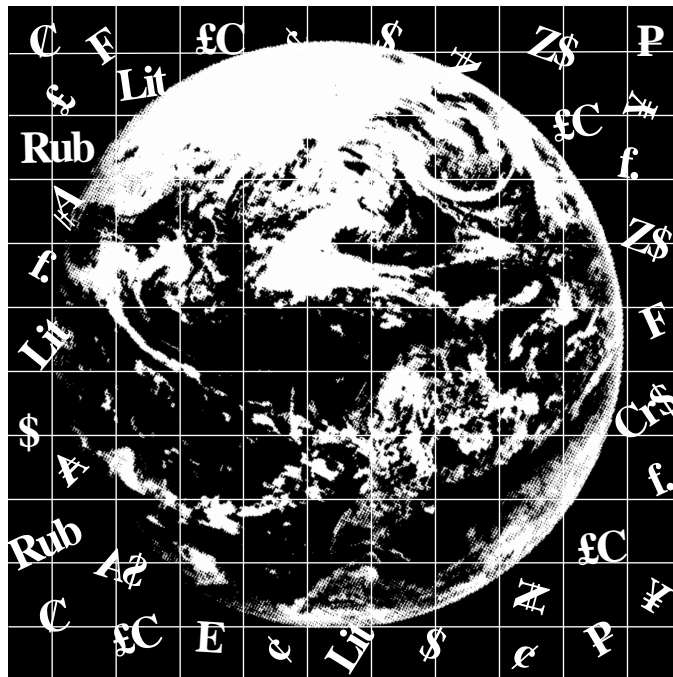

Emerging Market Financing

Quarterly Report on Developments and Prospects



Second Quarter 2000

By a Staff Team led by Bankim Chadha



The quarterly *Emerging Markets Financing* report is an integral element of the IMF's surveillance over developments in international capital markets. It is being published beginning with the report for the second quarter of 2000. The report draws, in part, on a series of regular informal discussions with a broad set of private financial market participants.

The report is prepared in the IMF's Research Department. The project is directed by Bankim Chadha, Chief, Global Markets Unit. Co-authors of the report are Anna Ilyina, Subir Lall, Gabrielle Lipworth and Jens Nystedt, all Economists; Martin Edmonds, Senior Financial Systems Officer; Anne Jansen, Senior Research Officer; and Christian Carrillo and Peter Tran, Research Assistants. Sheila Kinsella provided expert drafting assistance.

The report has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors (following their discussion of the *Emerging Markets Financing* report on August 2, 2000). The analysis and views are those of the contributing staff and should not be attributed to Executive Directors, their national authorities, or the IMF.

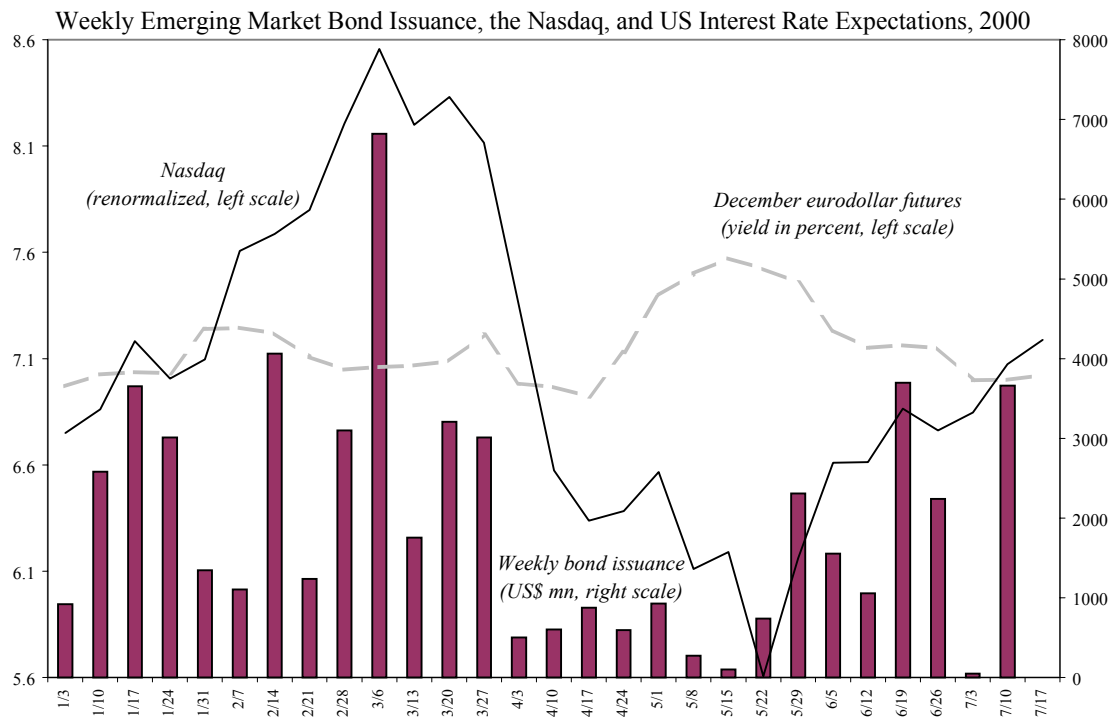
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I. OVERVIEW

Emerging market assets and financing on international capital markets were hostage in the second quarter of 2000 to fluctuating conditions on international financial markets:

- *In the first two months of the quarter, as the mature equity markets declined, expectations of US interest rates were revised up, competing credit markets deteriorated, and the Euro fell to an all time low, emerging market assets registered substantial losses, while bond and equity issuance slowed to a trickle.*
- *With an easing of US interest rate concerns in June, emerging market assets and fundraising on bond and equity markets rebounded along with global markets.*
- *Syndicated loan financing, as has frequently been the case in the past, remained relatively insulated from these developments.*



The poor performance of emerging markets assets prompted market debate about the relative roles of country fundamentals and the adverse external environment. In our view it was a variety of factors in the mature markets that played the biggest role: higher interest rates, greater uncertainty about the tightening cycle and its implications for the real economy, increased volatility of returns on equity markets, and deteriorations in credit quality. All of these factors encouraged international fund managers to rebalance portfolios in favor of cash, and to move closer to their benchmarks, implying a retrenchment from emerging debt and equity markets.

The tight link between the performance of emerging and US asset markets has tempered our optimistic outlook for emerging markets financing from a quarter ago. We expect overall financing flows to moderate in coming quarters. While we expect the syndicated loan market to remain supportive, we expect conditions on bond and equity markets to be choppy, with issuers exploiting windows of opportunity. In our view, a decisive decoupling of emerging from US markets is unlikely until a convincing resolution about the prospects for a soft versus hard landing of the US economy. While there was a deterioration in almost all of the factors on our list of risks for the emerging markets during the quarter, the potential for further negative impacts from each of these sources unfortunately remains as much a concern as it did a quarter ago.

	1998	1999	1999				2000		April	May	June	July 1/	YTD 2/
			1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.					
<i>(In billions of US dollars)</i>													
ISSUANCE	156.7	173.9	33.4	53.9	35.9	50.8	71.5	54.6	17.5	9.0	28.1	n.a.	126.1
Bonds	79.5	82.4	21.8	26.5	15.5	18.6	33.7	15.5	2.6	3.7	9.3	3.7	49.2
Equities	9.4	23.2	2.4	6.6	6.1	8.0	8.9	11.1	1.2	1.5	8.5	2.7	20.0
Loans	67.7	68.4	9.2	20.8	14.2	24.2	28.8	28.1	13.8	3.9	10.4	n.a.	56.9
ISSUANCE BY REGION	156.7	173.9	33.4	53.9	35.9	50.8	71.5	54.6	17.5	9.0	28.1	n.a.	126.1
Asia	41.1	65.9	12.5	18.0	18.9	16.6	30.5	28.2	13.1	3.6	11.6	n.a.	58.7
Western Hemisphere	65.9	61.4	13.2	21.8	9.4	17.0	23.7	12.8	2.0	3.6	7.2	n.a.	36.5
Europe, Middle East, Africa	49.7	46.5	7.7	14.1	7.5	17.2	17.2	13.6	2.5	1.8	9.3	n.a.	30.8
SECONDARY MARKETS													
Bonds:													
EMBI+ (spread in bps) 3/	1,037	703	1,046	939	965	703	674	712	708	784	712	679	679
Merrill Lynch High Yield (spread in bps)	536	435	490	447	465	435	543	582	538	585	582	577	577
U.S. 10 yr. Treasury Yield (yield in %)	4.7	6.3	5.2	5.9	5.9	6.3	6.0	6.0	6.2	6.3	6.0	6.0	6.0
Equity:													
Dow	16.1	25.2	6.6	12.1	-5.8	11.2	-5.0	-4.3	-1.7	-2.0	-0.7	2.7	-6.6
NASDAQ	39.6	85.6	12.3	9.1	2.2	48.2	12.4	-13.3	-15.6	-11.9	16.6	3.2	0.6
IFC Investable Composite	-21.9	67.1	10.9	23.8	-3.2	25.7	1.5	-10.4	-10.3	-2.8	2.8	-0.6	-9.6
Asia	0.7	72.6	6.5	43.2	-8.0	23.1	4.1	-11.7	-12.2	-2.0	2.7	-1.9	-9.9
Latin America	-35.5	61.8	13.4	15.4	-7.9	34.2	5.9	-7.9	-11.0	-5.3	9.3	1.6	-0.9

Sources: Bloomberg; Capital Data Ltd; International Finance Corporation, and Emerging Markets Data Base.

