RECENT DEVELOPMENTS

Shifting—but generally positive—prospects for a global economic recovery have brought improved financial market conditions in the first quarter of 2002 (Figure 2.1). However, concerns over the level and quality of reported corporate profits, and high equity valuations continue to weigh on mature stock markets. U.S. and European private debt levels remain high, and the U.S. continues to be reliant on strong capital inflows from abroad. Persistent significant strains in the Japanese financial system raise questions about the scope for international spillovers.

Risk appetite is at its highest level in two years, a factor that, together with expectations for a global economic recovery, has eased flows to emerging markets (Figure 2.2).[1] Emerging market financing, though somewhat lower than in the preceding quarter, was well above that of the third quarter of 2001, allowing many sovereigns to complete substantial portions of their 2002 financing needs. Bond issuance was nearly equal to that in the preceding quarter, with market access supported by new inflows into the asset class, as well as renewed interest by crossover investors, and a benign external environment. The fallout from Argentina appears to have been contained, with most emerging market asset classes unaffected by the ongoing turmoil and the fall in the value of the peso.

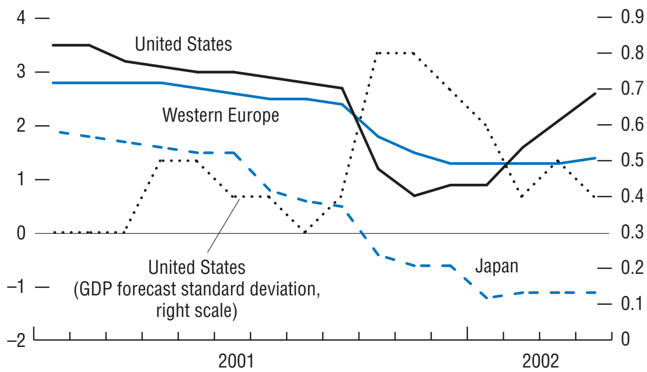
Mature Markets

Equity Markets

Despite an improved global economic outlook, stock prices were broadly unchanged in

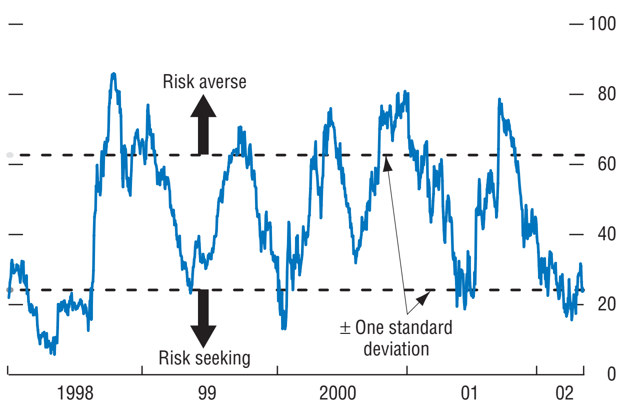
[1]See the November 14, 2001, issue of *Emerging Market Financing* for a definition of risk appetite. It is typically measured in an index by computing changes in various market indicators of credit risk and liquidity premiums.

Figure 2.1. Evolution of Consensus 2002 GDP Growth Forecasts
(In percent, year-on-year)



Source: Consensus Economics.

Figure 2.2. Liquidity and Credit Premia Index



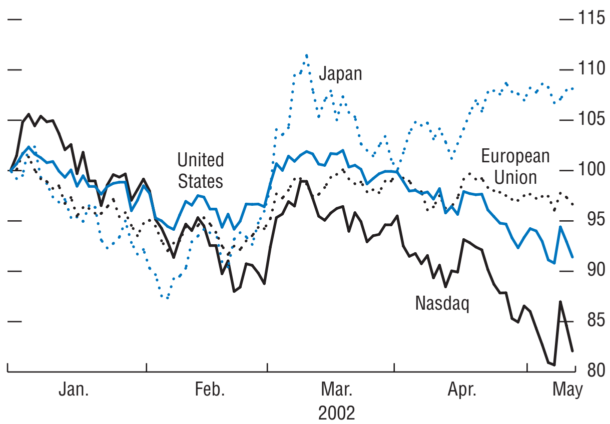
Source: JP Morgan Chase.

Table 2.1. Performance of Mature Equity Market Sectors, 2002: Q1
(In percent, dollar indices)

	United States	European Union	Japan
Total index	–0.1	–1.0	1.1
Consumer cyclicals	11.5	8.0	4.0
Industrial cyclicals	3.2	7.8	4.5
Tech, media & telecom	–8.4	–12.3	8.1
Defensive sectors	2.4	–2.2	–8.5
Banks & financials	3.8	0.7	–5.3

Sources: Bloomberg L.P.; and IMF staff estimates.

Figure 2.3. Mature Equity Market Dollar-Denominated Indices



Sources: Datastream; and Morgan Stanley Capital International.

Europe and the United States in the first quarter of 2002 (Figure 2.3). Concerns over the quality of reported earnings in the wake of the unexpected collapse of Enron and other large corporations weighed particularly heavily on the stock prices of highly leveraged firms and those that had been active in mergers and acquisitions (Box 2.1). Companies whose earnings appear to derive from mergers and acquisitions or questionable accounting practices have been heavily discounted in the market, with the share price of the 20 companies in the S&P 500 most active in mergers and acquisitions underperforming the index by 15 percentage points in the first quarter. Market concerns have also pushed highly leveraged firms to deleverage or extend the maturity of their liabilities in a steep yield curve environment, raising interest expenses to the potential detriment of future profitability. A rebound in earnings is necessary to justify current equity valuation levels, and to encourage corporate capital expenditure, which has so far been a missing element in the economic recovery. Japanese equities rose during the quarter mainly due to improved economic conditions in the United States and Japan, improved prospects for the Japanese export sector, and support measures taken by the Japanese authorities.

Consistent with the anticipation of recovery, consumer cyclicals were the best performing sectors in the United States and Europe, underscoring the relative importance of robust consumption, particularly in the United States, during the ongoing economic recovery, amid continued weakness in investment spending. Technology-

Box 2.1. Enron: Lessons Learned and the Response

The Enron failure highlighted a number of weaknesses in accounting rules and their implementation, corporate governance, and lax market discipline. There has been progress (mostly in the United States) in addressing these issues on numerous fronts. Regarding the appropriate degree of oversight of over-the-counter (OTC) derivatives, a bill proposing greater regulation of energy derivatives was defeated in the U.S. Senate.

Various international fora are also studying the issues raised by Enron and other corporate failures.

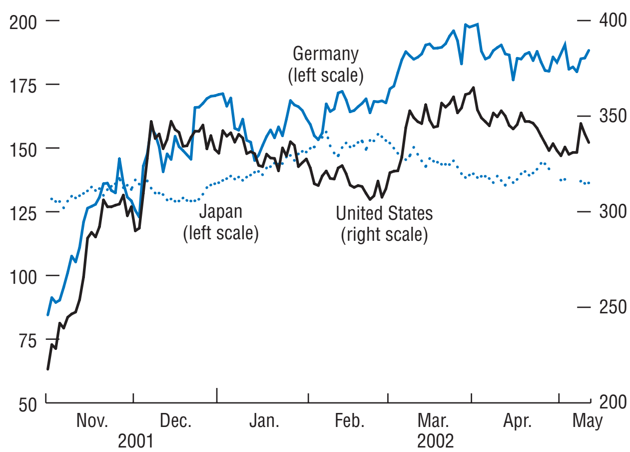
The March 2002 Financial Stability Forum meeting in Hong Kong discussed weaknesses in accounting and corporate governance. *The International Organisation of Securities Commissions (IOSCO) has created a high-level subcommittee* to assess accounting standards, disclosure and transparency practices, the role of ratings agencies, and the treatment of off-balance-sheet transactions. *The Basel Committee on Banking Supervision* is addressing banks' use of special purpose vehicles. *The OECD* plans to discuss corporate governance.

Issue	Response
Weak accounting rules	
Recognition of revenues	Increased market and regulatory scrutiny of financial reports; Financial Accounting Standards Board (FASB) examining issue of revenue recognition.
Employee stock options	Possible changes to accounting rules for expensing; International Accounting Standards Board (IASB) to examine and develop IAS accounting rules for stock options.
Consolidation of special purpose entities	New accounting rules under consideration by FASB, requiring stricter interpretation of "economic independence" to avoid consolidation; outside equity threshold increased to 10 percent.
Treatment of pension gains in income	Market scrutiny of accounting and reporting practices.
Gaps in the implementation of accounting rules and oversight of accounting profession	
Independence of audits, including conflicts of interest between audit and consulting	U.S. Securities and Exchange Commission (SEC) auditor independence rules (adopted in late 2000) phasing in.
Weak oversight of standards and audit quality	Proposals to create a new independent regulatory body passed by U.S. House of Representatives.
Complex rules-based accounting standards	Efforts to shift accounting framework toward system based on principles and simplify guidance.
Inadequate corporate disclosures	SEC proposal for more detailed and timely disclosure.
Poor corporate governance	
Lack of outside checks on management	SEC proposal to clarify responsibilities of corporate officers and outside directors.
	Proposed reforms of audit and compensation committees.
	Stock exchanges consider more stringent governance requirements in listing standards.
	Encourage shareholder approval of employee stock option plans.
Biased recommendations of stock analysts	New York state and SEC investigation of brokerage practices and conflicts of interest between analysts and investment bankers.

Media-Telecom (TMT) was the worst performing sector in both the United States and Europe, as high leverage and overcapacity in some segments persisted (see Table 2.1). In contrast, TMT shares significantly outperformed cyclicals in Japan.

Consensus earnings forecasts were upgraded during the quarter to reflect improved expecta-

Figure 2.4. International Yield Curve Differentials
(In basis points, 10-year minus three-month Treasuries)



Source: Bloomberg L.P.

tions of global recovery. The ratio of up/down earnings revisions increased in most mature markets, and, in some cases, crossed the threshold level of 1 around February–March.[2] In Japan and the United Kingdom, however, despite some improvement in the ratio, downgrades continued to exceed upgrades. As of April 1, the consensus forecast for S&P 500 earnings growth in 2002 was 15.9 percent year-over-year, with first quarter earnings expected to decline by 11.4 percent, and earnings for quarters two, three, and four expected to grow by 8.3 percent, 29.1 percent, and 42.5 percent, respectively.[3] Notwithstanding improved economic prospects, global equities appear to be overvalued, however, and the risk of a price correction due to earnings disappointments remains (Box 2.2).

