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Challenges Facing Global Financial Markets

WILLIAM R. CLINE

IN THIS PAPER, I attempt to add a few thoughts on the macroeconomic context in which the firm- and institution-level changes are taking place, with an emphasis on emerging markets.

Financial Integration and Regulation

The major presence of international firms in financial markets has made an important contribution to stability in domestic banking systems in a number of emerging-market economies. Argentina is a case in point. More than half of Argentina's banking system now comprises large international institutions. This helped to build confidence in the banking system, which in turn helped to avoid a run on bank deposits after the Russian and Brazilian crises comparable to that following Mexico's 1995 crisis. In view of the critical role that weak domestic banking systems played in the East Asian crisis, Argentina's experience suggests that increased openness in financial services can play a major role in stabilizing the domestic banking system.

The views expressed here are those of the author and should not be attributed to the Institute of International Finance.

A conspicuous challenge to the advisability of financial integration is the case of Malaysia and its controls on portfolio capital outflows. I suspect that an in-depth evaluation of Malaysia's experience would show that, at most, Malaysia is the exception that proves the rule. Malaysia's dismantling of the quantitative controls in less than six months and more recent phasedown to a moderate tax have limited the long-term damage that otherwise could have occurred. The short-term gains are likely to have been less than meet the eye, especially because most of the sell-off of foreign stock holdings had already occurred before the controls were imposed in September 1998.

The Basel Committee's proposals on capital adequacy requirements are another salient theme in the changing microeconomics and regulation of global finance. This is a complicated area that will require thorough evaluation. Several issues will need to be resolved. First, the heavy reliance on ratings agencies in setting capital requirements raises numerous concerns, most obviously regarding substantial business and geographic areas not currently covered by ratings, but more fundamentally regarding the reliability of ratings and implied responsibilities for them. Second, aspects of arbitrariness remain despite departure from a uniform 8 percent requirement, such as the strict tiering of a bank or corporation below the sovereign of its residence. Third, it seems likely that in numerous cases the new rules will raise the cost of capital in emerging-market economies, and the benefits of this outcome in terms of reduced financial system risk need to be weighed against the possible costs in terms of slower economic growth.

State of Emerging Markets

Let me turn now to the macroeconomic side of global financial markets and in particular to emerging capital markets. These markets remain in a nervous, even moribund, state. Yet it has been two years since the height of the East Asian crisis. Except for Indonesia, that acute liquidity crisis was handled decisively and broadly successfully. Korea and Thailand in particular have made strong comebacks. One might have thought that by now there would have been time enough to rebuild confidence in emerging markets. Instead, for 1999 net private capital flows to twenty-nine major emerging-market economies will remain about the same as the 1998 low

Figure 1. Net Capital Flows to Emerging Markets, 1992–2000

Billions of U.S. dollars

Source: Institute of International Finance.

of \$135 billion, down from their peak of \$335 billion in 1996 (figure 1). Only a modest upturn is likely in 2000. Moreover, the collapse in net credit flows from banks, bonds, and other lending sources has been much greater, from \$207 billion in 1996 to \$9 billion in 1998 and a net outflow of \$6 billion in 1999. In fact, net lending from banks has been negative and only approximately offset by bonds and other nonbank credits. Only direct equity investment has remained relatively strong throughout this period.

Similarly, as shown in figure 2, the interest rate spreads on emerging-market lending above U.S. Treasury rates have remained extremely high. For example, in October 1999 the thirty-year eurobond for Argentina had a spread of almost 800 basis points. This is equivalent to the market placing virtually a 100 percent probability on a default by Argentina with recovery of only 50 percent of present value. Such spreads show a continued state of severe risk aversion and great distrust of emerging markets following the crises of 1997–98.

—*Timing.* One reason for the persistence of fragility is the timing of the spread of the emerging-market crisis. Russia's collapse occurred in mid-1998, and its default continues. Brazil's currency crisis is even more

Figure 2. Eurobond Spreads, 1997–98

Basis points

Source: Institute of International Finance.

recent, although it so far has been overcome with considerable success. More time is likely to be needed in order for investors to regain broader confidence in these markets.

— *Politics*. Recent political developments in several countries have also tempered the rebuilding of confidence. In July 1999 a candidate in the Argentine election said he would ask the Pope to condone a year-long debt moratorium. That candidate's campaign adviser was subsequently fired, and the candidate lost the election, but the impact on market sentiment was not favorable. In Venezuela, the president seems to be flirting with a popular democracy lacking institutional checks and balances, again hardly reassuring to investors. And in Indonesia, East Timor dampened signs of a turnaround earlier in the year.

— *Differentiation*. The volumes and average spreads also hide signs of strength. Continued outflows in Korea and Thailand reflect deleveraging in a context of strength. Spreads are sharply down from their peaks in most of East Asia and continue at their customary low levels in the European Union candidate countries.

— *Official sector policies*. International official policies have arguably contributed to a lack of confidence in emerging markets by shifting from a forceful stabilizing role up through the Brazil crisis to what seems to be

a new phase intent on bailing in the private sector. Now that the systemic threat from the big countries has eased, international officials seem to be experimenting with the small countries—Pakistan, Romania, Ukraine, Ecuador—by sending signals that one way or another the private sector will be bailed in. Unfortunately, this could prove penny-wise and pound-foolish by undercutting the very confidence that the earlier large rescue packages had sought to restore.

