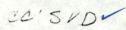
DIV. 3 1992-93 CLOSOD CAPITAL MARKETS SURVEILLANCE

1995-007-1

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M. Saits





To:

The Acting Managing Director

October 15, 1993

Heads of Departments, Bureaus and Offices

From:

Michael Mussa

Subject: Outline for International Capital Markets Board Paper

In response to Mr. Van Houtven's request, I attach the outline for the proposed 1994 Capital Markets Board paper.

The Managing Director (o/r)

Ms. Saunders

Attachment

Outline for International Capital Markets Board Paper

I. Government Securities Markets

This section will examine a number of issues linked to the operation of government securities markets in industrial countries including:

- 1. The scope for governments to reduce the cost of their borrowing though active debt management, including an analysis of whether authorities should shorten average debt maturity to benefit from low short-term interest rates.
- 2. The implications of increased participation by institutional investors in government securities markets.
- 3. Lessons (about issuing techniques and the like) from countries that have restructured their debt management offices.
- 4. An analysis of pricing of credit risk in major government securities markets.
- 5. The role of "market discipline" in the behavior of sovereign borrowers.
- 6. Clearing, settlement and payment systems in government securities markets: Can they accommodate large future increases in trading and issuing volumes?
- 7. The role of government securities as "benchmarks" for pricing other securities.
- 8. The adequacy of the supervisory and regulatory framework.

II. Short-term Financial Flows

This section will first evaluate the arguments in favor and against the imposition of various capital controls measures as mechanisms to slow short-term capital flows and to reduce the volume of transactions in major capital markets. The section will then examine the obstacles that authorities face in their attempts to restrict short-term flows. The analysis will include:

1. A review of the benefits of short-term flows, including those related with the efficiency and disciplining properties of short-term financial markets.

- 2. An assessment of the experience of transactions costs in limiting speculation in other markets--such as the real estate market.
- 3. An evaluation of the difficulties associated with making a priori distinctions between productive and unproductive financial transactions.
- 4. A review of the likely channels of circumvention available in today's sophisticated markets.
- 5. The effects of imposition of taxes or capital controls on the volatility of interest rates and other financial variables.
- 6. A discussion on the measures in the area of prudential policy which could contribute to ensure the appropriate pricing of risk.

III. Financial Risks in Emerging Capital Markets

This section will deal with some of the surveillance issues that can arise in rapidly growing but still fledgling financial systems. The following issues will be considered:

- 1. Factors determining the resistance of a fledgling financial systems to adverse shocks such as an economic downturn, a tightening of credit, a major movement in asset prices or the failure of a major borrower.
- 2. Risks on the financial system associated with a sudden reversal of capital inflows.
- 3. Limited financial disclosure requirements and its role on cross-country "contagion" effects resulting from a localized outbreak of financial distress.
- 4. Constraints on monetary policy arising from the fragility of a rapidly growing financial sector.
- 5. The management of risks associated with financial innovation an liberalization: Lessons from country experiences.

IV. Developing Country Access to International Capital Markets

This section will analyze recent developments and prospects for new private capital flows to developing countries. The main themes to be covered are:

1. The relative importance of internal and external factors in explaining the shifting pattern of capital inflows (between direct investment, securities market intermediation and bank lending).

- 2. The extent of diversification of the investor base for developing country securities and the implications for the adequacy of risk assessment and the resilience of market access in the face of a possible tightening of financial conditions as economic recovery gathers momentum in the industrial countries.
- 3. The effect of a country's relations with the Fund for investment decisions.
- 4. The progress and prospects for restructuring commercial bank debt for countries now embarking on negotiations.

CTA & SEA

To:

Mr. Beza

Mr. Touré

Mr. van Houtven

Mr Neiss

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Williams

Mr. Zulu/Guitián

From:

Morris Goldstein W. (4.

Subject: 1993/94 Capital Markets Mission

We are preparing the brief for management on the 1993/94 Capital Markets missions, and I would appreciate your reactions to the intended focus of the upcoming exercise. As in past years, PDR will participate in all three legs of the mission, and this note already incorporates their suggestions.

We plan to retain the format of the past two reports -combining a forward-looking discussion of key systemic policy issues with a survey of recent developments in international capital markets. The material will be presented in the customary form of a staff report and a background paper. If our planned mission schedule can be agreed with the authorities, we anticipate discussion of the report by the Executive Board in May/June 1994.

I. Focus of the 1993/94 Report

Last year, the choice of issues for the report was largely crisis-driven: recall that Part I dealt with the ERM crisis, while Part II emphasized the difficulties in some industrial-country banking systems (along with, inter alia, a discussion of the potential systemic risks associated with the growth of derivative markets). This year, it appears (at least so far) that the report could be less crisis-driven. More specifically, we plan to focus on the following four topics.

Government securities markets

Reflecting the repeated failures of past fiscal consolidation efforts, public debt levels in many industrial countries have increased substantially over the past twenty years. Indeed, the need to finance growing public-sector deficits, and the desire to tap foreign investors for an increasing share of this financing, were two

September 15, 1993

of the factors that helped to drive financial liberalization and reform during this period. The medium-term fiscal outlook for the G-7 countries, as discussed in the recent World Economic Outlook and elsewhere, points to a further increase in public-sector debt burdens. Gross, outstanding public-sector debt in the G-7 countries, for example, is expected to grow to over 70 percent of their GDP by 1995; for European countries alone, the corresponding figure is over 80 percent. The need to finance and roll over these obligations has already induced some important changes in global Government securities markets. International institutional investors (mutual funds, insurance companies, and pension funds) are rapidly becoming the dominant participants in the major government securities markets; issuing techniques are being reformed; clearance and settlement systems are being modernized and harmonized across borders to allow for the issuance of global bonds; trading and market-making systems are being refined in light of the massive increases in trading volume; the use of derivative instruments in government securities markets has grown explosively; and pre-sale or when-issued markets have become a regular feature of most markets. Officials have also stepped-up their surveillance over these markets, and some countries -- most notably, Ireland and New Zealand--have made innovative efforts to restructure their debt management offices.

We propose to examine a number of issues linked to the operation of government securities markets. A sample of those issues would include the following. What scope is there for governments to reduce the cost of their borrowing? Should authorities, for example, shorten average debt maturity to benefit from low short-term interest rates and perhaps be faced with the need to roll-over short-term debt at more difficult market conditions? What is the signalling role of the maturity structure of public debt? What are the implications of increased participation by institutional investors in this market (does it, for example, imply more short-term "churning" of positions)? What lessons (about issuing techniques and the like) can be learned from those authorities that have restructured their debt management offices? Is credit risk appropriately priced in these debt markets? How much can we count on markets to "discipline" sovereign borrowers, and does such discipline operate in a gradual or abrupt manner? Has the internationalization of borrowing diminished the incentives for reducing debt burdens by inflation or devaluation? Are clearing, settlement, and related payments systems up to the task of accommodating large future increases in trading and issuing volume? What role do government securities play as a "benchmark" for pricing other securities? In light of both the broader range of instruments and participants and the rapid growth of trading in these markets, are current efforts to strengthen the supervisory and regulatory framework adequate?

2. Financial risks in emerging capital markets

During recent years, a significant number of developing countries (most notably in East Asia and Latin America) have experienced very rapid growth in the volume and sophistication of their domestic financial markets. Although this development has been largely beneficial, improvements in the supervisory and regulatory structure have sometimes failed to keep pace with developments in the market place. That deficiency has frequently created problems for financial institutions (credit quality, concentrated exposures, risk management systems), for markets (inadequate liquidity, poor disclosure, undercapitalization of intermediaries), and for macroeconomic management (support for markets and institutions undermining credit policy and/or fiscal policy).

We propose to look into some of the surveillance issues that can arise in rapidly growing but still fledgling financial systems (in this connection, the Chinese experience may be instructive). interest is in issues along the following lines. What are the factors that determine the resistance of such fledgling financial systems to an economic downturn, or a tightening of credit, or a major movement in asset prices, or the failure of a major borrower? In countries that have recently experienced large capital inflows, what are the risks to the financial system that would be associated with a sudden, large capital outflow? Does increasing involvement of international investors add to or subtract from the stability of the local market? What is the impact on an emerging market of introducing financial instruments that allow an important part of trading to migrate offshore to an established exchange? To what extent can limited financial disclosure requirements contribute to cross-country "contagion" effects when there are localized outbreaks of financial distress? How can the fragility of a rapidly growing financial sector restrict the degrees of freedom of monetary authorities when trying to slow a rapid expansion of credit? What can be done to manage the risks associated with financial innovation and liberalization, without simultaneously restricting unduly the potentially valuable efficiency gains; what country lessons (both from good and bad performers) are relevant for that management issue?

3. Short-term financial flows

A notable feature of the recent ERM crisis was the speed and the size of short-term, cross-border capital movements. Similarly, large and relatively sudden shifts among domestic financial instruments, e.g., most recently from fixed-income and bank liabilities into equity funds, have become part and parcel of the modern financial landscape. Suffice to say that such short-term capital movements have instilled a sense of discomfort in some official quarters, and have prompted questions about what social purpose is being served by large volume, short-term speculation.

There have even been some calls for reconsideration of various "sand in the wheels" measures, such as trading taxes and capital controls, designed to slow short-term capital flows and to reduce the volume of transactions in major capital markets.

While these calls have thus far been effectively resisted by officials in the industrial countries, it would be useful to set out more systematically and thoroughly what the contributions of shortterm financial flows are, and what obstacles would be faced in any attempt to restrict them. This would involve an appraisal, inter alia, of what is known about the efficiency and disciplining properties of short-term financial markets, and about the role that liquidity plays in resource allocation. In addition, we would want to assess the experience of transactions costs in limiting speculation in other markets (for example, the real estate market where transactions costs are considerably larger than in the foreign exchange market). evaluate the difficulties that would be associated with making a priori distinctions between productive and unproductive financial transactions (and between credit and foreign exchange transactions), note the likely channels of circumvention that are available in today's sophisticated markets, and consider the effects on volatility of interest rates and other financial variables that might ensue from imposition of such restrictions or taxes. Finally, we would discuss what measures in the area of prudential policy (capital standards and the like) would make sense to ensure that risk is appropriately priced.

4. Developing country access to international capital markets

As in previous years, we intend to analyze recent developments and prospects for new private capital flows to developing countries. We would seek to understand the shifting pattern of these flows (particularly the relative importance of internal and external factors in explaining the balance among direct investment, securities market intermediation and bank lending) and to draw possible implications for developing countries in terms of funding costs, volatility, and market access. We would also assess the extent to which the investor base for developing country securities is diversifying and the implications for the adequacy of risk assessment and the resilience of market access in the face of a possible tightening of financial conditions as economic recovery gathers momentum in the industrial countries. We would explore with market participants how a country's relations with the Fund are factored into investment decisions. Finally, we would review the progress and prospects for restructuring commercial bank debt for the countries that are now embarking on negotiations, and discuss with participants how bank debt packages may need to be structured to reflect the particular situations of the countries involved.

In addition to these four topics, there is one related issue that will bear close watching. I speak here of the risk that a significant increase in interest rates in some of the major industrial countries (especially in the United States) could translate into large losses for those investors who have moved in a big way over the past year or two out of bank deposits into bonds and mutual funds.

II. Schedule and Staffing of Capital Markets Mission

The schedule and staffing of the mission would be broadly similar to last year. We suggest eliminating visits to the Netherlands and Switzerland, and shortening slightly the visits to France and Germany. We would add Ireland and Sweden to the European leg in order to explore the issue of government debt management in these countries. On the Asian leg, we are inclined to shorten the visit to Tokyo and to drop the visit to Singapore. We would add China, so as to get a sharper picture of the potential problems associated with explosive growth in domestic financial markets; similarly, we expect a visit to New Zealand to provide useful information about some relatively innovative techniques of debt management. On the North American leg, we would add Canada since it is the only G-7 country that the mission has not visited during the past two years and since it still is an important financial center.

Story agree

The proposed schedule of visits, along with likely staffing, would then look as follows:

Asia:

November 1-16.

Tokyo, Hong Kong, Beijing, Auckland
Goldstein, Folkerts-Landau, Spencer from RES, and
one staff member from PDR.

Europe:

January 18-February 10.

London, Dublin, Paris, Frankfurt, Rome, Stockholm,

Brussels, Basle.

Goldstein, Folkerts-Landau, Rojas-Suarez from RES,

and Rennhack from PDR.

North America:

February 28-March 4.

New York

Goldstein, Folkerts-Landau, Montgomery of RES, and

one staff member from PDR.

March 15-18

Toronto, Ottawa

Goldstein, Folkerts-Landau, Taylor from RES, and

one staff member from PDR.

We have checked these proposed dates with IMF area departments and with the World Bank's financial complex and it appears that our visits do not interfere with planned Article IV and other missions.

May I have your comments by c.o.b., Friday, September 17?

cc: Mr. Mussa Mr. Boorman Office Memorandum

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To:

Mr. Goldstein

September 17, 1993

From:

Manuel Guitián hol

Subject: 1993/94 Capital Markets Mission

I enjoyed reading this note, and I am in broad agreement with the subject areas you propose to investigate. They are indeed topical, and they should provide the basis for a stimulating Board discussion. I share your hope that the final selection of topics will continue to be less crisis-driven than was the case last year. My comments relate to only two areas of your brief.

First, in the section on government securities markets, it would be helpful to define clearly the scope of your investigation. In particular, I have in mind whether you will confine the discussion to domestic markets for government securities, which deal primarily in "domestic pay" issues, or to international markets, where "foreign pay" issues are traded, and whether you consider the issues of junior level governments and government business enterprises to be part of the market. On the questions you plan to discuss, the scope for reducing borrowing costs goes far beyond adjusting the maturity structure, which you mention, and they include: the choice between domestic and foreign pay issues; the extent to which issues of floating rate debt are swapped into fixed rate debt; the use of a range of issuing currencies; and the extent to which foreign currency exposure is managed and controlled. On issues of a more systemic nature, it would be desirable to have an assessment of the overall liquidity of these markets and their susceptibility to seize-up, the role and capital strength of principal market makers, the effects of regulation (for example, differential risk weightings applied to OECD and non-OECD sovereign debt), and the extent to which governments "crowd out" private borrowers through these markets.

Second, on the section on "Financial risks in emerging capital markets," I am interested in the sources you intend to use in assessing basic issues of safety and soundness in emerging markets in developing countries, since you do not propose to visit any of these countries. As you know, this general subject is of central interest to us in MAE and one in which we have gathered some experience through our program of technical assistance. Therefore, I have an interest in MAE's participation in the research and drafting of this section.

As a final passing comment, I wondered about the inwardness of your statement (page 5) that Canada "still" is an important financial center.

Contributor: William E. Alexander

cc: Mr. Beza

Mr. Touré

Mr. van Houtven

Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Williams

BUFF/93/25

DIVISION 3 (SEA) ROOM 4-302

0409

May 25, 1993

Summing Up by the Acting Chairman
International Capital Markets - Developments, Prospects
and Key Policy Issues, Part II
Executive Board Meeting 93/71, May 14, 1993

Executive Directors welcomed the opportunity to continue their review of developments and prospects in international capital markets. The discussion today focused on three central issues: recent banking problems in a number of industrial countries; the systemic risks associated with the rapid growth of off-balance sheet activities in banks; and the implications of the evolving pattern of developing country access to international financial markets.

Directors noted that the frequency and widespread country distribution of banking problems merited close attention, given the significant costs that resolving these problems can entail for taxpayers and the constraints that financial fragility can pose for the stance and effectiveness of macroeconomic policies. In discussing the common forces responsible for the deterioration of bank balance sheets, Directors noted that the extensive financial liberalization of the 1980s had opened up financial markets to intense competition and induced some banks to increase their tolerance for risk in order to maintain their earnings and market share, particularly when such risk was effectively underwritten by implicit and explicit government guarantees. As a result, during that period, bank balance sheets had expanded rapidly, concentration in single-risk classes had grown, and banks' activities in the over-the-counter derivatives markets had mushroomed.

Directors, however, also stressed that increased competition was not the only factor determining banks' attitude toward risk-taking and their related earnings performance. They noted that the current bout of banking problems--particularly their large real estate component--also owed a great deal to cyclical factors, which are related to an accommodative monetary policy that helped fuel asset price inflation, and to the subsequent unwinding of these asset price excesses in the face of the widespread slowdown in economic activity. As noted at the time of the WEO discussion, several Directors felt that this experience indicated the need for adequate attention to movements in asset prices in the formulation of monetary policy.

Directors agreed that supervisory guidelines that are suitable for a less competitive environment may not be appropriate to a more competitive and rapidly changing financial environment. Indeed, most Directors pointed out that a key lesson learned from the recent banking problems in industrial countries is that financial liberalization needs to be accompanied--and, as some emphasized, if possible, preceded--by a strengthening of the supervisory and regulatory framework. This lesson, it was noted, is equally applicable to developing countries with related implications for Fund advice

on the pace and sequencing of financial reforms in such countries. A number of Directors noted that a review of the experience of industrial countries that had largely avoided banking problems could also provide some useful insight. Stressing the importance of preventive measures, Directors welcomed the progress made in many countries in strengthening the capital base for banking and securities activities and they reiterated their support for the international efforts aimed at achieving a level playing field in the application of supervisory and regulatory initiatives. With regard to methods of coping with existing banking strains, Directors noted that a range of approaches has been applied in individual countries, and that the specific response would need to vary according to circumstances. Several Directors placed particular emphasis on the importance of prompt action in closing insolvent institutions, although the difficulties of implementing such closures where they have potential systemic effects were recognized. Many Directors saw the approach of "buying time" for troubled institutions to allow them to earn their way back to health as carrying the risk of delaying adjustment and of undermining the incentives for the banking sector to reduce capacity, lower costs, and control risk. Nevertheless, the point was made that this approach, when implemented under rigorous supervision, could be helpful, given both the special role that banks played in the financial system and the lack of attractive alternative policy actions. Directors were generally critical of the recourse to artificially high interest rate spreads as a response to strains in the banking system.

Directors also noted the drawbacks of direct government injection of capital into institutions facing difficulties, and several speakers advised that such an approach should only be used as a last resort to avoid systemic difficulties in the financial system as a whole. It was also generally agreed that this method of recapitalizing troubled banks should be made conditional on the appropriate downsizing, cost-cutting, and increased efficiency of the affected banks, and that it was important to avoid placing the remaining solvent institutions at an undue disadvantage. It was also pointed out that the managers and shareholders should not be protected from losses in the event of any restructuring of banks.

Turning to the unprecedented growth in the <u>financial derivatives</u> <u>markets</u>, Directors pointed out that these activities were clearly serving a useful function in hedging the risk of price changes, in separating and redistributing market risks to those better able to manage them, and in increasing the day-to-day liquidity of the underlying instruments. At the same time, however, Directors saw those markets and the growing involvement of banks in the over-the-counter segment as also representing a potential source of systemic risk. In particular, several Directors noted that the growth of these markets had added to the interaction and linkages of financial markets, which in turn posed the risk that disturbances could spill over rapidly across the financial system. Directors thus welcomed the mechanisms that the organized derivatives exchanges had established to reduce systemic risks, as well as the efforts undertaken under the auspices of the Basle Committee and by the authorities in several countries to strengthen the prudential supervision of banks in the area of off-balance

sheet exposures. A number of Directors felt that not much of a reduction in risk could be obtained by channeling more of the over-the-counter business to the organized exchanges. The staff was encouraged to continue its study of developments in the financial derivatives markets.

Directors welcomed the resurgence of private financing to developing countries over the past year, but they observed that market developments had been neither smooth nor uniform, with several important sectors suffering setbacks and access remaining geographically limited to a relatively small number of developing countries. This experience served as a timely reminder that the recent re-entry to private capital markets by a number of developing countries remained fragile, warranting continued study and monitoring by the staff. Directors observed that the investor base was still relatively narrow and largely based on the return of flight capital so that, for market access to be sustained, borrowing countries would need to diversify their financial resources. Perseverance with sound macroeconomic policies, as well as market reforms that foster a strong private sector that was open to international trade and free capital flows, would be the key to increased participation by a broader range of investors. Directors commented that it was also important to ensure that flows take place within a financial framework consistent with the adequate dissemination of information and an appropriate matching between risks and return. This would require efforts by developing countries to improve the transparency and integrity of domestic financial markets. It was also noted that the Fund should play a greater role in helping countries during the period of transition between graduation from the use of Fund resources and access to private capital market financing.

As regards international bank lending to developing countries, Directors noted that this remained on a declining trend, reflecting the difficult financial situation of many large banks and the lingering effects of the debt crisis. Directors welcomed the fact that a number of creditorcountry bank regulators had reviewed the application of provisioning requirements in light of the progress made by some debtor countries toward improving creditworthiness. However, some Directors expressed concern about the risk weight scheme applied under the Basle capital adequacy accord to bank lending to developing countries. They observed that the present scheme did not adequately reflect the intercountry differences in credit risk, and argued that it could serve unduly to discourage new lending to creditworthy countries. They urged that consideration be given to ways of linking the risk weights more directly to creditworthiness. Other Directors took the view that the current risk weights system had not had a significant impact on bank credits to developing countries and stressed the complexities of trying to introduce a more differentiated system of weights.

In line with the usual practice, it was agreed that the staff, after taking into account the comments and suggestions of Directors that had been made, would prepare a version of the papers discussed today for publication in the Fund's World Economic and Financial Surveys series.

CC: RKV

93 APR -9 PH 3: 01

To:

Mr. Goldstein

April 8, 1993

From:

Manuel Guitián has

Subject: Draft Staff Appraisal: International Capital

Markets, Part II

The report is well written and provides a comprehensive description of recent developments. All the topics it covers are fascinating; among them, my attention was drawn particularly to the section on the growing involvement of international banks in derivative finance.

The principal concern in your paper is that this development has created "new sources of risk" (page 18). Moreover, because banks may fail to understand, manage, and control appropriately these risks, "more attention" should be given to associated prudential considerations. While both conjectures may be true, there are also grounds for optimism, and I would urge you to adopt a more balanced presentation.

As pointed out by the BIS in its seminal discussion of derivative finance in international banking (published in 1986 as the Cross Report), the new instruments and techniques permit the separation and unbundling of risk, the pricing of its separate components (credit risk, liquidity risk, market risk), and the redistribution of risks to those best able to manage them. there exists the possibility to reduce overall systemic risk, not only the danger of raising it.

Like you, the Cross Report was concerned that banks were taking on new risks which they little understood and had no comparative advantage in managing. Credit risk, the main subject of bank concern, was a relatively minor component of the overall risk associated with many types of derivative products. Thus, it was likely only a matter of time before a major prudential problem would arise. Paradoxically, though, all of the recent difficulties in banking, which you chronicle so graphically in the preceding section of your paper, were due to the mismanagement of credit risk! I suggest that it would be appropriate for the paper to explain why this should be so. At least one possible explanation consistent with the evidence is either that banks better understand and manage derivative risk than you imply, or that the benefits associated with unbundling and redistributing risk have, to date, outweighed the costs, or both.

As to the possibility of the risk of a systemic disturbance in the derivative markets, the discussion (page 22) is well presented, as is the description of possible measures to reduce credit risk (page 23 and footnote 3). It is not clear, however, whether the staff considers these measures sufficient or if additional measures would need to be taken. Given the size of the market, the issue of systemic risks would need to be highlighted. They include, in addition to the possibility that risk will be overly concentrated in the hands of a few major market players, the possibility that risk will be systematically underpriced, and the possibility that the lender of last resort facility will need to be expanded beyond the banking system to cover certain nonbank financial institutions which are also major players in derivative markets.

Apart from these general comments, I have the following clarifying observations on other sections of the paper:

- 1. The three policy choices for dealing with significant banking system problems in Section II. 3 (ps. 15-16) are clearly available if no systemic effects are present. It would be useful for the Board discussion explicitly to recognize that a more limited range of options would be available if systemic effects were to be present.
- 2. The stylized facts and description of banking issues in Sections II.1 and II.2 are very clear, but it would be useful to include an analysis of why Germany has so far been exempted from a banking crisis. This could throw additional light on the underlying causes.
- 3. In the discussion of Japan, some estimates of losses from nonperforming loans assume that real estate prices will return to near pre-boom levels (p. 9). Is the analytical framework consistent with such a return in the short run?
- 4. Finally, in Section IV. 4, the report underlines that, as shown by the experience of Latin American countries' access to international markets, there is now greater scope for price adjustments which may signal emerging difficulties before the situation deteriorates to the point where access is cut off (p. 27).

Although it is clear that the trend toward securitization has changed the character of private financing for developing countries, these remarks need to be tempered by recognition that the overall amount of capital flows in securitized form is still relatively small.

Contributors: Mr. Alexander

Mr. Cortés

cc: Mr. Beza

Mr. Touré

Mr. van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Narvekar

To:

Mr. Goldstein

April 8, 1993

From:

S. Rothman A.A.

93 APR -9 AM 9:52

Subject: Draft Staff Appraisal: International

Capital Markets, Part II

We found the draft appraisal well structured and quite impressive in terms of both its comprehensiveness and clarity of argumentation. Moreover, given the complexity and breadth of the areas it addresses, the appraisal is commendably concise.

Our comments and suggestions for your consideration are as follows:

- Page 5. In discussing the industrialized countries that have suffered balance sheet problems in the banking sector, Germany is cited, en passant, as a "notable exception." It would be interesting to have some -- albeit brief -- explanation as to why this is the case; perhaps this could be provided by referring to the causes of bank problems mentioned in the "capsule summary" on page 4. Has Germany not yet undergone the innovation and liberalization of other financial markets, or has the particular structure of German banking ensured that the problems do not arise?
- Page 16. The second approach put forward for resolving banking problems, namely, government injection of capital, presumably includes government loan guarantees, as well as direct capital subscriptions. In the case of Sweden, for example, loan guarantees seem to have been a significant part of the overall package. Therefore, guarantees might usefully be explicitly listed as a policy option.

With respect to the third approach indicated -- the liquidation of financial institutions -- it would be useful to know whether any such institutions were liquidated during the period under review and, if so, what was the percentage of nonperforming assets to GDP in the given country. This would remove the impression that all ailing banks were bailed out by some form of government intervention.

- Page 18. The reference on this page to 1992 in Table 3 should be checked, as Table 3 covers the period 1986-91.
- Page 25. The final sentence of the first full paragraph should be clarified. In particular, what "potentially destabilizing market practices" are being referred to?

The draft appraisal accords relatively little attention to developing country access (apart from Latin America) to international capital markets. Therefore, the section on investor attitudes might usefully elaborate on the situations in other developing regions and the obstacles to renewed access. Such an elaboration seems warranted in light of point 4. in the Issues for Discussion concerning private flows to developing countries.

In both the first sentence of the second full paragraph and the first sentence of the ultimate paragraph, the word "differences" should replace "variations," as the appraisal is making comparisons at a given point in time.

-- Page 30. The perspective and emphasis with respect to International Capital Market Financing for Developing Countries differs between the body of the draft and the Staff Conclusions. The main discussion on pages 24-28 concentrates on investor attitudes and systemic developments in the markets, whereas the Staff Conclusions focus on the implications for the developing countries themselves. While both aspects are essential, it seems dichotomous to treat the former only descriptively and the latter solely normatively.

cc: Mr. Beza

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

cc: RK

To:

Mr. Goldstein

April 8, 1993

From:

Jack Boorman

Subject: Draft Staff Appraisal: International Capital Markets, Part II

We found this paper thoughtful and well-written. We did feel, however, that in contrast to the remarkable Part I of this year's International Capital Markets report, the paper lacks unity and reads as a succession of three separate papers dealing with specific issues.

One way to give the paper a more unified structure would be to add a broad introductory overview of market developments in 1992 and the prospects. Regarding Chapter II, the paper could discuss the extent to which balance sheet difficulties in several domestic banking systems have resulted from, affected, or could affect international financing patterns. We would also suggest compressing significantly the ten pages describing the specific problems in particular countries, which would probably improve the overall balance in the paper between the different issues.

On the substance of Chapter II, we wonder whether it might overstate the role in practice of moral hazard considerations in describing the deterioration of balance sheets in international banking. To the extent that financial innovation and deregulation led to an increase in competition for both depositors and borrowers and contributed to a decline in franchise value, exit from the banking sector would have been expected in any event. We wonder whether there is any empirical evidence on this question.

On a related point, to the extent that the moral hazard problem arising from explicit deposit insurance is important, the paper might discuss the possibility of improved pricing of deposit insurance in the policy options section on pages 15-16.

As regards the proposals for strengthening the entire prudential and regulatory framework (pages 28-29), we agree in principle but suggest that it might be useful to elaborate on the practical problems that might result to give a sense of what are the costs and limitations. If these steps were easy, they would probably already have been done. For example, the distinction between book and market valuation would appear to be a particular problem for bank regulators, raising questions about the operational feasibility of early closure policies.

Most of the empirical estimates of losses in the paper deal with the extent of the financial transfers from the Government. Are there any empirical estimates of the deadweight costs associated with banking problems? This is presumably also relevant in assessing the overall social welfare effects.

Before ending with some more detailed comments, I would note that the fact that the paper was prepared "in consultation with PDR" has been inadvertently omitted from the first page of the table of contents.

Detailed comments

We would suggest that "the decline of the system of main banks" (mentioned in page 11, first line) and that the concept of "novation" (page 23, fifth line of second paragraph) be explained.

On page 16, in the sentence beginning "While this approach is of course the most direct..." there appears to be one too many "not."

On page 12, the text should clarify that the FDIC does not guarantee all deposits-only certain deposits up to \$100,000.

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

Mr. Saite

Office Memorandum
SOUTHEAS

SOUTHEAST ASIA AND PACIFIC DEPARTMENT

93 APR -9 PM 3: 29

To:

Mr. Goldstein

April 8, 1993

From:

S.H. Hitti

Subject: Comments on International Capital Markets, Part II

We found each of the three main sections of this well written paper to contain a thorough and informative account of recent developments and issues in international capital markets. While admittedly difficult, you may wish to explore the possibility of a more comprehensive linkage of the analysis in the three sections (especially, that of Section IV), including through a discussion of the ongoing structural changes in the world financial system.

In searching for a common thread among the recent difficulties facing the banking systems of several industrial countries, the paper emphasizes the role of financial liberalization. While we agree with the policy implication -- the importance of timely action to strengthen the prudential and regulatory framework -- we feel that too much emphasis is being placed on the impact of financial liberalization, per se, as a source of instability. It seems to us that some of the factors contributing to the banking difficulties -including inappropriate pricing, loan concentration, and inadequate risk assessments -- are issues that merit further analysis beyond a simple linkage to financial liberalization. Indeed, history is full of cases of banking crises in unliberalized financial systems. Moreover, of the seven country cases covered in the paper, only two seem to have clearly involved a substantial liberalization process. Similarly, you may wish to look again at the emphasis placed on the increasing use of OTC instruments. 1/ The information presented in the paper is insufficient to support the conclusion regarding rising instability.

We have three comments on the developing country section. First, the paper could address the seemingly different market clearing process for bonds and equities. As regards bonds, the paper argues strongly that the price mechanism is playing an important role. On equities, the analysis is essentially limited to the statement that "equity issues ... almost completely dried up after mid-year" (page 24). Can the paper shed light on whether this reflected

^{1/} The paper's discussion of OTC issues could be usefully expanded to include some analysis as to their impact on the supply of credit. It would also be useful to include additional indications of the quantitative importance of derivatives in banks' total on and off balance sheet items.

quantity rationing on the demand side or supply side factors in response to lower-than-initially anticipated issue prices? Second, the discussion of the role of U.S. money center banks (page 25) begs the question of the extent of "insider trading." Indeed, this issue has given rise to concerns in certain regulatory circles. Third, the paper can be read to imply that the factors contributing to the growth in demand for holdings of developing country bonds were also responsible for the process "of financial disintermediation from the international banking system" (e.g., sentence starting on line 13 of page 26). Minor redrafting would correct this impression.

Finally, given the length of the paper, you may wish to shift the discussion in Section IV.3 (on the role of Hong Kong and Singapore) to the background paper. Similarly, the discussion in Section II.2 could be shortened and organized along two main themes (causes of crises and policy responses) rather than by country experience.

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier (o/r)

Mr. Mussa

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

Office Memorandum

To:

Mr. Goldstein

April 8, 1993

From:

G.A. Mackenzie

Subject: Draft Staff Appraisal: International Capital Markets, P.II

We found this report well written, thorough, and sprinkled with witty remarks. We have only two minor comments.

The capsule summary of the forces behind the deterioration of bank balance sheets largely ignores the role of the private nonbank sector. Apart from the effects on bank behavior, financial deregulation, presumably by loosening liquidity constraints, may also have affected the savings and borrowing behavior of private households. In turn, the changed savings and borrowing behavior of consumers may have influenced bank profitability adversely through two channels. First, the significant fall in private household savings rates widely observed in countries that embarked on financial deregulation reduced the intermediation volume as the size of financial resources channelled through the banking system decreased. Second, financial deregulation may have enabled less creditworthy consumers to take on more credit than was consistent with the standards of prudent consumption behavior.

The policy conclusions drawn at the end of Chapter II might also address the policy options of countries that have so far moved more cautiously with respect to banking deregulation, as for example Germany. The reports's key message for these countries appears to be that financial deregulation without "strains and crises" requires an orderly downsizing of the excess capacity of the banking sector generated by the cozy conditions of restricted competition.

Contributor: Albert Jaeger

cc:

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito V

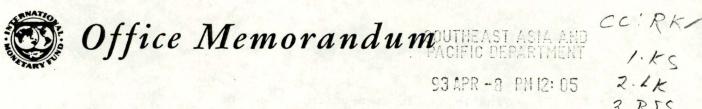
Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

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File Mr. Saito



Mr. Goldstein/Mr. Folkerts-Landau

April 7, 1993

4. FILEC

From:

To:

Alessandro Leipold AL

Subject: International Capital Markets, Part II

We enjoyed reading this well-written and interesting report: 1/ its lively, direct style helps bring even the most arcanely technical subjects to life, and will undoubtedly stimulate a number of reactions, both from other departments and at the Board. From our perspective, we have only two observations, both relating to Executive Directors' earlier requests.

First, the footnote on page 17 may appear a little dismissive of the concerns expressed about the effects of the Basle capital adequacy risk weights on new developing country lending and its terms. While there certainly appears to be little prospect for changes in the risk weights at this stage, a somewhat fuller treatment of the issue in the main text would represent a better response to those Directors who raised it during the discussion of Part I of the capital markets report. The conclusions need not be much different, though they could be more nuanced: after all, the report does state (page 26) that bank lending in general "has been constrained by ... efforts to adjust balance sheets to satisfy the Basle capital adequacy guidelines." This must be especially true when balance sheet-constrained lenders are faced with borrowers saddled with a 100 percent risk weighting.

Second, the discussion on developing country access concludes by emphasizing the importance of an "adequate dissemination of information" (page 30), and the question for Executive Directors' discussion also focuses on this point. You will recall that, at last year's capital markets discussion (June 1992), a number of Directors expressed interest in examining what the Fund itself could do in improving the dissemination of information on countries seeking to regain or maintain access to voluntary financing flows (see Periodic Report on the Work of the Executive Board, 7/10/92; the issue is also alluded to in the summing-up, Buff/92/106). The time may have come to try to elaborate on this somewhat: at the very least by noting that the modification of the enhanced surveillance procedures approved at the last Surveillance Review discussion in January is a step in this direction.

^{1/} Incidentally, it is a "report," rather than a "staff appraisal," as it is referred to in the first paragraph.

Finally, a minor question: we are not sure what you have in mind when advising participants in international securities markets to avoid "potentially destabilizing market practices--such as those that can temporarily mask imbalances in the market" (page 25)?

cc: Mr. Beza

Mr. Touré

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

INTERNATIONAL MONETARY FUND

Mr. Saito: I added one guery at the end of the paragraph on Hong Kong (last line on page 2). After discussion with Wanda, & also deleted The reference to Korea and Thouland in the para on balance sheet problems. Koga.

To:

Mr. Goldstein

April 7, 1993

From:

Kunio Saito

Subject: International Capital Markets Paper, Part II

We enjoyed reading this informative and well-written paper and are in agreement with your main conclusions. The following are our comments and queries.

1. The deterioration in bank balance sheets

The paper argues convincingly that the competitive pressures unleashed by financial liberalization, combined with moral hazards and insufficient prudential safeguards, induced banks to engage in increasingly risky investment practices which contributed to a growing concentration of lending to the real estate sector. Clearly, there were excesses on the part of particular institutions which could have been mitigated by more effective supervision. Nevertheless, the readers might be interested in your views on the degree to which regulators, without perfect foresight, could have prevented the emergence of balance sheet problems for the sector as a whole, given the evolution of real estate prices. Also, to what extent do you believe the behavior of banks contributed to the bubble in real estate prices?

In the discussion of Japan, the paper states that, in order for the "earn-your-way-out-of-trouble" scenario to work, real estate and equity prices would need to return to "pre-problem norms." However, notwithstanding the large declines that have already taken place, real estate prices still appear to be above their pre-problem levels. Accordingly, the challenge for policymakers must be, in my view, to facilitate economic recovery while allowing real estate prices to continue to adjust (and avoiding a financial sector crisis that might arise in the process of land price deflation). Hopefully, the paper is not suggesting there is a need to re-inflate these prices.

Also on Japan, you state (top of page 11) that several features of the Japanese financial system give the authorities more room for maneuver in dealing with the bad loan problem than is available in many other countries. However, you then go on to explain why this increased room for maneuver is largely illusory (or at least carriers other important risks) and (at the top of page 16) you emphasize the danger of a "buy-more-time" approach. Perhaps it would be better not to assert that Japan has greater flexibility in the first place.

In the discussions of the United States and France (pages 11 and 14), the paper notes an inverse relation between the level of interest rates and bank profits. One can think of reasons for this (e.g., a longer average maturity on fixed-rate bank assets than liabilities). However, one could also imagine situations in which the level of nominal interest rates would bear a positive relation to bank profits, at least in the short term (e.g., a change in interest rates stemming from a change in the demand for funds). It would, therefore, be useful if you could spell out more clearly the mechanisms you have in mind behind this relationship.

The paper states that liquidation would not be viable for troubled institutions whose closure would have a systemic impact (page 16). Does this statement remain valid in the presence of deposit insurance? At least in the U.S. context, it is not clear why government capital injections would necessarily be superior to the sale of one failed institution to another institution (although the government might still have to pick up some of the tab if the net value were negative).

2. Derivative financial instruments

If the derivative financial instruments have been "not fully understood by either senior bank managers or by senior regulators," it is possible that some Executive Directors and staff members might also be less than fully familiar with this subject area. While a description of the main instruments will be contained in the background paper, it might be helpful if you could relate the main messages of this section to a few more specific examples. You already cite the bankruptcy of Drexel Burnham Lambert; could you elaborate?

3. Financing for developing countries

The paper's main message is that portfolio instruments have taken the place of bank lending as the main source of developing country finance. In this context, it might be useful to draw a clearer distinction between equity and debt portfolio instruments. Perhaps you could also discuss why U.S. banks prefer to hold developing country bonds rather than loans.

On <u>Hong Kong</u>, the paper states that financial institutions have been bolstered by the high profitability of local operations. This is certainly true in the case of the four large banks with extensive local branch networks. However, it was our understanding that in most of the other major international banks tend to concentrate on international banking activities, primarily interbank activities; for them, local operations are relatively much less important (see the discussion of Hong Kong's role as an international financial center in the 1990 RED, SM/91/2). We would also be

- 3 -

interested in your assessment of how Hong Kong's banking system has fared under the more "hands off" regulatory style.

The paper notes the increased regional competition from China, Malaysia, and Thailand (page 27). You might be interested to know that Thailand has now established the Bangkok International Banking Facility (BIBF), having issued BIBF licenses to 47 Thai and foreign banks in March 1993.

cc: Mr. Beza

Mr. Mussa

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Narvekar

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

International Monetary Fund

April 5, 1993

To: Mr. Bercuson Ms. Tseng

I would appreciate any comments you might have on the attached paper by c.o.b. Wednesday April 7, 1993. Thanks.

Attachment

Roger P. Kronenberg

April 1, 1993

"at a major to refer was a read a material and and "

To:

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito V

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Mr. Guitián

Mr. Narvekar

From:

Morris Goldstein Wa

Subject: Draft Staff Appraisal: International Capital Markets, Part II

As you know, this year's Capital Markets Report has been divided into two parts. Part I on exchange rate management and international capital flows in the aftermath of the ERM crisis was discussed by the Executive Board on February 24. I am attaching the draft staff appraisal for Part II of the report, which deals with recent banking crises and strains in the industrial countries, the rapid growth of off-balance-sheet financial transactions, and recent developments in the access of developing countries to industrial countries markets.