Uncertain prospects for corporate profits also raised questions about U.S. banking sector profitability. The decline in mergers and acquisition activity is reducing fee income. At the same time, banks face higher costs from bad loans. Moreover, the virtual drying up of the U.S. commercial paper market (see the section "Corporate Debt Markets") has increased calls on bank credit lines at an inopportune time. These concerns have so far been overridden by expectations for an economic recovery, and U.S. and European bank stocks rose in the first quarter. Japanese bank stock prices, however, have underperformed the broader index and are now around 40 percent below their end-1998 level, reflecting continued concerns about their financial condition. Both European and Japanese insurance companies have experienced large insured losses and market returns that are below guaranteed rates on policies (see Chapter III).

[2]The ratio of up/down revisions is the number of index constituents for which the 2002 earnings forecasts have been revised up divided by the number of index constituents for which the 2002 earnings forecasts have been revised down.

[3]These forecasts do not fully reflect recent accounting changes in the United States (i.e., FASB 142) that stops the amortization of goodwill.

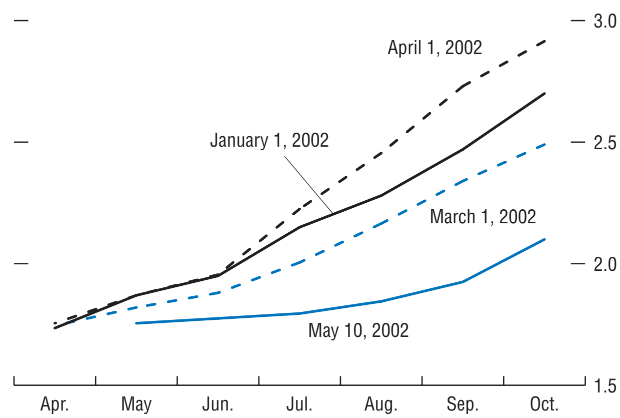
Primary market activity in the United States picked up sharply in March to $9.3 billion, above the 10-year average, although the quarter's total of $12 billion was $1 billion below the preceding quarter. Most U.S. initial public offerings (IPOs) have performed well in the aftermarket, mirroring the performance of the broader indices. Including long-dated convertibles, total first quarter equity and equity-like issuance in the United States amounted to $34 billion. The desire to replace debt with equity motivated many IPOs, with spin-off IPOs ($7.4 billion in the first quarter) a popular way for U.S. companies to repair balance sheets and reduce leverage. The total volume of global equity issuance was only marginally higher than in the previous quarter, at just over $20 billion. The volume of IPOs in Europe, however, fell 45 percent to $5.4 billion, led by the French government's €2.5 billion sale of ASF of France and Nestle's $2.3 billion sale of Alcon. Uncertainty over future earnings appear to have deterred many investors from the European IPO market.

Government Bond Markets

With mixed economic signals in the first two months of 2002, and the flight to quality from the Enron-related sell-off in corporate bonds, the U.S. yield curve paused for two months before resuming its steepening trend in March (Figure 2.4). In Japan, fears of Japanese government bond (JGB) sales by banks to cover equity related losses ahead of the fiscal year-end, among other things, contributed to rising JGB yields in January and early February. However, following the rally in the equity markets during mid-February–March, financial institutions regained their appetite for JGB purchases, contributing to a mild flattening in the curve.

U.S. futures markets appear to be pricing in a rate hike in August (Figure 2.5). Prices on eurodollar futures are consistent with market expectations of a cumulative increase in the Fed Funds rate of 100–125 basis points this year, although these numbers tend to be higher than consensus forecasts based on market surveys and

Figure 2.5. Expected Policy Rates: Federal Funds Futures, 2002
(In percent)



Sources: Bloomberg L.P.; and IMF staff estimates.

Box 2.2. Mature Equity Market Valuations

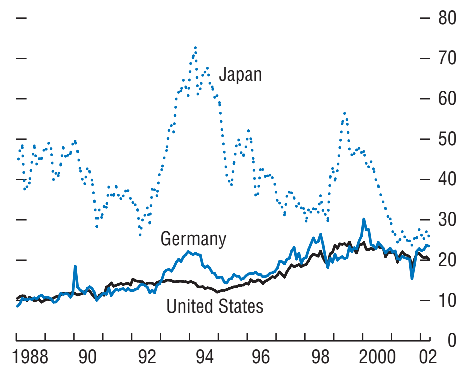
In spite of the correction in equity markets since early 2000, most traditional measures suggest major market equity valuations are high relative to historical averages. U.S. and German equity valuations appear to be at or above their “fair values,” while in Japan it is less clear to what extent recent history is a useful guide for judging the validity of forward-looking valuation measures.[1]

The 12-month forward *price/earnings (P/E) ratio* rose above its five-year average in most mature equity markets in the post-September 11 rally.[2] U.S. and German stocks are currently fairly to richly priced relative to their five-year average P/E of 21.3 and 22.2, respectively, assuming that the 15–20 percent average earnings growth rates observed during the past five years can be sustained going forward. Japanese forward P/E ratios remained below their five-year average of 35.5. Markets are even more richly valued relative to their longer term (1988–2002) average P/Es in the United States (16.1) and Germany (17.3), unlike in Japan (41.6) (see the first Figure).

Bond-to-earnings (BY/EY) yield ratios, which compare the 12-month forward earnings yield with the 10-year government bond yield, have also risen over the past few months. In the U.S. and German markets, stocks were trading about 10–20 percent above their “fair value” (the “fair value” is computed as the reciprocal of the bond yield) (see the second Figure).

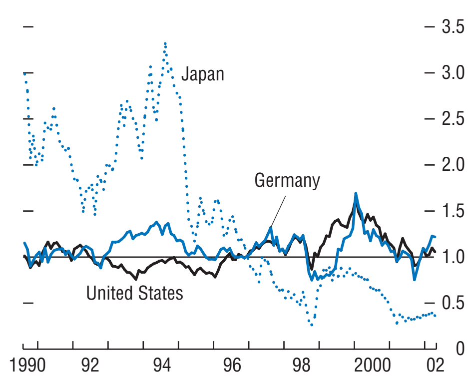
Implied equity risk premiums, a measure of the expected excess return on equity investments above risk-free returns, are calculated using the long-term consensus earnings growth forecasts, forward dividend yields, and long bond yields. According to this measure, the U.S. equity risk premium is currently 3.8 percent (compared to the 10-year average of 3.4 percent), the German risk premium is 2.7 percent (versus a 2.8 percent average), while the risk premium on Japanese equities is 4.6 percent (versus a 3.6 percent average), suggesting that equities are relatively cheap

Forward Price/Earnings Ratios



Source: I/B/E/S.

Bond-to-Earnings Yield Ratios

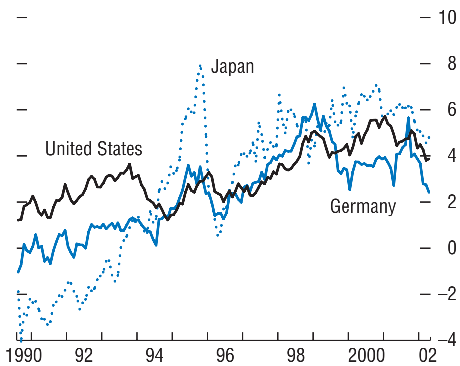


Source: I/B/E/S.

[1]Germany is used as a proxy for Europe in this box because pan-European data are not available.

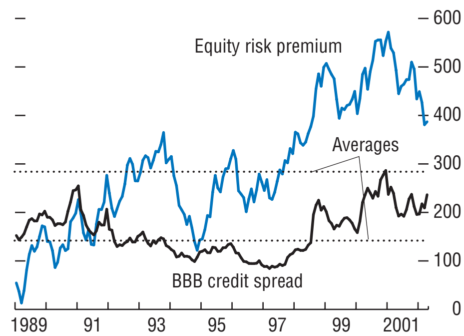
[2]The forward-looking equity risk premium (EQRP) is calculated using the Gordon valuation model, (i.e., EQRP = D/P + G – R), where D equals the expected dividend in the current year (the indicated annual dividend, or IAD); P, the current price; G, the forecasted growth rate in dividends, which is the long-run market consensus earnings growth rate multiplied by the retention rate (or 1-payout ratio); and R, a generic 10-year local government bond yield. Other methods for calculating EQPR produce equity risk premiums ranging from 2 percent to 9 percent for the United States.

Implied Equity Risk Premiums
(In percent)



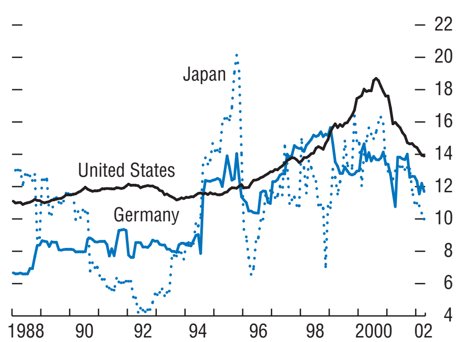
Source: I/B/E/S.

U.S. Equity Risk Premium Versus the BBB Credit Spread
(In basis points)



Sources: I/B/E/S; Merrill Lynch; and IMF staff estimates.

Consensus Earnings per Share Growth Rates over the Next Five-Year Cycle
(In percent)



Source: I/B/E/S.

compared to government bonds. However, it should be noted that consensus long-term earnings forecasts (particularly in the United States) remain well above their historical levels (see the final three Figures). For example, the U.S. equity risk premium calculated on the assumption that the long-run earnings growth rate is equal to the pre-tech bubble average turns out to be much lower; that is, only about 2.8 percent. In addition, if one looks at the average BBB corporate credit spread in the United States, which was at 209 basis points at the end of March, and adds the historical average difference between the equity premium and the credit spread, it would put the minimum excess return on equity required to compensate investors for the risk of corporate default at around 3.4 percent.

actual outturns (Box 2.3). In the United States, survey-based forecasts see rates rising in the third quarter at the earliest (Figure 2.5). Similarly in Europe, market participants do not expect a European Central Bank rate hike before the third or fourth quarter, but futures markets are discounting a hike of 25 basis points in the second quarter and another 50 basis points by year-end. Canada was the first Group of Seven (G-7) economy to raise its official rate by 25 basis points on April 16.

