VIII

Conclusions

Mature Markets

A key development in the major foreign exchange markets during the past twelve months was the appreciation of the dollar against the other major currencies. The strong economic performance of the United States, combined with attractive interest differentials, contributed to a correction of the dollar's valuation vis-à-vis the deutsche mark and the yen. The sharp yen appreciation in mid-May 1997, which is partly attributable to official statements, demonstrated that exchange rates can react quickly to changes in perceptions about future policies and fundamentals.

The relatively favorable economic fundamentals in the advanced countries produced a compression of interest rate spreads across a broad range of credit markets, as investors searched for higher yields in a global environment of low and declining interest rates. Although spreads have narrowed considerably, they have remained above previous lows in most markets. The narrowing of sovereign spreads—against benchmark yields—is consistent with the convergence of inflation rates, fiscal policies, and other fundamentals experienced recently. Likewise, the narrowing of spreads across different risk classes (within and across countries) is broadly consistent with an increased tolerance for risk, reflecting a growing risk-seeking investor base and advances in risk management techniques that have improved the ability to manage market and credit risk. The main concern is whether credit markets have fully priced in the risks of a further tightening of monetary policy and the associated increase in credit risks. As in currency markets, unexpected events or policy changes could trigger a widening of spreads and a rebalancing of portfolios across domestic and international financial markets.

Equity markets in the majority of advanced countries are presently at or near record highs, and U.S. markets have continued to rise after doubling in value during 1992–96. While some indicators suggest that U.S. equities are optimistically priced, others suggest that U.S. markets are not as far out of line as they were in 1987. However, there is a consensus that a moderate correction in U.S. equity prices would not significantly affect the U.S. economy, because real spending was apparently not significantly bolstered by positive wealth effects during the run-up in equity prices. The present strength of the U.S. economy, the strong financial condition of banks, the development and widespread use of risk management systems, and recent improvements in the U.S. financial infrastructure all support this view and suggest that a correction would be manageable.

Increased optimism about EMU has fostered stability in European currency and credit markets, and forward interest rate spreads suggest that markets are continuing to price in a high probability of EMU starting on January 1, 1999. With currency valuations now largely anchored to a single event, the current environment of low volatility, appreciated peripheral currencies, and interest rate convergence is a delicate situation that could change markedly between now and the start of EMU. As decisions are made about initial EMU membership and euro conversion rates, and as portfolios are rebalanced in light of this new information, there could be periods of increased asset-price volatility and sizable cross-border capital flows in the run-up to 1999. However, unless there are major disruptive events—a delay of the start of EMU or substantive policy disagreements, for example, about which countries should make up the initial EMU or how to interpret the Maastricht criteria—the uncertainty about these decisions need not lead to significant and disruptive market turbulence, such as was experienced during the 1992–93 ERM crises.

The yet-to-be-defined intervention rules for managing parities between the euro and the currencies of EU countries not in the initial EMU but likely to join before 2002 could become a source of speculative activity and volatility beyond 1999. Currency stability requires that the arrangements should be based on objective evaluations of economic convergence and should be credibly and transparently implemented so as not to be perceived by markets as an unconditional commitment for intervention support. The potential for currency market instability could be contained by announcing the basic features of exchange rate arrangements with non-EMU countries well ahead of the decision on the choice of countries, which is currently set to take place in May 1998, and in particular the rules and conditions for providing support for such countries' exchange rate parities and the convergence criteria for entry into the union.

Structural Aspects of EMU

The potential benefits to European financial markets of EMU are far reaching and include the development of EMU-wide securities markets, more efficient banking systems, and the creation of a pan-European payments system. But none of these benefits are assured. There are remaining impediments, including regulatory restrictions and tax disincentives that could delay or even prevent the development of EMU-wide private securities markets.

One of the most pressing challenges is the restructuring and consolidation of continental European banking systems. By removing the home currency advantage in local retail banking markets for deposits and loans, the introduction of the euro will raise the level of cross-border competition and disintermediation. The required consolidation and restructuring can be accomplished through market mechanisms, such as mergers, acquisitions, alliances, and exits. But, unless structural reforms are implemented across European banking markets, there is a risk that local market power, rigidities in labor practices, public ownership structures, and other longstanding features could delay or prevent these pressures from having the desired effects. This could allow financial problems in troubled institutions to build up to the point where public intervention might be unavoidable.

