ECO CAPITAL MARKETS/FLOWS
1997 ~~Correspondence~~ (~~May-June~~)

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Eco - Capital Markets

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Office Memorandum

To: Mr. Mussa

December 31, 1997

From: Peter S. Heller

Subject: **Draft Paper—Hedge Funds and Financial Market Dynamics**

This is a clear, nicely written paper that provides a useful introduction to an unfamiliar topic. The main conclusion of the paper—that hedge funds were more influential during the 1992 ERM crisis than during the 1997 Asian crisis—is a fairly convincing one, although it could be strengthened by the inclusion of data on hedge funds' forward sales of Asian currencies in addition to Baht, even if they are imprecise. The cautious approach to additional regulation of hedge funds is also appropriate. However, the paper could be clearer in presenting the staff position on reporting requirements. There would seem to be a case—from a transparency perspective at least—for arguing that U.S.- type requirements should be introduced on a global basis.

cc: Mr. Boorman, Mr. Calamitsis, Ms. Carson, Mr. Chabrier, Mr. Deppler, Mr. Guitián, Mr. Loser, Mr. Munzberg, Mr. Neiss, Mr. Odling-Smee, Mr. Saito, and Mr. Williams.

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Office Memorandum

To: Mr. Mussa December 31, 1997

From: Dhruba Gupta

Subject: **Draft Paper on Hedge Funds and Financial Market Dynamics**

Thank you for providing us with the opportunity of commenting on the above-mentioned paper. The paper provides a useful review of issues related to the role of hedge funds in international financial markets. We have the following general and specific comments.

General comments

Page 4, paragraph 5 and page 13, paragraph 40: The characterization of hedge funds as "nimble and quick on their feet" and as "the first investors to take positions against an unsustainable currency peg (or other asset prices)" begs the question of why or how hedge funds can respond to market signals more quickly than other types of investors. In fact, in some other parts of the paper the authors go to considerable length in explaining the contrary position in describing the size of the hedge funds. For example, it is noted in paragraph 98 that compared to international banks, hedge funds have less staff on the ground, and the smaller the economy, the less likely they are to devote their limited analytical resources to investment opportunities in its market. Also, in paragraph 39, hedge funds that operate offshore are shown to be at a disadvantage when there are market restrictions or capital controls that restrict the ability of domestic banks to do business with offshore counter parties, compared with commercial and investment banks which operate both offshore and onshore. In this connection, we would welcome some more explanation on how hedge funds can take large short positions against currencies. The paper correctly points to the ability of hedge funds to use leverage, but it could go further in presenting the wide variety of investment strategies which hedge funds have used, including new derivative instruments.

Page 31, paragraph 102: The conclusion drawn in the staff appraisal that only a minority of hedge funds take positions in emerging markets and that they allocate more than a fraction of their portfolios to those markets only under exceptional circumstances appears to be somewhat stronger than warranted by the preceding discussion. In particular, at the bottom of page 3 the discussion emphasizes the fragmentary nature of information on hedge funds, including the point that hedge funds are not subject to disclosure requirements and reporting of the sort that typically apply to banks and mutual funds, which makes it difficult to construct a comprehensive enumeration of hedge funds, much less to assemble information on their activities. In a similar vein, the discussion on the top of page 9 points out that no reliable estimates exist of the number of hedge funds and the value of hedge fund capital. Also, it is noted that commercial services which report on hedge funds rely on fund managers for information, which would tend to bias upward average returns, as the worst performing managers are least likely to provide information. However, these "biased estimates" and "no reliable estimates exist" in the words of the authors are transformed into referenced "facts" on page 10 when discussing that hedge funds cannot dominate or corner particular markets. Our point is not to question the general thrust of the staff appraisal on the position-taking capacity of hedge funds, which we agree should not be exaggerated, but rather to note the two conflicting points in the paper on the information available on the subject.

Page 34, paragraph 114: The costs of the policies aimed at limiting the ability of hedge funds to short a currency that are described in paragraph 114 could be explored further. Paragraph 116 correctly points to the costs involved in preventing hedge funds from acting as contrarians and paragraph 117 refers to the difficulties related to the shifting of transactions to unregulated or offshore jurisdictions. However, more could be said about why capital and other controls may be counter-productive to the extent that they are seen by market participants as a sign of unwillingness on the part of the authorities to address the underlying problems. It may be worth elaborating that attempts to impose position limits, margin requirements, and other permanent restrictions on trading in specific markets and instruments may restrain the development of domestic financial markets.

Specific comments

The discussion of the domination of particular markets by large investors (such as in paragraph 8) should be linked to Appendix I, which considers the applicability of theoretical models suggesting that large traders such as hedge funds can significantly influence market outcomes. In addition, a discussion of why the domination of particular markets can create serious problems for economic policy making would complete the analysis. Is there any evidence of large investors dominating a market that could be mentioned in the paper?

Page 15, paragraph 50: The paper correctly analyzes institution-based arguments for why hedge funds are less likely than other institutional investors to engage in positive-feedback trading that amplifies market volatility. It would be useful to expand on the limited discussion on the constraints faced by mutual funds, which leaves it unclear whether and to what extent these constraints check portfolio shifts. For example, a mutual funds prospectus may bind it to invest in emerging markets, but that still leaves it with many markets in which to invest and does not prevent it from moving funds out of a particular country.

Market jargon is used throughout the text but the market slang should be explained (in the case of "trigger levels" in paragraph 28; "market move" in paragraph 29; "carry trade" in paragraph 82) or avoided (in the case of "forex" in paragraph 25; "putting on a position" in paragraph 39; "establish a bottom" in paragraph 47; and "in train" in paragraph 48).

Page 10, paragraph 26: The relevance of the analysis in this paragraph for the question of hedge funds and market dynamics is not clear; the statement that "returns to do not come entirely for free" does not add to the analysis.

Page 10, paragraph 27: This paragraph should be expanded or omitted; it is not clear why the long-established hedge funds, but not the newer hedge funds, consider the fees on complex derivatives prohibitive.

Delete "it follows that" in paragraph 29; delete "for all these reasons" in paragraph 30; and delete "this process is ongoing" in paragraph 32.

Pages 5 and 14: "The negative correlation between the positions of hedge funds and the positions of other institutional traders" (paragraph 46) is not particularly surprising if there was a tendency for hedge funds to bet against the market (paragraph 7).

Page 22, paragraph 75: The implicit assumption underlying the argument that the actions of hedge funds served as a signal to other institutional fund managers appears to be that these market participants failed to use the same set of information; however, this assumption seems problematic, given that the crisis was precipitated by textbook problems with fundamentals.

Page 30, paragraph 97: The point that an appreciating U.S. dollar had made the Asian economies less competitive needs to be explained a bit more. For example, it could be pointed out that some of the Asian currencies were linked to the dollar even under managed floating. Please look at the point raised in the last sentence of the paragraph that there was a significant rise in Japanese interest rates in 1997; the data indicate that many Japanese rates were at historic lows, and short term rates (for example, the three-month certificate of deposit rate) were steady through most of the year and rose only in November, well after the onset of the Thai baht crisis.

Page 35, paragraph 120. The second sentence may need reworking: governments (as opposed to investors) offer the irresistible combination of inconsistent policies and unsustainable currency pegs.

cc: Mr. Williams (o/r)
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Mr. Calamitsis
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Office Memorandum

To: Mr. Mussa

December 31, 1997

From: V. Sundararajan

Subject: **Paper on Hedge Funds and Financial Market Dynamics**

1. The paper provides much interesting information on hedge funds, contributes to their demystification, and makes a rather convincing case that these funds do not play a fundamentally different role from other financial actors in international financial markets. Herd behavior is an attribute of financial market participants generally, and instability cannot be traced to hedge funds in particular.

2. Nevertheless, the somewhat sanguine tone toward hedge funds adopted by this paper carries the risk of understating their importance. While the capital of the hedge funds may be small compared to the assets of institutional investors, hedge funds have become big enough that a concerted position against a currency *could* provoke the abandonment of fixed rate policy (even if this was not the case in South East Asia), and generally have a large influence on the foreign exchange markets. As markets in emerging economies deepen further and become more liquid, they are likely to be of more interest to hedge funds (as the paper suggests). It may therefore be worth dedicating more space on the policy constraints that the activities of the hedge funds impose on central banks.

3. One implication of the "second generation" models of currency attacks seems to be that the effectiveness of a speculative attack is related to the impact of the attack on interest rates. As long as institutional investors withdraw from a market in the form of closing down long positions, the impact on short-term interest rates is likely to be lesser than if the attack takes the form of short-selling in the currency market. To the extent that the hedge funds are more likely to operate in this latter way (as the paper seems to suggest), their presence could be associated with more instability.

4. Another issue that the paper could raise in the section on policy options is that of controls on short-term capital flows (such as in Chile), which again are more likely to affect hedge funds. Unlike other forms of capital controls, they are probably less likely to push financial markets offshore.

5. Issues for discussion in Section VII could include a question on whether raising margins and collaterals (see para. 113) would effectively limit the impact of hedge funds on market volatility.

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CCO - Capital markets issues

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Office Memorandum

To: Mr. Mussa

December 31, 1997

From: Reinhard Munzberg

Subject: **Draft Paper—Hedge Funds and Financial Market Dynamics**

The paper provides a comprehensive overview of hedge funds. Sections V and VI, in particular, cover the major issues that have been raised in the Board. There are several important points in those sections, which could be emphasized in an executive summary, or in the introduction. Those points include: hedge funds have not always played a catalytic role in the speculative attacks on currencies—including the most recent Southeast Asian crises—hedge funds do not always engage in herding and, in fact, can be a stabilizing force by taking positions contrary to other market participants, and the best way for policymakers to protect their economies is to avoid offering one-way bets and maintaining indefensible currency pegs.

Given the technical nature of some of the terms used in the paper, it might be useful to have a glossary of financial terms (e.g. haircuts, forwards, futures, short/long positions, carry trade, etcetera).

cc: Mr. Boorman
Mr. Calamitsis
Ms. Carson
Mr. Chabrier
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Mr. Guitián
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Mr. Odling-Smee
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Mr. Williams

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Office Memorandum

To: Mr. Mussa

December 31, 1997 F

From: Carol S. Carson

Subject: **Comments on Draft Paper—Hedge Funds and Financial Market Dynamics**

The draft paper contains a thorough and well-organized review of the hedge fund industry and its role in recent financial crises, as well as a useful staff appraisal of the relevant policy issues. The paper is well researched, given the lack of data reporting by the hedge funds. I have only a few relatively minor comments.

1. Paragraph 13 seems to imply that the macro hedge funds primarily take speculative (unhedged) positions, whereas Paragraph 15 states that some relative value funds specialize in arbitrage. Have the macro hedge funds and some relative value funds basically abandoned the essence of "Jones' insight" on hedging (Paragraph 18)? Are the "arbitrage" activities of relative-value funds (Paragraph 15) truly arbitrage—i.e., risk-free? Is the arbitrage established in a straightforward way or through complicated hedging strategies? The same questions apply to the arbitrage of U.S. Treasury securities, mentioned in Paragraph 29.

2. In paragraph 13, "haircut" is described as the amount of capital needed to establish a position. I think that the generic use of "haircut" is different, or at least broader, than the usage in the draft paper. For example, "haircut" is used in the valuation sense to refer to a discount from the market value of a financial instrument.

3. In paragraph 16, the reference to fractional-reserve banking distracts a bit from the main point: Commercial banks are highly leveraged financial institutions; their liabilities are several times larger than their capital. It would be more conventional to refer to high debt-equity ratios: "... whose liabilities [rather than *assets*] are [a] multiple*s* of their capital" even though the point is the same whether debt-to-equity or assets-to-equity is used.

4. In paragraph 17, we would suggest amending the definition of short selling to "...being able to purchase the security at a lower price in the market at or before the time when it is must be repaid to the security lender." The definition of leverage should be more specific than "... the practice of using borrowed funds." Our suggestion would be: "Financial leverage refers to the level of liabilities (debt) relative to the capital base (equity) in the financial structure of a firm." Alternatively: "Highly financial leveraged firms have high debt-to-equity ratios."

5. In paragraph 28, does "But credit lines being expensive, ..." mean that fees on loan commitments are high or that *borrowing under credit lines* is expensive?

6. In paragraph 31, replace "...a variety of less correlated investments" with "... a variety of investments having returns that are not highly correlated."

7. In paragraph 37, is there alternative terminology for "one-way bets," discussed here and elsewhere in the paper? It seems to be synonymous with "a sure thing." Who takes the other side of these one-way bets?

Contributor:
Randall C. Merris

cc: Mr. Boorman
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Mr. Saito
Mr. Tanzi
Mr. Williams

OCO - Capital Markets

(F)

Office Memorandum

To: Mr. Mussa

December 31, 1997

From: C. Loser

Subject: **Draft Paper—Hedge Funds and Financial Market Dynamics**

We enjoyed reading this interesting paper. Nevertheless, it would be useful to make more explicit the motivation for it. If it is indeed true that hedge funds account for a relatively small share of cross border capital flows, that their activities blur with the activities of other kinds of investors, and that there is little firm empirical evidence that they act as market leaders, why focus specifically on them? The paper would probably benefit by explaining more specifically what motivated its focus, and how it relates to other ongoing or planned work on other segments of international capital markets. The paper could also spell out more clearly how the activities of hedge funds differ from those of other investors. A more detailed explanation of differences among the various categories of funds listed in Tables 1 and 2 and a glossary of key technical terms used in the paper, would help as well.

We feel that the paper may be too strong in its conclusions about the benefits of unfettered liberalization of capital controls and about the limited scope for strengthening supervision of the funds' activities. In particular the paper—perhaps relying too much on the views of regulators and/or of market participants—seems cavalier in endorsing exemption of the funds from improved reporting requirements if they accept investments only from institutional investors, companies or high networth individuals "who can fend for themselves" (paragraph 54). It is unclear that these investors are more likely than other investors to be required to bear the cost of misjudgements by the funds. We would avoid the argument in paragraph 115 that since equity markets are relatively unconstrained currency markets should be unconstrained also. Taken to its extreme, this could be saying that since some markets are unconstrained, all markets should be, but the characteristics of each market need to be assessed in making this kind of determination.

With respect to who invests in hedge funds, it is clear that individual investors have to be well off (although the criteria for qualified investors described in footnotes 6 and 18 do not seem the same). However, the criteria for determining which institutional investors can be involved in hedging activities is not so clear. More specifically, what prevents a group of small investors from pooling their resources to create a hedge fund?

As for the activities of hedge funds that differentiate them from other investors, the paper notes that hedge funds are more active in short selling than other investors, but this is said almost in passing. This point, as well as any other differences in activities, could be brought out more clearly.

The review of hedge funds in recent crises (Section V) should make clear that the authors have revisited the earlier assessments and consider them valid, rather than simply indicating that the analysis is based on earlier work.

Some points of detail:

- it would be helpful to clarify the point on relative value funds at the bottom of page 6;
- in footnote 19, we did not see the explanation of the 35 or fewer nonaccredited investors "explained above";
- table 3 suggests that global and macro hedge funds did well relative to the S&P 500 index only during the period 1991–93; after that they have been trailing the broad market index (paragraph 26 suggests otherwise).
- in table 4, it would be helpful to have a footnote explaining how the risk-adjusted return is calculated. Also,
- how can the global funds have a compounded annual return of 26.2 percent in 1996–97 (what does this time period mean?, table 4), if the return in either year is much less (table 3)?

cc: Mr. Boorman
Mr. Calamitsis
Ms. Carson
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Office Memorandum

To: Mr. Mussa

December 30, 1997

From: Malcolm Knight

Subject: **Draft Paper—Hedge Funds and Financial Market Dynamics**

We enjoyed reading the draft, which presents a useful overview of hedge funds and whether policy makers ought to be concerned about them. We agree with the paper's main conclusion that there does not seem to be a compelling need to strengthen the supervision and regulation of hedge funds beyond the norms applied in the U.S. We also strongly support the recommendation that provision of fuller information on government policies to markets would help to further encourage investors to act on fundamentals. Following are two specific comments:

1. The draft implies (in paragraph 26) that hedge funds are riskier than other investments, noting that the higher returns of hedge funds relative to market indices "do not come entirely for free." However, the remainder of the paragraph and the supporting Table 4 indicate that the monthly standard deviations of returns on most hedge fund categories have been lower than that of the S&P. Moreover, data from VAN Hedge Fund Advisors (not referred to in the draft) indicate that hedge funds have outperformed the DJIA in quarters when the latter has declined. Therefore, some attention may need to be given to squaring these data with the tenets of conventional wisdom.

2. On issues for discussion, I would suggest adding the question whether or not hedge funds have had, on balance, a positive effect on global financial developments as the text seems to suggest.

cc:
Mr. Boorman
Mr. Calamitsis
Mrs. Carson
Mr. Chabrier
Mr. Deppler
Mr. Loser
Mr. Munzberg
Mr. Neiss
Mr. Odling-Smee
Mr. Saito
Mr. Tanzi
Mr. Williams

Contributors: Sami Geadah, Alberto Musalem, Tito Cordella

P:\MAE\REVIEW\1997\GENERAL\HEDGEFUN.ME December 30, 1997 (3:32pm)

CB - Capital Markets - F

Office Memorandum

To: Mr. Folkerts-Landau July 10, 1997

From: Brian C. Stuart BCS

Subject: **Draft Background Material: International Capital Markets Report**

We have general comments on Chapters III and IV of this report, as well as a number of specific comments.