Corporate Debt Markets

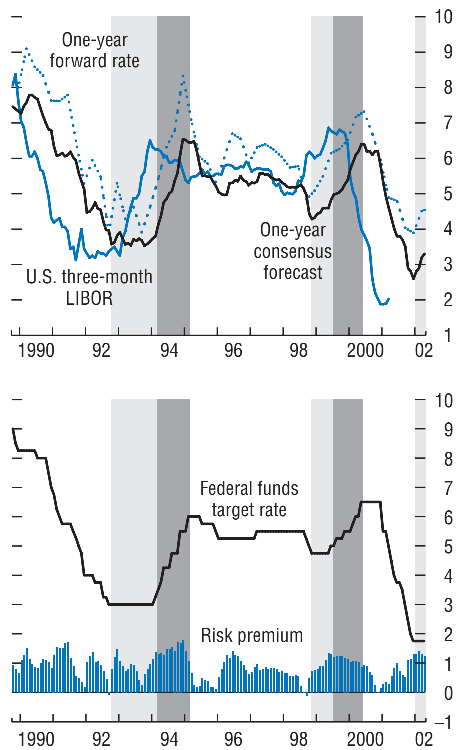
Concerns over the quality of earnings triggered by the Enron scandal and uncertain prospects for corporate profitability contributed to an aversion for corporate credit risk in the

Box 2.3. Are Forward Short Rates Useful Indicators of Market Expectations?

Federal funds futures (and forward) markets are biased and unreliable indicators of market expectations for future short-term policy interest rates (IMF, 2002). Average expectations of short-term interest rates are typically lower than those futures contracts price in, and the difference between the two can be seen as the "risk premium" built into the price of the contract, reflecting the risk that rates may, for example, have to be higher than the average expectation, if growth surprises on the upside.

One widely used gauge of the risk premium is the difference between consensus forecasts of short rates one year ahead, and the current short-term interest rate forward (or future) (see, for example, Goldman Sachs & Co., 2002). As the top panel of the Figure shows, the one-year forward, three-month U.S. Treasury bill rate for the 1990–2002 period is consistently higher than the consensus forecast, indicating a positive time varying risk premium. The risk premium tends to persist much more during tightening cycles (shown with dark shading in the Figures) suggesting markets are more comfortable about deciding when an easing cycle has ended rather than a tightening one. Also, during the last two tightening cycles, the risk premium entered the tightening cycle at relatively high levels and did not fully unwind until *after* the U.S. Federal Reserve had stopped hiking rates, again indicating markets are conservative and generally reluctant to take a bullish stance on forwards, even if they have a well-formed view on how high interest rates may go. Interestingly, when the eventual tightening has been very sharp, both forwards and consensus expectations have underestimated actual interest rates in the early part of the tightening cycle, before reverting to the long-term norm of overestimating them.

U.S. Interest Rate Premiums and Monetary Policy Cycles
(In percent)



Sources: Bloomberg L.P.; Consensus Economics; and IMF staff estimates.
Notes: U.S. three-month Libor rates one year ahead. White area equals easing; light shade, neutral; and dark shade, tightening.

United States, especially among lower rated issuers, leading to increased recourse to bank lines (see Figure 2.6). In the commercial paper market, those financial sector issuers that had taken advantage of low borrowing rates in the fall of 2001 faced greater scrutiny of their increased exposures to a rise in short-term rates and the adequacy of their backup lines, with both investors and rating agencies increasingly pressuring them to reduce their exposures (see Box 2.4). Credit concerns led to a distinct tiering in the market, with average spreads between A2P2 and A1P1 rated issuers remaining at more than double the usual 20 basis points throughout much of the quarter, while narrowing somewhat in April.

Nonfinancial corporations and lower rated entities experienced difficulty accessing bond markets, while financing for U.S. consumer spending and mortgages was less affected. By early March, with the rebound in equity prices and an abatement of corporate credit concerns, risk aversion dropped, and both high-yield and high-grade markets rallied sharply, with subinvestment grade credits strongly outperforming their high-grade counterparts, underpinned by a strong $3 billion inflow to high-yield mutual funds in March. The telecom sector, with its high refinancing needs, remained hard hit. Of total high-yield issues in the first quarter, telecoms accounted for just 6 percent, compared with 12 percent in 2001, and 40 percent in 2000.

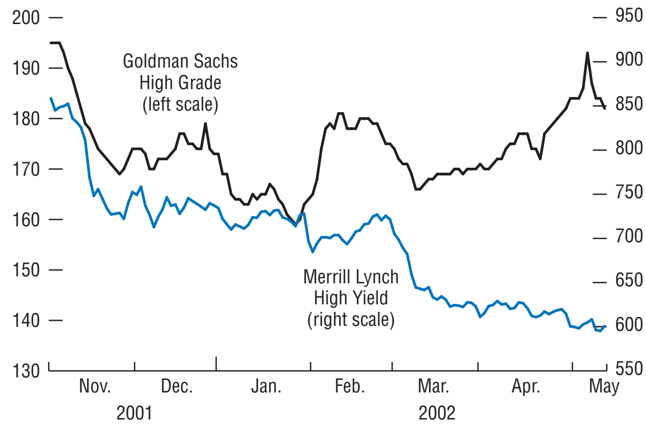
Movements in European spread markets broadly followed the patterns in the United States. Investment grade spreads compressed to their tightest levels in a year, while high-yield spreads managed to regain the ground lost in the January–February sell-off (Figure 2.7). European spreads experienced a mild form of "contagion" from accounting-related concerns in U.S. markets, but then also benefited from the March rally. Primary high-yield markets in Europe were anemic in first quarter, with just over €800 million in issuance, compared with some €2.4 billion in the first quarter of 2001.

Japanese credit markets were volatile over the first quarter. While credit spreads narrowed in the single A sector, risk aversion still plagued the BBB sector due to the Mycal default (Figure 2.8). Starting in late March, as equity markets rallied, the risk appetite for corporate debt increased. Seasonal increases in purchases of corporate bonds with the beginning of the new fiscal year in April also were increasingly being priced into bonds, with buying activity concentrated in the highest-rated banks and in bonds with partial or complete government guarantees.

Syndicated Lending

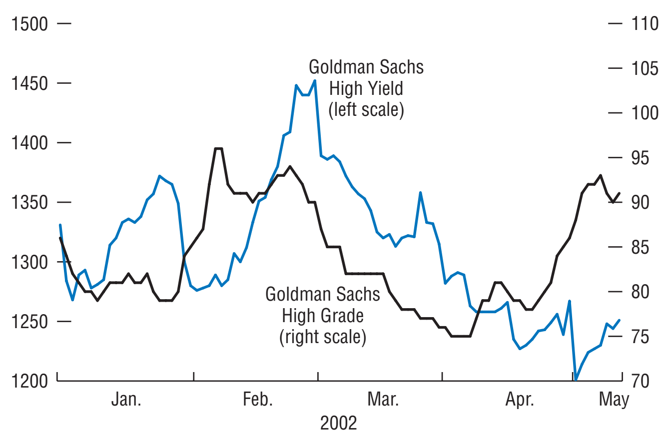
Refinancings continued to dominate activity in the U.S. and European syndicated loan mar-

Figure 2.6. Credit Market Spreads
(In basis points)



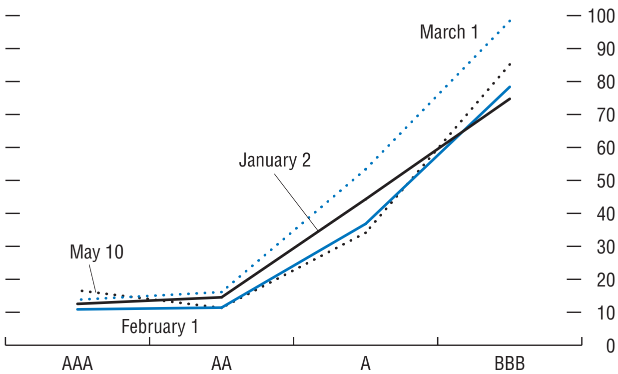
Sources: Goldman Sachs; and Merrill Lynch.

Figure 2.7. European Credit Market Spreads
(In basis points)



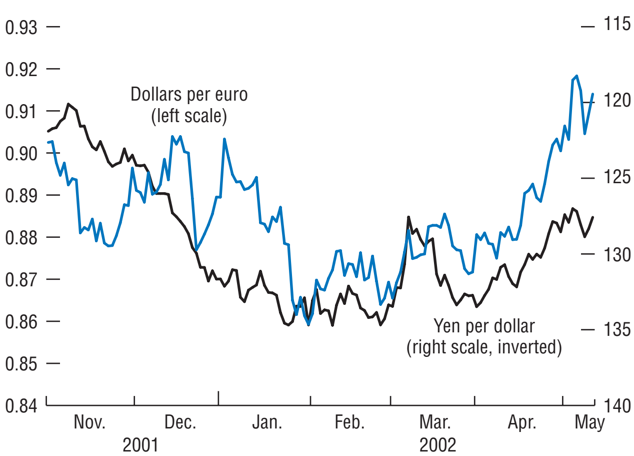
Source: Goldman Sachs.

Figure 2.8. Japan Credit Curves
(In basis points)



Source: Merrill Lynch.

Figure 2.9. Major Currencies Against the U.S. Dollar



Source: Bloomberg L.P.

kets in the first quarter, particularly in the investment grade sector, given the dearth of mergers and acquisitions and ongoing difficulties in the telecom sector. In addition, amid increased focus on credit risk in the aftermath of Enron's collapse and in an effort to dampen investor concern, a number of corporates drew on their backstop loans, as they were unable to issue in the commercial paper market, saddling banks with weak credits at an inappropriate time, with their having to honor funding commitments at wafer-thin "relationship" margins. These drawdowns appear to have been an important catalyst for change in the structure and pricing of these facilities, with banks reportedly increasingly hedging their exposures in the derivatives markets and the premiums on credit default swaps rising sharply. Meanwhile, Japanese banks continued to retreat from international loan markets, as they contend with ongoing difficulties in the Japanese economy and rising loan-loss provisions. There also appears to have been a retrenchment in lending to emerging markets, particularly Latin America, by European banks.