1/ Issuance data are as of London close of business July 18, 2000, secondary markets data are as of New York close of business July 21, 2000.

2/ Year-to-date as of the second quarter for primary markets and through July 21 for secondary markets.

3/ On April 14, the EMBI+ was adjusted for the recent London Club agreement for Russia. This resulted in a one-off 131 bps decline in average measured spreads.

II. RECENT DEVELOPMENTS

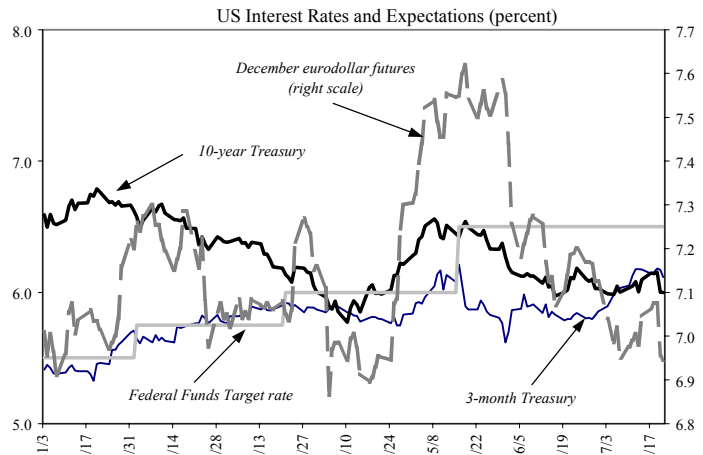
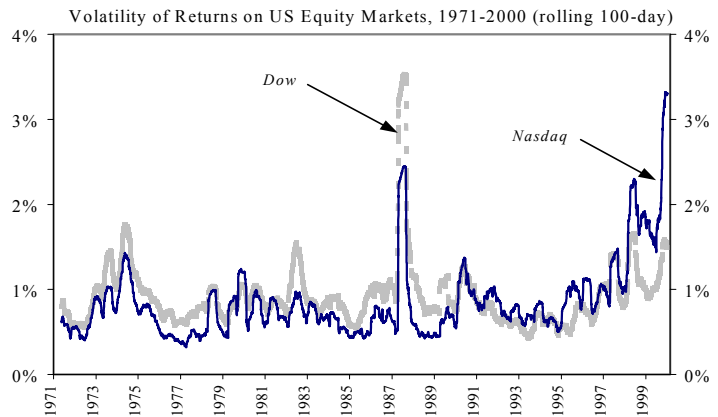
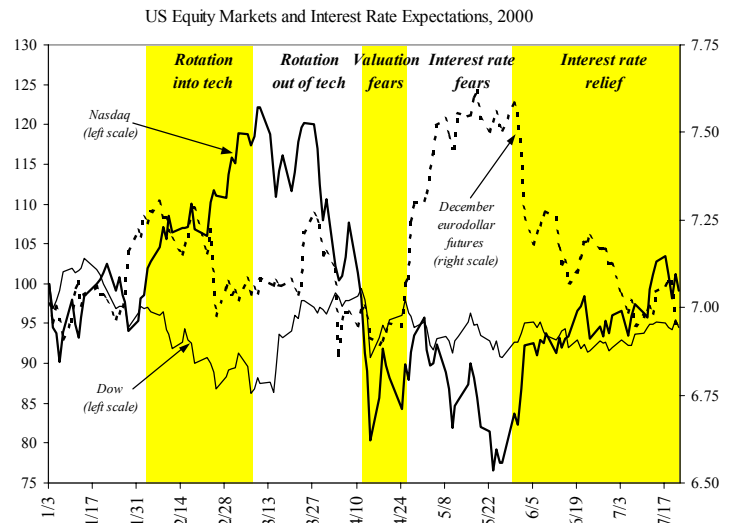
A. The External Environment

Developments in international financial markets, especially the US, have presented a **volatile backdrop for emerging markets this year**. This volatility, which has spanned the equity, money, government bond, credit, and foreign exchange markets to varying degrees, heightened in the second quarter.

There have been a variety of sources for the **volatility in US equity markets this year**: **cycles of rotation into and out of technology, media and telecom (TMT) stocks** as investor expectations about the earnings potential of the “new economy” changed versus the “old economy”; **generalized concerns about the high valuation of equity markets**; **expectations of higher interest rates**; and finally **relief about the US interest rate tightening cycle** (see chart).

The **volatility of returns on US equity markets increased** substantially during the second quarter, with that on the Nasdaq rising to levels not seen in US equity markets since the 1987 crash (see chart).

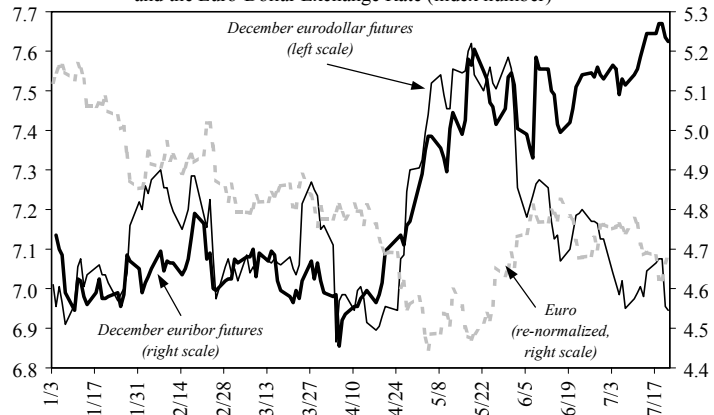
In the money markets, the monetary **policy tightening cycle continued**, with central banks in the US and Europe raising interest rates (see chart). **Uncertainty about the length and magnitude of the tightening cycles** continued to plague the market, especially in the US. Rising inflation fears in late April and early



May prompted a sharp increase in expectations of US interest rates, with the yield on the December Eurodollar futures contract rising by around 75 basis points. Weaker unemployment and earnings data then prompted a substantial reversal in the first week of June, with the yield falling by around 50 basis points. Expectations of the tightening cycle in Euroland got additional impetus from the **euro, which hit its lowest point** against the dollar during the quarter, fuelling expectations interest rates would have to be raised to support the currency. The price performance of the US Treasury market continued to benefit from the decline in supply from the Treasury's buybacks, with the yield curve remaining inverted since early in the year. The substantially **reduced liquidity of the long-term Treasuries market** has, however, left the market vulnerable to bouts of volatility.

In credit markets, the US **high yield and high grade sectors continued to suffer** in the first two months of the quarter. In the high yield sector, fund managers continued to experience **redemptions** as new funds flowed into equity markets, with the reduced demand and a **heavy issuance calendar** boosted by the TMT sector pushing spreads wider. Perceived future **default risk** also rose with actual default rates, expectations of a slowing economy and higher interest rates. The deterioration in the high grade sector was more modest. Interest rate swap spreads—sometimes viewed as a (inverse) barometer of appetite for credit and-or market risk—reached new peaks early in the quarter. Then, along with the interest rate outlook, there was an **abatement of pressures in June**, with spreads in all three markets narrowing, though high yield markets responded with a lag and quickly lost ground again.

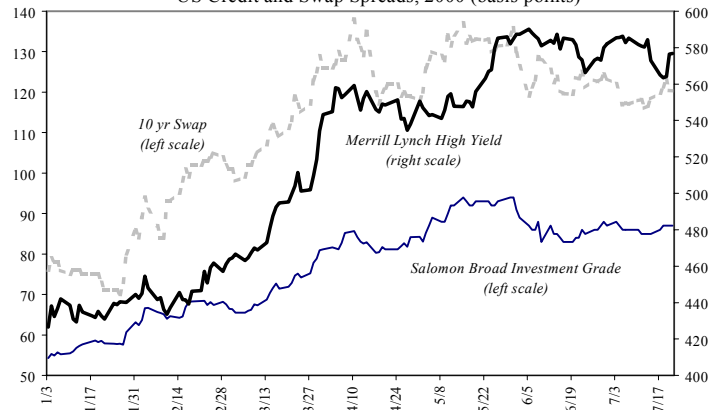
Yields on December 2000 Eurodollar and Euribor Futures (percent), and the Euro-Dollar Exchange Rate (index number)



Who are high grade and high yield investors?