Perhaps most questionable is the seeming international official endorsement of Ecuador's rescheduling of Brady bonds, as suggested both by statements of Ecuadorian officials and by the International Monetary Fund's acceptance of a letter of intent shortly after the Brady default toward the end of September. These claims had already forgiven forty-five cents on the dollar in 1994, and one would have thought they would have had seniority as a result. Moreover, the initial cash flow relief accorded by the suspension of payment could be minimal because the bonds have interest collateral that may have to be paid. More broadly, however, it is important that the official sector not seize defeat from the jaws of victory in its strategy on emerging-market debt.

The rallying cry of those who would bail in the private sector on an involuntary basis is "Moral Hazard." Studies at the Institute of International Finance have estimated large losses in these markets, on the order of \$350 billion in 1997–98, that cast strong doubt on any moral hazard incentive to overinvest in the future despite the official rescue support. The Institute of International Finance has recently completed a statistical study rejecting the notion of moral hazard in these markets following the international support given to Mexico in 1995.¹

A model that explains spreads with country economic variables—debt relative to exports, reserves relative to imports, and inflation—and global capital market conditions as represented by spreads on high-yield U.S. corporate bonds finds no additional reduction in spreads in 1996 to early 1997 as a result of Mexico-induced moral hazard. Buoyant international liquidity was the driving force in falling spreads in this period, not moral hazard, with the politically based exception of Russia.

In short, official policy seems to be flirting with adding to emerging-market risk at a time when these markets remain fragile. Moreover, the conceptual framework for doing so—moral hazard—does not seem to be

1. Institute of International Finance (1999).

supported by the facts. Indeed, it is a puzzle how the moral hazard argument persists when emerging-market spreads continue at levels that, in general, surely are too high rather than too low.

G-7 Macroeconomic Risk

Finally, the macroeconomic environment for global financial markets would seem to contain risk from growing questions about economic imbalances among the industrial countries. For some time the U.S. economy has been the principal or even sole locomotive in the world economy, and U.S. growth was crucial in particular to providing a “consumer of last resort” function for the world economy in the face of the shock from the East Asian financial crisis. It is reasonable, however, to question the sustainability of this role.

For its part, the International Monetary Fund has clearly stated its concern that a hard landing in the United States could shock the world economy. In particular, a sharp correction in the U.S. stock market could severely disrupt global financial markets, while undermining consumption growth in the U.S. economy. Figure 3 shows the divergence in recent years between the sharply escalating Dow Jones industrial average and the brisk, but much more moderately rising, aggregate profits of U.S. nonfinancial corporations. This divergence suggests that there is at least some risk of a major correction. It is an open question whether we may be experiencing a sort of “asset illusion” that is analogous to “money illusion,” but in a stable-price environment. Asset illusion exists if market participants bid up the price of financial assets to levels inconsistent with the growth of the economy’s productive capacity in the future to permit conversion of the assets into commensurate goods for consumption.

Another potential disequilibrium is in the external sector. The most recent consensus forecasts place the U.S. current account deficit at about \$315 billion in 1999 and \$335 billion in 2000. Although recession in Japan and key emerging-market countries and the resulting U.S. role as consumer of last resort are partly the cause, so is the 25 percent rise in the real value of the dollar from mid-1995 to mid-1999. If there is an abrupt shift of capital away from the United States, there could be a sharp rise in U.S. interest rates and consequent pressure on the stock market and, as a result, on private consumption.

Figure 3. Dow Jones and Corporate Profits

Index (1987–90 = 100)

Source: Datastream.

Figure 4 shows the path of the U.S. current account deficit, which reached a peak of about 3.5 percent of gross domestic product (GDP) in 1987 and is now headed back to that record level. The figure also shows perhaps the most important good news for the U.S. economy, however. The fiscal balance has turned from its chronic deficit, which reached 6 percent of GDP in 1983 and was still about 5 percent at the beginning of the 1990s, into a surplus of 1.7 percent for next year. The coexistence of a large external deficit with a sizable fiscal surplus means that domestic saving by households has fallen so sharply that domestic investment still exceeds domestic saving despite the elimination of government dissaving. This raises questions about the sustainability of growth when and if household saving rebounds and consumption growth moderates to more traditional rates.

The base case still remains one of soft landing. The U.S. equity market could return to somewhat more normal pricing by holding steady for a considerable period after its sharp run-up. With a sideways-moving market, household consumption growth could moderate rather than implode. Low U.S. inflation and high productivity growth would make it possible to avoid any sharp increase in interest rates. The external adjustment would

Figure 4. Current Account and Fiscal Balance, 1979–2000

Percent of GDP

Source: International Monetary Fund, *International Finance Statistics*; Council of Economic Advisers, *Economic Report of the President*.

occur gradually as the rest of the world recovers. Nonetheless, the hard-landing alternative seems likely to pose a significant risk to global financial markets for some time to come.

Conclusions

In sum, the trends toward global financial market consolidation outlined in this volume hold great promise for increased efficiency in the international allocation of capital and hence improved prospects for global growth. There is still a great need for rebuilding confidence in emerging capital markets in particular, however. It will be crucial for international official policies to nurture the recovery of these markets rather than push them into an even more depressed state. Potential imbalances in industrial economies will need to be overcome as well. Dexterity in the design of macroeconomic policies will be essential if the macroeconomic envi-

ronment is to be maintained in a condition that permits the efficiency gains from microeconomic and institutional restructuring to be fully realized.

Reference

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