Foreign Exchange Markets

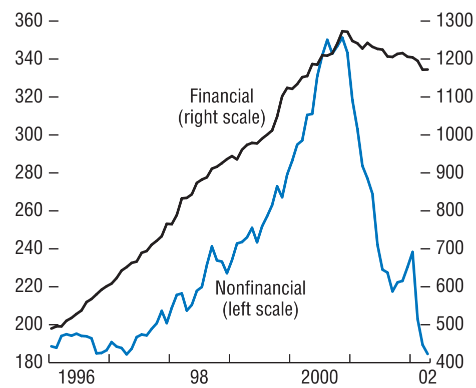
While strong capital inflows into the United States helped the U.S. dollar strengthen by about 1.6 percent on a trade-weighted basis in the first quarter, sentiment toward the dollar was mixed as the currency remained close to record-high levels (Figure 2.9). The dollar weakened 3 percent in April, and market participants suggested that a decline in portfolio and other flows into the United States may have contributed to the weakness. The surprising performance of the yen during the quarter played a part in limiting the dollar's gains. Markets had been near-unanimous at the start of the year that the yen would weaken significantly, especially as the authorities in the euro area, Japan, and the United States seemed ready to permit this. However, after an initial period of mild weakening, the yen snapped back, at one point strengthening more than 5 percent over seven sessions. At the end of the quarter, expectations of a recovery in Europe

Box 2.4. The Shrinking U.S. Commercial Paper Market

The U.S. market for commercial paper has shrunk dramatically over the past year (see Figure). The bankruptcies of California utilities in January 2001, as well as a more general deterioration of credit quality, sparked a precipitous decline in the outstanding stock of nonfinancial commercial paper during the first quarter of 2001. Many issuers whose ratings were downgraded drew on bank lines to repay paper, which prompted concerns over liquidity in the banking sector. Losses on commercial paper also raised fears that money-market funds, which seek to offer investors stable share prices, might be forced to "break the buck" if asset values fell below $1 per share. The decline continued through the third quarter of last year, albeit at a somewhat slower pace, as the relatively flat yield curve encouraged firms to switch to longer term funding in the bond market. Slower economic growth and a record liquidation of inventories in the fourth quarter also played a role by reducing funding needs. Within the nonfinancial sector, Tier 1 commercial paper declined more than 50 percent to $87 billion at the end of the first quarter of 2002, while (lower grade) Tier 2 commercial paper outstanding has declined by a somewhat lesser amount, mainly because paper downgraded from Tier 1 has offset some of the decline from lower-rated firms exiting the commercial paper market.

The driving force in the decline of the commercial paper market in 2001 was credit concerns, although the broader macroeconomic environment also contributed to the reduced demand for commercial paper based financing. Downgrades outnumbered upgrades by nearly a 7-to-1 margin in 2001. Many borrowers exited the market as the price for borrowing rose and the investor base dwindled, with many funds restricted from holding lower grade paper. While nonfinancial corporations typically have raised funds in the commercial paper market to finance inventories (as well as mergers and acquistions, and working capital), the economic downturn in 2001 has clearly implied a much reduced inventory-driven demand that eased funding needs.

Commercial Paper Outstanding
(In billions of U.S. dollars)



Source: United States Federal Reserve.

Many companies have turned to the corporate bond market, asset-backed commercial paper conduits, and bank loans as alternative sources of funding. Investment grade bond issuance rose in the first quarter of 2001 as firms took advantage of the flat yield curve to lock in lower rates for longer-term financing. Asset-backed commercial paper has proved another popular alternative, as securitized financing is often cheaper than unsecured debt in times of market stress. The asset-backed commercial paper market grew to more than half of the overall commercial paper market, from less than 10 percent a decade ago. Outstandings have fallen sharply this year, however, as the Enron failure has heightened scrutiny of off-balance-sheet financings. Borrowers have also accessed bank lines, which has aroused market attention since the Enron debacle and a rush of drawdowns. During a recent three-week period, Computer Associates, Qwest, and Tyco contributed to a $20 billion drawdown of commercial paper backstop loans. These and other drawdowns and scrutiny by rating agencies have focused attention on the pricing of backup lines of credit, as well as exposure to repricing and rollover risk.

were considered to have risen, as speculative long euro positions, proxied by noncommercial positions on the International Monetary Market, moved up sharply.

Mature Market Vulnerabilities—The Weakness in Japan's Banking Sector

Global concerns over financial stability in Japan have intensified in recent years, prompted by the deterioration of corporate and financial sector balance sheets amid low economic growth and deflation. Although the Japanese stock market recovery has had a stabilizing influence, significant strains in the Japan financial system remain, raising questions about the scope for international financial-market spillovers should the situation again deteriorate. These spillovers could occur through three channels: (1) a disorderly repatriation of Japanese assets held in mature markets; (2) strains on emerging market economies through a further decline in Japanese financing flows or yen depreciation; and (3) exposures of international investors and financial institutions to Japan.

Disorderly repatriation of Japanese assets. As of December 2000, Japan's international investment position showed a surplus of about $1.2 trillion at the time, of which one-third was accounted for by Japan's foreign exchange reserves. Although Japanese investors—particularly large life insurers—reportedly hold a share of up to one-fifth of actively traded U.S. Treasury securities, the overall amount of Japanese holdings in the wider U.S. bond market accounts for only about 2 percent. Shares in the European bond markets as well as the Asian and Latin American emerging markets are of a similar dimension, and holdings of foreign equity are much smaller still. Moreover, large-scale capital repatriation appears unlikely in current circumstances. By offering attractive risk-adjusted returns, notwithstanding relatively high costs of currency hedging, foreign investments provide an important source of income for Japanese financial institutions. Consequently, a decision to repatriate large amounts of capital would likely be made only to rebalance portfolio risks following significant losses on other domestic or foreign assets, or in the unlikely situation of extreme liquidity shortages. As for Japanese banks, many institutions have already withdrawn from international business, but the remaining banks still account for a considerable share of international bank lending. According to BIS statistics, Japanese banks' consolidated foreign exposure amounts to $1.2 trillion, the second largest global exposure behind German banks. While some of this exposure reflects the stock of loans committed earlier, Japanese banks have again become increasingly active in foreign markets in recent years, particularly in the syndicated loan market. However, their further withdrawal would no longer have as significant an impact on industrialized economies as it may have had in the early 1990s.

Impact on emerging markets. Compared to mature markets, emerging market economies may be more vulnerable to further cutbacks in bank lending, given that Japanese loans still account for a major share. Although a substantial part of these loans is linked to FDI-related projects, and could thus be replaced more easily, further withdrawals could still complicate efforts to build up long-term growth prospects in the region. Concerns for emerging markets also continue to emanate from possible exchange rate fluctuations, particularly if a depreciating yen were to put pressure on regional exchange rates and pose difficulties for countries with fixed exchange rate regimes. On the whole, however, economic fundamentals of many Asian countries have improved since the 1997–98 crisis, including stronger current account positions, higher official reserves, better external debt structures, and more flexible exchange rate systems. Consequently, countries in the region would be in a better position to cope with adjustment problems arising from financial disruptions in Japan.

Exposures to Japan market and counterparty risk. Although some foreign investors and financial institutions may still face substantial losses in the event of Japanese market turmoil, overall Japan exposures have been sharply reduced in recent years.

- Investment portfolios are largely underweight Japan. While still mostly positive, capital inflows into Japan in recent years appear small when assessed against the background of considerably stronger growth in U.S. and European financial markets. For example, the share of Japanese equity markets in global market capitalization (measured in U.S. dollars) fell from around 30 percent in 1990 to below 10 percent in 2001, which is also likely the upper limit allocated to Japanese equity in most foreign investor portfolios. Risks may be somewhat higher in Japan's bond market, which almost tripled in size over the past 12 years. The share of foreign holdings has remained constant around 5 percent, translating into an exposure of around $200 billion—a significant but small amount compared to a $24 trillion bond market outside of Japan. Foreign ownership of corporate securities is also minimal, owing to low risk-adjusted returns that reflect the supply-demand imbalance in that market.
- Foreign banks also appear relatively well protected against failures among their Japanese counterparts. The supply of capital to Japanese banks has been cut back, and Japanese bank credit risk is largely limited to short-term collateralized lending (mostly repos) or short-dated swaps. Moreover, since Japanese financial institutions have not been very active in markets for complex financial instruments, market participants are not particularly concerned about exposures, for example, in the credit derivative markets. According to their estimates, nominal amounts outstanding in Japan account only for about $100 billion, or 10 percent of the global credit derivatives market. On the other hand, banks' declining dollar-denominated exposure to Japanese borrowers appears to have been partly offset by an increase in yen-denominated lending. According to BIS *locational* statistics, banks' international claims against Japanese borrowers fell by about $100 billion between late 1999 and the end of September 2001 (to $513 billion), 90 percent of which was accounted for by a decline in lending to the nonbank sector. However, *consolidated* banking statistics, which include local exposure of subsidiaries in Japan, show an increase in claims on Japan by $150 billion over the past two years. This appears consistent with the increased presence of many foreign institutions in the Japanese market—including through acquisitions of local institutions. Although the quality of locally held assets could clearly be affected during a crisis, the bulk of this exposure is vis-à-vis foreign exporters and high-quality Japanese borrowers, and thus appears relatively secure.

Taking these three channels together, any potential Japan fallout on the regional and global financial system seems manageable—mostly as a result of the increasing delinkage of Japan's financial system from international financial markets.[4] However, despite the relatively benign aggregate situation, predictions about the knock-on effects of a Japan crisis on large foreign investors or financial institutions are hard to make. Owing to the complex web of financial interactions between Japanese and other globally operating financial institutions, as well as between Japanese corporations and their international counterparts, some parties could experience considerable losses in case of Japanese market turmoil. Although such disturbances would probably fail to pose a systemic threat, they could still be large enough to cause strains for the international financial system, and the costs from Japan-related uncertainty and volatility could also be quite high, both in the mature and emerging financial markets. Particularly, emerging economies in Asia still depend to a

[4]Japan has agreed to participate in the Financial Sector Assessment Program (FSAP). The program will assess many aspects of financial system soundness, beyond those covered in this report. Work on the Japan FSAP will start this year and will feed into the 2003 IMF Article IV consultation cycle.