Could I please ask you to send your comments either to me or to Mr. Folkerts-Landau by Thursday, April 8?

Attachment

cc: Mr. Mussa

Ms. Saunders

Page

1

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

International Capital Markets Developments, Prospects, and Key Policy Issues, Part II:

Systemic Problems in International Finance

Prepared by the Research Department

Approved by Michael Mussa

April 1, 1993

Contents

I.	Introduction
II.	The Deterioration of Balance Sheets in International Banking 1. Is there a common thread? 2. Recent banking crises in some selected countries 3. Three choices and an ounce of prevention
111.	The Growing Involvement of International Banks in Derivative Finance - A Challenge for Financial Policy 1. The management of risks in over-the-counter derivative business 2. The policy issues
IV.	 International Capital Markets Development in Developing Countries 1. The recent experience 2. Investor attitudes toward developing country financing 3. Intra-regional developing country flows: the role of Hong Kong and Singapore 4. Systemic implications of the evolving pattern of developing country financing
V.	Staff Conclusions

VI.

Questions for Discussion

I. Introduction

This year's capital markets report has been divided into two parts. 1/ Part I examined the implications of the growth and integration of international capital markets for the management of exchange rates, with particular attention paid to the currency turmoil that enveloped the European Monetary System last year. Part I was discussed by the Executive Board on February 24. 2/ Part II of the report--consisting of this staff appraisal and an accompanying background paper--focuses on three systemic issues in international finance: (i) recent loan loss experience--especially in real estate--of banking systems in a number of industrial countries; (ii) sources of systemic risk in the rapid growth of off-balance sheet financial transactions--particularly in the bank driven, over-the-counter derivative markets; and (iii) recent developments in the access of developing countries to international capital markets.

The rest of the paper is organized as follows. After reviewing some of the structural factors that have increased banks' tolerance for more risky investments, Section II discusses the nature and extent of recent banking problems in several industrial countries (the Nordic countries, Japan, the United States, France, and the United Kingdom), along with the policy responses to those problems. Section III documents the growing involvement of international banks in derivative finance, considers the potential risks associated with the rapid expansion of the over-the-counter derivative markets, and outlines the supervisory and regulatory approaches to the management of such risk. In Section IV, we turn to capital market financing for developing countries. Here, the emphasis is on the recent market correction for Latin American securities, on the marked variation (both by source country and by type of investor) in investor attitudes toward developing-country financing, on intra-regional developing-country financing flows, and on the systemic implications of the evolving pattern of developing-country financing. Finally, Section V contains the staff's conclusions, while Section VI offers some issues for discussion by Executive Directors.

^{1/} A staff team, headed by Mr. M. Goldstein (RES), including
Mr. D. Folkerts-Landau (RES), and at different times, Messrs. C. Collyns,
(PDR), R. Rennhack (PDR), Mrs. L. Rojas-Suarez (RES), Messrs. P. Garber
(RES), S. Fries (RES), and P. Szymczak (PDR), held discussions between
October and early December 1992 with national authorities, international
institutions, and market participants in Belgium, France, Germany, Hong
Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the United
Kingdom, and the United States. Background material to the present paper,
including a review of recent financial flows in international markets, is
provided in International Capital Markets, Part II: Background Material,
SM/ / .

^{2/} See EBS/93/17 International Capital Markets - Developments, Prospects, and Key Policy Issues, Part I: Exchange Rate Management and International Capital Flows in the Aftermath of the ERM Crisis; and SM/93/38.

II. The Deterioration of Balance Sheets in International Banking

1. Is there a common thread?

While banking cannot lay uncontested claim to being the world's oldest profession, it is clear that the principles that have helped to define sound banking behavior have a long history. At least five of those principles-namely, avoid an undue concentration of loans to single activities, individuals, or groups; expand cautiously into unfamiliar activities; know your counterparty; control mismatches between assets and liabilities; and beware that your collateral is not vulnerable to the same shocks that weakened the borrower--remain as relevant today as in earlier times. Indeed, behind all of the banking or financial-sector crises that have emerged in industrial countries over the past decade--ranging from the developing-country debt crisis of the early 1980s, to the saving and loan crisis in the United States, to the solvency crisis in the Nordic countries, to the spate of banking strains elsewhere--is a violation of at least one of those principles.

There is also little dispute that when such banking and financial crises do occur, their resolution can be costly. For example, it has been estimated that the saving and loan crisis in the United States carried a \$180 billion price tag for the tax payer (equivalent to over 3 percent of GDP) (Table 1). Similarly, the loan losses realized in 1991-92 by banks in Finland, Norway, and Sweden amounted to between 4 and 6 1/2 percent of these countries' GDP and carried with them a roughly equivalent degree of government financial support. Moreover, there has by now been ample demonstration of how large actual and projected losses in the banking system can weaken medium-term fiscal consolidation efforts, limit the room for maneuver of monetary and exchange rate policy, and--where banks overreact to past losses by taking an unduly restrictive approach to credit evaluation-restrain the pace of economic recovery.

Given all this, a crucial question to ask as a prelude to a discussion of current banking problems in the industrial countries is why after a long postwar period of stability have banking problems become so widespread and occurred with such frequency. That is, what is it that induces banks in different countries to abandon--seemingly periodically--the principles of sound banking. While there is no single answer that can do full justice to differing macroeconomic circumstances, institutional structures, and paces of liberalization, there is at least one common thread running through many recent banking crises that merits mention. That thread is in recognizing that the competitive pressures unleashed by financial liberalization do not merely increase efficiency: they also carry risks, as banks and other financial institutions alter their behavior to ward off institutional downsizing.

Table 1. Loan Performance and Government Support of Banks in Selected Countries

(In percent of GDP)

	Loan	Losses	Nonperforming	Government		
	Realized 1991-92	Projected Total	Loans 1992	Support		
Japan		0.9	2.6 1/			
Japan		3.2 2/	$10.8 \ \frac{2}{3}$			
Nordic countries			gar dinde the fire			
Finland	6.0	6.6	10.9	6.6 4/		
Norway	4.2	4.2		2.8 5/		
Sweden	6.7	6.7		$4.2 \frac{6}{6}$		
United States						
Commercial banks	1.0	0.5 7/	2.4	0.5 7/		
Savings & loans				$3.2\frac{7}{1}$		

Sources: Ministry of Finance, Japan; Bank of Finland; Norges Bank, Norway, Ministry of Finance, Sweden; Congressional Budget Office and <u>FDIC</u> <u>Quarterly Banking Profile</u>, United States, and staff estimates.

- 1/ Official estimate of narrowly defined nonperforming loans of the 21 major banks at end-September 1992. Such loans are defined as those on which interest has not been paid for at least six months. Restructured loans and problem loans to nonbank financial institutions are excluded from this estimate.
- 2/ Staff estimate about ¥ 16 trillion of losses derived from loans by all banks to the real estate, construction, and nonbank sectors. The assumption is that banks' real estate losses equal the difference between the face value of the loan and the current market value of the real estate collateral.
- 3/ Nonperforming loans are estimated using the chargeoff rate implied by the official figures.
- 4/ Government support of troubled banks and related losses incurred by the Bank of Finland in 1992.
- 5/ Support by the government and central bank to commercial banks, savings banks, and the Savings Bank Guarantee Fund in the period 1988-92.
- 6/ Government cash support of commercial banks and savings banks in 1992. Also, 1.3 percent of GDP in loan guarantees to the banking sector were provided in 1992.
- Net present value of actual and projected insurance losses to the deposit insurance funds of the FDIC and to the Resolution Trust Corporation.

A capsule summary of the forces at work runs along the following lines. Prior to the financial liberalization of the 1980s, officially sanctioned banking cartels, in concert with a host of regulations, served to restrict competition in the financial services industry. Banks and other financial institutions thus enjoyed a financial cushion in the form of excess profits (rents); in fact, banks who operated in these regulated markets were among the most profitable in the world. These rents were essentially obtained from the consumers of financial services who had limited alternatives. 1/ An important component of bank capital under these regimes was the discounted value of the rents that banks had expected to earn in the future Innovation and liberalization opened many financial markets to intense competition for these rents. Prime borrowers, for example, realized that they could meet a high proportion of their financing needs at lower cost by accessing markets directly via the issuance of commercial paper. Depositors too began more and more to have access to higher-yielding alternatives to bank deposits. This in turn increased banks' own marginal cost of funds. In addition, banks' cost of equity capital typically rose, as equity markets reacted, inter alia, to banks' loss of market share in the AAA wholesale market. With both higher funding costs and a lower average quality of client, banks' required rate of return on assets rose as well. Faced with a potential downsizing of their operations, many banks responded to this new, less hospitable environment by increasing the riskiness of their portfolios--a strategy which was also encouraged by the existence of a net of explicit and implicit government guarantees that both protected depositors and made "failure" a less credible deterrent to excessive risk taking. increased tolerance for risk shows up in several dimensions, including a particularly rapid expansion of bank balance sheets in the countries with the most pressured banking systems (ratios of aggregate bank balance sheets to GDP jumped by 50 percent or more within the space of several years), in a growing concentration of exposure to single risk classes (often in lending to real estate at the expense of lending to traditional manufacturing customers), and in the mushrooming of banks' participation in the over-thecounter derivative markets (as discussed in more depth in Section III). 2/ Bank supervisors frequently found that guidelines appropriate for an environment in which banks were highly profitable and had little incentive to risk their capital by exploring risky areas outside the range of

Economic and Financial Surveys contain an account of these developments. 2/ Bank lending as percentage of GDP expanded in Japan from 61 to 94 percent from 1980 to 1990; in Norway from 64 to 85 percent from 1983 to 1986; in Sweden from 43 to 68 percent from 1986 to 1990; and in Finland from 55 to 76 percent from 1986 to 1990; and, more modestly in the United States from 30 to 34 percent from 1984 to 1986. This expansion in credit was generally accommodated during the 1980s by the prevailing monetary policy stance. Monetary policy tightening in the late 1980s and early 1990s

slowed, in most cases, credit expansion and produced a sharp correction of key asset prices -- a development that impaired the value of bank credit.

1/ Previous Capital Markets Reports published in the Fund's World

Devely?

supervisor expertise were less appropriate for this new, more competitive financial landscape; but changes in those supervisory guidelines usually lagged behind developments. In most cases, the increased riskiness of bank portfolios did not translate into an increase in banks' net operating profits (when scaled by the size of their balance sheets). In the end, the increased risks taken by banks were often exposed and turned into losses by a significant, unexpected shift in economic conditions—be it a tightening of monetary policy, a large sectoral shock, a decline in asset prices, or a prolonged period of slow economic activity. Even loans that were collaterized (as in real estate) were adversely affected since the same shock that reduced the borrower's ability to pay simultaneously reduced the value of the collateral. Where these risks were not adequately protected by increases in banks' operating profits or a comfortable cushion of capital, the losses subsequently spilled over into the public domain.

2. Recent banking problems in some industrial countries

Balance sheet problems in banking are widespread among the major industrial countries (Germany is a notable exception). Banking sectors in the Nordic countries have been particularly hard hit but significant problems have also been evident in Japan and in the United States, and to a lesser extent, in France and the United Kingdom as well. This section outlines the recent experience and policy approaches in a sample of industrial countries.

Among the <u>Nordic countries</u>, the first signs of trouble emerged in <u>Norway</u> in 1987, following a period of several years during which domestic credit rose at an annual rate of more than 20 percent. The removal of credit rationing in 1984 triggered a channeling of bank activity into riskier, more unfamiliar markets, including stock market speculation that generated significant losses.

Initially, the industry-operated deposit insurance funds were used to facilitate the assumption of ailing institutions by stronger banks. By 1991, however, the Norwegian authorities were forced to inject preference capital and direct equity into the major banks. In return, shareholders agreed to substantial write downs of their shares. By the end of 1991, the government had become the sole owner or the majority shareholder of the country's three largest banks, accounting for about 85 percent of the total assets of all commercial banks. These banks suffered further sizeable losses in the third quarter of 1992, reflecting both temporarily high interest rates (initiated in the unsuccessful defence of the pegged exchange rate) and losses stemming from the failure of a large insurance company. maintain market confidence in banks, the authorities in November 1992 made available further subordinated and equity capital. The total injection of funds into the banking sector has been about 2.8 percent of GDP (Table 1). Banks have agreed to reduce their operating cost by 15 percent over the next two years and to reduce their risk-weighted assets to eliminate overcapacity in the banking sector.

A key lesson of the Norwegian case is that bank supervision may need to be restructured <u>prior</u> to financial market liberalization so as to cope with the new challenges and risks that liberalization entails. In a regulated regime with credit allocation guidelines, compliance with these guidelines may serve as an adequate instrument for limiting excessive risk taking by banks. But once those credit allocations are removed, supervisors may find themselves more at sea--both because of limited experience with monitoring new activities and because of an overstretching of limited personnel.

After a period of rapid credit expansion in 1988-89, banks in Finland began to experience a sharp rise in loan losses. Here too, liberalization of financial markets was followed by an increase in relatively high risk lending by banks and by their increased involvement in securities market speculation. In this case, however, the sharpness of the ensuing banking crisis in 1991 and 1992 was due primarily to the collapse of the real economy (linked, inter alia, to the collapse of trade with the former Soviet Union). The resulting nosedive in the cash flow of enterprises (that were formerly good credit risks) created balance sheet problems for borrowers; this was exacerbated by reduced bank lending, induced in turn by the decline in banks' own capital. In addition, the banks suffered from a collapse of the stock market that forced a write-down of bank share holdings. Real estate losses mounted with the collapse of economic activity. Losses from speculation in currency and securities markets also took a serious toll.

Concerns about both the widespread fall in banks' capital ratios and an incipient credit crunch, led the Finnish Government to initiate a plan in March 1992 to provide banks with an infusion of preference capital. In February 1993, the Finnish Parliament passed a resolution that requires the Government to guarantee that Finnish banks are able to fulfill their commitments on a timely basis under all circumstances. If necessary, the Parliament committed to provide the government with sufficient funds and powers to ensure fulfillment of these commitments. Total support to date has been huge--on the order of 6 1/2 percent of GDP.

As in the case of Norway, bank supervision and regulation in Finland proved inadequate to control the risk taking of banks in a liberalized environment. Risk taking (in 1988-89) associated with massive financial market speculation (undertaken in a contest for control of banking markets) proved especially troublesome. Finnish bank supervisors were apparently hampered by, inter alia, the opaque financial status of the large financial/industrial groups that dominate the economy. Supervisors were not empowered to examine subsidiaries and other companies under the control of the banking groups to determine the equity and lending interconnections within the group. In addition, bank supervision lacked sufficient staff resources to provide adequate and timely bank examination.

Compared with banks in Norway and Finland, banks in <u>Sweden</u> experienced a particularly abrupt increase in loan losses in 1990-92, following a rapid credit expansion in 1986-89. A liquidity crisis in the finance company sector, arising after heavy losses, triggered the crisis. The Government's

support has largely taken the form of capital injections and of loan guarantees. Total support is estimated to be somewhat above 4 percent of GDP (5.5 percent if loan guarantees are included). In December 1992, the Swedish Parliament passed a bill affirming the government's guarantee that banks and certain other credit institutions can meet their commitments on a timely basis. The only commitments not covered by the guarantee are shareholders capital and perpetual subordinated debt.

One option for recapitalizing a troubled banking system is to allow banks to earn above-market interest rates over a sustained period of time. In the Nordic countries, however, financial deregulation is sufficiently far advanced and financial systems are sufficiently internationalized to limit the feasibility of this tack. Hence, they have taken the alternative option of recapitalizing the banking system with public funds, coupled with measures, aimed at the elimination of excess capacity. More specifically, the banks were required to rationalize branch networks, reduce employment, and downsize balance sheets. Nevertheless, the injection of public funds has amounted to a de facto nationalization of these institutions. This has left those governments with the problem of reprivatizing the banks. There is also a risk that availability of cheap public capital to weaker institutions can place them at a competitive advantage relative to the remaining solvent institutions, thereby compounding the problems of the latter.

After several years of rapid growth in the exposure of <u>Japanese</u> banks to real estate-related borrowers (see Table 2), a decline of real estate prices by up to 50 percent <u>1</u>/ since 1989 produced an unprecedented increase in the volume of non-performing bank loans. Suffice to say that estimates of the size of non-performing bank loans at the 19 largest banks vary widely--from the Government's own estimate of yen 12.3 trillion (2.6 percent of GDP)

^{1/} It is possible that the decline in the value of real estate has in fact been larger, but lack of transactions data make it difficult to pinpoint the estimate closer. The decline is real estate values in London and New York has also been estimated at about 50 percent.

Table 2. Loan Concentrations in Japanese Banks

(Percentage of all loans)

	Manufacturing	Real Estate and Nonbank Finance Companies	Small Business
City banks			
1980	32.9	15.9	37.5
1992	21.0	19.5	54.8
Long-term credit banks			
1980	36.2	15.8	27.2
1992	12.3	36.9	41.6
Trust banks			
1980	30.9	13.2	22.3
1992	9.0	42.8	46.1
Trust accounts			
1980	28.4	16.1	19.3
1992	8.9	38.1	42.2
All banks			
1980	32.6	10.9	32.5
1992	13.2	26.3	50.4

Source: Bank of Japan, <u>Monthly Economic Statistics</u>, Special Tables, July 1980 and November 1992.

to other estimates of yen 60 trillion (over 12 percent of GDP). 1/ The ultimate losses are expected by the Ministry of Finance to be in the neighborhood of a third of non-performing loans; applying this one-third ratio to the above estimates of non-performing loans, losses could dig deeply in these banks' total Tier I capital base. In addition, a decline in equity prices by more than 50 percent since 1989 has taken a large bite out of the banks' revaluation reserves, held in the form of unrealized profits on their long-term equity investments. At the peak of the stock market boom in 1989, revaluation reserves of the major Japanese banks were sufficiently large to satisfy fully their Tier II capital requirement (4 percent of riskweighted assets)2/, while at end-September 1992 the contribution of such reserves had fallen to about one third of Tier II capital requirement. Since then, various official policy measures have helped to stabilize equity values and to ease the threat to the capital position of Japanese banks; that being said, the historical volatility of Japanese equity prices is sufficiently high to argue against a sense of complacency.

In response to the decline in their Tier II capital, the major banks doubled their subordinated debt to yen 10 trillion during 1992 $\underline{3}$ / and also reduced their risk-weighted assets by 2.5 percent. The reduction in total risk-weighted assets, along with a downgrading of the credit ratings of some Japanese banks, has induced them to adopt a much lower international profile than in earlier years, particularly in the international interbank markets and in lending to East Asian countries. $\underline{4}$ /

^{1/} Differences in the definition of non-performing loans and in coverage explain much of the discrepancy in the estimates. The Ministry of Finance defines nonperforming loans as those on which interest has not been paid for at least six months, and it excludes all restructured loans and nonperforming loans to nonbank financial institutions. The estimate of Y 12.3 trillion in non-performing loans is the Ministry of Finance estimate for the end of the 1992 interim accounting period. This was a relatively restrictive amount since, by its nature, it could not include nonperforming loans that will emerge following the steep real estate price declines in 1992. If real estate prices return to near pre-boom levels, a fairly conservative calculation for the real-estate oriented lending from the top 19 banks--direct real estate loans, construction loans, and loans to non-bank finance companies--indicates that non-performing loans will reach about Y 35 trillion or about 43 percent of the Y 82 trillion of lending in these areas.

 $[\]underline{2}$ / Under the Basle capital accord, banks are permitted to count 45 percent of unrealized capital gains on securities (but not real estate) as Tier 2 capital.

^{3/} The weakness in equity prices has precluded the issuance of Tier I capital. Also since loan losses have not yet been realized there has been less pressure to raise Tier I capital.

^{4/} There is currently no Japanese bank, apart from the Central Cooperative Bank for Agriculture (Norinchukin), that enjoys a AAA credit rating.

A second initiative, launched by the banking industry in February 1993, was the creation of the Cooperative Credit Purchasing Company (CCPC)--set up to buy problem loans collateralized by real estate from member banks and affiliated non-bank finance companies. The loan purchases will be at a discount to the face value of the assets, with funds provided by the selling institution. The seller will be allowed to record the discount as a tax deductible loss. 1/ The authorities are strongly supportive of this effort, but at this time are not prepared to provide more than some seed money to fund the agency. These efforts, in addition to the support of equity prices via the Government's recent fiscal stimulus package and other measures, have succeeded in raising the end 1992 (Basle) ratio of total capital to risk-adjusted assets of the major banks to somewhat above the required 8 percent; their average Tier I ratio was 4.4 percent.

The Japanese authorities expect banks to be able to earn and to costcut their way out of current debt problems over the next few years. This
strategy has been underpinned by: a supplemental fiscal package (2.25
percent of GDP)--designed in part to stabilize equity and real estate prices
by stimulating general economic activity; government purchases of land; new
loans by the Housing Loans corporation; and larger equity investments of
postal savings funds by the Ministry's Trust Fund account and public pension
funds. In addition, a gradual reduction in the discount rate since July
1991 from 6 to 2.5 percent has allowed banks to increase net interest income
(since in Japan, as elsewhere, deposit rates tend to fall faster than loan
rates).

For this earn-your-way-out-of-trouble approach to succeed, either real estate and equity prices need to return to pre-problem norms or spreads between lending and deposit rates must remain wider than would be the case under a fully liberalized financial system (or indeed, wider than they had been in the late 1970s and early 1980s before deregulation). On the latter count, the ongoing efforts to liberalize the Japanese financial system -- set in motion in more propitious times -- and the progress already made in moving toward a more competitive, market-based system, make it harder for the banking system to maintain above market interest rate spreads. In particular, the factors that are threatening the franchise value of large banks in other major financial markets -- a more competitive environment with more liquid money markets and direct debt markets--are putting pressure on the earnings of Japanese banks as well. Corporations have already gained access to competitive international markets and they are unlikely to allow banks to charge above market spreads. In addition, a growing presence of technically sophisticated foreign firms in Tokyo, unhampered by balance sheet problems, is eating away at the profits from technically upscale securities market activities. The increased competition between the securities houses and the banks, the desegmentation of the banking system, the already substantial liberalization of interest rate controls, and the

 $[\]underline{1}$ / The first batch of nonperforming loans of ¥ 700 billion face value was bought by the CCPC at 66 percent of face value in April 1993.

decline of the system of main banks, all an be expected to put additional pressure on the earnings of these institutions.

At the same time, several features of the Japanese financial system -- as well as some features of the broader economic situation -- give the authorities more room for maneuver in dealing with the bad loan problem than is available in many other countries. First, the accounting system does not yet force the timely recognition of gains and losses carried on balance sheets. Credit institutions can and do push loan losses into the future by financing interest-due with new money. 1/ Put in other words, "the system is still more Baker than Brady." In addition, many of the most common overthe-counter contracts are not subject to margin calls and can be rolled over at original prices. This lack of transparency can however have adverse longer-term consequences. By clouding the true extent of the loan loss problem and by pushing it into the future, it may only increase the adjustment that ultimately needs to be made. If, for example, banks use the grace period to undertake more risky investments rather than to cut costs. reduce capacity, and make better quality loans, then the size of the problem can mushroom (as demonstrated in the U.S. saving and loan crisis; see below). Second, and reflecting the economy's high saving history, there are a number of large institutional investors, such as pension funds, life insurance companies, and the postal savings systems, whose portfolio decisions are apparently amenable to informal official guidance, and thus can be directed in part toward shoring up sectors of the economy that are experiencing temporary difficulties. Finally, the pace of progress towards achieving a more market-based financial system remains to some degree a public policy decision; for example, those reforms that would increase the degree of competition facing banks could be slowed temporarily during the adjustment period. 2/ But here too there is a risk, namely that an interruption in the liberalization process could be seen as a weakening of the authorities heretofore strong commitment toward creating a more competitive, more transparent, and more efficient financial system in Japan.

After several years of serious difficulties, the banking industry in the <u>United States</u> has recently been enjoying at least a temporary respite: a strong upturn in profits flowing from the cyclical drop in interest rates. In fact, it is this rebound in bank profits that has thwarted earlier

^{1/} In this regard it is notable that lending by the banking sector to non-real estate related borrowers declined by 0.5 percent during 1992, while lending to the real estate sector grew by 5.9 percent during the same period. Since new construction activity was moribund during 1992 it is likely that a part of the increase in lending to the real estate and construction sector financed interest payments on outstanding loans.

 $[\]underline{2}/$ The authorities retain significant discretion in setting the pace of for the introduction of further liberalizing measures, such as the abolition of fixed commissions in securities trading, the removal of the remaining interest rate controls, the increased disclosure of financial information.

forecasts (including that of Presidential candidate Perot) of a "December surprise" in bank failures. In the 1980s and continuing into the beginning of the 1990s, U.S. commercial banks had experienced a series of significant losses arising from concentrated credit exposures to regional economies. Sizeable losses on loans to developing countries, to oil-related industries, and to real estate resulted in an increase in the number of bank failures. In 1989, one-half of all bank failures were attributable to oil-patch loans in Texas and the Southwest, while soured commercial real estate loans have since become the key factor in bank failures, particularly in New England and the West.

The origin of the current problems in the United States banking sector follows the stylized, declining-franchise-value story outlined earlier in this section. Confronted with increased competition in both deposit taking and lending activities, banks in the 1980s significantly altered the pattern of their lending. Total commercial bank lending relative to nominal GDP increased from 30 percent in 1980 to 34 percent in 1986, an increase that was sustained throughout the latter part of the decade. Much of this increase was concentrated in real estate loans, which increased to 32 percent of banks' total loans and securities in mid-1992, from 23 percent in 1980. At the same time, commercial and industrial loans, which traditionally formed the core of banks' lending operations, dropped to 18 percent of banks' total loans and securities in 1992 from 24 percent in 1980.

The recent wave of bank failures pushed the fund of the Federal Deposit Insurance Corporation's (FDIC) that guarantees deposits in commercial banks to the brink of insolvency in 1991. Failed banks insured by the FDIC in the previous few years were mostly located in the Southwest and New England. Banks in these regions are still suffering from locally depressed real estate markets. The savings bank sector, with a business similar to that of the savings and loans, constituted one third of the disbursements made by the FDIC. In 1991, FDIC funds were augmented with increased authority to borrow \$25 billion from the U.S. Treasury under the FDIC Improvement Act. Estimates of the present value of losses to the banks' insurance fund from the anticipated failure of troubled institutions over the next several years range from \$15 billion to \$88 billion and center around \$30 billion (0.5 percent of GDP). 1/ This amounts to roughly one-sixth of the losses sustained by troubled savings and loans during the latter part of the 1980s. While the wide range of estimates points to the difficulty of predicting these losses, it nevertheless is expected that the FDIC could at least meet the losses in the lower end of this range with the resources currently at its disposal, including the \$25 billion line of credit with the Treasury to cover insurance losses and the revenue from deposit insurance premiums.

The largest banks in the United States--the money center banks--have not recently been among those that have failed. Nevertheless, recent losses

^{1/} See Background paper.

in these banks--primarily due to commercial real estate lending--have exacerbated the difficulty of attaining or maintaining regulatory capital requirements. In the last half of the 1980's, money center banks dramatically shifted their asset portfolios: commercial and industrial loans fell from 29.5 percent of assets in 1985 to 21.6 percent in 1990. Simultaneously, real estate loans rose from 10.5 percent to 18.4 percent of assets as the retail-oriented money centers moved into nationwide mortgage lending. This shift soon produced an increase in loan losses: in 1987, non-current real estate loans were 3.4 percent of the real estate portfolio of money center banks; by 1991, that percentage had climbed to nearly 9 percent. By way of comparison, non-current real estate loans increased from 2.1 percent to 4.5 percent of the portfolios of regional banks. 1/

The approach of the United States authorities to current banking problems reflect some lessons that were painfully learned during the saving and loan crisis. The losses incurred by a large number of thrift institutions (related to a large mismatch between their cost of funds and the return on their assets) in the early 1980s virtually exhausted the industry's capital. In that crisis, regulators initially eased capital adequacy standards by relaxing accounting rules and by expanding the permissible investments of savings and loans. In effect, rather than closing insolvent institutions, the regulators allowed these savings and loans both to benefit from government insured deposits and to increase the riskiness of their operations in a bid to regain viability. The result by 1989 was an industry with one profitable and adequately capitalized segment, and with another deeply insolvent segment. The present value of losses to the government from this latter segment of the thrift industry was about \$180 billion. 2/ This experience led to an important and unique regulatory initiative in the United States, namely the prompt corrective action regulatory framework3/ implemented in 1992, which greatly reduces the scope for troubled institutions to increase the riskiness of their

¹/ The nonperforming numbers for both regional and money center banks are calculated at the holding company level. They include nonaccrual loans and loans past due 90 days or more.

^{2/} Congressional Budget Office, <u>The Economic and Budget Outlook: Fiscal Years 1994-1998</u> (Washington: Government Printing Office, January 1993).

^{3/} The prompt corrective action rules prohibit any insured institution that is classified as undercapitalized from paying dividends. Such institutions are also subject to additional mandatory supervisory actions, including increased monitoring by the appropriate Federal banking agency, formulation of a capital restoration plan, restrictions on growth in total assets, and limits on new acquisitions, branches, and business activities. Any significantly under-capitalized institution, in addition to the above measures, is subject to mandatory limits on managerial compensation, while any critically under-capitalized institution must be place in conservatorship or receivership within 90 days. The banking agencies many also use range of discretionary actions to protect the against losses.

operations. Rather than expanding the permissible assets and activities of troubled institutions, the new law curbs the operations of such institutions and requires the regulators to initiate the closure of a bank if the ratio of its tangible capital to total assets drops below 2 percent.

In 1992, concerns emerged about a rapid deterioration in the quality of domestic assets of <u>French</u> banks. The first sign of this deterioration began to appear around end-1991 as the economy slowed, with signs of strain emerging among many small- and medium-sized businesses. <u>1</u>/ Since then, the problems have intensified and spread to larger groups. An estimated 20 percent decline of prices in the Paris real estate market from their peak in 1990 has further compounded the deterioration of the banks' balances sheets. Finally, a rise in short-term interest rates triggered by the defense of the French franc cut interest margins and added to the banks' problems.

Banks exposure to the commercial real estate sector grew very rapidly in the period 1988-90, and the French Bankers Association estimates that loans to this sector now account for about 8-9 percent of banks' total loans. These exposures, however, are not distributed evenly throughout the banking system, as a handful of institutions have real estate exposures in the range of 10 percent to 30 percent of their total loans. In December 1992, representatives of the banking and insurance industry asked the government to support the ailing commercial property market. The government has responded by extending the holiday on the 20 percent transfer tax that is payable on property deals, by reinstating the favorable tax treatment of finance leases to encourage owner-occupation, and by easing administrative procedures that were designed to discourage the take-up of office space in Paris. There are also two features of the Paris real estate market that tend to promote stability. First, close co-operation between lenders and public authorities are helping to prevent fire sales and wholesale liquidations. Second, office vacancy rates are relatively low at around 6-7 percent, although the trend is upward.

The approach taken toward banking problems in France has traditionally relied on cooperative efforts from within the banking system (including a loss sharing arrangement) to prevent banking problems from spilling over into other sectors. So far, French authorities expect that this approach can again be used successfully to deal with current difficulties. As in some other industrial countries, much depends on the pace of recovery of economic activity and on the path of interest rates. The quicker the recovery and the more pronounced the decline in interest rates, the more likely it will be that the banking industry can solve its current problems on its own.

^{1/} Some of the major French banks have been heavily exposed to a string of international corporate failures such the real estate development firm Olympia and York, and the MGM studio.

The performance of banks and building societies in the <u>United Kingdom</u> has deteriorated significantly since 1989 owing to the prolonged recession and to a decline in real estate prices of more than 20 percent. Loan losses have come to a large extent from small- and medium-sized businesses that been least able to withstand the downturn; however, in 1991-92, there has also been a string of failures of larger corporations and property developers. Significant exposures to names like Bond, Olympia and York, and Maxwell have been particularly painful to the banking sector. More generally, the rapid expansion of credit in the late 1980s has left the private sector over-leveraged. U.K. banks and building societies have sharply increased loan loss provisions over the past two years. This has in turn been reflected in a marked reduction in pre-tax profits from their peak in 1988. Indeed, in 1992, one clearing bank reported the first loss in its history.

All this notwithstanding, UK financial intermediaries have remained in relatively stable financial position -- at least compared with banking systems elsewhere. UK authorities have generally required that UK banks achieve a higher capital to asset ratio than required by the Basle capital agreement. For example, the four clearing banks had a risk-weighted Tier I capital-asset ratio of nearly 6 percent in mid-1992, or 50 percent more than the required Basle ratio.

Like the banks, U.K. Building Societies, which specialize in mortgage lending, have been vulnerable to the troubled residential real estate market. A significant positive factor, however, is that while 100 percent mortgages have been relatively common in the United Kingdom, most mortgages with a loan-to-value ratio in excess of 75 percent were insured. Thus, the losses on residential mortgages have been borne in the first instance by the insurance companies.

As elsewhere, the future course of real estate prices and the timing and strength of the recovery are important variables for the health of the U.K. banking system. There are some signs that the U.K. banks may be at a turning point. Bank share prices rose sharply in 1992 and early 1993, outperforming the stock market as a whole by a wide margin. In the period ahead, bank earnings are likely to benefit from the recent drop in U.K. interest rates and from efforts to trim operating expenses.

3. Three choices and an ounce of prevention

As hinted at above, countries faced with significant banking problems generally have three broad policy options.

One option consists of slowing deregulation and innovation, so as to create a less competitive environment, to allow institutions time to earn their way out of losses by keeping spreads high. This approach requires regulatory forbearance to push accounting losses into the future, and it places the costs directly onto depositors and borrowers. The rub with the

buying-more-time approach is that it can undermine the incentives for the banking sector to reduce capacity, lower costs, and reduce risk-taking. In the U.S. saving and loan crisis, this approach produced very poor results because many institutions used the extra time not to adjust--but to redouble their bets. In the developing-country debt crisis, the buying-more-time approach eventually yielded a more favorable outcome--but only because the additional time was used by lenders to build up provisions against eventual losses and by borrowers to undertake adjustment and reform programs that improved their debt service capacity.

A second approach consists of a direct government injection of capital into the troubled institutions, conditional on downsizing to avoid future problems. This approach is often the default option when the troubled institutions are regarded as "too large to fail" and when liberalization and internationalization of the financial system has already proceeded to such a degree that depositors and borrowers cannot be held captive to higher spreads. In any case, when this approach has to be taken, it is essential that the direct capital injections be made conditional on downsizing of the industry and on a strengthening of bank supervision so as to avoid a recurrence of the same problem.

The third approach is to accept the reality that certain troubled institutions have no remaining value and that liquidating them before they can do more harm is the most sensible long-term solution to the problem. While this approach is of course the most direct answer to overcapacity in the industry, it is only likely to be feasible in situations in which the problems are not concentrated in institutions whose closure would not have "systemic" effects--either for that economy or for the international financial system at large. In addition, this approach also is subject to the judgmental problem of distinguishing a permanent from a transitory or cyclical weakness.

So much for current banking strains and crises. What can be done in the future to minimize the probability of recurrences? Financial authorities in the industrial countries have been making major efforts-mostly through the G-10 Basle Committee on Banking Supervision--to revamp the regulatory and supervisory framework so that it can cope better with the new more competitive international environment. Considerable progress has been made in putting into place more stringent risk-based capital

requirements 1/--for credit and market risk--to induce more prudent behavior by banks and other financial institutions and to serve as a financial buffer against losses through official safety nets. By early 1993, international banks in all G-10 countries met the January 1993 Basle capital requirements. Similarly, improvements in the consolidated supervision of international banking should reduce the practice of regulatory arbitrage. In addition, several countries are undertaking reforms of their financial disclosure requirements to make banking and finance more transparent.

All these reforms are welcome. Given the cost of resolving banking and financial crises, this is indeed an area where an ounce of prevention is worth many pounds of cure. Still, it would be unreasonable to expect these improvements in the regulatory and supervisory framework to eliminate strains in national banking systems. The reality is that major banking systems are in a structural transition to a changing competitive environment and current banking problems are to some extent a reflection of that transition. That transition will not be completed over night--especially in countries where financial innovation is still accelerating.

III. The Growing Involvement of International Banks in Derivative Finance - A Challenge for Financial Policy

In its continuing search for profitable new activities, the international banking sector has expanded its involvement in the over-the-

^{1/} Concerns have been expressed that the Basle capital adequacy accord could discriminate against new lending by commercial banks to creditworthy developing country borrowers. Under the accord, a risk weight of 100 percent is applied to exposure to non-OECD/GAB governments compared with a zero weight to such borrowers in OECD/GAB countries. The distinction between countries with a zero percent risk weight and those with a 100 percent risk weight is to some degree arbitrary, and not based on strictly prudential criteria, and various proposals for refining the system have been put forward from time to time. In principle, the higher risk weight applied to non-OECD/GAB borrowing countries increases the cost of loanable funds for the commercial banks. This could be reflected, ceteris paribus, in higher interest rate spreads and may generally deter new lending to these borrowers as banks look to increase their risk-weighted capital ratios. However, there has been little conclusive evidence that risk weight categories have had a major impact on the terms of new bank lending to developing countries. Empirical evidence on this point was presented in Management of the Debt Situation, EBS/92/52, Supplement 1.

counter (OTC) derivative business. $\frac{1}{2}$ Indeed, the most notable development in international financial markets during the past five years has been the growth in volume and in diversity of over-the-counter financial derivative instruments. 2/ Exchange-traded derivative contracts have likewise grown at a dizzying pace, stimulated in large part by the over-thecounter business of the banking sector. The volume of outstanding exchangetraded and over-the-counter contracts -- e.g., futures, forwards, forward rate agreements, swaps, options, and caps/floors/collars--has grown from \$1.5 trillion in 1987 to \$10 trillion in 1992, or from 33 to 160 percent of United States GDP (Table 3). This development has fundamentally altered the structure of international finance and the interaction of markets. It has also created new sources of risk. 3/ By now, the advantages that derivative markets offer for hedging price risks and for increasing the liquidity of underlying markets are well appreciated. But the exponential growth of the derivatives market has forced regulators and other financial authorities to wonder if prudential considerations are being given enough attention. After all, harking back to the principles of sound banking alluded to earlier, experience suggests that rapid expansion and concentration in a particular banking activity often signals both a weakening of internal controls and an underassessment of credit risk.

The market in over-the-counter derivative contracts--e.g., forward interest rate contracts, interest rate and exchange rate swap agreements, interest rate options--is highly concentrated in a few large banks and securities firms in the United States, Japan, France, the United Kingdom, Germany, and Switzerland. These firms act as dealers entering into transactions with end-users or with other intermediaries. The most actively used OTC instruments are interest rate swaps, the notional principal outstanding of which was estimated to have grown from \$0.5 trillion in 1987 to \$3.5 trillion in 1992. In the first half of 1992, the total notional principal amount of interest rate and currency swaps written amounted to

<u>1</u>/ While OTC contracts are tailor-made by the intermediaries to fit the end-users' needs, exchange-traded contracts are of standard maturity, contract size, and delivery terms, and the exchange itself is the counterparty in each transaction. The most actively traded financial derivatives on organized exchanges are futures on interest rates, primarily US Treasury bond rates, Eurodollars, French Government bonds (OAT) and German Government bonds, and Japanese Government bonds.

^{2/} See Background paper for detailed description of types of instruments.

^{3/} Derivatives allow borrowers and lenders to change easily the risk characteristics of securities, e.g., currency denominations or interest rate structure (floating or fixed, caps), or to create completely new risk positions. For example, a US borrower who would like to obtain floating rate DM to fund a direct investment in Europe, might access the fixed-rate US\$ market, but swap the proceeds into the floating rate DM market and attach a DM interest cap.

Table 3. Markets for Selected Derivative Financial Instruments, Notional Principal Amounts Outstanding, 1986-91

(In billions of U.S. dollars, end-year data)

		-				la la company de		
							Percent Change	
	1986	1987	1988	1989	1990	1991	1986-91	1990-91
Exchange-traded instruments	583	725	1,300	1,762	2,284	3,518	503	54
Interest rate futures	370	488	895	1,201	1,454	2,159	484	49
Interest rate options 1/	146	122	279	387	600	1,072	634	79
Currency futures	10	14	12	16	16	18	80	12
Currency options 1/	39	60	48	50	56	59	51	5
Stock market index futures	15	18	28	42	70	77	413	10
Options on stock market indices $\underline{1}/$	3	23	38	66	88	132	•••	50
Over-the-counter instruments 2/		/ 866	1,326	2,423	3,451	4,449	790	29
Interest rate swaps 4/ Currency and cross-currency interest	400 3	/ 683	1,010	1,539	2,312	3,065	666	33
rate swaps $4/5/$	100 3	/ 183	316	434	578	807	707	40
Other derivative instruments $3/4/5/$				450	561	577		3

Sources: Staff estimates; Bank for International Settlements (BIS) calculations; Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Comptroller of the Currency, "Joint Study on Derivative Product Activities of Commercial Banks" (January 27, 1993); Futures Industry Association (FIA); International Swap Dealers Association (ISDA); and various futures and options exchanges worldwide.