Argentina

- On p. 34, the gain in the main stock market index from end-1995 through May 1997 is 53 percent according to our source, not 46.3 percent as stated in the paper.

- On p. 38, towards the end of the first full paragraph, the reference to the Central Bank of Argentina having arranged a US$6.1 billion *stand-by facility* with international private sector banks should be changed to a US$6.1 billion *Contingent Repo Facility* with international private sector banks. This nomenclature should also be used in footnote 63 on p. 108.

- On p. 80, footnote 7, the word "been" in "were been privatized" should be deleted.

- On p 81, line 4, "Banco Calmest" should be changed to Banco Quilmes; next, we suggest that the reference to BUCCI be rephrased to ..."which had been facing capital adequacy problems" (instead of saying that the bank had failed in December 1996); and in the last sentence of the same paragraph the reference to ", Banco Hypothecary National" should be changed to "(BHN)" or "Banco Hipotecario Nacional."

- In Table 30, our figures indicate a long-term public and publicly guaranteed external debt of US$87.1 billion, not US$62.2 billion.

Brazil

- Page 81, paragraph 2: change "some 35 financial institutions" to "some 30 financial institutions", as reported in the correction of the last RED (SM/97/44, Correction 1).

- Page 110, paragraph 1: eliminate sentence that says: "Moreover, the continuing very high real interest rates have caused the interbank market to dry up." This is simply not correct.

- Page 110, second paragraph,second line: It should read: "There are first, the publicly-owned banks, including the banks owned by the state governments which have in the past ....."

- Page 110, last line: insert "in 1994" following "after a net loss of R$151 million" .

- Page 110, footnote 67: delete "and the province of Buenos Aires"; we do not think that the Argentinean authorities will want to have a reference to this bank in the middle of the discussion on Brazil.

- The discussion on pp. 110-111 is based on data produced by IBCA Ltd. We are not familiar with this source and we hope that RES knows that this is a reputable source given the amount of detail that they provide in the discussion. If this is not the case, *we would suggest strongly that this discussion is shortened drastically.*

- Page 111, para 3: delete the remaining part of the paragraph that starts from "Despite the capital injection..." and ends with "the balance sheet will have to be considered". We are attaching **(Attachment 1)** to this memo figures on non-performing loans, provisions and charge offs provided to us by the Banco do Brazil during the last staff visit. For this reason we feel that it is better to drop this discussion. Also, the last sentence of this paragraph is speculative, at best, and should be dropped.

- Page 113, para. 2, rewrite the second sentence to reflect that the Banco do Estado de Rio de Janeiro was privatized on June 26, 1997, and that it is the first bank controlled by a Brazilian state to be privatized.

Chile

Please see **Attachment 2.**

Mexico

- On p. 19, second paragraph, the average stripped spread level of Brady bonds declined to below the Mexican crisis level as early as mid-1996.

- On p .21, third paragraph, the liquidity of individual Brady bonds is high. Argentina FRB and Brazil C bonds are amongst the most liquid of all traded assets (see **Attachment 3**).

- On p. 22, first paragraph, the reference to Argentina FRB is not consistent with the previous reference to the problem of stripping since FRBs are not collateralized. Yield curves for Brady bonds are normally plotted against spread duration not duration. In June 1997, the difference between Mexico Par and the UMS 5/26 Eurobond was around 100 basis points only, not 210 basis points.

- On p. 23, first paragraph, Eurobonds increasingly replace Brady bonds as country benchmarks. UMS 5/26 is now more liquid than the Mexico Par bond (see **Attachment 3**).

- On p. 27, third paragraph, the peak of Brady bond spreads in March 1995 can mostly be attributed to the "Tequila effect."

- On p. 29, second paragraph, the probability of default can be derived from the spread level at least for the probability of default in the first year. With reference to the Merrill Lynch high yield index, which may include C and BBB rated assets, the discrepancy between the implied probability of default, as derived from the spread level, and the historical probability of default as given by the credit rating may provide an interesting comparison to estimate the "adequacy" of spread levels.

- On p. 115, third paragraph, the paper says that there is a weakness in the composition of capital as much of its recent increase has been in the form of reserves, revaluation and subordinate debt. It is our view that reserves represent an adequate means of recapitalization.

Peru

Please refer to **Attachment 4.**

Venezuela

- In page 14, please note that the bolivar depreciated 62 percent in local currency terms in April 1996 (from Bs 290 per U.S. dollar to Bs 470 per U.S. dollar).

- In page 82, it could be mentioned that Banco Republica was sold to a Colombian–based savings and loan institution and that there remain two nationalized banks to be privatized: Banco Popular and Banco Andino.

- With regard to the banking system in Venezuela (pages 116–17), please note that the financial assistance to banks was formally provided by FOGADE and not by the central bank. Needless to say, FOGADE received credits from the central bank and transfers from the central government. According to our data, official financial assistance during the banking crisis amounted to Bs 1.6 trillion (12.7 percent of 1994 GDP plus 3.9 percent of 1995 GDP). On the other hand, FOGADE would recover an estimated 1.4 percent of GDP through the sale of assets and recovery of credit during 1996—97.

- In page 117, the financial assistance helped to cover losses of the financial system and, therefore, it should not be considered a factor to explain the relative strength attained by Venezuelan banks.

- Finally, in page 117, we would like to note that lending operations to the private sector have increased substantially so far during 1997, leading to changes in the structure of the banking system assets.

On Developments and Trends in the Mature Capital Markets (Chapter III):

- On p. 45, the reference to monetary conditions in industrial countries could be illustrated more clearly by referring to a table/chart with actual estimated monetary conditions indices for each country (as has been done in the WEO), rather than just referring to money supply growth and changes in claims on private sector.[1]

- On pp. 58-59, it would be interesting to make an explicit reference to the narrowing margins in the U.S. syndicated loan market (data are available from Loan Pricing Corporation), in addition to the reference to the weighted-average spreads for OECD countries, particularly since U.S. regulators (as noted, for example, by the U.S. Comptroller of the Currency) have expressed concerns about the narrowing of spreads in the domestic syndicated loan market.[2]

- On p. 62, the assertion that large-scale financial sector liberalization measures may be exerting downward pressure on bank equity prices may need to be qualified. It is unclear how the TOPIX bank index is constructed (and it would be helpful to explain its composition), but an exception to this premise would be Canada. Canadian bank equity prices have outperformed the relatively strong performance of the TSE300 in recent years, even though significant liberalization measures have been recently introduced in Canada.[3]

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[1] See, for example, Chart 8, page 19, in *World Economic Outlook*, IMF, October 1996.

[2] Comptroller of the Currency, *1996 Survey of Credit Underwriting Practices*, National Credit Committee, September 1996.

[3] While Canadian banks performed relatively poorly immediately following the revision of the Bank Act in 1992, which introduced some important financial liberalization measures, this

(continued...)

- In section F (Derivatives Markets) it would be useful to discuss recent developments regarding automated trade execution systems (e.g., Globex).

- In section G (Systemic Risk Management), p. 72, regarding the importance of disclosure policies, it would be interesting to review recent developments in New Zealand as the new system of banking supervision has shifted away from detail rules and monitoring by the Reserve Bank in favor of greatly enhanced public disclosure by financial institutions themselves.

- On p. 73, it would be useful to broaden the explanation of what are these "Generally Accepted Risk Practices" developed by one U.S. accounting firm.

Developments in International Banking (Chapter IV)

- On p. 75, it would be helpful to broaden the explanation of how Moody's Bank Financial Strength Rating is constructed.

- On p. 78, Canadian banks were allowed to own securities dealers subsidiaries in 1987 (not 1992). With the revision of the Bank Act in 1992, financial institutions were allowed to offer most other financial services (though some restrictions still remain, such as banks are not permitted to distribute insurance products through their bank branches). Thus, for example, since 1992 banks are allowed to own trust companies and insurance firms.

- On p. 78, the reference that since the end of Q1-1996 there has been relatively little activity regarding Canadian banks acquiring other international banks could be usefully deleted. Recent reports suggest that Canadian banks continue to be interested in extending their international acquisitions and joint ventures (indeed, as it is noted on p. 81, Bank of Nova Scotia took control of a Chilean bank in May 1997).

- On p. 80, the reference that "among the Asian emerging markets, the absence of crisis atmosphere in most countries has prevented a sense of urgency about the need for restructuring from emerging..." would probably need to be modified in light of recent developments in Thailand's financial sector.

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[3](...continued)
coincided with a period of protracted cyclical weakness in economic activity. Since the economy began to recover in early 1996, bank equity prices have soared.

- On p. 81, fn. 11, Bank of Nova Scotia took a larger stake in Inverlat in 1996. Bank of Nova Scotia already had a relatively small stake (less than 10 percent) in Inverlat following the introduction of NAFTA in 1992.

- On p. 84, it is not clear what measures are referred to in regard increased powers of U.S. banks to sell insurance; fn. 15 on Section 20 Subsidiaries of U.S. banks refers to increased powers of U.S. banks to engage in securities activities.

- On p. 89, it should be noted that Canadian banks (like U.S. banks) are increasingly generating earnings from non-interest income; thus, earnings have been rising even though interest margins have declined.

- On p. 90, not only the U.S. banks' quality of consumer lending has been a source of concern, but also the increased risks in the domestic syndicated loan market (as noted, for example, by the U.S. Comptroller of the Currency).

- On p. 115, fn. 80, it is not clear why Mexican banks with a higher share of mortgage loans would be expected to have a lower level of nonperforming loans. It is the case that mortgage loans, as well as a variety of credit card and consumer loans, were restructured through different government programs during 1995-96 to improve the credit quality of those loans. However, most observers agree that mortgage loans (many of which were extended during the early 1990s when there was arguably a real estate asset bubble in Mexico, and in light of considerably pent-up demand for loans that had virtually disappeared in the previous decade) have constituted a fairly risky class of loans.[4]

Appendixes to Chapter III

Appendix I: As written, paragraph 3 (on option pricing) could be misinterpreted to mean that option prices are conditioned on options being in-the-money today ("assuming that it does lie somewhere above the strike price.") Perhaps this could be rephrased "will lie.." or "above the strike price at expiry."

Appendix II: In paragraph 5, it is unclear why the relatively high level of bond-yield volatility is "disappointing." It seems from the preceding text that it has followed from (favorable) surprises on the inflation front and increased uncertainty about the course of monetary policy.

Appendix III:

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[4] For some evidence on this issue, see Brenda González-Hermosillo, Ceyla Pazarbasioglu and Robert Billings, "Banking System Fragility: Likelihood Versus Timing of Failure--An Application to the Mexican Financial Crisis", IMF Working Paper WP/96/142, December 1996 (forthcoming, *IMF Staff Papers*).

- Appendix II suggests that the high level of U.S. stock prices could be the result of low risk (and hence a low risk premium): perhaps this would merit a mention in the last paragraph.

- Figure in paragraph 2 ("[X]") and charts are missing; also "trend less" should be one word.

Appendix IV: In the United States, some of the shift in household saving to the stock market reflects demographics, though how much is unclear ("Deposits and Demographics?", *Federal Reserve Bank of San Francisco Economic Letter* 97-19, June 27, 1997).

Appendix V: It might be useful to cite some of the empirical evidence that circuit breakers can increase volatility (Lauterbach and Ben-Zion, *Journal of Finance* December 1993, and Lee, Ready and Seguin, *Journal of Finance* March 1994).

Attachments

ATTACHMENT 1

PROGRAM CIRCULAR
PART B

SUPERSEDING THE PROGRAM CIRCULAR DATED OCTOBER 7, 1994,
THE SUPPLEMENTAL PROGRAM CIRCULAR DATED OCTOBER 28, 1994
AND THE SUPPLEMENTAL PROGRAM CIRCULAR DATED DECEMBER 7, 1994

BANCO DO BRASIL

Banco do Brasil S.A.

(Incorporated in the Federative Republic of Brazil with limited liability)

U.S.$1,000,000,000

Global Medium-Term Note Program

Business Description of Banco do Brasil S.A.

The date of this Program Circular is June 9, 1997.

The effect of this new policy is apparent from the following table which shows the total non-performing Brazilian currency loans of the Bank recorded in credit operations and other credits (excluding leasing), broken down into those which are in arrears and in default, the percentage of provisions and the percentage of loan losses, in each case at December 31 for each of the three years ended December 31, 1996. Loans include all Brazilian currency rural, industrial, commercial and service sector loans, inter-bank loans, repassed loans and export financing.

	December 31,		
	1996	*1995*	*1994*
	in thousands of reais, except percentages		
Bank loans, gross(1)	47,353,136	53,557,074	59,138,897
Total performing loans (Credit Operations)	26,310,079	35,289,099	42,112,062
Private sector	24,304,607	30,449,201	28,372,425
Public sector	2,005,472	4,839,898	13,739,637
Other Credits	14,593,692	11,349,291	10,341,706
Specific credits	6,114,342	59,302	59,915
Other	8,479,350	11,289,989	10,281,791
Leasing Operations	206,150	222,954	382,357
Total non-performing loans	6,243,215	6,695,730	6,302,772
Loans in arrears	980,594	2,885,639	5,650,533
Private sector	980,463	2,845,167	2,685,810
Public sector	131	40,472	2,964,723
Loans in default(2)	5,262,621	3,810,091	652,239
Provisions(3)	(7,048,945)	(5,118,483)	(1,886,128)
As a percentage of total Bank loans	14.9%	9.6%	3.2%
As a percentage of total non-performing loans	112.9%	76.4%	29.9%
As a percentage of total Loans in default	133.9%	134.3%	289.2%
Charge offs	3,183,698	1,036,854	1,453,817
As a percentage of total loans	6.6%	1.9%	2.5%
As a percentage of total non-performing loans	51.0%	15.5%	23.1%
Recoveries	199,766	80,540	274,044

Notes:

(1) Includes credit operations, leasing transactions and other credits.

(2) Includes loans in default related to the line item "other credits".

(3) Includes provisions against credit operations, leasing transactions and other credits.

banks that merge with or acquire all or part of another bank.[73] Funding through PROER has been used on a number of occasions (most notably in the cases of Banco Economico, Banco Nacional, Banco Mercantil, Banorte, Banco United and Banco Martinelli).[74]

In August 1996, the federal and state governments agreed to a program to reschedule the state government's debt in return for the privatization, liquidation or transformation (to development agencies that would not accept deposits) of the state-owned banks. As a result, a number of state banks, including Banco do Estado do Río de Janeiro are to be privatized. In 1996, the federal government established a program to restructure up to R$7 billion in debt of small agricultural producers (individual loans up to R$200,000) at an interest rate subsidized by the government.

The banking system in ***Chile*** is considered to be one of the strongest among the emerging markets. This is reflected mainly in the asset quality of Chilean banks. At end-1996, only 1.03 percent of total loans of the major Chilean banks were nonperforming, somewhat below the 1992-95 average.[75] This low ratio is not thought to be due to lax accounting practices. Rather, the Chilean authorities have one of the most conservative accounting standards in this respect among all emerging markets regimes, and they are believed to cross-check the information they receive from the banks on loan performance against information from the tax authorities. On the issue of accounting for bad loans, therefore, the Chilean banks are widely considered to be among the most conservative banks in the world. Like their counterparts elsewhere in Latin America, Chilean banks maintain very high loan loss reserves compared to the stock of bad loans, although at ~~167~~ 180 percent at end-1996, this ratio has declined rapidly since end-1993 (when it was almost twice as high).

Chilean banks' earnings have come under pressure from increasing competition in recent years. The net interest margin has declined gradually over the past four years to just over 3 percent, and this is not due to a large stock of nonperforming assets. Rather, it reflects declining interest rates, increasing competition, and the concentration of the banks' activity in corporate lending. Approximately only 24 percent of end-1996 loans were to the consumer

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[73]Program of Incentives to the Restructuring and Strengthening of the National Financial System. In March 1996, PROER was expanded to allow a (solvent) bank to finance a restructuring of its assets and liabilities.

[74]Since the introduction of the PROER, liquidity lending (which includes lending under PROER) by the Central Bank to financial institutions has increased significantly, reaching a peak of R$20.6 billion at end-July 1996 (compared to R$4.3 billion at end-July 1995). As of end-February 1997, the outstanding balance had fallen back to R$5.2 billion.

[75]This discussion of Chilean banking developments is based on data of the Superintendencia de Bancos e Institutiones Financieras collected and published by Salomon Brothers (1997b). The measure of nonperforming loans used includes all past-due loans.

and mortgage sectors where margins are higher than in the corporate sector. The banks are gradually changing this orientation—consumer loans grew at three times the overall growth rate in loans in 1996—and over time this will tend to increase net interest margins. Similarly, noninterest income has tended to be relatively unimportant for Chilean banks, but this has increased significantly in the last few years. Faced as they are with relatively low income, Chilean banks are forced to be relatively efficient providers of banking services, as indicated in the low overhead ratio (63 percent at end-1996).

untrue

While the Chilean banking sector is relatively efficient and free of the asset quality problems that plague other banking industries elsewhere, it is a relatively capital-poor industry. With the subordinated debt situation essentially resolved (the last bank has just announced its agreement with the central bank to repay its debt), the banks' capital levels have declined (subordinated debt was part of secondary capital). Compared to banks in other emerging markets even, Chilean banks are undercapitalized. The average equity/assets ratio was only ~~5.5~~ percent at end-1996, and has declined steadily since at least 1992. Moreover,
10.4 Chilean banks are also not highly liquid. The ratio of liquid assets to total assets was only 8.9 percent at end-1996. If a highly liquid, well capitalized banking system is desired as a defense against adverse shocks, then the Chilean system appears somewhat vulnerable, although with such high loan loss reserves, the shock would have to be serious indeed.