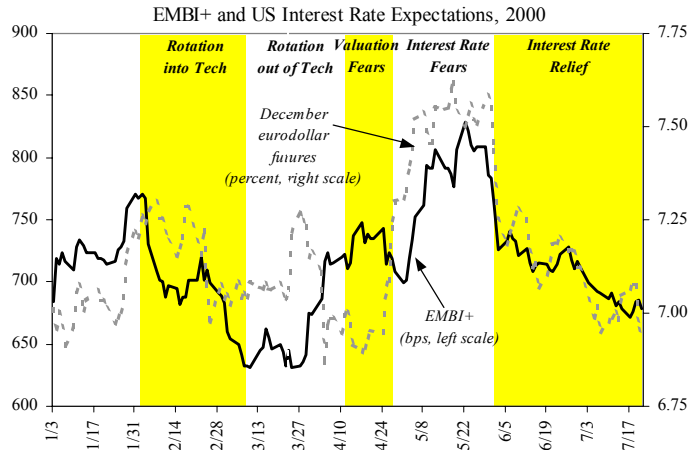
Managers of **high grade funds** invest primarily in investment grade corporate, sovereign and quasi-sovereign debt, offering investors a portfolio with minimal credit risk. Many pension funds, insurance funds, and some mutual funds in the mature markets fall into this category. **High yield funds** invest primarily in sub-investment grade corporate and sovereign debt, offering a yield pickup relative to high grade funds in return for greater credit risk.

US Credit and Swap Spreads, 2000 (basis points)



B. Emerging Bond Markets

Spreads widened during the quarter by a modest 38 bps to 712 bps. They were, however, **volatile**, continuing to be heavily **influenced by developments in US financial markets**. Viewed against that backdrop (see chart), the continued sell-off in the Nasdaq at the beginning of the second quarter spilled over into the emerging bond market, pushing spreads wider by about 100 bps from their first quarter lows of 630 bps. After being range bound for most of April, the EMBI+ again sold off by another 100 bps to reach a peak of 830 bps during the quarter as US interest rate concerns rose. In early June, easing interest rate concerns pushed the EMBI+ back to early-May levels of 730 bps. With growing evidence of a slowing economy in the US, spreads then continued to tighten through the end of the quarter. They have narrowed further since the end of the quarter, boosted by the outcome of the Mexican elections.



Unlike the first quarter, when emerging markets outperformed competing asset classes, remaining resilient to the deteriorations in US credit markets and volatility in US Treasuries, they **underperformed in the second quarter** (see table). Despite the high yields on emerging market bonds, and positive returns on underlying US Treasuries in the quarter, spreads widened (and prices fell) enough that **the EMBI+ (excluding Russia) turned in losses of 0.3%**.

Emerging market **credit spreads deteriorated across the board** during the quarter, with only two exceptions:

Russian spreads narrowed 783 bps, and Turkish spreads 14 bps. For the second quarter in a row, **Russia was the top performer (6.0%)**, supported by optimism surrounding the London Club restructuring and high oil prices. Continued success with the implementation of the IMF-supported stabilization program set the stage for Turkish eurobonds to rally, providing the second best return in the quarter (3.7%). Validating a key relative value play for many investors, Brazil yielded positive total returns (1.1%), while Argentina had losses (-2.1%). The worst performers were Colombia (-6.9%), in the wake of rumored sell-offs initiated by the closings of large macro

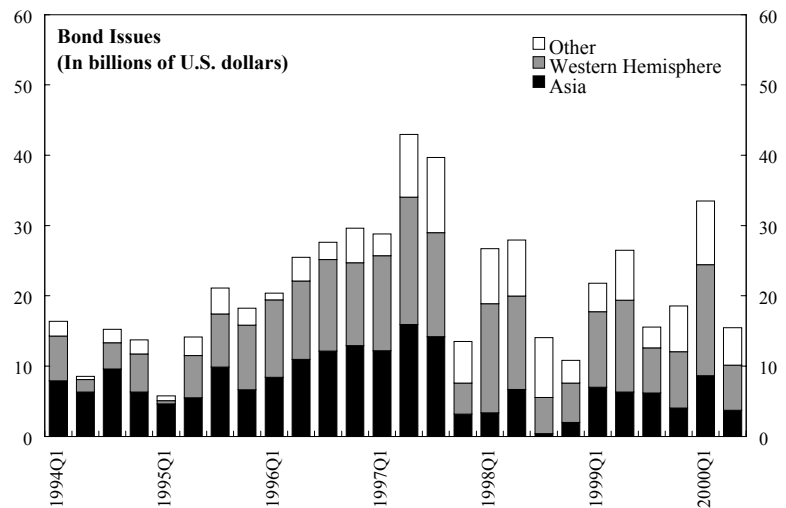
Relative Performance of Emerging Market Debt

(Total return in %)	Q1	Q2
EMBI+	7.6	0.4
EMBI+ ex-Russia	4.2	-0.3
Government Bonds (JP Morgan GBI)	4.0	1.5
US Investment Grade (Salomon's BIG)	2.2	1.7
US High Yield (MLHY)	-1.8	0.6
10-year swap spreads (bps)	+50	-2

hedge funds (Tiger and Soros) and domestic political troubles, and Ecuador (-9.1%) and Nigeria (-12.5%), in the face of restructuring concerns.

New bond **issuance also closely followed developments in US markets**, drying up in April and May, then rebounding in June. The global issuance squeeze in the first two months of the quarter was, as would be expected, more severe lower down the credit spectrum, and both high yield and emerging markets issuers lost share. The **share of emerging markets** in total international bond issuance for the quarter **hit a low** of 4.6%, a level **not seen since 1991:Q1**.

Adjusted for Brady exchanges, **bond issuance totaled \$15.5 bn**, with **60% of it taking place in June**. The overall volume of fundraising during the quarter was comparable to **the crisis quarters** of 1997:Q4 (Asia) and 1998:Q3-Q4 (Russia). As is common during periods of **limited market access**,



investors moved up the credit ladder, preferring to hold paper from countries that did not need to issue, while issuers that could, decided to wait. Only those issuers that really needed to raise money did so, often damaging returns. The **Argentine sovereign**, with \$2.6 bn, **was the largest issuer**. The sovereign remained absent from the dollar market, coming to the euro-market frequently. Some market participants criticized its euro-denominated issue in end-June for leaning on the European investor base too far, and the €500 mn issue was the first to price below a recent Brazilian euro-denominated issue. **Latin American issuance continued to dominate**, with a share of around 40%. Issuance from other regions was dominated by Qatar (\$1.4 bn) and Turkey (\$1.7 bn). Activity from Asia remained limited. The single Asian sovereign issue during the quarter was from China, a ¥30 bn Samurai eurobond. The Philippines was unable to come to market during the quarter, and subsequently issued in the Samurai market. As is also common during periods of limited market access, **sovereign issuance dominated**, with **corporate issuance again taking the backseat** and several deals were put on hold.

Key characteristics of the **behavior of the investor base** during the quarter were:

- The **dedicated investor base** increased allocations to cash in response to continued redemptions and uncertainty about US interest rates, while investment allocations “hugged the index,” that is, were risk neutral relative to the benchmark index.

- The **dollar-based crossover** investor retrenched from emerging markets. High yield fund managers continued to experience deterioration in their home market, and like high grade fund managers moved closer to their core benchmarks, reducing allocations to emerging markets not in their benchmark indices. The one exception where high grade fund managers did *not* move towards their benchmarks was Mexico. In this case, underweight positions resulting from the country's upgrade to investment grade in the first quarter, and its subsequent inclusion in some high grade indices were, due to uncertainty about the elections, largely maintained.

Who are crossover investors?

The term "**crossover**" investor is used to describe those investors whose primary focus is in one market, but whose investment mandate permits them to acquire a limited amount of other assets. In the emerging debt market, for example, crossover investors include high yield and high grade funds, global fixed-income funds, pension funds, and insurance companies. These investors typically do not have dedicated allocations to emerging markets, and instead "cross over" into (and out of) emerging

- **Demand for new issues from euro-based institutional investors**, who have been crucial for the issuance of large longer-maturity euro-denominated bonds, **dried up** as the euro's fall to a new low fuelled expectations

	Currency of Issuance (Shares in %)													
	97Q1	97Q2	97Q3	97Q4	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
U.S. dollars	69	77	77	71	62	77	86	83	62	68	60	60	65	50
Euro	0	0	1	0	8	9	7	0	26	27	35	31	31	29
Deutsche mark	16	5	2	16	15	7	6	14	2	0	2	0	0	0
Yen	8	6	3	3	0	0	0	1	2	1	1	7	3	17