Much remains to be done to transform the still highly segmented national securities markets into deep and liquid EMU-wide securities markets. Whether institutional arrangements and financial policies may also affect the pace of market integration and development is an open question. It has been argued that the active participation of the U.S. Federal Reserve has fostered the development of the extremely efficient U.S. money and securities markets. Although final decisions have not been made, the current plan for monetary policy operating procedures is to rely on infrequent (weekly) decentralized repo operations and on decentralized fine-tuning operations, while leaving open the possibility of a system of minimum reserve requirements, with reserve averaging acting as a liquidity buffer. Some expect that leaving room for arbitrage by market participants, together with the European payments system (TARGET), will lead to an active single money market. By contrast, others have argued that the decentralized implementation of repo and fine-tuning operations would limit the ability of the ESCB to manage liquidity in money markets by way of active day-to-day operations in private interbank and repo markets.

Plans for establishing mechanisms for managing systemic banking and payments crises are still evolving. A lender of last resort is not identified in the Maastricht Treaty, and the single central institution, the ECB, is assigned only a supporting role in financial market surveillance. Moreover, banking supervision will remain national, with national supervisors responsible for functions normally delegated to a central authority, and the immediate mechanisms for information sharing, coordination, and crisis management lack transparency. As EMU-wide markets evolve, the ECB may have to assume a greater independent supervisory capacity under the enabling articles of its statutes. This would help safeguard EMU financial markets from the consequences of incompatible incentives in the midst of a crisis: under existing plans, situations could arise in which national supervisory authorities would have information about the solvency of an institution that for practical reasons it may be unwilling or unable to provide to the ECB. Transparency about the supervisory framework and market surveillance would improve the ability to deal with these potential problems. Although constructive ambiguity about the conditions under which lender-of-last-resort facilities will be available is a necessary element in preventing moral hazard, there should be no ambiguity among policymakers about the mechanisms that can be used to manage crisis situations.

Emerging Markets

The record private capital flows into emerging markets observed in 1996 have been underpinned by sound economic fundamentals, reflecting both the efforts of large institutional investors to obtain the benefits associated with holding globally diversified portfolios, as well as the improved macroeconomic and structural policies of many recipient countries. Nonetheless, divergent macroeconomic conditions in capital-importing and capital-exporting countries are likely to impart a cyclical character to private capital flows even if the trend of further integration of emerging markets into the global financial system continues. Moreover, political and economic developments in individual countries and regions will undoubtedly lead to a highly uneven pace of capital inflows and outflows in individual emerging market countries. Strong and consistent macroeconomic, financial, and structural policies are the necessary conditions to ensure sustained market access.

The dramatic decline in emerging market spreads in an environment of low interest rates and ample liquidity in the mature markets raises the question of whether the compression in spreads has been excessive to the point where credit risk is underpriced. Some have suggested that abundant global "liquidity"—associated with low nominal interest rates in some of the major mature markets—has been a key factor in pushing down spreads on emerging market instruments, as the search for higher yields has generated high cyclical demand for emerging market obligations. If this is true, then a general tightening of global monetary conditions could produce a magnified response in the level of interest rate spreads on emerging market debt. When the Federal Reserve tightened monetary policy in early 1994 by initially raising the federal funds interest rate 25 basis points, spreads on the emerging market bond index rose from roughly 400 basis points in January 1994 to over 800 basis points by March 1994. Similarly, there was initially a sharp increase in spreads when the Federal Reserve announced a one-quarter increase in the federal funds interest rate in March 1997.

While markets will offer improved terms and conditions to countries whose economic performance is viewed as strong, recent experience indicates that they can impose large costs on countries where market participants perceive policy inconsistencies and structural weaknesses. The imposition of such "market discipline" can occur by way of a sudden speculative attack on a country's exchange rate arrangements. Authorities in many countries have increasingly relied on a graduated defense beginning with sterilized foreign exchange intervention. However, it has frequently been necessary to allow short-term domestic interest rates to rise, that is, to intervene without sterilizing. When the cost of maintaining high short-term interest rates has been viewed as excessive, temporary and selective capital controls have also been used to limit speculators' access to domestic credit, thereby denying them the possibility of establishing a net short position in the domestic currency. While such controls can at times be an effective means of limiting short-term speculative pressure, and may be justified when the attack is not warranted by underlying fundamentals, they soon begin to interfere with normal trade and finance. Moreover, the growing sophistication of financial markets has meant that "leakages" will quickly force authorities into casting ever-widening nets of administrative controls. In addition, the expectation that a country is likely to use capital controls during a crisis, thereby restricting the ability of investors to adjust their portfolio positions, could influence the cost and availability of external funds during normal periods. In contrast to imposing selective capital controls, the introduction of exchange controls—restricting the ability of market participants to exchange foreign for domestic currency—could have costly and disruptive effects on trade and finance and on market confidence.