Notwithstanding the improvement in the underlying economic environment, banks in *Mexico* endured a very difficult year in 1996. Commercial banks recorded an aggregate net loss of MexN$6.9 billion in 1996, after a profit of MexN$2.5 billion in 1995.[76] The deterioration in net income was due mainly to a 27 percent decline in net interest revenue, reflected in a fall in the net interest margin to 3.83 percent from 6.54 percent in 1995. This contraction in interest income is attributable to the increase in nonperforming or low-yielding assets on the bank's balance sheets. Of total loans of MexN$698 billion, only MexN$292 billion (42 percent) represented truly commercial lending—a decline of 27 percent since end-1995. The bulk of the bank's loan assets are loans to FOBAPROA, UDI-restructured loans, loans to the government due to the ADE program, and nonperforming loans.[77] These assets, which more than doubled in 1996, earn much lower yields than commercial loans, which drags down the banks' income. In the face of this collapse in interest earnings, even a doubling of noninterest and other revenue had little impact. Loan loss provisions, which had been mainly responsible for the deterioration in income in 1995 over 1994 levels, rose by only 20 percent in 1996, to MexN$30 billion.

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[76]The discussion of developments in the Mexican banking system is based on the audited year-end financial statements of the 36 private domestic and foreign commercial banks for which both 1995 and 1996 results have been made available by IBCA Ltd.

[77]FOBAPROA is the Fondo Bancario de Protección al Ahorro; UDIs are Unidades de Inversión; the ADE program is the Programa de Apoyo Immediato a Dendores de la Banca.

Euroclear Market Data Most actively traded issues
April 1997

5. Emerging Markets Bonds

(All amounts in '000)

COMMON CODE	ISIN	NAME OF ISSUE	RATE	MATURITY	CURRENCY	ISSUE AMOUNT	DAILY AVERAGE A/P TURNOVER IN USD	CLOSING DATE
004999347	XS0049993479	BRAZIL, REPUBLIC OF FLIRB CAP S.L	4.5	15-04-14	USD	6,987,688	2,608,565	
004311914	XS0043119147	ARGENTINA, REPUBLIC OF PAR SERIES L	5.25	31-03-23	USD	11,173,328	1,784,358	
004312023	XS0043120236	ARGENTINA, REPUBLIC OF FRN SERIES L	VAR	29-03-05/10-94	USD	7,154,715	1,029,410	
007321473	US040114AR16	ARGENTINA, REPUBLIC OF	11.375	30-01-17	USD	2,000,000	862,422	
006573584	US593048AX90	UNITED MEXICAN STATES	11.5	15-05-26	USD	1,750,000	652,720	
004999363	XS0049993636	BRAZIL, REPUBLIC OF EI SERIES L	VAR	15-04-06	USD	4,886,953	633,025	
002943549	XS0029435491	VENEZUELA, REPUBLIC OF - S. DL - MAIN SN	VAR	18-12-07	USD	5,100,240	564,364	
004998553	XS0049985533	BRAZIL, REPUBLIC OF PAR SERIES Z-L	5.25	15-04-24	USD	287,059	434,632	
003622681	XS0036226818	BRAZIL, REPUBLIC OF - IDU	VAR	01-01-01	USD	7,000,000	428,459	
004997719	XS0049977191	BRAZIL, REPUBLIC OF DEBT CONV S.L	VAR	15-04-12	USD	7,054,883	395,591	
002948303	XS0029483038	VENEZUELA, REPUBLIC OF - PAR SER A - MAIN SN	6.75	31-03-20	USD	5,130,403	368,053	
001515802	XS0015158024	MEXICO, REPUBLIC OF - PAR SERIES B - MAIN SN	6.25	31-12-19	USD	9,593,278	349,257	
001515799	XS0015157992	MEXICO, REPUBLIC OF - PAR SERIES A - MAIN SN	6.25	31-12-19	USD	7,383,767	311,314	
005147271	XS0051472719	BULGARIA, REPUBLIC OF - INTEREST ARR	VAR	28-07-11	USD	1,512,508	305,827	
004998120	XS0049981201	BRAZIL, REPUBLIC OF DISCOUNT S.Z-L	VAR	15-04-24	USD	3,373,998	284,009	
005557119	XS0055571193	ECUADOR, REPUBLIC OF-PDI BEARER	VAR	28-02-15	USD	1,908,132	243,110	
005146887	XS0051468873	BULGARIA, REPUBLIC OF - DISC TR. A	VAR	28-07-24	USD	1,550,085	187,862	
007562128	USP8055QAA06	ECUADOR, REPUBLIC OF	11.25	25-04-02	USD	246,130	156,207	25-04-97
004311817	XS0043118172	ARGENTINA, REPUBLIC OF DISCOUNT SERIES L	VAR	31-03-23	USD	3,962,997	156,143	
005557208	XS0055572084	ECUADOR, REPUBLIC OF-PAR		28-02-25	USD	1,517,391	154,956	
006807178	USP66239AB38	UNITED MEXICAN STATES	VAR	06-08-01	USD	3,609,837	146,450	
007022140	US040114AN02	ARGENTINA, REPUBLIC OF	11	09-10-06	USD	1,000,000	142,476	
006982026	US593048BA88	UNITED MEXICAN STATES	11.375	15-09-16	USD	1,000,000	136,696	
004999355	XS0049993552	BRAZIL, REPUBLIC OF FLIRB C-BOND S.L	4.5	15-04-14	USD	260,772	124,452	
004997816	XS0049978165	BRAZIL, REPUBLIC OF NEW MONEY S.L	VAR	15-04-09	USD	1,741,668	118,335	

ATTACHMENT 3

April

ATTACHMENT 4

Box 1. The Brady Bond Market Comes of Age

Since the first restructuring of Mexico's defaulted sovereign loans into Brady bonds in 1990, the Brady market has grown to become the largest and most liquid emerging debt market. The investor base, comprised originally of commercial and investment banks, gradually widened to include mutual funds, insurance companies, and other institutional investors. The number of distinct issuers and diverse characteristics of the different classes of Brady bonds—fixed and floating rate, collateralized and uncollateralized—and more recently the availability of derivatives, facilitated a rich set of sovereign and interest rate investment strategies. However, seven years after Mexico turned its defaulted sovereign loans into the first Bradys, some market participants are forecasting a rapid demise of the market. With the conclusion of Peru's debt restructuring deal in March 1997, the stock of outstanding dollar-denominated Brady bonds reached a peak of around $156 billion, and has been declining following the series of buy backs and exchanges for uncollateralized global and Eurobonds. Côte d'Ivoire and Vietnam are expected to be the last significant entrants to the market, but their additions to the stock of Bradys is unlikely to offset the amounts recently retired by Brazil, Ecuador, Panama, and Poland.

As in previous Brady deals, Peru's debt restructuring operation offered a menu of options to creditors, with the government repurchasing ~~$2.6~~ 2.7 billion of principal and past-due interest and issuing $4.8 billion of Brady bonds. Creditor preferences determined the 2.3 issuance of $~~2.4~~ billion in past-due interest bonds (PDIs), $~~1.7~~ billion in front-loaded 1.8 interest reduction bonds (FLIRBs), $~~560~~ 521 million in discount bonds and $~~182~~ 159 million in par bonds. The PDI bonds and FLIRBs carry below-market interest rates for the first ten years, paying LIBOR plus 13/16 percent thereafter, and have a graduated amortization schedule to maturity in 2017. The discount and the par bonds are collateralized and mature in 2027.

Improved conditions in emerging debt markets following the sustained rally since the Mexican crisis has led several countries to buy back and/or exchange their outstanding Brady bonds, mainly the collateralized instruments, at significantly lower spreads. Following the high-profile exchange in April 1996, Mexico used the proceeds of a 20-year global bond to retire $1.2 billion of discount bonds in September and called the remainder of its $2.6 billion stock of Aztec bonds in early 1997. In a deal that mimicked the Mexican swap, the Philippines exchanged one third of its par bonds for a $690 million 20-year uncollateralized Eurobond in September 1996. The exchange freed up $183 million of collateral in U.S. Treasury bonds. Ecuador, Panama, and Poland also followed this strategy and bought back some $250 million, $600 million, and $1.7 billion of Brady bonds, respectively. More recently, Brazil—the largest Brady country, with almost $50 billion bonds outstanding—exchanged US$2.7 billion of Brady bonds for a 30-year uncollateralized global bond.

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*** ACTIVITY REPORT ***
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CONNECTION ID	IMF CAP MKTS
START TIME	07/10 12:19
USAGE TIME	07'18
PAGES	13
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SERIES	WHDAI Economic Subject Files, 1975-1999
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FILE NUMBER	4

CLASSIFICATION	Strictly Confidential
DATE REVIEWED	2022-08-16

DETAILS OF WITHDRAWN MATERIAL	
DATE	1997-05-16
TYPE	Office Memorandum
TO	The Managing Director; The Deputy Managing Directors
FROM	David Folkerts-Landau
SUBJECT/TITLE	International Capital Markets Mission to South Africa
NO. OF PAGES	15
AUTHORITY	International Monetary Fund
LANGUAGE	English

CCD – Capital markets Chron

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Office Memorandum

To: Managing Director
The Deputy Managing Directors

July 2, 1997

From: David Folkerts-Landau DFL

Subject: **International Capital Markets Report**

Because financial developments in Thailand and in the region are still unfolding we propose to make at this time only one change in the draft Capital Markets Report that was sent to you on Monday (June 30, 1997) and which has to go to Doc. Prep. this coming Monday morning. On page 36, paragraph 93, lines 4-5 will be changed to read "...Market sources reported that the increased financing cost had resulted in losses of $1-1.5 billion for forward sellers of baht through mid June 1997." However, we propose to issue a brief supplement in time for the Executive Board session on July 30. This supplement will examine the events in Thailand and other more recent capital markets developments. After receiving comments from Executive Directors, the supplement will be folded into the published Report.

cc: Mr. Mussa
Mr. Boorman
Mr. Calamitsis
Ms. Carson
Mr. Chabrier
Mr. Deppler
Mr. Gianviti
Mr. Guitián
Mr. Khan
Mr. Khan
Mr. Loser
Mr. Munzberg
Mr. Neiss
Mr. Odling-Smee
Mr. Russo
Mr. Tanzi
Mr. David Williams

CCO

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FJB ERK SD F

INTERNATIONAL MONETARY FUND WESTERN HEMISPHERE DEPT.

97 JUN 31 PM 3:01

Office Memorandum

To: Mr. Folkerts-Landau July 1, 1997

From: David Williams /s/

Subject: **Draft Staff Report: International Capital Markets**

We enjoyed reading this draft staff report. We are in broad agreement with the assessment and concerns highlighted in the staff appraisal, but would offer the following points, which may be useful in finalizing the draft.

1. Pages 11-12. The point is made that the large volume of long dollar positions held at present by investors, speculators, and dynamic hedgers might have increased the sensitivity of international portfolios to downward movements in the dollar. The draft also refers to the introduction of the euro and possible increased market volatility up to 1999 as decisions are reached about the initial country composition of EMU. In this context, reference could be made to the likelihood that these conditions could prevail for much longer than the pre-1999 period. Elsewhere in the paper (pages 17-18), it is noted that there will probably be a long-term global process of diversification out of U.S. dollar reserves and into euro; while the exact magnitude of this shift is uncertain at this time, most observers believe it will be large. The volatility in exchange markets and the general downward pressure of the dollar may therefore be more permanent than suggested. This point could also be emphasized in the staff appraisal as well as in the earlier discussion.

2. Page 19. The second paragraph provides a nice discussion of how institutional arrangements and financial policies can affect the pace of market integration and development of private securities markets. In particular, the discussion usefully points out how the different monetary operation procedures of the central banks of the United States and Germany have led to sharp contrasts in the role of bank-intermediated finance. However, it may be useful to redraft the last sentence because it defines "narrow central banking" as having price stability as the overriding central banking function, but the discussion then goes on to fault it for discouraging the development of private securities markets. Price stability should indeed be the overriding objective of central banking but that in itself should not lead to any particular impediments to the development of private capital markets.

3. Page 20, line 2. Replace "ECSB" with "ESCB".

4.. Page 25. Some figures in the report seem to come out of the blue without full backing. For example, in the paragraph starting on the bottom of page 25, it is not clear how the shares of capital inflows going into reserves (bottom of page 25) are derived. These estimates are presumably derived from the WEO data base, but data on composition of financing in Figure 11 are from the DCBEL database. Are these consistent with each other in terms of the timing of flows? Incidentally, the latest data show that only five of the top ten reserve holders are emerging markets.

5. Page 25. The first sentence of the second paragraph in explaining the regional distribution of private capital flows appears to put too much emphasis on the "improved ability of investors to discriminate among countries according to the quality of policy and economic performance." First, it is not clear as to *how* there has been a marked difference in the ability to discriminate among countries according to performance, and second, as detailed in the rest of the paragraph, the divergences in the magnitudes of capital flows to different regions was related to the slowdown of growth in the exports or output, financial sector weaknesses, etc. and these are easily observable variables.

6. Pages 25-26. The discussion here makes the important point that throughout the 1990s, almost half (some $575 billion) of the very large capital flows to the emerging market countries were accumulated as foreign exchange reserves. While it is generally agreed that the new conditions of footloose capital require that these countries hold more reserves than in the past, most discussions of their situation point only to the risks and dangers of a reverse in short-term capital inflows and fail to mention on the positive side the existence of this sizable buffer against exchange rate depreciation in many (though not all) of these countries. This point, also, could be made in the staff appraisal.

7. Page 26. Box 2 and Figure 12 present an interesting approach, but it is not clear what the message is, given the selection criterion for distinguishing between group A and B, except that obtaining a credit rating is correlated—sooner or later—with better economic performance, or that having had a credit rating before 1990 is no safeguard against weak performance. Collapsing groups A and B and comparing with Group C might bring out more clearly a point in the rest of the section that capital inflows can strengthen performance.

8. Page 27. The text could at times be more focused with more of the quantitative and technical material relegated to tables (or footnotes). A case in point is the first complete paragraph in on this page. The section on the "Sustainability of Capital Flows" is nearly exclusively devoted to a lengthy description of speculative attacks, but has little to say about the possible effects of changes in general world market conditions.

9. Pages 28 and 35. There is a marked difference in the way the effectiveness of capital controls is evaluated in the two sections, especially on these two pages. On page 28 the authors very clearly and in general terms point out that financial markets circumvent official controls and stress the need for national authorities in emerging markets to understand the "limited effectiveness of many restrictions that are being placed on financial transactions, lest institutions engage in a variety of unobserved, let alone unregulated, transactions." But on page 35, when commenting on the two-tier exchange system set up by the Thai authorities to

deny speculators the domestic credit needed to establish a net short domestic currency position, the authors do not provide any comments on whether or not there are possibilities of leakages, and instead point out that the "Thai authorities have so far been able to withstand the attack on the baht by relying on extensive application of selective capital controls." In this connection, it might be useful to emphasize the special circumstances underlying the speculative attack on the Thai baht.

10. Page 44. Japan's "Big Bang" financial reforms are given short shift in the report, particularly when compared with the high expectations raised by their announcement in November 1996. However, they are covered in only one paragraph, and the final sentence therein ("The rigor with which these measures are implemented will be the main factor in determining their effectiveness.") seems to raise doubts about the impact of the Japanese reforms. Moreover, there is no reference to the release this month (June 13) by the Japanese Government of the blueprint for "Big Bang" reforms. On that day, three government advisory panels announced their reform proposals to break down barriers between banks, brokers and insurers, and it is expected that the program will be implemented two years ahead of the original goal of 2001.

cc: Mr. Russo
Department Heads: AFR, APD, EU1, EU2, FAD, LEG, MED,
PDR, SEC, STA, WHD,

From: David Williams (Leila Atienza)
To: MLI2S.PO17.DFOLKERTS
Date: 6/27/97 6:22pm
Subject: Draft Staff Report: International Capital Markets

Hard copy will only be sent to Mr. Folkerts-Landau.<WP Attachment Enclosed>

CC: MLH3S.PO04.JBOORMAN, MLH4S.PO10.ECALAMITSIS, MLI1S...

cco- Capital markets/ Flows

Mr. Loser Senior Staff

FU

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

NOV 25 PM 4:55

Office Memorandum

Confidential
November 25, 1997

To: The Managing Director
The Deputy Managing Directors

From: Michael Mussa MM

Subject: **Hedge Fund Study--Back-to-Office**

Attached is the back-to-office report for the hedge fund study prepared by Mr. Eichengreen.

