International Capital Markets Charting a Steadier Course

International financial markets and their participants—financial intermediaries and supervisory authorities—appear to be settling into a more steady pattern of growth and innovation, in marked contrast to the turbulence that characterized the transitional years from 1992 to 1995. In fact, according to the IMF's just-published annual review, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, the global financial system appears to have emerged stronger and more resilient from the costly and disruptive crises of the previous three years.

Two financial policy challenges remain, however, whose resolution is essential for the stable evolution of the international financial system over the longer run:

• How to strengthen the system by extending the successful supervisory and regulatory practices developed under existing Group of Ten (G-10) multilateral arrangements to include the growing number of systemically important emerging market countries.

• How to further reduce the potential for disruptions in the global foreign exchange market, where turnover now exceeds $1 trillion a day.

Profiting from the School of Hard Knocks

Over the last ten years, international financial markets and participants have been visited by several costly and contagious financial crises. These have included abrupt declines in asset prices, major bouts of volatility in foreign exchange markets, an exchange rate and debt crisis in the emerging markets in early 1995, and costly banking problems in several industrial and some key emerging market countries.

According to the IMF study, many factors have contributed to these events, including macroeconomic events and policies and internal management control failures. But they are also to some extent a by-product of the transformation and restructuring of international finance that have taken place over the last ten years. Both the private and the official sector have been forced to learn how to manage new risks generated by the evolving financial environment. Although the scale of financial activity continues to grow, market participants—including high-risk, high-return investment funds—are more disciplined, cautious, and sensitive to market fundamentals.

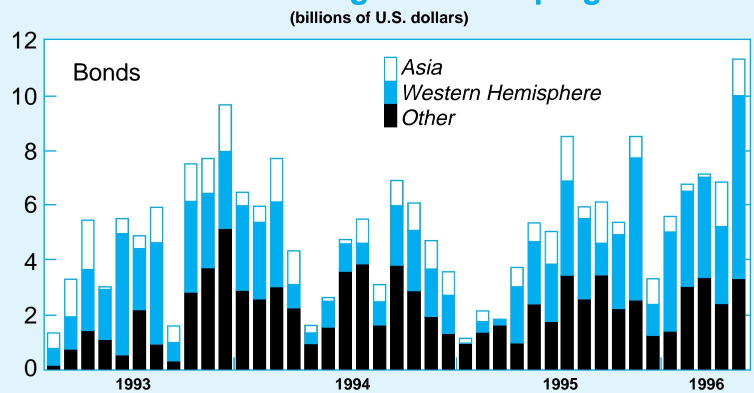
Furthermore, the major industrial countries have made significant strides in restructuring their financial regulatory and surveillance activities and strengthening market infrastructures. Cooperation among industrial countries in the surveillance of international banking markets has also been strengthened through the activities of the Basle Committee on Banking Supervision. This Committee consists of representatives from the G-10 industrial countries and serves as the focal point for issues relating to the supervision of international banks. It was established in 1974 in the aftermath of the Herstatt crisis in foreign exchange markets and has a permanent secretariat at the Bank for International Settlements.

The authorities responsible for financial surveillance in the major industrial countries have also strengthened existing cooperative arrangements. For instance, the Basle Concordat, which divides supervisory responsibility between home and host country, has been extended to allow the host country to deny access to banking institutions from countries whose oversight of the consolidated activities of their institutions is not in keeping with minimum standards. In addition, the G-10 central banks have been considering more orderly procedures to prevent and resolve sovereign liquidity crises, such as the December 1994 Mexico peso crisis.

The international banking sector has made significant progress in managing the risks it faces in the new financial environment. Initiatives include the following.

Private Market Financing for Developing Countries

(billions of U.S. dollars)



Data: DCBEL database, *Financial Times*, and *International Financial Review*

• Efforts to reduce credit risk exposures—the traditional source of banking problems and the most difficult exposure to hedge—have increased. The international banking sector has also become more diversified, and the management and control of the credit risk associated with off-balance-sheet derivative positions has been improved.

• The investment activities of the high-risk, high-return pools of institutional investment funds have, for now, become more cautious and less aggressive, following two years of significant losses that offset the major gains realized in 1990–94.