A notable feature of several of the emerging market currencies that were subjected to speculative pressure—the Czech koruna, the Thai baht, the Philippine peso, and the Malaysian ringgit—was their rigidity prior to the recent crises. These currencies either were officially fixed or had fluctuated recently within very narrow bands. Taking a short position in a currency is like short selling in any asset market where investors expect prices to decline. However, typical short selling, for example of equities, entails not only the costs of borrowing the equities, but also the risk that equity prices may actually rise. By contrast, in a general bear market for currencies created by a slowing of capital inflows, the fixity of the exchange rate limits the downside risks from shorting the currencies, and this downside limit tends to intensify speculative pressures. In fact the more rigid the exchange rate, the smaller the perceived downside risk to shorting the currency.

The recent episodes of foreign exchange market pressures illustrated some important interactions between central banks' defense of currencies and market perceptions of the costs and ability of sustaining such defenses. For one thing, the sharp increase in interest rates dictated by the arithmetic of discrete devaluations over short periods of time illustrated graphically the high level to which interest rates need to be raised to deter speculators from shorting a currency. Moreover, subsequent increases in the perceived likelihood of devaluation require successively higher interest rates. Market participants' perceptions of the costs of the cumulative increase in interest rates on the domestic corporate sector, real economic activity, and particularly the soundness of the domestic financial system appeared to play a key role in affecting expectations of an eventual devaluation. The experiences also illustrated that maintaining interest rates at a high level for a prolonged period of time—as in Thailand—can actually increase the market's belief in an eventual devaluation. It is also notable that while reserve levels declined in each of the emerging markets as the currencies came under pressure, they remained at relatively substantial levels. This fact suggests that the costs of defense in terms of higher interest rates may play a larger role than reserve levels—even with the prospects of enhanced regional cooperation of central banks—in affecting both market participants' expectations of eventual devaluation and the authorities' decisions whether or not to continue defending their currencies.

The small scale of emerging capital markets relative to the size of international capital flows has at times implied substantial movements in domestic asset prices, particularly for equities and real estate, in response to capital flows. Consequently, some countries have adopted or strengthened measures to reduce volatility in asset markets or to limit downside risks or both. Such policies include restrictions on margin purchases of securities and on short selling; prohibition of certain types of derivative products; limitations on foreign ownership; transactions taxes; and direct government intervention in equity and real estate markets. Such temporary prudential restrictions can, if applied selectively and sparingly, be helpful in maintaining market stability. However, price movements of equities and other assets in the face of changes in capital flows represent an important element of the adjustment mechanism. Restricting price movements can increase the adjustment in the quantity of flows as international investors attempt to alter their exposure to the country. For example, the loss of reserves in the event of an outflow is likely to be greater when prices do not fall. Furthermore, direct government intervention to prevent price declines can increase moral hazard since investors will come to expect that the government will provide at least partial protection against large losses. To improve the resilience of the economy to reversals in capital flows will need to become a key policy objective. In particular, policy needs to ensure that the financial sector adequately manages the risks to its balance sheets from sharp changes in asset prices.

Given the concerns about the potential cyclical nature of capital flows to emerging markets, as well as the recent experience with speculative attacks, a key issue for many market participants is *what role the IMF will play* in the new environment of increasingly integrated global capital markets. Investors are keenly aware of the role that the IMF, and other official institutions, played in the 1994–95 Mexican crisis and that the IMF's ability to address acute systemic crises will be augmented once the country ratification process for the New Arrangements to Borrow is completed. There appears to be a growing expectation that the IMF will use its own resources, as well as act as a catalyst for regional official balance of payments support for systemically important emerging market countries. It is, therefore, particularly important that the IMF's surveillance over the financial positions of its member countries be strengthened to compensate for a potential lack of market discipline over sovereign borrowers, and that the IMF's financial support be granted only in the context of rigorous adjustment programs.

The global financial developments discussed in this report can, and frequently do, exert an important impact on developments in the balance of payments and on the stock and composition of external liabilities of various IMF members, and these issues are being considered in the context of the periodic review of IMF surveillance. These discussions have, among other things, recognized that the management of the various risks associated with the financial sector and with foreign liabilities are key areas where IMF surveillance needs to be, and has already been, strengthened.

Beyond surveillance there is the question of the availability and use of IMF resources by countries experiencing balance of payments difficulties as a result of volatile international capital flows and speculative currency attacks. This important issue is under consideration.