Attachment

cc: Heads of Department
Mr. Russo
Mr. O. Evans
Mr. Cross

Executive Summary

•Hedge funds are private investment pools, often domiciled offshore and managed on a fee-for-performance basis. There exist two general types: macro funds taking large directional positions based on their assessment of macroeconomic fundamentals; and relative value funds, which arbitrage the relative prices of related securities (Treasury bills and bonds, for example).

•But even within these categories, there is a great diversity of investment strategies. While a few large macro funds, for example, invest in both G-7 and emerging markets and hold equities, bonds and currencies, the vast majority of funds hold a more limited range of assets and invest in a limited number of markets. They are unlikely to shift their positions from, say, Latin American bonds to Asian currencies in response to events.

•Hedge funds are large, to be sure. Their capital is upwards of $100 billion according to industry estimates. That said, they are dwarfed by other institutional investors, such as pension funds, mutual funds, insurance companies and investment companies. In the OECD countries, the assets of institutional investors exceed $20 trillion. Moreover, these other institutional investors engage in many of the same practices as hedge funds. These facts raise doubt that hedge funds can dominate, or corner, particular markets under most circumstances.

• In the case of Thailand, several hedge funds began to perceive in the latter part of last year and the first half of this year that the exchange rate of the Thai baht could not be sustained in view of the large current account deficit and the incapacity of the authorities to maintain very high real interest rates to defend the peg in view of weaknesses in the economy and the financial system.

• On the other hand, a number of hedge funds reportedly jumped into the market to buy Indonesian rupiah and Singapore dollars after the recent initial declines of these currencies, based on the perception that they had been pushed down more than was justified by fundamentals.

•The role of hedge funds in such situations, however, should not be exaggerated. There is little indication that they played a leading role in pushing down the rupiah or more recently the Korean won, and, earlier in 1994-1995, there is little indication that hedge funds were primary players in the tequila crisis that hit Latin America.

•Regulators in the US and the UK, the countries in which banks and brokers are most active as counterparties and creditors to hedge funds, are generally satisfied that these institutions are adequately managing their exposure to hedge funds, which therefore pose no special problems of systemic risk.

•G-10 regulators also seem satisfied that there are no investor-protection grounds for more regulation of hedge funds. Hedge funds, it should be noted, are not free from all reporting requirements. They must still provide investors with material information about their securities and activities through an offering memorandum and regular audited financial statements.

●If policymakers nonetheless fear that hedge funds are large enough to dominate or corner markets, they could emulate the large trade reporting requirements in effect in the United States. There, hedge funds that participate in exchange-traded derivative markets generally must comply with regulations requiring registration, regulatory disclosure and record keeping. The Commodity Futures Trading Commission (CFTC), for example, has extensive inspection powers concerning the details of all large transactions and positions, and rules limiting speculative positions.

●In principle, policymakers might contemplate measures to limit the ability of hedge funds to take positions in financial markets. But taking this tack very far would be counterproductive. For one thing, it would prevent hedge funds from acting as contrarians. While hedge funds have the flexibility to take short positions against overvalued currencies, they can also be among the first to take long positions in currencies which have depreciated in the wake of a crisis, providing liquidity and helping the currency to establish a bottom. In this sense they can act as "stabilizing speculators."

●That said, because some hedge fund managers have well-publicized reputations, the news that they have taken short or long positions in particular assets or particular markets may encourage other portfolio managers to follow their lead. Hedge funds may play an important role in the herding that is characteristic of incompletely-informed investors.

●The solution is not to limit trading but to provide better information on government policies and the condition of domestic financial institutions to encourage investors to trade on fundamentals rather than to run with the herd. It is to avoid presenting hedge funds and other institutional investors whose combined resources constitute a market vastly larger than the assets of central banks and governments with an incentive to take large positions by offering the irresistible combination of inconsistent policies and unsustainable currency pegs.

Office Memorandum

Confidential

To: Mr. Mussa November 24, 1997

From: Barry Eichengreen *BE*

Subject: **Back-to-Office--Hedge Fund Study**

During the first two weeks of November, a mission headed by Mr. Eichengreen and comprised of Mr. Mathieson, Mr. Chadha and Ms. Kodres (RES) traveled to New York (November 10-12 and 14), Greenwich, Connecticut (November 13), and London (November 17-18) to discuss the role of hedge funds in financial markets generally and emerging markets in particular. Discussions were held with representatives of hedge funds, prime brokers, commercial and investment banks, and regulators in both the US and UK.[1] Mr. Chadha joined by Mr. Lall and Mr. Sharma (both RES) continued on to Asia, where they are conducting discussions with market participants and officials in Hong Kong (China), Kuala Lumpur (Malaysia), and Singapore. (A back-to-office report for this part of the mission will be available in early December.) Given that this part of the mission is still underway, the sections of this back-to-office concerned with financial developments in Asia and their policy implications necessarily remains partial and tentative.

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[1] These included in New York: Morgan Stanley (Mr. Jerry Bergman), JP Morgan (Mr. James A. Greenberg and Mr. Irenee du P. May Jr.), Citibank (Ms. Rosanne B. Olsen), Citicorp (Mr. Klaus Winter), Moore Capital Management Inc., (Ms. Kim White and Mr. Michael Garfinkle), Tass (Ms. Nicola Meaden), Merrill Lynch (Messrs. Robert Murphy and Robert McDonough), Goldman, Sachs & Co. (Ms. Debby Schezer, Messrs. A. Carver Wickman, Christopher K. Norton, Kenneth A. Miller, Jeffrey S. Flug, and Jonathan Lopatin, and Ms. Frances Bermanzohn), Bear Sterns (Messrs. Richard Harriton and Michael Minikes), Soros (Messrs. Arminio Fraga and Stan Druckenmiller), Caxton Associates L.L.C. (Mr. John H. Makin), Caxton Corporation (Mr. Bruce Kovner), Banco Santander International (Mr. Norman Chait), Baker Nye (Mr. Richard Nye), Salomon Brothers (Mr. Lawrence J. Bernstein), and Federal Reserve Bank of New York (Messrs. Peter Fisher, Joel Stein, and Chester Feldberg). In Greenwich: Columbus Advisors (Mr. Mario Covo) and Long-term Capital (Messrs. Myron Scholes and David W. Mullins, Jr.). In London: Bank of England (T. A. Clark), SBC Warburg Dillon Read (Messrs. William W. Johnson and Stephen Yorke), Deutsche Morgan Grenfell (Messrs. Anshu Jain and Steven Bell), BZW Markets (Ms. Noreen Harrington and Messrs. Mike Keegan and Paul Thrush), Credit Suisse, First Boston (Mr. Sadeq Sayeed), Tudor Proprietary Trading Plc (Dr. Sushil Wadhwani and Mr. Mark Heffernam), Tokai Bank Europe (Messrs. Peter Eirew, B.C. Grigsby, David Behan, and Laurence Mutkin), and Union Bank of Switzerland (Messrs. Simon Wheatley and Ron Tannenbaum).

Overture

When the mission reached New York, the situation in Indonesia and Hong Kong had stabilized or gone into remission, though market participants were increasingly aware of the scope for problems in Korea, Brazil, and other emerging markets. The Brazilian stock market declined by more than 10 percent and spreads on Brady bonds jumped by more than 100 basis points on our third day in New York. These events inevitably colored our discussions. Market participants who some months earlier would have been advertising the aggressiveness with which they had jumped into emerging markets and congratulating themselves for the profits on their long positions took pains to emphasize their conservative approach and the care with which they designed and implemented risk-management techniques. They were aware that hedge funds had been singled out as the culprits behind recent market moves. In this respect and others, our discussions revealed the considerable difficulty of obtaining systematic, comprehensive information on hedge funds' activities. That said, a fairly clear pictured emerged.

Definitions

Hedge funds are private investment pools, often domiciled offshore (where the fund itself has no tax liability), whose managers are paid on a fee-for-performance basis. While they have substantial capital and make substantial use of leverage, their resources are nonetheless small relative to those of other institutional investors (pension funds, mutual funds, insurance companies, and the proprietary trading desks of investment and commercial banks), many of which utilize investment and trading strategies that are virtually indistinguishable from those of hedge funds (and who are among hedge funds' most important clients). Moreover, the macro funds which take positions in any number of developed- and developing-country currency markets comprise only a subset of the hedge fund industry; they account for less than half of its capital. The costs of executing trades and liquidating positions, and attendant political risks, render macro funds reluctant to commit more than a fraction of their portfolios to positions in emerging markets.

Hedge funds and market moves

Many of the financial market participants with whom we spoke regarded hedge funds as nimble and their managers as astute. In their view, hedge funds are often among the first investors to take a position against what later comes to be perceived as an unsustainable currency peg (or to take a long position in an overdepreciated currency). Because they have a reputation as being acute prognosticators of future financial market developments, news of their positions can at times lead other, less well-informed international investors and domestic residents to follow their lead. Sensitive to the difficulties this can pose for the execution of trades and to possible political repercussions, hedge funds go to considerable lengths to ensure the confidentiality of their transactions, splitting up trades and signing confidentiality agreements with their counterparties.

Still, despite these efforts, news of their positions can spread, for example from the desk within the commercial or investment bank that serves as counterparty to the hedge fund's transaction to the proprietary trading desk of that same institution and from there to other parts of the financial community. To be sure, credit officers and dealers are aware of how upset a hedge fund would be if they freely spread information about the latter's positions. At the same time, investors depend on their banks for general market intelligence. It would be naive to think that this information never goes any further than the sales and credit desks of the investment and commercial banks. For all these reasons, hedge funds can and do sometimes serve as the lead steer when the financial herd begins to move.

That said, not everyone agreed that hedge funds are always first in staking out a position against a questionable currency peg. In the view of a significant minority, hedge funds are in general no quicker to move than commercial and investment banks and, for that matter, other institutional investors.

Policy implications

Despite the lead role sometimes taken by hedge funds in market moves, financial-market participants and regulators in London and New York see little justification for a specialized policy response to regulate and limit the activities of hedge funds. Hedge funds are investors like other investors. Those which take short positions in emerging-market bonds and equities do so in response to the perception that other investors have erred so as to render those markets fundamentally overvalued. Hedge funds which take short positions in emerging-market currencies do so in response to evidence of inconsistent policies likely to render currency pegs unsustainable. In this sense they are prime sources of the market discipline that policymakers regard as important and salutary (when they are not the ones being disciplined). And insofar as hedge funds are contrarians inclined to buy sharply depreciated currencies in the wake of a speculative crisis, they are sources of liquidity and stabilizing speculation that dampen market fluctuations.

That said, some limited measures might be contemplated to render hedge fund operations more transparent and thereby prevent the spread of misapprehensions about the extent of their activities. These include strengthening and replicating the large-trader reporting mechanisms in place in countries like the United States in order to reassure officials that hedge funds, and for that matter other institutional investors, are not cornering markets. But more comprehensive measures intended to prevent hedge funds from taking positions in emerging-market currencies are neither feasible nor desirable. The most important action policymakers can take to protect their economies against the uncomfortable market movements in which hedge funds participate is to avoid offering them one-way bets in the form of inconsistent policies and indefensible currency pegs. They can strengthen the ability of clearance, settlement and payments systems to withstand asset-price volatility. And they can provide better information about government policy and private-sector financial conditions in order to ameliorate the tendency of incompletely-informed investors to "follow the herd" and thereby magnify the repercussions of the positions taken by large institutional investors, including but not limited to hedge funds.

Distinguishing features of hedge funds

Any analysis of hedge funds is complicated by the difficulty of formulating an adequate definition of the financial-market entities under consideration.[2]

Regularities

Hedge funds are private investment pools, often domiciled offshore to take advantage of tax and regulatory advantages. In the U.S. case they have traditionally had fewer than 100 investors in order to be free of SEC regulation.[3] They are managed on a fee-for-performance basis (typically, management is rewarded by "the 1 and 20," that is, by a 1 per cent management fee and 20 percent of profits, although some management and investment fees are higher than this). They require a sizeable minimum investment, usually at least $1 million. They require shareholders to provide advance notification if they wish to withdraw funds: the notice period varies from 30 days for funds with more liquid investments to 3 years for other funds. Hedge funds are not required to disclose information on their portfolios and trades to their clients or the public, though it is not uncommon for them to provide shareholders with a

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[2] A number of the investment professionals with whom we spoke noted the absence of a legal definition of hedge funds and, as if to emphasize their point, attempted to dispute any characterization we put forward.

[3]To be exempt from registering their shares as securities, a fund need only issue its shares via a private placement and in so doing attract investments from only 35 or fewer non-accredited investors. An accredited investor is defined to include inter alia individuals (with their spouses) with net worth of $1 million or any individual with income of $200,000 in each of the two most recent years or joint income with his/her spouse in excess of $300,000 in each of these years, and who has a reasonable expectation of earning a like amount in the current year. In addition, the Investment Company Act provides funds with exemptions from registration as investment companies. In the original 1940 Act, exemption was provided for funds that had no more than 100 beneficial owners and were not making, and did not intend to make, a public offering of their securities. Taking advantage of this exemption and the above meant that the funds would have fewer than 35 non-accredited investors and fewer than 100 total investors. In 1997 a second type of exempt fund was introduced, which sold their securities only to "qualified purchasers" and were not making, and did not intend to make, a public offering of their securities. A qualified purchaser is defined to include individuals with investments of at least $5 million or any other investor acting for his own account or for other qualified purchasers, with investments of at least $25 million. Hence, by raising the qualification standard, the Act has eliminated the quantitative limit on the potential number of participants in a hedge fund. But such funds cannot have any non-accredited investors.

short monthly letter or an annual report with summary information on holdings and transactions. In addition, some managers meet periodically with their principal investors. Hedge funds' prospectuses and legal status place relatively few restrictions on their portfolios and transactions. Compared to, say, mutual funds, hedge funds are freer to take short positions, utilize derivative securities, and employ leverage.

This freedom and flexibility allow hedge funds to respond quickly to changes in market conditions. However, while some fund managers frequently alter their portfolios, many invest with longer-term horizons. Some global hedge funds with equity investments anticipate holding them for 12 to 24 months, while fixed-income arbitrage funds often anticipate holding the bonds they purchase for 12 to 18 months.

Diversity within the hedge fund community

Two problems arise as soon as one attempts to build on these regularities. First, practices vary enormously. Market participants distinguish two general classes of funds: (1) macro hedge funds taking large directional (unhedged) positions in national markets, based on their assessment of underlying macroeconomic and financial conditions (and getting all the publicity!); and (2) relative value funds, which take bets on the relative prices of closely related securities (Treasury bills and bonds, for example), which are less exposed to macroeconomic fluctuations. Credit providers regard the first class of funds as riskier and are therefore less willing to provide them with large amounts of credit. Relative value funds tend to be more highly levered than macro funds because they are regarded as better credit risks and because haircuts--the amount of capital needed to establish a position--on the instruments they hold are relatively small. (These are two ways of saying the same thing.)

As soon as one looks more closely at these subcategories, one detects further diversity. Some macro hedge funds take positions mainly in G-3 markets; others take positions mainly in emerging markets. A number of the largest macro funds do both and spread their holdings across equities, bonds and currencies (both short and long positions), and hold commodities and other less liquid assets like real estate in both developed and emerging markets. But the vast majority of hedge funds hold a more limited range of assets. Similarly, within the relative value category one finds hedge funds specializing in fixed-income arbitrage, merger arbitrage, and distressed-securities arbitrage. Most funds engaging in, say, merger arbitrage or distressed-securities arbitrage will limit their holdings to the G-7 countries, if not the United States, because their institutional knowledge does not carry over to other countries and because they worry about liquidity constraints in small markets.

Only dedicated emerging-market funds, which are a small minority of the hedge-fund universe, allocate a large share of their portfolios to investments (including short positions) in emerging markets. To be sure, the large macro funds take positions in emerging markets, but they typically allocate only a fraction of their portfolios to investments in those markets because they regard these as relatively risky and illiquid.

Use of leverage and derivatives

Many of the older, long-established hedge funds regard fees on complex derivatives as prohibitive and transact mainly through bonds, forwards, and futures. Newer hedge funds, especially relative value funds, are more inclined to use derivatives. Model-based relative value funds are constantly trolling for mispriced derivatives. Some hedge funds negotiate secured credit lines with a range of banks, although many managers regard these as prohibitively expensive. At least one large, well-reputed relative value fund has a large unsecured credit line. (It is simultaneously planning to give back a substantial amount of capital to its shareholders, effectively increasing the leverage that it applies to its capital.) In New York we were told that European investment banks seeking to penetrate the U.S. hedge-fund market had offered large credit lines to a number of hedge-fund clients.

Credit lines are expensive to negotiate. Hedge funds use them mainly to finance calls for additional margin when the market moves against them: on a day-to-day basis they obtain leverage by buying securities on margin, putting up collateral, and/or using collateralized borrowing in repo markets. Better-known hedge funds can buy structured derivative products without putting up capital initially but pay a succession of premium payments when the market in those securities moves up or down to trigger levels. Haircuts vary with the riskiness of the underlying securities, from 50 per cent on equities to 3-10 per cent on foreign exchange transactions to 1 or 2 percent on U.S. Treasury bonds. Five years ago, when hedge funds were less familiar to the banking community, they had to take more substantial haircuts. Haircuts have declined as hedge funds have acquired a track record and become more of a known quantity.