^{1/} Calls plus puts.

^{2/} No statistics are available on forward rate agreements or over-the-counter foreign exchange options. Only data collected by ISDA.

^{3/} Estimates.

^{4/} Contracts between ISDA members reported only once.

^{5/} Adjusted for reporting of both currencies.

^{6/} Caps, collars, floors and swaptions.

\$1.5 trillion, a 50 percent increase in activity over the second half of 1991.

1. The management of risks in over-the-counter derivative business

Financial intermediaries in OTC markets are subject to several types of risks. The credit exposure is the market value (that is, the capital gains due to the holder) of the contract, which is normally much smaller than the notional value of the contract. 1/ On organized exchanges, such capital gains and losses are squared at the end of the day through margin payments. Hence, credit risk tends to be low for contracts traded on organized exchanges. In contrast, some longer-dated OTC contracts can generate significant credit risks and banks have begun to mark OTC contracts to market and require periodic margin payments. 2/ Banks increasingly are including their OTC credit exposure to a particular counterparty in that counterparty's overall credit exposure limit. The market risk of a derivative contract is the risk that price movements in the underlying security will adversely affect the value of the derivative instrument. Banks manage their derivative book in a manner that is technically balanced to set market risk to any desired level. 3/

The most difficult risk to counter is liquidity risk, that is, the risk that the act of selling an existing position in derivatives will have a significant impact on the price. 4/ Unfortunately, the demands made on derivative products for the hedging of positions can cause liquidity to disappear suddenly in these markets. In the OTC market, where instruments are tailor-made for a particular group of clients, there is in any event less liquidity than in more homogeneous exchange-traded products. For this reason, market makers with uncovered positions at the end of a day's trading will cover either by taking opposite positions in the organized derivatives markets or by synthesizing an opposite position via use of dynamic hedging

¹/ In interest rate or currency swap contracts, for example, the market value of a new contract generally begins at zero and changes only as market interest rates or exchange rates move.

^{2/} Since OTC contracts are tailor-made they frequently lack a market, it is therefore difficult to determine capital gains and losses on a continuous basis.

^{3/} For example, if in an interest rate swap a bank agrees to deliver floating rate interest payments and receive fixed rate payments with a client, it will seek a balancing swap to deliver fixed rate payments and receive floating rate payments.

^{4/} Exchange based derivative markets are frequently more liquid than the markets for the underlying securities so that the transactions cost of establishing an interest rate or stock index position is cheaper in the derivative markets than in the underlying markets.

techniques. 1/ The use of such dynamic hedging methods can generate liquidity problems because they often mandate sales of underlying securities when prices fall or purchases when prices rise; this can trigger an avalanche of sales into a relatively illiquid market for the underlying security, thereby collapsing the price or causing a breakdown in trading. 2/ Thus, the presence of liquidity risk puts limits on the reliability of the methods used to control market risk and should generate skepticism over claims that risk control software has eliminated market risk as a matter of concern.

One type of risk that can potentially be substantially reduced but that has caused the greatest loss to date is legal uncertainty. For example, some participants in the U.K. interest rate swap markets suffered major losses on their contracts with local authorities, which had exceeded their legal authority to enter into such contracts. Another source of such risk is the possibility that swaps may be judged to be futures contracts, in which case the off-exchange trading prohibition of the Commodity Exchange Act in the US would come into play. The CFTC has recently removed some, but not all, of this risk by excluding certain types of swap transactions from being considered as futures or options.

A major source of legal risk is the uncertainty surrounding the <u>legal</u> enforceability of netting arrangements among market participants. Under such arrangements, the exposure arising from multiple derivative transactions is netted. Informal industry estimates suggest that exposure reductions of more than 50 percent are achievable through bilateral netting. In the swaps market, master agreements with netting provisions have come into use in which transactions are automatically netted. Without legal certainty, however, the receiver of a bankrupt counterparty might repudiate the agreement and demand payment on all contracts with positive value

^{1/} In theory, the price behavior of derivative instruments such as call or put options can be mimicked by the price behavior of a specific portfolio of positions in cash and in the underlying securities. Such a portfolio is referred to as a synthetic option. When a position in actual options is balanced by the opposite position in synthetic options, the overall position is perfectly hedged, but maintaining the hedge requires dynamic adjustment of the cash and underlying security positions. Hence the term dynamic hedging.

^{2/} Alternatively, the models used to produce the theoretical hedge may be invalid. During the September 1992 ERM crisis, for example, interest rate volatility was far outside its normal range. Hedging models built on assumptions of low volatility prescribed inappropriate mimicking portfolios to some currency and interest rate OTC options, thereby imposing serious losses on market-making banks.

(cherry picking), while placing the holders of contracts with negative value among the general creditors. $\underline{1}/$

Regulators have at times also raised concerns about the risk of a systemic disturbance in the derivative markets. The worry here is that the failure of a major dealer in the OTC derivatives market could cause liquidity problems both in the OTC market itself and in the cash markets and the organized exchange markets. These markets are all closely linked through arbitrage strategies commonly employed by major dealers. concerns are justified became clear during the stock market crash of 1987 and during the bankruptcy of Drexel Burnham Lambert in 1990; since then, the markets have increased in volume and sophistication. Indeed, a seasoned observer has noted recently that "the expansion of market linkages, which cut across national boundaries and embrace a wide range of financial and nonfinancial firms, raises concerns about the ability of central banks to contain systemic difficulties should they emerge." 2/ Such linkages to other markets were also stressed in the report prepared by the G-10 central banks on Recent Developments in International Interbank Relations (the Promisel Report). 3/

3. The policy issues

^{1/} The BIS sponsored report on netting schemes (Lamfalussy Report) endorses netting as a general risk reduction technique, and suggest a speedy implementation of measures to ensure legal certainty.

^{2/ &}quot;Challenges Posed by OTC Derivatives" Remarks of Susan M. Phillips, Member, Board of Governors of the Federal Reserve System, at the Meeting of the National Futures and Options Society, New York, Dec. 3, 1992.

^{3/} The explosive growth of trading in derivative products and other securities has greatly increased payments traffic through the world's major domestic and international payments systems. In the past five years, these mounting pressures on payments systems have spurred central banks to implement mechanisms to control associated credit risks. Non-settlement of a bank's payment operations in a particular currency would either impose a loss directly on the central bank or trigger a systemic problem. credit risks, caps can be placed on daylight overdrafts in gross payment systems (systems in which payments messages sent by payor banks coincide with the receipt of good funds by the payee bank) or on daylight net debit positions on net end-of-day payment systems. Such limits have been imposed on the Fedwire and CHIPS systems in the United States and are planned for the SIT system in France. In addition, some systems have either imposed a partial collateral requirement on net debit positions (CHIPS) or have formally announced intentions to shift to a real-time gross settlement with fully collateralized overdrafts (CHAPS in the UK). The Swiss SIC system has already shifted to the latter mode of operation. Such changes are still in the planning stage for other countries.

Considering the phenomenal growth of over-the-counter derivative markets, the potential for systemic risk, and the fact that this relatively complicated subject is admittedly not fully understood by either senior bank managers or by senior regulators, it is not surprising that questions have been asked about the adequacy of the existing regulatory framework. As one prominent observer put it to the mission, "Derivatives have revolutionized finance, but have yet to revolutionize regulation." That evaluation notwithstanding, several regulatory initiatives are underway to improve the prudential supervision of OTC derivatives activities. Regulators have recently sought to encourage institutions to strengthen their internal risk management practices and to improve oversight of this activity, by their senior managements. In addition, regulatory authorities in several countries are currently in the process of upgrading their prudential supervision of banks in the area of off-balance sheet exposures and of improving their overall understanding of derivatives. Several government and private sector studies now underway aim to address this latter shortcoming.

The main approach to the prudential regulation of the OTC derivative business has been the application of capital requirements to the credit element of derivative contracts. 1/ At present, the capital requirements are applied almost exclusively to gross OTC derivative positions. Only net positions achieved through novation are recognized by the accord. However, efforts are underway in the Basle Committee to recognize other types of netting arrangements that have legal certainty. 2/

Could risk-reduction also be achieved by channelling more of the OTC business to the organized exchanges? Organized exchanges are generally better at risk-management than OTC markets. Margining requirements combined with loss-sharing arrangements have gone a long way toward eliminating credit risk, as well as the risk of spill-over from a major default. It is generally agreed that capital regulations in the OTC markets ought to establish or maintain a level playing field for competition between the

^{1/} Under the terms of the Basle capital accord, which came into full effect in 1993, the credit equivalent measures of derivatives are composed of two elements. The first is current credit exposure of an instrument, which is its positive market value, if any. The second is an add-on for potential future credit exposure, which ranges from zero to 5 percent of the instrument's notional principal value. The sum of the current and potential credit exposure of an instrument attracts a 50 percent risk weight under the accord. However, exchange-traded derivative instruments are excluded from this requirement if they are subject to daily margining requirements.

^{2/} An additional area of controversy surrounding the capital standards as applied to OTC derivatives is the appropriate size of the add-ons for potential credit exposures. Industry representatives have called for changes in the way these amounts are calculated once netting is recognized, with a distinction to be drawn between seasoned and unseasoned portfolios of derivatives.

exchanges and OTC. The problem is that it is not entirely clear what "level" means. At the heart of this question is the concern that the massive growth in OTC business has occurred because the obligations of major banks and their liquidity are implicitly guaranteed by the financial safety net. There may also have been a reluctance on the part of regulators to deprive banks of this lucrative source of income at a time when such income is much needed to bolster capital positions.

IV. International Capital Market Financing for Developing Countries

1. Recent experience

Over the past two years, there has been a resurgence of capital market financing for developing countries. Most notable has been the heavy volume of international bond and equity issues by a group of countries, mainly in Latin America, that had lost market access in the wake of the 1982 debt crisis (although the re-entry showed signs of strain after mid-1992). Asian and European countries that had maintained access during the 1980s also have made increased recourse to international securities markets, although again some countries have experienced setbacks. The growth in scale of portfolio flows has been paralleled by increasing market maturity, by a broadening range of instruments, by rising market liquidity, and by growing availability of information. By contrast, international bank lending to developing countries has remained on a declining trend, notwithstanding continued use of syndicated loans by Asian borrowers and heavy borrowing by some Middle Eastern oil-exporting countries to help meet the costs of reconstruction after the Gulf war. Outside these countries, bank financing has continued to be mainly trade or project related. 1/

A notable feature of the last year was a major shift in the market for Latin American securities. International equity issues by these countries almost completely dried up after mid-year, while yields on Latin American bond issues rose sharply after early October. By early 1993, markets appeared to have stabilized. Yet while new issues have continued to appear, volumes have declined and spreads remain higher.

This market correction reflected a range of factors. In the first place, it seems that the large amount of bonds, equities and short-term debt instruments issued in 1991 and early 1992 meant that investors' portfolios were becoming saturated with Latin America securities. In retrospect, it seems clear that the investor base for these securities remains relatively narrow, notwithstanding reports of increasing involvement of institutional investors. At the same time, there were increasing concerns in the market about economic and/or political developments in Latin American re-entrant

 $[\]underline{1}$ / These developments are described in more detail in the accompanying background paper.

countries. Prices in local stock markets declined sharply around mid-1992, which in turn discouraged domestic issues and made international investors more aware of the volatility of these instruments.

The correction may be regarded as a positive development that should lead to a more careful assessment of risks, more appropriate pricing of new issues, and better information being provided to investors. It is also encouraging that to date the adjustment has occurred mainly through the price mechanism, and that the market has stabilized in early 1993. On the other side of the ledger, there are concerns that the drying up of liquidity and sales of paper on margin could have lingering effects on the market and discourage some potential investors. Looking ahead, it will be important that participants in international securities markets allow the price mechanism to function and that potentially destabilizing market practices—such as those that can temporarily mask imbalances in the market—be avoided.

2. Investor attitudes toward developing country financing

A striking feature of the recent experience has been the <u>marked</u> <u>variations</u> in investor attitudes toward developing country financing both by <u>source country and by investor type</u>. The rapid growth of portfolio financing to Latin America over the past two years has in large part been centered on U.S.-based investors, including flight capital, and intermediated through New York. Resources devoted to emerging markets activity in this financial center have increased rapidly, as have related profits. U.S. money center banks have been main players in this market, even while they have been involved in debt restructuring, often with the same countries, and remained cautious about extending their own balance sheet exposure. It should be emphasized, however, that while involvement by the more mainstream U.S. institutional investors--pension funds and insurance companies--is reported to have grown, it seems to have remained on a relatively small scale.

European-based financial institutions and investors have been much less active in Latin America, and European banks in particular have been reluctant to arrange securities issues for countries with continuing bank debt problems. European interest has focussed more on opportunities in Asia and Eastern Europe, and to a much lesser extent in Africa. The most conservative attitudes seem to be found in Japan, where new developing country financing remains largely limited to traditional customers in Asia and Europe that had avoided debt servicing problems in the 1980s.

The variations in investor attitudes toward developing countries among geographical regions and among types of investor reflect mainly fundamental differences in financial conditions that affect the propensity for holding high-yielding but risky assets, as well as the ties of business and cultural relationships. Differences in regulatory environments among creditor countries may also have contributed to the pattern of re-entry. For example, the relaxation of limitations on the private placement market in

the United States has facilitated the rapid growth of developing country issues on this market. More generally, however, financial regulation is probably relevant to decisions mainly at the margin, and, from discussions with market participants, regulatory frameworks do not seem to have been major impediments to portfolio flows to developing countries. Thus, while efforts to remove regulatory impediments to flows to developing countries may be justified where consistent with prudential considerations, it should not be expected that shifts in the application of regulatory policies would lead to major changes in investor attitudes.

The contrast between the increasingly receptive attitudes found among securities investors and the continued caution exhibited by commercial banks toward the same group of countries reflects in part broader trends in international capital markets. The increasing availability of derivative instruments to address currency and interest rate risk, discussed elsewhere in this report, together with growing investor awareness of the benefits of global portfolio diversification, have facilitated a process of international financial disintermediation from the international banking system. At the same time, bank lending has generally been constrained by the difficult financial situation of many major banks and efforts to adjust balance sheets to satisfy the Basle capital adequacy guidelines. Bank lending to countries that had previously experienced debt servicing difficulties has also been discouraged by the perception that, as in the 1980s, unsecured bank debt would be treated as a relatively junior claim if countries encountered renewed debt servicing difficulties in the future.

Intra-regional developing country flows: the role of Hong Kong and Singapore

Hong Kong and Singapore have traditionally played important roles in intermediating financing flows in the East and South East Asian region, including arranging of and participation in syndicated lending and securities issues, trading of equities, and fund management. Both centers have achieved a critical mass of technical expertise and professional skills, combined with stable macroeconomic environment, strong communications, and attractive tax regimes. Moreover, financial institutions in these centers have generally been bolstered by the high profitability of local operations. It is notable that banks based in these centers--which generally did not participate heavily in the bank lending boom of the late 1970s/early 1980s--have recently gained an increased share of regional syndication business as Japanese banks have pulled back.

While there is much overlap, there is also <u>complementarity in the roles</u> of the two centers, both <u>geographical and functional</u>. Geographical specialization reflects location and political relationships. Hong Kong institutions have increasingly focused on opportunities in South China with the rapid development in that area, while Singapore has particularly close ties with other ASEAN countries. Regarding functional complementarily, Hong

Kong has a larger role in originating new issues and in fund management, while Singapore has specialized more as an off-shore banking center and in regional equity trading, as well as being the world's fourth largest foreign exchange market. This pattern seems to reflect in part the different regulatory characters of the two centers, with Hong Kong's more hands-off regulatory style encouraging a more "free-wheeling" approach to deal-making, while the closer regulatory oversight in Singapore has contributed to confidence in the center for off-shore deposit-taking and foreign exchange activities. International syndication out of Hong Kong has also been encouraged by the relatively larger role of Hong Kong in foreign direct investment, particularly in South China, and the larger local investor base.

Looking ahead, the future development of both centers will be affected by both economic and external factors. While the profitability of local operations has generally been a source of strength, the relatively limited domestic investor base and underdeveloped local capital markets may serve as a constraint in the longer term. In Hong Kong's case, there remains uncertainty about the consequences of integration with China in 1997. Moreover, for both centers, regional competition is likely to increase as other countries--such as China, Malaysia, and Thailand--seek to develop their own financial markets and even to establish rival off-shore centers (such as Malaysia's Labuan Island).

4. Systemic implications of the evolving pattern of developing country financing

The changing character of private market financing for developing countries--securitization of flows/disintermediation from the international banking system -- carries implications for the resilience of the international financial system. As shown by the recent experience with market correction in Latin America, the modalities and timing of market adjustment may differ in the present circumstances from that in the early 1980s. Specifically, there is now greater scope for price adjustments, which may signal emerging difficulties before the situation deteriorates to the point where access is cut off. Also, as an increasing proportion of cross-border flows are in the form of securities held by non-banks, balance of payments difficulties experienced by developing countries would not directly put at risk banks and the international payments system. Instead, adjustment to debt servicing difficulties would likely involve a drop in the price of securities and result in a decline in financial wealth of investors, the global macroeconomic consequences of which would be limited since most large investors would hold only a small proportion of their assets in the form of developing country securities. Consequently, the new financing pattern would seem to imply lower systemic risks than the bank credit flows of the 1970s and early 1980s.

The implications of greater openness to international portfolio flows for the underlying volatility of emerging markets is unclear. These markets traditionally have had a fairly shallow domestic investor base, a limited range of actively traded shares, and financial asset prices that have been

particularly volatile. Greater openness may help broaden the investor base, deepen the market, transfer more sophisticated investment strategies and ultimately stabilize emerging markets. Nonetheless, there is a concern that at least until a broad domestic investor base has developed, competition among international asset managers, combined with the narrow range of liquid markets in which they can invest, would mean that a concerted move in the same direction might generate a high degree of financial asset price volatility.

V. Staff Conclusions

This is not the first time during the past ten years that some industrial countries find themselves faced with crises or strains in their national banking systems, and with the significant costs and constraints that resolving those problems can entail for tax payers and for the stance and effectiveness of macroeconomic (and in some countries, also their exchange rate) policies. To be sure, the current bout of banking problems -- which has a large real estate component -- owes a good deal to "cyclical" factors (the shift from relatively loose to relatively tight monetary policy, the unwinding of earlier asset price excesses, and the slowdown in economic activity). Moreover, it has to be expected that even the most ably managed banks will occassionally make incorrect credit decisions. Still, there is strong evidence to suggest that the frequency and widespread country distribution of banking problems are not independent of the changing competitive environment facing banks in the wake of financial liberalization. More specifically, it is precisely when banks and other financial institutions find both that their competitive position is being eroded and that they suddenly have expanded investment opportunities that they are most suspectible to abandoning the principles of sound banking and to taking excessive risks -- particularly when much of that risk is effectively being underwritten by implicit and explicit government guarantees.

But the right policy message is <u>not</u> to reverse--or necessarily, even to slow--financial liberalization. That would sacrifice the substantial benefits that liberalization brings not only to the consumers of financial services but to the more efficient functioning of the global economy more broadly. Instead, the message ought to be that financial liberalization needs to be accompanied--and when possible, <u>preceeded</u>--by a strenthening of the entire prudential and regulatory framework so that excessive risk-taking by banks and by other financial intermediaries is kept under adequate control. <u>1</u>/ This means, inter alia, maintaining a comprehensive risk-

^{1/} In this connection, once the provisions of the European single market in financial services are fully implemented, banking competition will likely become acute in some of the major continental European markets now dominated, at least in the retail market, by a few monopolistically-competitive universal banks. Some national banking systems may therefore be facing a period of consolidation and rationalization.

weighted capital cover for on- and off-balance sheet positions, strengthening international cooperation to achieve a level playing field in the application of supervisory and regulatory initiatives, consolidating the supervision of international financial conglomerates, increasing the transparency of financial relationships, and taking more prompt action to close insolvent institutions. None of these reform measures--many of which are well underway in international fora as well as in national capitals--are costless. But they are far less costly than cleaning up after the next banking or financial crisis has already occurred.

With regard to the methods used to resolve current banking problems, it is crucial that policies designed to allow banks to earn their way back to health not undermine the incentives for the banking sector to reduce capacity, lower costs, and control risk. Similarly, it is equally important that any direct injection of public sector assistance be conditional on the downsizing of the industry. Finally, if it is decided to close institutions this should be done promptly.

2. The past five years have witnessed enormous growth in the volume and diversity of financial derivative instruments. What was approximately a \$1 1/2 trillion market in 1987 is more than a \$10 trillion market today. Much of that growth has been concentrated in the bank-driven over-the-counter markets, although exchange-traded derivative contracts has shown an impressive expansion on their own. There is no doubt that these markets serve a useful function in hedging price risks and in increasing the liquidity of markets in the underlying instruments. In a similar vein, because over-the-counter derivative contracts can be custom-tailored to the needs of participants in ways that exchange-traded contracts cannot, their rapid development reflects in some measure a genuine market demand.

On neither count, however -- be it the growth and operation of the derivative markets as a whole, or on the participation of banks in that market -- would it be wise to conclude that benign neglect would be a sensible policy approach. While recent official studies of the derivatives markets (e.g., the Promisel Report) have found that participants have made real progress over the past few years in moving up the learning curve -particularly as regards management of market risk, various potential sources of systemic risk remain. For one thing, the lack of transparency in these markets and the nature of their connection to other markets raises the spectre that a problem in one market might rapidly be transmitted to other markets; indeed, both the stock market crash of 1987 and the recent ERM crisis last fall provided some glimpses of how assumptions about the continuous availability of liquidity in closely-related markets can be belied in crisis situations. The possibility that the consequences of a default of a major participant could not be immediatly unravelled would also make it difficult for regulators to close an insolvent institution. Given the vast amounts of claims that now exist in these markets, there would seem to be a compelling case for relying more on netting as a useful tool for reducing bilateral credit risk, and with it, the risk of systemic

disturbances. It therefore also follows that there would be dividends from moving forward within the G-10 to implement legal reforms that ensure that netting, both bilateral and multilateral, will survive any legal challenges.

Turning to the heavy and rapidly growing involvement of banks in the OTC derivative market, the concern is that this involvement may in part represent yet another manifestation of an excessive shift toward higher risk/higher return activities -- induced by competitive pressure and by the privileged access of banks to the official safety net. In this connection, the fact that the organized exchanges have in place mechanisms --namely, margining, netting, and loss-sharing -- that help to reduce systemic risk argues for not tilting the future growth of the market toward the bank-driven OTC component. Application of appropriate capital requirements to off-balance sheet commitments and claims would be a step in that direction. Alternatively, measures might be taken to put in place similar risk-reduction mechanisms in the OTC market. For example, the legal framework might be altered to permit banks to set up multilateral clearing houses with loss-sharing arrangements.

3. While the resurgence of capital market financing to developing countries has continued over the past year -- with flows reaching unprecedented levels -- it is noteworthy that market developments have been neither smooth nor uniform, with several important sectors suffering This experience should serve as a timely reminder that the recent re-entry to private capital markets remains fragile for a number of developing countries. The investor base is still relatively narrow. If market access is to be sustained, borrowing countries will need to avoid over-dependence on any particular source of funding by broadening their financing base. Inevitably, this will require perservering with sound macroeconomic policies as well as market reforms that foster a domestic environment conducive to increased participation by more risk-averse investor groups and by commercial banks. Attainment of investment grade credit ratings would be an important step toward increasing access to mainstream institutional investors. It will likewise be important to ensure that flows are taking place within a financial framework consistent with adequate dissemination of information and an appropriate matching between risks and returns. This will require efforts by developing countries to improve the transparency and integrity of domestic financial markets, and also by intermediaries in international capital markets to avoid destabilizing market practices.

VI. Issues for Discussion

- 1. What factors do Directors see as contributing to the current banking crises and strains in industrial countries, and what policy measures would be most effective in discouraging a recurrence of those problems?
- 2. In coping with existing banking strains in individual industrial countries, how do Directors evaluate the relative merits of approaches

that rely alternatively on higher interest rate spreads, on more prompt closure of insolvent institutions, and on direct government injection of capital?

- 3. How do Directors view the rapid growth of derivative markets over the past five years, and the heavy involvement of banks in the OTC segment of those markets? What policy measures would be most effective in reducing the potential for systemic risk in the derivative markets?
- 4. What steps can be taken in source countries and in recipient countries to ensure that private flows to developing countries take place in a framework conducive to adequate dissemination of information and adequate matching of risks and returns?

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DIVISION 3 ROOM 4-302

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BUFF/93/9 March 2, 1993

Summing Up by the Chairman
International Capital Markets
Executive Board Meeting 93/25 - February 24, 1993

Executive Directors welcomed the opportunity to discuss the implications of the growth and integration of international capital markets for exchange rate management, and to continue their ongoing review of the lessons of the currency turbulence in Europe. Directors praised the documents the staff put at their disposal. The debate, for obvious reasons, was centered on the European crisis of the past September, but the point was correctly made that many of the observations apply equally to currencies in floating regimes.

Directors shared the staff's view that the behavior of the foreign exchange market has to be seen against the broader trends that are shaping the growth, integration, and agility of international capital markets. The last decade has witnessed the development of an extensive menu of liquid securities, an unprecedented growth of international portfolio investment, the increasing concentration of saving in institutional investment funds, and rapid progress in the technology of financial transactions. On the whole, Directors saw these structural changes in financial markets as welcome and irreversible, entailing significant efficiency gains for the world economy. Moreover, Directors noted, there was little to suggest that the global integration of capital markets had run its course; on the contrary, it appeared to be still in its early stages.

A noteworthy element of the existing financial landscape pointed out by Directors is that the resources available to private foreign exchange market participants are much larger than those available to central banks. While it was observed that this was not a new development, most Directors felt that the recent growth and sheer volume of funds that could be mobilized by the private sector at short notice meant that authorities were now increasingly operating in an environment that was less forgiving of policy inadequacies. In the view of Directors, this put a premium on more timely correction of macroeconomic imbalances, on closer monitoring of exchange rates to see that they remain consistent with underlying fundamentals, and on improved monetary cooperation.

These are areas central to Fund surveillance, and Directors stressed that the strengthening of the Fund's role along the lines of the Board's recent discussion on surveillance would make a crucial contribution in this regard. In particular, the timely, clear, and candid provision of the Fund's views on exchange rates and underlying policies to the relevant authorities, with the appropriate safeguards for confidentiality, would help to ensure that the international implications of national or regional policy decisions are adequately taken into account in the policymaking process.

While recognizing the disciplining role exercised by capital markets over government policies, Directors emphasized that such discipline was neither infallible nor applied in a smooth, consistent manner in all cases. Indeed, several Directors were concerned that the recent ERM crisis was characterized not only by attacks on currencies with relatively weak fundamentals, but also by some attacks on currencies with stronger fundamentals. It was noted in this respect that, in the eyes of market participants, fundamentals might not only include traditional macroeconomic indicators, but also the market's assessment of the authorities' political will to subject the domestic requirements of monetary policy to exchange rate objectives. In any event, all Directors agreed that sound policies and strong fundamentals remained the best preventive mechanism that was available to the authorities to avoid exchange rate crises, whether relating to fixed or floating regimes.

In reviewing the prologue to the recent crisis in the ERM, many Directors drew attention to the large cumulative inflows of capital into the higher-yielding ERM currencies, motivated in part by the diminishing expectation of further exchange rate changes on the way to Economic and Monetary Union, and creating the potential for a large volume of outflows once political uncertainties about EMU arose. Beneath the surface of such "convergence plays" was the reality that achievements in macroeconomic convergence among ERM countries--while significant--were not durable and deep enough to justify an assumption of complete fixity of exchange rates.

Directors noted that the range of private sector participants involved in last fall's ERM crisis was broad--encompassing banks, securities houses, institutional investors, corporations, and a number of hedge funds. All things considered, Directors concluded that markets had functioned reasonably well during the crisis. Despite some liquidity strains, there was no failure of major financial firms, nor any persistent seizing up of the largest asset markets, and the crisis remained localized to European currency markets. Some Directors felt that this experience had illustrated the utility of the improvements in risk-control systems that had been implemented since the 1987 equity market crash, but they also stressed the importance of avoiding complacency and of making further progress in this area.

With regard to the instruments of exchange rate management, Directors generally felt that the effectiveness of exchange market intervention depended largely on circumstances and, importantly, on the extent of coordination among the main players. In this regard it was noted that it was often the quality, rather than merely the quantity, of intervention that would determine its ultimate success. The ERM crisis had clearly illustrated the limits of sterilized exchange market intervention as an instrument in circumstances where markets are convinced that certain exchange rates are out of line with fundamentals and where there are tight constraints on interest rate coordination. On the other hand, where fundamentals and monetary policy cooperation are stronger, Directors pointed out

that intervention can play a useful supporting role, in particular in countering disorderly market conditions in the short term.

Several Directors saw limits to borrowing from private markets to try to correct the imbalance in resources between private market participants and the official sector. Other Directors, however, felt that the perception of inadequate reserves could itself induce future unwarranted speculative attacks and, therefore, that consideration should be given to various modalities for increasing the supply of official reserves or of official lines of credit--including, it was noted, the usefulness of considering a new short-term facility from the Fund. Also, mention was made by a few Directors of a possible role for the SDR in this regard.

Directors agreed with the staff that the scope for using aggressive interest rate action to defend fixed exchange rates is much greater in situations where the participants have healthy fundamentals and where the disparity between the internal and external requirements for monetary policy is not unusually wide. It was recognized that a number of ERM countries were not in this situation during the crisis. Several Directors felt that the key to the effectiveness of interest rate policy in exchange rate management was to consistently demonstrate to markets that the exchange rate commitment superseded other monetary policy objectives. It was also argued by a number of Directors that central bank independence could be an important -- although certainly not exclusive -- ally in enhancing the credibility of an exchange rate commitment since it allowed the central bank to have greater flexibility in quickly raising interest rates for purposes of defending the currency. It was also noted, however, that institutional arrangements were ultimately less important than the market's perception of the authorities' overall commitment to steadfastly pursue sound, anti-inflationary policies.

Directors discussed the extent to which the longer-term damage to investor confidence caused by even the temporary use of capital controls during an exchange rate crisis outweighed short-term considerations. All Directors stressed the wide-ranging benefits of open capital markets, which militated strongly against the imposition of controls. It was noted, in addition, that, once capital controls had been imposed, or existing restrictions tightened, investors could well demand an additional risk premium on that country's liabilities. On the other hand, it was also noted that in certain, albeit limited, circumstances the temporary use of capital controls could be legitimately defended--at least in situations where economic fundamentals were consistent with the existing parity and where there were tight constraints on other policy instruments.

Turning to the existing regulatory framework on position-taking in the foreign exchange market, Directors felt that banks should be holding adequate capital against such positions in order to safeguard the soundness of the banking system and to provide the appropriate pricing of risk. In this connection, Directors noted the effort under way within the Basle Committee on Banking Supervision to bring market risk--including exchange

rate risk--into the Basle Accord. A question was raised in this regard about the classification of countries under the Basle capital adequacy accord, and hope was expressed that this issue will be reviewed in the appropriate fora.

Some Directors argued that the regulatory framework relevant to other large players in the foreign exchange market--ranging from securities houses to institutional investors, to hedge funds--could also be re-examined by the appropriate authorities to ensure a level playing field and to determine whether some of these institutions were not taking excessive risks in their foreign exchange operations. All Directors, however, took the view that supervision and regulation should be directed toward prudential purposes, and that it was important not to overreact to the recent currency turmoil, especially with regard to introducing measures that could unduly restrict the positive integration and innovation in international financial markets.

Finally, Directors exchanged views about possible options for improving the operation of the exchange rate system--and especially that of the ERM--in the aftermath of the crisis. Many Directors felt that more frequent, small changes in exchange rates within the ERM band--while firmly continuing with efforts to promote greater convergence along the lines of the Maastricht Treaty--would help to forestall future crises. Several Directors emphasized that there remained considerable scope for improving the functioning of the ERM within the existing rules--by following the Basle-Nyborg guidelines more consistently, by taking earlier interest rate action, by monitoring interest rates more closely for consistency with fundamentals, and by improving the quality of monetary policy coordination. The pooling of reserves by central banks was mentioned by several Directors as worthy of consideration.

We intend to hold our discussion of Part II of this year's capital market report in May. In line with our usual practice, I would propose that, after taking account of the suggestions of Directors, the staff should prepare a version of the papers discussed today for publication in our World Economic and Financial Surveys series.

93 FEB 10 PM 2: 51

To:

Mr. Folkerts-Landau

February 9, 1993

From:

Jack Boorman

Subject: Capital Markets Report, Part I: Background Paper

We found this background paper a most useful complement to the foreground paper, providing the reader with a wealth of information on today's foreign exchange markets and the mechanics of speculative attacks. You may find helpful the detailed comments attached, which were prepared by Messrs. Szymczak and Schwartz.

Attachment

cc: Mr. Mussa

Mr. Beza

Mr. Neiss

Mr. Russo

Mr. Saitov

Mr. Goldstein

Capital Markets Report -- Comments on Background Paper

Given the key role that <u>hedge funds</u> seem to have played in September 1992 (as brought out clearly in the foreground paper), we would recommend ta thorough discussion of the structure, regulatory framework, and role of these funds. (A list of these funds might also be useful). In that regard, it is unclear whether the US\$10 billion mentioned in page 10 (first line) only refers to the total assets of hedge funds or covers a broader range of institutions.

The case of <u>Ireland</u> should be discussed explicitly in the background paper, and Table All should summarize the sequence of events that led to the recent devaluation of the Irish punt.

It might be useful to mention on page 23, the volume of transactions generated by the implementation of hedging programs, and possibly refer to the estimate given on page 48.

It is doubtful that gross reserves numbers tell the whole story in the case of countries whose currency was under speculative attack in September 1992. Therefore we would advise to present information on the <u>net international reserves</u> position of these countries. (For instance on page 45, last sentence of the second paragraph, in the case of Italy).

Given the way the base rate (taux de base bancaire) is set in France, and its limited relevance, it is unclear whether this rate can be described as a market rate. Therefore, we would suggest to replace the phrase "that was below the market rate" by the more neutral phrase "that was kept unchanged although money market rates had increased markedly" in the second sentence of the first full paragraph in page 49. Also, it is unclear that large French banks such as Société Générale, CCF, or Paribas were discriminated against during the September defense of the parity of the French franc. If we have no material evidence of this, the last sentence of the first full paragraph in page 49 should be redrafted, since these banks are private entities, and not government-owned. Also, it is not fully correct to write "SICAVs, the money market mutual funds mainly managed by the banks" (line 9, second full paragraph on page 49). In fact, the MMMF are only one of the many kinds of SICAVs. We suggest to drop the reference to the SICAVs in this sentence.

In the discussion of the <u>attack on the Swedish krona</u>, it might be interesting to discuss the role of the economic package passed by Parliament on September 21, 1992 on page 50, including to illustrate the more general point that a speculative crisis can be lessened through a change of the stance of fiscal policy and the display of a relative political consensus on the goals of macroeconomic policies.

We are not convinced that the view presented here of central banks implicitly "financing" the currency attacks is correct. In the absence of

sterilization, the exchange interventions would certainly have led to an increase in interest rates via the contraction in the money supply, but would the rise been enough to "choke off the demand for credit," and thereby stem the attack? The argument really should be that by allowing a contraction in the money supply and a resulting increase in interest rates, policies would have become consistent with prevailing exchange rate levels. This would have helped to eliminate the expectation of an impending devaluation.

Although Annex I is useful, it leaves unclear whether there are significant regulatory constraints on transactions by major institutional investors in the foreign exchange markets. Also, in the case of the U.S., (page 79), it is unclear whether the authorities monitor foreign exchange exposures of all banks or of commercial banks only.

Regarding Annex II, perhaps the first sentence on page 84 should read "attacks are the market's response to policy goals that are <u>perceived to be</u> inconsistent with a given parity." Finally, we found that paragraph 2 on page 89 somewhat unclear and would advise that the discussion of these relevant issues be expanded.

We also have a number of minor editorial comments.

In footnote 2, page 12, FCPs should be written with an s.

Part of the last sentence of the first paragraph of section III. 1. (page 32) seems to be missing.

The content of footnote 1, page 39, is important and should be in the text.

Page 43, second paragraph. It is unclear what the six countries referred to are. A list should be included. (To date, only 5 ERM countries were forced to either devalue or pull out of the ERM. Three non-ERM members were also force to abandon a peg to the ECU--Finland, Norway, and Sweden).

Page 44, footnote 1. It seems to us that MATIF stands for "Marché à Terme d'Instruments Financiers", and not "Marché à Terme International de France." (The same applies to Table A13).

Page 46a. What is the vertical line in the charts meant to indicate?

Page 49, footnote 1: OATs stand for Obligation Assimilables du Trésor.

Page 51: Presumably, the exchange rate of the DM, and not the Bundesbank, was at or near the top of the band. The second full sentence in page 51 may need some redrafting.

Page 74: We wonder whether it is entirely justified to include Belgium among the countries shown in table A12, given that out of these nine

countries, Belgium is the only one that did not eventually devalue its currency.

Page 88: Referring to the German deutsche mark is redundant (second sentence of the third paragraph).

The terms "out-of-money and "deep-in-the-money" options should be added to the glossary.

93 FEB 10 PM 2:51

To:

Mr. Folkerts-Landau

February 9, 1993

From:

Paul R. Masson PEM

Subject: Comments on Capital Markets Report, Part I: Background Paper

The following are the comments of EU1 on this interesting and comprehensive report. Though unable to check all the wealth of country data, we have no major problems with the draft. $\underline{1}$ / Some typos are noted on the attached copy.

A few points that may warrant changes:

- -- Table 4, p.9: It would be useful to make clear the notion of "Leading Fund Managers" underlying the data presented in the table to gauge how representative are their funds. While for the U.S., the market share of "leading Fund Managers" appears to be of the order of 70 percent of the total (see table 4 and table A2), for Italy, based on the figure supplied in table 4 (US\$55.2 billion), the share is only some 17 percent. 2/
- -- Table 5, p. 11: data for Italy differ slightly from the figures that can be derived from Bank of Italy, Annual Report, 1991, table 40, p. 109 (abridged english version). For example, in 1990 and 1991 the correct figures would be 12.7 and 11.6 percent rather than 11.3 and 10.9 percent.
- -- p. 32, fn. 3 does not mention Greece, which is however a country that retains capital controls.
- -- p. 35 (bottom): the argument that a speculative attack inevitably entails an increase in demand for credit in the targeted currency is overstated. In principle, there is no reason why a speculative attack could not be financed by "liquidating" existing assets and reshuffling the portfolio towards foreign currency denominated assets. In the Italian case, for example, credit to the private sector was slowing down during the crisis. 3/ Of course, yields on domestic assets might have to increase to allow the required portfolio adjustment, but it is probably misleading to state that

 $[\]underline{1}$ / John Green has raised a few data problems concerning the United Kingdom and Sweden with Peter Garber.

^{2/} See Banca d'Italia, Relazione Annuale per il 1991, pp. 215-226. 3/ Domestic credit growth to private sector stood at 14.6 percent in January 1992, 13.7 percent in June, 12.3 percent in August and 11.3 percent in September (all figures are end-of-period).

- "... the central banks <u>financed</u> the attack by not allowing interest rates to rise, as the demand for <u>credit</u> in the currencies under attack increased". Perhaps, more appropriately, central banks did not allow <u>liquidity</u> to be squeezed. Unfortunately, the draft does not provide detailed quantitative evidence of the role of credit-led versus portfolio-adjustment-led speculative attacks.
- -- p. 41 table 8: Italy, long-term private capital, the sign should be reversed: the correct figure is -7,872.0.
- -- the discussion of "convergence plays" goes too far in assuming that interest rates are exogenous, so that causation goes solely from rates to capital flows (for instance, in the bottom paragraph on p. 42). The reverse causation also operates; for instance, in the U.K. the strength of capital inflows after October 1990 both lowered long-term rates and permitted the authorities to lower short rates. The convergence play really relies on countries with high inflation wanting to keep interest rates higher than in Germany in order to disinflate; while true in 1990 this became increasingly less true later, and most countries were eager to lower rates whenever possible.