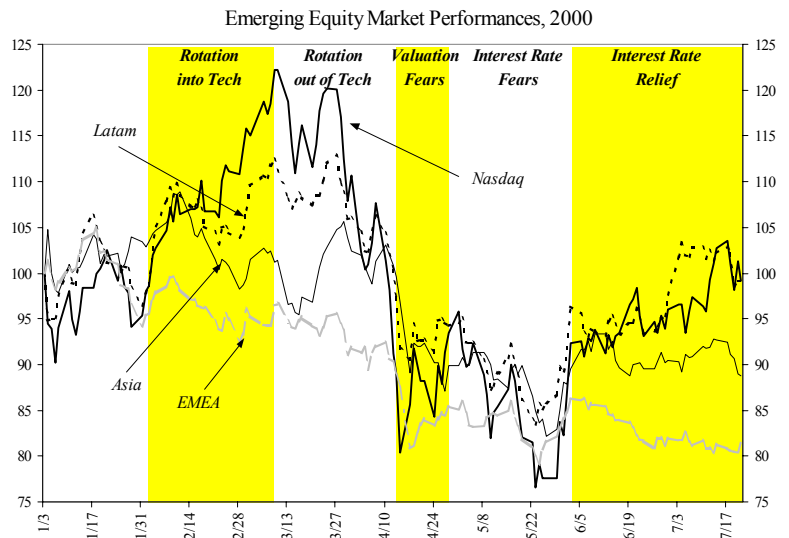
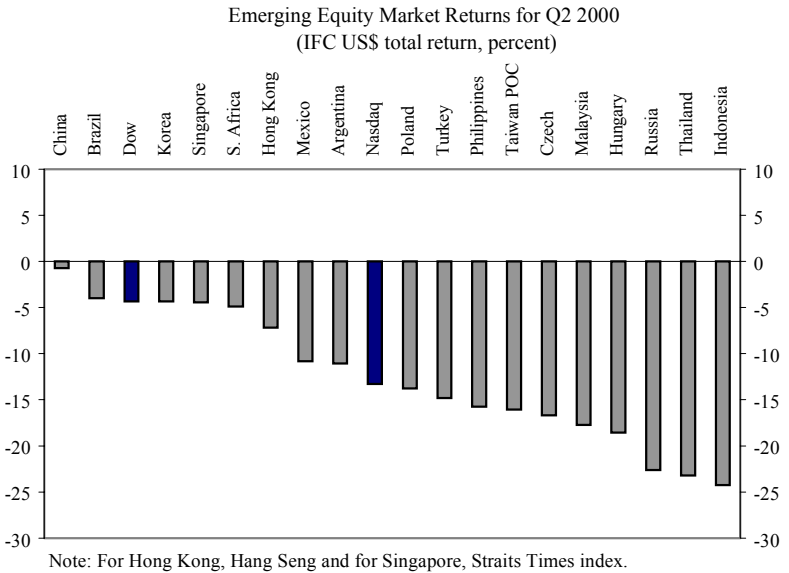
retail investors provided some relief, surprising most market observers. Their reaction to recent emerging market issues showed, however, the limits to such demand.

- Poor market conditions in the US and Europe were **alleviated to some extent by the re-emergence of the Japanese Samurai market**, where issuance picked up (\$2.1 bn) as Japanese retail investors used some of their freed up postal savings to increase exposures to higher yielding emerging markets.
- **Local entities**, whose importance in the bid for emerging bond markets we had highlighted last quarter, added to volatility, pointing to some **unusual links between world equity and emerging bond markets**. In Argentina, the sell-off in the local equity market pushed the share of government bonds held by pension funds close to or above the regulatory limit of 50%. This forced them to curtail purchases, contributing to the widening of Argentinean secondary market spreads. The lack of local pension fund demand also explains the absence of any dollar-denominated eurobond issuance during the quarter (except a Brady-eurobond swap). As the local equity market recovered along with US markets at end-May and June, pension funds again moved in and by end-June had increased their holdings of outstanding Argentinean dollar-denominated eurobonds to an estimated 37%, from 34% a quarter ago.

C. Emerging Equity Markets

Emerging equity markets significantly underperformed their broad counterparts in the mature markets in the second quarter. The IFCI composite fell 10.4% in US dollar terms, reflecting sharp declines in all regions, with Asia (-11.7%), and Europe, Middle East and Africa (EMEA) (-10.7%) suffering somewhat higher losses than Latin America (-7.9%). With the Dow falling 4.3% and the MSCI World Free Index 3.8%, **emerging equity markets turned in losses closer to those on the Nasdaq (-13.3%).**

In spite of the relatively benign domestic environment in most emerging markets, supportive of robust equity market valuations, **the performance of emerging market equities' was closely correlated to the distinct phases seen in US financial markets, and in particular the Nasdaq (see chart and Box 1).** A key risk we highlighted last quarter, the vulnerability of emerging equity markets to excessive gyrations in the Nasdaq, materialized in the second quarter, overshadowing the positive fundamental factors that continued. During the US markets' rotation out of tech stocks into blue chips, Asian markets were relatively unaffected, unlike Latin American and EMEA markets which saw much sharper declines along with the Nasdaq. Telecom shares bore much of the brunt of this decline, with investors globally questioning the prospective profitability of new generation wireless telecom ventures. During the subsequent tech sector-led stock market rout in mid-April, all emerging markets suffered large losses. Information technology shares in particular suffered severe losses, affecting Asian markets most.



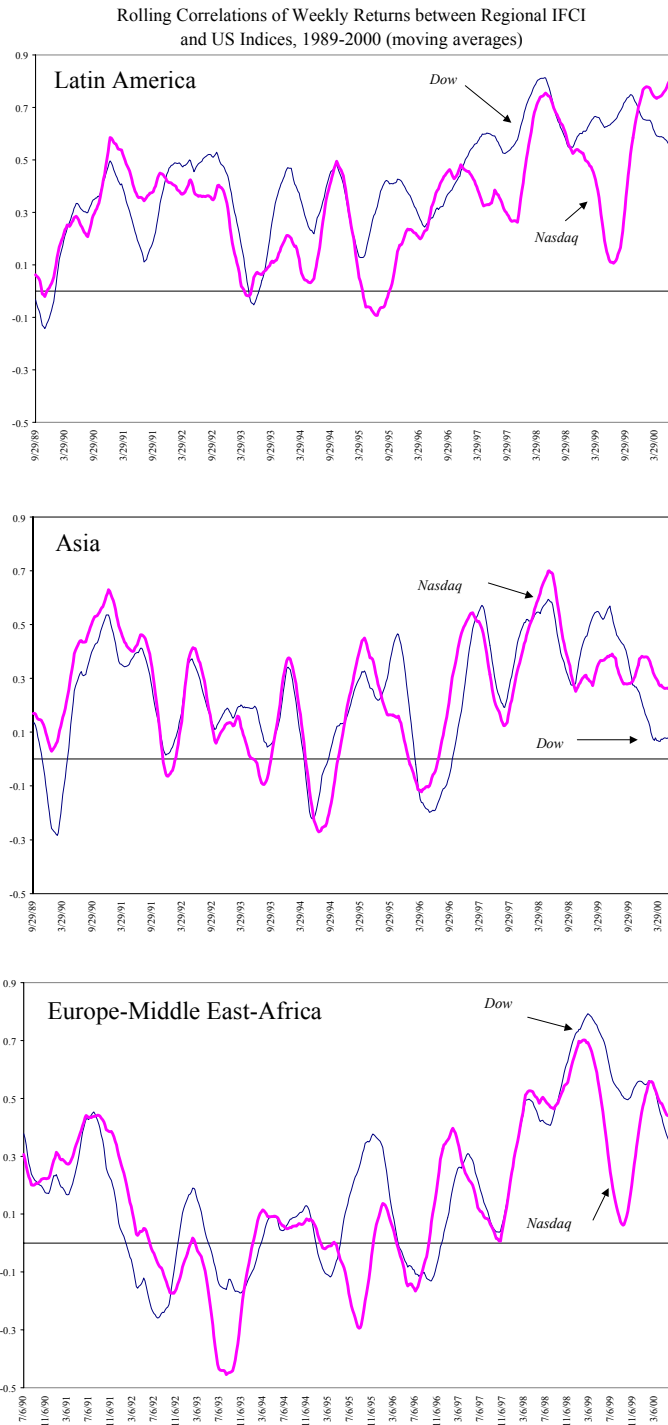
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Box 1. The Comovement of Emerging and US Equity Markets in the Short and Long Run

The high short-run correlation between returns on emerging and US equity markets recently has raised several questions. Is this a new phenomena? Does it reflect the global boom in the TMT (technology, media & telecommunications) sector? Do these correlations persist over the long run? What explains these comovements?

Short run correlations: the facts

- The correlations of **returns** between emerging and US equity markets in the short run has **historically often been high, though volatile** (see charts). The correlations have been **somewhat higher recently**, at the upper end of—but by and large mostly within—the historical band of correlations.
- The correlations of emerging equity market returns with those in the mature markets is about the **same with “new economy” stocks**, as represented by the Nasdaq, **as it is with “old economy” stocks**, as represented by the Dow.
- Across regions, the correlations are **highest for Latin America** at around 0.8 at their recent peak, **followed by Europe, Middle East and Africa** with a recent peak of around 0.5, and **lowest for Asia** at around 0.4 at their recent peak.
- Together, the first two points establish that the **strong correlations recently between emerging and US equity markets are not a reflection of the recent global “technology phenomena.”**



Box 1. (continued)

The evidence on long run relationships

- There is **no evidence that aggregate emerging and US equity markets tend to move together in the long run** (see table below).
- At a **sectoral level, however, the long run link is tight**. There is strong evidence for long run relationships between the information technology and telecoms sectors in emerging markets and their respective counterparts in the Nasdaq.