The devaluation of the Mexican peso in December 1994, and the financial contagion that followed during the first quarter of 1995, produced a sharp decline in flows to emerging markets, combined with significant pressures on the exchange rates of several countries. Most of the emerging market countries felt at least temporary effects from the changes in investor sentiment and the rebalancing of international portfolios that followed.

After the initial overreaction to the Mexican crisis, investors began to discriminate more carefully between regions and between countries within regions, and investment increasingly took the form of more stable, longer-term direct investment. For example, in 1995, foreign direct investment in developing countries increased by 17 percent, while net portfolio flows declined by 27 percent.

Developments in the emerging markets from late 1995 to early 1996 also suggest a return to a more stable environment. Most developing countries have become more cautious about relying on highly volatile short-term portfolio capital flows, and investors are paying greater attention to economic fundamentals when evaluating the risks of investing in emerging markets.

All in all, international financial markets are now better placed to support global macroeconomic developments. Nevertheless, the IMF study cautions, there is no guarantee that financial turbulence, stress, and crises will not reappear. The hard lessons learned in recent years could be forgotten, and the current cautious behavior could well give way to renewed bouts of exaggerated optimism and herd behavior. But at least for now, international capital markets appear to have become more resilient and are less likely to be a source of disturbances.

Emerging Markets Stage Quick Recovery

The big news in emerging capital markets was their unexpectedly strong recovery, in late 1995, from the Mexican financial crisis of December 1994. In the first quarter of 1995, portfolio flows to emerging markets declined dramatically, premiums on developing country bonds increased, equity prices in emerging markets fell sharply, and currency pressures were felt—at least temporarily—from Argentina and Brazil to Hong Kong and South Africa.

Some emerging market countries responded successfully to the changed investment climate with economic reforms and defensive policy measures. In addition, the concerted liquidity support extended during the crisis in the beginning of 1995 by the international community was successful. Most of the major market indicators in the emerging markets recovered by the end of 1995 and early 1996, including local equity price indices, new international bond issues, international syndicated loans, and currency values. By the end of 1995, overall capital flows to emerging markets had not only resumed but had surpassed their previous peak reached in 1993 (see chart, page 3).

The good news about international capital flows was dampened by the realization that the fragility of the banking systems in some of the emerging market countries could seriously impede macroeconomic performance. It is widely recognized that the efforts being made to improve the health of these banking systems are critical to improved economic performance. Foreign investors appear to be paying far greater attention to the soundness of a recipient country's financial system as a key variable in investment decisions. Indeed, the soundness of the financial sector has become one of the economic fundamentals.

Capital Flows. Net capital inflows surged to a record $228 billion in 1995, with $194 billion going to developing countries and $34 billion to countries in transition to market-oriented systems. The inflows were bolstered by a strong performance by Asian emerging markets, liquid bank-loan markets, and strong demand for emerging market bonds by Japanese and German investors.

Much of the investor community appears to be more risk-aware and more likely to do its homework in assessing the economic fundamentals and to respond to good data and equal treatment. Investors are differentiating among countries in two important ways:

• They are relying on a broader array of macroeconomic and financial indicators in assessing the sustainability of internal and external macroeconomic balances and investment opportunities.

