CURRENT CHALLENGES IN WORLD FINANCIAL MARKETS

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It is a great pleasure for me to take part in this conference. The issues I will address are central both to so much of the work I was privileged to do at the IMF, and to so many of the controversies about the operation of the global economy provoked by the crises of the last decade, that I greatly value the opportunity to discuss them again. It is a special pleasure to be speaking at a conference hosted jointly by the South African Treasury and the World Bank, where I feel so much among friends. And there is another, more personal, reason I am happy to be here: Cape Town is almost home, the town where I spent many happy summer vacations, and where for a time I went to school, literally next door to the Mount Nelson.

We are meeting at a time of rapidly changing conditions in the world economy, with global economic prospects far better than expected until very recently. Less than two months ago, the World Economic Forum took place in New York, with extensive South African representation, including President Mbeki and the economic team. At that time, there was deep nervousness over the economic shocks from September 11th, Argentina's default, and the collapse of Enron. However, in the weeks since, evidence of a United States recovery has accumulated. Alan Greenspan made it nearly official[2] by stating on March 7 that an economic expansion was already "well under way" in the United States, one that he predicted would be moderate in strength. European data too are sending signals of recovery, also likely to be moderate. Of course, we need to be cautious: there are clear risks to the recovery in the United States and Europe – including the possibility of another major terrorist attack, instability in the Middle East, and the consequences of possible military action against Iraq – and the underlying condition of the Japanese economy remains a major concern.

Global recovery will improve the external environment for the developing countries, and improve their growth prospects. But their economic policies will also be critical in determining how rapidly they grow. Our host country, South Africa, ranks high on any list of countries pursuing consistently strong macroeconomic policies, within a sound institutional framework. With that sound basis in place, improved export prospects should help give a push to growth, and that – together with a strengthening of

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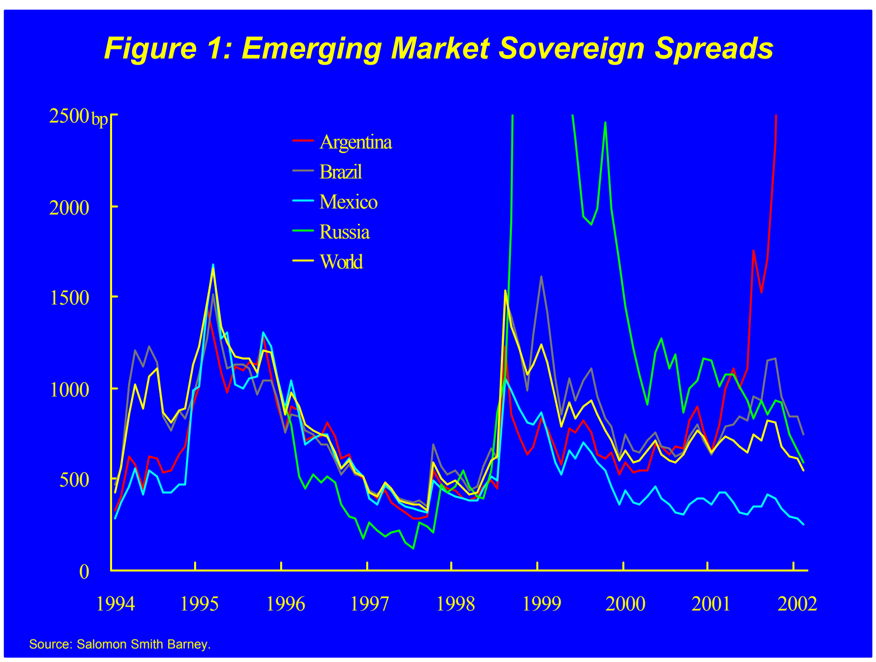
[2] "Almost" because it is not the government, but the National Bureau of Economic Research, that dates business cycles

structural reforms and measures to address important non-economic policy concerns – could help the country break through to a consistently higher level of growth.

