World Economic and Financial Surveys

Global Financial Stability Report

Market Developments and Issues

September 2002

International Monetary Fund

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CONTENTS

Tables

Figures

The following symbols have been used throughout this volume:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 1997–99 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 1998/99) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

"n.a." means not applicable.

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this volume the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

PREFACE

This is the third issue of the *Global Financial Stability Report*, a quarterly publication launched in March 2002 to provide a regular assessment of global financial markets and to identify potential systemic weaknesses that could lead to crises. By calling attention to potential fault lines in the global financial system, the report seeks to play a role in preventing crises before they erupt, thereby contributing to global financial stability and to the prosperity of the IMF's member countries.

The report was prepared by the International Capital Markets Department, under the direction of the Counsellor and Director, Gerd Häusler. It is managed by an Editorial Committee comprising Hung Q. Tran (Chairman), Donald J. Mathieson, David Ordoobadi, and Garry J. Schinasi, and benefits from comments and suggestions from Charles R. Blitzer and Effie L. Psalida. Other contributors to this particular issue are Francesc Balcells, Peter Breuer, John Dalton (of the IMF's Monetary and Exchange Affairs Department, or MAE), Burkhard Drees, Martin Edmonds, Anna Ilyina, Charles Kramer, Gabrielle Lipworth, Chandima Mendis, Chris Morris, Martin Mühleisen, Jurgen Odenius, Jorge Roldos, Calvin Schnure, Srikant Seshadri, Mazen Mahmoud Soueid, and Ken Sullivan (MAE). Mansoor Gill, Silvia Iorgova, Anne Jansen, Oksana Khadarina, Yoon Sook Kim, Advin Pagtakhan, and Peter Tran provided research assistance. Caroline Bagworth, Jane Harris, Vera Jasenovec, Ramanjeet Singh, Adriana Vohden, and Joan Wise provided expert word processing assistance. Jeff Hayden of the External Relations Department edited the manuscript and coordinated production of the publication.

This particular issue draws, in part, on a series of informal discussions with commercial and investment banks, securities firms, asset management companies, insurance companies, pension funds, stock and futures exchanges, and credit rating agencies in Brazil, Chile, China, Germany, Hong Kong SAR, Hungary, Italy, Japan, Poland, Russia, Singapore, Switzerland, Thailand, the United Kingdom, and the United States. The report reflects mostly information available up to August 12, 2002.

The study has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors following their discussions of the *Global Financial Stability Report* on August 28, 2002. However, the analysis and policy considerations are those of the contributing staff and should not be attributed to the Executive Directors, their national authorities, or the IMF.

CHAPTER I

OVERVIEW: KEY DEVELOPMENTS AND SOURCES OF FINANCIAL MARKET RISKS

During the period under review, a sharp erosion of investor confidence, heightened risk aversion, and growing concerns about the strength and durability of the global recovery and the pace and quality of corporate earnings had repercussions in all of the major equity, credit, and foreign exchange markets (see Chapter II). Market adjustments occurred against the background of the bursting of the telecom, media, and technology (TMT) bubble, which exposed a culture of irrational exuberance, and sometimes greed, among many buyers, sellers, and intermediaries, and most recently some senior executives who adopted business practices—some unethical and illegal—to boost their companies' share prices at any cost. First, major equity market indices declined significantly and by early August were near or below levels not seen since the autumn of 1998, when global markets were unsettled by Russia's default and the near-collapse of the global hedge fund, Long-Term Capital Management (Table 1.1). Second, as U.S. corporate bankruptcies hit records, institutional investors and banks discriminated more clearly between classes of borrowers and reduced lending to high-risk borrowers. As a result, corporate credit spreads widened, and speculative grade borrowers faced dramatically higher borrowing costs. The credit deterioration also created a record number of "fallen angels" whose outstanding bonds were downgraded from investment grade to junk status. Third, the dollar continued to depreciate against the other major currencies, reflecting reductions in foreign portfolio flows into U.S. equity markets and in foreign direct investment. The dollar's decline, together with the continuous stream of accounting irregularities in the United States and the relative absence of them elsewhere so far, intensified concerns about how much further the major currencies would be realigned

Second Quarter at a Glance

Conditions in global financial markets have deteriorated significantly since end-March 2002, reflecting a sharp erosion of investor confidence and heightened risk aversion. During the reporting period, corporate earnings disappointments, increased pessimism and uncertainty about the earnings outlook, and a series of revelations of corporate accounting irregularities, abuses, and fraud shifted the balance of investor sentiment from caution to anxiety, sometimes bordering on fear. This was accompanied by short periods of extremely high volatility and market contagion.