France may deserve more discussion, especially given the very large capital outflow in Table 8 for 1992. This figure in fact almost entirely reflects reduced foreign holdings of franc assets in the third quarter, associated with the EMS crisis.

- -- p. 44 (middle): "... the wealth tax <u>on deposits</u> included in the July budget package..." It may also be worthwhile to mention that Moody's downgraded its credit rating of Italy from AA1 to AA3 in July.
- -- p. 45 (3rd par.): the sentence "This may have been intended to push the banks into using special advances at rates above the repo rate" does not seem to be fully supported by the data. Excluding the month of August, the rate on special advances stood, on average, 100 basis points below the repo rate during the crisis. 1/
- -- p. 45 (4th par.): replace "... government debt ..." by "government paper". The reported maturity structure refers to outstanding securities not to total government debt.
- -- p. 47 (1st par.): the correct figure for Bank of Italy holdings of government bills and bonds is Lit 14.2 trillion. The sentence "At the weekly Treasury note auction ..." should be corrected to "at the bi-monthly T-bill auction."

^{1/} The repo rates averaged 15 basis points below the special advances rate.

- -- p. 48. The chronology of the attack on the franc seems somewhat off. We would suggest changing the last two sentences of the 2nd para. in this section to: "The turning point came on the morning of September 23 after the Banque de France raised the short-term repurchase rate by 250 bp to 13 percent. The market finally stabilized on Wednesday afternoon with a decline in pressure from New York and with the direct intra-marginal intervention of the Bundesbank."
- -- p. 50, fn. 1. Omit the 2nd sentence, and move the third sentence "Funds from the Riksbank..." to the end of the note.
- -- Table All (p. 69ff). The chronology for Sweden could include: "December 4: Riksbank lowers marginal lending rate from 12.5% to 11.5%. December 16: Riksbank lowers marginal lending rate from 11.5% to 11.0%."

There are no actions given under Denmark for the last two dates in the Table.

For Belgium, the dating of events is wrong; the attached copy has the corrected dates.

For Italy, the reported figure for the June 4 repo rate (14.80 percent) is not correct. The interest rates for the repos undertaken on June 3rd and 8th were 12.5 and 13.1 percent respectively. September 20: the description of the restructuring of taxation for bonds issued abroad is incorrect. Basically, new bonds issued abroad by Italian public institutions, which were exempted from the 12.5 percent withholding tax, are no longer tax exempted. At the same time, the 30 percent withholding tax applied to bonds issued by non-resident financial institutions has been reduced to the standard 12.5 percent for all, outstanding and new, issues. October 23: the last sentence "Banca d'Italia" is wrong and should be replaced by the following: "The reserve requirement on lira-denominated interbank deposits held by nonresident banks with Italian banks was abolished".

- -- p. 74, table Al2. Even though the title says June-November 1992, you report the Italy's ECU 8 billion loan in January. Therefore, I suggest adding the Republic of Italy eurobond issue also undertaken in January. The main characteristics are the following: syndicated DM 5 billion, 7.25 percent coupon, maturity 5 years, date of issue January 12, 1993. The issue is part of a planned US\$10-15 billion borrowing program to be carried out in 1993.
- -- p. 81, Italy. I suggest adding that the prudential regulation applied to mutual funds implies that forward foreign exchange transaction should be strictly limited to hedging current open positions (i.e. short sales of foreign currency are prohibited).

-- Annex II. The review of the literature on speculative attacks, while useful, ignores certain elements of uncertainty. In particular, speculators do not know for certain the situation facing the country, nor the objectives of the authorities. There is an extensive literature on policy credibility that is relevant here; by defending a currency, the authorities signal their "type" and hence may change speculators' perception of the likelihood of a devaluation. Allowing for this possibility (as does the literature) would reduce the bias of the Annex toward the view that speculators are always right (or, if not, that expectations of devaluation are self-fulfilling)--for instance, at the bottom of p. 83, which says "It is now recognized ... that attacks are the market's response to policy goals that are inconsistent with a given parity."

Attachment

cc: Mr. Beza

Mr. Boorman

Mr. Neiss

Mr. Russo

Mr. Saito

Contributors: Mr. Corker, Mr. Green, Mr. Habermeier, Mr. O'Callaghan, Mr. Violi

93 JAN 27 PH 12: 53

To:

Mr. Goldstein

January 26, 1993

From:

Caroline Atkinson and Paul R. Masson

Subject: Draft Staff Appraisal: International Capital Markets

The following are the comments of EUR I on this interesting and well drafted report. We have no major substantive disagreements, though we have some suggestions concerning both the wider context and some drafting details.

First, since this report deals primarily with the events in the EMS, and highlights the lack of convergence as one of the major causes of turbulence, it is curious that more attention is not paid to the provisions of the Maastricht Treaty concerning convergence, and the role that the timetable may have had in bringing forward the markets' anticipations that some countries would not be part of the first group proceeding to EMU. The discussion of central bank independence (pp. 28-29) could also mention the Maastricht provisions.

Second, the interesting discussion of the official credit facilities to defend parities emphasizes the constraints on those credit facilities: since VSTFF loans are denominated in ECUs, they will involve exchange rate risk for the Bundesbank, which may therefore not be willing to extend unlimited credit. However, lending for marginal (compulsory) intervention is in principle not subject to discretionary limits, and furthermore, the Bundesbank can lend in DM and hence not be subject to exchange rate risk. These two possibilities are mentioned only in passing; it would be interesting to expand on them, and to consider in what circumstances they could provide sufficient credit facilities to defend parities, or whether they also were effectively limited.

Third, the discussion of suggestions for improving the ERM in section VI would benefit from more information concerning the source of the suggestions. Are there disagreements between those private and official sector officials who were consulted? It would be surprising if there were not; it would be interesting to know (without identifying individuals) if private financial institutions were favorable to a quicker move to EMU, for instance, or whether they thought that the ERM (and EMU) had been discredited.

We also had the following specific points:

- 1. p.9: The source for the information in the table was unclear. We are trying to check it, but are uncertain in particular about the listed regulatory constraints on banks.
- 2. p. 11, Table 4: why is this in national currencies?
- 3. p. 17, footnote 1: the US\$20 billion (the precise number is US\$20.4) quoted for Italy applies to reserves of foreign exchange only--this should be made clear in the text (the Italians, and perhaps others, are very sensitive on this point).
- p. 17, line 28: We are not able to confirm the intervention figure.
- 4. p.23, second full paragraph:
- (a) it is the size of Italy's debt, as well as its short average maturity, that creates difficulties (the percentages quoted refer to the shares of government paper--which in total amounts to some three-quarters of all government debt);
- (b) the last two sentences of the paragraph, as drafted, are somewhat questionable, although we agree with the underlying thrust that interest rate policy was constrained by the large public sector debt, at floating rates. The sentence on funding difficulties raises the question of what was an acceptable rate, and overlooks the fact that for some of the period of exchange rate pressure (before and after the August/September peak of the crisis) there were large gross sales of government debt (although the government withdrew from the longer end of the market). The funding difficulties were mainly in August and September whereas official interest rates were first increased in June/July. There is a non sequitur in the link between the sentence on funding difficulties and the following one. Finally, we would not describe the increases in interest rates as "modest," although (by definition) they proved insufficient to defend the lira parity. Italian rates were raised sooner, and by more, than in the U.K., Spain (or France).
- 5. p.26: The "capital controls" in the case of Portugal involved an administrative tightening of existing (prudential) regulations regarding banks' Euro-escudo operations. The authorities still dispute that this amounted to the introduction of capital controls; but the regulations were lifted on December 16, 1992 (in conjunction with other restrictions aimed at restricting inflows of capital), to comply with the EC Single Market Act. It may be worth including a short description, as follows, in the footnote, which at present deals only with Ireland and Spain:

"In Portugal, the central bank notified resident banks of existing restrictions on the transfer of funds for lending in the Euro-escudo market on September 17, 1992. A tightening of the restrictions and the strict enforcement of the regulations effectively limited the exposure of resident banks in the Euro-escudo market. These restrictions were lifted on December 16, 1992 together with the elimination of other short-term capital controls."

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Mussa

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Williams

Mr. Zulu

Mr. Guitián

Mr. Narvekar

Mr. Artus

Ms. Saunders

cc:sDV

93 Jan 27 PM 3: 01

To:

Mr. Goldstein

January 26, 1993

From:

J. Márquez-Ruarte

Subject: Draft Staff Appraisal -- International Capital Markets

Please find attached comments on the draft staff appraisal by

Mr. Towe, with which I concur.

Attachment

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Williams

Mr. Zulu/Mr. Guitian

Mr. Narvekar

To:

Mr. Márquez-Ruarte

January 26, 1993

From:

Christopher M. Towe

Subject: Draft Staff Appraisal: International Capital Markets

I had two general comments on the draft staff appraisal (detailed comments are also attached).

First, the draft seemed overlong, and there was scope for substantial shortening. Moreover, the usefulness of the paper is diminished by its inconclusiveness. Rather than simply describing the range of views on the options available to the ERM, the draft should have provided a more explicit statement of the staff's views.

Second, in assessing the breakdown in parities, the draft could be read to suggest that an improvement in shorter term intervention strategies could have overcome the strains on the parities caused by weaknesses in fundamental policies. In particular, the draft focusses much of its attention on central banks' interest rate response to the speculative attacks (e.g., the discussion on pages 14, 20, and 21-26), noting its inadequacy to stem the speculative pressures. While the link between interest rate policies and the fundamentals is acknowledged, the distinction between shortrun tactical considerations and longer term policy imbalances could have sharpened.

Attachment

Additional Comments

Section II

- Note that the discussion on page 1? suggests that the details in Table 3 (page 9) apply only to net open positions.

Section III

- The description of the so-called "convergence play"--in which ERM interest rate differentials "increasingly underestimate the actual risk of exchange rate depreciation"--left a number of questions unanswered. First, presumably the risk of depreciation would have to have been <u>overestimated</u>. Second, why was the overestimate increasing, and why, given the "prevailing view," did interest rate differentials persist? Third, since interest rate differentials apparently did not equal relative expected returns on assets, their similarity to the peso problem described in footnote 1 on page 12 was not clear.
- The argument that capital markets eventually impose discipline over government policies and force adjustment is open to some question (last complete paragraph, page 12).

Section IV

- The discussion on page 14 was somewhat confusing. It states that commercial bank activity during the crisis was to draw upon lines of credit in the vulnerable currencies and to buy forward those same currencies. It was difficult to judge the relevance of this fact without knowing which institutions were on the other sides of the transactions; i.e., which institutions were the banks intermediating between?
- Some elaboration of what was meant by "attempts to ration liquidity to those taking positions against existing parities" (second line of page 15) would have been helpful.
- The conclusion that "improvements in back-office processing and risk control systems instituted since the 1987 crash obviously helped to accommodate the increases in forex and money trading volumes" (page 15) was not obvious from the preceding discussion.
- The caution raised regarding the possibility that future forex crises could have greater spillovers to other asset markets and provoke a wider crisis (bottom of page 15 and over to page 16) was introduced rather casually. If this indeed is a significant risk it should have been introduced more carefully and discussed in greater detail.

The discussion in the footnote on page 16 seemed out of place. Moreover, it was inconclusive; was the crisis different for the reasons suggested or not? The issues raised here--in particular, the possibility that international capital markets have evolved to the point that where central banks can no longer use increases in short-term interest rates to curtail the demand for foreign exchange--has important policy implications that should have been addressed in the text.

Section V

- The statement that "most countries estimated the size--if not the probability--of the attack" (page 16) was imprecise. Did the authorities underestimate the probability of attack or not?
- The discussion on pages 17 and 18 appeared to suggest that central bank borrowing from commercial bank sources to defend their currencies could have been effective but for the amount of credit that could be obtained from such sources. Surely there must be more fundamental questions regarding the effectiveness of this strategy, especially in the context of a systemic shift in sentiment. Borrowing foreign exchange from the private sector to satisfy the private sector's demand for foreign exchange would seem unlikely to have had a significant effect on exchange rates.
- There are references to creditor countries' (i.e., Germany) possible unwillingness to extend credit through the VSTFF on page 19 and 20. Was this a factor during the recent crisis?
- There was a suggestion (page 20) that, in the recent simultaneous attack on the pound, lira, and franc, the Bundesbank was alone in defending the parities. Surely the reserves of the other three countries involved were also "on the table."
- The description of the Bank of France's intervention tactics (page 24) was interesting but somewhat difficult to follow.

Section VI

The suggestion that small exchange rate adjustments should be taken within the band (first complete paragraph, page 28) was confusing since it suggested that exchange rates were fixed within the band.

Office Memorandum
SOUTHEAST ASIA AND
PACIFIC DEPARTMENT

cc:SDV

93 JAN 27 PH 4: 43

To:

Mr. Goldstein

January 26, 1993

From:

P. Chabrier

Subject: Comments on the International Capital Markets Paper

We found the draft to be a highly readable and informative analysis of developments leading to the ERM crisis and their relationship to international capital markets issues. The paper raises a number of interesting analytical and policy issues. We have the following comments for your consideration:

- 1. While the paper's coverage is appropriate, you may wish to look at the possibility of moving some of the institutional descriptive material (particularly in Section II) from the main paper to the background document. To sharpen the policy focus, you may also wish to expand somewhat the summary of points provided on pages 1-2.
- 2. The central point in Section II--viz., that developments in capital markets have provided for the possibility of massive flows that can easily overwhelm central banks' exchange rate defenses--is well argued. It does raise, however, a number of additional public policy points that you may wish to address. For example, given the stated assumptions regarding information availability and the markets' assessment capacities, to what extent are these flows fundamentally stabilizing/destabilizing? Specifically, does the evidence point, in balance, to a faster convergence to the new equilibrium (given prior incompatibilities of policies)? How about the variance? Is a predominantly stabilizing factor nevertheless accompanied by contagion effects?
- 3. Section III argues that the essential problem was the inappropriate level of convergence among ERM countries. While we agree with the general point, there may be a need for some qualification. In effect, were there not some isolated events of massive speculative attacks (e.g., on the French franc) that had a heavy contagion aspect to them?
- 4. We found Section IV to provide the most important ingredient and catalyst for the Board discussion. The analysis raises issues of relevance to Fund activities (particularly in the surveillance area), some of which may warrant discussion at this stage and reflection in the section on Issues for Discussion.
- 5. Section V's emphasis on reactive rather than anticipatory policies is the correct one. There is a question however as to whether the capital markets developments described earlier in the

paper have not, for some cases, dramatically shortened the time frame in this regard; i.e., there is now a higher risk of incomplete anticipatory actions turning into reactive ones.

6. Finally, on a minor point, given the realized financial flows in response to market perceptions about common currency yields, we would have thought that the 1987-92 interest rate differentials in favor of the high-yielding ERM currencies were viewed by the market to overstate (rather than underestimate, as noted on page 10) the actual risk of exchange rate depreciation.

cc: Mr. Beza

Mr. Toure

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Williams

Mr. Zulu/Mr. Guitian

Mr. Narvekar

93 JAN 25 FH 4: 28

To:

Mr. Goldstein

January 26, 1993

cc; SD

From:

Sheetal K. Chand

Subject: Draft Staff Appraisal: International Capital Markets

We read this informative paper with interest and have only a few comments.

- 1. In light of the discussion in the earlier part of the draft on the overwhelming dominance of private market makers in the currency and financial markets of concern, some discussion of the need and scope for an enhanced international regulatory framework would be appropriate.
- 2. There is some risk of imprecision in the last sentence in the middle paragraph on p. 21 as a result of an overly precise implication about the timing of an increase in the fiscal deficit. We would suggest changing the text in question to read "... and may increase the fiscal deficit if explicit or implicit government insurance of commercial bank deposits is present." The fiscal deficit does not necessarily increase in economic terms at the time the government recapitalizes banks if such recapitalization takes the form of an exchange of formal government obligations for implicit obligations that had already accrued as a result of government deposit insurance. In such cases, it is better to regard the fiscal deficit as having increased earlier, when the government's liability first accrued. The Fund recognizes that fact by recommending that such recapitalization operations sometimes be accounted for below the line.
- 3. An editorial point: the term "irrecovably" at the bottom of p. 1 should read "irrevocably."

Contributor: Mr. Frederick Ribe

cc:

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Williams

Mr. Zulu/Mr. Guitian

Mr. Narvekar

/ Souto



CC: 50

To:

Mr. Goldstein

January 26, 1993

From:

John Odling-Smee №-5

Subject: <u>Draft Staff Appraisal</u>: <u>International Capital Markets</u>

Thank you for the opportunity to comment on this thoughtful and well presented paper. In general we agree with the views that are expressed--or more often hinted at--in the paper. The clear descriptive material combined with the open ended approach to the policy discussion should provide an excellent basis for a Board discussion. Nevertheless, the lack of firm policy conclusions is rather frustrating to the reader. Perhaps the paper could be rounded off with some firmer policy prescriptions once the Board meeting has taken place.

We have one general comment plus a few specific comments. The general comment relates to the apparent lack of contingency planning and crisis management capability that was demonstrated on the part of the central banks involved in the crisis. While we can argue about the ideal framework for responding to market attacks within the ERM, whether it be via sterilized intervention, interest rate policy, capital controls, or some combination of these, there is clearly a requirement for each central bank to have in place a well defined contingency plan for dealing with speculative attacks on its currency. Such plans should consider, ahead of the event, the risk/return possibilities of continuing a defense with and without healthy fundamentals; with and without consistent domestic and external objectives; with and without full support from fellow central banks; etc. Despite the massive sums at stake, and the ever-present possibility of speculative attacks on pegged currencies, it does not appear that the defending authorities were at all well prepared for the September crisis.

It would be interesting to hear whether the mission saw any evidence of well defined crisis management strategies at any of the defending central banks, or indeed whether the September crisis has caused any of the central banks to re-examine their contingency plans for dealing with speculative attacks. Directors could then be asked to evaluate the overall performance of central banks in handling the crisis and to consider whether central banks participating in fixed exchange rate regimes could be better prepared for making rapid and rational policy decisions in the event of speculative attacks.

Specific comments

Page 12, para. 2: We agree that the challenge is for the authorities to make the necessary policy adjustments before the markets force the issue. It could be noted, however, that the choice of exchange rate regime can affect the nature and timing of market discipline on policy makers. In particular a commitment to a peg, and the subsequent effects of "convergence plays" can reduce both the incentive and the scope for the authorities to bring the fundamentals into line with partner countries.

Page 15, end of para.: Why is it that the crisis did not spread to national debt and equity markets when the paper suggests that the crisis was associated with the liquidation of long (debt and equity) positions that had been built up over the preceding years?

Page 20, middle of para.: How would sterilized intervention send "a signal about future monetary policy intentions"? Sterilized intervention to support an exchange rate could well be seen to indicate a <u>lack</u> of resolve to defend a rate with tighter monetary policy.

Page 20, end of final para.: In assessing the adequacy of official reserves the question must surely be asked whether there is now any point in holding large reserves for the purpose of defending the ERM parities. The risk of holding large reserves is not that needed policy adjustments will be delayed; that may result from the peg policy, not the level of reserves. Rather, the risk is that the reserves will be used in futile and expensive attempts to defend against speculative attacks when only fundamental (and early) policy changes will have any chance of success.

Page 21, 2nd para., last sentence: This sounds as though government assistance to support insolvent banks is taken for granted. We would suggest: line 9: delete "government"; line 11: rewrite "(if the government has to inject...".

Page 21, last para.: It is suggested here that higher interest rates might at some point actually weaken the attractiveness of the domestic currency. Is there any evidence, for example from the Swedish defensive operation, that this has actually occurred?

<u>Page 29, last para.</u>: The requirement that intervention be mandatory and unlimited is clearly now not credible. A redefinition of the intervention obligation would therefore not damage the system's present ability to counter speculative attacks. Such a change might however promote more rational and less costly crisis management strategies on the part of member central banks.

93 JAN 27 MM 9: 48

To:

Mr. Goldstein

January 26, 1993

From:

Manuel Guitián M6

Subject: Draft Staff Appraisal: International Capital Markets

Your paper provides an extremely readable account of recent developments in foreign exchange and international financial asset markets. The institutional detail on markets, market players, and volumes of transactions adds richness, perspective, and a sense of urgency to the discussion of policy options. As the paper focuses in the "Issues for Discussion" section on many subjects that were only recently discussed during the recent Board Seminar on Economic and Monetary Union in Europe, such detail may prove to be helpful in provoking new discussion. I have only three comments to offer you.

- At a general level, I believe that the paper would benefit from a deeper discussion of the analytic underpinnings of some of the conclusions it reaches. For example, the conclusions that exchange markets can be prone to sharp shifts in sentiment which induce large exchange rate movements or that sterilized exchange market intervention is relatively ineffective lack force because they seem to be based on little more than descriptive generalizations of recent experience. Yet, sharp movements in sentiment and exchange rates are consistent with efficient markets, and sterilized intervention is theoretically ineffective when domestic and foreign financial assets are perfect substitutes. Thus, it would be interesting for the paper to assess whether the ongoing processes of internationalization, global integration, and securitization of capital markets it so well describes are driving the world in a direction that can be characterized using models of efficient markets and perfect asset substitutability. Such an assessment could strengthen confidence in the robustness of the conclusions reached. In a similar vein, it would be helpful to list the perceived benefits that justify the opinion (page 10) that it is a good thing that emerging trends in international capital markets appear to be irreversible.
- 2. The observation (page 15) that there was no persistent seizing-up of the largest asset markets during the crisis, for example, is interesting, particularly because it stands in marked contrast to the experience in 1987 during the international stock market panic. I wonder whether there are lessons or conclusions here that could be drawn by comparing the very recent experience with other episodes of disruption in financial markets. For example, is the difference in response due to factors inherent in exchange markets

that are not present in other markets, or is the difference attributable to the continuing process of global integration of financial markets?

3. On the "Tactics of Defending ERM Parities," the paper notes that official intervention is limited by the supply of reserves, and (page 17) "only the reserves of the defending central bank and its potential access to borrowed reserves could be used to meet the demands of buyers of exchange." Since central banks can intervene also in forward markets, and since such intervention, strictly speaking, is not bounded by access to spot resources, the statement seems unduly restrictive. Indeed, given the high degree of integration of spot, forward and derivative foreign exchange markets, as well as actual use of these markets by some central banks in previous episodes, some discussion of this potential option for intervention would seem warranted.

cc:

Mr. Beza

Mr. Boorman

Mr. Chabrier

Mr. Mussa

Mr. Neiss

Mr. Odling-Smee

Mr. Narvekar

Mr. Russo

Mr. Saito

Ms. Saunders

Mr. Tanzi

Mr. Toure

Mr. Van Houtven

Mr. Williams

CC: SD V 1. KS 2 LF 3.BIS 4.FILES

To:

Mr. Goldstein

January 26, 1993

From:

G.G. Johnson

Subject: Draft Staff Appraisal: International Capital markets

A number of us in AFR have read your paper and think it will provide an excellent basis for the Board discussion as well as providing us all with a clear and concise analysis of the events of last fall. I attach comments prepared in four AFR divisions. I would particularly draw your attention to Mr. Lipschitz' suggestion that two other options be mentioned, even if they were not covered by the discussions you had with market participants, and to Mr. Acquah's suggestion that the Board be invited to consider what implications this experience might have for other weak-currency countries.

Presentationally, "staff appraisal" is a term of art in the Fund, and it seems odd to use it to describe a whole paper. More substantively, though the whole paper is informed by the staff's analysis, there is little in it that is explicitly the view of the staff, in contrast to the "staff appraisals" that conclude Fund staff reports on countries.

Attachments

cc: Messrs. Beza, Mussa, Van Houtven, Boorman, Chabrier, Neiss Odling-Smee, Russo, Saito, Tanzi, Williams, Zulu/Guitian, Narvekar

Ms. Saunders

To:

Mr. G.G. Johnson

January 26, 1993

From:

Paul A. Acquah

Subject: Draft Staff Appraisal: International Capital Markets

The staff appraisal is thorough in setting out the factual aspects of exchange market operation and providing insight into the genesis of the ERM crisis. It also provides a succinct statement on changes that might improve the functioning of the exchange system and its ability to withstand pressure.

That being said, we have one main observation.

The paper rightly notes (pp. 15-16) that "the crisis remained localized in European currency markets" but adds that complacency is not warranted since there is no certainty that a future currency crisis would not spread to the U.S. dollar and the yen. The question of the threat of a spread of such a crisis is pertinent, but with the U.S. dollar, the yen, and the deutsche mark (the anchor currency of the ERM) freely floating and subject to continuous market review and correction, such localization of the crisis was indeed to be expected. As it was, the weaker currencies came under attack when the market became convinced that the parities were no longer sustainable and it moved to enforce discipline. Viewed in a global context, the system has an inbuilt discipline that puts the burden of the adjustment on currencies anchored not only to the deutsche mark in the ERM, but also to any other anchor currency in a free float.

In light of the above, perhaps Directors could be invited to discuss the lessons to be drawn from the experience for adjustment by countries with weak currencies, including those within the ERM, that are linked with varying degrees of flexibility to freely floating anchor currencies such as the U.S. dollar. That is, is anything in this experience for other countries, e.g., in the CFA franc zone, given the greater degree of exchange liberalization and freedom of capital movements?

To:

Mr. Johnson

January 26, 1993

Leslie Lipschitz

Subject: Draft Staff Appraisal: International Capital Markets

These comments are much more than you need. But I found the paper interesting and I'm jotting down these points as much for myself as for you. Incidentally, I think the paper warrants distribution among the economists, especially in light of the amount of discussion among senior staff generated by the earlier (and equally long) backto-office reports.

I have a few questions on the mechanics and history in the paper and some suggestions on the "policy options" section and on presentation.

On mechanics and history, four things were unclear:

First, given the hundreds of billions of dollars available for "convergence plays" (pp. 10-11), how were such large interest rate differentials sustained?

Second, much is made of credit restraint effectively reducing speculative pressures against a currency. But it seems that many of the plays described do not really need credit. For example, a U.S. fund holding Italian government paper in lira, hedged by a DM/dollar contract, would react to a loss of confidence in the lira/DM rate by simply shorting lira. It would use its government paper for its initial margin and no credit would be required. The bank on the other side of the transaction would be buying lira forward and selling it spot--hence the pressure in the spot market.

Third, constraints on interest rate policies of central banks (pp. 21-22) might be even tougher when a large portion of mortgage paper is variable rate. A rise in mortgage rates in the United Kingdom (brought about by a sustained increase in short-term rates in order to defend sterling) would have sharply exacerbated the recession and been politically untenable.

Fourth, is it correct to characterize the DM/franc defense as requiring all the adjustment from the French with the Bundesbank unwilling to countenance any deviation from a monetary policy set on domestic considerations (e.g., p. 25)? Surely the bundesbank eased domestic money market rates and accepted a rate of monetary expansion significantly above that targeted based on domestic criteria.

On policy options it seemed to me that two much-discussed options were missing:

First, the Tobin proposal for taxing forex transactions. As we have learned from the Swiss and German money markets, if a transaction is short-term and reversible a small tax is equivalent to a very large annualized interest rate differential.

Second, if the franc/DM turbulence can be characterized as a whimsical (i.e., not dictated by fundamentals) shift in the demand for money between the two currencies, might not the appropriate monetary aggregate for targeting be some sum of the two monies? (This is suggested in a different context in the Kremers-Lane paper.) In this case a run against the franc would elicit a reduction of the franc part of the joint money supply and a corresponding expansion of the deutsche mark portion. This might be a better halfway house en route to EMU for countries with convergent macroeconomic conditions.

On presentation, there are a few infelicities in a paper that generally, despite its complexity, is remarkably clear. On p.6, for example: "daily...turnover....per day" and on p.10 "that" in the toothpaste analogy (which itself seemed a bit contrived) should be "the". Also, esoteric shorthand should be avoided if possible--e.g., VSTFF is used without explanation on p.17, though it is subsequently explained at some length.

cc: Immediate Office AFR Divisions To:

Reimer O. Carstens

January 26, 1993

From:

Ludger Schuknecht

Subject: Staff Appraisal: International Capital Markets

The paper is well written and informative both in describing the recent events around the European currency crisis and the underlying developments in financial markets. However, since the terminology is developing rapidly, new financial instruments and expressions might be explained more frequently when they are first used, and uncommon abbreviations should be avoided or explained.

More specifically, it would be interesting to know whether the development in capital markets and the EMS crisis affected speculation against the CFA franc or whether it has implications on exchange rate policies of developing countries in general.

Page two indicates that investments by institutional investors increased to US\$6.5 trillion by 1990, but then dropped to \$4.5 trillion in 1992 (Table 1). Is this is an important change in the trend?

Table 3 on page 9 provides a nice survey of regulatory constraints. However, many fields in the table are difficult to understand by itself and explanations in the text are very limited.

At the beginning of Section III (page 9) it should be mentioned that the convergence game led to a significant reduction in the interest differential between 1987 and 1992, as indicated in chart 1 (so far it only says that the average differential was 5 percent). This trend suggests increasing credibility of the EMS parities in contrast to the peso problem briefly mentioned on page 12.

On page 12/13, it is argued that the hedge funds set the speculative signal for institutional fund managers. Does this not overstate the role of hedge funds, since the crisis developed out of the political developments of those days, which was easily observable information for other market participants?

The French response to the EMS crisis was to introduce a twotier money market based on close cooperation within the banking sector. Would this response be suitable for other EMS countries to reduce the costs of defending parities, or is its applicability limited to the French case with government ownership of banks? The discussion on policy options (pages 27ff) only provides scattered suggestions on the improvement of economic fundamentals. A summary regarding fiscal and monetary policies and deficits at the beginning might be useful. The section provides a shopping list of suggestions without clear-cut distinctions between politically or ideologically motivated statements (e.g., on the merits of central bank independence or the lack thereof) and more technical proposals on the future of exchange rate management. It might be worthwhile considering to structure the suggestions by the respective goals of exchange rate management (e.g., conversion and EMU, fixed rates or adjustable rates) instead of by instruments (interest rate policy, intervention policy, etc.).

Page 29 contains the interesting suggestion to introduce a type of "Monetary Fund" for the EMS and conditionality for receiving countries.

To:

Mr. Johnson

January 26, 1993

From:

Reinold van Til .

Subject: RES Paper on International Capital Markets

This paper has been reviewed by various people in the division. The paper is interesting, informative, but also, highly technical, and the meaning of such terms as financial derivative instruments and synthetic positions are not immediately clear to some readers.

We have the following general comments:

First, a brief outline of the objectives of exchange rate management could be inserted, including: 1) increased economic stability and lower, more diversified risk, 2) induced investment and growth, 3) lower inflation, 4) smooth and orderly economic international economic conduct, and 5) free flow of factors for welfare maximization. Second, although fundamental internal and external imbalances often receive attention, the paper could be enhanced with some references to the coordination of fiscal as well as monetary policy. Finally, the descriptive section makes repeated references to market makers and leaders. Greater emphasis could be placed on the role of prudential and other financial regulations. Increased coordination and homogenization of these regulations across market actors and across countries may be necessary to achieve the goals noted above.

The following are specific comments:

Certain paragraphs on pages 6-7 are unclear as to wnether the figures refer to the actions of institutional players or all market participants.

As noted at the top of page 8, there are no regulatory rules to separate investment risk from exchange rate portfolio management, but it is common practice. This self regulation raises issues of moral hazard. Similarly at the bottom of the page, it could be interesting to discuss the method by which institutional investors formulate their exchange rate views and the influence of consensus views by market makers. Both of these issues relate to the homogenization of financial sector regulations.

In the discussion on the "growth, integration, and agility of international capital markets" (page 8), the limited capacity of the central banks to defend currencies has been mentioned. It would be useful to spell out more clearly the implications of these developments for central banks.

The middle paragraph on page 12 is unclear. It is written in a way which leads the reader to believe that capital markets make policy decisions.

On page 27, paragraph (ii), unlike other paragraphs in this section, does not mention the doubts or disadvantages of the proposal.

The option of frequent small changes in exchange rates within the band (page 27) to remove the prospect of large realignments and "depoliticize" exchange rate adjustments seems to run counter to the original goal of the EMS, viz. to achieve convergence of fiscal and monetary policies across borders, in order to move ultimately to one currency. The purpose of the latter was to remove exchange rate uncertainty from cross boarder transactions with ERM member countries. The implication, though not spelt out, is a collapse of fiscal and monetary coordination.

The example of Sweden, regarding use of interest rates to defend a currency, comes immediately to mind as a policy that did not work. It should be stated more clearly (page 28) that such a policy may not work.

The proposal for invigorating interest rate coordination (page 29) is a good one but would also have to include the USA and Japan.

CC: SD V 1.KS 2.1K 3.BJS 4.E1LES

93 JAN 25 PH 3:48

To:

Mr. Goldstein

January 25, 1993

From:

U. Baumgartner

Subject: Draft Staff Appraisal -- International Capital Markets

Mr. Horiguchi, myself, and other colleagues in the department read this paper with great interest, as it deals with the most important episode of recent exchange market developments. We have very little to offer in terms of comments on your description and analysis of events, except that in certain passages--the story of the "synthetic put" on page 22 comes to mind in this context--the message is sometimes obscured by perhaps too heavy a dose of technical language.

Our comments relate, first, to the absence of a clear staff view in the report; and, second, to questions concerning the links between the crisis, the policy options, and the issues for discussion as presented in the paper.

First, the paper is not a "staff appraisal," but a report on what the mission learned in various capital market centers. Sections II-V provide an account of the crisis, Section VI reports on the policy options as seen by capital market participants and officials, and Section VII offers a mixed menu of issues for discussion. But nowhere is there a staff appraisal. Reading through the presentation of the policy options, one gets the feeling that the staff implicitly has reservations, but its own views do not emerge.

Second, the policy questions arise from a more fundamental issue than the market developments covered in the first sections of the paper. The key policy issue is the sustainability of a fixed exchange rate regime in the face of a large asymmetric shock--German unification--to the center of the fixed exchange rate area, which was already troubled by a less than smooth convergence. The rest--players, the instruments, the convergence play, and the defense tactics -- are merely manifestations of the underlying problem, interesting as they are to read about. I am sure you would agree that large capital flows overwhelming official defenses are nothing new, as the last phase of Bretton Woods demonstrated more than 20 years ago, despite the changes in the financial market landscape. Hence, the policy questions are not related to the nature and size of speculative capital flows or their instigators, but to the underlying problem of fixed exchange rates in what seems, at least for now, a less than optimal currency area. However, this paper is perhaps not designed for an in-depth discussion of this issue. Thus, also the problem of the absent staff appraisal.

A third issue, which is directly related to the recent exchange market experience, concerns regulatory questions. These, however, do not receive much attention. Perhaps, there are risks for the world financial system--and not just the danger of large punishments for policy mistakes-inherent in the present situation. There are hints provided here and there in this and other papers on capital markets produced recently (e.g., on the potential for breakdown of the settlement mechanism), but no systematic appraisal is given or suggestions put forward.

The issues presented for discussion seem to be too numerous and are of uneven importance or relevance. The issues could perhaps be recast more systematically in three groups: developments and their significance; policy issues such as intervention, interest rate actions and capital controls; and regulatory concerns, if any.

cc: Mr. Beza

Mr. Toure

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. D. Williams

Mr. Zulu/Guitian

Mr. Narvekar

93 JAN 27 PH 12: 53

To:

Mr. Goldstein

January 26, 1993

From:

Jack Boorman

Subject: Exchange Rate Management and International Capital Flows in

the Aftermath of the ERM Crisis -- Draft Staff Appraisal

We enjoyed reading this informative, well-written, and timely paper, which should stimulate an interesting Board discussion. being said, as a general comment we would suggest a somewhat broader treatment of some policy issues relevant for Board consideration, while certain factual material, particularly in Section II, could be relegated to the background paper.

One important aspect of the September 1992 currency crisis that does not come across clearly in the draft is that of the sequence of events. In particular, it would be useful to tell the story of how speculative attacks moved from one currency to another (i.e., the sequence of "parity cracking"), leading eventually to the attack on the French franc in spite of apparently strong fundamentals. In that regard, you might want to discuss the view (reported in your back-to-office report dated December 2, 1992) that the attack on the French franc would never have taken place were it not for the earlier successes of the attacks on the lira, the peseta, and the pound.

This discussion would set the basis for an assessment of whether, in the new market environment, any currency could potentially be vulnerable to speculative attack, irrespective of whether its parity were in line with economic fundamentals. In your back-tooffice report dated December 28, 1992, you reported the view of market participants that policy fundamentals had not become less important, and that unfounded speculative assaults were likely to fail. The arguments supporting this view could usefully be presented to the Board.

We would also suggest that the discussion of policy options in the aftermath of the crisis be broadened to cover the feasibility, effectiveness, and desirability of various proposals that have been made to "throw sand in the wheels," such as introducing taxes on international transactions.

Two other points could perhaps be handled in the background paper. First, we would be interested to learn more about hedge funds, which seemed to have played an important role during the September In particular, to what extent is their freedom of action to take large open positions derived from their off-shore status?

Second, it would be useful to explain why the recent exchange market crisis did not spread to national debt and equity markets. We understand that a key factor was the ability of investors to adjust the net currency exposure of their asset portfolio through transactions in currency spot and derivatives markets without needing to liquidate their underlying positions. You might want to elaborate on this point, possibly after the last full sentence on page 15.

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven Mr. Chabrier

Mr. Neiss

Mr. Neiss Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Saito Mr. Tanzi Mr. Williams

Mr. Williams
Mr. Zulu/Mr. Guitián
Mr. Narvekar

Mr. Saito

CC: SD

1. KS

2. LK

3. BJS

4. FILES

To:

Mr. Goldstein

January 26, 1993

From:

L. Van Houtven

Subject:

International Capital Markets; Draft Staff Appraisal

We enjoyed reviewing this paper. It describes the events leading up to the recent ERM crisis, and the unfolding of that crisis, in a clear way that keeps the readers attention. It also present the material in a way that will hopefully stimulate an active exchange of views in the Board on a number of issues that are very important for the Fund. There is, perhaps inevitably, some use of technical jargon that will need explanation, and some passages are long-winded. As for the fresh and occasionally idiomatic style, I hope you can resist suggestions to resort to officialese.

On substance, I have not much to suggest. We were struck, however, by the fact that there is little reference to the fact that the internationalization and liberalization of capital markets has been a major benefit, and has undoubtedly contributed much to efficiency gains. Indeed, apart from a sideways reference on page 10, lines 7 and 8, " and we think it better, given the wide ranging benefits of integrated capital markets", there is little to indicate that this has been (despite the recent problems) an important element of global progress, until the passage in the middle of page 30 (lines 18-25). Without a more explicit and up-front treatment of the benefits, don't you run a risk of inadvertently supplying ammunition to those who think it would be <u>desirable</u> (even if probably impossible) to "put the toothpaste back in the tube"? Related to this, I note that the discussion on pages 23-24 of the attempt by French authorities to engineer a two-tier market, in order to restrict the squeeze to the speculators, is carefully worded to show the limitations of this approach. It will be important to retain this balanced treatment.

I wonder also whether it might be helpful to bring up front some of the reasons (hidden away at the end of a long paragraph on page 15) for not exaggerating the importance of the recent crisis-for example, there were no failures of major firms, no seizing-up of major asset markets, and exchange markets operated continuously (albeit with wide spreads). These were surely among the most striking features of this crisis, and they offer support for the opinion of "most officials" (mentioned on page 30) that "it would be ill-advised to over-react to the recent currency turmoil" by introducing measures that would unduly restrict the integration and innovation in international markets.

It would be appropriate to mention explicitly the Fund's interest in promoting a stable, open, and well-functioning international system, as well as the role of policy surveillance. I recognize that this does not fit in very easily with the flow of the paper, but the Fund does have a responsibility under the Articles. I may come back to you on this after tomorrow's Board discussion on surveillance, when the limited role of the Fund in responding to the crisis will probably be discussed.

Lastly, as I mentioned earlier, we welcome the readable style. We are returning a copy with a number of wording suggestions by Mr. Mountford that are intended to enhance the clarity of the paper and to correct some minor errors.

cc: Mr. Beza

Mr. Toure

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Zulu/Mr. Guitian Mr. Narvekar

Mr. Mussa

Ms. Saunders

1. KS 2. L.K 3. B.T.S

93 JAN 27 AHII: 52

To:

Mr. Goldstein

January 26, 1993

From:

Samir Fawzi

Subject:

Draft Staff Appraisal: International Capital Markets

The paper presents a good review of the events surrounding the turmoil in the exchange rate mechanism (ERM) in September 1992 and we have little difficulty with the main thrust of the analysis viz. that fundamental economic divergences, accumulating over a period of years, underlay the "speculative" attacks against the weaker currencies.