There are also early signs of recovery for many other developing countries, especially in East Asia and in some of the leading countries in Latin America. Russia's greatly improved economic performance has helped its neighbors, including Ukraine and Kazakhstan. China especially, and India, are growing fast. Of course, the picture is not unblemished. Too many countries in Africa, including neighboring Zimbabwe, are in economic crisis. The extremely difficult situation in Argentina will have deep consequences for its people. It is in their interest – and that of their neighbors as well – that Argentina and the IMF reach agreement on a policy framework and financing package that will support the recovery and sustained growth of the economy.

Against that background, I want to talk today about emerging country debt markets. The thesis is simple: that there is growing evidence that in the last few years, and even in the last few months, those markets have been maturing, becoming more efficient, and less subject to contagion, with market pricing more accurately reflecting underlying risks. I shall try to make that case, and explain why those changes have happened. But to prevent any misunderstanding, let me also note that these markets, like other financial markets, will remain vulnerable to occasional episodes of irrational exuberance or, what may be worse, irrational pessimism. Countries accessing these markets need to take the possibility of such episodes into account, both by restraining their overall external borrowing, and by ensuring that they can withstand short periods in which their market access is interrupted.

Now to develop the argument. During the crises of 1990s, there was much alarm over the performance of the international capital markets. These markets seemed too powerful, as capital flow reversals put macroeconomic policies and financial systems under massive stress. Specifically, first, the markets were extraordinarily volatile – the average spread in September 1997 was below 400 basis points, a year later it was nearly 1700 basis points (Figure 1).



Second, the flow of lending to sovereign borrowers was highly variable, and on one or two occasions the markets closed, with borrowers unable to borrow at any price. And third, perhaps of most concern, the markets seemed too subject to contagion, evident in the tequila crisis, powerfully so in the Asian crisis particularly after the attack on Hong Kong, and worst of all after the Russian default and the LTCM crisis in the fall of 1998; as recently as last summer, with Brazil seeming to suffer from Argentine contagion, there were fears that an Argentine credit event would touch off another episode of contagion.

In addition, fourth, spreads seemed too high, in the sense that the probability of default implied by typical spreads was considerably higher than the frequency of defaults actually experienced.[3] Some calculations made by Gabrielle Lipworth and Lars Nystedt of the IMF illustrate. Suppose the spread is 800 basis points, with a recovery value of 40 percent; then, under the specified assumptions, the implied probability of default is over 17% per annum, implying that a country with that level of spread defaults on average about once in six years. Those frequencies of default have simply not been observed among the emerging market countries.

No wonder that there were so many who argued that countries dependent on the international capital markets were being subjected to unfair and unnecessary hazards. I know that I certainly believed these concerns to be true from time to time, especially when the explanation for the contagion from Russia to Mexico was that the market for Mexican debt was the most liquid in which holders of emerging market debt could raise cash – an argument which made the notion of an emerging market asset class itself virtually a guarantee of contagion. These problems were even more serious in light of the possibility of dual equilibria: if the capital markets believe a country likely to succeed, spreads will be low and the country is more likely to succeed; if the capital markets believe the risk of default to be high, spreads will be high, and the country will be more likely to default. There were certainly specific occasions on which I believed a country was for no good reason that I could discern, caught in a bad equilibrium that while entirely consistent, was based primarily on investor pessimism.

One response to that view of the operation of the international capital markets would have been for countries to close themselves off from the markets. It is striking that despite the press of events and the blandishments of some well-known economists, almost no country did that. Even Malaysia did so only temporarily, removing most of its capital controls less than two years after imposing them. To be sure, some emerging market countries, particularly in Asia, imposed controls trying to close down offshore markets. Nonetheless, all emerging market countries have sought to remain engaged with the international capital markets; they clearly have thought it useful to remain within the international financial system despite the problems that had caused for them.

What is the evidence for the view that the markets for emerging market debt are becoming more efficient – in the sense that the cost and availability of credit reflect the true underlying economic conditions? First, (Figure 2) the volatility of the spread (as measured by the SSB Global Emerging Markets (GEMS) index) has declined since the Asian and Russian crises, although there was an increase in its volatility as the Argentinian crisis worsened in the second half of 2001. More important, as can also be seen in Figure 2, the correlation across emerging market spreads has declined markedly in recent months, and – despite the Argentine default – is almost as low as it has been since mid-1995.