The bursting of the telecom, media, and technology (TMT) bubble continued to weigh on global equity markets, as institutional investors rebalanced their portfolios away from equities and low-grade bonds—seen as riskier than before—and toward higher quality assets, such as government securities, high-grade corporate bonds, and cash. The rebalancing of portfolios sparked significant declines in equity markets reaching well beyond the TMT sector, greater discrimination in credit markets—including a widening of credit spreads—and a further move away from dollar assets. Consistent with this global asset reallocation, investors reassessed their appetites for emerging market investments, which adversely affected countries seen as higher risk.

Despite significant corrections in a range of markets, as of early August 2002, the global financial system had remained resilient, in part because risks have become more widely spread in recent years. In addition, market adjustments remained orderly and stopped short of the kind of overall flight from risk that might derail the global recovery or threaten financial stability. But key risks remain, in particular that retail investors will begin to liquidate their equity holdings and that foreign investors will significantly reduce investment in U.S. equity markets.

Table 1.1. Financial Market Data
(Percentage change; unless otherwise noted)

	Change to August 12, 2002 from			
	Peak (March 24, 2000)	September 11, 2001	December 31, 2001	March 29, 2002
Equity market				
Major stock indices[1]				
S&P 500	–40.8	–17.3	–21.3	–21.2
Nasdaq	–73.7	–22.9	–33.0	–29.2
FTSE Eurotop 300	–43.0	–14.6	–25.2	–26.3
Topix	–41.5	–9.3	–7.0	–9.5
Bank indices				
S&P 500 bank index	12.5	5.1	2.5	–5.1
FTSE Eurotop 300 bank index	–18.1	–8.4	–20.7	–22.4
Topix bank index	–51.5	–31.2	–5.5	–3.0
Bond market				
U.S. corporate bonds				
Yields (level change; basis points)				
AAA	–123	–54	–21	–50
BAA	–70	–16	–29	–60
High-yield bonds	155	92	78	155
Spreads (level change; basis points)[2]				
AAA	74	1	62	68
BAA	127	39	54	58
High-yield bonds	352	147	161	273
U.S. corporate bond price indices[3]				
AAA	. . .	2.5	3.2	5.3
A	. . .	1.1	2.2	4.1
BBB	. . .	–7.7	–5.9	–3.1
Government bond yields (level change; basis points)[4]				
United States	–197	–55	–83	–118
Germany	–71	–27	–46	–72
Japan	–61	–16	–11	–14
Government bond price indices[5]				
United States	11.5	2.5	5.8	9.3
Germany	7.5	6.3	4.9	7.7
Japan	4.9	1.4	0.4	1.3
Exchange rates				
Euro/U.S. dollar	–0.1	–6.7	–9.1	–10.9
Yen/U.S. dollar	11.3	–0.4	–9.6	–10.4
Trade-weighted nominal U.S. dollar[6]	5.9	–2.8	–6.6	–7.0

Sources: Bloomberg L.P.; and Datastream.
[1]In local currency terms.
[2]Spread over a 10-year U.S. treasury bond.
[3]Merrill Lynch corporate bond indices.
[4]Ten-year government bonds.
[5]Merrill Lynch government bond indices, 10+ years.
[6]Changes from August 9, 2002.

and doubts about the sustainability of capital flows needed to finance the U.S. current account deficit.

At the same time, the favorable climate for emerging market financing of the first quarter deteriorated quickly as investors reassessed the pace of the global economic recovery and global financial conditions (see Chapter III). The loss of investor confidence worldwide contributed to substantial price declines and increased volatility in emerging bond and equity markets, even though emerging market bonds and equities have outperformed similar U.S. and European assets so far this year. Investor concerns were especially focused on, but not limited to, emerging market countries whose economic reform agendas could be affected by domestic political uncertainty. Signs of contagion surfaced, especially toward the end of the quarter, as movements in emerging market bond markets became more correlated with developments in Brazil, but less so than in previous crises. In addition, countries in the neighborhood of Argentina experienced contagion through banking and real sector channels. The relatively open market access that prevailed in the first quarter was also partially reversed. Primary markets were effectively closed to subinvestment-grade issuers in Latin America, unless they offered credit enhancements. Issuers with solid credit ratings and those in Asia, Eastern Europe, and the Middle East retained market access, however. Given that sovereign borrowers actively prefinanced their borrowing programs, Latin American corporate borrowers are the most vulnerable to prolonged market closure.