It follows that hedge funds' use of leverage is correlated with the mix of assets in their portfolios, those which arbitrage U.S. Treasury securities typically being more highly levered than those which take long positions in emerging equity markets, although this distinction grows less clear with the rise of margin optimization, or cross margining, where closely offsetting positions can be netted to reduce required margin. In practice, neither hedge funds nor those who provide them credit think in terms of leverage; rather they assess the risk of their portfolios, attempting to assess the drawdown that will come with a 2 or 3 standard deviation market move.

For all these reasons, it is difficult to generalize on the use of leverage by macro hedge funds. Throwing caution to the wind, a rough ball-park estimate would be that macro funds lever their capital four to seven times on average (that is, the sum of long and short positions is typically four to seven times investors' equity).

The fuzzy line between hedge funds and other institutional investors

The second fundamental problem with defining and describing hedge funds is that other institutional investors engage in many of the same practices as hedge funds. Individual investors and their institutional-investor counterparts such as investment banks buy stocks on margin. Commercial banks use leverage in the sense that a fractional-reserve banking system is a group of levered financial institutions whose assets are a multiple of their deposits. The proprietary trading desks of commercial and investment banks take positions, buy and sell derivatives, and alter their portfolios in the manner of hedge funds. A non-negligible number of mutual funds, pension funds, insurance companies, and university endowments engage in some of these same practices and are among the most important investors in hedge funds. For all these reasons, any line between hedge funds and other institutional investors is artificial.

Hedge funds as the lead steer in the financial herd

One popular generalization is that hedge funds are nimble and quick off the mark. Their managers have a reputation for astuteness. The fact (or rumor) that hedge funds are taking a position may thus encourage other investors to follow their lead. Hedge funds' transactions, especially when they are large, will not escape the notice of other investors. Insofar as the Chinese walls separating sales desks and proprietary trading desks within the banks are porous, institutional investors serving as counterparties and providers of credit to hedge funds may not just lay off the positions acquired in their transactions with the hedge funds; in addition they may put on positions of their own. (In the words of one highly-regarded hedge fund manager, "the only Chinese walls are in China.") Parallel transactions may not be limited to the banks' proprietary trading desks; for example, an underwriting department which has an unwanted inventory of bonds may use information on dealings with hedge funds to pick the time to lay off that exposure. Moreover, while pension funds, insurance companies, and mutual funds may be subject to prudential restrictions on their foreign exchange market positions, they still have some freedom to follow the hedge funds. And the financial assets at their disposal are several orders of magnitude larger than those of the hedge funds. Even some central banks actively manage their reserve portfolios to capitalize on impending exchange rate movements: Bank Negara was a frequently-mentioned example.

These are all reasons, then, why hedge fund may play a catalytic role in market movements.

Hedge funds as providers of liquidity

While hedge funds have the flexibility to take short positions, they can also be the first to take long positions in currencies which have depreciated in the wake of a speculative attack, providing much needed liquidity to illiquid markets and helping the currency in question to establish a bottom. The expectation on the part of their clients that hedge funds will make above-normal returns will, other things equal, discourage hedge fund managers from buying the same assets being purchased by other investors or shorting the same assets being unloaded by other investors, since the prices of those assets will already reflect moves by the others.

Thus, while managers of macro funds search for fundamentally overvalued currencies against which to go short, they also search for currencies that have recently depreciated and are now trading for prices lower than warranted by fundamentals with the goal of buying these on the rebound. They seek to anticipate where policy reform is in train in order to buy the currencies in question before the market has come to recognize that improved macroeconomic and financial conditions will now support a stronger exchange rate. In this sense they sometimes function as "stabilizing speculators."

Two additional arguments were cited by market participants for why hedge funds are less inclined toward "positive feedback" trading strategies than other investors. First, hedge funds, unlike mutual funds, are not bound by their prospectuses to invest new inflows of funds in the same manner as existing capital. A mutual fund that enjoys high returns may attract new investors and be bound by its prospectus to buy more of the recently appreciated asset; hedge funds have more flexibility.

Second, other institutional investors may be forced to liquidate declining positions -- to sell into a falling market. A mutual fund that makes losses may suffer withdrawals, while other institutional investors may be forced to cut their losses by their risk management strategies. A mutual fund manager who allows losses to mount in anticipation of a subsequent reversal may find himself an ex-mutual fund manager before that reversal takes place, creating an understandable reluctance to let the position ride. Hedge funds are better able to ride out these fluctuations because their investors are locked in for substantial periods and because they have credit lines on which they can draw when asked to put up additional marginal money or collateral.

Quantitative dimensions

No reliable estimates exist of the number of hedge funds and the value of hedge fund capital. Over and over, market participants warned us of the difficulty of attempting to construct estimates of these magnitudes. Commercial services that report on hedge funds rely on the cooperation of fund managers to provide them with information, and fund managers are not always forthcoming. This will not only bias downward estimates of number of funds but bias upward average returns, since the worst performing managers are least likely to provide information. Newer, smaller hedge funds may be picked up only with a lag. Estimates of hedge fund capital may suffer from double counting insofar as some commercial services provide data for funds of funds (hedge funds which invest in other hedge funds) as well as other categories.

Above all, there is the problem of who to include. Should one include individuals or family groups who take highly levered positions? Should one include universities whose endowments are managed according to the same principles as hedge funds? Should one include the pension fund of the IMF as a fund of funds manager? Here we are at the mercy of the commercial services, which provide little information on how they select the investment pools they track.

First estimates

It is useful to see how far the available data allow us to go. Data from Managed Account Reports Inc. (MarHedge) for both U.S. and offshore funds were used to generate the attached tables which show the seven investment styles available in the database and a fund of funds category. Since treating this last category symmetrically with the others may introduce double counting, grand totals are presented both including and excluding funds of funds.

The resultant estimates of number of funds (Table 1) come to more than 1,000, of which approximately one quarter are funds of funds. The corresponding estimates of capital (Table 2) are somewhat in excess of \$100 billion including funds of funds, just under \$100 billion excluding them (\$98 billion to be precise). Journalistic accounts and other services put forth much larger numbers (as many as 3,000 funds and \$368 billion in assets). These larger figures are extrapolations based on conversations between commercial services and fund managers (and on strong assumptions) and should be taken with a grain of salt.[4]

Of this \$98 billion, \$24 billion is in the hands of global macro funds, \$30 billion in the hands of global funds. While here too any line is artificial, the following distinction is conventionally drawn. Global macro funds engage in "top-down" analysis, looking at national macroeconomic and financial variables such as the current account, the inflation rate, and the real exchange rate, while global funds engage in "bottom-up" analysis, diversifying their portfolios internationally but picking individual stocks on the basis of companies' prospects.

These are large numbers, although they pale in comparison with the more than \$1 trillion of daily turnover in the forex market or the securities holdings of investment and commercial banks. Perhaps the most notable feature of these tables is the rapid rate of growth of the number of hedge funds and hedge fund capital.

Table 3 presents estimates of returns to hedge fund capital, as reported to MAR. The performance of the global macro funds stands out: it exceeds the return on the S&P 500 and the J.P. Morgan Global Bond Index every year since 1990. Returns to other types of hedge funds are less uniformly impressive. But excess returns do not come for free: a clear correlate is high volatility (Table 4).

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[4]The competing services actually provide similar data on number of funds and fund capital. These come to 1,023 and \$116 b. for MAR, 1,100 and \$139 b. for Hedge Fund Research, and 2,500 and \$130 b. for VanHedge. The larger numbers cited in the text are extrapolations of reported data. Based on conversations with managers, for example, HFR estimates there to exist 3,000 funds. To gross up their estimates of capital to the \$370 b. range, they therefore essentially multiply reported capital by 3,000/1,100 (give or take a few billion...).

Future prospects

How are these magnitudes likely to evolve from here? Most market participants saw the development of the hedge fund industry as a normal corollary of financial deepening and maturation. Individual and institutional investors (pension funds, insurance companies, etc.) wish to diversify their portfolios with a variety of less correlated investments. Hedge funds offer attractive investment opportunities at the high risk-high return end of the spectrum. This suggests that hedge-fund-style investment vehicles are likely to grow more important in the future.

The existence of a growing client base willing to pay performance fees is inducing entry by independent investment managers, while investment banks and securities houses like Deutsche Morgan Grenfell and Credit Suisse First Boston are setting up hedge-fund look-alikes to take advantage of their brand name. (The relevant division of CSFB has approximately $1 billion under management, half its own funds and half those of institutional clients, and operates identically to a hedge fund.) As these branded leveraged funds grow in number and size, the line of demarcation between hedge funds and other institutional investors will become increasingly difficult to draw.

Some commentators suggested that entry and maturation will mean that the super-normal profits that some hedge fund investors have come to expect will be competed away. Increased competition will drive down profits, especially if countries adopt more flexible exchange rates, eliminating the one-way bets that macro funds find so attractive. Hedge funds that offer extraordinary profits will have to assume extraordinary risks. The counter-argument, also offered by market participants, is that because hedge funds are freer than, say, mutual funds to go short as well as long, they may be able to continue offering more attractive risk-return packages, insofar as certain investments are chronically overvalued due to asymmetric buy-side pressure.

Supervision and regulation

In formulating regulatory policy toward hedge funds, supervisory authorities have focused on issues related to investor protection and systemic risk.

To date, hedge funds have been established in a manner that has generally satisfied regulators that there are no investor protection-grounds for more intensive regulation. For hedge funds to be exempt from most investor-protection regulation in the United States, they are generally limited to accepting investments from accredited investors (footnote 3 above) consisting of institutional investors, companies, or high net worth individuals who can "fend for themselves." This means that most hedge funds do not have to register as securities issuers or broker/dealers or publicly disclose data on their financial performance and asset positions. This does not free them from all reporting requirements, however. They must still provide investors with all material information about their securities and activities through an offering memorandum and usually regular audited financial statements thereafter. They are subject to statutes governing fraud and other criminal activities.

Hedge funds that are participants in exchange-traded derivative markets usually have to comply with regulations requiring registration, regulatory disclosure, and record keeping. In the United States, the Commodity Futures Trading Commission (CFTC), for example, has inspection powers concerning the details of all large transactions, positions, inventories and commitments, as well as the names and addresses of all entities involved. The CTFC also has rules limiting the speculative positions of all market participants. To reinforce CFTC surveillance, the future exchanges have their own systems for identifying large traders and limiting positions and credit risk exposures through margin requirements. To date, however, such large trader reporting requirements have not been extended to over-the-counter (OTC) trading in derivative products.

Regulators in the US and the UK, the countries in which banks and brokers are most active as counterparties and creditors to hedge funds, are generally satisfied that these institutions are adequately managing their exposure to hedge funds, which therefore pose no special problems of systemic risk. In order to manage the credit risks associated with lending to hedge funds, prime brokers and credit banks continuously monitor the funds' investment strategies, monthly returns, and investor withdrawals. Based on the results of this monitoring and the length of their relationship with each fund, creditor banks and brokers establish limits on their credit exposure to each fund. To ensure that these limits are being met, there can be daily or weekly marking-to-market of outstanding contracts and settlement of margins.

Perspectives on the current crisis

Discussions with managers, counterparties, and officials have convinced us of the impossibility of isolating the positions taken by hedge funds in the currency, fixed-income, and equity markets, much less of "identifying the contribution" or "isolating the role" of hedge funds in recent events. Hedge funds do not report their positions to their own investors, much less the regulators (aside from the large trader reporting requirements described above). This is a statement of fact; whether it should be changed is another question, which we defer to below. But it means that more than informed guesses of the positions taken by hedge funds are impossible to come by.

The carry trade

Discussions with market participants do, however, paint a consistent interpretative picture. It begins with the markets' enthusiasm for the fixed-income debt and equities of emerging economies, especially the high-growth East Asian tigers. It is important to emphasize, given the controversy over short selling, that hedge funds were long in these markets an extended period. Tiger Fund was reportedly short in Asian equities (including but not limited to Japanese banks), but it was the exception, not the rule. And the positions taken by hedge funds were paralleled by those of other institutional investors, including commercial and investment banks.

International investors were encouraged to establish and maintain these positions, in but not limited to fixed-income markets, by low interest rates in the major financial centers. They funded themselves by borrowing on industrial-country markets and investing in securities in Thailand and elsewhere in East Asia. The ample credit of which they made use reflected, inter alia, the low level of yen-denominated interest rates. Hedge funds in particular enjoyed an influx of capital from Japanese insurance companies and banks searching for yield (we were told of one Japanese bank that has been consistently attempting to invest $5 billion with a hedge fund) and ready access to credit courtesy of European banks seeking to build a hedge-fund client base.

Using this cheap funding to buy high-yielding East Asian fixed-income securities was attractive so long as East Asian exchange rates did not move. In the case of Thailand, in 19 of the 20 quarters through 1997-II this carry trade was profitable, the pegged exchange rate ruling out large exchange-rate surprises. In this sense, the process leading up to the current crisis extends back some years.

Global financial disturbances

A series of shocks then disturbed the carry trade in the spring of this year. There were small but significant increases in interest rates in the U.K. and Germany. Japanese long rates ticked up from 2 to 2 ½ per cent as the outlook for the Japanese economy appeared to brighten after March, and short rates firmed with talk that the Bank of Japan might raise rates by the end of the year. Similarly, a rise in U.S. rates may not have eventuated, but rumors that it was coming did nonetheless circulate. It became less attractive to borrow in the U.S., Europe or Japan to hold positions in, inter alia, Thailand. The carry trade became less attractive, making it increasingly difficult for Thailand and other countries in its position to attract the capital inflows necessary to finance their current account deficits.

Meanwhile, a growing number of international investors concluded that the Asian economies had problems and that the period of exchange-rate stability might be drawing to a close. Some observers pointed to Hanbo's collapse in January as having been particularly important for changing investors' perceptions of Asian economic and financial prospects. One claimed to having overheard a fund manager from Tiger to the effect that the proceedings of an IMF conference in October 1996 had tipped him off to the deterioration of financial conditions in Thailand. The international investors (including but not limited to hedge funds) that were important players in the carry trade progressively closed out their positions over the period leading up to July 1997 and began shorting the baht.

With benefit of hindsight, international investors cited clear problems with fundamentals in Thailand as their rationale for shorting the baht. But while they saw devaluation coming, they admitted to considerable uncertainty about the timing. However, they could afford to hold their positions for many months because the cost of funding was low and the probability of appreciation was negligible (they perceived the existence of a one-way bet). We heard estimates as high as $15 billion for the hedge funds' baht forwards, although consensus estimates were little more than half of this. A number of hedge funds also bet that there would be an increase in volatility and therefore purchased put options on the baht.

When the hedge funds began to short Thailand, their counterparties were the large international banks, who for a time remained happy to continue holding the other side of the hedge funds' transactions. As time went on, a growing number of those banks closed out their positions, shifting their forward exposure to the Bank of Thailand, which was forced to intervene. But that a number of international banks, Chase Manhattan for example, made large losses in the third of quarter of 1997 is consistent with the stories we heard of international banks not hedging their exposure.

In Indonesia and Malaysia, in contrast, hedge fund managers did not see comparable problems with fundamentals. They did not attach such a high probability to large exchange rate changes. Not only were many of them surprised by the sharp movement of these currencies, but a not inconsequential number of hedge funds were long in Malaysian and Indonesian equities and bonds, not to mention the securities of other emerging markets, and took heavy losses when these crashed. One estimate, by Van Hedge Fund Advisors, is that offshore hedge funds lost 7 per cent of their value in August. According to market participants, the main institutional investors betting against Indonesia and Malaysia were the investment banks, which were better able to take on short positions due to their access to the domestic broker market. The hedge funds, for their part, were important mainly as purchasers of Indonesian currency forwards once that currency fell to 3100.

Factors magnifying the shock

The price dynamics of the baht in the period following July 2 could have been affected by dynamic hedging techniques used by options dealers to limit the risk of their positions.

A number of market participants viewed the level of volatility implied by options prices to be low relative to their expectations. This made options a cheap instrument with which to take a bet on depreciation or increased volatility. Sellers of options, who are implicitly taking the opposite bet, sometimes hedge by finding participants willing to take the offsetting position. When this is not straightforward, they engage in dynamic hedging. Dynamic hedging is the practice of obtaining an offsetting position in the underlying cash instrument, in this case the baht, with the goal of maintaining a delta neutral position through time. Since sellers of options know that, with some probability, they will incur losses as the baht depreciates, they sell a certain proportion of the amount of baht underlying the options contract. Assuming the baht does, in fact, depreciate, they have profits on their short baht position with which to offset the losses incurred due to the exercise of the put options. However, as the baht depreciates it becomes increasingly probable that the put options will be exercised. The options seller will then sell increasing amounts of baht to cover for these potential losses until the amount sold is almost equivalent to the amount underlying the contract. Thus, options sellers would be required to sell the baht in a falling market to maintain a hedged position, potentially exacerbating the original movement.

The effects of dynamic hedging are difficult to quantify. Several clues suggest, however, that it may have played a role. Options sellers were probably large international commercial and investment banks who had access to the spot market and maintained relatively sophisticated options dealing desks. According to market sources, options buyers were more numerous late in the period leading up to July 2 because other instruments like forward contracts were already building in the expectation of depreciation. Moreover, it was becoming increasingly difficult for options dealers to find counterparties willing to take offsetting options positions, forcing them to rely on dynamic hedging techniques. When the baht fell and markets became illiquid, additional selling pressure from dynamic hedging may have forced the baht to fall further that it would have otherwise.