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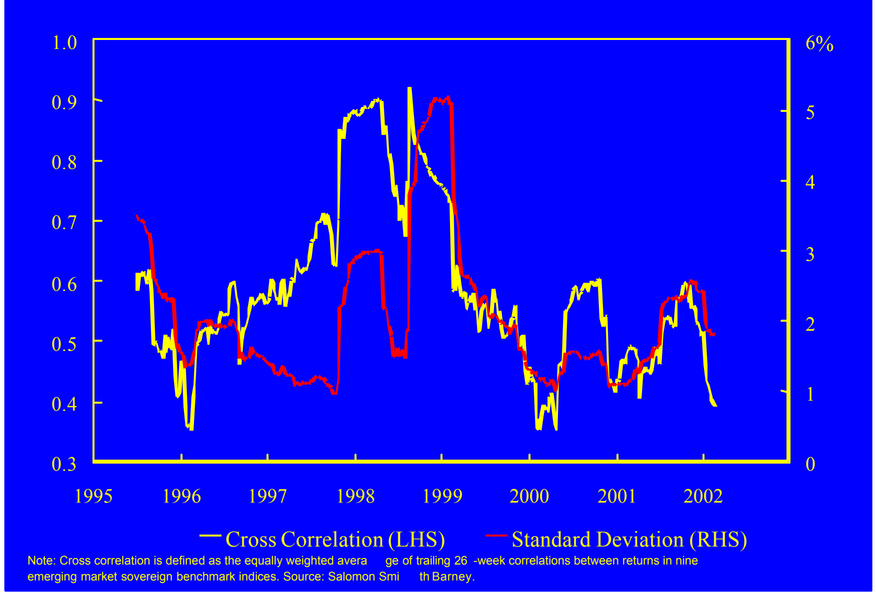
[3] This argument was made by Larry Summers

Figure 2: Volatility and Contagion Appear To Have Fallen in Emerging Markets



The low correlation in the last few months shows the lack of capital market contagion from the Argentine default. That could be because the Argentine default and devaluation had been anticipated for so long – one often heard before the event that "everyone is underweight Argentina".[4] Another frequently given explanation is that emerging market debt holders have been much less leveraged recently than in earlier periods – and this would tend to reduce the extent of contagion. In any event, starting November 2001, the tight correlation between Brazilian and Argentine spreads was broken, and as a result the fear that an Argentine default would produce widespread contagion was markedly reduced. The recognition by the markets of the very different situations of the Argentine and Brazilian economies is one important sign of the increasing efficiency of the emerging debt markets.

As a second piece of evidence for greater efficiency, not only are the spreads among countries less correlated; spreads overall, and for individual countries, have been declining, as can be seen in Figure 1. Spreads for emerging market countries have dropped overall to their levels before the Russian crisis of 1998. Given the argument that spreads on average have been too high, I believe that declining spreads are a sign of greater efficiency.

Third, the overall flow of capital to emerging markets has resumed, again to a level that might have seemed improbable in the darkest days of 1997 and 1998, or even just a few months ago, following September 11, when many emerging market governments believed the markets would again be closed to them. (Figure 3) Instead, emerging market countries began to access the Euro markets on a significant scale as early as October; the dollar markets started coming back in November, and January 2002

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[4] It was as difficult to make sense of this as it was to understand how many capital market participants could claim to have been surprised by the Russian default, given the spreads on Russian debt in the period before that default. In the Argentine case, perhaps the argument was that the debt was increasingly locally held; in the Russian case, presumably those who held Russian debt at the end were those most convinced Russia would not be permitted to default – even so, these debt holders must have known there was information in the high spreads before August 17, 1998.

was the best single month for dollar-denominated sovereign debt issuance in several years. Ironically, one reason for the improved conditions in emerging economy debt markets may be increased uncertainty in the industrialized country private debt markets, where corporate credit and accounting woes may have led some investors to look elsewhere to lend.

