the major credit rating agencies during the recent financial crises.

Chapter II provides a comprehensive assessment of recent developments and trends in the mature financial markets and identifies key risks and uncertainties in the outlook. Beyond the turbulence in international capital markets, the mature financial markets were influenced significantly over the last year by continued sharp differences in macroeconomic performance and policies across the major advanced countries, notably the continued strong performance of the U.S. economy vis-à-vis Europe and Japan; spillovers from problems in the emerging markets, especially to banking systems; and the global shift toward a low-inflation environment. On the structural side, important factors have included the further progress toward European financial integration with the successful launch of the euro, Japan’s initiation of a program to address its financial sector problems, and stepped-up mergers and acquisitions within and between major banking systems. Notwithstanding the recent improved global situation, there are a number of risks related to the sustainability of current configuration of asset prices, especially in the United States, potential vulnerabilities in the major banking systems of the advanced countries, and the possibility of increased uncertainty in the lead-up to the Y2K (Year 2000) transition.

Chapter III reviews and assesses recent developments in the emerging markets with particular focus on how they have been affected by the global turbulence. After declining in 1997 for the first time this decade, private market financing for the emerging markets fell dramatically in 1998, with much of the decline in the latter half of the year in the wake of the international turbulence. With the notable exception of foreign direct investment, all categories of private inflows fell sharply with significant further retrenchments in bank lending. Many regions shared in the cutbacks, with the Asian crisis countries becoming net capital exporters as they began to build up reserves following sharp declines during the crisis. In response to the tightening and cutback of external financing, emerging markets adopted a number of innovative approaches to accessing international capital markets, but generally only the highest quality borrowers have been successful, in some instances supported by official guarantees. Not surprisingly, the tight external financing conditions have placed strains on emerging markets, with effects varying according to underlying vulnerabilities, including dependence on short-term external funding, the strength of banking and corporate sectors, and progress in improving financial sector resilience. Notwithstanding a rally in emerging markets early this year, external financing for many emerging market borrowers remains weak.

In the immediate aftermath of last year's turbulence in international financial markets, the *World Economic Outlook and International Capital Markets Interim Assessment*[3] identified several weaknesses in private risk management, bank supervision, and financial markets surveillance that had been intended to provide key lines of defense against systemic risk. Subsequently, in the wake of the LTCM episode, recommendations have been made by both official and private groups in a number of countries to address these weaknesses. Against the background of deep-seated and ongoing changes in global financial markets, Chapter IV considers a number of conjunctural factors, such as abundant global liquidity and the search for yield in competitive financial sectors, that may have contributed to unsustainable levels of leverage in key financial centers, as well as the factors underlying the market dynamics set in train by the increase in risk aversion following the Russian crisis. High and unchecked levels of leverage have not only raised important systemic issues but have also been a source of concern for a number of countries that believe their markets have been pushed around by the large and concentrated positions taken by a number of highly leveraged institutions (HLIs). Appendix 2 to Chapter IV addresses the impact of HLIs on small and medium-sized countries.

The evolving role of emerging markets in the new financial system is discussed in Chapter V. A number of emerging markets have recently responded to extreme financial pressures through relatively nonstandard approaches, taking into account developments in the instruments used—and high leverage employed—by some international investors. Included among these nonstandard approaches have been the interventions last year by the Hong Kong Monetary Authority (HKMA) in domestic equity and derivative markets to deal with concerns about a "double play" by highly leveraged speculators, the adoption by Malaysia of

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[3] International Monetary Fund, *World Economic Outlook and International Capital Markets Interim Assessment*, *December 1998: A Survey by the Staff of the International Monetary Fund* (Washington).

controls on capital outflows to provide greater domestic monetary independence and effectively close down the offshore market in its currency, and interventions by Brazil in its external debt market.

As capital markets become a major source of funding, major credit rating agencies have been assuming an increasingly important role in providing standardized assessments of the credit risks associated with emerging market investments. Although the major credit rating agencies identified weaknesses in the financial systems of a number of Asian countries before the crisis, the maintenance of investment-grade ratings for many countries and the subsequent sharp downgrades during the crisis have been seen by some observers as imparting a pro-cyclical element, exacerbating herding behavior before the crisis and contributing to the massive turnaround in capital flows. Against this background, the report reviews in Chapter V the credit rating experience during the Asian crisis and considers steps the major rating agencies are taking to address weaknesses revealed by the episode. The recent Basel Committee proposals to base banks' capital risk weights on external credit ratings add importance to rating agencies' current efforts to strengthen the rating process, and could help dampen the boom-bust cycles in international capital flows, lock in some of the recent shift away from bank lending and toward portfolio flows, and facilitate a better pricing of risk.