As of early August 2002, despite dramatic asset price movements and significant financial losses for investors worldwide, the global financial system remained resilient. Part of this resilience, no doubt, is related to the wider dispersion of corporate and financial risk to nonbank financial institutions. Another important element is the greater participation of retail investors—that is, households—in U.S. equity markets, and, increasingly so, in European equity markets. Market adjustments to date can be judged as having been orderly and contained, stopping short of the kind of widespread withdrawal from risk taking that could derail the global recovery. As this report went to press, markets remained concerned about the strength of corporate earnings, the reliability of earnings reports, the likelihood of further corporate scandals in the advanced economies, and prospects for macroeconomic and financial stability in the emerging market countries. In addition, global financial institutions are realizing that the profitability of wholesale banking has diminished, only in part because of the ending of a boom, and accordingly are reevaluating their business models. In the immediate future, their strategy may well continue to be a further reduction in the amount of capital devoted to wholesale banking, a continued retrenchment from lending to higher-risk borrowers—including many in emerging market countries—and a shift toward providing consumer services. This could aggravate the financing constraints already faced by higher-risk borrowers.

Assessment of Likely Outcomes and Sources of Financial Risk

Looking ahead, and notwithstanding special political and economic problems in important emerging market countries, the most likely outcome is that financial resilience and stability will be maintained. First, the global economy appears to be still improving, although perhaps at a slower pace than expected. Second, the recent market corrections have worn off some of the unrealistically high equity valuations that were once a direct source of risk. This is particularly true in the TMT sector, where continued sluggishness has reduced equity prices by so much that private equity and restructuring funds have attracted net inflows of capital from investors, and might be ready to purchase assets of selected telecom companies and other industrial companies. In so doing, they provide a degree of stability to the market. As of early August 2002, valuations in U.S. and European equity markets had moved closer to longer-term averages from excessive levels (see Box 2.2 in Chapter II). Third, although markets are likely to remain volatile and may even become more so, there is little evidence now to suggest that market dynamics are likely to lead to the kind of liquidity and credit events that could create the potential for systemic problems. While more news of corporate scandals and poor earnings cannot be ruled out in the near term and further global market adjustments may occur, continued value erosions need not adversely affect the economy much. A key to this uncertainty is the behavior of retail investors. If households continue to remain invested in equities, selling pressures could remain contained and negative wealth effects limited. If this occurs, it is a reasonable expectation that the global economic recovery will continue—perhaps at a slower pace than previously expected, as suggested in the IMF's forthcoming *World Economic Outlook*—and that international financial resilience and stability will be maintained.

Nevertheless, risks to international financial market stability emanate from both mature and emerging financial markets. In the mature markets, the most immediate concern is that investor trust and confidence may continue to erode to the point where investors withdraw en masse from financial and economic risk taking. The implosion of the TMT sector in 2000 and that sector's continued weakness raise the concern that further equity price corrections could cascade across markets and thereby trigger liquidity and/or credit events. The likelihood of a pervasive withdrawal from risk taking, including by households, would seem to depend, in part, on whether corporate governance problems continue to surface, in particular in other parts of the world. Such a withdrawal would most likely be associated with further sharp corrections in already weak corporate securities markets, a continued loss of resilience and flexibility by global financial institutions, and a greater withdrawal of lending to even low-risk borrowers. This could create market conditions in which "fear feeds on fear," and panic selling occurs. The short-term risks associated with such a process are well known and entail the potential for global market turbulence, including the possibility of a strong impact on emerging markets; a related risk is that the global economic recovery could be weakened, if not derailed, in part as a result of wealth effects on spending behavior.

A second related source of global risk—but one that is consistent with other scenarios as well—is the possibility that the accumulated losses experienced by financial institutions could impair capital positions of key institutions, or a large number of smaller ones. This could significantly reduce the remaining resilience of these institutions. This is a particular concern in Europe, where TMT and energy companies have been hard hit and face significantly higher funding costs, where insurance and reinsurance companies have fared poorly recently, and where bank stocks overall have been devalued about as sharply as the overall European markets. By contrast, in the United States, bank stocks have fallen by less than the overall market (see Table 1.1). One possible reason for this differentiation is that European insurance companies and banks are more heavily exposed to corporate and TMT risk—in the form of both equity holdings and loans—largely because European corporate finance is still primarily intermediated by financial institutions rather than markets. In addition, for many European banks, their diversification into investment banking and international businesses has produced losses. Additional signs of weakened bank balance sheets would be consistent with, and exacerbate, a further withdrawal of risk taking and lending in the major international financial centers, including from syndicated lending to emerging market countries.