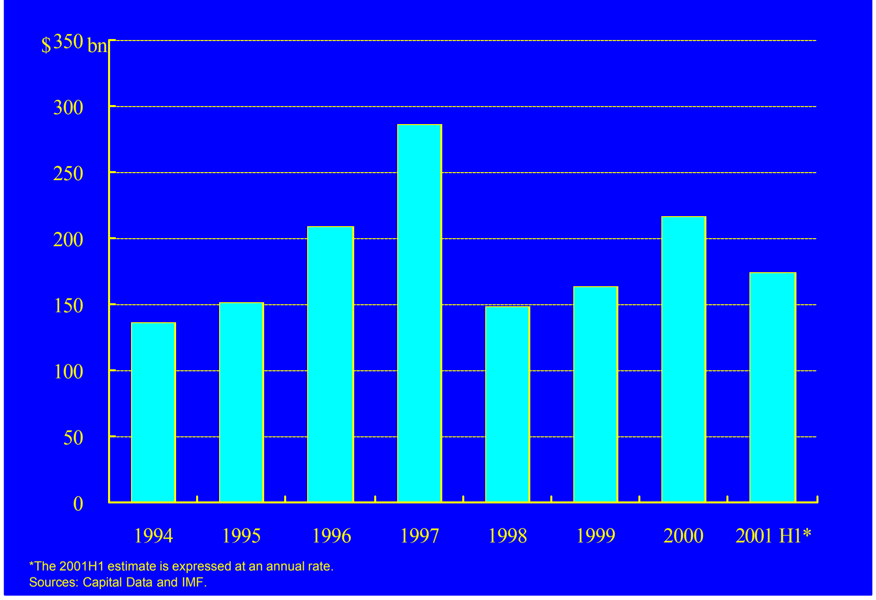


Figure 3: Gross Private Market Financing to Emerging Markets

Fourth, a country-by-country look at recent spreads suggests fewer anomalies than has been typical for some years (Figure 4). To be sure, it is difficult to know how to evaluate such a statement, particularly since private sector individual claiming that there are pricing anomalies are free to put their money where their mouths are, rather than to talk about it. Nonetheless, I stand by the statement.

So much for the tentative evidence that the markets for emerging country debt are becoming more efficient. There is no doubt much more serious work to be done appraising that view, and only time will tell whether this period is itself anomalous, a fortuitous intermission between two periods of market excess.

Figure 4: Emerging Market Sovereign Spreads

	Stripped Spread	S&P Rating		Stripped Spread	S&P Rating
China	90	BBB	Uruguay	450	BBB-
South Korea	104	BBB+	Russia	492	B+
Chile	124	A-	Colombia	542	BB
Malaysia	150	BBB	Turkey	582	B-
Poland	154	BBB+	Ukraine	626	B
Mexico	227	BBB-	Brazil	714	BB-
Qatar	233	BBB+	Pakistan	716	B-
South Africa	287	BBB-	Lebanon	886	B
Egypt	340	BBB-	Venezuela	936	B
Panama	356	BB	Ecuador	1091	CCC
Bulgaria	379	BB-	Nigeria	1138	NA
Dominican Republic	387	BB-	Ivory Coast	2045	NA
Peru	407	BB-	Argentina	6289	D
Philippines	414	BB+			

Note: Spreads are duration-market value weighted and as of March 13, 2002. Sources: Salomon Smith Barney and S&P.

But suppose the markets are becoming more efficient, why did this happen? Most fundamentally, the international capital markets now operate with markedly improved information. In 1994, when Mexico devalued the peso, and again in 1997, when Thailand went into crisis, no one – in or out of the country, save a few people in their central banks – knew what their reserves were. Today, by contrast, countries that subscribe to the Special Data Dissemination Standard – and most emerging market countries do – provide a comprehensive set of data, especially on reserves. Subscribing countries must make data on reserves available monthly, with no more than a one month lag. Data on forward commitments must also be revealed. And increasingly countries understand that transparency about data, and improved investor relations, pay off in the long run, even if there could be some short-term gain to concealing information on specific occasions.

At the IMF itself, there has been nothing short of a revolution in the availability of information, with more of it, provided with far greater transparency, and much more rapidly. It was only in 1998 that the Executive Board of the Fund voted to allow countries to publish their annual Article IV reports. Now that is almost routine for all the industrialized countries and most of the emerging market countries, and there are very few countries left that do not agree to publish PINs (Public Information Notices) following Board discussions of their economies. Almost all countries now publish their loan agreements with the IMF. All this information is not only essential to the efficient workings of the markets, it also improves policy by putting constraints on what policymakers can do, it builds confidence in the international financial institutions, and – I believe – it strengthens democracy.