Tests for long-run relationships (cointegration, i.e, common long run trends)

		Dow		NASDAQ		NASDAQ-Information Technology		NASDAQ-Telecom	
		ECM	COMFAC	ECM	COMFAC	ECM	COMFAC	ECM	COMFAC
		Wald test/ Unit root test	Wald test	Wald test/ Unit root test	Wald test	Wald test/ Unit root test	Wald test	Wald test/ Unit root test	Wald test
Latin America	(weekly data) Jan., 89 - June, 00	-	-	-	-				
Asia	Jan., 89 - June, 00	-	-	-	-				
Europe	Jan., 89 - June, 00	-	-	-	-				
MSCI-EMF-Information Technology	(daily data) Jan., 99 - June, 00			**/**	**	**/**	**	**/**	**
MSCI-EMF-Telecom	Jan., 99 - June, 00			**/**	**	**/-	-	**/**	**

Notes: '**' denotes test is significant at 1% confidence level, '*' at 5% and '-' that test is not significant

Explanations for high short-run correlations but no long-run relationships

The most common **explanations for the high short run correlations** are: **direct economic linkages, common global disturbances, changes in sentiment** with the major mature markets providing the lead and local investors following, **portfolio rebalancing** by global fund managers then followed by local investors. We are particularly sympathetic to the last interpretation, especially in the recent period.

Emerging equity markets can be thought of as being subject to **two basic forces: domestic fundamentals** and the **external environment**. The relative importance of these two shifts over time, explaining the fluctuations in short-run correlations. During periods when domestic fundamentals unfold as markets expect, for example, while the external environment is subject to surprises, one would expect higher correlations between the performance of emerging markets with those abroad. Conversely, in other periods the influence of domestic fundamentals dominates and correlations will be weaker. In our view, the **lack of long-run relationships to date is explained by the fact that emerging equity markets have in the past followed their own long-term “macro-political” cycles**, which were not synchronized with the equity market return cycles in the US.

Structural change in fundamental investor paradigm?

A key structural change in recent years has been the **growing importance of the TMT sector** globally, but especially in the emerging markets, where it is estimated to broadly account for 54% of market capitalization in Asia, 39% in Latin America, and 18% in Emerging Europe. If the TMT sector continues to grow in importance, the strong sectoral link with those in the mature markets noted above will become increasingly important in determining the comovement of the broad markets. This suggests that the **traditional paradigm of equity market investment into emerging markets may be at the cusp of a fundamental structural shift**, with international equity investments into emerging markets based more on **sectoral rather than macro-political** considerations.

As US markets trended lower on interest rate concerns during May, all emerging markets again followed. Once interest rate uncertainty diminished in early June, Latin American and, to a lesser extent, Asian markets recovered some ground along with the Nasdaq. The EMEA markets, however, continued down in this (last) phase as Turkey, Russia and the Czech Republic moved substantially lower.

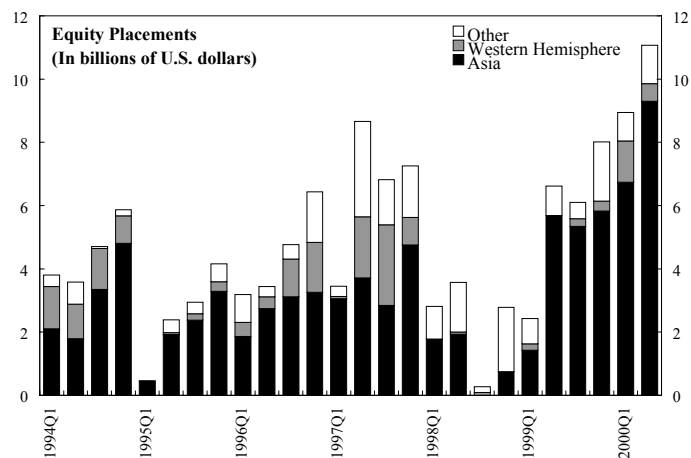
Last quarter we highlighted the **key role played by changes in benchmark indices**, and in particular the MSCI, in affecting capital flows and the performance of emerging Asian equity markets. The largest beneficiary had been Malaysia on its re-introduction into the family of MSCI indices following the alleviation of capital controls. This prompted fund managers benchmarked against these indices to increase allocations to the country, making it the best performer in emerging Asia. This quarter, Chile announced the alleviation of some of its capital controls. However, unlike the case of Malaysia, Chile already enters the MSCI indices with a full weight due to the existence of significant amounts of ADRs. No changes in the MSCI indices have been, therefore, announced or are expected as a consequence of this liberalization, and additional capital flows prompted by such changes can, therefore, be expected to be limited.

The ongoing **shift away from a regional/country focus to a global (cross-regional and sectoral) one** was in evidence during the quarter, with cumulative flows into both global and global emerging market equity funds positive from end-April through the end of the quarter, while regional emerging market funds continued to experience net redemptions. Uncertainty about tech stock valuations and the US growth slowdown led the **majority of fund managers**—dedicated, crossover, and global alike—to **move closer to their benchmark indices and increase cash reserves** during the quarter.

New equity issuance rose to a record \$11.1 bn in the quarter, the **bulk of which (76%) took place in June**. Asia was again the dominant issuer, with a share of 84%. The \$5.7 bn IPO by Chinese telecom company China Unicom was the largest ever from ex-Japan Asia, making China the most active issuer in the quarter (53% of the total), followed by Taiwan Province of China (16%) largely reflecting issuance from Taiwan Semiconductor Manufacturing (TSMC), and Singapore (10%) led by Chartered Semiconductor.

The **TMT sector (92%) dominated issuance**. In contrast, financial services were again marked by their low share (0.5%), comprised of China Insurance's single \$55 mn issuance. China

Unicom's June IPO surpassed initial size and pricing expectations, reversing trends earlier in the quarter when communications companies had to cut deal sizes and IPO prices to move issuances



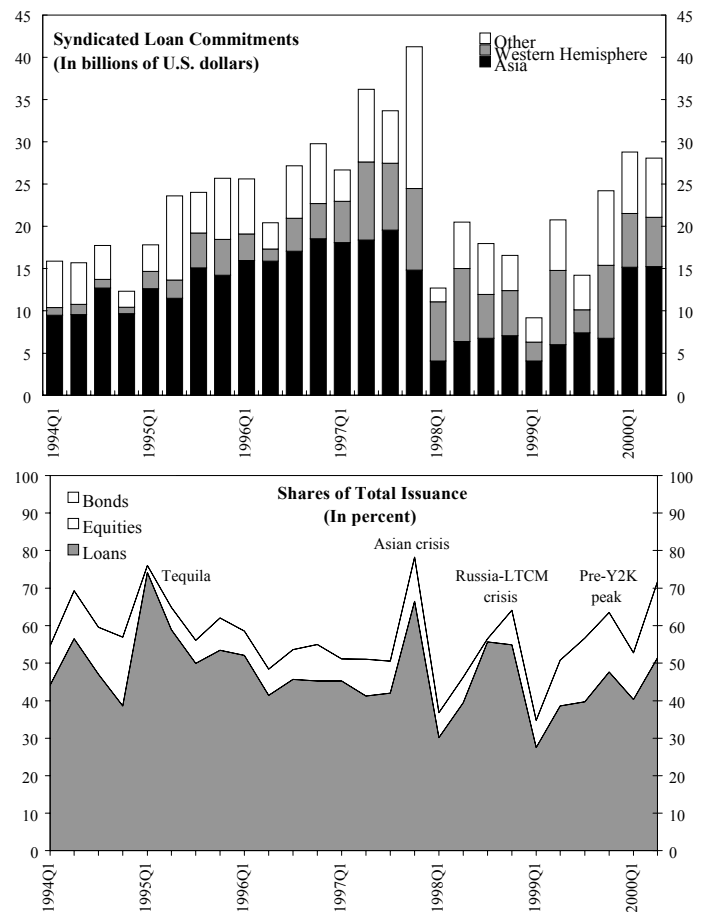
off the shelf. The success of the deal was attributed in large part to renewed interest in China on expectations of imminent WTO entry, and Unicom was seen as a cheaper alternative to competitor China Telecom. TSMC's \$207 mn sale in April fared poorly, caught in the downdraft of the fall in the Nasdaq. Its subsequent \$1.17 bn offering in June on the other hand benefited from the revived interest in TMT stocks, and from Taiwan Province of China's increased weighting in the MSCI indices.

D. Syndicated Lending

In sharp contrast to the bond and equity markets, the syndicated loan market remained **relatively immune to the volatility on international capital markets experienced in the second quarter**. The overall volume of syndicated lending remained steady at \$28.1 bn, compared to \$28.8 bn in the first quarter, conforming with our view in the last quarterly report that syndicated bank lending to emerging markets has indeed reached a turning point from the steep declines following the Asian crisis.