We do feel, nevertheless, that the paper does not quite answer the question of why the French authorities were able to weather the attack (while the United Kingdom were not), particularly that, it is possible that if the underlying macroeconomic forces persist, the market doubts about the parity of the franc within the ERM could resurface.

The treatment of capital controls in the paper seemed too cursory. While the conventional wisdom on this is well known, the manner in which some weaker ERM members used controls to ward off attack deserves closer examination.

Some editorial comments are pencilled into the margins of the attached draft.

Attachment

cc:

Mr. Beza

Mr. Toure

Mr. Van Houtven

Mr. Boorman

Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo

Mr. Saito

Mr. Tanzi

Mr. Zulu/Mr. Guitian

Mr. Narvekar

of private market participants and that of central banks, the ascendancy of institutional investors with a global horizon, and the rapid progress in the technology of financial transactions have combined to increase the challenges associated with the management of exchange rates. Second, drawing on the mission's meetings with both private market participants and officials, the paper discusses the activities of—and several of the tactical issues that faced—some key players during the crisis itself. And third, the paper identifies the types of policy options available to authorities for managing (fixed) exchange rates in today's world of global capital markets.

25

The rest of the paper is organized as follows. Section II outlines the changing landscape in international capital markets--with emphasis on the main features of the global foreign exchange market (including existing regulatory constraints). In Section III, we introduce an important prologue to the currency crisis, namely, the substantial capital inflows into high-yielding ERM currencies. Section IV then goes on to discuss the roles of institutional investors and of banks during the turmoil, as well as to assess the behavior of liquidity in that period. The tactics of defending ERM parities--with a focus on official intervention and on defensive increases in interest rates--are taken up in Section V. Section VI introduces some of the policy options for managing exchange rates in the aftermath of the ERM crisis. Finally, Section VII offers several potential issues for discussion by Executive Directors.

II. The Foreign Exchange Market in Today's World of International Investment: Players, Instruments, and Opportunities

Liberalization and reform of the financial sector has been a common theme in the industrial countries over the past decade; in some of them, liberalization gained momentum even earlier. The competitive forces unleashed by liberalization have swept away market segmentation and have greatly increased the menu of tradeable financial instruments. Liquid markets in central and local government securities, in corporate debt, in equity, in commercial paper, in bank certificates of deposit, in asset-backed securities, and in both exchange-traded and over-the-counter derivative instruments have become a prominent feature of the financial landscape in most G-10 countries. By 1992, the outstanding stock of publicly-traded debt and equity securities in Europe and the United States had climbed into the neighborhood of US\$24 trillion, while the notional amounts of financial derivative instruments outstanding had reached US\$7 trillion. Suffice to say that retail and institutional investors--be they domestic or foreign--now have on offerma wide choice of liquid securities.

The growth of liquid securities markets has gone hand in hand with the <u>increasing concentration of savings in institutional funds</u> (that is, in mutual investment funds, pension funds, insurance portfolios, unit trusts, and SICAVs). Total assets of leading U.S. institutional investors rose from US\$2 trillion in 1981 to US\$6.5 trillion in 1990. Similarly, the total

manage their (large) international reserve positions quite actively. In institutional funds management, the trend is to separate the exchange risk from the investment risk through hedging, and to treat the exchange risk as just another investment opportunity with its own risk/return profile. Using their capital as collateral, hedge funds can generally leverage by a factor of ten to take speculative positions. Those hedge funds with superior (long-term) track records of profitability have influence beyond their net position-taking because of their role as market leaders.

A capsule summary of the existing regulatory constraints on foreigncurrency denominated investments for banks and institutional investors in the larger industrial countries is presented in Table 3. In short, these constraints differ across types of financial institutions, as well as across countries -- to say nothing of differences between financial and nonfinancial corporations. For example, whereas some G-10 countries have a standard limit on net open forex positions by banks relative to capital, others prefer to set limits on an individual bank-to-bank basis (with higher limits for banks with superior risk-management systems) as part of the overall bank examination process; in some cases, the regulations also differ across currencies (e.g., a prohibition against shorting the home currency). Hedge funds and corporates are not subject to any regulation at all with respect to their forex activities. Securities houses also typically are not required to hold dedicated capital against open forex positions. As seen in Table 3, mutual funds, insurance companies, and pensions are usually subject to some type of "prudence rule" on their foreign-currency denominated investments but there is little uniformity in how such prudent behavior is defined. Based on the mission's discussions with private market participants and regulatory officials, we got the impression that existing prudential constraints are generally not binding, and that internal riskmanagement guidelines tend to be more restrictive. Put in other words, the existing regulatory framework prevents some players in the forex market from making large-scale currency speculation their main line of business -- but it does not much constrain the ability of the private sector as a whole to implement quickly a large shift in its currency preferences.

To sum up, behavior in the forex market has to be seen against the broader trends that are shaping the growth, integration, and agility of international capital markets. The reality is that the resources available to the private sector for taking positions in the forex market are now much larger than those of (G-10) central banks. In those cases when private markets, led by the increasing financial muscle of institutional investors, reach the concerted view (rightly or wrongly) that there has been a significant deterioration in the risk/return outlook for a particular currency, the defending central bank could well be a faced with a run that could easily amount to say, US\$100-200 billion or more within the space of a week. Moreover, there is little in the factors underlying the evolution of international capital markets to suggest that this increased clout of private markets (vis-a-vis official reserves) will reverse itself in the future. Quite the contrary: International diversification is still in its adolescence, the pace of financial liberalization and innovation continues

unabated in most countries, the pool of savings managed by professionals is on the rise (as private pension schemes supplement or replace public ones, and savings shifts from the banking sector into mutual funds), and the same reforms that reduce systemic risk (e.g., improvements in payments and settlement systems) often also enhance the capacity of the private sector to redominate the currency composition of its assets at short notice. For better or worse--and we think it for better, given the wide-ranging benefits of integrated capital markets--that toothpaste cannot be put back in the tube.

III. The Prologue to the ERM Crisis: The Convergence Play

In order to understand why the sales of certain ERM currencies in the summer and fall of 1992 were so huge, it is necessary to take the story back at least five years. Specifically, over the 1987-92 period, there were large, cumulative inflows of capital into the higher-yielding ERM currencies (see Table 4). One of the important factors motivating these inflows was the growing perception on the part of international investors that the member countries of the EMS were on a continuous convergence path toward EMU, under which interest rate differentials in favor of the high-yielding ERM currencies would increasingly underestimate the actual risk of exchange rate depreciation. As one portfolio manager recalled the prevailing view, "why settle for the yield on a DM bond when you could get the higher yield on a peseta or lira bond without a compensating exchange risk?" This came to be known in major financial centers as "the convergence play." As shown in Chart 1, the average spread during the last five years of the one-year lira yield over the corresponding deutsche mark instrument was nearly 5 percent (so too with the yield differential over U.S. dollar instruments); the attraction of peseta instruments (over the 1989-92 period) is likewise apparent. When the United Kingdom entered the ERM in October 1990, it too became a candidate for convergence plays. Based on the same convergence scenario, the financial sector and the larger corporates in the high-yield currency countries increasingly funded themselves in the lower-interest ERM currencies (mainly the deutsche mark but also the Dutch guilder). 1/ In yet another reflection of the fixed exchange rate assumption, the exchange risk of positions against non-ERM currencies was frequently " proxy-hedged," e.g., a hedge of a deutsche mark position against the U.S. dollar was emplaced when lira securities were acquired. As the period since the last realignment in the ERM lengthened and as the political commitment toward EMU solidified -- culminating with the signing of the Maastricht Treaty in December 1991--the strategy of riding the high nominal interest, seemed secure. Without pretending to much precision, estimates suggest that the

Rough

^{1/} For example, the short-term external funding of Italian deposit money banks doubled to US\$160 billion since 1987.

injections into the banking system and a large and mounting fiscal deficit. In the end, after failing to reach agreement with opposition parties on how to bring the fiscal deficit under control, the authorities had to reluctantly abandon their peg to the ECU and permit the krona to float.

In contrast to Sweden, the U.K. case was one where the authorities attempted to defend the currency with minimal use of the interest rate. Here, the relevant background included two years of recession, excessive debt accumulation in the private sector, and a financial market structure under which any rise in the Bank of England's minimum dealing rate spreads relatively quickly to the whole yield curve, including to retail markets and mortgage markets. After raising its minimum dealing rates from 12 percent to 15 percent on September 15, it became clear that these changes had no impact on the selling pressure: traders, apparently recognizing the high costs of maintaining this rate for long, continued to sell sterling, and the exchange rate did not budge from its floor value. The Bank of England then ceased the defense of the floor parity and dropped the minimum dealing rate back to 12 percent. By October 16, it had dropped the minimum dealing rate to 8 percent.

In Italy, it was apparently the link between interest rates and the fiscal deficit that led traders to question the sustainability of high interest rates. Money market interest rate rises have a large impact on Italian government finance because 29 percent of its debt is in the form of T-bills (BOT's), 48 percent is in floating-rate securities (CCT's), with the rest being primarily medium and long term bonds (BTP's). Indeed, the government experienced difficulty funding itself through new issues at acceptable rates during the crisis. The Bank of Italy, therefore, made modest use of the interest rate defense throughout the attack on the lira, raising in steps its discount rate from 12 percent to 15 percent, allowing the interbank overnight rate to reach 36 percent on September 16.

If part of the constraint on using increases in interest rates to defend a fixed exchange rate arises because innocent bystanders as well as speculators get hit by the same higher cost of credit, isn't there something that can be done to restrict the squeeze to the speculators -- or at least to limit the spread of higher interest rates to the rest of the economy? The French defense provides an example of one effort in this direction--albeit one that admittedly can only be used for a short period and only where the banks themselves are prepared to cooperate. Although initially reluctant to raise interest rates in the early stages of the attack, the French authorities increased rates as the attack against the franc intensified. Banks with normal commercial requirements received relatively cheap funding that could be passed through to customers to avoid a rise in the base rate (about thirty percent of bank credit depends on the base rate, which governs loans primarily to small businesses). Thus, a two-tier money market operated -- with near-normal interest rates for regular customers and high interest rates for others. Lending was not distinguished by the nationality of the buyer but by the class of business.

end

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file

INTERNATIONAL MONETARY FUND

January 22, 1993

TO: Division Chiefs
Mr. Bercuson

I would appreciate any comments on the attached by close of business, Monday, January 25.

Attachment

Steven Dunaway

Office Memorandum

PACIFIC CEPT CHICAT

93 Jan 21 FM 12: 51 January 21, 1993

To:

Mr. Beza

Mr. Toure

Mr. Van Houtven

Mr. Boorman Mr. Chabrier

Mr. Neiss

Mr. Odling-Smee

Mr. Russo Mr. Saito Mr. Tanzi Mr. Williams

Mr. Zulu/Mr. Guitian

Mr. Narvekar

From:

Morris Goldstein M. Co,

Subject: Draft Staff Appraisal: International Capital Markets

I attached for your comments a draft staff appraisal:

Developments, Prospects, and Key Policy Issues in International

Capital Markets, Part I: Exchange Rate Management and International

Capital Flows in the Aftermath of the ERM Crisis. As you may know, it

has been agreed to hold the discussion of this year's capital markets

papers on two dates. On February 26th, the Executive Board will

consider the issues discussed in the attached paper. That will be

followed by a meeting in early April on more traditional capital

markets issues--including, inter alia, potential systemic risk

associated with the rapid growth of off-balance financial activity,

loan loss experience in major banking sectors, and trends and issues

in developing country access to international finanacial markets.

In view of the somewhat compressed schedule, could I please ask for your comments on the attached paper by c.o.b. Tuesday, January 26th?

cc: Mr. Mussa

Ms. Saunders

INTERNATIONAL MONETARY FUND

International Capital Markets Developments, Prospects, and Key Policy Issues, Part I;

Exchange Rate Management and International Capital Flows in the Aftermath of the ERM Crisis

Prepared by the Research Department

Approved by Michael Mussa

January 20, 1993

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I. Introduction

This year's report on developments, prospects, and key policy issues in international capital markets is divided into two parts. 1/ Part One, consisting of this staff appraisal and an accompanying background paper, examines the implications of the growth and integration of international capital markets for the management of exchange rates; in this connection, particular attention is paid to the inferences that can be drawn from the currency turmoil that has enveloped the European Monetary System (EMS) over the past five months. Part Two of the report, which is expected to be available for discussion by the Executive Board in April, will be focused on: sources of systemic risk in the rapid growth of off-balance sheet financial transactions; the recent loan loss experience--especially in real estate--of national banking systems; and trends and issues in developing-country access to international financial markets.

This is not the first paper by the staff to review the currency crisis in Europe. In examining the main factors behind the September crisis, the December 1992 World Economic Outlook concluded that the crisis "...reflected an unusual combination of divergent economic forces and important political events that raised doubts about countries' commitment to control inflation and to reduce excessive budget deficits, and about prospects for monetary cooperation in Europe. " 2/ In a similar vein, a recent staff paper on "Economic and Monetary Union (EMU) in Europe - Policy Issues and Implications for Fund Surveillance, " stressed: (i) that uncoordinated monetary policies are incompatible with fixed exchange rates in the context of free capital movements and sophisticated financial markets; (ii) that a smooth transition to EMU without exchange rate adjustments requires a larger degree of convergence of underlying economic conditions than exists at present; and (iii) that pegged exchange rates are not a substitute for a common currency because there will always exist doubts concerning even "irrecovably fixed" parities. 3/

This paper supplements earlier staff analysis of the currency crisis in three respects. <u>First</u>, it provides a fuller picture of how the liberalization of capital flows, the growing imbalance between the resources

^{1/} A staff team, headed by Mr. M. Goldstein (RES), including Mr. D. Folkerts-Landau (RES), and at different times Messrs. C. Collyns (PDR), R. Rennhack (PDR), Mrs. Rojas-Suarez (RES), Messrs. P. Garber and S. Fries (RES), and P. Szymczak (PDR) held discussion with national authorities, international institutions, and market participants in Belgium, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the United Kingdom, and the United States between October and early December 1992. Background Material to the present paper is provided in International Capital Markets-Background Material (forthcoming).

^{2/} EBS/92/103, p.27.

^{3/} SM/92/129, Supplement 2, December 1992, p.5.

of private market participants and that of central banks, the ascendancy of institutional investors with a global horizon, and the rapid progress in the technology of financial transactions have combined to increase the challenges associated with the management of exchange rates. Second, drawing on the mission's meetings with both private market participants and officials, the paper discusses the activities of--and several of the tactical issues that faced--some key players during the crisis itself. And third, the paper identifies the types of policy options available to authorities for managing (fixed) exchange rates in today's world of global capital markets.

The rest of the paper is organized as follows. Section II outlines the changing landscape in international capital markets--with emphasis on the main features of the global foreign exchange market (including existing regulatory constraints). In Section III, we introduce an important prologue to the currency crisis, namely, the substantial capital inflows into high-yielding ERM currencies. Section IV then goes on to discuss the roles of institutional investors and of banks during the turmoil, as well as to assess the behavior of liquidity in that period. The tactics of defending ERM parities--with a focus on official intervention and on defensive increases in interest rates--are taken up in Section V. Section VI introduces some of the policy options for managing exchange rates in the aftermath of the ERM crisis. Finally, Section VII offers several potential issues for discussion by Executive Directors.

II. The Foreign Exchange Market in Today's World of International Investment: Players, Instruments, and Opportunities

Liberalization and reform of the financial sector has been a common theme in the industrial countries over the past decade; in some of them, liberalization gained momentum even earlier. The competitive forces unleashed by liberalization have swept away market segmentation and have greatly increased the menu of tradeable financial instruments. Liquid markets in central and local government securities, in corporate debt, in equity, in commercial paper, in bank certificates of deposit, in asset-backed securities, and in both exchange-traded and over-the-counter derivative instruments have become a prominent feature of the financial landscape in most G-10 countries. By 1992, the outstanding stock of publicly-traded debt and equity securities in Europe and the United States had climbed into the neighborhood of US\$24 trillion, while the notional amounts of financial derivative instruments outstanding had reached US\$7 trillion. Suffice to say that retail and institutional investors--be they domestic or foreign--now have on offer a wide choice of liquid securities.

The growth of liquid securities markets has gone hand in hand with the <u>increasing concentration of savings in institutional funds</u> (that is, in mutual investment funds, pension funds, insurance portfolios, unit trusts, and SICAVs). Total assets of leading U.S. institutional investors rose from US\$2 trillion in 1981 to US\$6.5 trillion in 1990. Similarly, the total

assets of U.K. institutional investors climbed from 52 percent of GNP in 1980 to 108 percent in 1990. U.S. and European mutual funds alone now manage over US\$8 trillion in assets (Table 1). We are thus seeing a growing concentration of investment decisions in the hands of professional fund managers. Simultaneously, the spread of sophisticated information technology means that "news" relevant to financial decision-making is more and more reaching these managers at the same time wherever their geographical base. As a consequence, during those periods when fund managers share homogeneous perceptions about both the evolution of financial variables and the impact of news, there is the potential for new information to produce massive purchases/sales and sharp volatility in prices.

The progressive liberalization of cross-border financial flows, in tandem with the growth of liquid domestic securities markets and the increasing clout of institutional portfolio management, has induced an historically unprecedented growth in international portfolio investment among the major industrial countries. Complete liberalization of capital flows was accomplished within most of the EC by July 1990. Total gross cross-border equity holdings among the United States, Europe, and Japan increased from US\$800 billion in 1986 to US\$1.3 trillion in 1991, while total cross-border ownership of tradeable securities is estimated to have risen to US\$2.5 trillion. 1/ Institutional investors have played an important role in this international portfolio investment. At present, institutional investors in Europe invest a higher proportion (about 20 percent) of their assets abroad than do those in the United States or Japan (where the corresponding percentages seem to fall in the 5-7 percent neighborhood). While these percentages seem modest, the size of the total portfolios under management are large enough to translate into potentially large financial flows. For example, a 5 percent share of U.S. pension fund assets means US\$125 billion, while a 6 1/2 percent share of the assets of U.S. mutual funds amounts to roughly US\$50 billion (see Table 2). Just as significant, it is widely expected that the international diversification of institutional investors will increase markedly over time. In this regard, it has been estimated that the share of foreign-currency denominated assets in the portfolios of the 300 largest pension funds in the world will increase from their present level of about 7 percent to about 12 percent by the mid-1990s.

Another noteworthy development is that <u>relationship buy-and-hold</u> <u>finance is giving way to transactions-driven finance</u>. Improved liquidity allows investors to get quickly in and out of domestic and international investment positions. Likewise, advances in the technology of financial transactions--ranging from back office clearance and settlement, to trading

^{1/} In some instances governments actively have sought to broaden their international investor base. For example, in late 1988 the French Government successfully listed two issues of government bonds, OATS, (Obligations Assimilable du Tresor), in the form of American Depositary Receipts at the New York Stock Exchange.

Table 1. Distribution of Assets Managed by Leading Fund Managers in Europe and the United States,
December 31, 1992

	United Kingdom	Switzerland	France	Germany	Other Countries European	Total Europe	United States
Number of funds	41	17	12	11	19	100	100
		(In milli	ons of U.S.	dollars)			
Total assets	1,191,151	844,754	632,811	408,406	624,316	3,701,438	4,486,648
		(In perc	ent of tota	l assets)			
Equity Of which:	57.3	7.6	13.1	19.6	14.1	27.0	33.9
Foreign	20.8	1.6	2.7	6.8	8.2	9.7	2.3
Fixed-income Of which:	27.6	16.1	47.5	48.9	60.2	36.2	39.9
Foreign	13.4	5.3	1.0	20.4	8.6	9.4	0.5
Other assets	12.6	4.6	3.0	21.0	13.3	10.2	26.0
Not reported	2.5	71.7	36.3	10.5	12.3	26.6	0.2

Sources: <u>Institutional Investor</u>; and IMF staff estimates.

Note: Totals may not add up due to rounding.

Table 2. Foreign Investments of Pension and Mutual Funds for Selected Industrial Countries, 1991

	Mutual	Funds	Pension Funds			
	Total Assets	Share of Foreign Assets in Total Assets	Total Assets	Share of Foreign Assets in Total Assets		
	(In billions of U.S. dollars)	(<u>In percentages</u>)	(In billions of U.S. dollars)	(<u>In percentages</u>)		
France	429.5	4.3				
Germany	160.8	34.9	••			
Japan		••	655.0	7.0		
United Kingdom	101.3	39.2	560.0	20.0		
United States	807.1	6.6	2,725.0	5.0		

Sources: Investment Company Institute and InserSec Research Corporation.

and information systems, to settlement of payments--have reduced transactions costs to the point where they less and less serve as an impediment to rearranging portfolios when expectations change. It is, for example, increasingly common to see large investors switch between bond and equity funds as soon as expected yields diverge. Also, many of the major equity and government securities markets have become sufficiently liquid to permit automated program trading and hedging strategies. The fact that trading volume in most major markets in the United States, Europe, and Japan has more than tripled in the last five years, and is dominated by institutions, bear testimony to the propensity of fund managers to adjust their portfolios in light of changes in expectations. In cases where the transaction in the spot market is still too expensive, the investor has the opportunity to take synthetic positions in the derivative markets, where daily trading volume has nearly tripled since 1986.

The global forex market has grown even faster than international investing, with net turnover in the three largest markets (that is, in London, New York, and Tokyo) estimated to have undergone a three-fold increase over the past six years. Market surveys conducted by the Federal Reserve Bank of New York, the Bank of Japan, and the Bank of England suggest that global daily net turnover now approaches US\$1 trillion per day (up from US\$640 billion in April 1989). 1/ By way of comparison, total (non-gold) foreign exchange reserves of G-10 central banks amounted to roughly US\$400 billion in April 1992.

The <u>U.S.</u> dollar remains by far the <u>dominant currency in forex trading</u> (accounting for 76 and 89 percent of 1992 net turnover in the London and New York markets, respectively). That being said, the <u>share of cross-currency transactions</u> (i.e., those that do not involve the dollar in one leg of the transaction) <u>has gained ground</u> over time, particularly cross-trading involving the deutsche mark--a development that traders ascribe primarily to the limited volatility of the deutsche mark vis-a-vis other ERM currencies (relative to that for dollar/ERM exchange rates).

The most significant development in foreign exchange markets in recent years has been the expansion of trading in derivative securities. Spot transactions accounted for only 50 percent of gross turnover in the United Kingdom in 1992 versus 73 percent in 1986. In contrast, trading in forwards and swaps increased from 27 percent of gross turnover in 1986 to 47 percent in 1992 (of which only 6 percent involved straight forwards). The expansion of the currency swaps market has been dramatic, with outstanding notional principal increasing more than fourfold to US\$800 billion between end-1987 and end-1991. The most commonly swapped currency is the U.S. dollar.

^{1/} This estimate is supported by data from CHIPS (the international payments system for foreign exchange transactions) which report average daily transmissions in excess of US\$850 billion in April, 1992.

Trading in the markets for <u>currency futures and options contracts</u> has also <u>mushroomed</u>. Daily turnover in these markets in London grew from negligible amounts in 1986 to US\$8 billion in 1992, and from US\$3 billion to US\$23 billion in the United States. Most of this activity is in the Overthe-Counter (OTC) options market (where average daily turnover is reported by dealers to be about US\$15 billion in the United States and US\$5 billion in the United Kingdom); futures market activity in these countries is lower-in the neighborhood of US\$6 billion and US\$3 billion, respectively).

The <u>main players</u> in the forex market have long been <u>large international banks</u>, <u>securities houses</u>, <u>corporates</u>, <u>and central banks</u>. As suggested earlier, these traditional players have increasingly been joined by a powerful, new set of players, namely, <u>institutional investors</u> (mutual funds, pension funds, insurance companies) and <u>hedge funds</u>. In their forex activities, hedge funds differ from institutional investors in two-ways: they are unregulated and their primary mode of operation is to take highly leveraged, speculative positions (typically using their assets as collateral or initial margins).

Market activity is dominated by inter-dealer transactions. Indeed, it has been estimated that each customer order leads to four or five interdealer transactions, as dealers lay off their risk with other dealers, seek to earn profits by taking sometimes large intra-day positions, and engage in frequent price-discovery trades. On first impression, turnover in the forex market may seem startlingly high. But that turnover needs to be compared with that in other liquid markets. To take a specific example, the average daily volume of U.S. government securities settled through the book entry system amounted to about US\$400 billion in 1990--on an end-of-year stock of U.S. Treasury marketable debt of US\$3.4 trillion (US\$2.6 trillion in the hands of the public). This means that the entire marketable debt turns over once every eight days! Since the forex market can be thought of as a mechanism for pricing tradable wealth internationally and since the stock of publicly traded debt and equity is probably in the vicinity of US\$24 trillion, an average daily turnover of US\$1 trillion in the global forex market is not so remarkable; in fact, we would expect daily turnover to continue to increase over time.

The 30-50 largest banks (along with a handful of the largest securities houses) serve as <u>market makers</u> in the key currencies. Banks and securities houses also use the information they gather in the course of market making to help guide their own--albeit usually limited--position taking. On the whole, banks and securities houses are best seen as <u>intermediaries</u> in the forex market, supplying liquidity and advice to their customers (some of whom will be less constrained in their forex activities). Corporations routinely cover their commercial exposure, funding themselves in the most advantageous geographic markets and using the currency swap market to eliminate the exchange risk. More and more, the <u>forex activities of corporate treasury operations</u> have come to be viewed as <u>profit centers</u>. In addition to normal intervention operations that are undertaken by virtually all central banks, a relatively small set of central banks are known to

manage their (large) international reserve positions quite actively. In institutional funds management, the trend is to separate the exchange risk from the investment risk through hedging, and to treat the exchange risk as just another investment opportunity with its own risk/return profile. Using their capital as collateral, hedge funds can generally leverage by a factor of ten to take speculative positions. Those hedge funds with superior (long-term) track records of profitability have influence beyond their net position-taking because of their role as market leaders.

A capsule summary of the existing regulatory constraints on foreigncurrency denominated investments for banks and institutional investors in the larger industrial countries is presented in Table 3. In short, these constraints differ across types of financial institutions, as well as across countries -- to say nothing of differences between financial and nonfinancial corporations. For example, whereas some G-10 countries have a standard limit on net open forex positions by banks relative to capital, others prefer to set limits on an individual bank-to-bank basis (with higher limits for banks with superior risk-management systems) as part of the overall bank examination process; in some cases, the regulations also differ across currencies (e.g., a prohibition against shorting the home currency). Hedge funds and corporates are not subject to any regulation at all with respect to their forex activities. Securities houses also typically are not required to hold dedicated capital against open forex positions. As seen in Table 3, mutual funds, insurance companies, and pensions are usually subject to some type of "prudence rule" on their foreign-currency denominated investments but there is little uniformity in how such prudent behavior is defined. Based on the mission's discussions with private market participants and regulatory officials, we got the impression that existing prudential constraints are generally not binding, and that internal riskmanagement guidelines tend to be more restrictive. Put in other words, the existing regulatory framework prevents some players in the forex market from making large-scale currency speculation their main line of business -- but it does not much constrain the ability of the private sector as a whole to implement quickly a large shift in its currency preferences.

To sum up, behavior in the forex market has to be seen against the broader trends that are shaping the growth, integration, and agility of international capital markets. The reality is that the resources available to the private sector for taking positions in the forex market are now much larger than those of (G-10) central banks. In those cases when private markets, led by the increasing financial muscle of institutional investors, reach the concerted view (rightly or wrongly) that there has been a significant deterioration in the risk/return outlook for a particular currency, the defending central bank could well be a faced with a run that could easily amount to say, US\$100-200 billion or more within the space of a week. Moreover, there is little in the factors underlying the evolution of international capital markets to suggest that this increased clout of private markets (vis-a-vis official reserves) will reverse itself in the future. Quite the contrary: International diversification is still in its adolescence, the pace of financial liberalization and innovation continues

Table 3. Regulatory Constraints on Foreign Currency-Denominated Investments by Major Financial Institutions in Selected Industrial Countries $\underline{1}/$

Country/ Region	Banks	Pension Funds	Insurance Companies	Mutual Funds	
France	No formal control over banks' foreign exchange positions but banks are not permitted to take open global positions against the French Franc		Investments by insurance companies are subject to the matching assets rule; the location rule and; the allocation of assets rule.	Mutual funds are subject to disclosure and asset diversification rules. A fund may not hold more than 10 percent of any one category of securities of one issuer.	
Germany	Banks' net open foreign exchange positions (spot and forward combined) at the close each business day must not exceed 30 percent of the liable capital.	No more than 5 percent of assets can be invested in overseas bonds.	Investment must adhere to the principle of localization; the principle of congruence which matches the asset side with the liability side of an insurance company's balance sheet in order to avoid currency risks.		
Required to belance overall (spot and forward combined) foreign exchange position vis-a-vis residents and nonresidents. Open positions are limited to working belances subject to specific ceilings.			Investment is subject to the matching requirement, i.e., commitments in a currency must be covered by assets denominated in the same currency.	A fund may not invest more than 5 percent of the fund resources into securities issued by the same company if quoted or more than 10 percent if unquoted on a stock exchange, and it may borrow up to 10 percent of its assets including borrowing in foreign currency.	
Japan	Authorized foreign exchange banks are subject to individual ceilings on their overall (spot and forward combined) net positions in foreign currencies at the end of each working day.	Are required to keep at least 50 percent of assets in guaranteed fixed-return domestic yen vehicles, and up to 30 percent of the total portfolio can be in foreign currency securities.	Bolding by insurance companies of securities issued by nonresidents is limited to 30 percent of total assets; the same ratio applies to purchases of foreign currency-denominated assets.		
United Kingdom	Net open dealing position in any one currency may not exceed 10 percent of the adjusted capital base. The net short open dealing position of all currencies taken together may not exceed 15 percent of the adjusted capital base.	Mot subject to any specific limitations in their holdings of foreign currency assets.	Subject to metching and localization rules which require them roughly to belance liabilities expressed in a particular currency with assets in that currency.	Collective investment schemes (unit trusts) are required to invest at least 90 percent of their assets in transferable securities in "approved markets," which includes markets in virtually all OECI member countries.	
United States	Foreign currency exposure of banks is not subject to any regulatory limitations but it is monitored through weekly and monthly reports on spot and forward positions.	Regulated by a special federal law-ERISA. Permissible investments subject to the "prudent expert" rule. Otherwise no explicit restrictions on holding foreign securities including foreign equities and foreign currency denominated bonds.	The U.S. state insurance regulations attempt "to prevent or correct undue concentration of investment by type and issue unreasonable mismatching of maturities of assets and liabilities." These laws usually allow an unrestricted "basket" of investments for certain amount of assets, which can be allocated to foreign securities.	open-ended fund may not hold more than 15 percent of its net assets in illiquid assets. Otherwise no explicit restrictions are imposed on investment in foreign securities.	
European Community	Under the EC Directive on capital adequacy if a firm's overall net foreign exchange position exceeds 2 percent of its total own funds, it will multiply the excess by 8 percent in order to calculate its own funds requirements against foreign exchange risk. 2/	The EC Pension Fund Directive requires member states to abolish arbitrary investment requirements such as lists of permissible assets or minimum investment requirements. Member states cannot require funds to hold more than 80 percent of their assets in matching currencies and must take account of the effect of any currency hedging instruments held by the institution.	The EC Life & Non-Life Insurance Directives intend to remove all legal barriers for the creation of a common market in insurance. They also set out provisions to harmonize rules on admissible investment.	The UCIIS Directive introduced the principle of the single authorization requirement & simed at coordinating the laws of member states. No guideline are set out for restricting UCIIS fund's cross-border investment.	

^{1/} For the securities houses of these countries there are no explicit regulatory restrictions on foreign exchange positions and other cross-border investments.
2/ The same regulatory constraints apply to security houses.

unabated in most countries, the pool of savings managed by professionals is on the rise (as private pension schemes supplement or replace public ones, and savings shifts from the banking sector into mutual funds), and the same reforms that reduce systemic risk (e.g., improvements in payments and settlement systems) often also enhance the capacity of the private sector to redominate the currency composition of its assets at short notice. For better or worse--and we think it for better, given the wide-ranging benefits of integrated capital markets--that toothpaste cannot be put back in the tube.

III. The Prologue to the ERM Crisis: The Convergence Play

In order to understand why the sales of certain ERM currencies in the summer and fall of 1992 were so huge, it is necessary to take the story back at least five years. Specifically, over the 1987-92 period, there were large, cumulative inflows of capital into the higher-yielding ERM currencies (see Table 4). One of the important factors motivating these inflows was the growing perception on the part of international investors that the member countries of the EMS were on a continuous convergence path toward EMU, under which interest rate differentials in favor of the high-yielding ERM currencies would increasingly underestimate the actual risk of exchange rate depreciation. As one portfolio manager recalled the prevailing view, "why settle for the yield on a DM bond when you could get the higher yield on a peseta or lira bond without a compensating exchange risk?" This came to be known in major financial centers as "the convergence play." As shown in Chart 1, the average spread during the last five years of the one-year lira yield over the corresponding deutsche mark instrument was nearly 5 percent (so too with the yield differential over U.S. dollar instruments); the attraction of peseta instruments (over the 1989-92 period) is likewise apparent. When the United Kingdom entered the ERM in October 1990, it too became a candidate for convergence plays. Based on the same convergence scenario, the financial sector and the larger corporates in the high-yield currency countries increasingly funded themselves in the lower-interest ERM currencies (mainly the deutsche mark but also the Dutch guilder). 1/ In yet another reflection of the fixed exchange rate assumption, the exchange risk of positions against non-ERM currencies was frequently " proxy-hedged," e.g., a hedge of a deutsche mark position against the U.S. dollar was emplaced when lira securities were acquired. As the period since the last realignment in the ERM lengthened and as the political commitment toward EMU solidified -- culminating with the signing of the Maastricht Treaty in December 1991 -- the strategy of riding the high nominal interest seemed secure. Without pretending to much precision, estimates suggest that the

^{1/} For example, the short-term external funding of Italian deposit money banks doubled to US\$160 billion since 1987.

Source: Data Resources, Inc.
Legend Indicates maturity of both components of the differential.

1 Daily data for the Spanish peseta are not available before July 1989.

Table 4. Capital Account for Selected Countries in the EMS, 1986-92 1/

(In billions of local currencies)

				No. of the State o	The same of the same of the same		
	1986	1987	1988	1989	1990	1991	1992
France	-6.5	-26.0	19.3	43.4	138.2	-20.4	0.1 2/
Germany	-82.6	-39.0	-127.5	-135.6	-90.1	14.4	26.0 <u>3</u> /
Italy	3,597.0	11,721.0	21,297.0	33,940.0	51,503.0	26,583.0	12,366.0 <u>3</u> /
Spain	-373.0	1,418.0	1,311.0	1,950.0	2,281.0	3,229.0	1,155.0 <u>4</u> /
United Kingdom	-0.2	16.3	12.2	13.8	11.2	8.3	-0.7 <u>4</u> /

Sources: IMF, Recent Economic Developments (various issues); and national sources.

- 11

^{1/} Excluding changes in official foreign exchange reserves and errors and omissions.

^{2/} For the first quarter of the year.

^{3/} For the first half of the year.

^{4/} For the first three quarters of the year.

total of such convergence plays could have been as high as US\$300 billion; 1/

The problem of course was that actual achievements in convergence among ERM countries were not durable enough and deep enough to justify an assumption of complete fixity of exchange rates. Suffice to say that losses of competitiveness, large fiscal deficits not yet under control, weaknesses in financial sectors, sharp cyclical differences, and divergent mixes of monetary and fiscal policy across countries (in the wake of German unification)--each constituted elements of vulnerability. Those vulnerabilities took on greater significance once the negative outcome of the Danish referendum and uncertainties about the outcome of the French referendum put into question both the certainty of the EMU treaty ratification process and the ability of some countries to deliver enough convergence (in the absence of EMU) to make existing exchange rate parities sustainable. In short, the markets "rediscovered" exchange risk. There followed a massive shift out of certain currencies and the beginning of the recent crisis in the ERM.

The convergence-play prologue to the ERM crisis should serve to remind us that international capital markets can be prone to sharp shifts in sentiment about the outlook for currencies. The discipline exercised by capital markets over government policies is neither infallible nor is it always applied in a smooth, consistent manner. Eventually, however, the markets recognize unsustainable situations and force adjustments. The challenge for authorities is to make those adjustments in an orderly way before the markets force a more costly resolution.

IV. The Behavior of the Private Sector During the Crisis

The role of institutional investors

Global hedge funds. As noted earlier, hedge funds--private, closed-end investment funds--assemble pools of private capital to engage in highly-leveraged position-taking. Some of these funds have long been perceived as

In some way, the convergence play is another version of the "peso problem." In the mid-1970's, the Mexican peso had exchanged for the US dollar at the same rate for two decades. It was noticed that the Mexican interest rate was significantly higher than dollar interest rates year after year. This phenomenon was dubbed the "peso problem." The interpretation in 1975, which is now commonplace, was that there was a low probability of a large devaluation--the probability was low because empirically the event had not occurred in a long run of data. The devaluation, once it occurred, would be large because of the large divergence in interest rates. The game for any investor, as for any currency speculator, in the peso was to time the conversion of funds back to dollars before the devaluation and get higher than the market return on dollars.

market leaders, and their moves during the summer were a signal for other institutional funds managers to reexamine their own positions. Thus, although hedge funds have less than US\$10 billion in capital, they have a potential influence much beyond their size.

The hedge funds appear to have taken two types of positions during the crisis. First, with respect to foreign exchange, they typically sold forward the vulnerable currency, usually using longer-dated contracts (one to two months). Second, they also took interest rate positions in that currency (for example, by buying interest rate futures contracts), in anticipation of a rate decline after the devaluation. Intrinsic to this strategy was the expectation that authorities in the weak-currency country would raise interest rates to defend the parity--but also that this period of high interest rates would be short-lived. To close out their short currency positions, the hedge funds bought the devalued currency in the spot market before the expiration of the forward contracts.

Institutional investors and corporates. As hinted at above, these market participants sought to undo as quickly as possible their increased holdings of assets denominated in high-interest rate currencies and/or to cover their deutsche mark funding. For most mutual funds, their mandates were written in a broad enough way such that they were permitted to rebalance their portfolios once they anticipated exchange rate movements. In some cases, however, either the prospectus of the fund or the regulatory constraints on permissible financial operations limited the room for maneuver. For example, if a fund was established as a peseta bond fund, it could not cease to hold peseta-denominated securities even if it anticipated a peseta devaluation. 1/ In some countries (e.g., United Kingdom), mutual funds can short a currency only up to the amount that they hold securities denominated in that currency. In other countries, mutual funds are limited in their ability to leverage their investments and, in effect, to short a currency. Corporate and financial sector borrowers from the high-yield ERM countries who borrowed extensively in low-cost ERM currencies undertook massive hedging operations during the summer and early autumn. U.S. corporations appear to have been engaging in the proxy hedging of their European currency exposures, using deutsche mark and French franc positions to hedge exposures in other European currencies. These corporations sought to unwind these hedges as the crisis unfolded.

The role of the banking system

Based on the mission's discussions with supervisory authorities, it appears that the <u>international banking system itself did not take unusually large net open positions in foreign exchange during the crisis</u>. We say "appears" because the information typically does not allow one to ascertain

^{1/} Similarly, if a fund had promised to always hold at least x percent of its total assets in foreign-currency denominated instruments, it could only rebalance currency composition subject to that x percent floor.

intra-day net open positions of banks -- nor are the data on foreign exchange payments comprehensive enough to estimate with precision how bank earnings during the crisis were apportioned as between market making and other activities. Nevertheless, a robust conclusion is that the main role played by banks (and securities houses) during the crisis was to provide credit to those institutions seeking to liquidate long positions in vulnerable currencies, hedge such long positions, or to establish open short positions in these currencies, and to make markets in foreign exchange. Both of those activities proved profitable. In the early summer of 1992, immediately after the Danish vote, U.S. and European commercial banks and securities firms -- many of which had in their capacity as market makers in foreign exchange witnessed first hand the flow of funds into the convergence plays-began to negotiate credit lines in the currencies that were perceived to be vulnerable -- lira, sterling, peseta, escudo, but not yet the French franc. By building up cash reserves and arranging credit lines in the vulnerable currencies prior to the crisis, they were subsequently able both to lend at a premium above their borrowing costs in the weak currencies and to buy forward the currencies under attack. In our meetings, several banks argued that such "liquidity plays" made more sense for banks than outright currency plays because the former were less risky and allowed banks to employ their comparative advantage, namely, their access to large credit lines (relative to those available for other types of financial institutions). Since the crisis was also characterized both by a large widening of spreads and by extremely high volumes, simple market making likewise paid handsome returns.

