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INTERNATIONAL CAPITAL MARKETS

Developments, Prospects, and Key Policy Issues

By a Staff Team led by
Donald J. Mathieson and Garry J. Schinasi

International Monetary Fund
August 2001

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Production: IMF Graphics Section
Cover & Design: Luisa Menjivar-Macdonald
Figures: Theodore F. Peters, Jr.
Typesetting: Choon Lee

ISBN 1-58906-056-3
ISSN 0258-7440

Price: US$42.00
(US$35.00 to full-time faculty members and
students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel.: (202) 623-7430 Telefax: (202) 623-7201
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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 part 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, insurance companies, pension funds, stock and futures exchanges, regulatory and monetary authorities, finance ministries, credit rating agencies, and the staff of the Bank for International Settlements. The discussions leading up to the present report took place in Argentina, the Czech Republic, France, Germany, Hong Kong SAR, Italy, Japan, the Republic of Korea, Malaysia, Mexico, Singapore, the United Kingdom, and the United States during the period November 2000–April 2001. The report reflects information available up to the end of May 2001.

The *International Capital Markets* report was prepared in the Research Department, under the general direction of the Economic Counsellor, Michael Mussa. The *International Capital Markets* project is codirected by Donald J. Mathieson, Chief of the Emerging Markets Studies Division, and Garry J. Schinasi, Chief of the Capital Markets and Financial Studies Division. Contributors to the report from the Research Department are Torbjorn Becker, Peter Breuer, Jorge Chan-Lau, R. Sean Craig, Piti Disyatat, Burkhard Drees, Gaston Gelos, Iryna Ivaschenko, Ronald Johannes, Charles Kramer, Ramana Ramaswamy, Jorge Roldos, R. Todd Smith, Amadou Sy, and Caroline Van Rijckeghem. Silvia Iorgova, Anne Jansen, Oksana Khadarina, Yoon Sook Kim, and Peter Tran provided research assistance. Kenneth Kletzer of the IMF's Research Department also contributed. Contributors from other departments are Kenneth Kang and Martin Mühleisen, Asia and Pacific Department; Roger Nord, European I Department; and Vivek Arora, Western Hemisphere Department. Caroline Bagworth, Ramanjeet Singh, Adriana Vohden, and Joan Wise provided expert word processing assistance. Jacqueline Irving 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 June 28, 2001. 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.

ACRONYMS AND ABBREVIATIONS

ADR	American depository receipt
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CBO	Collateralized bond obligation
CP	Commercial paper
CTD	Cheapest to deliver
DVP	Delivery versus payment
ECB	European Central Bank
ECU	European Currency Unit
EMBI	Emerging Markets Bond Index
EMTA	Emerging Markets Traders Association
EMU	European Economic and Monetary Union
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	Foreign direct investment
FRA	Forward-rate agreement
GDR	Global depository receipt
GEM	Global Equity Market
G-7	Group of Seven
G-10	Group of Ten
HLI	Highly leveraged institution
IFC	International Finance Corporation
IOSCO	International Organization of Securities Commissions
IPO	Initial public offering
IRB	Internal ratings based
ISDA	International Swaps and Derivatives Association
JGB	Japanese government bond
LCBO	Large, complex banking organization
LIBOR	London Interbank Offered Rate
LTCM	Long-Term Capital Management
MBS	Mortgage-backed securities
MSCI	Morgan Stanley Capital International (index)
MSCI EMF	Morgan Stanley Capital International Emerging Markets Free (index)
NASDAQ	National Association of Securities Dealers Automated Quotations
NPL	Nonperforming loan
NRF	Name registration form
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-counter
QFI	Qualified foreign intermediary
ROA	Return on assets
ROE	Return on equity
RTGS	Real-time gross settlement
SAR	Special Administrative Region
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer
TMT	Technology, media, and telecommunications

CHAPTER I INTRODUCTION

During the year ending May 2001, the global economic slowdown and greater synchronization between economic and financial cycles gave rise to reappraisals of financial risk, portfolio rebalancing, and asset repricing in a wide range of financial markets. As discussed in previous *International Capital Markets* reports, past financial market adjustments, such as that which occurred in 1998, often seemed to have originated in concerns that excessive leverage, market illiquidity, and other potential financial fragilities could engender real economic consequences such as a "credit crunch." By contrast—and contrary to concerns expressed by market participants last year that the U.S. and global economies might experience overheating—the recent adjustment reflected perceptions, and then the reality, of deteriorating economic conditions and prospects. Concerns later arose that the attendant financial repercussions, including downward pressure on corporate earnings growth and rising default rates, would adversely affect prospects for real economic growth.