Parallels

Market participants love to draw parallels. One we found particularly appealing was with the ERM in 1992. In 1992 institutional investors including but not limited to hedge funds were attracted into European securities by the combination of high European interest rates, ample cheap funding, and the mirage of pegged exchange rates, just as the combination of high interest rates, cheap funding and the mirage of pegged exchange rates more recently attracted a flood of money into Asia. While in 1992 it was called the convergence play rather than the carry trade, the phenomenon was the same.

In 1992 this process was disrupted by a depreciating US dollar, which rendered the European economies less competitive and by rising interest rates which made funding more expensive (foreign interest-rate rises providing the shock that catalyzed the reversal of opinion). In 1997 the process was disrupted by an appreciating dollar which made Asian economies less competitive and a small but sudden rise in European and Japanese interest rates, which again catalyzed the reversal of opinion. In 1992 hedge funds which had been among the first institutional investors to take convergence plays were among the first investors to short currencies such as sterling and the lira, although other institutional investors soon followed. Similarly, in 1997 hedge funds which had been among the most active participants in the carry trade were reportedly among the first institutional investors to begin shorting the baht, but other investors followed in their train.

Policy implications

For officials at the national and international levels concerned with the stability of financial markets generally and emerging markets in particular, no strong implications for regulatory reform follow. But a number of relatively modest policy measures might be considered.

Strengthening large trader reporting requirements

Hedge funds, with at least $100 billion of capital, and the largest macro hedge funds, with perhaps $40 billion of capital as a group, are non-negligible participants in financial markets. But those markets are also inhabited by a large number of other participants. Even taking account of leverage, the positions that can be taken by hedge funds pale in comparison with the position-taking capacity of mutual funds, pension funds, insurance companies, and the proprietary trading desks of investment and commercial banks. In any case, only a minority of hedge funds take positions in emerging markets, and only under exceptional circumstances do they allocate more than a fraction of their portfolios to those markets. Those individuals with whom we spoke, whether they manage hedge funds, compete with hedge funds, serve as counterparties to hedge funds, provide credit to hedge funds, or surveil hedge funds from official quarters, expressed skepticism that hedge funds are large enough to dominate or "corner" particular markets.

Still, if this is policymakers' fear, then a logical response is for other countries to emulate the large trade reporting requirements in effect in the United States. But even in the United States, trades must be very large to be subject to these requirements. To increase the likelihood that they will catch hedge funds in their net, policymakers would need to consider an appropriate minimum threshold for reporting.

More generally, attempting to obtain information on hedge funds' balance sheets and positions is problematic. Coordination of, say, monthly disclosure requirements among the G-10 countries would not suffice, since hedge funds are free to locate in Bermuda or the Cayman Islands. The Euro-currency Standing Committee at the BIS has been studying the feasibility of standardized portfolio reporting requirements for institutional investors, and it would be prudent to wait for their report. But on the basis of our discussions in New York and London, we are skeptical of the feasibility of extending any such initiative to hedge funds.

Limiting position taking

Policymakers might contemplate a variety of measures to limit the ability of hedge funds to take positions in financial markets, and in emerging markets in particular. By requiring banks and brokers to raise collateral and margin requirements, it might be possible to limit the use of leverage by hedge funds and, for that matter, other investors. By limiting the ability of financial institutions to provide the domestic credit needed short the currency and to loan the securities needed to short equity and fixed-income markets, it might be possible to limit the ability of hedge funds and other investors to take short positions. By slowing the development of active and liquid bond markets, it might be possible to discourage trading in those assets by hedge funds and other investors that prefer to transact in markets where positions can be easily taken and easily liquidated.

Taking this tack very far would be counterproductive for three reasons identified in our discussions. First, it would prevent hedge funds from acting as contrarians. While hedge funds may be among the first institutional investors to short a currency when there is evidence of inconsistent macroeconomic fundamentals and shaky currency pegs, they are also among the first buyers to jump back into the market after a crisis in which a depreciating currency overshoots and the market in sovereign bonds dries up. As such, they act as stabilizing speculators, providing liquidity in illiquid markets. (Market participants suggested that hedge funds played just such a role in the market for rupiah.) It is far from clear that discouraging hedge fund trading would reduce asset-price volatility; a plausible argument can be made to the contrary.

Second, attempts to impose position limits or margin requirements will provide incentives for financial market participants to arrange transactions in unregulated, or offshore, jurisdictions, neutralizing efforts to constrain their activities.

Third, the costs in terms of economic growth of policies of financial repression -- for that is what we described above -- are extremely high. The evidence that financial liberalization leads to financial deeping and accelerating growth is incontrovertible. Repressed markets may be relatively stable, but this does not mean that they are efficient or conducive to growth. To be sure, precipitous liberalization associated with inadequate supervision and regulation of domestic financial institutions can create problems and provide justification for going slow, but this has nothing to do with hedge funds.

Discouraging herd behavior and avoiding one-way bets

That said, because some hedge fund managers have well-publicized reputations for astuteness, the news that they have taken short or long positions in particular assets or particular markets may encourage other portfolio managers to follow their lead. Hedge funds leave footprints. They may play a singular role in the herding that is characteristic of incompletely-informed investors. Herding gives rise to a situation in which a large number of investors simultaneously scramble in or out of a market on the assumption that others doing so know something that they themselves don't. It can create problems of instability and disrupt a government's best-laid plans.

The solution is not to limit trading but to provide better information to the markets on government policies and the condition of domestic financial institutions to encourage investors to trade on fundamentals rather than to run with the herd. It is to avoid presenting hedge funds and other institutional investors whose combined resources constitute a market vastly larger than the assets of central banks and governments with an incentive to take large positions against a currency by offering the irresistible combination of inconsistent policies and unsustainable currency pegs.

Table 1. Hedge Funds: Assets Under Management by Investment Styles 1/

	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997
					(In millions of U.S. dollars)					
Event-driven	0	29	373	544	780	1,743	2,878	3,843	5,613	7,881
Global macro	0	29	4,504	6,462	8,919	18,141	19,252	17,326	24,498	24,510
Global	193	489	1,229	2,161	3,858	6,553	12,486	15,377	21,103	29,615
Long only	0	0	0	0	16	41	58	92	179	291
Market Neutral	0	78	664	961	1,716	3,414	4,776	5,703	10,176	16,233
Sector	0	0	2	3	8	47	85	169	670	1,774
Short-sales	0	0	187	239	226	244	403	432	473	450
Not classified	0	0	0	0	0	0	0	0	14,688	17,268
Fund of Funds	0	190	1,336	1,940	3,086	6,462	8,017	9,288	13,007	18,218
Total (including Fund of Funds)	**193**	**814**	**8,295**	**12,311**	**18,610**	**36,645**	**47,956**	**52,230**	**90,407**	**116,242**
Total (excluding Fund of Funds)	**193**	**624**	**6,959**	**10,371**	**15,523**	**30,184**	**39,939**	**42,942**	**77,400**	**98,023**
					(In percent of total) 2/					
Event-driven	0	5	5	5	5	6	7	9	7	8
Global macro	0	5	65	62	57	60	48	40	32	25
Global	100	78	18	21	25	22	31	36	27	30
Long only	0	0	0	0	0	0	0	0	0	0
Market Neutral	0	12	10	9	11	11	12	13	13	17
Sector	0	0	0	0	0	0	0	0	1	2
Short-sales	0	0	3	2	1	1	1	1	1	0
Not classified	0	0	0	0	0	0	0	0	19	18
Total (excluding Fund of Funds)	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: MarHedge.

Table 2. Hedge Funds: Number of Funds by Investment Styles 1/

	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997
					(In numbers)					
Event-driven	0	2	17	25	26	43	52	77	99	116
Global macro	0	3	14	16	21	30	37	42	52	53
Global	1	8	39	60	90	132	198	259	341	369
Long only	0	0	1	1	3	5	6	7	10	15
Market neutral	0	5	18	23	40	64	95	125	159	179
Sector	0	0	1	1	2	5	8	14	21	31
Short-sales	0	0	6	6	7	8	10	10	10	11
Not classified	0	0	0	0	0	0	0	0	2	2
Fund of Funds	0	4	32	45	63	85	133	178	217	247
Total (including Fund of Funds)	**1**	**22**	**128**	**177**	**252**	**372**	**539**	**712**	**911**	**1,023**
Total (excluding Fund of Funds)	**1**	**18**	**96**	**132**	**189**	**287**	**406**	**534**	**694**	**776**
					(In percent of total) 2/					
Event-driven	0	11	18	19	14	15	13	14	14	15
Global macro	0	17	15	12	11	10	9	8	7	7
Global	100	44	41	45	48	46	49	49	49	48
Long only	0	0	1	1	2	2	1	1	1	2
Market neutral	0	28	19	17	21	22	23	23	23	23
Sector	0	0	1	1	1	2	2	3	3	4
Short-sales	0	0	6	5	4	3	2	2	1	1
Not classified	0	0	0	0	0	0	0	0	0	0
Total (excluding Fund of Funds)	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: MarHedge.
1/ At end-period.

Table 3. Annual Returns by Investment Styles

(In percent)

	1990	1991	1992	1993	1994	1995	1996	1997
J.P Morgan GBI	8.6	14.8	7.2	10.1	-2.9	17.3	2.9	6.3
S&P 500	-3.1	30.5	7.6	10.1	1.3	37.6	23.0	29.6
Global macro	28.9	69.8	18.9	47.2	-8.4	32.1	24.9	23.8
Global	-8.1	39.0	25.2	29.6	-1.3	21.7	21.9	23.3
Event-driven	N/A	30.6	23.0	34.7	2.9	17.9	19.4	18.1
Long only	N/A	44.2	21.1	28.7	-5.1	50.2	25.8	36.1
Market neutral	N/A	7.9	6.8	10.5	5.1	9.8	15.0	10.6
Sector	N/A	70.2	44.4	27.6	-7.2	41.0	50.1	56.8
Short-sales	N/A	-14.1	7.9	8.4	20.2	-5.2	-2.3	4.9
Not classified	N/A	N/A	N/A	N/A	N/A	N/A	N/A	24.8
Fund of Funds	8.5	19.5	15.9	27.8	-8.7	17.3	16.5	19.9

Source: MarHedge.

Table 4. Standard Deviations of Monthly Returns by Investment Style
(In percent)

	90-92	92-94	94-97	90-97
J.P Morgan GBI	1.16	1.19	1.24	1.18
S&P500	4.20	2.32	3.28	3.53
Global macro	6.16	5.23	3.86	4.91
Global	3.05	2.17	2.42	2.57
Event-driven	2.01	1.79	1.48	1.72
Long only	4.61	2.99	3.72	3.86
Market Neutral	0.59	0.42	0.57	0.57
Sector	4.68	3.52	4.71	4.49
Short-sales	4.45	3.12	4.71	4.38
Fund of Funds	1.32	1.93	1.98	1.72

Source: MarHedge.

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+ CL

ACTION

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Office Memorandum

To: The Managing Director
The Deputy Managing Directors

November 3, 1997

From: Michael Mussa /s/

Subject: **Clearance of Briefing Memorandum for the Hedge Fund Study Missions**

Attached is the briefing memorandum for the study of hedge fund activities that is being undertaken by RES at the request of management. The first mission to support preparation of this study is scheduled for New York on November 10-11, 1997. In order to make the arrangements for this mission, including clearance by the U.S. ED's office, I would like to secure management's approval for the mission brief by close of business, Wednesday, November 5. I am circulating the mission brief simultaneously to APD, EUI, MAE, PDR, and WHD, with a request that they submit any substantial comments by close of business tomorrow, November 4. As the purpose of the missions is to support a study which will be reviewed by relevant departments before going to management, I do not anticipate that there should be significant controversy over the mission brief. Unless management objects, I would plan to approach the U.S. ED's office on Wednesday for travel clearance for the New York mission; this would not involve the substance of the mission brief.

Attachment

cc: Mr. Boorman
Mr. Deppler
Mr. Guitian
Mr. Loser
Mr. Neiss

Hedge Fund Study Missions—Briefing Memorandum

At the request of management, the staff is undertaking a study of the influence of hedge funds on global capital flows and market dynamics in both mature and emerging markets. The study will consist of an overview paper assessing the influence of hedge funds on market developments and on the policy issues raised by their activities, followed by an appendix containing three background papers—one examining the location, size, investments and returns accruing to hedge funds, a second describing trading strategies and investment vehicles, and a third exploring issues of prudential supervision and regulation. If the planned mission schedule can be agreed with the relevant authorities, the report could be discussed by the Executive Board in late January 1998.

I. Structure of Study

The recent speculative attacks on the exchange rate arrangements of many Asian countries, as well as the broader asset price volatility, have raised the issue of what factors have contributed to the intensity, duration and spread of these disturbances. Some observers have stressed the role of speculators, particularly hedge funds, in generating speculative attacks and disruptive capital flows. Recent estimates have placed total hedge fund assets as high as $145 billion. These entities are viewed as having played an important role in the 1992-93 ERM crises and the 1994 volatility in international bond markets as well. Hedge funds are also viewed as market leaders in affecting the activities of proprietary trading desks at major international banks and investment houses.

In order to evaluate the influence of hedge fund activities on global asset prices and capital flows, five issues will be addressed in the report. First, subject to data limitations, the report will trace the development of hedge funds since their appearance in the 1950s, providing information on the number of funds, where they are located, the value of their assets, the nature of their investments, and the returns on their equity. It will examine how hedge funds differ from other investment vehicles, particularly with regard to their use of leverage, their investment and trading strategies and how their activities and returns vary with macroeconomic and financial market conditions. In undertaking this analysis, the staff will utilize information from the proprietary databases that have been developed to monitor hedge funds activities—including those maintained by Managed Account Reports Inc., TASS Management Ltd., and VAN Hedge Fund Advisors. (The first annex to the report will utiilize these data to provide more detailed information on hedge fund size, location, investment performance, and trading activities).

Second, the report will discuss the types of trading and investment strategies that have been employed by hedge funds, the financial instruments employed to implement these strategies, and funding techniques. (The second annex to the overview paper will provide a more in-depth analysis of the trading and investment strategies that have been utilized by hedge funds during both normal and crisis periods.)

The third issue is the role of hedge funds in market dynamics. The report will present an intuitive discussion of recent theoretical models of large agents in selecting among multiple market equilibria and summarize previous empirical studies of the role of hedge funds in the 1992-93 ERM crisis, the 1994-95 Mexican crisis and, to the extent information is available, the 1997 Southeast Asia crisis, as well as in other arbitrage and investment activities.

The report will then discuss the supervision and regulation of hedge funds. It will provide information on disclosure requirements, proposals for regulatory reform, and options for and obstacles to closing existing supervisory and regulatory gaps. (The third annex to the paper will review the nature of the supervisory and regulatory practices in different countries.)

Finally, the report will discuss some of the policy implications of the growing scale of hedge fund and proprietary trading activities. It will include an examination of the implications of hedge fund activities for the design and implementation of macroeconomic, exchange rate and financial policies; for the international efforts to coordinate financial supervision and disclosure; and for the role of the Fund. It will summarize the views of market participants and regulators on the role of hedge funds in global financial markets.

II. Schedule of Missions and Work Program

The staff will undertake missions to selected financial centers in mature and emerging market countries in order to discuss with market participants and officials the role of hedge funds in global asset markets, as well as to examine the existing prudential supervision and regulatory environment in which these funds operate. The intention is to hold discussions with three categories of market participants: the banks and other financial institutions that provide finance to hedge funds; the proprietary trading desks of large banks and investment houses; and hedge fund managers. The staff will also hold discussions with the relevant supervisory authorities. There will be three one-week missions to New York, London, and Asia (Hong Kong, Singapore, and Malaysia) respectively. In Asia, the staff will focus their discussions with the authorities and market participants on the role of hedge funds in the events which have taken place since May 1997. Unlike in the major financial centers, in Malaysia our intent would be only to obtain the officials views. We would like your guidance on whether you think this would be appropriate. The proposed schedule of visits and staffing is as follows:

WESTERN HEMISPHERE

Dates:	November 10-13, 1997
Location:	United States (New York)
Staffing:	Eichengreen, Mathieson, Chadha, Kodres

EUROPE

Dates:	November 18-19, 1997
Location:	United Kingdom (London)
Staffing:	Eichengreen, Mathieson, Chadha, Kodres

Asia

Dates: November 20-26, 1997

Location: Hong Kong, Singapore and Malaysia

Staffing: Chadha, Sharma

ACTION

Office Memorandum

ACTION

To: The Managing Director
The Deputy Managing Directors

November 3, 1997

From: Michael Mussa /s/

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No comments
called Mussa
11/4
CS

cc: Mr. Boorman
Mr. Deppler
Mr. Guitian
Mr. Loser
Mr. Neiss

Hedge Fund Study Missions—Briefing Memorandum

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In order to evaluate the influence of hedge fund activities on global asset prices and capital flows, five issues will be addressed in the report. First, subject to data limitations, the report will trace the development of hedge funds since their appearance in the 1950s, providing information on the number of funds, where they are located, the value of their assets, the nature of their investments, and the returns on their equity. It will examine how hedge funds differ from other investment vehicles, particularly with regard to their use of leverage, their investment and trading strategies and how their activities and returns vary with macroeconomic and financial market conditions. In undertaking this analysis, the staff will utilize information from the proprietary databases that have been developed to monitor hedge funds activities—including those maintained by Managed Account Reports Inc., TASS Management Ltd., and VAN Hedge Fund Advisors. (The first annex to the report will utiilize these data to provide more detailed information on hedge fund size, location, investment performance, and trading activities).