Buoyant activity reflected:

- **Banks' more positive view of corporate credit quality in emerging markets** than in the bond markets. This is not new. As we have noted on several occasions in the past, for a variety of reasons, banks have performed what we have termed the **lender-of-next-to-last resort function**, stepping in when capital markets have closed to borrowers. This is readily apparent from the behavior of the share of syndicated bank loans in total financing of emerging markets on international capital markets. This share peaked around each of the (see chart) emerging markets crises—the Tequila, Asian, and Russian crises—then in the run up to Y2K and again in the last quarter, representing at around half, the **largest component of all fundraising by emerging markets on international capital markets**.



- Abundant **liquidity of banks** in the mature markets, and the continued availability of banks' underutilized **internal risk limits** to emerging markets, which were increased at the start of the year.
- The **return of recapitalized Japanese banks** in the second quarter. After being sidelined for the past two years, a number of Japanese banks have been anxious to recapture lost market share.
- As in the mature markets, an **increase in acquisition borrowing**, particularly in the telecom sector, as mergers and acquisition activity continued to gather pace. The quarter was dominated by a \$9 bn loan (31% of total activity in the quarter) to fund Pacific Century CyberWorks' (PCCW) takeover of Cable & Wireless HK. For borrowers such loans are viewed as a safer alternative to high yield bonds, given the speed with which deals can be put together or cancelled should the planned acquisition not take place, the confidentiality afforded the borrower during the negotiating phase of the acquisition, and the ease with which loans can be refinanced.
- Reflecting high oil prices, a perceived **improvement in credit quality of oil exporters**. Russia's Blue Stream Pipeline secured a \$1 bn loan, in the first sizable international loan syndication for the country since the Russian crisis, while a flurry of Middle Eastern financial institutions tapped the markets.
- Increased use of **political risk insurance (PRI)** in the syndicated loan market for particular countries, with cover regularly being provided by export credit agencies, MIGA, and private insurers. PRI is often used by banks to alleviate their internal country risk limits.
- The increased presence of **foreign partners** in emerging market ventures.

Reflecting the large jumbo loan to fund the PCCW takeover, the composition of syndicated lending to emerging markets continued to shift in favor of **Asia, the recipient of roughly 60% of all loans**. Hong Kong SAR's syndicated loan market was particularly robust, followed by Taiwan Province of China.

The second quarter witnessed, in our view, a **growing supply-demand imbalance** in the syndicated loan market. A lack of demand rather than supply constrained lending to the top-tier emerging market corporates as they continue to turn increasingly to domestic sources of finance, which have been cheaper and do not entail exchange rate risk. We see several **signs of this imbalance**:

- An **increase in competitive pricing pressures**, with spreads declining across regions, and instances of banks looking to increase tenors. With bank appetite for Mexican risk high, for example, oversubscriptions at syndications has been the norm so far this year, with inevitable pressure on spreads. This was illustrated by the increase of Grupo Televisa' \$300 mn 3-year

loan to \$400 mn in response to oversubscriptions, even as pricing was lowered from 150 bps to a tight 125 bps over Libor. Similarly, Turkish banks consolidated their return to the traditional Euroloan 1-year trade financing market, borrowing over \$1.1 bn in the second quarter, while **pricing tightened back to pre-Asian and Russian crisis levels**. Akbank, for example, secured a \$250 mn 1-year financing at 50 bps over Libor, close to its all-time low of 47.5 bps in September 1997.

- There have been growing reports of banks eager to lend, arranging **cheaper bilateral deals** for clients by avoiding syndicate pressures to maintain higher spreads.
- Last quarter we discussed in some detail the increased “**rationalization**” of syndicated loan pricing with bond markets, and the **decline of “relationship” banking**, whereby low spreads on bank loans were justified on grounds they were (an unprofitable) part of a bigger package of services offered (and revenues earned) by banks from their clients. We viewed both developments very positively. While both remain broad features of the market, **competitive pressures eroded the former**, while **several deals were clearly priced aggressively for relationship reasons** during the quarter.

III. STAFF APPRAISAL

There have been two particularly notable features of the performance of emerging market assets and financing on international capital markets this year. First, the behavior of emerging market fundraising in the first two quarters once again starkly illustrated that it is **prone to sharp reversals**. Emerging markets financing boomed in the first quarter to a new post-Asian crisis peak, ranking as the best *first* quarter ever, then fell to complete bust levels in the first two months of the second quarter. Second, emerging market assets **closely mirrored the performance of US markets** in the second quarter, raising questions about the transmission mechanism. Emerging market assets also generally **underperformed** their counterparts in the US, raising questions about whether there was a coincident deterioration of emerging market fundamentals.

A. Boom-Bust Cycles in Emerging Markets Financing

Boom-bust cycles have been a **salient feature of emerging markets financing** in the 1990s: flows built up in 1993 and 1994 until the Mexican crisis in December, followed by the bust of 1995; the longest boom occurred in 1996 and 1997 until the Asian crisis in October-November, followed by bust through much of 1998, and so on. While it may be an exaggeration to label the behavior in the first two quarters as a boom-bust cycle, the point is emerging markets financing in the 1990s has always been volatile and susceptible to abrupt shifts. In our view, there were **some special factors at play** this time around. However, **traditional “factors,” reflecting the nature of the investor base** for emerging market assets, which have always made them vulnerable to sharp swings, were also at play.

The **special factors** at play this time around were:

- The fundraising cycle in the first two quarters was **exaggerated by the global pre-Y2K dry up of liquidity, followed by a post-Y2K liquidity and euphoria driven boom**, which allowed emerging markets—especially many large sovereign borrowers—to pre-finance much of the year’s needs. Some of the boom financing in the first quarter, therefore, simply reflected a **“bunching” of issuance**, resulting from pent-up demand in the run up to Y2K and volumes had been expected to abate in the second quarter. The extent of contraction in flows and the quick rebound with the alleviation of interest rate concerns in the US in June indicates, however, that the constraints to access were binding in the interim.
- The dry up of emerging markets financing **reflected the global drying up of primary markets in the wake of US interest rate uncertainty** and was not limited to emerging markets. Data on the share of emerging markets issuance in global markets indicates, however, that the global dry up had a **more than commensurate impact on emerging markets** fundraising and represented, in our view, the crowding out of emerging markets.
- Part of the decline in fundraising in the second quarter represented a **downward revision** to the payoff from the **US TMT** bet. The buoyancy of the TMT sector has played a key role in elevating the volume of financing flows to emerging markets recently through not only equity placements, but also syndicated bank loans and bond issues. The reduction in flows to emerging markets in the second quarter reflected a reduction in fundraising by the sector globally.

In our view, **one of the fundamental reasons** for boom-bust cycles in flows to emerging markets in the 1990s has been the predominance of a **nondedicated investor base** for emerging market assets that has invested opportunistically in these assets.

- The notion that emerging market debt and equity were separate asset classes drew in and created specialized dedicated emerging market fund managers in the early 1990s. **Dedicated investment** in emerging markets even in the peak boom years of 1995-96, however, **never grew to absorb the majority of international portfolio flows** to emerging markets. The substantial **remainder represented “crossover” investor flows** from global bond and equity funds, and investments from hedge funds and proprietary trading desks of investment and commercial banks. We estimate that currently some 30-40% of emerging market debt, and around 50% of emerging market equity flows come from the dedicated investor base, implying that flows are dominated by nondedicated investors.
- In our view, crossover investors are **“opportunistic” investors** in emerging market assets for whom such investments remain the occasional peripheral investment. Since most emerging market assets do not form part of the benchmark indices against which their performance is judged, portfolio managers can afford “not to be dedicated” to these investments, just taking the occasional small punt. Hedge funds and the proprietary trading

desks of investment and commercial banks, representing speculative capital are, by definition, opportunistic investors. The opportunistic nature of the investor base has **always exacerbated, and sometimes created, the sharp swings in emerging markets financing.**

- This structure of the investor base has also meant a **strong direct link between the performance of the crossover investors' home markets**, to which they are primarily dedicated, and their allocations to emerging markets. The long boom in emerging debt markets during 1996-97, for example, which culminated with emerging market spreads being compressed to a historic low in October 1997, saw substantial crossover flows from high grade and high yield funds in search of higher returns in emerging markets. These flows occurred against the backdrop of low interest rates and credit spreads in the US. These links, in our view, **also largely explain the pullback from emerging markets during the second quarter**, which is discussed in more detail in the next subsection.