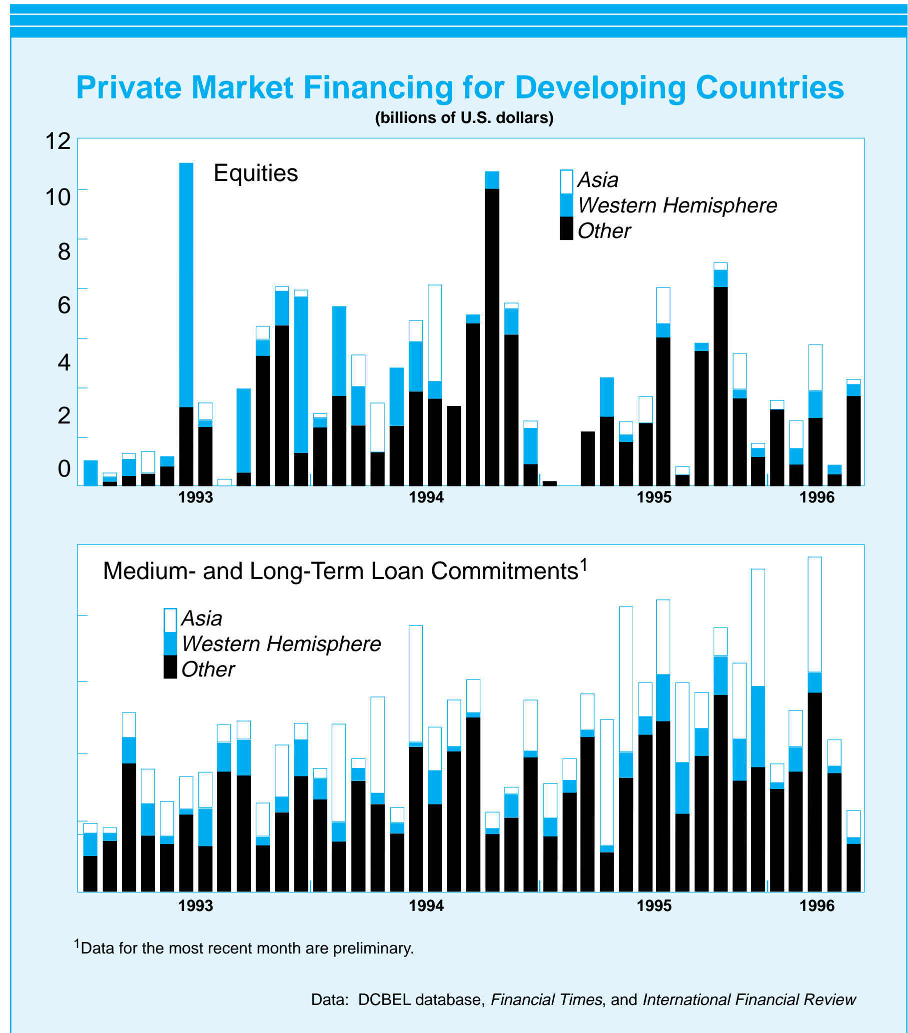
• They are paying more attention to the safety and soundness of banking systems, the integrity of financial data, the availability of legal recourse, and the efficiency and safety of the financial infrastructure.

The process of learning to assess the risk of various investments in emerging market countries on a continuous and timely basis has just begun. According to the IMF study, there is a long way to go before the availability and

quality of macroeconomic and corporate data and the supporting analysis will compare favorably with that of the major international financial markets. The IMF's new standards for improving the quality, timeliness, and dissemination of economic and financial data should be helpful in this context.

International Bond Issues. Many emerging market countries were welcomed back into international markets during the second and subsequent quarters of 1995. By the end of the year, total bond issuance by all developing countries had surpassed the level reached in 1994.

A notable development was the shift in currency denomination of developing country issues from the U.S. dollar to the yen and the deutsche mark. In 1995, 26 percent of new bond issues by developing countries were issued in yen, amounting to $15.3 billion, compared with 13 percent in 1994; and $6 billion or 10 percent were issued in deutsche mark, compared with 3 percent in 1994. According to the IMF study, sovereign borrowers apparently do not hedge the currency risk incurred with these issues, preferring instead to reap the immediate positive benefits—including fiscal—from the relatively low interest coupons on these obligations. Given the potential for an increase in the local currency value of these obligations in the event of an appreciation of the yen or the deutsche mark, these positions will have to be carefully monitored and managed.



Extending Global Surveillance to Emerging Markets

An important challenge facing the major industrial countries is how to extend and broaden current arrangements for surveillance over international banking systems to include a growing number of systemically important emerging market countries.

Capital markets have remained relatively underdeveloped in most emerging market countries, and the banking system typically still plays a central role. In many emerging market countries, however, the banking system is prone to serious problems that have the potential to spill across national borders. The extension of international supervisory arrangements to include emerging market countries is therefore important not only to safeguard the stability of the international financial system but also to increase the effectiveness of surveillance over domestic banking institutions in emerging markets.