Table 2.2. Emerging Market Financing Overview

					2000				2001				2002				
	1998	1999	2000	2001	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Jan.	Feb.	Mar.	Year to date[1]
	(in billions of U.S. dollars)																
Issuance	149.0	163.6	216.4	162.5	60.4	55.4	50.3	50.3	42.2	50.5	29.4	40.3	35.3	12.0	7.2	16.0	38.4
Bonds	79.5	82.4	80.5	89.0	33.8	16.1	21.1	9.4	26.8	28.8	11.7	21.7	22.0	8.3	5.1	8.5	24.5
Equities	9.4	23.2	41.8	11.2	8.9	11.6	8.8	12.4	2.3	5.3	1.0	2.6	4.1	1.7	0.9	1.5	4.1
Loans	60.0	58.1	94.2	62.2	17.6	27.7	20.4	28.5	13.1	16.4	16.7	16.0	9.2	2.0	1.2	6.1	9.8
Issuance by Region	149.0	163.6	216.4	162.5	60.4	55.4	50.3	50.3	42.2	50.5	29.4	40.3	35.3	12.0	7.2	16.0	38.4
Asia	34.2	56.0	85.9	67.4	19.5	26.1	18.3	22.0	19.6	22.8	7.5	17.6	13.1	5.2	1.9	5.9	14.1
Western Hemisphere	65.7	61.4	69.1	54.0	23.7	13.9	18.8	12.7	15.2	15.4	11.4	12.1	11.4	4.3	2.4	4.7	13.0
Europe, Middle East, Africa	49.0	46.3	61.4	41.0	17.1	15.4	13.2	15.6	7.4	12.4	10.6	10.7	10.8	2.5	2.9	5.4	11.3
Secondary Markets																	
Bonds																	
EMBI+ (spread in basis points)[2]	1037	703	756	731	674	712	677	756	784	766	1005	731	598	713	644	598	648
Merrill Lynch High Yield (spread in basis points)	555	453	871	734	584	615	664	871	757	736	915	734	623	697	722	623	601
Salomon Broad Inv. Grade (spread in basis points)	58	55	89	78	81	87	83	95	89	80	77	78	69	74	74	69	73
U.S. 10 yr. Treasury Yield (yield in %)	4.7	6.5	5.1	5.1	6.0	6.0	5.8	5.1	4.9	4.9	4.6	5.1	5.4	5.0	4.9	5.4	5.2
	(in percent)																
Equity																	
DOW	16.1	25.2	–6.2	–7.1	–5.0	–4.3	1.9	1.3	–8.4	6.3	–17.5	15.7	3.8	–1.0	1.9	2.9	–0.8
NASDAQ	39.6	85.6	–39.3	–21.1	12.4	–13.3	–7.4	–32.7	–25.5	17.4	–30.5	29.9	–5.4	–0.8	–10.5	6.6	–17.9
MSCI Emerging Market Free	–27.5	63.7	–31.8	–4.9	2.0	–10.8	–13.4	–13.5	–6.2	3.1	–23.4	28.4	10.7	3.3	1.5	5.6	10.0
Asia	–12.4	67.6	–42.5	4.2	4.0	–14.0	–22.3	–17.3	–0.1	–1.6	–22.1	36.1	14.9	4.6	2.8	6.9	13.4
Latin America	–38.0	55.5	–18.4	–4.3	3.2	–8.1	–6.0	–8.5	–3.5	7.1	–24.7	23.0	7.1	–0.4	3.4	4.0	–0.5
Europe/Middle East	–27.4	76.7	–23.4	–17.7	3.0	–9.7	–3.9	–14.3	–22.0	4.5	–26.1	36.8	0.2	4.0	–10.3	7.3	–0.7

Sources: Bloomberg; Capital Data Ltd.; Merrill Lynch; Salomon Smith Barney; and IMF staff estimates.
[1]Issuance data are as of April 16, 2002 close-of-business; London and Secondary markets data are as of May 10, 2002 c.o.b. New York.
[2]On April 14, 2000 the EMBI+ was adjusted for the London Club agreement for Russia. This resulted in a one-off (131 basis points) decline in average measured spreads.

significant, albeit reduced, degree on Japanese financial inflows.

Emerging Market Developments and Financing

Gross capital market financing flows to emerging markets in the first quarter of 2002 amounted to $35.3 billion, some $5 billion lower than in the fourth quarter of 2001 (see Table 2.2). Bond issuance was in line with the previous quarter, consistent with improving risk appetite in financial markets. However, sovereign issuance as a share of total bonds placed jumped to 64 percent, from 36 percent. Equity issuance also rose, although it remained well below levels seen in 2000 (see Figure 2.10). There was, however, a sharp decline in syndicated lending, as banks cut back exposure to emerging markets.

Bond Markets

Emerging bond markets rallied in the first quarter, outperforming most asset classes (see Table 2.3). The ongoing spread compression continued (see Figure 2.11) with inflows into the asset class, while issuance in the dollar segment remained in line with historical levels. After having postponed inflows in anticipation of the Argentine crisis, the lack of contagion supported new emerging market allocations in early 2002.

Table 2.3. Index Performance
(In percent)

	1999	2000	2001	2002 Q1	2002 Year to Date[1]
EMBI+	26.0	15.7	–0.8	6.6	6.3
EMBI+ adj Arg.	31.2	18.3	19.8	6.8	6.6
Dow	25.2	–6.2	–7.1	3.8	–0.8
Nasdaq	85.6	–39.3	–21.1	–5.4	–17.9
EM Free	63.7	–31.8	–4.9	10.7	10.0
Salomon BIG	–0.8	11.6	8.5	0.1	2.1
Merrill Lynch High Yield	1.6	–3.8	6.2	2.0	3.4

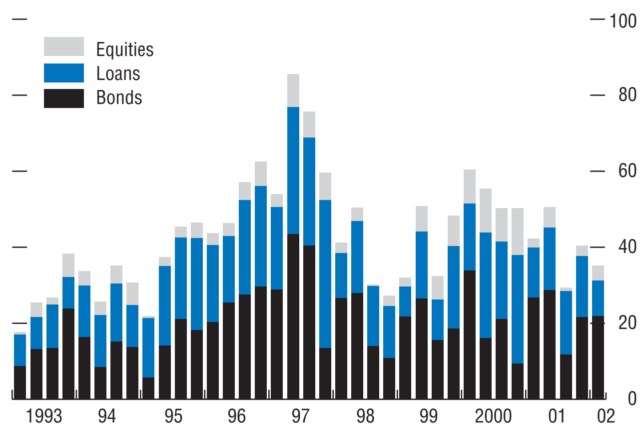
Sources: Bloomberg L.P.; JP Morgan Chase; Merrill Lynch; and Salomon Smith Barney.
[1]May 10, 2002.

Inflows originated from a number of sources. The ongoing consolidation among large buy-side firms increased the pool of capital benchmarked to a "core plus" benchmark.[5] Russian local demand grew, as did demand from German pension funds, and from European retail demand channeled through new mutual funds with an emerging market focus.[6] In the United States, three years of good emerging bond market performance encouraged increased exposure of crossover investors to BB or higher-rated emerging market issuers. Consequently, many investment banks' overweight recommendations were based on increased crossover inflows, rather than any substantial perceived improvement in the fundamental outlook. In this context, dedicated investors largely maintained preexisting overweights in Brazil, Mexico, and Russia, and some higher-yielding Andean countries.

[5]The traditional "core" Lehman Aggregate index does not include noninvestment grade emerging market issuers and U.S. high-yield corporates. A "core plus" benchmark includes some or all noninvestment grade dollar-denominated bonds.

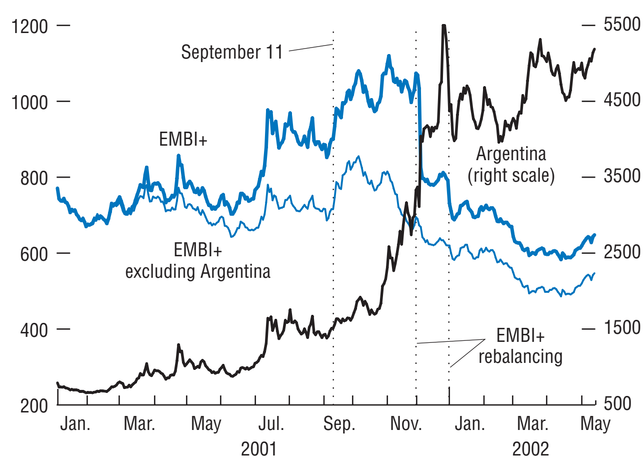
[6]New dedicated emerging market mandates are largely benchmarked against the EMBI Global Constrained, as the EMBI Global and the EMBI+ are still seen as too concentrated in a handful of credits (most notably Brazil, Mexico, and Russia). European institutional investor demand is also mostly targeted at the dollar segment due to illiquidity in the euro-denominated market. However, the currency risk to which European investors become exposed as a result continues to limit allocations to emerging bond markets.

Figure 2.10. Emerging Markets Financing
(In billions of U.S. dollars)



Source: Capital Data.

Figure 2.11. Emerging Market Spreads
(In basis points)



Source: JP Morgan Chase.

Table 2.4. Performance of Emerging Bond Markets
(In percent)

	2001	2002: Q1
EMBI+	–0.8	6.6
EMBI+ adj. for Argentina	19.8	6.8
Argentina	–66.8	–5.0
Brazil	7.2	8.2
Bulgaria	25.7	1.1
Colombia	30.8	0.7
Ecuador	36.1	14.5
Korea	14.5	1.3
Mexico	14.2	2.9
Morocco	11.1	4.8
Nigeria	22.4	7.8
Panama	17.9	3.9
Peru	26.2	7.5
Philippines	27.6	6.9
Poland	10.6	2.1
Qatar	21.4	2.3
Russia	55.8	12.1
Turkey	21.7	7.7
Ukraine	n.a.	10.2
Venezuela	5.5	11.3

Source: JP Morgan Chase.

Rising inflows from crossover investors helped boost Latin sovereign credit returns, with the exception of Argentina, where investors continued to view short-term prospects as bleak and beset with uncertainty (see Table 2.4). Despite domestic political concerns, Brazil's performance was supported by positive economic releases and expectations of a U.S. recovery. Brazilian spreads, however, widened 164 basis points from the end of first quarter through May 2 largely on political concerns and market sensitivity toward the inflation outlook. Ecuador was the best performer in the emerging market universe. In Venezuela, a recovery in the price of oil and the adoption of a flexible exchange rate regime led to a sharp tightening in spreads, but this has been partly unwound amid recent political turmoil. Russia was the second best performer in the quarter and exhibited notably low volatility, continuing to benefit from its solid macroeconomic outlook, based in part on oil exports, while Ukraine's strong rally was justified as a "Russia play." Sentiment toward Mexico continued to improve during the quarter, with upgrades by both Standard & Poor's and Fitch to investment, and a further upgrade by Moody's.