The financial effects of slowing economic growth and deteriorating prospects were clearly reflected in the repricing of risks in a wide range of equity and high-yield credit markets. Equity prices fell substantially during 2000, particularly for technology stocks, which registered virtually simultaneous sharp falls in markets around the globe. For a variety of borrowers, high-yield credit spreads surged to the highest levels since the 1991 recession as issuance dried up. The increased correlation between asset prices across countries probably reflected elements of the ongoing globalization of finance, including the greater tendency for global investors to manage portfolios from a sectoral rather than geographic perspective. A key exception was the Japanese fixed-income market, where spreads seemed compressed compared with those of other countries. Compressed spreads in Japan may have been due to the more important role of domestic investors relative to foreign investors and efforts by the authorities to promote corporate lending through loan guarantees. Global equity and fixed-income markets rebounded in early 2001 following monetary easing in the major economies.

Because economic and financial conditions and prospects deteriorated more or less simultaneously across a wide range of countries and markets, the pattern of global capital flows was broadly unchanged. The United States continued to absorb the bulk of international capital flows, including flows from Japan and the euro area. Accordingly, the dollar continued to strengthen on a multilateral basis, while the yen declined and the euro was broadly stable. The euro depreciated against the dollar, however, amid strong outflows of equity portfolio capital to the United States. Strong U.S. capital inflows might have reflected investor confidence that the U.S. downturn would be short-lived and that high productivity growth—which underpinned strong, risk-adjusted returns in U.S. asset markets during past years—would be sustained.

During the period under review, financing to emerging markets was significantly affected by the aforementioned economic and financial developments. Although total gross private financing to emerging markets rose by one-third in 2000, there were repeated episodes in which access to international markets by emerging market borrowers was limited. This "on-off" access of emerging markets to international capital markets reflected both structural and conjunctural factors. As a key structural factor, because dedicated emerging market investors are limited in number and size, "crossover" investors played a key role in determining capital flows to and from emerging

markets.[1] The conjunctural factors included market turbulence in Argentina and Turkey—which affected the level of market access for many emerging markets—as well as periodic bouts of asset-price volatility in mature markets (particularly in equity markets) and concerns about the prospect of slowing global growth.

The on-off nature of emerging market access to international capital markets appears to have become a key characteristic of international financial markets. Emerging market borrowers have begun to adapt: when the market for U.S. dollar-denominated bonds has closed, these borrowers turn to the syndicated loan markets, attempt to issue in bonds denominated in euro or yen, or issue in local-currency bond markets. In addition, they employ staff with extensive experience in investment banking and securities trading, exploit "windows of opportunity" to prefund their yearly financing requirement, and engage in debt exchanges to extend the maturity of their debt and avoid a bunching of maturities.

This year's *International Capital Markets* report explores these main themes, as it examines recent developments in the mature and emerging markets and analyzes key structural changes in global financial markets.

Chapter II provides a comprehensive description and assessment of developments in the mature markets. As the global economic outlook weakened during the second half of 2000 and concerns about overheating of the U.S. economy waned, monetary tightening gave way to easing or the expectation of easing in the major markets, and concerns arose about credit risk and slowing corporate earnings growth. Long-term interest rates declined, credit spreads rose, and equity prices fell sharply in all the major markets, particularly for technology stocks. The dollar continued to strengthen on a multilateral basis amid continued strong flows of capital into the United States, as the repricing in U.S. markets was broadly mirrored in other markets. In early 2001, monetary easing in the major economies renewed optimism about the economic outlook, and credit spreads narrowed and stock prices recovered. Deteriorating market conditions and credit quality weighed on bank earnings in the major economies but, except in Japan, no concerns arose about the stability of any major banking system.[2]