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Location: United Kingdom (London)

Staffing: Eichengreen, Mathieson, Chadha, Kodres

ASIA

Dates: November 20-26, 1997

Location: Hong Kong, Singapore and Malaysia

Staffing: Chadha, Sharma

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Office Memorandum

To: Mr. Mussa

November 4, 1997

From: Jack Boorman /s/

Subject: **Comments on the Brief for Hedge Fund Study Missions**

We are in general agreement with the proposed brief, but would like to offer the following suggestion.

It would be useful, in the first section of the proposed study, to discuss factors that have contributed to the rapid growth of hedge fund activities in recent years, from both the market evolution and regulatory systems' point of view. This would help an appropriate assessment of the role of these funds in the third section of the study.

cc: Mr. Deppler
Mr. Guitián
Mr. Loser
Mr. Neiss

Eco-Cap. markets

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FUB
SD

Office Memorandum

To: Mr. Mussa — November 4, 1997

From: Jacques R. Artus /s/

Subject: **Hedge Fund Study Missions**

We have no major comments on this memorandum. We would only suggest that you review closely what has been the strategies followed by the Hedge Fund, and the extent to which one can say that they have been destabilizing, or on the contrary, have contributed to needed adjustments. We are also somewhat puzzled by the sentence "in Malaysia our intent would be only to obtain the officials views." It seems to us that it will be mainly in Malaysia that you should try to obtain views of other economic agents or market participants.

cc: Mr. Boorman
Mr. Guitián
Mr. Loser
Mr. Neiss

ECO-
Capital markets

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Office Memorandum

To: Mr. Mussa November 4, 1997

From: Manuel Guitián MG

Subject: **Briefing Memorandum for the Hedge Fund Study Missions—Comments**

The result of these missions should be a very interesting paper on an important aspect of the functioning of international financial markets. In particular, given the controversy surrounding hedge funds, it will be useful for the report to clarify their role, making sure that a distinction is made between the material that is descriptive and that which is prescriptive. It will also be useful to examine whether hedge funds are functionally and not merely institutionally distinct from other participants in international financial markets, and the implications for the issue of regulation of those markets. My specific comments indicate where these points might be brought out more sharply in the briefing memorandum.

- The report would benefit from a definition of a hedge fund. The intention to "examine how hedge funds differ from other investment vehicles" (page 2, line 6) suggests that a comparison will be made with mutual funds, direct investment, etc., when it might be useful to compare hedge funds with other market participants, such as banks trading on their own account.

- The first and second sections of the report are both meant to discuss the financing of hedge funds and their trading strategies (page 2). Is it worth keeping these sections separate?

- Empirical studies of the role of hedge funds in exchange rate crises will be summarized (page 3, top three lines). More emphasis might be placed on the stabilizing role of speculators in both turbulent and calm periods. It might also be useful to look at studies of the 1987 stock market crash. In this context it may be helpful to distinguish between "orderly" markets, which are not subject to discrete price jumps, and efficient markets, which are.

- The fourth section seems to mix the provision of information on existing regulatory practices with an evaluation of regulatory "gaps" (page 3, first full paragraph). The fifth section also seems designed to lead to normative conclusions on regulatory policy. Perhaps it would be useful first to describe the practice, and then consider the policy implications of the report as a whole . It will be important to distinguish between regulation to protect the soundness of the financial system (hedge funds might be of particular concern if they are heavily leveraged), and regulation to improve the functioning of the international monetary system (such as "sand in the wheels"), where hedge funds as institutions would not necessarily be singled out.

- Here also the report can discuss the constraints on policy, which may be severe if operating a hedge fund is highly profitable. An issue worth considering carefully is the possibility of hedge funds migrating to less regulated jurisdictions, thus vitiating attempt to limit their activities. Only once the objectives of, and constraints on, public policy are clarified, can one determine the appropriate action, whether it be exchange controls, prudential regulation, other market regulatory measures, or macro and exchange rate policy measures.

cc: Mr. Boorman
Mr. Deppler
Mr. Loser
Mr. Neiss

Contributors: William E. Alexander, Daniel Hardy, Peter Hayward, Mark Swinburne

CCO-capital markets

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Office Memorandum

To: Mr. Folkerts-Landau

June 30, 1997

From: Carol S. Carson CSC

Subject: **Draft Staff Report: International Capital Markets**

This is a well-written paper that provides a good overview of the major developments, recent trends, and prospects for international banking and capital markets. Of particular interest was the timely discussion in Chapter III of the systemic implications and challenges for the EMU.

One area where we thought that the paper might be developed further was in the section dealing with the role of the Fund. The section posits that the market expects that the Fund will continue to use its own resources, as well as act as a catalyst for regional balance of payments support, for "systemically important emerging market countries." It further notes that it would be important for the Fund to strengthen surveillance over the financial position of its member countries. However, the paper does not offer any additional insights on how the Fund might increase its involvement in the new environment of increasingly integrated global capital markets.

This issue is likely to be of interest to the Executive Board and the paper might therefore benefit from a more forward-looking discussion of the Fund's role in fostering the development of emerging capital markets.

cc: Mr. Mussa
Mr. Boorman
Mr. Calamitsis
Mr. Chabrier
Mr. Deppler
Mr. Gianviti
Mr. Guitián
Mr. Loser ✓
Mr. Munzberg
Mr. Neiss
Mr. Odling-Smee
Mr. Russo
Mr. Tanzi
Mr. Williams

P:\STA\AI\POLICY\INTCAPMA.MEM June 30, 1997 (9:20am)

ICO - Capital markets

CL o/r
BCS
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Office Memorandum

To: Mr. Folkerts-Landau

June 26, 1997

From: Peter S. Heller

Subject: **Draft Staff Report: International Capital Markets**

This report is well-written and highly informative, and covers the issues as outlined in the earlier briefing memorandum. Accordingly, we have only a few specific comments.

- *Restructuring costs of European banking systems*: at the bottom of page 21, the report identifies the banking systems in France and Italy as being relatively more vulnerable, and mentions the possible need for public funds in their restructuring. This section would benefit from an elaboration, possibly with some rough quantitative indication, on any budgetary implications of the restructuring in the EU in general, and in the aforementioned countries in particular.

- *Defending speculative attacks*: in describing the recent experiences of different currencies coming under pressure (pages 34-35), the report is unclear as to the staff's view on why the defense against the speculative attacks on the Thai baht was largely successful--was it because of the selective capital controls employed by the authorities, of the coordinated exchange market intervention of the regional central banks, or of the fact that the baht exchange rates were not too out of line of economic fundamentals in the first place? Why were the Czech authorities, in contrast, unsuccessful in defending the koruna?

- *External liability management*: on both page 37 and page 55, the report cautions sensibly against open foreign currency exposures beyond a "safe" maximum, but is mute on the determinants of this safe maximum. It would be useful to include a brief discussion on the broad parameters that would define the safe limit beyond which a country should hedge its currency risks.

- *Currency composition of EMU reserves*: the text beginning at the bottom of page 17 makes the point that official portfolio rebalancing following the introduction of the euro is unlikely to be large, and refers to Table 11 for relevant statistics. Table 11 provides, however, no information on the currency composition of EMU reserves.

cc: Mr. Mussa, Mr. Boorman, Mr. Calamitsis, Ms. Carson, Mr. Chabrier, Mr. Deppler, Mr. Gianviti, Mr. Guitián, Mr. Loser, Mr. Munzberg, Mr. Neiss, Mr. Odling-Smee, Mr. Russo, Mr. D. Williams

Contributor:
Howell H. Zee

From: Constanza Bryant
To: MLI2S.PO17.SKINSELLA
Date: 6/26/97 3:37pm
Subject: Draft Staff Report: International Capital Markets

Attached please find Mr. Heller's comments on the above. Hard copy being sent only to Mr. Folkerts-Landau.

CC: MLI2S.PO17.MMUSSA, PO13.CCARSON, MLH3S.PO06.PCHABR...

eco - Capital Market

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
97 JUN 26 AM 10: 47

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

June 25, 1997

From: François Gianviti F.G. and Manuel Guitián MG

Subject: **Multilateral Agreement on Investment (MAI)—Informal Consultation on Financial Services, June 9–10, 1997**

The Fund's role in the temporary safeguard article in the MAI is generally accepted; nevertheless, there are still some delegations which sought to limit the scope of application of the article and this and other matters remain undecided.

In the attached back-to-office note, Messrs. Holder and Johnston report on their participation in the above meeting which discussed, inter alia, the design of a temporary safeguard clause in the MAI and the role of the Fund.

It continued to be generally accepted that MAI would include a temporary safeguard clause and that the Fund would play a central role in its operation. It was also acknowledged that greater consideration would have to be given to the role of the Fund in related dispute settlement proceedings. However, a few delegations sought to narrow the scope of application of the temporary safeguard clause and proposed criteria that would make it difficult for the Fund to make the necessary assessments, and staff indicated as such during the meeting.

On other matters, there was general support for including public debt in the MAI while excluding the rescheduling of public debt, but little progress was made on the applicable modalities. Similarly, no agreement was reached on the precise carve-out from the agreement for actions taken by central banks in pursuit of monetary and exchange policies, with one delegation seeking to narrow its scope.

In sum, several important many matters remain unresolved and some delegations expressed frustration with the slowness in progress.

Attachment

cc: AFR, APD, EU1, EU2, EXR, FAD, INS, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Russo
Mr. Quick

R:\DOC\ER\OECD\MAI\97JUNEBTO.MG June 25, 1997 (10:53am)

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

June 25, 1997

RBJ

From: William E. Holder and R. Barry Johnston

Subject: **Multilateral Agreement of Investment (MAI)—Informal Consultation on Financial Services, June 9–10, 1997**

We represented the Fund at the above meeting of an informal group that is continuing the work of the previous Expert Group on Financial Matters (EG5) and that has, within its mandate, consideration of the role of the Fund in the MAI and, in particular, the terms of a derogation clause for temporary balance of payments problems. This group is also considering the treatment of public debt in the MAI and the need for a "carve out" from the agreement for transactions by central banks in pursuit of monetary and exchange rate policy objectives.

I. Temporary Safeguard Clause

At this stage, it is generally accepted that a temporary safeguard clause will be included in the MAI, and that the Fund will play a central role in its operation. To this end, increasing comparison is made to the GATS provision as a model—but, in several respects, the existing draft differs significantly from the GATS.

Within the Group, however, there are substantial differences on many important points and, while some progress was made on details, it was recognized that progress was overall disappointing. In fact, several delegations expressed frustration at the lack of a clear direction and even of backsliding. This related, in particular, to the scope of the balance of payments clause and the role of the Fund; some important delegations (U.S., Canada, and Switzerland) made suggestions that would narrow the effectiveness of the clause.

There is also growing recognition that the Fund's initiative relating to asserting jurisdiction over capital movements will have to be taken into account. In this respect, Fund staff responded to questions about the scope and work program for such an amendment, including the time required to adopt an amendment.

Accordingly, a lot of matters are still undecided and the Group is not in a position to provide agreed advice to the Negotiating Group, and will need to meet again, probably in October 1997.

A. Role of the Fund in the Safeguards Clause

It is accepted that the clause would protect measures approved by the Fund in the exercise of its jurisdiction. As drafted, this clause would extend to measures approved by the Fund under an amendment of the Articles for capital movements; such an effect is generally recognized and not resisted.

Secondly, the draft continues to posit a Fund role for certain matters outside its jurisdiction. It is accepted that the Fund would assess the balance of payments situation of the member imposing the measure (paragraph 1 of the text). It is also anticipated that the Fund would have some role in the assessment of certain conditions for the application of the safeguards clause. As yet, however, the relationship of this Fund involvement with the Parties Group remains open. One possibility is that a Fund determination would be at the option of the Parties Group; an alternative is that it would be a required part of the system (the majority favored the latter, but the alternative provisions remain). In several respects, therefore, the Fund's role can be expected to go beyond that conferred on it by the WTO. In particular, its determinations, once made, will bind the Parties Group.

B. Scope of the Safeguards Clause

The scope of the safeguards clause is still in flux. In this respect, two features of the discussion were worrisome.

First, the United States, in particular, suggested that the generality of the derogation should be narrowed so as to apply only to specified aspects of the MAI. While most delegations considered that the safeguards clause would allow derogation to obligations concerning transfers and national treatment (non-discrimination), some delegations would confine it to transfers. Excluding national treatment for cross-border transactions from the scope of the clause would effectively mean that restrictions could not be imposed on transactions that would affect inflows. This issue was left open for further discussion.

Secondly, certain new provisions have been suggested among the issues that the Fund would evaluate, but which, in the view of the staff, are not susceptible to our assessment. One issue concerned whether the measure restricted "the acquisition of investment where the point of comparison for a foreign investor using foreign-sourced funds is a domestic investor using domestic-sourced funds" (paragraph 1). Another issue concerned whether the measure "provide[d] for the least disruptive effect [sic] to the functioning of the Agreement" (paragraph 2). We informed the group of our difficulty in engaging in such assessments, in particular, the practical difficulties in distinguishing the source of funds as proposed by the United States.

II. Role of the Fund in Dispute Settlement

Considerable progress has been made on the role of the Fund vis-à-vis the Parties Group. Thus, for activation of the safeguards clause, the Fund must be consulted and its determinations accepted by the Parties Group. In addition, for non-jurisdictional matters, if consulted, its findings cannot be contested. Finally, access to dispute settlement on these matters is limited.

Provisions for dispute resolution, however, do not explicitly address the role of the Fund vis-à-vis the dispute resolution. To clarify this point, the staff explained the gap, and reiterated its proposal for explicit language that would require a dispute settlement panel considering a matter involving the safeguards clause or Fund jurisdiction to consult with the Fund and to be bound by the balance of payments and jurisdictional rulings. It was agreed that, pending further consideration of the issue, such a clause would be inserted in a footnote.

III. Public Debt

There is general agreement that public debt should be included in the MAI. There is also general agreement that debt rescheduling should fall outside the MAI, but as yet there is no consensus on how to accomplish this. The French delegation tabled a revised proposal which would allow for the reorganization of debts between contracting parties, and related obligations covered by comparability of treatment, to prevail over the MAI agreement. The U.S. delegation suggested an alternative approach that would effectively "carve out" public debt from most of the MAI obligations. The delegation emphasized that this proposal was still under discussion within the U.S. Government.

IV. Transactions in Pursuit of Monetary and Exchange Rate Policies

As in the case of the safeguard clause, the U.S. delegation tabled a proposal to narrow the scope of this "carve-out" from the agreement for actions carried out in pursuit of monetary and exchange rate policies. In the U.S. proposal, the carve-out would be limited to open market transactions in securities and foreign exchange intervention rather than to all transactions carried out by the central bank or monetary authority in pursuit of monetary and exchange rate policies. However, most delegations considered that such a narrowing of the carve out would not be appropriate.

cc: AFR, APD, EU1, EU2, EXR, FAD, INS, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Russo
Mr. Quick

cc - Capital Flows
CL
BCS
IO
F

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

April 25, 1997

From: François Gianviti F. G.

Subject: **Multilateral Agreement on Investment (MAI)--Informal Consultation on Financial Services, April 15-16, 1997**

The MAI Expert Group continued discussions on a specific text on a temporary safeguards clause in the MAI. While details of a role for the Fund need to be finalized, an important role for the Fund is ensured.

In the attached back-to-office report, Mr. Johnston, Mr. Fisher, and Ms. Siegel report on their participation in the recent meeting on financial services that concerned, inter alia, a temporary safeguards clause including a key role for the Fund. Considerable progress was made in solidifying a role for the Fund in the derogation from obligations under the MAI with respect to restrictions both within and outside the Fund's jurisdiction. In addition to accepting restrictions that have been approved by the Fund in the exercise of its jurisdiction, the draft text provides for significant Fund input on matters outside its jurisdiction. In response to suggestions by Fund staff, the Fund would, in all cases, provide an assessment of the balance of payments and external financial situation of the member imposing the measure. In addition, alternatives are under consideration for the Fund either to evaluate whether the measures are justified under all the stated MAI criteria in all cases, or for the Fund to be requested to do so on a case-by-case basis. Under both alternatives, the Fund's role would exceed its role in the WTO.

Draft text on this temporary safeguards clause still needs refinement, as do provisions concerning the role of the Fund in dispute resolution procedures, an exception for monetary and exchange rate policies and the treatment of public debt in the MAI. As the delegates have looked to the Fund for suggestions on the formulation of these provisions, it will be important for the staff to continue to be involved in these discussions. We will keep you informed of the proposed schedule.