With the EMBI+ spread compressing some 110 basis points over the first quarter (and an additional 20 basis points by mid-April), market participants remain divided as to whether spreads have come in "too far too fast." Table 2.5 shows the spreads of the three largest components of the EMBI+ as of early May 2002, compared with their levels when the overall index spread was last at similar levels, as well as with October 1997, another time when this issue was widely debated. The market now places a much stronger political risk premium on Brazil than in May 1998, when it was just as far away from its elections as currently. Participants frequently expressed the view that the signs of "froth," such as Ukraine's 350+ basis point spread compression since the beginning of the year (to trade well inside Brazil) merely reflects a rational rotation of exposures away from more vulnerable to less vulnerable regions. The differences in Mexican and Russian spreads from May 1998 are also seen by most market participants to be fundamentally justified, and the market is clearly also not as "rich" as it was in October 1997. Proponents of

Table 2.5. Sovereign Spreads and Ratings
(In basis points)

	May 10, 2002		Feb. 27, 2002		Jun. 9, 1998		Oct. 15, 1997*	
EMBI+	648	—	670	—	545	—	341	—
EMBI+ adj. Argentina	547	—	561	—	—	—	—	—
Argentina	5,188	Ca	4,217	Ca	463	Ba3	331	Ba3
Brazil	952	B1	794	B1	580	B1	348	B1
Mexico	261	Baa2	279	Baa2	422	Ba2	325	Ba2
Russia	487	Ba3	549	Ba3	783	B1	300**	Ba2

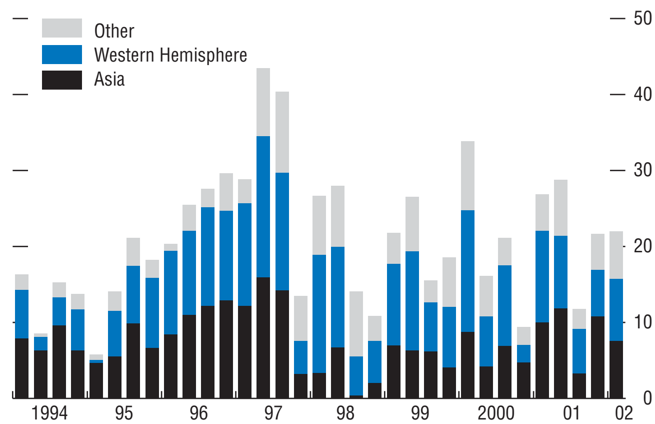
Sources: JP Morgan Chase; and Moody's.
*EMBI spreads for October 15, 1997.
**Russia 2007 bond spread.

the "too far too fast" view, on the other hand, contend that a significant portion of the rally in the first quarter was also driven by factors such as a drop in risk aversion *within* the asset class, with credits like Ecuador, Ukraine, and Venezuela delivering highest period returns, and high-rated credits underperforming. They also note that the longest duration bonds in most spread curves outperformed in the first quarter, and point to other technical factors such as increased crossover investor exposure. Though past history and current valuations may not unambiguously suggest excessive spread compression, the combination of the technical position of the market, and a broadly benign set of assumptions on political risks (both country specific, and external), and the beginning of a rising interest rate environment, have led some to expect a correction.

The decoupling of Argentina from the rest of the emerging market sovereign credits continued during the first quarter, supported by inflows into the asset class. Our measure of contagion, the average cross-correlation of individual country returns in the EMBI+, continued to fall to an historic low of around 0.12, rebounding modestly late in the quarter. Most emerging market sovereigns continued to trade independently of Argentine sovereign bonds. However, the potential for a renewed bout of contagion remains, if conditions in Argentina deteriorate and the currency goes into a free fall. A sharply declining peso would not only have an impact on trading partners through real economy channels, but also could be expected to sour international investor sentiment to the emerging market asset class by raising the risk premium on holding these assets.

Emerging bond issuance has remained at healthy levels since international capital markets reopened in November, following the longest bond market drought since the Russian crisis. Despite the deteriorating situation in Argentina, bond issuance reached $22 billion in the first quarter (see Figure 2.12). Investor demand was driven by both crossover and dedicated investors, with the latter drawing on relatively high

Figure 2.12. Bond Issues
(In billions of U.S. dollars)



Source: Capital Data.

Table 2.6. Currency of Issuance
(In percent of total)

	1999				2000				2001				2002
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
U.S. dollar	62	67	59	53	62	51	65	60	57	72	63	72	76
Euro	26	28	36	37	33	28	18	21	31	17	7	20	16
Yen	2	1	1	8	3	17	14	13	7	6	19	6	1

Source: Capital Data.

cash positions held in the beginning of the year. January was a particularly good month, with dollar issuance reaching its highest level since April 1999 and both Brazil and Mexico successfully launching $1 billion plus issues. After a brief lull in February, issuance picked up strongly, and by the end of the first quarter, sovereign issuers had completed a considerable portion of their funding requirements for 2002. While a modest reallocation by U.S.-based crossover investors from emerging markets toward U.S. corporate markets weighed on new issue appetite in the latter part of March, some support has been found during early April from the large amount of coupon and amortization flows together with small inflows into emerging market funds.

A salient feature of the quarter was the liability management transactions undertaken by a number of sovereigns, in the context of a supportive fixed income environment and a compression of emerging market spreads. In early February, Peru accessed international capital markets for the first time since 1928, launching a $500 million 2012 global bond, followed by a $1.2 billion Brady-eurobond swap. The Bulgarian government undertook a $1.32 billion Brady-eurobond exchange in late March, with the government swapping FLIRBS (Front-loaded Interest Reduction Bonds), IABs (Interest Arrear Bonds) and Discount bonds for either new 2015 dollar-denominated global bonds or new 2013 euro-denominated global bonds. Brazil issued a seven-year €500 million in euro-denominated bonds in late March, using part of the proceeds to buy back €36.4 million worth of eurobonds maturing between 2004 and 2006. The Mexican government continued with its liability management transactions in the first quarter and into the second quarter. In late March, Mexico announced plans to buy back $500 million of dollar-denominated—and $329 million of euro-denominated—floating rate bonds maturing in April 2004. Continuing with its debt management strategy in April, Mexico announced plans to retire the entire remaining stock amounting to $153 million of series B Brady discount bonds in December 2019. The Finance Ministry also announced plans to buy back $106 million of Brady bonds due 2019, freeing up an estimated $51 million in collateral, and thereby retiring all series C Brady discount bonds.

Although the dollar segment of emerging bond markets was robust in the first quarter, the Argentine default continued to have a negative impact on the receptiveness of euro- and yen-based investors to new issuance, especially from Latin American credits (see Table 2.6). In particular, euro-denominated issuance declined in the first quarter from the fourth quarter of 2001, with European institutional investors primarily interested in "correctly-priced" investment grade sovereign credits, including issues by Croatia, Cyprus, Israel, and Poland. In Japan, the Samurai market remained firmly shut, as retail investors continued to suffer from the impact of the Argentine and Enron defaults. It remains unclear when the euro and yen markets will fully reopen to new issuers, highlighting the vulnerability of emerging market issuers, especially Latin American ones, to any abrupt market closure in the dollar segment. Such concern remains at the forefront of many issuers' minds, with Brazil's March issue coming at a much higher-than-expected spread and only after an "exchange" component was introduced, and Uruguay's issue proving harder than expected to place.

Looking forward, coupon and amortization flows combined with renewed inflows into dedicated emerging market funds should support the issuance pipeline in the short term. For sovereigns, this pipeline is full, dominated by investment grade issuers, including Chile, South Africa, and Tunisia in the dollar segment, and Lithuania and Morocco in the euro segment. With investors increasingly focused on political risk, greater difficulty may be encountered placing paper by regular sovereign Latin issuers, while issuers with an investment grade rating and/or "convergence plays" and "exotic" issuers with rarity value will likely continue to face unimpeded market access. Corporates from the region may be expected to continue to come to market with enhanced structures or political risk insurance.

Equity Markets

Emerging equity markets significantly outperformed global equity markets during the first quarter of 2002 (see Table 2.7). Emerging Asia was the best performing region, on the back of the exceptionally strong performance by Korea (+28.4 percent) and solid gains by Malaysia (+11.9 percent), Taiwan Province of China (+8.6 percent), and India (+6.9 percent). The impressive gains by tech-heavy Asian markets stand in sharp contrast to the 5.4 percent decline in the Nasdaq, reflecting the differences in product mix, balance sheets, and valuations of tech and telecom companies in emerging markets and those in developed ones.[7] China was the worst performing market in Asia, posting negative returns (–3.6 percent), due to concerns about the overvaluation of stocks and oversupply of shares as the government plans to divest its asset holdings through IPOs, as well as stepped up regulatory investigations. These concerns spilled over, constraining stock market gains in Hong Kong SAR and Taiwan Province of China. In addition to a heavy privatization schedule, Taiwan Province of China's National Stabilization Fund announced early in the year that it would accelerate its ongoing program of divestiture, leading investors to expect large block sales of shares throughout the quarter.

Table 2.7. Performance of Emerging Equity Markets

(In percent, dollar indices)

	2002: Q1	April 2002
Regions		
EM Free	10.7	0.4
EM Asia	14.9	0.1
EM LatAm	7.1	–1.8
EMEA	5.1	3.7
Mature Market Comparators		
ACWI Free	0.7	–3.3
MSCI US	–0.1	–6.6
Nasdaq	–5.4	–8.5
MSCI EU	–1	–1.5
MSCI Japan	1.1	5.8

Source: Bloomberg L.P.; and IMF staff estimates.