B. The Poor Performance of Emerging Market Assets in Q2: The External Environment or Fundamentals?

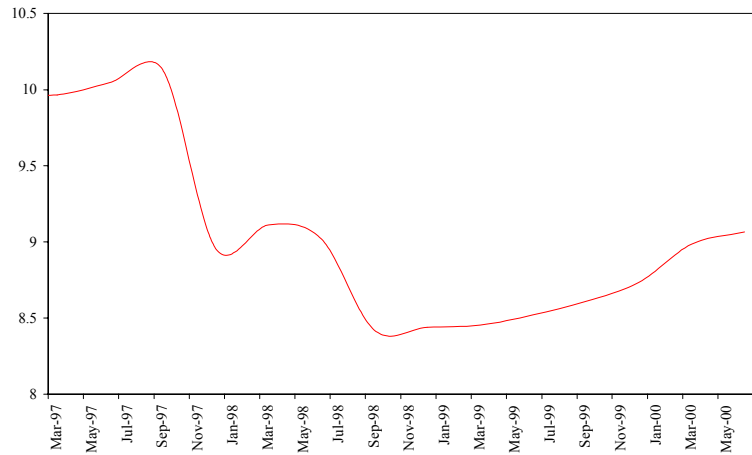
This is a difficult but important question and has been a key focus of market discussion. With most of the emerging markets still recovering from the 1997-98 crises, the answer has profoundly different policy implications. We offer the following observations.

- As an empirical matter, the **close link in terms of timing** between the performance of emerging debt and equity markets with US markets during the quarter **suggests that it was fluctuations in the external environment** that were responsible.
- Was there a coincident deterioration in fundamentals? Any answer is complicated by the fact that the **deterioration in the external environment directly impacted domestic fundamentals**. For example, a transmission of higher US interest rates to local rates would lower asset price valuations and the growth outlook. There are a variety of other such direct linkages: **higher international borrowing costs** and lower access to capital markets imply greater credit risks so a widening of spreads was justified; **trade links**, with a slowing in the US expected to impact emerging market exporters' profits; **direct sectoral links in asset markets**, for example in the TMT sector, where US valuations have served as benchmarks for a highly uncertain sector, and so the correction there should have been expected to lead to corrections in these sectors in the emerging markets.
- **How did markets view emerging market credit quality and fundamentals during this period?** Our **aggregate credit quality index**, which has been rising gradually since October 1998, reflecting a spate of upgrades to sovereign ratings and rating outlooks, indicates a **continued, albeit gradual, improvement in the second quarter** (see chart).

- A second summary measure is provided by **consensus forecasts for GDP growth**. The regional aggregates in the accompanying charts are constructed by weighting the major emerging markets by their respective shares in the IFCI emerging equity market index, thereby providing a market capitalization weighted growth outlook for each of the regions. The charts present consensus forecasts for 2000, but the patterns noted below also apply to 2001. The charts indicate that **despite the increase in US interest rates and substantially increased uncertainty** about the extent and timing of the tightening cycle during the quarter, for the **large segment of emerging equity markets, representing over 90% in terms of market capitalization, there was not only no deterioration, there was in fact an improvement in projected growth**, which should have been positive for the markets.

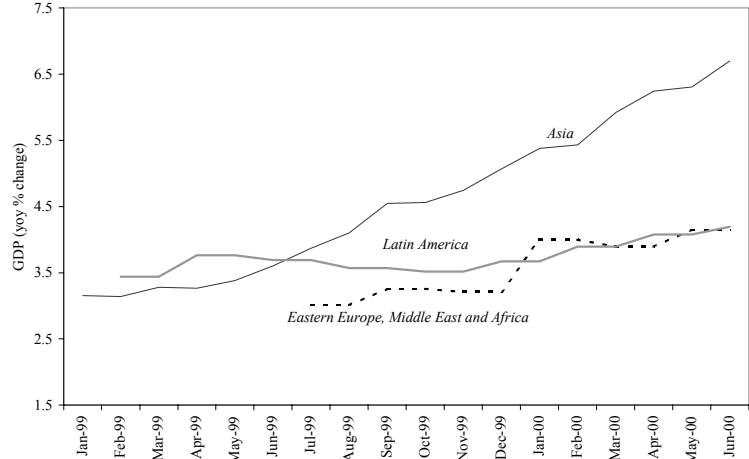
- * The market consensus forecast for **Asia** continued to be **revised upward**. There were some exceptions—Indonesia, Thailand, and the Philippines—though they represented only a small share (7%) of the region’s market capitalization.

Emerging Markets Credit Quality Index



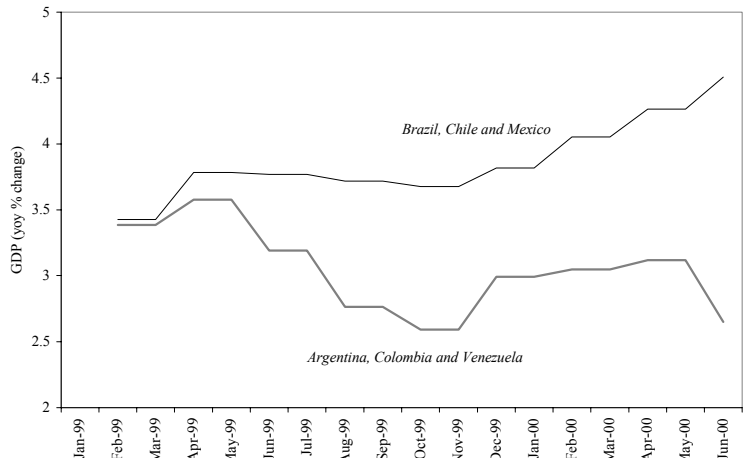
Sources: IMF Staff estimates

Evolution of 2000 GDP Growth Forecasts



Sources: Consensus Economics and Staff Calculations

Evolution of 2000 GDP Growth Forecasts: Latin America Breakdown



Source: Consensus Economics and Staff Calculations

- * Forecasts for the major **European emerging markets** continued to be revised up.
- * In **Latin America**, the outlooks for the larger markets of Brazil, Chile and Mexico, which comprise almost 90% of the region's equity markets were revised up. On the other hand, the outlooks for Argentina, Colombia, Ecuador and Venezuela were revised down.
- The picture is **quite different for the emerging debt markets**, where Latin America dominates the key indices. The **countries** (Argentina, Colombia, Ecuador, Venezuela) **for which the outlook deteriorated represent a substantial 33%** of the emerging debt market universe (using EMBI+ weights), with Argentina alone accounting for almost a quarter.
- These summary indicators of aggregate credit quality and the markets' outlook for growth support **our reading of the consensus international investor sentiment, and our view, that in the emerging equity markets any deterioration in economic fundamentals during the second quarter was relegated to a modest share of the market.** If anything, for the remainder of the market, return fundamentals as proxied by the growth outlook improved. In the debt markets, the fundamentals, as proxied by the growth outlook, of a more significant share of the market—around a third—deteriorated.
- The relevant fundamentals relate, of course, not only to returns but also to risks, though the latter are harder to quantify. There was clearly an **increase in perceptions of local risk** in particular markets. For example, due to the elections in Mexico, the fallout from the troubled Investment Trust Companies in Korea, and more broadly concerns about the extent of the progress with financial and corporate sector restructuring in the crisis affected countries in Asia. All of these were, however, **identifiable as relatively country-specific.**
- We, therefore, **interpret the broad-based withdrawal from emerging markets**, as demonstrated by the fact that every major emerging equity market fell, and the overwhelming majority of credit spreads rose during the quarter, as indicating that **the poor performance was due to the external environment rather than a broad change in investor perceptions of emerging market fundamentals.**
- If it was not a change in broad investor perceptions or sentiment about emerging market fundamentals, what then caused the broad-based pullback from emerging markets? **In our view**, it was the **variety of factors emanating from the mature markets**, all of which in concert **encouraged international fund managers to reallocate portfolios away from emerging market assets.** In addition, there was some negative fallout from other segments of the investor base.
- * **Higher** (risk-free) **interest rates** in the mature markets and **greater uncertainty about the course of interest rates**, each prompted an increase in holdings of cash (dollars) by both dedicated and global, bond and equity fund managers. This is borne out by survey data of fund managers across asset classes. The increased allocation to cash represented,

along with a retrenchment from other markets, a pull-back from emerging debt and equity markets.

- * The **sharply increased volatility of the Nasdaq** during the quarter **raised the value at risk** of any portfolio including stocks from the sector and those correlated with it. As fund managers attempted to maintain preferred Sharpe ratios—returns adjusted for volatility—of performance for overall portfolios, this encouraged a retrenchment from **other high-volatility assets**, which included emerging market assets.
- * **Greater uncertainty about the outlook for the US economy**, in particular whether there would be an eventual hard or soft landing, with implications for the global economy, **encouraged fund managers across the board to move closer to their benchmark indices**. In a period of increased uncertainty, when the probability of a large movement in the benchmark index increases, but it is unclear which direction it will be in, it does not pay to take off-index bets, since the punishment for deviations can be high in terms of poor performance relative to the index. Being neutral relative to the index on the other hand means the fund manager mimics the performance of the index regardless. We noted in the last subsection the **importance of crossover investors for both emerging debt and equity markets**. **For these investors, emerging market assets represent an off-index bet**, that is, these assets are not included in the indices against which their performance is benchmarked. **Moving closer to their benchmarks indices, therefore, entailed a retrenchment from emerging markets**.
- * **Crossover high grade and high yield fund managers sold off** emerging market allocations. This was partly due to spreads becoming more attractive in their home markets, and in the case of high yield fund managers, continued redemptions.
- * The quarter saw the **closures of the two biggest macro hedge funds** (Soros and Tiger) who had traditionally been important investors in emerging markets. Though their involvement appears to have been decidedly more limited recently, the closures of their funds did spark some selling of emerging market debt as positions were closed out.