Several features of the financial systems in these countries, however, tend to make financial surveillance more difficult than in the major industrial countries. For instance:

- Technical ability and supervisory resources are sparser than in the G-10 countries.
- Legal systems make it occasionally difficult for supervisors to implement prudential directives, such as cease-and-desist orders.
- In cases where the economy is dominated by a small number of large corporate groups, it is difficult to avoid concentrations of risk and ownership.
- Extensive implicit and explicit financial safety nets have tended to remove some of the discipline imposed by the market on the credit allocation process.
- Domestic and foreign banks are increasingly tending to shift some of their wholesale activities in emerging markets to

offshore locations and to alter their risk positions through the use of derivatives and offshore transactions.

Despite these impediments, there is widespread agreement among supervisors and market participants in the major industrial countries on the need for a way to extend the improvements in the supervisory and regulatory infrastructure in international financial markets to the systemically important emerging market countries. Most G-10 supervisors think it unlikely that their existing institutional arrangements—whose success derives from the relatively small number of homogenous participants—can be easily extended to include an increasing number of emerging market countries. Any effort to do so, according to the IMF study, would need to be mindful of the main lessons of the postwar experience with surveillance:

- International cooperation in the area of financial surveillance should be based on home country control rather than on supranational legal arrangements.
- Any cooperative global agreements should include all countries whose financial institutions are significant and active players in the international financial markets.
- International agreements should be narrowly focused on minimum standards for the regulation and surveillance of internationally active financial institutions; the assignment of responsibility between home and host countries for the surveillance of the operations of international banking institutions; and the exchange of information among national supervisory authorities.

The first step in constructing a more comprehensive arrangement should be the formulation of international regulatory and supervisory standards; these standards should cover, at a minimum, consolidated supervision of international banks, capital requirements, provisioning rules, exposure limits, and the authority of supervisors over all aspects of the operations of financial institutions. The effectiveness of such standards in strengthening the stability and performance of banking systems would depend crucially on the ability and willingness of the authorities to implement them.

Settlement Risk in Global Foreign Exchange Markets

The second major policy issue addressed in the IMF study is how to reduce the potential for disruptions in the global foreign exchange market. This market, which is at the center of the international financial system, is the largest, most liquid, most innovative, and only 24-hour global financial market in the world. Turnover in this market has risen to $1.2 trillion daily, with much of it concentrated in a handful of international dealing banks. A disruption in this market could have serious consequences for global trade and finance and for the international banking system.

The risk of disruption in the global foreign exchange market arises from the possibility that sudden doubts about the solvency of one of the major market participants could cause its counterparties to withhold or delay payments for foreign exchange transactions that are not yet settled, thereby aggravating the difficulty, and possibly causing a chain reaction of other settlement failures.

Foreign exchange settlement risk could be substantially reduced if the two payments of a transaction could be finalized simultaneously. But this would require two major changes in international payments arrangements:

- eliminating gaps in operating hours of the major wholesale payments systems; and
- linking payments systems in real time to achieve "intraday finality" (that is, closing the books on both transactions as they happen, within one business day).

Implementing these steps would entail substantial reforms in the major domestic payments systems and either an increased need for continuous coordination among the major central banks or greater efforts by the private sector to reduce foreign exchange settlement exposures significantly.

Keeping a Firm Hand At the Helm

The evidence provided by developments in international financial markets since the early 1990s suggests that these markets will continue to become more global and more dominated by institutional investors; that the continuing diversification of institutional portfolios will mean that the exposure of these investors to emerging markets will grow in line with recently established trends; and that global derivative finance will continue to spread.

The evidence also suggests that this evolution will take place against the backdrop of improved risk management in the international banking sector, strengthened market surveillance within an adaptive regulatory environment, a more resilient market infrastructure, and with an official sector that has made it a top policy priority to create the infrastructure required for a stable market environment.

International Capital Markets: Developments, Prospects, and Key Policy Issues, by a staff team from the IMF's Research Department, is part of the IMF's World Economic and Financial Surveys series. Copies are available for $20.00 (academic rate: $12.00) from Publication Services, Box XS600, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org