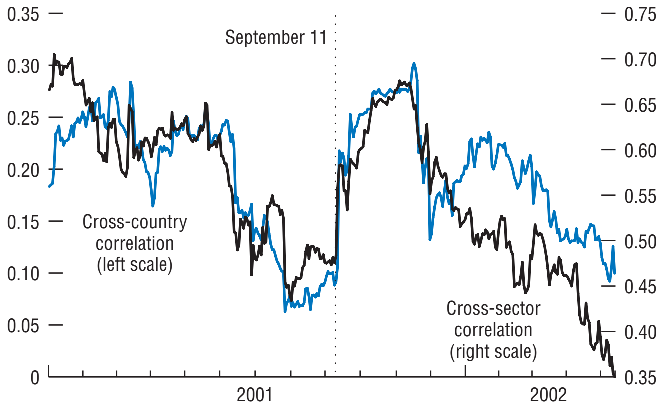
Latin American equities rose 7.1 percent, led by Mexico (+17.1 percent). The Argentine stock market index lost almost 50 percent in dollar terms, but given Argentina's weight in the Emerging Market Free (EMF) of 1 percent as of the end of 2001, its broader impact was negligible. Emerging Europe, Middle East, and Africa gained 5.1 percent, with the two largest oil/commodity exporters in the region, Russia and South Africa, gaining 10.7 percent and 18.6 percent, respectively.

Notably, when equity market sentiment was dominated by concerns about the quality of corporate balance sheets, investors in emerging markets had a more difficult time making "country calls" than "sector calls," as seen in rising cross-country correlations while cross-sector correlations continued to decline (see Figure 2.13). However, investor discrimination rose later in the quarter amid diminished balance sheet concerns and the dominating influence of the U.S. recovery story.

Consumer cyclicals and industrial cyclicals were the best performing sectors in the emerg-

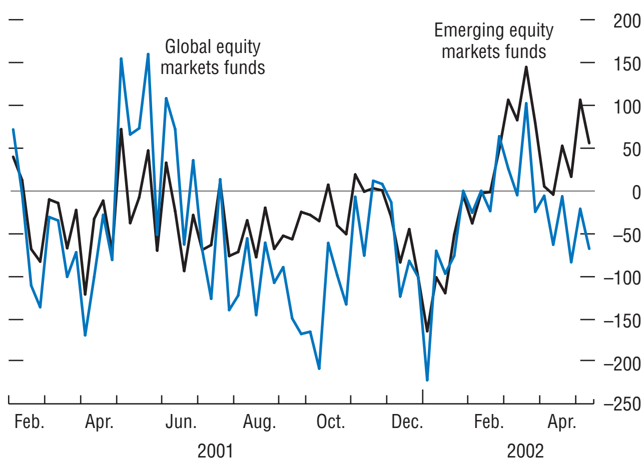
[7]See previous issues of the IMF's quarterly *Emerging Markets Financing* for the discussion of these differences, available at www.imf.org/external/pubs/ft/emf/index.htm.

Figure 2.13. Average Correlations of the Returns on Emerging Equity Markets Indices



Sources: Morgan Stanley Capital International; and IMF staff estimates.

Figure 2.14. Net Inflows into U.S. Equity Mutual Funds
(In millions of U.S. dollars, four-week moving average)



Source: AMG Data Services.

ing market universe, followed by financials, TMT, and defensive sectors. The relative strength of consumer cyclicals underscored the fact that robust consumption growth supported by recovering export demand was a key factor explaining the gains in some of the best performing markets this quarter, particularly Korea and Mexico.

Net flows into emerging equity markets picked up during the quarter, with dedicated emerging market equity funds registering positive inflows in both February and March (see Figure 2.14). Net inflows into the U.S.-based emerging market equity funds over the quarter (+$0.7 billion) significantly exceeded net inflows into the global equity funds (+$0.1 billion). Local retail investors in emerging equity markets have also shown greater signs of participation, particularly in Asia.

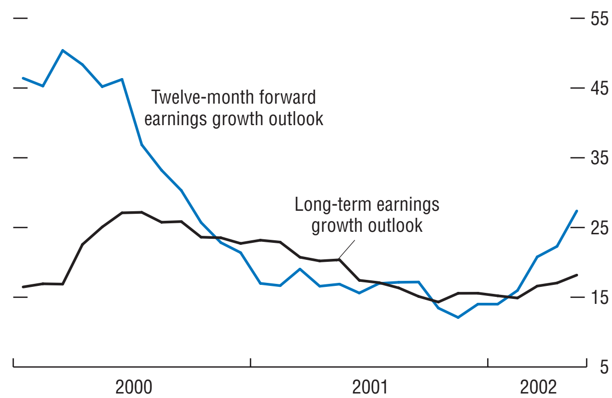
Earnings growth expectations during the quarter were optimistic, with both near-term and long-term earnings forecasts being continuously revised upward throughout the quarter. The 12-month forward consensus 2002 earnings growth forecast for the EMF Index was revised up from 14 percent in December 2001 to 22 percent in March 2002 (see Figure 2.15). At the same time, emerging market valuations remained substantially lower than mature market valuations.

While the historical evidence is mixed, more recent data suggest emerging equity markets outperform mature ones at the early stages of a U.S. economic rebound, provided none of the major emerging equity markets is in crisis. An analysis of the balance of risks for emerging equity markets suggests that emerging markets should perform at least as well as (or better than) mature markets at the early stages of the monetary tightening cycle, when global equity markets and global growth are recovering, earnings expectations are rising, and commodity price increases are not too sharp (see Box 2.5).

International equity issuance by emerging markets was around $4 billion during the quarter, representing an improvement compared to the previous quarter ($2.6 billion) and in the first quarter of 2001 ($2.3 billion) (see Figure

2.16). Once again, issuance was dominated by Asian names. Four privatization issues (three Taiwanese tech firms and a Brazilian mining company) accounted for more than 60 percent of total issuance. The largest equity placement, a $1 billion offering by Taiwan Semiconductor Manufacturing Company was 1.6 times oversubscribed, with three-quarters of the new shares acquired by U.S.-based funds. The pipeline of issues from China continued to swell, with more than 300 companies reportedly expressing interest in securing overseas listings. The market also expects several Chinese jumbo privatization issues this year (including international equity placements by the Bank of China, China Telecom South, and China Unicom).

Figure 2.15. Emerging Market Earnings Forecasts
(In percent)



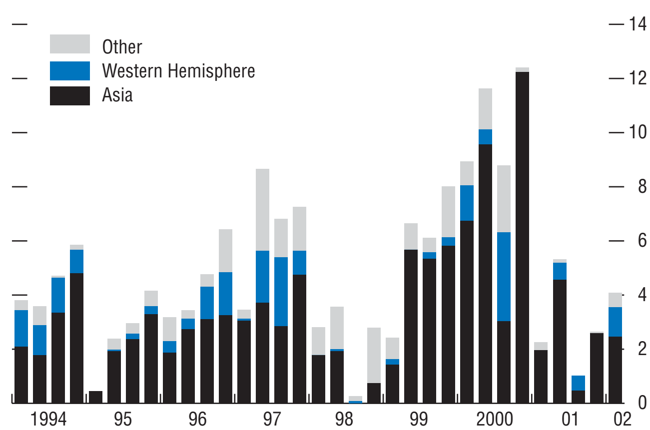
Source: I/B/E/S.

Syndicated Lending

Syndicated lending to emerging markets declined in the first quarter of 2002, reflecting lenders' heightened awareness of credit risk post-Enron and increased caution after losses suffered on Argentine exposures. In the context of a tightening in lending standards, the overall volume of lending fell to $9.2 billion in the first quarter of 2002 from $17.5 billion in the fourth quarter of last year (see Figure 2.17). In the context of the focus on banks' credit quality, emerging markets have suffered along with other relatively high-risk lending by mature market banks. While loan volumes were particularly low in January and February, lending has picked up since early March and is expected to gather pace into the second quarter.

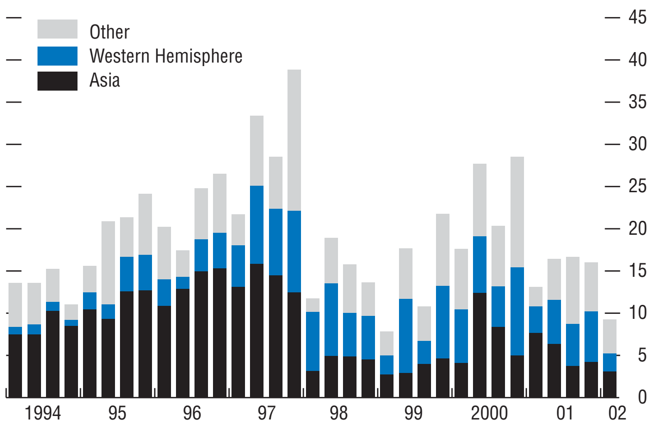
Latin America suffered the steepest decline in volumes. Mexico benefited from the flight to quality, although most lending was secured, while in Brazil, Chile, and Colombia, sovereign and public sector entities accounted for much of the borrowing. Brazilian deals were reportedly the toughest to syndicate, given the lack of political risk insurance and lack of retail demand. Asian corporates continued to express little demand for investment capital, and deal flow was related primarily to refinancing. In contrast, emerging European and Middle Eastern markets

Figure 2.16. Equity Placements
(In billions of U.S. dollars)



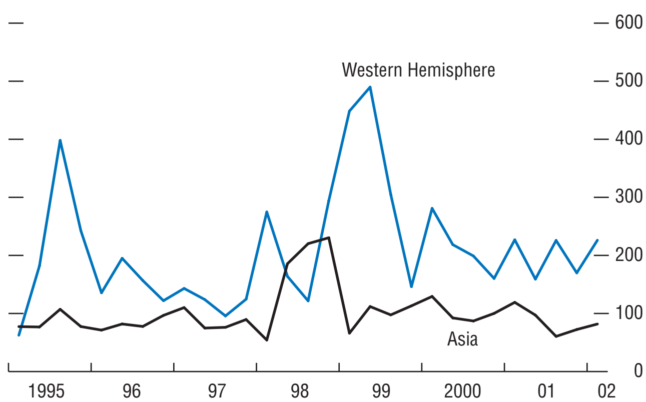
Source: Capital Data.

Figure 2.17. Syndicated Loan Commitments
(In billions of U.S. dollars)



Source: Capital Data.

Figure 2.18. Loan-Weighted Interest Margin
(In basis points)



Source: Capital Data.