Messrs Boorman and Guitian have also reviewed this back-to-office report. *No Management action is necessary.*

Attachment

cc: AFR, APD, EUR I, EUR II, EXR, FAD, INS, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Quick

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

April 24, 1997

From: R. Barry Johnston, Matthew Fisher, and Deborah Siegel

Subject: **Multilateral Agreement on Investment (MAI)—Informal Consultation on Financial Services, April 15-16, 1997**

We represented the Fund at the above meeting where an informal group continued the work of the Expert Group on Financial Matters (EG5) considering the role of the Fund in the MAI and the terms of a temporary safeguard clause to address balance of payments problems.[1] Mr. Clarke (PAR) also attended and, as in the past, provided us with useful background information regarding developments in the negotiations on all aspects of the treaty. We were closely involved in the discussion of the design of the safeguards clause, which will include an important role for the Fund. Although the group made some progress in refining the clause, details remain to be resolved on such issues as its scope and the precise role of the Fund in matters outside of its jurisdiction. As open issues also remained on other topics on the group's agenda, its report is not likely to be discussed at the meeting of the Negotiating Group in late April as was originally anticipated; instead, this group considered seeking a mandate to continue discussions, perhaps at a meeting in June.

Role of the Fund in the Safeguards Clause

The group accepted the proposal of Fund staff that the clause would protect measures approved by the Fund in the exercise of its jurisdiction. (See report on the previous EG5 meeting, March 21, 1997). We understand that the report will state that, given the ongoing discussions on a possible amendment of the Fund's Articles, this provision will need to be reviewed to ensure its adequacy in light of any extension of Fund jurisdiction.

As for measures outside of the Fund's jurisdiction, the current text reflects a role for the Fund that could exceed its role in the WTO Committee on Balance of Payments. In those consultations, the Fund provides an assessment of the balance of payments and external financial situation of the member imposing the measure, while the Committee makes the ultimate determination of whether the measure is justified under the WTO-related agreements. Under the draft text for the MAI safeguards clause, two alternatives are currently being considered, both of which involve the Fund providing at least the assessment of the BOP and external financial situation of the member imposing the measure. The first alternative would

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[1]Messrs. Johnston and Fisher returned to Washington on Tuesday, April 15, in order to attend the Executive Board discussion on a possible amendment of the Fund's Articles on account of capital transactions.

provide in all cases for the Fund to determine whether the measure is justified under all the criteria of the MAI safeguards clause. Under the second alternative, an MAI "Parties Group" evaluating a restriction imposed under this safeguard would have the option to request that the Fund determine whether the restrictions are justified under all the MAI criteria (which the WTO BOP Committee does not have authority to request). In any event, the Fund would provide a review of the situation every six months; Fund staff suggested flexibility in the timing of this review, for example, to coincide with Executive Board review under a Fund program. Under either alternative, the draft text states that any assessment provided by the Fund must be accepted under the MAI.

Scope of the Safeguards Clause

The group agreed that the safeguard clause should explicitly deal with difficulties arising from inflows (as well as outflows) and (aside from Belgium) that the Fund should provide the assessment of these circumstances. The group has not reached agreement, however, on certain other aspects of the clause's scope, such as whether any restrictions imposed must treat foreign investors and domestic investors equally in order to be justified under the clause. Fund staff explained that careful consideration needed to be given to this requirement, but, were it to be a criterion under the clause, the Fund could make the necessary evaluation in any determination it provided for the MAI. The group also left open whether certain underlying transactions, and/or payments relating to compensation from expropriation, could not be restricted, even under the temporary safeguards clause.

Role of the Fund in dispute settlement procedures

Reflecting progress over last meeting, the draft text now clearly indicates that restrictions determined to be justified under the clause (by the Fund or a "Parties Group") could not be subject to dispute resolution; however, dispute resolution would be available if the restriction actually applied differed from that approved, and the Fund would be consulted in any such proceedings. Discussion has not yet taken place on explicit language proposed at the last meeting by Fund staff to require that any dispute settlement panel considering a matter involving the safeguards clause or Fund jurisdiction be required to consult the Fund and be bound by its jurisdictional rulings and balance of payments assessments. Informally, a few delegations indicated support for this provision, although its acceptance by the group is not clear at this stage.

Other topics of interest to the Fund

The group also advanced the discussion of whether public debt should be explicitly included in the MAI (see March 21 report). Most delegates (with the notable exception of Mexico) believed that such inclusion would be beneficial, in part because of the arbitration procedures that would become available under the MAI to resolve any disputes on this debt. Nonetheless, there was general consensus that sovereign debt rescheduling, refinancing or workouts should be excluded from this provision. Fund staff again explained the importance of taking into account possible workouts on sovereign debt owed to private non-bank creditors (e.g., bondholders), and offered to work with the group to refine the provision.

The group made little progress on refining an exception for measures taken by monetary authorities in pursuit of monetary and exchange rate policies, but the existence of this exception does not appear in jeopardy.

Next meeting

While it seems clear that the Negotiating Group will not discuss the group's report at its late April meeting, it is not yet clear whether it will permit the group to continue its discussions (as the mandate of this and other expert groups have expired) or take financial services matters up itself at a later meeting. Given the extension of the negotiations until next year, it seems more likely that the group will meet again, at least informally. Once the delegates' proposal on the Fund's role in the safeguards clause has become firm, we should consider briefing the Executive Board, as the Fund would need to formally agree to provide the services discussed. We will keep you informed of developments.

cc: AFR, APD, EUR I, EUR II, EXR, FAD, INS, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Quick

WHD CL

IO

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

March 21, 1997

F.G.

From: Jack Boorman, François Gianviti, and Malcolm Knight

Subject: **Multilateral Agreement on Investment (MAI)-Expert Group No. 5 on Financial Service Matters, March 13-14, 1997**

The MAI Expert Group considered specific texts on a balance of payments safeguard clause in the MAI that would provide for a key role for the Fund. Such a clause had been recommended by Fund staff which had also made proposals for its formulation. No Management action is necessary in connection with this back-to-office report.

As you know, staff has been participating in a number of meetings on the MAI, particularly concerning its relationship with the Fund and the inclusion of a safeguard clause to address balance of payments problems. In the attached back-to-office report, Mr. Havrylyshyn, Mr. Johnston and Ms. Siegel report that the draft texts discussed by the delegates firmly establish the inclusion of a safeguard clause that would involve a significant role for the Fund. Two alternative texts are currently under consideration by the group, which will reconvene in mid-April for further discussions.

At the suggestion of staff, both draft texts include provisions designed to protect measures approved or requested by the Fund in the exercise of its jurisdiction. As for measures imposed under this clause that are outside of the Fund's jurisdiction, the Fund would also have a role that at a minimum parallels its role in the WTO Balance of Payments Committee. Under this alternative, the Fund would provide the information on which an MAI Parties Group would determine if the measure were justified under the MAI. Under the alternative, text the Fund would make this determination.

Both texts also reflect comments by staff that the safeguards clause, and the Fund's role therein, explicitly extend to measures necessary to control inflows as well as outflows, although the precise rules on inflows remain to be finalized. The April meeting is expected to result in progress towards resolving these issues, including issues relating to the role for the Fund in dispute resolution procedures, an exception for monetary and exchange rate policies and the treatment of public debt in the MAI. As the results of this group's deliberations on these issues of interest to the Fund will be discussed by the Negotiating Group in late April, it will be important for the staff to continue to be involved in these discussions.

Attachment

cc: AFR, ADP, EUR I, EUR II, EXR, FAD, INS, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Quick

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

March 21, 1997

From: Oleh Havrylyshyn, R. Barry Johnston, and Deborah E. Siegel

Subject: **Multilateral Agreement on Investment (MAI)—Expert Group No. 5 on Financial Service Matters, March 13–14, 1997**

We represented the Fund at the above meeting which addressed the role of the Fund in the MAI generally and considered terms of a general safeguard clause to address balance of payments problems. Mr. Clarke (PAR) also attended. As at the previous meeting, the Chair and delegations looked to the IMF staff for a significant input on the design of a safeguard clause and were to a large extent guided by our views. The discussion reflected progress over prior meetings because the existence of such a clause and an important role for the Fund in its implementation are now firmly accepted. Nonetheless, the group still needs to establish the details of the specific role for the Fund in determining whether measures outside of its jurisdiction are justified under the MAI. The group adjourned with two alternative draft texts, which it will discuss at its next meeting, tentatively scheduled for April 14–15.

Protecting Fund Jurisdiction

Based on suggestions by Fund staff, language included in both alternative texts is designed to protect measures approved by the Fund under its jurisdiction, which would automatically be considered consistent with the safeguard.[1]

The treaty would also permit a member to apply capital controls if requested by the Fund under Article VI, Section 1. This is not in the safeguard clause itself, but is the intent of a separate provision that explicitly retains all obligations under the Fund's Articles.

Fund Role in Evaluating Measures Outside of Its Jurisdiction

While the meeting was inconclusive on the precise role of the Fund concerning measures outside of its jurisdiction, at a minimum, the Fund would have the same role as it does in the WTO Committee on Balance of Payments. In those consultations, the Fund provides an assessment of the balance of payments and external financial situation of the member. Although the WTO is required to accept this assessment, it is legally permitted to make its own conclusion on whether the measure is justified under all the requirements of the safeguard

[1]This provision does not extend to measures maintained under Article XIV; none of the MAI Contracting Parties are Article XIV members.

clauses in the WTO-treaties. The revised draft of the safeguard clause prepared by the Chair supported this role for the Fund. Nonetheless, several delegations continued to support a more extensive role under which the Fund would make the legal determination whether recourse to this clause was justified under the MAI. This broader role was reflected in the alternative text circulated by the European Commission and the Netherlands. Fund staff explained how the Fund would analyze the various criteria identified in the MAI as conditions to have recourse to the safeguard clause.[2] We plan to discuss informally with delegations the relative merits of the alternative approaches in advance of the next meeting.

Scope of the Safeguard Clause

The Group concluded that the safeguard clause should explicitly deal with difficulties arising from inflows as well as outflows. Fund staff explained the nature of such difficulties and provided advice on how they could be addressed under the MAI. As many delegates had difficulty viewing inflow disturbances as a "balance of payments" problem, the clause has been renamed "temporary safeguards." The Fund's role would thus extend to measures applied to address circumstances where movements of capital cause (or threaten to cause) serious difficulties for the operation of macroeconomic and, in particular, monetary policy.

The Group revisited the issue of whether the safeguard clause should cover underlying transactions or be limited to payments and transfers, and whether certain payments, such as compensation from expropriation, should be excluded from the safeguard. Fund staff explained that, especially on the inflow side, restrictions tend to be imposed on the underlying transaction rather than the transfer. Differences of view are reflected in the alternative drafts to be reconciled at the next meeting.

Role of the Fund in dispute settlement procedures

Also to be resolved at the next meeting is the role of the Fund in any dispute resolution related to recourse to the temporary safeguard clause. While the Group tended to the view that a measure approved (by the Fund or an MAI "Parties Group") under this clause would not be subject to dispute resolution, the Chair's text is ambiguous on this point. Also, there appears to be a consensus that dispute settlement would be available when a restriction was applied in a manner that departs from the terms under which it was approved. Consequently, we proposed that specific language be included to require consultation with the Fund on these matters and to require that any dispute settlement panel be bound by the Fund's jurisdictional rulings and balance of payments assessments, as is the case with the WTO. This language has not yet been discussed in detail.

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[2] For example, an issue requiring further clarification is whether the Fund has the capacity to evaluate the impact of any restriction imposed under the clause on individual investors.

Other Issues of Interest to the Fund

The Group agreed in concept to an exception to national treatment and most favored nation treatment for measures taken by monetary authorities in pursuit of monetary and exchange rate policies. This would allow the central bank or monetary authority to discriminate between residents and non-residents in the pursuit of its monetary policy. We commented that, while such an exception could be helpful in addressing volatile capital inflows in countries with developed financial markets, countries with less developed markets may need to rely on a range of measures and would therefore need to take country specific reservations under the agreement to safeguard the use of these measures. The application of measures under the exception provision would not be subject to prior approval under the MAI but could be challenged through dispute settlement.

The discussion on public debt brought out two conclusions. First, most of the delegations favored including reference to obligations on public debt in the MAI because of the discipline that this imposes on meeting these obligations and the adverse signaling effect that would result absent this reference. A couple of delegations nonetheless strongly opposed such a reference. Second, it was noted that sovereign debt rescheduling, refinancing or workouts had to be excepted from any requirements, but how to do so remained very vague. Fund staff commented by noting that inclusion of public debt did have the positive effects noted by delegations, but also raises concerns about debt–workout opportunities for debtors in critical situations. While Paris Club and London Club mechanisms exist to handle two categories of public debt, for the third, residual category (essentially involving private bond holders) there are no clear–cut mechanisms. Apart from one delegation's reference to the G–10's discussion on orderly workouts, the issue was not discussed in detail by delegates. It was expected that some further proposals on language will be made to incorporate recognition of at least the presently existing mechanisms.

Next Meeting

The Group tentatively agreed to meeting informally on April 14–15 to attempt to resolve outstanding issues. While a report of the March meeting will be presented to the Negotiating Group at its March 24–25 meeting, these issues will not be addressed as an agenda item until the Negotiating Group's meeting at the end of April, where presumably, the results of the informal April meeting of will also be considered..

cc: AFR, ADP, EUR I, EUR II, EXR, FAD, INS, MED,
RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Russo
Mr. Quick

Thank you for distributing the above draft for comment by departments, bureaus and offices.

BLS finds the report clear and well drafted, and has no substantive additions to make to Section III. We do have two small comments with respect to detail, however.

On page 4, at the end of last sentence of paragraph 4 preceding the chart, it might be useful to clarify whether the "expanded dollar budgets for some expenditure categories [which] continue to be effective"are effective in some, or in all, of the categories concerned. The current phrasing could be interpreted either way.

In the sixth line of paragraph 45 (p.27), it would appear that "not" or "not yet" may need to be inserted immediately before "been fully realized."

04. F

(2) Capital Flows

Office Memorandum

To: Mr. Ito

January 22, 1997

From: Brian C. Stuart BCS

Subject: **APEC--Background Paper on Capital Flows**

Thank you for the opportunity of reading this interesting paper. It provides a very useful update of the current situation and policy thinking with respect to international capital flows, and we hope that it will be available within the Fund when it is transmitted to the APEC Finance Ministers' Working Group.

We agree with the treatment of issues in the paper and our comments relate to a few details and points of clarification.

1. At the top of page 3, it is not only the resolution of the debt crisis but also substantial policy reforms in many countries that have facilitated private capital flows.

2. In the middle of page 6, is there evidence to suggest that syndicated loan issues are related to the refinancing of commercial bank loans?

3. At the end of the next paragraph, "sharp acceleration" could read "sharp acceleration in bond issues".

4. In the middle of page 8, should the reference be to tables 4 and 5? If so, we presume that these tables cover more than just APEC countries.

5. In the middle of page 11, the reference to "the issue of financial stability" and "a valid 'speed bump'" were not clear to us.

6. In footnote 5 on page 11, we wondered about the relevance of the final sentence.

7. The incomplete paragraph at the top of page 14 seems to be saying that capital outflows associated with the purchase of technologically advanced companies may be associated with the transfer of technology to the investing country, but this point could be made more clearly.

8. In the middle of page 16, "about the future exchange rate path" could read "about the future path of inflation and the exchange rate".

9. Towards the bottom of page 18, we would not lump Chile and Mexico together in terms of their relative exchange rate volatility, especially if the focus is on the period of adjustment and reform that began in the mid-1980s. This general point applies also to the reference to Chile in the middle of page 28.

10. The paradox of a currency appreciation going together with strong growth may be explained in part by strong productivity--in a situation where productivity is rising sharply in the tradeable goods sector, these would be a tendency for the currency to appreciate in real terms and for output to rise.

11. In the middle of page 24, it is not fully correct to say that interest rate differentials were eliminated in Argentina. Rates other than the overnight rate have reflected a significant country risk on Argentine paper, and increases in interest rates in early 1995 associated with the functioning of the Currency Board were an important element in stabilizing the situation in the period of the Mexican crisis.

12. In the paragraph at the top of page 25, the sentence could read "real interest rates in industrial countries".

13. At the top of page 26, it is not obvious that particular attention should be given to fiscal policy if capital inflows are seen as more permanent--if the inflows indeed are permanent, the case could be made for a real currency appreciation and changes in relative prices to help restructure the economy.

14. The discussion in the middle of page 29 that downplays the role of strong policies in explaining capital flows contrasts with the importance that is attached to these policies elsewhere in the paper--for example on page 34.

15. At the bottom of page 30, we did not understand the reference to "a maturity mismatch between a country's short-term liabilities and assets" and the "currency composition of external debts and assets".

16. In the paragraph at the top of page 32, it may be necessary to relate the need for a change in exchange rate policy to other policies, given that the real exchange rate is a reflection of these policies. For example, in a situation where the exchange rate is floating and short-term capital inflows are continuing at a pace that the authorities believe is unsustainable, it will be difficult to engineer a currency depreciation without changes in other policies.

17. In the following paragraph, we are mindful of the criticisms that are made when we suggest that the appropriate response to both capital inflows and outflows is a fiscal tightening. However, we doubt in a situation where the prospects of a capital

outflow are sufficiently worrying that a policy response is being planned, that the appropriate response is a loosening of fiscal policy. If interest rates need to increase to stem outflows, this should be induced by a tightening of monetary policy.

cc: Mr. Boorman
Mr. Neiss
Mr. Saito