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March 5, 1998

Summing Up by the Acting Chairman
Hedge Funds and Financial Market Dynamics
Executive Board Meeting 98/22
March 3, 1998

Directors welcomed the opportunity to discuss hedge funds and financial market dynamics in a world of increasingly integrated capital markets. They felt that events taking place in East Asia rendered timely this discussion of the activities of hedge funds and institutional investors more generally.

Directors stressed that information on hedge funds is limited. Hedge funds, as private investment pools, are not subject to most of the reporting and disclosure requirements applicable to banks and mutual funds. This makes it difficult to construct a comprehensive enumeration of hedge funds, much less to assemble information on their activities. More fundamentally, Directors noted the analytical and definitional difficulties of clearly demarcating the boundaries of the hedge fund industry, and therefore of estimating its size. They emphasized the difficulty of generalizing about its activities, given the great diversity of investment strategies pursued by fund managers. Some Directors, pointing to the fact that hedge funds are only one among many institutional investors and engage in many of the same activities and use many of the same instruments as other investors, suggested that issues regarding regulation and monitoring to secure market integrity should be discussed from a broader point of view, to include all institutional investors.

Directors noted that several commercial services gather information on the industry. Excluding funds of funds, such estimates suggest that hedge fund capital was in the neighborhood of $100 billion as of the third quarter of 1997. Of that, some $25 billion was in the hands of macro funds, which typically lever their capital through borrowing by a factor of 4 to 7. Directors also noted that, in comparison, the capital of other institutional investors, such as investment and commercial banks in the mature markets alone, exceeds $20 trillion.

Against this background, Directors expressed differing views on the impact of hedge funds on market dynamics. While agreeing that hedge fund capital is only a small fraction of liquidity in global financial markets, several Directors emphasized that the positions taken by highly leveraged hedge funds can be large relative to the scale of smaller emerging markets. They also noted the relative freedom and flexibility of hedge fund activities. Some Directors also argued that hedge funds can play an important role in encouraging herding behavior among investors, while others saw only limited evidence that hedge funds contributed significantly to herding, and noted their potential role as contrarians or stabilizing speculators.

Directors had differing views on the extent of the involvement of hedge funds in the Asian crisis. Several Directors did not see clear evidence that hedge funds were earlier than other investors to take short positions against Asian currencies, or that their trades were necessarily a signal for other investors to follow. They noted that while hedge funds had large short positions on the Thai baht, the same does not appear to have been true for Asian currencies in general. Because some governments and central banks employ capital controls and moral suasion to limit the ability of offshore counterparties to borrow domestic currency from onshore banks, other investors with better access to the domestic broker market may have been in superior positions to act as market leaders. This points to the likelihood that the entire constellation of institutional investors, and not merely hedge funds, had played a role in the market fluctuations of 1997.

A few Directors suggested that hedge funds had played a more important role in the recent crisis than indicated by the staff's paper, arguing that hedge funds at times had a strong effect on asset prices, particularly in light of the relative size of their positions in local emerging markets. However, Directors generally agreed that recent developments highlighted the need for policymakers to pursue sound and prudent macroeconomic policies that are transparent to markets, in order to protect their economies against sharp market volatility and speculation. In particular, they underlined the importance of avoiding offering one-way bets in the form of inconsistent policies and indefensible currency pegs; of maintaining strong, well-regulated, and competitive financial systems; and of providing timely and comprehensive information to the public about government policy and private sector financial conditions. While recognizing the role of better information about macroeconomic developments and policies in limiting herding behavior, several Directors, however, cautioned that experience suggested that the disclosure of market-sensitive information could on occasion trigger or exacerbate market volatility.

Directors expressed diverse views on whether hedge funds should be subject to additional regulatory and disclosure requirements. Some argued that hedge funds are already subject to appropriate disclosure requirements on large trades and positions, as established by government authorities and by self-regulating futures exchanges. In their view, given the relatively scant evidence of market failure associated specifically with hedge funds, the case for adopting new regulations is slim. A number of Directors, however, indicated that further options need to be explored to render hedge fund operations more transparent and assure officials and market participants that hedge funds are not dominating or manipulating markets. A few Directors called on the Fund to take a more pro-active role in promoting such transparency for all institutional investors and in helping to ensure the stability of international and regional financial markets, and suggested that consideration be given to an SDDS-type mechanism for greater transparency of financial market players and transactions. Some Directors warned that hedge funds are only one part of the larger constellation of institutional investors, so that any system of detailed portfolio and position reporting, to convey useful information, would have to encompass, inter alia, commercial banks, investment banks, insurance companies, and pension funds as well.

Some Directors suggested extending large trade and position reporting systems, such as those that already exist in the United States. They noted, however, that such reporting systems are more difficult to implement in an over-the-counter environment such as that of the foreign exchange market. Pointing to the crucial role to be played in such reporting by the emerging markets in which hedge funds are most active, Directors noted that, to be totally effective, reporting requirements would have to be applied by all countries. Otherwise, market participants who regarded reporting as onerous could simply book their transactions offshore.

A few Directors suggested that enhanced disclosure requirements could be combined with a policy of mandating minimum margin or collateral requirements to limit position taking in periods of market volatility. Several Directors again noted, however, that such requirements, to affect the operation of the markets, would also have to apply to banks, pension funds, and insurance companies, among others, and not merely to hedge funds.

Directors generally agreed that the staff paper, with appropriate revisions to take account of Directors' comments, should be published.