To the extent that banks play a key role during a currency attack by providing liquidity to other participants, one can ask where the banks, in turn, get that liquidity. The answer is from the central banks who ultimately finance the attack by not allowing interest rates to rise enough to choke off the increased demand for credit in the currency under attack. 1/ And taking the argument one step further, the reason interest rates may not rise much during the attack is that central banks typically sterilize the (contractionary) monetary effects of their exchange market intervention. In this sense, one can regard the US\$150 billion or so of exchange market intervention undertaken by central banks during the ERM crisis as financing a roughly equivalent capital outflow from the high-yielding ERM currencies.

<u>Liquidity Problems during the crisis</u>. In the view of both private market participants and authorities, the <u>forex market</u>--as well as <u>domestic money markets in ERM countries</u>--generally worked well during the crisis.

^{1/} This is true whether the participant trying to get out of the currency under attack undertakes a short sale (i.e., borrowing a currency and selling it spot), or an asset sale (i.e., direct sale of securities denominated in the attacked currency and a simultaneous spot sale of the proceeds), or a currency hedge (i.e., redomination of the security by way of a hedge program).

Given the huge volumes of securities and currencies traded during that period -- as well as attempts to ration liquidity to those taking positions against existing parities -- that outcome was hardly pre-ordained. This is not to say that there weren't strains. While forex spot markets operated continuously, there were times when spreads widened from five to ten times the norm in most of the ERM cross-rates. The size of trades also declined at times. For example, the normal size of the a lira-deutsche mark trade is DM 50 million, but this size was not available in mid-September. Dealers in lira hesitated to quote forward rates because of the great volatility in short-term interest rates, and this market did not operate for two weeks after the devaluation. OTC option markets suffered, as interest rate volatility many times the norm made quotation of prices hazardous. As credit-line limits filled, those institutions with lower credit ratings lost their access to interbank markets and had to move to derivatives exchanges to hedge their positions. The greatest liquidity problems actually surfaced in the ECU market, where it has not proved possible since mid-September to complete wholesale transactions (as market makers will no longer bear the risk of holding an ECU trading portfolio), where a significant spread (250 basis points) developed between the official ECU and the private ECU (ECUdenominated bank deposits at ECU clearing banks) when some central banks tried to use their ECU reserves to support their currency, and where trading in private ECU against the basket came to a halt for about a week immediately after the onset of the crisis; presumably, the political events that raised uncertainty about the future of EMU also created increased uncertainty about the value of the private ECU in terms of the official basket. Still, looking across all the markets, there were no failures of major financial firms -- nor any persistent seizing-up of the largest asset markets. The improvements in back-office processing and risk control systems instituted since the 1987 crash obviously helped to accommodate the increases in forex and money trading volumes. Just as important, (with the exception of the ECU bond market), the crisis remained localized in European currency markets. It did not spread to national debt and equity markets, nor to the dollar or yen exchange markets. As pointed out by several authorities, one reason for not being complacent is that there is no

assurance that this would necessarily be the case in a future currency crisis. $\underline{1}/$

V. The Tactics of Defending ERM Parities

The policy responses of authorities (both in the ERM and in countries whose currencies were linked to the ECU) to severe downward pressure on their exchange rates in the summer and early fall of 1992 ran the gamut from exchange market intervention, to interest rate policy, to arranging syndicated loans from private markets, to the imposition of capital controls. For the group as a whole, policy responses were more reactive than anticipatory—with early increases in interest rates and significant support for the exchange rate well before it hit the bottom of the band, being more the exception than the rule. Based on our meetings with authorities, it is our impression that most countries underestimated the size—if not the probability—of the attack.

Official intervention

One way to view an attack on a fixed exchange rate is to see it as an assault on the central bank's accumulated international reserve stock and on its access to international reserve credit. Speculators are buying international reserves from central banks at the fixed parity, with the expectation that the value of those reserves will increase in terms of domestic currency. Seen from that perspective, the supply of international reserves potentially available to the defending authorities in relation to

^{1/} It is often claimed that this crisis was different from earlier speculative attacks because a large fraction of sellers were liquidating long positions in securities denominated in the currency under attack. According to this argument, the seller of an asset denominated in the currency under attack is not deterred by a central bank defensive squeeze aimed at raising the short-term interest rate against short-term borrowers who are making speculative short sales. Notwithstanding this view, it is the funding requirements of a buyer of the dumped securities that are squeezed by the central bank action. The buyer will pass through any anticipated costs of a liquidity squeeze to the seller by reducing the offer price for the security. Thus, the seller of the security will pay up-front the same cost of the squeeze as would the simple short-seller of currency, and will not be less deterred, if funding for either sale is available only on a short-term basis. If funding for the purchase of the securities is available on a long-term basis and therefore not easily squeezed, such longterm funding should also be available to the short seller unless the money market has somehow been segmented.

the size of the resources available to the speculators, becomes a crucial element in the defense of a currency.

ERM members had access to three sources of international reserves: their own stock of reserves, borrowing from international capital markets, and borrowing from official sources in the form of bilateral credits or loans from the multilateral VSTFF. During the recent crisis, each of these sources was tapped.

Existing stock of international reserves. While there is no way to know definitively whether a much larger stock of international reserves would have allowed authorities to resist the realignments and recourse to floating that actually took place, it is clear that official reserve holdings proved to be "small" in comparison with private-sector positions. By the end of August 1992, the total stock of reserves held by those ERM countries that were subsequently heavily involved in intervention was about US\$270 billion. 1/ Since these reserves were not pooled to ward off the sequential attacks on currencies, only the reserves of the defending central bank and its potential access to borrowed resources could be used to meet the demands of buyers of exchange. Those demands were massive. For example, the amounts involved in the September attack on the French franc were five times the amounts experienced in previous attacks: In earlier episodes, the amount of intervention required in one day might be \$1.5 billion, while in September, it was from \$7 to \$9 billion. Reports suggest that the Bundesbank spent about DM 92 billion on support purchases of EMS currencies during the months of August and September, and that it also lent US\$28 billion to the Bank of France (which was repaid as of November 2, 1992). The Bank of England may have spent as much as US\$25 billion directly out of its reserves; ballpark estimates for other active central banks include US\$32 billion by the Bank of France, US\$18 billion by the Bank of Italy, US\$25 billion by the Bank of Spain, and US\$3 billion by the Bank of Ireland.

Borrowing from private markets. Several countries whose currencies came under attack sought recourse to the international syndicated loan markets, where sovereign loans can sometimes be arranged in a matter of days. For example, to signal its support for the ERM parity of the pound, the United Kingdom announced on September 3 a foreign-currency borrowing program valued at ECU 10 billion. On September 18, Sweden engaged an ECU 8 billion syndicated loan and revolving credit line to replenish its currency reserves. The total borrowing by sovereign borrowers with weak currencies

during and immediately after the crisis amounted to about US\$30 billion in September and October. $\underline{1}$ /

There is, however, a limit to how much foreign-currency credit the international banking system can extend even to a sound credit risk like a major ERM central bank. A syndicate of domestic banks is constrained by large-exposure prudential rules and by limits on the amount of deutsche mark interbank lines it can arrange to finance its deutsche mark loan to its government. Such interbank lines are subject to Basle capital charges and are limited by prudential concerns, as would be any direct sovereign lending by foreign banks. What's more, central banks are generally reluctant to become dependent on the domestic banking system for credit, preferring instead to borrow from official sources.

Borrowing from official sector. An important element of the ERM is the possibility of obtaining reserves through the Very Short-Term Financing Facility (VSTFF). This facility provides ECU credit for three and a half months, with the possibility of a further three month extension. The ECUs borrowed are exchanged for the currencies of one or more member countries and used for exchange market intervention. Initially available only for compulsory intervention, the use of the VSTF facility was made available for intramarginal intervention in the Basle/Nyborg agreement of September 1987. Unlike compulsory intervention, for which VSTFF credit is automatically available in unlimited amounts, access to the VSTFF for intramarginal intervention is limited to twice the member's debtor quota in the Short-Term Monetary Support mechanism. The permission of the central bank issuing the currency is still required for intramarginal intervention, but the agreement provided for a "presumption" that such permission will be forthcoming. 2/

Examination of the Bundesbank's balance sheet indicates that claims of the Bundesbank on the EMCF in connection with the EMS averaged around DM 27

^{1/} This disproportionality of available resources between the private financial sector and even groupings of major countries is reminiscent of an earlier epoch in which major countries based exchange rate defenses on private bank funding. For example, through the Belmont-Morgan loan of 1895, the U.S. Treasury defended the dollar gold standard. Loan contracts were written to ensure that supporting lending syndicates did not simultaneously abet the run on the currency. Thus, the Belmont-Morgan contract required the underwriters to support the exchange rate through their own interventions. This provision led J.P. Morgan to organize a syndicate of all the major banks in New York and London to freeze out financing to anyone speculating against the dollar.

^{2/} By Article 16.1 of the articles of agreement establishing the EMS, settlement of VSTFF loans must be carried out first by settling the VSTFF's ECU claim on the borrower in the creditor's currency and then in ECU. However, the Basle/Nyborg agreement allows the creditor country to demand reimbursement of VSTFF in its currency rather than in ECU for loans granted to finance intramarginal intervention.

billion during the period January-August 1992. The stock value of these claims increased to DM 52.7 billion in the second week of September and reached a peak of DM 90 billion in the week ending September 23. Since Germany is the major creditor in VSTFF, these numbers are probably a good indicator of the use of this ERM financing facility. $\underline{1}/$

The creditor central bank, as well as the debtor central bank, may decide to limit the amount of credit for two reasons. First, both take a substantial exchange risk if the borrower finally devalues. Second, a significant volume of lending could well disrupt the monetary policy goals of the creditor bank.

The exchange risk for the borrowing bank--whether bilateral or through the VSTFF--arises because, after a devaluation, it will book a capital loss if it has negative net reserves that must be repaid. The exchange risk for the creditor arises because the VSTFF denominates its claims and liabilities in ECU. In the September crisis, the Bundesbank probably suffered losses well in excess of DM 1 billion in its VSTFF lending to sustain the lira and the pound.

The second constraint arises if the lending central bank, say, the Bundesbank, insists on sterilizing the increase in deutsche mark base money created by the intervention with the borrowed deutsche marks in support of. say, sterling. Such sterilization is done through a reduction in its other assets: repurchase holdings, direct holdings of securities, Lombard loans, or holdings of other foreign currencies. Data indicate that about two thirds of the net inflows were sterilized. 2/ Inflows due to the support purchases of EMS currencies of about DM 92 billion "presented quite exceptional challenges to the Bundesbank's money market management." While the Bundesbank could have sterilized significantly more than it actually did, this would not have been without some disruption. For example, repos (currency swaps) of non-ERM currencies with the banking system were undertaken at rising deutsche mark interest rates, and this was viewed as self-defeating. Ultimately, if the amounts that need to be sterilized get too large, the creditor bank faces the unattractive prospect of abandoning its interest rate policy -- and that, in turn, places a ceiling on the amount that the weak-currency central bank can borrow from the strong-currency one. 3/ The greater is the difference in the strong currency country -- at the time of the exchange rate attack--between the interest rate requirements for

^{1/} In addition to the VSTFF central banks may, of course, enter into bilateral credit arrangements with each other.

^{2/} For example, repurchases by the Bundesbank fell from DM 147 billion to DM 68.5 billion at the beginning of October; and from September 7 September 30 holdings of domestic bills fell from DM 57 billion to DM 51 billion; net holdings of external assets rose from DM 104 billion to DM 181 billion; and total assets rose from DM 346 billion to DM 380 billion.

^{3/} Alternatively, it may be forced to impose capital controls.

defense of the exchange rate and that for maintaining internal balance, the more binding is this sterilization constraint likely to be.

A related factor that can limit the willingness to extend credit through the VSTFF is the number of currencies in the system that are simultaneously under siege. The Bundesbank's (practical) limits are more likely to be hit when there is a Bank of Italy and a Bank of England and a Bank of France simultaneously appearing as potential borrowers--than if just one is involved. The issue is whether any one central bank can reasonably be expected to match chips with the huge pile (from the private sector) that is now on the other side of the poker table. Indeed, it is for this reason that there continues to be interest in proposals for pooling the reserves of central banks.

Last but not least, it needs to be emphasized that the effectiveness of exchange market intervention is conditioned by the flanking policies that are implemented along side it. This of course means interest rate policy-but not just that. In this regard, private-market participants noted that the unequivocal, strong joint statement of support by the Bundesbank and the Bank of France for the existing parity was helpful in relaying the message that those betting on a devaluation of the French franc would be fighting two central banks rather than just one. As some authorities put it, the quality of exchange market intervention can be just as significant as the quantity. On a broader level, this is merely another illustration of the proposition that the quality of monetary policy cooperation is itself an important element in the credibility of exchange rate parities.

In sum, the events of last fall made plain the limits of sterilized exchange market intervention in a situation when markets are convinced that some existing parities are out of line with fundamentals and when--for a variety of reasons (to be discussed below) -- there are tight constraints on interest rate coordination. To ask sterilized intervention to handle exchange rate pressures while leaving the domestic monetary policy stance unaltered is to ask too much. But this is not the same as saying that sterilized intervention does not have a useful role to play when its mandate is framed (more modestly and) closer to its capabilities. Specifically, it still can he helpful in countering disorderly market conditions in the short-term, in sometimes sending a signal about future monetary policy intentions, and in providing a short breathing space while more fundamental policy changes are being put in place. The relevant question is whether official reserves and other sources of resources for intervention are still adequate to carry out those more limited functions. When official resources are too large, there is the moral hazard that needed (and often, more painful) policy adjustments may be too long delayed; when they are too small, there is the risk that shocks and political uncertainties may derail policy reforms that, if sustained, would underpin exchange rate credibility over the longer term.

Defensive increases in interest rates

The classical prescription for a central bank facing an unwarranted run on its currency is to raise its own lending rate to banks in order to "squeeze" short sellers of funds denominated in its currency. The basic idea is to see to it that these short sellers pay dearly to borrow the domestic funds they need for delivery under the forward contract. To the extent that the increase in lending rates filters through to other interest rates, it also serves to attract additional demand to assets denominated in the home currency. Even more fundamentally, the essence of the credibility of a fixed exchange rate is convincing markets that the authorities will take whatever action is needed on interest rates to defend the exchange rate commitment -- even if in so doing, they incur other costs. The rub, of course, is that circumstances can arise in which the costs of interest action needed to defend the exchange rate are perceived by markets as so high as to raise doubts that the authorities will be both willing and able to sustain them. Here, let us mention four of the more important side effects of increases in interest rates in the weak-currency country.

First, the same increase in interest rates that serves to squeeze speculators can simultaneously squeeze the funding of securities and banking markets, which typically finance their positions through short-term rollover credit. Since central banks also carry the responsibility for maintaining the safety and soundness of the financial markets, they have to be careful about inducing an extreme punitive rise in central bank lending rates, except perhaps over the very short term. To the extent that some large banks are already laboring under heavy loan losses--or even worse, are at the brink of needing government assistance to remain solvent, increases in interest rates exacerbate their problems and may even end up increasing the fiscal deficit (as the government has to inject new capital into those banks).

Second, in situations where the household and corporate sectors have allowed their debt-to-income and debt-servicing positions to become unsustainably high, a sharp rise in interest rates makes it more difficult to reduce those ratios to more manageable levels--without simultaneously reducing spending to such a degree as to appreciably slow economic activity. In cases where the economy is already in recession, the problem takes on an added dimension because of the risk that a protracted period of high interest rates could force the pace of disinflation to become too rapid, and perhaps even push the economy into a debt-deflation cycle.

Third, in countries with both extremely weak fiscal fundamentals and with a high share of floating rate government debt, a large increase in interest rates can feedback quickly and powerfully to increase the government's fiscal deficit. At some point, increases in interest rates can actually weaken the attractiveness of the domestic currency if market participants believe that they increase the probability of default or if

interest volatility presents asset holders with unacceptably high levels of market risk.

Fourth, in cases where the economy has been in recession, where unemployment rates are high, where inflationary pressures are moderate and receding, and where the consensus forecast is for slow growth in the period ahead, high interest rates--maintained mainly for the purpose of defending an exchange rate target--will be viewed as having a high opportunity cost in terms of domestic economic activity. The greater are the current differences between the domestic and external requirements for monetary policy in the weak-currency country, the more likely is it that questions will be raised about the wisdom of "tying one's hands" on monetary policy--whatever the long-term benefits of such a policy strategy. In this situation, increases in interest rates will be politically unpopular. In fact, it is precisely because of the potential political fallout from increases in interest rates that some observers believe that central bank independence is a necessary element for true interest rate credibility.

In addition to the potential costs of taking defensive increases in interest rates, central banks sometimes also have to contend with the possibility that such action may not always have its intended effect on speculators or on the exchange rate. To the extent that short sellers of the domestic currency have put in place their financing before the defensive increase in interest rates comes about, then they will not be squeezed by the rate rise--unless the monetary authorities are prepared to hold rates high for a long period. Recent developments in derivative markets may also have weakened the power of the classical interest rate defense. If holders of foreign currency securities hedge by creating a synthetic put, as do many pension funds and wholesale banks offering over-the-counter derivative products, they commit to a dynamic trading strategy that mandates a forward or spot sale of the currency when the spread between the foreign and domestic interest rates rises. Thus, raising the interest rate in the classical manner could perversely induce sales of the currency being defended; the more widespread such dynamic trading strategies become, the more central banks would need to take this automated response into account.

Several of the constraints and concerns outlined above were evident during the recent currency turmoil.

The Swedish case was a text-book example of the limits of an aggressive interest rate defense under conditions of a large fiscal deficit and significant financial fragility. The three-month siege of the krona began on August 21 with a sequence of increases that moved the Riksbank's marginal lending rate from 13 percent to 500 percent on September 16. The pass-through to other interest rates was rapid. For example, the ask rates for interbank one-month funds jumped from 16 to 70 percent between September 7 and September 17. The large interest rate increases imposed more losses on an already troubled banking system, directly through rises in funding costs and indirectly through exacerbating the already existing debt-deflation problem. These losses were imposed in an environment of ongoing capital

injections into the banking system and a large and mounting fiscal deficit. In the end, after failing to reach agreement with opposition parties on how to bring the fiscal deficit under control, the authorities had to reluctantly abandon their peg to the ECU and permit the krona to float.

In contrast to Sweden, the U.K. case was one where the authorities attempted to defend the currency with minimal use of the interest rate. Here, the relevant background included two years of recession, excessive debt accumulation in the private sector, and a financial market structure under which any rise in the Bank of England's minimum dealing rate spreads relatively quickly to the whole yield curve, including to retail markets and mortgage markets. After raising its minimum dealing rates from 12 percent to 15 percent on September 15, it became clear that these changes had no impact on the selling pressure: traders, apparently recognizing the high costs of maintaining this rate for long, continued to sell sterling, and the exchange rate did not budge from its floor value. The Bank of England then ceased the defense of the floor parity and dropped the minimum dealing rate back to 12 percent. By October 16, it had dropped the minimum dealing rate to 8 percent.

In Italy, it was apparently the link between interest rates and the fiscal deficit that led traders to question the sustainability of high interest rates. Money market interest rate rises have a large impact on Italian government finance because 29 percent of its debt is in the form of T-bills (BOT's), 48 percent is in floating-rate securities (CCT's), with the rest being primarily medium and long term bonds (BTP's). Indeed, the government experienced difficulty funding itself through new issues at acceptable rates during the crisis. The Bank of Italy, therefore, made modest use of the interest rate defense throughout the attack on the lira, raising in steps its discount rate from 12 percent to 15 percent, allowing the interbank overnight rate to reach 36 percent on September 16.

If part of the constraint on using increases in interest rates to defend a fixed exchange rate arises because innocent bystanders as well as speculators get hit by the same higher cost of credit, isn't there something that can be done to restrict the squeeze to the speculators -- or at least to limit the spread of higher interest rates to the rest of the economy? The French defense provides an example of one effort in this direction -- albeit one that admittedly can only be used for a short period and only where the banks themselves are prepared to cooperate. Although initially reluctant to raise interest rates in the early stages of the attack, the French authorities increased rates as the attack against the franc intensified. Banks with normal commercial requirements received relatively cheap funding that could be passed through to customers to avoid a rise in the base rate (about thirty percent of bank credit depends on the base rate, which governs loans primarily to small businesses). Thus, a two-tier money market operated -- with near-normal interest rates for regular customers and high interest rates for others. Lending was not distinguished by the nationality of the buyer but by the class of business.

The Bank of France normally operates in the money markets through two funding windows. It provides liquidity through a 5 to 10 day repurchase market at the "auction rate" or "prime" rate. 1/ Notwithstanding its name, the auction rate was set initially at 9.6 percent and then raised to 10.5 percent in the midst of the crisis. The Bank of France also provides funds at a "refinancing rate," a standard Lombard facility, for eligible collateral. This rate was set initially at 10.6 percent and then raised to 13 percent during the crisis. There was insufficient available paper (Tbills, T-notes, and eligible trade paper) during the crisis to provide for all liquidity demand at this refinancing rate, so money market overnight rates rose to between twenty-five and thirty percent. The Bank of France was in a position to ration credit in this manner because of the discountable paper shortage. Discountable paper is held mostly by SICAVs (money-market mutual funds managed primarily by banks) which have a limit on the amount of paper that they can lend from their portfolios -- that is, they must maintain a certain percentage of their holdings in such paper. Also, there is a limit on the amount of paper that a bank can issue to its own fund. It appears that this temporary rationing system did have some success in squeezing those market participants who did not have access either to appropriate paper or preferential access to the repurchase facility. 2/ It may also have helped to share the burden of the cost of interest rate adjustment that was less politically unpopular than would have been a more uniform increase in rates. But it is clearly a tactic that can only be used as a very short-term instrument of crisis management since going beyond that would put undue strains on the banking system and, more fundamentally, would put at risk the efficiency gains that come from following a market orientation to the allocation of credit.

In normal circumstances under a fixed exchange rate arrangement, the costs associated with asking weak-currency countries to adopt large increases in interest rates are diminished by having the strong-currency country share the adjustment burden by reducing its own interest rates. In the run-up to, and during the ERM crisis itself, this course of action was rejected by the Bundesbank because of its perceived incompatibility with controlling inflationary pressures within Germany. In short, the level of interest rates that many other ERM countries saw as appropriate for dealing with their domestic economic situations was different (lower) than the level of rates that the anchor country in the ERM saw as appropriate to its own domestic economic conditions and responsibilities. Markets are sensitive to such conflicts over the appropriate course of monetary policy in an area of

^{1/} Use of this window was suspended under the continuing exchange market pressure on January 5, 1993.

^{2/} The squeeze also harmed dealers in longer term treasury government securities carrying positions through overnight funding. To alleviate this difficulty, paper eligible for collateral at the refinancing rate was extended to include OAT's during the crisis. The OAT's refinanced at the discount window amounted to about 10 billion francs.

fixed exchange rates, and may have reasoned that the anchor country would have preferred a realignment of the deutsche mark against many other ERM currencies to a large reduction in German interest rates. That of course, plus the cumulative losses of competitiveness in some ERM countries with relatively high inflation rates, presented speculators with a "one way bet" that merely fueled exchange market pressures.

Thus far, we have spoken about interest rate policy in the countries whose currencies were attacked during the crisis and in the anchor country. But there is also useful information in the countries whose currencies were not attacked--particularly the Netherlands and Belgium-Luxembourg. These countries have maintained close links with the deutsche mark and have consistently refrained from any efforts to decouple their monetary policies from that of the anchor country. In so doing, they have apparently been successful in convincing markets that their commitment to the exchange rate parity is paramount among economic objectives. Even though there are some elements of vulnerability to high interest rates (e.g., the high ratio of debt-to-GNP and the relatively large fiscal deficit in Belgium), markets presumably have reached the verdict that, if necessary, those costs would be absorbed to protect the longer-term benefits associated with exchange rate stability. It may also be that the (relatively small) size of these countries is an ally because it makes any decoupling option (of either interest rates or exchange rates) less attractive. In any case, it is not hard to see why, from their perspective, these countries argue that closer adherence to the guidelines of the Basle-Nyborg agreement -- especially taking early action on interest rates at the first sign of capital market pressure --is the right preventive medicine for avoiding crisis-induced realignments in the ERM.

In sum, whatever the prowess of aggressive interest rate action to sustain fixed rates in countries with healthy fundamentals and in situations when the disparity between the internal and external requirements of monetary policy is not unusually wide, the recent ERM crisis testifies to its more limited capacities when those conditions are not satisfied. The fact is that when push came to shove, Germany was not willing to reduce interest rates significantly before it had better assurance that inflationary pressures in Germany were under control -- and Italy, the United Kingdom, and Sweden each decided in the end that the costs of keeping interest rates above what would otherwise be required on domestic grounds were too high to live with. This is not to say that devaluation or floating gives free rein to domestic monetary policy or that it permits the country to avoid internal/external policy dilemmas -- particularly in view of significant volatility of these recently floated rates in the aftermath of the crisis; here, the differences in regime are more a matter of differences in degree than in kind. But what is suggested by recent events is that strong reliance on interest rate coordination to sustain parities across the EMS may have to await greater progress in eliminating the macroeconomic imbalances and financial fragilities that handicapped interest rate policy in the first place, as well as closer convergence of economic conditions

within the EMS so as to facilitate a consensus on the appropriate course of monetary policy.

Capital controls

As is well known, three ERM countries (Spain, Portugal, and Ireland) reluctantly resorted to capital controls during the exchange market crisis. A sudden imposition of capital controls can almost always reduce the shortterm pressures that a central bank faces in an attack on its currency. The controls operate by essentially breaking the speculator's (or hedger's) chain of finance to the domestic banking system -- thereby inhibiting his ability to fund a redenomination of the currency. Over time, channels of avoidance typically grow and the initial slow drain of reserves accelerates (unless the fundamentals that initially motivated the attack are addressed). But the most damaging effects are those that show up in the longer term. Since investors have had the experience of seeing their liquid investments transformed by controls into illiquid claims, it will be much harder in the future to attract portfolio investment inflows and to assure market participants that open capital markets are an essential element in a country's long-term outward-looking policy strategy. In most cases, investors will demand in the aftermath of controls a risk premium on the country's liabilities beyond the usual markup for depreciation risk. 1/

^{1/} Among other restrictions, Ireland required that credits to nonresident punt denominated accounts exceeding 250,000 be reported to the Central Bank of Ireland unless the credit was trade related. Both loans to non-residents for periods of less than one year and swaps had to have permission of the Central Bank of Ireland. These restrictions were rescinded on January 1, 1993. In Spain on September 23, non-interest bearing deposits of one year were required at the Bank of Spain equal to both the peseta value of increases in long positions in foreign exchange above close of business September 22 positions and the increase in peseta denominated credits to nonresidents excluding export financing. Also, a cash reserve was required for 100 percent of the maximum increase of resident Spanish financial institutions' peseta liabilities with branches and subsidiaries abroad and resident foreign institutions' peseta liabilities to nonresidents beyond the level at close of business September 22. These restrictions were rescinded on October 5 and replaced by a requirement for noninterest bearing deposits at the Bank of Spain for the peseta counterpart of peseta sales to non-residents, the increase in the forward short position in foreign currency contracted with nonresidents beyond the value at close of business October 2, and the increase in the next-day value of net sales of peseta to nonresidents against foreign currency beyond the value at close of business October 2. These restrictions were rescinded on November 22.

VI. Policy Options in the Aftermath of the Crisis

In the course of its discussions with officials and with private market participants, the mission heard a large number of suggestions and proposals for managing exchange rates in the aftermath of the crisis. These suggestions spanned the characteristics of exchange arrangements, the credibility of interest rate policy, the nature of intervention arrangements, and the adequacy of the regulatory framework (pertaining to position-taking in the forex market); most of the proposals were directed specifically at the ERM, but some of them had a wider orientation. In this section, we attempt to give the "flavor" of some of those ideas, in order to help motivate the Executive Board's discussion.

Characteristics of exchange arrangements

- (i) Putting the "adjustable" back into the "fixed and adjustable peg." The suggestion here is to have more frequent, small changes in exchange rates within the band -- so as to move the ERM closer to what its proponents regard as its original design (namely, a system of stable, but adjustable par values). The aim is to "depoliticize" exchange rate adjustments and to restore the "two way" bet for speculators. The exchange rate changes themselves could perhaps be made with respect to a set of indicators, and would presumably provide less than one-to-one offset for inflation differentials. By removing the prospect of large realignments and by putting more responsibility for exchange rate changes in the hands of technicians, they seek to take away what the speculators like most--that is, large profits from the collapse of large misalignments. Also, by allowing the exchange rate to take on more of the burden of adjusting to both country-specific real shocks and different speeds of disinflation across countries, there would be less pressure on interest rate coordination. Some participants were skeptical about the ability to really depoliticize exchange rate adjustments. A more fundamental concern was that such a "softening" of the exchange rate commitment in the ERM would entail a simultaneous weakening of policy discipline -- particularly in the member countries that still had a long way to go to meet the Maastricht inflation, interest rate, and fiscal convergence criteria.
- (ii) <u>Wider margins</u>. Again, the motivation here is to discourage "one way" speculative bets, to allow the exchange rate to play more of a "safety valve" function when progress on economic policy convergence proves less rapid than anticipated, and to place less of a burden on interest rate coordination and on mandatory exchange market intervention.
- (iii) Move more rapidly to EMU. No one suggested that the Maastricht Treaty be renegotiated. Still, some observers felt that the recent exchange market crisis had validated just what they had feared, namely, that ERM parities would be most vulnerable during Stage II on the way to EMU. The lifting of capital controls, cum country-specific shocks and incomplete monetary policy coordination, was a flammable compound. The way to go was

to get conflicts over monetary policy out of the newspapers and into the ECB boardroom and to remove the inevitable doubts about "irrevocably fixed" exchange rates by adopting a single currency. The longer the delay in making this jump to Stage III, the greater the likelihood of further exchange rate crises. Those opposed to this option emphasize the sizeable divergences in economic performance and policies that still exist within the EMS and the adverse effects that this lack of convergence would have on the union's common monetary policy and on incentives for further convergence around sound fiscal policies.

(iv) Leave the ERM design as it is, but improve implementation of the rules. The proponents of this view argue that future crises could be avoided if member countries would respond more quickly to market pressures; once authorities delayed and got themselves into a full-scale battle of resources with the private sector, it was too late to save the day. Countries should instead take interest rate action early on and intervene well before exchange rates hit the bottom of the band. Small, exchange rate adjustments within the band might sometimes also be needed. The key was to build up credibility gradually by showing the markets that whenever there was a potential conflict between the internal and external requirements for monetary policy, the exchange rate was king. Once the markets learned that countries were not schizophrenic about monetary policy and that exchange rate adjustments -- when they occurred -- would be small, attacks would cease; countries could meanwhile continue the convergence process toward EMU. Moreover, the recent changes to the parity grid had produced a more realistic set of parities. Also, as inflationary pressures in Germany continued to recede and, in turn, to make possible significant cuts in interest rates, disagreements about the appropriate course of monetary policy would diminish. Doubts about this option centered around the heavy weight it gave to interest rate coordination in a world where there were still significant differences between the internal and external requirements for monetary policy in certain EC countries, and around the ability of the system to avoid future attacks at times when the political calendar (as well as future EMU entry decisions) provided a natural focal point for speculators.

Interest rate policy

(i) Give greater independence to central banks. The line of argument is that exchange rate credibility depends on interest rate credibility, and that interest rate credibility in turn is difficult to acquire without an independent central bank. Those who favor this approach note that those countries who were most reluctant to push up their interest rates early during the ERM crisis were predominantly those that had less independent central banks. Since hiking up interest rates to defend the currency is typically most unpopular, an independent central bank can take that necessary but unpleasant medicine much quicker than a less independent one. By the time politicians get around to raising interest rates, the capital markets will have overwhelmed the country's exchange rate defenses. Those less enthused about this proposal note that independence can sometimes mean

intransigence--much to the detriment of economic policy and performance (particularly when sustainable growth--rather than just low inflation--is brought into the picture); moreover, they question whether central bank independence (beyond that independence that is founded in a consensus of public opinion) is either necessary or sufficient for interest rate credibility.

(ii) Invigorate interest rate coordination more widely. Some participants felt that tensions in the ERM in the run-up to the crisis had been exacerbated by (unduly) low interest rates in the United States and Japan which, in combination with the increase in German interest rates, had put strong upward pressure on the deutsche mark. In their view, the need was not only for better monetary policy coordination within the EMS, but also for taking greater account of the international repercussions of national policy decisions throughout the G-10 countries. While not challenging the desirability of improved economic policy coordination more generally, some other participants regarded the recent ERM crisis as predominantly "home grown"--and likewise saw its solution as primarily lying with closer monetary policy coordination in Europe itself.

Intervention policy

Reexamining the "unlimited" intervention obligation. One view was that when the intervention obligations of the EMS were drawn up and when it was decided that support should be mandatory and "unlimited" when a currency hit the bottom of the band, there was little conception that international capital markets would reach today's size and influence. In light of the recent crisis, it is now apparent that such an intervention obligation could mean that a single, strong-currency country would be providing massive amounts of intervention resources -- perhaps even beyond its ability to sterilize the impact of those flows on its own monetary stance. What's more, since there is no guarantee that the country receiving those resources will have either adopted appropriate interest rate action or given appropriate consideration to a change in its exchange rate, those massive intervention resources could go toward supporting "unsustainable" exchange rate parities -- thereby enriching only speculators. The argument then goes to suggest that either provision of those unlimited intervention resources would need to be conditional on the receiving country taking appropriate interest rate action and/or on it having fundamentals consistent with its existing parity; alternatively, obligations for intervention would have to be shared more widely since any single country in the ERM is too small relative to the world capital market. In this connection, there is the possibility of pooling reserves so that sequential attacks on parities don't put undue pressure on the same creditor. On the other side of this issue is the concern that either a de facto or de jure redefinition of intervention obligations within the ERM would damage its ability to counter what is already a large imbalance as between public and private resources for intervention in the forex market. Their view is that until it is replaced by something else, the existing provisions should stand and should be

implemented according to both the spirit and the legal letter of the arrangement.

Regulatory and prudential framework

Reexamine the existing regulatory framework on position-taking in the forex market. Since exchange rates are volatile assets and since positiontaking in forex can involve a bank in large losses, some officials felt that banks should be holding adequate capital against such positions if the safety and soundness of the banking system is to be protected. In this connection, there was strong support for the examination now going on within the Basle Committee on Banking Supervision -- as part of its broader efforts to include market risk in the Basle Accord -- to determine whether banks are holding adequate capital against open currency positions, and if not, to propose new requirements. Some others thought that regulatory framework relevant to other large players in the forex market--ranging from securities houses to institutional investors to hedge funds -- should likewise be examined by the appropriate authorities, both to ensure a level playing field and to determine whether some of these institutions were not taking excessive risks in the forex operations. On the whole, however, most officials were of the opinion that it would be ill-advised to over-react to the recent currency turmoil; while it was always prudent to ensure that risks were priced appropriately, one should be cautious about introducing measures that could restrict unduly the evolving integration and innovation in international financial markets, which on the whole had made such a positive contribution to the performance of the world economy.

VII. Issues for Discussion

- 1. Do Directors share the staff's assessment that the growth, integration, and agility of international capital markets is irreversible, and that the growing imbalance in resources as between private market participants and central banks, has made the management of fixed exchange rates a more demanding task?
- 2. How do Director's evaluate the overall functioning and liquidity of the forex market during the crisis?
- 3. What significance do Directors accord to the large capital inflows into assets denominated in high-yielding ERM currencies in the five years preceding the recent exchange rate crisis? If convergence plays had been much smaller over this period, would the outcome on holding parities been any different in September 1992?
- 4. What lessons about the capabilities and limitations of sterilized exchange market intervention--and about the adequacy of the existing stock of international reserves--do Directors draw from recent experience?

- 5. Was too much or too little weight put on interest rate increases in weak-currency countries during the crisis? If there was a breakdown of monetary policy coordination in the run-up as well as during the crisis, what were the main contributing factors--and how can they be avoided in the future?
- 6. Do Directors believe that smaller, more frequent exchange rate adjustments (within the band, when possible) would improve the functioning of the ERM and help forestall future crises? What would be the effects on "discipline" of softening the exchange rate constraint? Alternatively, are the events of last fall kinder to the proposition that, if possible, countries should endeavor to move as rapidly as possible toward Stage III of EMU?
- 7. Would a move toward greater independence for central banks reinforce the credibility of interest rate policy?
- 8. What lessons about the imposition of capital controls should be taken away from the recent crisis?
- 9. Is the existing regulatory and prudential framework with respect to position-taking in the forex market and to international investment activities of institutional investors adequate?



92 HOV 19 MM 9: 33

To:

The Managing Director

The Deputy Managing Director

November 18, 1992

From:

Donald J. Mathieson

Subject: Meetings on International Financial Markets

and International Capital Flows

Recently, I attended two meetings that examined developments in international financial markets, especially during the foreign exchange market disturbances in Europe in September, and the international coordination of supervisory and regulatory policy for financial institutions. The International Organization of Securities Commissions (IOSCO) held its 16th Annual Conference in London from October 25-29, 1992; and the Committee on Financial Markets of the OECD held a regular meeting from November 2-4, 1992. Mr. Robert Rennhack (PDR) also attended the Committee on Financial Markets meeting.

1. Financial market integration and the exchange rate system

The participants at the OECD meeting discussed, inter alia, trends in financial market integration and recent exchange rate developments in Europe. The impetus for financial market integration is increasingly being driven by the arbitrage activities of large institutional investors (e.g., pension funds, insurance companies, mutual funds) rather than by traditional financial intermediaries (e.g., large commercial banks). Some financial market participants (particularly from the German banking industry) argue that the growing importance of institutional investors is destabilizing capital flows since such investors are more subject to "herd" instincts. It was suggested that this behavior was particularly evident during the recent exchange rate crisis in the European Monetary System. However, other participants indicated that, when there are exchange rate uncertainties, the capital flows and financial transactions undertaken by institutional investors primarily reflect an attempt to hedge the value of their investments. The influence of institutional investors is likely to expand given both the scale of their assets and the still limited proportion of these assets that is devoted to purchases of nondomestic assets. The 300 largest private pension funds in the world currently have assets of \$2.7 trillion. In addition, these funds invested only 7 percent of their asset in external claims in 1988, but such cross-border investments are anticipated to rise to over 12 percent of total assets by the mid-1990s.

Recent foreign exchange market developments in Europe were regarded as having important implications for the global exchange rate system since they provide an indication of the scale of international capital flows that can now arise during an exchange crisis. In particular, the increasingly rapid market response to uncertainties about the authorities' exchange rate commitments was seen as sharply reducing the time period in which the authorities in the Exchange Rate Mechanism (ERM) would be able to negotiate adjustments in exchange rates.

It was generally agreed that the foreign exchange market disturbances were triggered by a combination of short-term factors and more fundamental differences in the policies and economic prospects of countries both within and outside the Exchange Rate Mechanism (ERM). In the short-term, the Danish referendum and the prospect that the French referendum might lead to a no vote resulted in growing uncertainties about whether or when a European Monetary Union was going to be established. In addition, the rise in short-term interest rates in Europe relative to those in Japan and in the United States was viewed as contributing to an appreciation of the deutsche mark and other closely linked European currencies relative to the U.S. dollar. In countries such as the United Kingdom, this appreciation combined with a slowdown in activity to raise doubts about the authorities' ability to sustain their monetary and exchange rate policies. This experience was seen as indicating that a higher degree of capital mobility has increased the importance of establishing monetary, fiscal and structural policies in ERM countries that are consistent with their exchange rate commitments.

In order to limit the short-term effects of the large scale capital flows, a variety of policies were employed including making use of the wider bands within the ERM, extensive foreign exchange market intervention, sharp increases in official and market interest rates, capital controls, and, in some cases, withdrawal from the ERM. Only a few European authorities actively considered the option of reintroducing capital controls, and it was generally argued that this was not a desirable mechanism for dealing with conflicting policy fundamentals. Even those countries which had employed capital controls, such as Spain and Portugal, emphasized that these controls were temporary measures and were to be relaxed shortly. authorities from several countries indicated that in future crisis they would make greater use of high short-term interest rates and a widening of the exchange bands in order to make speculation unprofitable, provided that policy fundamentals were otherwise consistent.