C. Outlook and Risks

The close association of the performance of emerging market assets with US financial markets reflected, in our view, primarily portfolio rebalancing by international investors in response to a variety of factors emanating in the mature markets. Indeed, these factors reflected **deteriorations in almost all of the factors on our list of risks** for emerging market assets we **noted last quarter**: larger than expected tightening in mature market interest rates; corrections and volatility in “old” and “new economy” mature market equities; deterioration in the US high grade and high yield fixed income markets; and overweight positions of local entities in some key issuing countries. Unfortunately, the **potential for further negative impacts from each of**

these sources remains as much a concern as it did a quarter ago. In addition, there remains the risk of a sharp correction of the US dollar.

In a sense the performance of emerging market assets largely reflected “technical” forces in that perceptions of emerging market fundamentals, by-and-large remained positive, though to somewhat different degrees in debt and equity markets, and relative valuations of emerging market assets, especially equity, remain favorable. Both fundamentals and relative valuations remain supportive of a decoupling of emerging from US markets. When will **emerging markets decouple from US markets?**

- On the **positive side**, first, the broad-based retrenchment by international investors from emerging markets during April and May, which so far appears only partially reversed in June, places emerging markets in a **better “technical” position**, in that it has reduced the potential for crossover investor selling of emerging market assets in response to negative shocks, increasing resilience in the face of further negative shocks. Second, as we discussed in some detail last quarter, international debt investors’ **underweight positions in Mexico** following its upgrade to investment rating has positive implications for the rest of the emerging markets. As these investors increase allocations following the successful elections there, and on expectations of an upgrade by S&P, dedicated investor funds for other emerging markets should be freed up, again implying some decoupling.
- On the **negative side**, in our view, the most important factor is the uncertainty surrounding the prospects for a soft versus hard landing in the US, and a **decoupling is unlikely until there is a convincing resolution in favor of a soft landing**. Increased perceptions of a hard landing in the US will undoubtedly be negative for the emerging markets as it would likely imply a deterioration in all the factors on our list of risks noted above. The **high correlation recently** between emerging and US assets will likely further **undermine the notion of emerging market assets as a separate asset class**, offering high yields with the benefit of diversification, and will create **further redemption pressures on the dedicated investor base**. The **deterioration in the mature credit markets**, especially the high yield sector, will **continue to cap emerging market spreads**.
- In the event of a positive outcome, i.e., increased perceptions of a soft landing, **we expect that debt markets will decouple earlier than equity markets**. In equity markets, the sectoral link between the US and emerging TMT sectors remains strong, while TMT has grown to account for a significant share of the broad markets. A decoupling of emerging debt markets from US markets will, however, by lowering discount rates, itself encourage a decoupling of equity markets.

In the **emerging bond and equity markets**, we expect **choppy conditions, with issuers forced to exploit windows of opportunity** until a resolution of the uncertainty about the prospects for a soft landing in the US. In the near term, issuance will slow in US and Euro markets as we move closer to the summer vacation period, with August anticipated to be a very slow month. As

markets come back on line in September, the pace will be set by the state of expectations about US interest rates.

In the bond markets, the largest provider of financing for emerging markets in the 1990s, the **financing needs of the major sovereign borrowers for this year have already been met** (see table). This absence of major new financing by the largest sovereign borrowers creates a **window of opportunity for corporate issuers**, for whom access has been severely limited for some time now, **and other smaller sovereign borrowers**, before the major sovereigns come back to market towards the end of this year to begin pre-financing

External Financing Needs Accomplished by June 30, 2000
(in US\$ bn)

	Total Needed	Issued YTD	Share (in %)
Argentina	9.8	8.8	90
Brazil	3.9	4.6	119
Colombia	1.5	1.0	69
Mexico	3.0	3.0	99
Turkey	6.0	5.7	95
Philippines	1.6	0.8	53
Total	25.8	24.0	93

Source: Bondware and Staff Estimates

for next year. The pipeline of smaller emerging markets issuers in the Japanese Samurai market has been increasing and we believe most will be able to successfully issue, with issuance at around current levels in both Q3 and Q4. The **prospective shift in the composition of borrowers** from large sovereigns **to smaller sovereign and corporate deals** suggests the **overall volume of flows can be expected to decline**. For several of the larger sovereign borrowers, whose financing needs for the year have been met, we expect liability management operations such as **Brady-eurobond swaps to take center stage** (see Box 2). Market reports suggest that currently both Brazil and Venezuela are considering further Brady-eurobond swaps in the third quarter. Another major swap will be Russia's exchange of the \$29 bn in old London Club Prins and Ians for about \$22 bn in new eurobonds.

We expect the **outlook for emerging equity markets** and new financing to remain **closely tied to the outlook for the US TMT sector**, as TMT now accounts for a substantial share of the broad emerging market indices, and from which a substantial chunk of new issuance has come. The fact that TMT stocks are typically "longer duration" stocks in that their earnings stream is expected further out in time relative to old economy stocks, suggests that price volatility will remain high, especially when compared to old economy stocks.

We expect the **syndicated loan market**, the largest provider of financing for emerging markets in the second quarter, and the mainstay for (top-tier) corporates, to **continue to be relatively resilient to fluctuations in global capital markets** of the order of magnitude observed in the second quarter. In the event of increased perceptions of a hard landing in the US economy, however, deteriorations in loan quality could have implications for capital devoted to emerging markets. In the meantime, we expect **continued downward pressure on pricing** across the board, as international banks' liquidity remains abundant, they compete with local banks to provide financing to emerging market entities, and banks such as the Japanese re-enter the business, especially in Asia.

Box 2. Brady-Eurobond Swaps

From a liability management perspective, Brady-eurobond swaps can provide up-front cash, net present value (NPV) savings, and extend the duration (maturity) of existing debt. Since Mexico's Brady-eurobond swap in April 1996, a number of countries have completed such swaps in the last four years, **extinguishing around a fifth of the total stock of Bradys** (\$150 bn in 1996; in addition an unspecified number of Bradys have been bought back by various sovereigns in the secondary market). The one Brady-eurobond swap during the second quarter was done by Argentina (its third, extinguishing \$3.3 bn worth of Brady bonds for \$2.4 bn in 15-year eurobonds). The swap received mixed reviews by investors, renewing debate on what constitutes a "good" Brady-eurobond swap.

There are a variety of different **goals** a Brady-eurobond swap can seek to attain:

- Generate **nominal debt service savings and extend the maturity and duration** of external debt by replacing Bradys that begin amortizing in the near term by longer-term bullet payment eurobonds. Extending duration can help **delineate and extend the sovereign's yield curve**.
- **Free up the collateral** held against certain Bradys for both fiscal revenue and/or financing purposes.
- Capture the spread differential between Bradys and eurobonds resulting in **NPV savings**.
- **Improve the liquidity** of outstanding bonds by allowing holders of illiquid bonds to tender these bonds, at a small discount, for new larger issue size vanilla eurobonds.
- **Raise new money**. Several swaps in the past have included a new money element.

There are three aspects of **execution** of a Brady-eurobond swap that are important for achieving these goals:

- Sequencing can be important. Issuing an exchange bond wide of the existing eurobond yield curve when it is well defined, will encourage switching and can result in a widening of the whole curve. When a well defined yield curve does not exist, as noted above, the swap can serve to define it. It has been argued that a sovereign can limit the damage on its yield curve by distinguishing purely liability management swaps from those which also attempt to raise new money.
- From a pricing point of view, there are advantages of announcing the debt exchange to the broader market just before, or just after, completion of the deal. If there is a long delay between announcement and execution, secondary market price adjustment make a potential exchange less profitable for the sovereign.
- The eventual success of the exchange depends on the extent to which investors holding the targeted to-be-exchanged bond are interested in the new exchange bond (which is usually tailored to fit the sovereign's need).

A Brady-eurobond swap can, therefore, have multiple objectives. The swaps carried out during 1996-97, when market access was good, were very successful in terms of liquidity management, with emerging market sovereigns able to place new eurobonds at previously unheard of maturities (all the major Brady sovereigns issued 30-year bonds in their first swaps). In the year following the Russian crisis, reflecting the limited access of most emerging market sovereigns to international capital markets, Brady-eurobond swaps suffered a temporary lull. Expectations of Ecuador's default last year caused Brady-eurobond spreads to widen substantially, prompting many sovereigns (Mexico, Uruguay, the Philippines and Brazil) to capture this differential in NPV savings through smaller swaps. The most recent string of swaps (Argentina in June, Brazil in July, and rumors of large imminent swaps by both Brazil and Venezuela) suggest they can again play a useful role in extending the sovereign's yield curve to new tenors, while creating a more "efficient" and liquid dollar-denominated eurobond yield curve going forward.