(EMEA) proved buoyant, with Russia a hive of activity following its recent credit rating upgrade. While deals continued to be secured by gold or other commodity delivery contracts, a wider array of corporates, including banks, gained market access, albeit for small amounts and at high margins. Elsewhere in the EMEA region, South African corporates and banks proved active, Oman LNG received a secured $1.3 billion refinancing facility, and Qatar's Ras Laffan $572 million water and power project was successfully completed, the latter benefiting importantly from funding by regional players.

On the pricing front, the syndicated lending market in Asia remains characterized by stiff competition between banks to lend to the top tier corporates and financial institutions, while lower tier borrowers remain excluded from the loan market. As a result, loan spreads remained broadly flat at low, near pre-Asian crisis levels. Notwithstanding the flight to quality within Latin America, syndicated loan spreads rose sharply, as attention focused squarely on credit quality (see Figure 2.18).

Foreign Exchange Markets

Emerging market currencies performed well during the quarter, helped by rising equity markets and, in some cases, commodity prices boosted by expectations of stronger world growth.

Argentine authorities adopted a free floating exchange regime in early January following a sovereign debt default at the end of last year. During the quarter, the peso fell as low as 2.975 pesos per dollar, and it ended the quarter down 66.1 percent. This was a faster and larger depreciation than had been experienced by the Brazilian *real* at the time it abandoned its peg to the dollar in early January 1999 and was akin, in some respects, to the depreciations seen during the Asian crisis. However, the floating of the currency provided one of the necessary conditions for the authorities to start the process of defining a comprehensive package to reestablish macroeconomic stability. As in other

Box 2.5. The Balance of Risks for Emerging Equity Markets

Returns on emerging equity markets are sensitive to unanticipated changes to a number of global risk factors, including: (1) Group of Seven government bond yield spreads (time horizon risk); (2) Group of Seven industrial production (business cycle risk); (3) the real commodity price index (terms of trade risk); (4) the 12-month forward global earnings yield (earnings revisions risk); and (5) variations in the market risk premium unexplained by items 1 through 4 (market timing risk, also referred to as the market beta).

The regression sample covers the period from January 1995 to March 2002 (see the Table). The independent variables are the detrended monthly changes in the variables described above. Global and emerging equity market risk premiums are calculated using the dollar-denominated MSCI ACWI Free and EM Free equity indices and short bond yields. Segments of the emerging equity markets are represented by the corresponding MSCI indices.

- Almost all risk factors except business cycle risk have a statistically significant impact on emerging market equities.
- Market timing risk (or market beta) is an important global risk factor for all emerging equity market segments. All emerging equity market segments tend to react more than proportionately to returns on global equity market indices. The sensitivity of the TMT sector to market timing risk is much higher than that of the non-TMT sector.
- All emerging market segments are hurt by unexpected increases in commodity prices.
- Asia and EMF IT tend to benefit more than other emerging market segments from the widening of global bond yield spreads, which tends to occur during the early stages of the monetary tightening cycle.
- All emerging equity market segments react positively to unexpected upgrades of the forward global earnings yield, with Asia and EMF IT being particularly sensitive to changes in expectations about the future earnings potential of global equities.

The above analysis suggests that, on balance, emerging markets should perform at least as well as (or better than) mature markets at the early stages of the monetary tightening cycle, when global equity markets and global growth are recovering, earnings expectations are being revised upward, and commodity price increases are not too sharp.

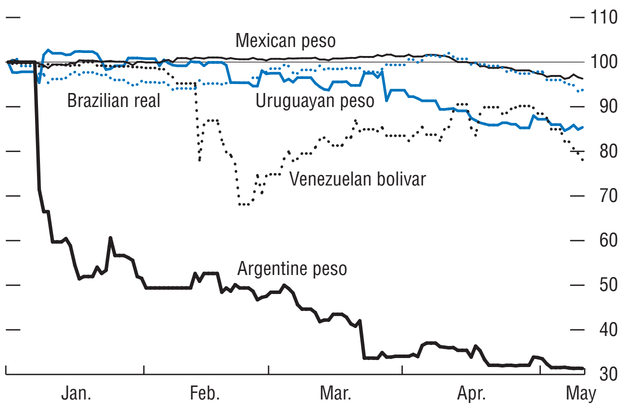
Regression Coefficients

	EMF	Latin America	EMEA	Asia	EMF Info. Technology	EMF Telecom	EMF non-TMT
Dependent variables							
Constant	–0.01	0.00	0.00	–0.01*	0.00	–0.01	–0.01**
Time horizon risk	0.05**	0.04*	0.04*	0.06***	0.07***	0.04***	0.04***
Business cycle risk	0.02*	0.03	0.03*	0.01	0.01	0.01	0.02*
Terms of trade risk	–0.01***	–0.01**	–0.01***	–0.02***	–0.02***	–0.01***	–0.01***
Earning revisions risk	0.07***	0.06**	0.05*	0.09***	0.08**	0.06**	0.07***
Market timing risk	1.28***	1.49***	1.35***	1.03***	1.67***	1.72***	1.10***
Adj R-sq	0.66	0.49	0.49	0.58	0.52	0.64	0.58

Sources: Bloomberg L.P.; I/B/E/S; Merrill Lynch; and IMF staff estimates.
*denotes statistical significance at 0.1 level; ** denotes statistical significance at 0.05 level; ***denotes statistical significance at 0.01 level.

markets, the ending of the pegged exchange rate in Argentina had a smaller impact on currencies than had been feared. The Brazilian *real* was briefly tested, but was supported by strong portfolio inflows and finished the quarter little changed. The Venezuelan bolivar fell only in February (see Figure 2.19) amid accelerating capital flight and increasing political tension,

Figure 2.19. Latin American Currencies Against the U.S. Dollar
(January 1, 2002 = 100)



Source: Bloomberg L.P.

when the government abandoned its crawling band exchange rate system and allowed the currency to float freely. The bolivar swiftly depreciated more than 25 percent before regaining some ground to end 17.8 percent lower for the quarter. This was a considerably stronger level than some commentators had predicted at the time the currency was floated. The currency has strengthened further since, despite political and economic turmoil, in part due to higher oil prices and very tight liquidity conditions.

The Turkish lira strengthened as the authorities continued to implement the IMF-supported program and inflation fell. The currency appreciated 8.3 percent during the quarter, bringing the total appreciation since mid-October to more than 20 percent, as the trend toward dollarization of the economy appeared to have diminished. Increasingly, concerns were expressed about the possible impact of the strong currency on the government's growth objectives under the program. Market participants were inclined to accept that the currency had become overvalued, but some believed the lira may have to overshoot for a prolonged period before falling back. After having weakened suddenly in December, the South African rand rebounded, helped in part by higher commodity prices. The rand strengthened 6.1 percent during the quarter.

Currencies in Eastern Europe benefited from the convergence play and generally good economic data. The forint, koruna, and zloty weakened against the dollar in January in line with a weaker euro. From that point, all three currencies strengthened consistently, driven by expectations of eventual entry into the European Union, foreign investment inflows, and generally positive economic data.

The Czech koruna was particularly strong during the latter part of the quarter, rising 5.7 percent from its low at end-January to end-March, with a further modest gain in April. The currency's rapid appreciation was due to expectations of large capital inflows from greenfield FDI and privatization, as well as hedging by exporters. To a degree, the stronger exchange rate was thought justified on the basis of improved efficiency and expectations of EU accession and eventual adoption of the euro. At the same time, the speed of the appreciation could complicate macroeconomic management in the near term. The authorities therefore agreed to keep privatization proceeds from the foreign exchange market. Moreover, to stem the currency's rise, the central bank intervened on several occasions during the first four months of 2002, and reduced interest rates by a cumulative ¾ percentage points. The zloty, too, reached its strongest level consistent with economic fundamentals.

In Asia, carry trade investors bought the Korean *won*, Thai baht, and Singapore dollar. The Thai baht rose a little over 1.5 percent against the dollar during the quarter, but for the most part investors had to be content with the yield pickup. Yen-funded investors, in particular, had to be satisfied with only the yield pickup as the major Asian currencies followed the yen even more closely than in previous quarters. In addition, the Philippine peso strengthened steadily as sentiment toward the currency became more positive (see Figure 2.20). Yields in the non-deliverable forwards (NDFs) market fell sharply. A new factor at the end of the quarter was the possibility of a revision of the Chinese yuan peg, but markets doubt any change will be made in the short term (see Figure 2.21).

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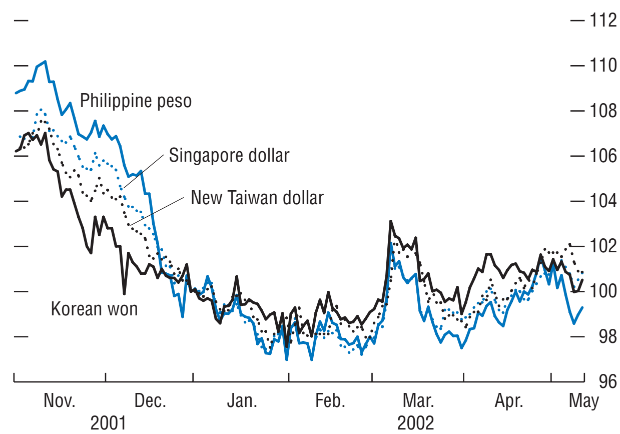
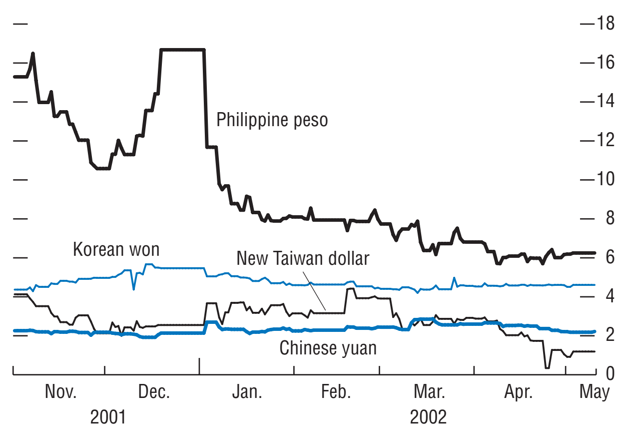
Figure 2.20. Asian Currencies: Cross Rates Against the Yen
(December 31, 2001 = 100)



Source: Bloomberg L.P.

Figure 2.21. Asian Currencies: Non-Deliverable Forward Implied Yields
(In percent, three months)



Source: Bloomberg L.P.