2. International coordination of financial supervisory and regulatory policies

The implications of the growing integration of major financial markets for the formulation of supervisory and regulatory policies was a subject of some debate at the IOSCO meetings. It was agreed that public scrutiny of supervisory agencies has increased as a result of new scandals (especially the Bank of Credit and Commercial International (BCCI) failure), increased asset price variability, and a growing belief that a financial "crunch" has limited the availability of credit and intensified the current downturn in economic activity in a number of countries. Moreover, it was recognized that the higher degree of capital mobility was creating pressures for better international coordination and harmonization of supervisory and regulatory practices. Nonetheless, there are still significant differences between IOSCO members regarding the appropriate level of such harmonization. This was most clearly illustrated at this meeting by the disagreement surrounding capital adequacy standards for securities firms.

The controversy surrounding capital adequacy requirements for securities firms was focused on the appropriateness of the standards contained in the European Community's Capital Adequacy Directive (CAD). Mr. R. Breeden (Chairman of both the U.S. Securities and Exchange Commission (SEC) and IOSCO's Technical Committee) labelled the CAD's standards as "imprudent in the extreme"; and argued that, if the standards had been in place in the United States during the October 1987 stock market crash, several large U.S. securities houses would have collapsed. In contrast, Sir L. Brittan (Vice-Chairman of the European Community Commission (ECC)) stated that the CAD's standards were quite appropriate, and that no single national regulator can expect to impose its standards on other countries. This dispute centers on the amount of capital that securities firms should hold to cover the risk of losses on their equity portfolios. While the SEC wants firms to hold the (relatively) high minimum capital standards currently in force in the United States, the ECC proposals would allow firms to lower the amount of capital they are required to hold if they hedge their equity holdings by simultaneously entering into contracts to sell other shares (at some future date).

An additional area of controversy focused on the Basle Committee of Bank Supervisors' treatment of banks' holdings of bonds for investment purposes. The Basle Committee has proposed to exclude banks' holdings of bonds for investment purposes-as opposed to holdings for trading purposes--from capital requirements. IOSCO has opposed this distinction and recommends that capital should be required for all bond holdings.

The scandal surrounding the failure of BCCI highlighted current weaknesses in the supervision of financial conglomerates that are engaged in a variety of banking and securities activities in many countries. As a result, supervisory authorities have focused on (1) specifying the primary supervisor for such organizations, (2) specifying capital adequacy requirements for both the individual subsidiaries and the group as a whole, and (3) developing measures of the group's exposure to a single borrower or customer. The supervisory measures being implemented naturally differ across regions. In the EC, for example, the lead supervisor will normally be determined by where the holding company is based, unless it does not undertake any banking activities in that country. In the latter case, the lead supervisor will be determined by where the largest banking affiliate is located. Moreover, there will be consolidated supervisory of banking and investment services group with a single capital adequacy standard, a single large exposure limit, and capital requirements that reflect market risks.

Another area of disagreement concerned what the linkages between cash and derivative markets for equities implied for regulatory policies. Much of the discussion focused on the recent measures adopted by the Japanese authorities to limit activity in the stock index futures market, especially stock index arbitrage. Mr. Saito (Deputy Chairman of the Tokyo Stock Exchange) argued that any financial innovation must be adapted to the local market setting and that there should be minimum international standards governing futures markets activities. He indicated that the Japanese exchanges had taken steps to limit some futures market activities since stock index arbitrage had contributed to equity price volatility. He noted that Japanese efforts to limit stock index arbitrage were being hindered by the unwillingness of regulators in overseas markets, where futures contracts on the Japanese stock indices are traded (such as in Chicago and Singapore), to adopt similar regulations.

In contrast, Professor M. Miller (University of Chicago) argued that the cash and futures markets were essentially two different doors into the same market. Those customers interested in the prospects of individual firms use the cash markets to purchase shares; whereas those investors interested in market trends use stock index futures contracts. He noted that there is no empirical evidence that stock index arbitrage contributes to equity price volatility. Moreover, regulations and taxes which limit futures markets activities in a given country not only shift activity to markets in other countries but also shift activity to the over-the-counter markets for derivatives.

IOSCO's Development Committee has issued an extensive report on creating <u>clearance</u> and <u>settlements</u> systems in <u>developing</u> countries (including formerly centrally planned economies). This report stresses the importance of developing essential clearance, settlement

and payments systems $\underline{\text{prior}}$ to attempting to establish more complex securities markets.

Mr. Mussa cc:

Head of Departments Ms. Saunders

Office Memorandum HEAST ASIA AND CONSO

92 SEP -9 PH 5: 35

To:

Mr. J. E. Ismael

September 9, 1992

From:

Morris Goldstein W.g.

Subject: Staff Visit to Discuss Developments in International

Capital Markets

As part of the 1992/93 capital markets surveillance exercise the staff is beginning to prepare its report on "International Capital Markets -- Recent Developments and Prospects, " which is to be discussed by Executive Directors early next year. Staff discussions with country authorities and market participants have in past years been a key input into the preparation of the report. 1/ This year I shall again lead the staff missions to Asia (October), Europe (November), and the United States (December).

We would propose that the staff team visit Singapore during the period October 21-22. As in previous years, and in response to this years Board discussion, we intend to maintain the same format as in the current Report--combining a survey of recent developments and prospects with a discussion of key, systemic policy issues. particular, we intend to focus on the following four topics: (i) sources of risk in the ongoing adjustments in international financial markets; (ii) the systemic implications of EC financial and monetary integration; (iii) recent growth of nonbank capital markets in some developing countries; (iv) developing country access to international capital markets.

We would greatly appreciate it if we could rely on your office to assist us in arranging this year's meetings in Singapore. In particular, in order to expedite the preparations, it would be helpful if you could provide Mr. Folkerts-Landau, Chief of the Capital Markets and Financial Studies Division, with the name of the official in Singapore who would be helping with making the administrative arrangements there. This would then allow us to discuss in detail the schedule for visits to individual institutions.

Mr. Mussa cc: Mr. Saito

^{1/} The staff papers SM/92/109 (5/29/92) and SM/92/118 were discussed by Directors on June 26, 1991. The papers and Director's comments formed the basis of a modified text, which will be published in the Fund's World Economic and Financial Survey ahead of this year's Annual Meetings.

To:

Mr. Goldstein

September 10, 1992

From:

F. van Beek

Subject: 1992/93 Capital Markets Surveillance Exercise

We have no difficulties with the proposed structure and focus of the upcoming capital markets surveillance exercise. I attach some comments from the North American Division on the first topic concerning the sources of risk in the ongoing adjustments in international financial markets.

Attachment

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Neiss

Mr. Russo

Mr. Saito V

Mr. Williams

Mr. Zulu/Mr. Guitian

To:

Mr. van Beek

September 9, 1992

From:

W. Dee and T. Alleyne

Subject: 1992/93 Capital Markets Surveillance Exercise

Our comments on the proposed agenda for the 1992/93 Capital Markets Surveillance exercise center on the first topic concerning the sources of risk in the ongoing adjustments in international financial markets.

The fragility of many of the world's banking systems raises doubts about their ability to provide short-term financing for private investment. Furthermore, the liberalization of financial markets has increased the importance of nonbank sources of credit as means of funding short-term private investment. It may therefore be interesting to investigate the extent to which nonbank credit sources are indeed separate from the banking system. Many forms of nonbank credit are themselves dependent upon the banking system. For example, commercial paper has become a favorite source of short-term financing for many businesses around the world. However, commercial paper issuers depend upon back-up lines of credit from banks.

Because the United States has recently experienced a period of apparent bank credit tightness stemming from banks' reluctance to lend, part of the assessment of overall financial system risk might also include an analysis of the impact of tightening by nonbank credit sources during this period.

cc: Mr. Márquez-Ruarte (o/r)



file

To:

Mr. Goldstein

September 8, 1992

From:

Steven Dunaway

Subject: 1992/93 Capital Markets Surveillance Exercise

As proposed, this would be a rather ambitious report focusing on a number of key topics generally of immediate interest. Care will need to be taken to ensure that each topic is treated in sufficient depth. In particular, there is a question as to whether at this juncture a substantive assessment can be made of the implications of EC financial and monetary integration. It might be better to delay tackling this subject until next year after the current round of financial integration has sorted itself out a bit. From this experience, it might be easier to draw somewhat less speculative conclusions regarding the eventual evolution of the system as it moves toward complete integration and its implications for the rest of the world.

With regard to the other topics to be addressed by the report, I would make the following comments:

- 1. In assessing sources of risk in international financial markets, the report perhaps could focus more broadly on the question of the soundness of bank balance sheets and implications for the pricing and availability of credit. It would seem that, in the case of several major countries (e.g., Japan and the United States), sources of concern have shifted from foreign to domestic lending, particularly real estate loans. In this context too, it would be useful to discuss modifications to regulatory regimes as they potentially impact on the riskiness of bank portfolios and credit availability.
- 2. The recent Board paper on management of the debt situation briefly touched on possible implications of increased developing country reliance on the direct debt market. The proposed section on developing country access to international capital markets might explore these implications more fully.

cc: Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Williams

Mr. Zulu/Guitián

Mr. Baumgartner



Office Memorandum

To:

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Neiss
Mr. Russo
Mr. Saito
Mr. Williams

Mr. Zulu/Guitián

From:

Morris Goldstein 7.9.

Subject: 1992/93 Capital Markets Surveillance Exercise

SOUTHEAST ASIA ARTMEN SOUTHEAST ASIA ARTMEN OF SEP-3 PH 1: 06

We are beginning to prepare the brief for management on the 1992/93 Capital Markets mission, and I would appreciate your reactions to our plans for the structure and focus of the upcoming exercise. This note has already benefitted from comments by PDR (which will participate in all three legs of the mission).

I. The Structure of the Capital Markets Report

We intend to follow the same format as in last year's report--combining a survey of recent developments and prospects with a discussion of key, systemic policy issues. As is customary, the material will be divided into a Staff Report and a paper on Recent Developments. We also hope to have available by the time of the Board discussion one or two additional background papers.

II. Focus of the Report

The 1991/92 report concentrated on the ongoing structural changes in international financial markets. Against that background, we plan to focus this year's report on the following four topics (although unexpected developments may well require some shifting of the agenda):

(i) Sources of risk in the ongoing adjustments in international financial markets

Major segments of the international financial system are undergoing a stressful period of adjustment. Asset price deflation is testing the resilience of major banking systems. In some cases, bank capital positions are in double jeopardy from nonperforming assets and from eroding unrealized capital gains on equity portfolios. Such developments, for example, progressed far enough in Japan to prompt the adoption of strong measures to stimulate the economy, to support the equity market, and to help the banks. In other cases, increased

competition--unleashed by deregulation, desegmentation, and internationalization--is threatening long-established oligopolistic practices and the rents that carried the banks through previous times of trouble. Moreover, ongoing and/or prospective fiscal consolidation in some of the major industrial economies would reduce subsidies to industries whose ability to service liabilities to the banking system would then be threatened further. Finally, the explosive growth in off-balance sheet positions of the major money-center banks (the volume of swaps with banks as counterparties grew from \$10 billion in 1985 to over \$4 trillion today) seems to represent yet another example of a fast-growing concentration of risk that carries potential systemic overtones. And all of this is taking place against the backdrop of a still sluggish recovery in the real economy.

We propose to assess the risks that the adjustment now underway in many of the major financial markets pose for the stability of the international financial system and for the medium-term adjustment policies undertaken by the major industrial countries.

(ii) The systemic implications of EC financial and monetary integration

The European Economic Area is already well on the way to becoming a single market for financial services and the EC may soon become a full monetary union (we will know better after September 20). We propose to discuss a number of issues that are of systemic concern including: (i) the implications of the growth of the ECU, and of its ultimate adoption as the EC currency, for the role of the U.S. dollar as the predominant vehicle currency of international financial transactions; (ii) the implication of the establishment of a pan-European ECU-based wholesale payments system for the international, (U.S. dollar-based) wholesale payments system; (iii) the implications of the evolution of centralized European money and capital markets for the management and pricing of member-state public-sector obligations; (iv) the implication of the proposed EC supervisory and regulatory structure for the access of nonmember countries to EC capital markets; and (v) the implications of EC financial integration for the future growth and operation of the Euromarkets.

(iii) Recent growth of nonbank capital markets in some developing countries

Some developing countries (particularly in Southeast Asia and to some extent in Latin America) have recently experienced unprecedented growth in nonbank capital markets. Although this development can complicate short-run macro management, the potential benefits for resource allocation, for risk management, and for stimulating savings are substantial. The growth of nonbank capital markets in one country also tends to attract activity from neighboring countries with less developed markets; Last but not least, the growth

of nonbank capital markets has played a supporting role in recent capital inflows to some developing countries. We propose to assess these developments and their policy implications.

(iv) Developing country access to international capital markets

As in previous years, we intend to analyze recent developments and prospects for restructuring commercial bank debt and for new capital market flows to developing countries. One area of interest is the potential for phased debt operations--similar to that recently agreed with Brazil--in cases where insufficient resources are available upfront to fund the enhancements needed for a comprehensive bank package. With regard to new flows, we would seek to broaden our understanding of the market reentry process. Of particular interest here are difference in investor interest across countries. Also, there is the broader question of why access to the direct debt market appears more readily available than bank financing. We also propose to discuss the scope for further modification of regulatory regimes in creditor countries, including bank provisioning, and other steps to promote the adequate flow of information and pricing of sovereign debt.

III. Schedule and Staffing of Capital Markets Mission

The schedule and staffing of the mission is broadly similar to last year. We have again decided (for budgetary reasons) to do without a planned visit to Canada. The overall visit to Europe has likewise been shortened by 2-3 days. We have eliminated visits to Berlin and Bonn, but have added Zurich and Rome. The visit to Asia remains much as in earlier years.

Asia: October 13-22

Tokyo, Hong-Kong, Singapore

Goldstein, Folkerts-Landau, Rojas-Suarez from

RES, and one staff member from PDR.

Europe: November 3-23

London, Amsterdam, Frankfurt, Brussels, Paris,

Zurich, Basle, Rome

Goldstein, Folkerts-Landau, Garber from RES.

and one staff member from PDR

United States: December 8-11

New York, Washington

Goldstein, Folkerts-Landau, Fries from RES, and one staff member from PDR

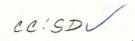
We have coordinated travel with the World Bank's financial complex to avoid undue pressure on authorities' schedules. We have also communicated with area-department division chiefs to ensure that our visits do not interfere with planned Article IV consultations.

VI. Date of Board Meeting

We propose that the discussion of the report by the Executive Board be scheduled immediately after the Interim Committee meeting in early Spring 1993.

May I have your comments by c.o.b. September 8, 1992?

cc: Mr. Mussa Mr. Leddy





To:

Mr. Goldstein

September 8, 1992

From:

Warren Coats WC

Subject: Capital Markets Surveillance Exercise

Thank you for the opportunity to comment on this draft outline. The topics proposed seem interesting and relevant. We will look forward to reading the final report.

You might wish to consider adding a discussion of the role of the international capital market for the economic reforms underway in Eastern Europe and the former Soviet Union. Questions of current interest include: how best to integrate the newly emerging market economies into world capital markets; how best to deal with the outstanding foreign debt of these countries; how important a contribution world capital markets (and especially banks) can make to increasing the flow of saving to these countries, improving its allocation within these countries, and providing financial services and exporting financial know how to these countries.

cc: Mr. Zulu (o/r)

Mr. Guitián (o/r)

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Williams

Mr. Sundararajan (o/r)

SOUTHEASA TSA SHTUOS THEMTARAGED DIFIOSA PS : 5 MA 6- 938 SE



To:

Mr. Goldstein

September 8, 1992

From .

S. Rothman A.nl.

Subject: 1992/93 Capital Markets Surveillance Exercise

We certainly have no problem with your proposed procedural and written format, as, indeed, it has been successfully tested and proven. In fact, we wonder what "unexpected developments" you have in mind that could require a major change in the agenda.

At this stage, we would merely observe the following:

-- In the section on "recent growth of nonbank capital markets in some developing countries," emphasis is appropriately placed on Southeast Asia and Latin America. But might not some attention be accorded to the necessary conditions for such growth in Africa, taking into account the recent movements toward regionalization?

-- Within the section on "developing country access to international capital markets", we look forward to the examination of "differences in investor interest across countries" in the market reentry process. Also, would it not be possible to examine in this section--even in a cursory manner--the outlook for, and the possible diversionary effects of, new capital market flows to the Former Soviet Union?

cc: Mr. Beza

Mr. Van Houtven

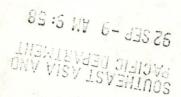
Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Williams

Mr. Zulu/Mr. Guitián





Office Memorandum

cc:5DV

To:

Mr. Goldstein

Sept, August 8, 1992

From:

Paul R. Masson

rom. radi k. nasso

Subject: 1992/93 Capital Markets Surveillance Exercise - Comments

I hesitate to suggest further topics for the mission, given that the list is already so comprehensive. However, under topic (ii), the systemic implications of EC financial and monetary integration, there are other aspects of integration that may warrant attention (and already have, in previous work of the Research Department): the impact of increased competition in banking services in the context of the Single Market, and effects on the solvency of banks; exchange rate instability in the transition to EMU (or to a reformed EMS?); and the evolving process of central bank coordination and the eventual role of the EMI.

cc:

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Neiss

Mr. Saito

Mr. Williams

Mr. Zulu/Guitián

To:

Mr. Goldstein

September 9, 1992

From:

Orlando Roncesvalles

Subject: 1992/93 Capital Markets Surveillance Exercise

On the draft brief for management on the next capital markets mission, you may wish to consider the following points.

- As regards the sources of risk in international financial markets, it may also be useful to assess the impact of the increasing concentration of financial flows controlled by particular institutional investors, especially pension funds and insurance companies. The activity of these nonbank market participants is definitely changing both the direction of financial flows and the liquidity of various assets (equities and bonds) in different markets, including the derivatives markets. Of course, systemic risk may well decline if these investors were to be willing to absorb more risk, through, for example, greater equity participation.
- Developing country access to international capital markets seems to be an area where innovation has recently gained greater importance. In this connection, we would suggest that structured finance techniques, e.g., aircraft leasing or commoditybacked instruments, might also be evaluated. Such techniques might possibly reduce the risk exposure of commercial banks, or permit countries to share risk with a varied range of investors.

As you are aware, we continue to have an interest in the functioning of currency composites in international financial markets as part of work related to the operational aspects of the SDR system. We would, therefore, be interested in receiving any information collected by the mission as regards recent developments in the private SDR and ECU markets.

Mr. Beza

Mr. Touré

Mr. Van Houtven

Mr. Williams

Mr. Neiss

Mr. Russo

Mr. Saito/

Mr. Zulu/Guitian

65 SEb - 6 PH 3: 18

SOUTHEAST ASIA AND SHIDARY

1. KS File 2. LK 3. BJS 4. PA 5. FILES

92 MAY 18 PM 3: 17

To:

Mr. Goldstein

May 18, 1992

Mr. Saita

From:

Alessandro Leipold

Subject:

Staff Appraisal: International Capital Markets

We found the paper interesting and thought-provoking. The main concerns from this Department's perspective are that it may be somewhat lengthier than strictly necessary, and that it may not easily lend itself to a well-structured and articulated Board discussion. We believe there is some scope for pruning (there is, for example, a fair amount of repetition of material already contained in earlier capital markets or other Board papers, e.g., on the Basle capital accord, its extension to market risk, the EC Banking Directives, the "credit crunch", developing country access, etc.). A second look at the paper for areas to cut would, we believe, enhance rather than detract from the presentation. More importantly, we feel the paper would benefit from a more pointed concluding section, which should be drafted around a number of key "issues for discussion," in order to guide Executive Directors' interventions on the range of issues raised, and to draw out their views.

A further general point we would make is that in parts the paper appears a little outdated, perhaps as a result of the long lapse of time since the missions. By way of example, does the debate on the "credit crunch" really need to be rehearsed once again? Not incidentally, most of the literature cited in the footnote on page 14 is dated April-May 1991, and at the last Board discussion of the WEO at least one Director was relieved to note the absence of discussion of this issue. In a similar vein, some of the data cited could be updated: e.g., the capital ratios of Japanese banks (which are given only for end-March 1991 (Table 2), and thus miss the effects of this year's stock market decline), and the references to developments in international banking activity in the first half of 1991 (page 12) and the first three quarters of 1991 (page 15), whereas the Board is about to be provided with data for the year as a whole (the paper on "International Banking Activity in 1991" is currently with management).

Finally, three minor points, arranged by page order for ease of reference. First, it is arguable whether the process of internationalization of financial markets really "gathered speed" in 1991 (bottom of page 1), as the examples cited (EC single market and U.S. and Japanese reforms) at best only neared completion; it could, indeed, be argued that the process stalled in 1991, as evidenced by the difficulties encountered in reaching agreement on financial services in the Uruguay Round, the stalemate on the EC Investment Services Directive, and the setback suffered by the U.S. Administration's wide-ranging banking reform proposals (where one of the few measures approved by Congress is in fact in contrast with the process of liberalization, as noted on page 18). Second, the discussion (on page 10) of the possible role of the European Central Bank in supervision would be clearer if the countries

were identified; for example, it is unclear which countries are alluded to at the end of the paragraph: who are the countries "with more sophisticated financial structures but where there is some concern that central bank independence... can go too far?" Finally, it struck us as a little odd to refer to the securities markets in Germany and Japan as "emerging" (top of page 20).

cc: Mr. Beza

Mr. Touré

Mr. Boorman

Mr. McLenaghan

Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Shaalan

Mr. Tanzi

Mr. Zulu/Mr. Guitián

To:

Mr. Goldstein

May 18, 1992

From:

U. Baumgartner 073

Subject: Comments on the Staff Appraisal of International Capital Markets

We enjoyed very much reading this very interesting, well written and thoughtful paper.

One general comment that we have is that the focus on policy issues could perhaps be sharpened. On the matter, for instance, of how the downsizing process of wholesale banks should be "managed," which is identified as one of the key issues, the paper promises more than it eventually delivers. In a few places, the descriptive sections could also be pared down. For example, the description of the illiquidity risk on pages 6-7 is long but leaves the reader unconvinced. Is this new and more competitive, more securitized and more liquid structure really so fragile that the "hint of a problem" affecting a small part could lead to its collapse? (Events like October 1987 are, it is hoped, not the normal problems a system needs to cope with.) Are we here giving too much credibility to those who see systemic problems lurking around every corner? On the other hand, if the risks are grave, then an appropriate policy response would need to be laid out.

Another general comment is that the text is dense with financial market jargon, the discussion in the first paragraph on page 20 being notable in this regard. Greater reliance on plain English would be helpful, while it would not suggest less understanding of financial market developments and issues.

We have the following specific comments:

- Evidence supporting the belief that the "franchise value" of wholesale banks has declined (pages 5 and 6) applies only to the United States, yet banks in the United Kingdom and Japan are lumped into the same group. Either the case should be made explicitly for these countries as well, or they should be treated separately from the U.S. banks.
- There appear to be problems with Table 2 describing the capital ratios of the major Japanese banks. If the data are in fact as of March 31, 1991, when the NIKKEI stock price index was over 26,000, then the implied sensitivity of Tier II capital to changes in stock prices is implausibly low. More generally, we do not believe it

is useful to show hypothetical levels of stock prices at which the B.I.S. guidelines are not met. This presupposes no changes in other components of the banks' balance sheets, which is not a likely scenario. Instead, it would be preferable to include a brief reference in the text to the sensitivity of Tier II capital to changes in stock prices.

- 3. The discussion of <u>refinements to the B.I.S. ratios</u> deals almost exclusively with off-balance sheet activity; the existing Accord is judged to be "doing what it was intended to do" in terms of bank lending. There is a danger that this felicitous state of affairs will not last long. As banks become more comfortable with the B.I.S. guidelines, behavior that exploits their anomalies will increase. More attention should thus be devoted to reducing these anomalies, such as the choice of risk weights for different assets, the "point in time" aspect of when the capital ratios are calculated, and the often perverse impact of exchange-rate movements on measured capital ratios.
- 4. Concern is expressed at the top of page 15, and elsewhere in the paper, about the effects of reduced "liquidity" in financial markets. The case for concern would be more convincing if it were supported by historical evidence that changes in liquidity, however measured, have affected performance in non-financial sectors of the economy.
- 5. Footnote 2 on page 19 should be changed to read "However, the Ministry of Finance had issued an administrative guideline prohibiting the compensation of trading losses. Legislation is pending that would make loss compensation illegal."

cc: Messrs. Beza
Toure
Van Houtven
Boorman
McLenaghan
Neiss
Narvekar
Russo
Saito
Shaalan
Tanzi
Zulu/Guitian

cc: SD book

May 13, 1992

Mr. Baungartner (CTA) to handle for both departments.

92 MAY 13 PM 5: 07

To:

Mr. Beza

Mr. Touré

Mr. Van Houtven Mr. Boorman

Mr. McLenaghan

Mr. Neiss

Mr. Russo

Mr. Saito

Mr. Shaalan

Mr. Tanzi

Mr. Zulu/Mr. Guitián

From:

Morris Goldstein Tag .

Subject: Staff Appraisal: International Capital Markets

I attach the staff appraisal for this year's Capital Markets Report. While it is somewhat longer than suggested by the recent guidelines, I would like to think that this is justified by the range and complexity of the policy issues discussed.

Could I please ask for your comments by noon, Monday, May 18, 1992.

We plan to send the background paper on recent developments for your comments early next week.

Attachment

cc: Mr. Mussa (o/r)

Mr. Narvekar

Mr. Folkerts-Landau

INTERNATIONAL MONETARY FUND

International Capital Markets: <u>Developments, Prospects, and Key Policy Issues, 1991/1992</u>

Prepared by the Research Department

(In consultation with the Exchange and Trade Relations Department)

Approved by Michael Mussa

May 1992

Contents

- I. Introduction
- II. Structural Change in the Major Financial Systems: Main Features, Risks, and Policy Challenges
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- III. Capital Adequacy Standards for Banking and Securities Activities
 - 1. Implementing the Basle Accord
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 - 1. Supervision of banks' foreign establishments
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 - 3. Is there a common thread?
- V. Developing Country Access to International Markets
- VI. Conclusions

I. Introduction

This paper presents the staff's annual survey of developments, prospects, and key policy issues in international capital markets. 1/ This year the focus is on: (i) the challenges posed by the ongoing structural changes in major financial centers; (ii) the effects of higher capital standards on risk-taking and lending of financial institutions; (iii) recent threats to the integrity of financial markets; and (iv) the changing pattern of access of developing countries to international capital markets. 2/ Underlying these issues is a broader theme that ran through much of the staff's discussion with authorities. That theme is how to manage the restructuring of capital markets in an environment of wide ranging liberalization, intense competition, and growing securitization -in a way that avoids both a systemic crisis and moral hazard risks and budgetary costs associated with public-sector support of weak financial institutions. The stakes involved, both for the countries most immediately affected and for the international community as a whole, are considerable. The mounting cost of the U.S. saving and loan restructuring -- by now well in excess of one hundred billion dollars -- is a vivid illustration of how an initial, industry-specific financial problem can take on much larger At a time when meeting the growing global demand for saving hinges critically on decreasing the dissaving of the public sector in many industrial countries, problems of the financial industry can no longer be viewed as a side show to macroeconomic developments; the potential liabilities and risks are too large for that.

II. Structural Change in Major Financial Centers: <u>Main Features, Risks, and Policy Challenges</u>

1. Main features of the emerging financial system

Although the evolution of finance into a competitive international industry occurred gradually during the 1980s, the process gathered speed during 1991 as the regional EC Single Market in financial services--perhaps the most ambitious and comprehensive financial sector reform undertaken in

^{1/} A staff team, headed by Mr. M. Goldstein (RES), and including at
different times Messrs. D. Mathieson (RES), M. El Erian (ETR), D. FolkertsLandau (RES), J. Di Tata (ETR), Mrs. L. Rojas-Suarez (RES), and S. Fries
(RES) held discussions with national authorities, international
institutions, and market participants in Belgium, France, Germany, Japan,
the Netherlands, Switzerland, the United Kingdom, and the United States
between September and early December 1991. Background material to the
present paper is provided in SM / / ..., and WP/ / , WP/ / , and WP/
/

 $[\]underline{2}/$ A discussion of recent market developments is contained in the background paper SM/92/--.

recent history-- neared completion, and as the next stage in U.S. and Japanese banking reforms began getting underway in earnest. 1/ As a result, by 1992, domestic financial markets, particularly wholesale markets, have become adaptive and international, with the segmented nature of financial structures increasingly giving way to broader-based markets with multi-product conglomerates. 2/

A key feature of the new financial environment is the competitiondriven disintermediation from banking systems -- particularly from wholesale banking -- into securitized money and capital markets. The more creditworthy borrowers in major industrial countries are increasingly able to satisfy their liquidity, risk management, and financing needs directly in liquid securities markets. Commercial paper and repurchase agreements are becoming the short-term financing instruments of choice; money-market mutual funds are siphoning deposit liabilities out of the banking system; and the explosive growth of exchange-traded futures and options is reflective of the greater non-bank opportunities to hedge risks and to mimic the liquidity of bank-like products. Financial claims, ownership rights, and contingent obligations are more and more taking the form of liquid securities. credit rating function is increasingly performed by specialized firms (e.g., Moody's, Standard and Poors, IBCA) rather than by banks. In short, relationship-banking is being replaced with transactions-driven securities finance. This securitization is farthest advanced in the United States, the United Kingdom, and France, but it is also picking up steam in Japan and in other major industrial countries.

This securitization is forcing adjustments across the entire spectrum of activities and institutions in financial markets. The loss of traditional balance-sheet business has led to a consolidation in the wholesale banking sector and to an expansion in their off-balance sheet activities, including backup lines of credit and forward interest rate and foreign exchange contracts. Banks are now acting as counterparty to more than \$1 trillion in currency and interest rate swaps, which has become the major source of fee income for banking institutions. At the same time, bank-led financial conglomerates are using their branch networks to charge into new financial service areas, such as insurance.

^{1/} The Community has implemented, inter alia, full liberalization of capital movements; also, a single license issued by the home authority allows banking institutions to engage in banking and securities transactions throughout the Community. Negotiations are underway that would permit non-bank investment intermediaries to operate on a Community-wide basis once recognized by their home authority, and stock-exchanges and derivative markets will be opened to cross-border membership of bank and non-bank financial firms.

²/ Some of these developments have been chronicled in previous Capital Markets Reports. See IMF, International Capital Markets: Developments and Prospects, 1985 to 1990.

The declining importance of the banking sector is readily apparent from the aggregate portfolio data presented in Table 1.

These trends notwithstanding, Table 1 also documents the pronounced differences in financial structure across the major industrial countries that still remain. Specifically, while New York and London, and increasingly Paris and Toyko, conform to the securitized, bankdisintermediated prototype outlined above, Germany (and to a lesser extent, Amsterdam and Brussels) do not. In Germany, a few large, universal banks dominate the financial system, and private securities markets have remained relatively illiquid, fragmented, and of secondary importance. 1/ German universal banks enjoy close institutional ties to the corporate sector (in terms of both equity stakes and their membership on corporate supervisory boards), and they often play a major role in helping the corporate sector work out debt difficulties. They benefit from a large and relatively loyal domestic retail base and, at least so far, have not had to confront the effects of a large-scale direct approach of the corporate sector to credit markets. When firms need liquidity, they typically turn to their "house bank; " similarly, when they have excess liquidity, they deposit it there. Thus, in addition to longer-term credits, short-term wholesale payments also flow across the banks' balance sheet. This, combined with the Bundesbank's relatively high minimum reserve requirement, probably explains why the German money market is less developed than those of some other large industrial countries. Their considerable placement power allows universal banks to exercise strict quality control over which potential domestic and foreign borrowers obtain access to the direct DM debt markets. sense, the private sector in Germany takes on more responsibility for investor protection than in some other industrial countries.

One issue thrown up by these differences in financial structure, with the United States and Germany at either end of the spectrum, is which structure is most likely to prevail over the medium term. While each of these structures carries its own strengths and weaknesses (see discussion below), it is the staff's view that the trend is headed toward the disintermediated, liquid, securitized structure. Increased competition in a liberalized financial market generally means that domestic money and capital markets activity will migrate to the most hospitable environment; and since some authorities, particularly in France and the United Kingdom, have supported the development of securitized markets, there is likely to be an alternative to bank intermediation in reach. For this reason, five years from now, the continental European financial markets will probably look a lot more like the New York and London markets than they do today. The

^{1/} Although there is a large Government bond market, the German stock market is fragmented among eight regional exchanges, and approximately 30 percent of the turnover for German stocks takes place in London. The first commercial paper program was arranged in 1991. The first interest futures contract on a German government obligation was not traded in Frankfurt until late 1990.

Table 1. Germany, Japan, and the United States: Indicators of Relative Importance of Banks in Financial Activities of Corporations and Households

(In percent)

	Bank Deposits as a Proportion of Corporate Financial Assets	Bank Deposits as a Proportion of Household Financial Assets	Bank Loans as a Proportion of Corporate Liabilities
65			
Germany			
1980	57.7	60.5	63.1
1985	51.1	54.5	60.9
1990	43.8	48.9	61.3
Japan			
1980	78.9	64.4	67.4
1985	77.8	58.5	67.4
1990	46.5	53.2	58.8
United States			
1980	17.8	23.1	33.0
1985	21.5	23.4	29.2
1990	18.8	21.3	25.4

Source: IMF staff estimates and national Flow of Funds Data.

significant transformation of the French financial market (especially the rapid development of the money market) is showing the way. The recent growth of the DM commercial paper market and of the Deutsche Termin Borse is another indication of things to come. The continuing interest rate liberalization in Japan will likewise reinforce this trend. More generally, it is difficult to keep firms and individuals away from innovations that reduce the cost of capital, increase the return to saving, and expand the range of risk-management possibilities.

2. Risks in the new environment

Current developments are part and parcel of the maturing of financial systems, with considerable potential for increasing the contribution that the financial sector can make to growth and stability. Nevertheless, the process of restructuring is inherently fraught with risk of systemic instability. Structural change, involving the displacement of established institutions and practices, is difficult in any sector; it is much more difficult in the financial sector, with its fiduciary responsibilities, its extensive public sector safety-net support, and its globally interrelated activities.

Wholesale banks -- particularly those in the United States, United Kingdom, and Japan, whose traditional business of supplying liquidity, and of lending through large syndications, is shifting to securities markets -appear to be responding to the downward pressure on their franchise value in part by undertaking higher risk/higher return activities. The availability of deposit insurance and other safety-net guarantees in these countries permits an increase in the riskiness of bank assets without a corresponding increase in the cost of the bank liabilities. This strategy is reflected in considerable exposure to sectors and activities with high upfront fees, such as leveraged-buy outs and other highly-leveraged transactions, and a host of off-balance sheet contingent commitments. The inherent risks in such activities, combined with significant concentration in loans to developing countries and for commercial real estate, have taken a heavy toll on bank earnings: twice in the last five years, provisioning for bad loans more than wiped out the aggregate net income of U.S. wholesale banks, forcing the payment of dividends out of capital. Furthermore, in order to compensate for the loss of more traditional business, wholesale banks have been more aggressive in their pricing strategies in some newer activities (e.g., the swap market), often at the expense of other competitors (e.g., the organized future exchanges). It is difficult to explain how else the notional value of swaps in which U.S. banks (only one of which has a AAA rating) are counterparties could have risen from \$250 billion in 1987 to \$1 trillion by 1992.

In addition, the growth of off-balance sheet business has also contributed much to the growing opaqueness of the financial system. It has become increasingly difficult to assess fully all the risks of individual positions, let alone the risk exposure of the entire consolidated balance sheet of financial institutions.

Although the problems besetting wholesale banks are probably most pronounced in the United States, there is evidence of similar trends in other major industrial countries (such as Japan and the United Kingdom). 1/ The pressure comes as liberalization and competition progressively reduce the safe profit opportunities of banks. At this point, it remains to be seen how the elimination of excess capacity from the wholesale banking system will be resolved; it is not too early, however, to assert that this restructuring problem is a source of vulnerability in the period ahead.

A second source of increasing systemic risk is the ever greater reliance on the uninterrupted availability of liquidity by securities markets and financial institutions. In highly securitized financial systems, such as those of the United States and the United Kingdom, there exists an intricate network of short-term obligations connecting diverse financial institutions. Broker/dealers rely on the liquid repurchase markets to finance their positions. Corporate borrowers rely on the commercial paper market to satisfy their day-to-day liquidity needs. Participants in the futures exchanges rely on wholesale banks for liquid funds to meet their margin requirements. Wholesale banks themselves rely on the interbank market and on the wholesale CD market to meet their end-of-day settlement obligations to the payments system. Finally, all non-bank financial institutions, as well as the corporate sector, rely on wholesale banks to act as lender-of-next-to-last resort through prearranged lines of credit. Here, the vulnerability arises because a hint of problems at an already weak, but not yet insolvent, institution can lead to a loss of access to money markets, which in turn can cast doubts on the solvency of the creditors of this institution. In the absence of central bank support and assurances, such incidents could snowball into a liquidity gridlock in the financial system, with serious impact on the real economy. For example, during the precipitous decline in equity values in October 1987, U.S. wholesale banks were reluctant to keep on financing dealers in securities markets. The solvency of dealers was in question because of losses on their inventories. It took reassurances by the Federal Reserve to prevent a generalized liquidity crisis.

^{1/} More severe banking problems have recently emerged in Scandinavia. In Norway, mounting loan losses forced the government to acquire complete control of two large banks and a substantial share in a third large bank. The Finnish banking system also experienced large and growing credit and trading losses last year. The Bank of Finland had to take over the clearing bank of the savings bank system, absorbing the loss on its own books. Finally, the Swedish government has been obliged to make capital injections into a large bank to cover its losses. In each country, banking problems can be traced in part to facets of the recession that are country-specific. At the same time, a decline in credit standards, an increased appetite for risk-taking activities (including stock market speculation), and a longer-term decline in the franchise value of banking were also contributing factors.

Trading strategies, such as stop-loss sales or portfolio insurance, likewise rely on market liquidity for their success. For any one small player, the assumption of a liquid market with price continuity is reasonable. When many selling strategies are triggered simultaneously, however, they have proved to be infeasible. If the price falls dramatically below its fundamental value because of a shortage of liquidity, further sales may be triggered. Banks may make margin calls on their loans to security holders and dealers, as well as cancel lines of credit. This, in turn, could either bankrupt holders and dealers or force a sale of their securities, further depressing prices. The spread of insolvencies resulting from price declines and from inability to meet margin calls may ultimately affect the banking system itself, as defaults on bank loans increase.

Ensuring that a highly developed financial system has enough liquidity to keep the wheels of its interdependent parts well greased when there is a shock to the system is one thing. Doing so without creating a "moral hazard" of excessive risk taking in the future is quite another. As officials of central banks emphasized during the discussions, the central bank has to be careful in responding to liquidity strains not to widen unduly the safety net, lest it encourage the very kinds of behavior that it seeks to restrain. Indeed, it was for this reason that some central bankers operating in more securitized markets spoke of maintaining "constructive ambiguity" about which types of institutions might qualify for liquidity support, while others stressed the desirability of either inducing more secure, private market participants (senior partners) to lend the first line of assistance, or of requiring collateral (from the endangered institution) before undertaking such liquidity support.

Again, market structure counts. The risks associated with interruptions in liquidity are clearly lower in'a less securitized, more bank intermediated, market. Here, short-term funding and liquidity management must occur through bank balance sheets, and banks also act as the major brokers and dealers for money. In such a system, there has generally been a small number of large bank players in the market for wholesale funds. Clearing of payments is effectively done internally to banking organizations or among a small group of tightly connected banks. Without securitized money markets, loans on the books of banks are difficult to value and cannot be accurately "marked to market." Though banks are leveraged, their ability to receive short-term funding is not impaired by sudden swings in the trading prices for securities. Few occasions will arise when funds are demanded on a large scale for unexpected settlements. The central bank, therefore, will not often be called upon to provide credit. Alternatively stated, placing most short-term funding on bank balance sheets means that financial markets create few liquid claims, so liquidity problems emerge relatively infrequently.

In the end, there would appear to be elements of a compromise associated with the evolution of financial structure in the major industrial countries. As these systems have become more competitive, more securitized, and more liquid, they have generated increases in efficiency. But at the

same time, these systems are more susceptible to liquidity strains and crises than are less liquid, more bank-intermediated financial structures. It is to this search for a reasonable combination of efficiency and stability that we turn next.