Chapter III reviews recent developments in emerging market financing over the past year, including trends in net and gross financing flows, and in primary and secondary markets for emerging market assets. Although net and gross capital flows were positively correlated throughout the 1990s, net capital flows declined substantially in 2000, whereas gross flows expanded sharply. This divergence primarily reflected the sharp rise in the current account surpluses of the oil-exporting emerging markets, which led to both an accumulation of foreign exchange reserves and increased claims (mainly deposits) on international banks. However, foreign direct investment flows also declined in 2000 for the first time since 1990. Emerging market equities issuance rose sharply in 2000, but issuance by Chinese entities accounted for the lion's share. There was also a sharp contrast between the secondary market performance of emerging market bonds and equities. Despite the repeated episodes of limited bond market access, emerging market bonds were among the best performing asset classes, in part reflecting market perceptions of improving fundamentals for selected emerging markets. In contrast, emerging market equities were closely linked to developments in mature equity markets and experienced a 30 percent decline.

This year's report also continues the analysis of key structural changes in global financial

[1]Crossover investors are mature market institutions that have mature market investments as their main mandates and benchmarks but they may also opportunistically buy and sell emerging market assets. Crossover investors determine how much to hold in emerging market assets based on their current appetite for risk and prospects for both market categories of investments.

[2]Annex I discusses the ongoing financial weaknesses in Japan's corporate and financial sectors.

markets that has been undertaken in recent reports. Chapter IV discusses the financial implications of and policy issues surrounding the ongoing structural changes in the major government securities markets, which have been key building blocks of global finance. Major government securities and their markets have characteristics such as minimal credit risk and strong liquidity that distinguish them from other financial instruments and markets. Because of these characteristics, private market participants have come to rely on government securities and markets to play important roles in facilitating private finance. These roles, which include benchmarks, hedging vehicles, and safe haven assets during periods of stress, might not easily be filled by other financial instruments. The chapter analyzes the unique features of the major government securities and links them to their roles. The chapter then discusses recent structural changes in the major government securities markets, examines their financial implications, and identifies attendant public policy questions.

Chapter V provides a comprehensive assessment of financial sector consolidation in emerging markets, including both banking and securities trading and asset management. The last few years have witnessed accelerating consolidation among financial institutions in the mature markets and a similar trend is gathering momentum in emerging markets. The chapter discusses how the same forces driving consolidation in the mature markets are leading to different consolidation patterns in the emerging markets. In particular, consolidation in the latter is predominantly cross-border and the authorities have played a larger role in guiding the earlier stages of the process. Ownership structures, in particular family ownership, are seen as the main obstacle to faster, market-driven consolidation in emerging markets. The consolidation of financial institutions is driven by attempts to exploit economies of scale and scope, and technological advances such as the Internet and deregulation that facilitate universal banking activities are making it easier to reap such economies. Advances in technology are also transforming the securities trading industry. In response to the associated competitive pressures, stock and derivatives exchanges in emerging markets are consolidating, liberalizing access, and deregulating brokerage commissions. Barriers to entry of foreign brokerages and antiquated trading and governance structures have delayed the adaptation of some securities markets, however, with the result that liquidity and trading has migrated to offshore markets. Another feature of the consolidation process in emerging markets has been the rapid growth and consolidation of private pension funds, which sometimes contrasts with the stagnation of domestic securities markets. Finally, the trend of consolidation in emerging markets raises a number of policy issues, including the relevance of market discipline and adequate exit policies for institutions in distress, the importance of consolidated supervision and the architecture of supervisory agencies, the systemic risks derived from a more concentrated industry, and the rising importance of consumer protection and antitrust issues as a result of the potential of increased market power and privacy concerns.

Chapter VI provides a staff appraisal of the issues raised in the preceding chapters. It includes a discussion of the staff's views on the important risks and vulnerabilities present in global capital markets and the potential broader policy implications of changes in the structure of the major government securities markets and consolidation in emerging market financial systems.