External Liability Management

In a world of increasingly mobile capital flows and integrated capital markets, large and unhedged external sovereign liabilities could expose countries to risks that some of them are not fully prepared to manage. In the current environment, the sound management of sovereign liabilities has become an important element in safeguarding a country's economic stability. As a first step toward achieving a reduction in exposure to external shocks, countries should aim to improve the management of their net foreign exchange exposure. The choice of the currency denomination of external debt should not be driven by the level of nominal interest rates; instead, such borrowing costs should be calculated on a hedged or risk-adjusted basis. Reducing currency risk does not preclude sovereigns from tapping international markets to broaden their investor base, lengthen their maturity profile, or develop benchmark debt instruments. Rather, it implies that, unless governments have access to foreign currency revenues, sovereign foreign currency borrowing beyond a safe level should as far as possible be hedged against currency risks.

The relatively low spreads in the Eurobond markets have raised concerns about whether the pricing of external debt is efficient, or whether it reflects expectations on the part of the lenders of priority treatment in case the country experiences economic difficulties. Such priority treatment could arise through the aggressive use of legal instruments, or it might be based on assumptions about international financial rescues organized to support systemically important emerging markets. If the pricing of external debt does not reflect all economic costs of such debt, then countries may be led to exceed the optimal amount of external debt.

Limiting the sovereign currency exposure beyond what can be achieved through hedging should be viewed as a medium-term strategy and a gradual process. The more pressing issue confronting governments is to reform the institutional arrangements governing debt policy, so that the technical expertise and experience to risk-manage debt competently and transparently can be applied. The experience of the growing number of governments that have reformed their debt management practices suggests that such professionalism and accountability is best achieved when debt management is assigned to an agency that is separate and autonomous from the political process. Within this framework, the ministry of finance would formulate and publicly announce the strategy for debt management (e.g., composition and maturity of the public debt), while the debt office would implement that strategy and manage the daily risk exposure of the sovereign portfolio. Entrusting debt management to a separate and autonomous debt office signals to financial markets and to the general public the authorities' commitment to a transparent and accountable debt management policy. It also enables the authorities to assign a clearly defined objective to the debt agency, and to organize the agency to achieve such an objective, without being hampered by either the management structure or pay scale of the public sector.

Developments in International Banking

Performance of the industrial country banking systems has ranged from strong in the United Kingdom and the United States to broadly acceptable in continental Europe. By contrast, difficulties remain in the Japanese banking system. While problem loans among the 20 major banks are officially estimated at just under 5 percent of total loans, the true quantity of bad loans may be much higher. The current low interest rate environment has not been conducive to exposing potentially nonperforming borrowers, and it has boosted bank profitability. An increase in short-term interest rates could have a detrimental effect on net cash flow into the banking sector. The experience with resolving banking problems in a number of other industrial countries suggests that a timely resolution of bad loan problems serves to limit losses and restore the health of the banking system earlier than an approach based on forbearance. Furthermore, a timely writing down of bad loans, together with the sale of collateral assets, has the effect of restoring liquidity to the real estate market. As a case in point, Japanese experience during the last five years suggests that an earlier and more decisive and transparent approach to the resolution of the bad loan problem could have been less costly to the financial system and to the economy as a whole.

The restructuring of the international financial system toward a model in which financial conglomerates provide the full range of services requires a reexamination of the structure of financial supervision and regulation, as is currently under way in the United Kingdom, Japan, and elsewhere. Since financial institutions increasingly manage risk on a consolidated legal entity basis, a supervisory structure that combines the supervision of banking, securities, and perhaps insurance activities, would seem appropriate. At the same time, it is important to ensure that the central banks retain a role in the supervision of the money center banks, which are the key participants in the wholesale payments system, and which may at some time be the recipient of central bank liquidity support.

With international barriers to competition having been reduced significantly among the industrial countries, regulators need to reconsider policies that hinder competition between different segments of the domestic financial systems. Thus, both Japan and the United States have begun the process of lowering the barriers between commercial and investment banking. Similarly, the issue of assistance to government-owned banks and its effect on competition in the industry has been raised in France and Germany. There is broad international agreement that government-owned banks should be made to operate as purely commercial entities, and subsidization of their cost of capital is incompatible with that principle.

In emerging markets, banks and regulators in most countries continue to deal with the aftereffects of banking crises or with efforts to prevent new crises from developing. While asset quality in the Brazilian and Mexican systems is not yet showing much improvement, the other major Latin American banking systems appear to be recovering. In Asia, however, banking systems in a number of countries remain vulnerable to further deterioration in corporate liquidity, an exchange rate devaluation, or a correction in property prices. There are concerns about the banking systems in Korea, the Philippines, and Thailand, although regulators there and elsewhere are attempting to address the underlying problems of poor credit risk management, overcapacity, and excessive foreign exchange risk or other large exposures.