3. The policy response to changing financial structure

The evolution of financial systems is perceived as a major policy challenge by authorities. It is widely recognized that without reforms in financial policy and close attention by central banks, the new financial system could resemble a new, high-speed train attempting to run on old, ill-maintained tracks.

The plight of the wholesale banking sector is generally viewed with sympathetic concern. In the United States and Japan, the authorities are responding with reform packages that would remove some of the geographic and product restrictions now faced by banks. In the United States, these reform efforts are aimed, at least in part, at "leveling the playing field" and improving the competitiveness of home banks vis-a-vis foreign banks (particularly, large universal European banks). The Japanese banking reforms are motivated in part by a desire to introduce more countervailing power into the securities market where the four largest securities firms have long held a dominant position. Banks would be allowed to undertake securities activities in a separately capitalized subsidiary. This subsidiary would be separated from the bank by a "firewall" so as to restrict the exchange of information and funds and thereby, to limit conflicts of interest and to protect the banks' financial integrity. In the United States, the authorities favor the concept of a bank financial-service holding company that would exclude bank/commercial links, but would allow an insurance company subsidiary as a member. The legislative process on bank reform is moving steadilly forward in Japan. In the United States, the Congress passed in November 1991 a narrow reform bill that stopped far short of the Administration's proposals but nevertheless did strengthen banking supervision, replenish the Bank Insurance Fund, and roll back somewhat the too-big-too fail doctrine.

The effectiveness and desirability of allowing banks to expand their activities remains a hotly contested issue. Bankers take the view that existing legal restrictions on their activities, cum the decline in some of their traditional lines of business (especially falling corporate demand for bank liquidity), have put them in an unviable long-term position. $\underline{1}$ / Critics, however, note that, in general, it is not feasible to help out a declining business by investing in a good business because investors will demand the competitive rate of return on the marginal investment. Put in

^{1/} See S.Weisbrod, H. Lee, and L. Rojas-Suarez, "Bank Risk and the Declining Franchise Value of the Banking System in the United States and Japan," WP/92/, May 1992. The declining franchise value is more in evidence for wholesale banking than for retail banking.

other words, unless there exist unexploited monopoly profits, entering a market "late" does not offer the newcomer favorable prospects; in this connection, the track record of banks, as well as of financial corporations as a whole, in trying to dislodge entrenched competitors in established markets has been less than impressive. In the staff's view, deregulation of functional restrictions will attract new capital to banks only if there are complementarities between the securities business and the wholesale payments business. Bankers argue that the information generated in the course of providing bank credit and of underwriting and dealing in securities, generates potential saving (i.e., "economies of scope") in the real resources spent on information gathering. But such synergy in the gathering of information also must confront the question of possible conflicts of interest: a banker who knows more than the public securities market might be tempted to use such information for profit. In any event, it is important that any increased powers granted to banks be accompanied with increased supervision and regulation to reduce their ability to leverage the safety-net by taking on excessive risks.

In Europe, the European Community's Second Banking Directive and its (proposed) Investment Services Directive are giving a liberalizing impetus to the financial restructuring process by essentially authorizing a "single passport" (to be issued by the home country) for conducting banking and securities business throughout the Community. National authorities are making efforts to upgrade their financial infrastructures so that they can be competitive within the Single Financial Market in 1993. This generally means modernizing clearance and settlement systems for payments and securities transactions, establishing automated market mechanisms, and strengthening supervisory and regulatory structures; it also means dismantling or reducing any local taxes or regulations (e.g., turnover taxes) that put home institutions and exchanges at a competitive disadvantage relative to their Community competitors. In some cases, even long-standing institutions (e.g., the state pension system in France and the regional stock exchanges in Germany) are being reexamined with an eye toward assessing how they affect financial competitiveness. The continental European countries, in particular, are keenly aware of the migration over the past decade of a significant share of trading activity to London, and are naturally interested in recapturing some of that business by offering, where possible, comparable transaction costs. More generally, there is recognition that with the completion of the Single Market, it will be the national financial systems with the most developed infrastructures that will attract the lion's share of EC financial transactions. In this regard, the efficiency of the dollar payments system was regarded as a non-trivial contributory factor to the dominance of the U.S. dollar as a vehicle currency in foreign exchange markets; the country with the most efficient payments system in the EC would likewise enhance its chances of attracting the bulk of EC money market transactions after European Economic and Monetary Union comes into effect.

The financial restructuring that is underway in Europe invites two immediate policy questions: first, what will it imply for monetary policy;

and second, is the intensified competition in financial services generally constructive?

On the issue of monetary control, the mission noted some difference of view among national authorities. More specifically, there was a greater inclination on the part of the French and U.K. authorities to regard the benefits associated with more liquid, securitized markets as outweighing the cost of the possible increases in risk. Indeed, they were confident that such a market could be managed without hindering monetary control so long as the authorities kept a close eye on financial institutions, were prepared to step in firmly when there was a major (liquidity) disturbance in the markets, were constantly mindful of the moral hazards involved, and were committed to a medium-term noninflationary stance for monetary policy. In contrast, monetary authorities in Germany were less convinced that more liquid, securitized money markets generated such significant social benefits -- especially in relation to the potential dilution of monetary control brought on by the growth of close substitutes for bank deposit liabilities (such as mutual funds). More fundamentally, they argued that involving closely the central bank in regulation and supervision of financial markets would inevitably detract attention from its primary responsibility for implementing monetary policy, with adverse consequences for its performance. In their view, the fact that bank supervision in Germany was lodged in a separate agency, combined with the lesser need to monitor liquidity on a short-term basis, gave the Bundesbank an advantage in implementing monetary policy. To some extent, this debate spilled over into the negotiations over the responsibilities of the future European Central Bank (ECB). The draft statutes of the ECB make maintaining price stability its primary objective. The ECB does not have an explicit mandate to maintain the stability of the financial system, nor to act as a lender of last resort; similarly, its supervisory and regulatory responsibilities, if any, are not clearly spelled out. In short, those who favor an ECB with broader responsibility tend to be from countries that have, or soon expect to have, liquid, disintermediated financial structures; they tend to doubt that this kind of financial market can be kept on an even keel without a good deal of attention from the central bank. Those allied on the other side tend to be either from countries which have less liquid (and typically, more bankintermediated) financial structures, or from countries with more sophisticated financial structures but where there is some concern that central bank independence and responsibilities can go too far.

Turning to the <u>nature of financial competition among EC countries</u>, most of it thus far is of the constructive variety. To be sure, the strengthening of clearance and settlement systems is to be welcomed as a valuable preventative measure against systemic risk. The serious reexamination of national restrictions, taxes, and barriers to entry should also pay dividends in terms of improved resource allocation for Europe as a whole. Two caveats, however, merit mention. One is that each country has to assess realistically its comparative advantage in providing financial services in a single market, lest significant excess capacity be created. It is a good question, for example, how many futures exchanges can co-exist

in Europe over the medium term; in a similar vein, it remains to be seen whether establishing a niche in trading of stocks of smaller, national firms will be sufficient to guarantee the survival of some, smaller, regional stock exchanges. The second caveat is that competition should not be allowed to water down those features of the financial system that are necessary for safety and soundness.

III. Capital Adequacy Standards for Banking and Securities Activities

The main emphasis of recent policy efforts to reduce systemic risk has been an internationally coordinated strengthening of the capital base of the banks and securities firms. The Basle Committee on Banking Supervision, comprising the banking supervisors of the G-10 countries and Luxembourg, concluded an agreement in July 1988 on risk-weighted capital adequacy standards. The Accord sought to strengthen banks against potential losses, mainly through a systematic treatment of credit (default) risk and the inclusion of some off-balance-sheet exposures in the capital framework, while reducing the competitive inequalities arising from differences in national standards.

1. Implementing the Basle accord

According to a recent Price Waterhouse survey, implementation of the Accord through legislative changes or binding guidelines issued by regulatory authorities is completé within the G-10 countries, except in Italy. 1/ Spurred by market pressures, most large international banks have responded by meeting the final capital standards well before its entry into effect under the Accord. This strengthening of capital positions has occurred despite the decline during 1990 in bank earnings and in asset quality in several countries, particularly in the United States and the United Kingdom. However, to meet the minimum standards, banks in several countries have needed to raise additional capital or to change their asset portfolios, or both.

While relatively well-capitalized German, Dutch, and Swiss banks have not been much affected 2/ many banks in the other G-10 countries have raised Tier 1 and Tier 2 capital since agreement on the Accord was reached. U.S. banks have raised significant amounts of capital through bond and

^{1/} Price Waterhouse World Regulatory Advisory Practice, Bank Capital
Adequacy and Capital Convergence (London: Price Waterhouse, July 1991).
Implementation of the accord has been chronicled in International Monetary
Fund, International Capital Markets: Developments and Prospects, World
Economic and Financial Surveys (Washington: International Monetary Fund,
April 1990 and May 1991).

^{2/} German banks have raised significant amounts of Tier 2 capital, mainly in the form of Genußschiene (non-voting, tax-favored participation certificates), as means of financing expansion.

equity issues in 1990-91. At the same time, for a number of institutions in France and Italy, a significant constraint has been the limitation on their capital funding arising from public ownership; this has been overcome through several equity cross-participations between these banks and nonfinancial, state-owned enterprises.

Japanese banks have long enjoyed substantial revaluation reserves in the form of unrealized capital gains on their long-term equity investments. Under the Accord, banks are permitted to count 45 percent of such unrealized capital gains on securities (but not on real estate) as Tier II capital. However a decline in the Nikkei stock index in excess of 50 percent over the last two years has significantly eroded such capital and Japanese banks have been forced to issue subordinated debt. Although the average capital ratio of the Japanese banking system has remained above the prescribed 8 percent ratio (see Table 2), it is estimated that recently some Japanese banks have been pushed below the 8 percent target of the Accord. Furthermore, some institutions are now constrained by the requirement that subordinated debt not exceed 50 percent of Tier I capital. Hence, their only options are to raise equity or to reduce risk-adjusted assets by selling securities, reducing interbank exposure, and disposing of assets carrying 100 percent risk weights. In fact, the unprecedented decline in cross-border banking activity in the first half of 1991 can largely be accounted for by a retrenchment of Japanese banks in the interbank market, presumably reflecting efforts to preserve capital.

2. Policy issues relating to the Basle Accord

Perhaps the main reason why the Accord has received so much attention over the past year is that the strengthening of capital positions has coincided in certain countries, most notably the United States, Japan, and the United Kingdom, with concern about a tightening of bank credit conditions. This naturally has raised the issue of whether it would be advisable to relax the Basle standards so as to give a boost to bank lending.

In considering this issue, four factors need to be taken into account. First, evidence on the existence of a "credit crunch" is not clear

Table 2. Japan: Capital Ratios of Major Banks at March 31, 1991

(In percent)

	Tier 1 capital/ Risk-adjusted assets	Total capital/ Risk-adjusted assets	Nikkei level at which total capital ratio falls below 8 percent <u>1</u> /	
City banks	4.43	8.54	15,577	
Long-term credit banks	s 4.05	8.11	15,773	
Trust banks	5.63	10.38	8,225	

Source: IBCA Limited.

1/ Estimates.

cut. 1/ It has proved difficult to isolate the effects of shifts in the supply of credit from shifts in demand; the demand for credit would have been expected to fall in these countries on account of the recession or growth slowdown, as well as because of the recognition by businesses and households that existing levels of indebtedness required correction. Second, focusing on bank credit can lead to an inaccurate indication of overall credit availability given the substitutes that exist for some types of bank loans; commercial paper and bonds are prime examples of such substitutes. 2/ Even for business with no access to money and securities markets and for households, an alternative to bank credit often exists in the form of lending by finance companies. Third, a decline in bank lending may also partially reflect a secular trend of borrowers drifting into securities markets. Finally, and most important, even if the Basle standards are acting at the margin to decrease somewhat the supply, and to increase the cost. of bank credit, this would need to be weighed against the more substantial longer-term benefits of increased soundness of banking practice and of reduced competitive inequities. For these reasons, the staff shares the view of authorities that a weakness in economic activity. cum the deceleration in bank lending, should not be taken as a justification for relaxing or fine-tuning the Basle capital standards. Based on the staff's meetings with private market participants, the Accord did seem to be inducing banks to give more careful attention both to the pricing of risks associated with different kinds of lending activity and to the need to hold adequate capital against these risks. It is therefore doing what it was intended to do. As the industrial economies rebound and as more sustainable balance-sheet positions are restored, prospects for making goodquality bank loans should improve.

This being said, there is one related issue that merits both close attention and further investigation. It is the role of the capital standards, cum the steep decline in Japanese equity prices and real estate values, in the large reported contraction in the interbank market. 3/

^{1/} The evidenced is surveyed in the World Economic Outlook: A Survey by the Staff of the International Monetary Fund, World Economic and Financial Surveys (Washington, D.C.: International Monetary Fund, May 1991), pp. 109-115. See also Bank of England, "Is There a 'Credit Crunch'?" Bank of England Quarterly Bulletin, Vol. 31 (May 1991), pp. 256-259, Board of Governors of the Federal Reserve System, "Monetary Policy Report to the Congress," Federal Reserve Bulletin, Vol.78 (April 1991), pp. 223-241, B.S. Bernanke and C.S. Lown, "The Credit Crunch," Brookings Papers on Economic Activity: 1 (1991), Brookings Institution (Washington), pp. 205-247; P. O'Brien and F. Browne, "A Credit Crunch"? OECD, Working Paper No. 107 (Paris), 1992; annd the Annex to Chapter IV of the background paper.

 $[\]underline{2}$ / Chapter IV of the background paper SM/92/ , sections 2b, 3a, and 3b examined developments in money and securities markets.

 $[\]underline{3}/$ It is worth noting that much of the decline in Japanese equity prices and real estate values represents a return to more normal, historical relationships.

Volume in this market fell by an unprecedented \$190 billion in the first three quarters of 1991 (apparently largely reflecting the retrenchment of Japanese banks). It is of some concern because it could compromise liquidity in the international banking system and cause difficulties for banks facing short-term liquidity needs.

Looking ahead, since the Accord focused almost exclusively on credit risk, the <u>Basle Committee is broadening its coverage to include "market risks."</u> Three types of risk, in particular, are being considered: foreign exchange risk, interest rate risk, and position risk in traded equity securities. <u>1</u>/ Banks' exposure to such risk has increased in recent years as interest rates and capital controls were liberalized and as permissible banking activities were expanded. Of the three types of market risk, proposals for the treatment of <u>foreign exchange risk</u> are the most advanced.

Capital regulations for securities firms aim to ensure that market mechanisms, including clearance and settlement systems, can withstand periods of extreme market volatility or the failure of a large institution. In this regard, these regulations have goals similar to those for bank capital standards. However, key differences in the core businesses of securities firms and banks have, in the past, led to fundamentally different approaches to the setting of capital standards.

A first time meeting between the Technical Committee of the International Organization of Securities Commissions (IOSCO) and the Basle Committee of Bank Supervisors was held in January 1992 to consider proposed minimum capital rules for internationally active banks and securities firms. Preliminary understandings were achieved on several fundamental issues. First, a" building block" methodology (that is, a methodology that separates credit risk from market risk, as distinct from the earlier "comprehensive" method of capturing the two types of risk in a single weight) would be used to establish capital standards for traded debt securities. Second, the building block methodology would also be used for traded equity securities. Those securities supervisors that have long successfully applied the comprehensive methodology, however, could continue to due so. Any supervisors using the comprehensive approach would undertake to show that its application yielded capital requirements that were consistently equal to, or greater than, the capital that would be required under the building block approach. Third, progress was made in reaching mutually acceptable definitions of capital, particularly with regard to subordinated debt.

^{1/} Regarding position risk in traded equities, the Committee's aims are twofold. The first goal is to overcome a shortcoming of the current capital framework which does not distinguish between the risk in a single equity and the risk of a broad market movement, while the second is to achieve convergence with securities regulators, limiting thereby any competitive inequalities created by the capital requirements.

3. The effectiveness of the accord in reducing systemic risk

Although efforts to strengthen the capital base of wholesale banks have undoubtedly curbed the on-balance sheet lending of these banks, the overall reduction in systemic risk has been blunted by the risks associated with an expansion in off-balance sheet activity in derivatives and in other transactions that result in contingent claims on the banking system.

Capital requirements act as a constrainst on certain activities of banks; as such, it is perhaps not surprising that they have induced banks to move into activities that are less constrained. Recent attempts to apply capital requirements to off-balance sheet activities have elicited another response: the growing use of "netting" of off-balance sheet positions--most prominently in the banks' swap books--so as to reduce the base against which capital requirements are figured. Because of these substitutions among different activities, the incidence of the Accord is not as clear as first thought; for example, it may well have had a greater impact on the regional and retail banks than on large, wholesale banks.

In the end, it is difficult to map out the desired evolution of capital standards without taking a view on the desired size of the wholesale banking system itself. For example, rigorous application of capital standards to the off-balance sheet activities of wholesale banks, particularly to netting arrangements, may well cause such business to migrate onto the organized futures exchanges, depriving banks of what is easily their most important source of fee income. Although this would undoubtedly reduce systemic risk, it would also lead to a smaller wholesale banking system. But the degrees of freedom are limited: any desire on the part of the authorities to maintain a banking sector that is beyond its optimal size will require some form of subsidy, either via implicit guarantees or via occasional liquidity support by the central bank.

The ability of the Accord to produce a level playing field is limited by the <u>differences that still exist in national financial safety nets and in accounting procedures.</u> Differences across countries in deposit insurance and in implicit liquidity and solvency guarantees, imply that the cost of capital to banks remains unequal countries. Differences in accounting procedures make it more difficult to determine true (as oppossed to measured) differences in capital across countries.

IV. Ensuring the Integrity of Financial Markets

Whatever the advances in technology and in the range of services available to participants, financial markets cannot be said to have evolved to a higher plane unless the integrity of those markets -- that is, the protection afforded to investors -- is maintained. Unfortunately, 1991 might be remembered as much as "the year of the scandals" as for more salutory developments in financial markets. Without any attempt to be comprehensive, there was the closure in July 1991 of Bank of Credit and Commerce International (BCCI); the admission in June 1991 of a number of Japanese securities firms to paying loss compensation to favored investors (primarily large institutions); the allegations in June and August, 1991 of insider trading on the Frankfurt Stock Exchange at two large German banks; and the admission by Salomon Brothers in August 1991 of violating rules governing auctions of U.S. Treasury securities. What policy issues are raised by these scandals? Is there a common thread running through them? What policy actions have been taken in their wake to minimize the chances of a recurrence?

1. Supervision of banks' foreign establishments

The internationalization of financial markets is posing a particularly serious challenge for supervisors since it undermines the ability of domestic jurisdictions to enforce domestic regulations in domestic markets. The event that has served most to focus attention on gaps in the supervision of banks' foreign establishment was the closure of BCCI in July 1991. It is worth noting at the outset that although the bank was active in 70 countries and had a reported balance sheet of some \$20 billion, BCCI's closure had a minimal systemic impact on the international banking system. 1/

BCCI had successfully avoided being under consolidated home country supervision. Its parent holding company was chartered and nominally headquartered in Luxembourg, but its London offices served as operational headquarters. Much of its activities were channeled through its two largest banking subsidiaries--chartered in Luxembourg and the Cayman Islands. Since under Luxembourg law, holding companies are not subject to supervision, BCCI was able to avoid being responsible to a single supervisory authority because of its complex corporate structure.

An early agreement among G-10 authorities, working through the Basle Committee on Banking Supervision--the Basle Concordat of 1975--had assigned the responsibility for supervising the solvency of foreign branches to the home country, while the host country would supervise foreign subsidiaries and joint ventures, and parent authorities were to take account of their domestic banks' exposure to foreign enterprises. A later supplement to the Concordat outlined the information needs of both parent and host authorities

 $[\]underline{1}$ / BCCI's credit rating and general reputation among wholesale banks was such that it was pretty much excluded from the interbank market.

and urged the establishment of contacts when authorization is given to open a foreign establishment. However, the adequate exchange of information between home and host regulatory authority proved to be difficult to implement, in part because of bank secrecy laws.

The BCCI closure highlighted a key unresolved issue--how to supervise banks' foreign operations when there is inadequate home country supervision. While the importance given in the Concordat to comprehensive consolidation techniques and to adequate exchange of information between home and host regulatory authorities remains beyond dispute, the limited effectiveness in the BCCI case has induced deliberations and policy adaptations to strengthen the supervision and regulation of international banks.

Two approaches have been formulated so far. The first includes measures by host countries to impose sanctions on home countries that do not adequately supervise their banks. For example, the European Community is exploring a scheme that would give a stronger incentive for home countries in the European Community to supervise their banks' foreign operations by requiring that any insured EC deposit losses, including those incurred in foreign branches, be paid by the home country.

Another variant of this approach has been taken by the U.S. Congress, which passed legislation in November 1991 that bars any bank from operating in the United States that is not subject to firm, consolidated home country supervision, including foreign banks that have already obtained U.S. charters. The new law also gives the Federal Reserve Board broad powers to supervise both state--and federally--chartered foreign banks and requires that foreign banks conduct retail operations through separately capitalized subsidiaries rather than branches. While the U.S. measures will tend to reduce the value of bank charters in lightly regulated jurisdictions, they represent a step away from the home country principle of the Basle Concordat toward a host country rule. This, in turn, has raised legitimate concerns that reversion to a host-country orientation for bank supervision might, if widely adopted, utimately prove to be inconsistent with maintaining progress toward liberalization in financial services.

The second approach relies on the international harmonization of banking regulations and the creation of a means to enforce them. A recent Group of Thirty report explored the merits of this approach, suggesting that bank supervision should be placed in the hands of a single international forum. 1/ The main benefit from harmonization is a reduction in market distortions created by differences in regulatory regimes. However, a lack of consensus among the major industrial countries regarding the permissible activities of banks, inter alia, poses a significant obstacle to international harmonization and enforcement.

^{1/} S.J. Key and H.S. Scott, <u>International Trade in Banking Services: A Conceptual Framework</u>, G-30 Occasional Papers No. 35 (Washington: Group of Thirty, 1991).

2. Manipulation of securities markets

The scandals have also focused attention on the problem of market manipulation and fraud.

In Japan, the four large securities firms and 13 second tier firms acknowledged paying compensation for trading losses to 608 corporations and nine individual investors, totaling about ¥172 billion during 1987-1990. 1/ The payments, which were not illegal under Japanese law, were justified by market participants as an important part of the long-run relationship between the securities firms and their clients given the fixed brokerage commission system. 2/ The loss compensation episode in Japan has increased pressure both to introduce greater competition into the securities market (so as to reduce the dominance of the four largest securities houses) and to give greater weight to "consumer" (as opposed to "producer") interests. As noted earlier, reforms to ease market entry into the securities business for banking institutions (and for foreign securities firms) are seen by the authorities as facilitating these objectives.

In September 1991, the Provisional Council for the Promotion of Administrative Reform, a blue-ribbon commission, recommended to the Prime Minister the establishment of a semi-independent agency to oversee Japan's financial markets. The new agency would have the power to investigate alleged securities market abuses. However, the imposition of any disciplinary measures would be at the discretion of the Ministry of Finance. In addition, the Ministry of Finance intends to strengthen the "transparency" of financial regulations by seeking to have the Diet amend the Securities and Exchange Law to prohibit loss compensation and discretionary-account contracts, by converting administrative guidance into laws or rules of self-regulatory organizations, and by making penalties for rule violations more stringent.

Allegations of <u>insider trading</u> on the Frankfurt Stock Exchange by traders at two large German banks emerged in June and August, 1991. Insider trading, while not illegal under German law, does breach voluntary market codes. Prior to 1991, the most recent finding of insider trading on the Frankfurt Stock exchange was in 1986. To comply with an EC Directive, insider trading is to become illegal in Germany by the middle of 1992. 3/An unresolved issue, however, is what authority will be responsible for enforcing the law and for oversight of the securities markets more generally. At present, the Länder oversee the fragmented system of regional stock exchanges in Germany. As in Japan, the German Ministry of Finance is

^{1/} H. Tomomatsu and Y. Idei, "Securities Watchdog: Hunter or House Pet?" The Nikkei Weekly, August 10, 1991, p. 1.

 $[\]underline{2}$ / The Ministry of Finance (MOF) has since issued an administrative guidance to prevent firms from paying loss compensation.

^{3/} Council Directive 89/592/EEC (Official Journal of the European Communities, November 18, 1989).

considering the creation of a centralized SEC type of securities markets regulator. The relative success of the SEC in policing the securities market would appear to make it a good model for the supervision of the emerging securities markets in both Japan and Germany.

In August 1991, Salomon Brothers admitted to violating on three separate occasions rules governing U.S. Treasury securities auctions that prohibit individual bidders from purchasing more than 35 percent of the Treasury securities in a single auction. Salomon Brothers took these large positions with the intent of implementing a corner and short squeeze. By controlling the bulk of an auction and by gradually reversing that position in either the cash or repurchase market, the securities firms could induce investors that were short in the when-issued market to bid up the secondary market price of the new securities to meet their maturing obligations. Salomon Brothers would then sell or lend the new securities at advantageous yields.

As a preliminary response, the U.S. Treasury Department in November 1991 implemented new rules aimed at creating fairer auctions. First, all broker dealers may bid without posting a deposit or guarantee, a privilege that primary dealers alone enjoyed before. Second, investors may purchase up to \$5 million of each auction through "noncompetitive" bids, which do not vie directly with those of large dealers. Previously, these bids were limited to \$1 million.

The above measures, while necessary to promote greater competition in the primary market, would not have been sufficient to promote fairer auctions and to reduce the incentive for cornering the new issues market. The more difficult issue of how best to auction government securities remained to be tackled, since the favored position of the primary dealers was created not only by certain privileges but also by the type of auction used by the Treasury. The current practice is to solicit sealed bids and to award the securities at and above the price at which the auction is completely subscribed. Thus, each investor has an incentive to shade his or her bid toward the market consensus rather than to tender an offer at his or her reservation price. In such an auction, knowledge about the distribution of bids is at a premium, so potential bidders willingly turn to experts-the primary dealers--rather than place bids directly. This concentration of orders also makes cornering the market relatively inexpensive for a large dealer.

The Treasury Department, Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System completed in January 1991 a joint study of reforms in the auction of government securities. $\underline{1}/$ The

^{1/} Department of the Treasury, Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System, <u>Joint Report on the Government Securities Market</u> (Washington: Government Printing Office, January 1992).

report addressed a broad range of government securities market issues, including measures to combat short squeezes and changes to Treasury auction procedures. The report recommended that the Treasury be prepared to provide the market with additional supply of any security that is the subject of an acute, protracted shortage, regardless of the reason for the shortage. The possible reopening of issues would greatly reduce the potential for short squeezes. The reopenings could occur either through standard auctions, through a "tap" issue whereby the Treasury offers the securities to the market on a continuous basis, or through securities with the Federal Reserve acting as the agent. 1/

The desire to strengthen the integrity of markets also underlies the discussion of transparency and concentration vs. liquidity in markets taking place in the context of the proposed EC Investment Services Directive. Transparency means that information on security trades and prices are made available as soon as technologically feasible. One view (held by the socalled "Club Med" group, which comprises France, Spain, Italy, and Belgium) is that trading in securities should be conducted on recognized exchanges, subject to the aforementioned transparency and concentration requirements. Its adherents are concerned about the significant share of trading taking place off-exchange in London (on SEAQ International), where transparency and concentration are not required. They argue that lack of transparency damages the integrity of markets and leads to an inferior price discovery process. The opposing view (held by the so-called "North Sea" group, comprising the United Kingdom, Germany, and the Netherlands) emphasizes that transparency requirements reduce liquidity in the market because market makers will be unwilling to trade large blocks of securities in open view of their competitors. They also argue that restricting trading to recognized exchanges is more costly because it would split European securities markets into small local exchanges. They also do not want to burden securities firms with establishing a locally capitalized subsidiary in every market. Germany, in particular, insists that its universal banks be granted access to security markets on the same terms as security subsidiaries from countries with bank-holding companies. There are signs that a compromise is in the offing. This might take the form of an "opting-out clause" that would permit an investor to choose not to have his trade conducted on a recognized exchange, thus leaving open the possibility that wholesale trades continue to be conducted off-exchange.

^{1/} Though such discretionary action should go a long way toward preventing negative-sum games of price manipulation, they do have at least one shortcoming. Intervention will be triggered by upward price jumps -whether or not these jumps are attributable to corner attempts. Since the policy will inevitably cut out some of the upside, competitively-generated bond price movements, auction participants may well have an incentive to bid low (since bearish players now need have less fear of either a squeeze or other yield-lowering events).

Is there a common thread in the recent scandles?

The short answer is "no." Neither officials nor market participants were able to find a common factor that would explain the scandles that came to the surface last year. Some participants felt that the greater competitive pressures in the industry, along with the prospect of a further shake-out, had increased the incentives for "double or nothing" behavior, including engaging in illegal activity. It is, however, difficult to explain why such pressures would have produced scandals in these cases and not in others, as well as to seperate the influence of these broader factors from that of plain, idiosyncratic fraud; moreover, some of the scandals represented longer-standing practices that had, perhaps by coincidence, been publicized simultaneously in several countries. None of this of course alters the conclusion that ensuring integrity in financial markets is a first order objective that calls for clear regulations, for strong codes of conduct, and for continuous monitoring of those laws and codes to ensure that they are being observed.

VI. Developing Country Access to International Markets

The retrenchment of bank lending activity relative to other financial operations that was highlighted earlier is also evident in the pattern of developing-country financing. Thus, with the notable exception of flows to some Middle Eastern oil producers and Asian countries, the banking sector in the major industrial countries has remained reluctant to extend loans to developing countries, especially those with recent debt servicing problems. 1/ In contrast, some of those countries have been able to restore access to international bond and equity markets. 2/

Banks' reluctance to extend credits to developing countries reflects primarily their difficult balance sheet situation, as discussed earlier. It has also been influenced in some cases by regulatory factors, including risk-weights under the Basle Accord and regulatory provisioning requirements. Under the Basle Accord, loans to developing countries (except Saudi Arabia, Turkey, and Yugoslavia) carry a 100 percent risk factor in the determination of the capital-asset ratio; other sovereign loans carry a zero risk factor. In certain circumstances--particularly where capital constraints are binding and the cost of raising incremental capital is not fully compensated by higher spreads--this can discourage lending to developing countries. Similarly, the cost of lending increases as a result of regulations that require banks to establish loan-loss provisions against

¹/ Consolidated data on the changes in banks' cross border claims on developing countries are provided in the May quarterly report on international banking activity, SM/92/-- (5/--/92).

²/ Further information is contained in the background paper, SM/92/--(5/--/92).

exposure to developing countries with recent debt servicing problems. $\underline{1}/$ While these regulatory factors result from genuine prudential considerations, they would tend to lead to undue credit rationing if they do not adjust in a timely fashion to reflect sustained improvements in developing countries' debt servicing capacity.

In contrast to bank lending, there has been a significant increase in bond financing and equity flows to developing countries. This reflects primarily the restoration of market access by countries with recent debt servicing problems. Bond issues by the five re-entrants--Argentina, Brazil, Chile, Mexico and Venezuela -- more than doubled to US\$6 billion in 1991, and continued at a heavy pace in 1992 (Table 3). 2/ The higher volume has been accompanied by improved market terms, with significant reduction in the spreads relative to "risk-free" bond placements. Some re-entrants have also gained access to international equity markets, with Mexico raising some US\$3 1/2 billion in the last 2 years through equity offerings in industrial countries. Indeed, the enthusiastic response of international capital markets in 1991-92--in terms of both volumes and country borrowers-emphasizes the importance of borrowers sustaining adjustment and reform efforts that contribute to a lasting improvement in their economic and financial situation. This is the critical factor for minimizing the risks of renewed disruptions to voluntary market access--disruptions that would also adversely affect the on-going process of repatriation of flight capital and foreign direct investment inflows.

The restoration of access to capital markets by some developing countries has also been accompanied by an expansion in the international investor base. In particular, while the greatest demand for developing country bond issues continues to emanate from the U.S. and German markets, there are indications of growing interest on the part of the Spanish and U.K. markets. Nevertheless, there remains marked differences among industrial country markets in the appetite of institutional and retail investors. Such differences reflect primarily overall portfolio considerations and the availability of information on borrowers' debt servicing prospects; they are also influenced by regulatory differences. Thus, the largest investor interest for developing country bond issues has come from markets with an established tradition for placement of non-investment grade yield corporate bonds (also known as "junk bonds"), in the context of readily available credit-rating analyses. Such analyses have

^{1/} It may be noted that, in some cases, market-induced provisioning level are above the regulatory requirements.

^{2/} The figures quoted in the text are based on issues reported in the International Financing Review, the Financial Times, and Euroweek. Estimates are somwhat higher than those reported by the OECD and reported in Table 3, which do not include private placements or medium-term note programs. Factors contributing to the re-entry process are discussed in M. El-Erian, "Restoration of Access to Voluntary Capital Market Financing," Staff Papers, March 1992.

Table 3. Developing Countries Access to Voluntary Financing, 1989-91 1/

(In billions of U.S. dollars)

	International Bond Issues by Developing Countries 2/			International Bank Credit Commitments 3/		
	1989	1990	1991	1989	1990	1991
Developing countries	5.8	6.6	10.7	20.2	20.6	28.0
Capital importing developing countries	5.8	6.6	10.7	18.8	20.6	18.0
Africa	0.2		0.3	0.5	0.6	0.4
Asia	2.2	3.1	3.6	8.9	12.0	13.4
Europe	3.4	2.3	2.2	4.1	4.9	1.7
Middle East		7.0	4	0.7	0.1	
Western Hemisphere	<u>:</u> :	1.2	4.6	4.6	3.0	2.5

Sources: Organization for Economic Co-operation and Development, <u>Financial Statistics Monthly</u>; and IMF staff estimates.

^{1/} Excludes offshore banking centers.

^{2/} Foreign bonds and Eurobonds.

³/ OECD data on developing countries have been adjusted to include new money commitments under bank agreements in principle.

been provided by long-established credit rating agencies or, as discussed earlier, universal banks whose widespread retail networks provide for low-cost access to retail investors. As a result, developing countries have been able to target specific segments of investors' diversified portfolios, supported by "market-credible" information regarding borrowers' creditworthiness. The process has been reinforced by regulatory actions-particularly in the United States, Japan and Switzerland--seeking to relax quantitative restrictions (in the form of modifications to regulations concerning floor credit ratings) and to lower the cost associated with accounting and disclosure requirements. 1/

The change in banks' developing country activities is also evident in trends in the secondary market for bank claims. Thus, in contrast to the retrenchment in primary lending activity, there are increasing indications of greater bank involvement in the secondary market. Initially, this reflected banks' efforts to rationalize their loan portfolios. In the recent past, however, increased emphasis has been placed on trading book operations, per se. This, combined with the expansion in the market participant base to institutional investors, contributed to a further surge in trading volume in 1991 (to an estimated US\$200 billion), concurrent with increasing efforts to improve the transparency and liquidity of the market through standardization of documents and trading practices. There has also been a marked increase in the product range, particularly with regards to derivative products. With the significant evolution of the market, financial authorities are likely to devote increasing attention to the adequacy of the regulatory and supervisory structure which, to date, is based essentially on self-regulatory mechanisms at the individual firm level, re-enforced by the activities of a traders' association.

VI. Conclusions

Liberalisation and technological advances have unleashed powerful competitive forces that are now transforming the financial systems of the major industrial countries. Although this development is further advanced in some countries than in others, none are immune. In many ways this transformation of the financial service industry resembles the restructuring that has already occurred in some other sectors (such as in the steel and airline industries). But the financial sector is different from other sectors: it allocates increasingly scarce capital to competing uses, it prices the risk of alternative financing instruments, and it facilitates the payments that make trade and exchange possible. Furthermore, unlike any other industry, a failure in the financial system of a major industrial country that went unchecked by direct and immediate public sector intervention could exert an instantaneous and powerful detrimental effect on the performance of the global economy. For these reasons, the formulation

^{1/} Further discussion is provided in the background paper, SM/--/-- (5/--/92).

and the implementation of a sound, internationally-consistent financial policy -- encompassing both the supervisory and regulatory framework, and the design of the financial safety net -- poses no less a challenge for public policy than does the design and implementation of appropriate macroeconomic policies.

In this report, particular attention has been focused on one of the main elements -- indeed, probably the key element--of the ongoing restructuring of the financial service industry, namely, the retrenchment in major banking systems and the corresponding growth of securitized money and capital markets. One important task is to "manage" the elimination of excess capacity in the wholesale banking industry in a manner that both maintains the safety and efficiency of the payments mechanism and avoids incurring a large public-sector liability. Another one is to meet the need in an increasingly securitized, bank disintermediated, financial sector for uninterrupted availability of liquidity, while both still implementing a medium-term noninflationary stance of monetary policy and discouraging excessive risk-taking by recipients of short-term liquidity support.

Public policy should avoid distorting competition between non-bank suppliers of financial services and the banking system. In particular, it should not provide a cradle-to-grave safety net for the latter. The US savings and loan crisis serves as a reminder that deregulation in an environment without market discipline but with an extensive safety net can have very severe fiscal implications. While the special nature of banks in providing liquidity and payments services must be safeguarded, efforts by banks to offset declines in their traditional lines of business by engaging in higher risk - higher return activities (including off-balance sheet activities) and by leveraging their access to the safety net, need to be carefully monitored and evaluated. Policy reforms that remove some of the geographic and product restrictions now faced by banks may improve somewhat banks' competitive position vis-a-vis non-banks but are likely to provide a significant boost to banks' franchise value only if there are strong complementarities between existing and new activities.

It is still an open question what structure of financial markets will yield the best combination of efficiency and stability. As markets have become more competitive, more securitized, and more liquid, they have generated significant increases in efficiency. In any case, in a liberalized global environment, there is not much prospect of keeping individuals and firms away from innovations that have the potential to reduce the cost of capital, to increase the return to saving, and to expand the range of hedging possibilities. Nevertheless, these more "sophisticated" markets also appear to be more susceptible to liquidity strains and crises and to failures of financial firms than more bank-intermediated financial structures; in short, the former may well be less stable.

The Basle capital standards have been an important instrument in forcing more discipline into the banking markets. 1/ They have induced banks to give more careful attention to the appropriate pricing of risks for different activities and to the need to hold adequate capital against these risks. They probably have had some impact at the margin (particularly in Japan where unprecedented declines in equity prices and real estate values have added to banks' adjustment problem) in decreasing the supply, and increasing the cost, of bank credit; but these shorter-term difficulties are outweighed by the longer-term benefits for the soundness of banking practice. As regards systemic risk, the favorable effect of Basle standards has been blunted by the expansion into off-balance sheet activities which are not covered by the Accord but which nevertheless result in a contingent claim on the banking system. These off-balance sheet activities could of course be brought under the aegis of the standards but probably only at the cost of driving much of this business (particularly the swap business) to the organized futures exchanges, and of reducing the size of the banking industry itself. This may argue for a gradual incorporation of off-balance sheet activities into the Accord.

The past year has also witnessed a spate of scandals in financial markets. These should serve to remind us that the supervisory and regulatory framework must remain strong and evolve along with the evolution of markets themselves if the integrity of those markets--which is a sine qua non for their long-term development--is to be preserved. There is little evidence to indicate that the scandals had a common underlying cause. The policy measures that have taken by authorities in the wake of the scandals are clearly positive and should go a long way toward preventing recurrences. In the end, of course, it is not possible to eliminate fraud--only to make it more difficult for fraud to go undetected.

A final notable development of the past year has been the intensification of the restoration of access to international capital markets by developing countries with recent debt-servicing problems. This is evident in the higher mobilization of financing from bond and equity markets, the improvement in terms, and the broadening of the borrower and investor base. Further consolidation of this process, including its positive externality effects on other private capital inflows (viz., capital repatriation and foreign direct investment), will depend on prudent debt managment by developing country borrowers in the context of sustained adjustment and reform efforts. In contrast to bond and equity markets, international banks have remained reluctant to engage in significant lending

^{1/} There is an important, broader issue running through many of the policy questions taken up in this paper: it is how the responsibility for bringing "discipline" to financial markets and to governments and firms ought to be allocated as between the markets on the one hand, and official regulations and intervention on the other. For an analysis of the conditions necessary for "market discipline" to be effective, see the background paper, T. Lane, "Market Discipline," WP/92/--.

to developing countries with recent debt-servicing problems. While this primarily reflects their difficult balance-sheet situation, close monitoring of the regulatory structure is warranted to ensusre that developing-country financing is not inadvertently constrained by regulations that do not adjust in a timely manner to sustained improvement in countries' debt-servicing capacity.