A third ongoing source of risk is the possibility of a rapid slowdown of net capital flows into the United States. During the 1990s, the United States attracted growing amounts of capital from the rest of world, and during the past several years it has absorbed about 70 percent of the world's net savings (current account surpluses). By the end of 2001, net capital inflows reached some $400 billion, in part because the United States was widely perceived as the most desirable place for investing. Throughout the 1990s, inflows into U.S. asset markets and investments were associated with sustained sharp rises in asset prices and a persistent increase in the value of the dollar, which has already begun to decline. To the extent that net inflows decline, some of the dynamics associated with the inflows necessarily will be reversed. While there are significant economic and financial risks, market adjustments—including in currency markets—need not be abrupt or disruptive, in the sense that they create liquidity and credit problems. Partly mitigating the risk of disorderly financial adjustment is the possibility that investors might decide that there are few more desirable places to invest, at least until there are more credible signs of higher growth elsewhere: as noted in the forthcoming *World Economic Outlook*, the pickup in Europe does not yet appear to be self-sustaining; and domestic demand growth in Japan is likely to remain constrained by banking and corporate sector difficulties for some time.

Emerging markets remain vulnerable to a further decline in market sentiment. First, indicators of risk aversion and contagion have increased, even though they remain well below historical peaks. Further shocks could come from developments within key emerging market countries or from a deterioration in mature markets. Second, within emerging markets, developments in Brazil are critical, as a further deterioration in sentiment toward Brazil would likely be felt more widely, especially as investor concerns over policy continuity and debt sustainability span a number of emerging market countries. Third, continued weakness and volatility in mature equity markets, particularly if accompanied by a further downward assessment of global growth prospects, could trigger a further retrenchment from emerging markets.

While confidence in emerging market investments has been shaken and signs of contagion have increased, there are also indications of continued investor discrimination, as certain high-grade credits have remained largely immune to the recent turmoil. In addition, technical conditions in emerging markets have improved, as investors have reduced their exposure and increased cash positions. However, these mitigating technical factors are by themselves insufficient to turn investor sentiment.

Those emerging markets countries that have well-developed local bond markets may be less vulnerable to any further shifts in international investor sentiment. The analysis in Chapter IV suggests that local bond markets could be a relatively stable source of finance during periods when international bond markets are unreceptive to emerging markets. If so, they may help to stabilize financing to emerging market borrowers—sovereigns, banks, and corporates—in periods of heightened stress in international capital markets. In Latin America, for example, the corporate sector faces large debt amortizations, and has switched to the local bond markets. However, this substitution of funding is ongoing, and some corporates and countries face greater difficulties than others. Moreover, some countries—especially with macroeconomic weaknesses—have found it necessary to index local instruments to the dollar, a practice that could lead to unsustainable debt dynamics. More generally, emerging local bond markets have grown considerably over the past five years, and are gradually but steadily becoming an alternative source of funding for sovereigns and, to a lesser extent, corporate borrowers, and this may contribute to international financial stability.

Promoting Global Financial Stability

Concerns about global recovery, eroding investor confidence, and heightened risk aversion have played important roles in the recent deterioration in markets and also shape the risks going forward. By the same token, they also suggest steps that could help to promote stability in global and key national financial markets in the period ahead.

- In *all countries*, there should be increased vigilance by those in charge of financial stability—in the areas of market surveillance, prudential supervision, and financial regulation—for signs of further weaknesses in key institutions and markets that could threaten financial stability and economic recovery globally. Emphasis should be placed—by both executives and their supervisors—on enhancing the soundness of institutions and improving the operating profitability of the core businesses of the various types of financial institutions. In this regard, for each class of institution, actions to ensure that the risks in unfamiliar non-core businesses are well managed might go a long way in securing financial soundness and therefore financial market stability. To complement these actions and bolster confidence in markets, countries can be encouraged to participate in IMF Reports on

Standards and Codes (ROSCs) in the areas of corporate governance, accounting, and auditing, and to subscribe to the OECD's principles of corporate governance.

- In the *advanced economies,* macroeconomic policies should continue to support economic activity, and medium-term policies should continue to foster an orderly reduction in global imbalances. As discussed in the forthcoming *World Economic Outlook*, in current account deficit countries this would entail maintaining credible medium-term fiscal consolidation, while in surplus countries it entails aggressively implementing badly needed structural reforms. Moreover, additional efforts to improve corporate governance, accounting, disclosure, and transparency will most likely be needed to strengthen the self-correcting forces of the market. In particular, governance should provide incentives for prudent accounting and reporting, and for reducing the tendency toward looking to short-term share price developments by senior managers. In light of recent revelations of weaknesses in corporate governance, a more medium-term approach to corporate strategy and to maintaining shareholder value could help enhance the stability of financial markets.
- In *emerging market countries*, the consistent implementation of strong policies aimed at bolstering macroeconomic and financial stability is essential, and could also improve the allocation of capital internationally—by helping investors discriminate more clearly between countries as investment destinations. In countries where domestic saving rates are presently low, and the need for external financing high, authorities should encourage greater domestic savings. In addition, and in order to more effectively channel domestic savings to domestic investment, authorities should further encourage and foster the development of sound banking systems and aggressively diversify their financial systems by strongly encouraging the development of local securities markets to supplement external market financing.