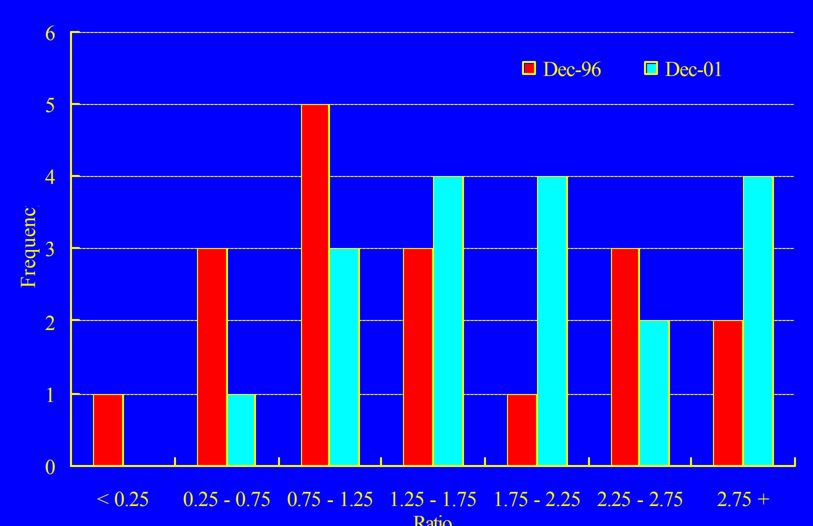
Second, policies in most emerging market countries have improved. The most fundamental change has been the shift to more flexible exchange rates. Unfortunately this shift took place most often in crisis – but that illustrates one of the reasons adjustable peg exchange rate regimes are problematic, for they are very difficult to get out of: when the system is operating well, policymakers see no reason to change, and when it is operating badly, they are frightened to make the change. Incidentally, I include managed floats in the group of flexible exchange rate systems; the key dividing line is whether the government has committed to defending a particular exchange rate, or a particular narrow exchange rate band. Such an adjustable peg system is highly vulnerable to attack when the capital account is open. Once the exchange rate is flexible, countries need to define a basis for monetary policy, and increasingly and appropriately inflation targeting is seen as the preferred choice. That shift is being helped by the growing understanding by markets that it is permissible to miss the inflation target by small amounts when exogenous events make it unwise to try too vigorously to attain the target in the short run.

At a conference in South Africa today, one cannot avoid the question of whether exchange rates in floating rate systems are too volatile. I believe the answer is yes, and not only for emerging market countries, for the fluctuations in the dollar-yen rate have been extraordinary. The question is what to do about these excessive fluctuations. Some have called for a Tobin tax or more direct capital controls. But there is no evidence that a Tobin tax would make financial markets less volatile, nor does theory support that view. As for capital controls, they may bring short-run advantages, but countries in the end seek to remove them. When capital controls are in place, they should generally be removed gradually, as underlying conditions permit.

Countries faced with what they regard as excessive fluctuations in exchange rates generally end up complaining about the verdict of the market, but not able to do very much about it. It would be desirable if exchange rates fluctuated less, and moved more in accordance with underlying fundamentals, but we do not know how to bring that about except through currency unions that eliminate the exchange rate entirely. I should note though that empirical studies have found surprisingly little support for the view that exchange rate volatility markedly reduces the volume of international trade, but that result is surprising.[5]

Beyond the exchange rate system, and improving monetary policies, emerging market countries have generally been pursuing more responsible fiscal policies. It was once fashionable to tease the IMF by saying that the initials stand for "it's mostly fiscal"; if they do, recent events, including in Argentina, have provided justification for the view that a conservative fiscal policy is a powerful bedrock for good macroeconomic policies – and also a warning that policies that look sustainable when growth is good can look much less impressive if the growth rate declines.

Figure 5: Emerging Markets: Reserves/Short-Term Debt



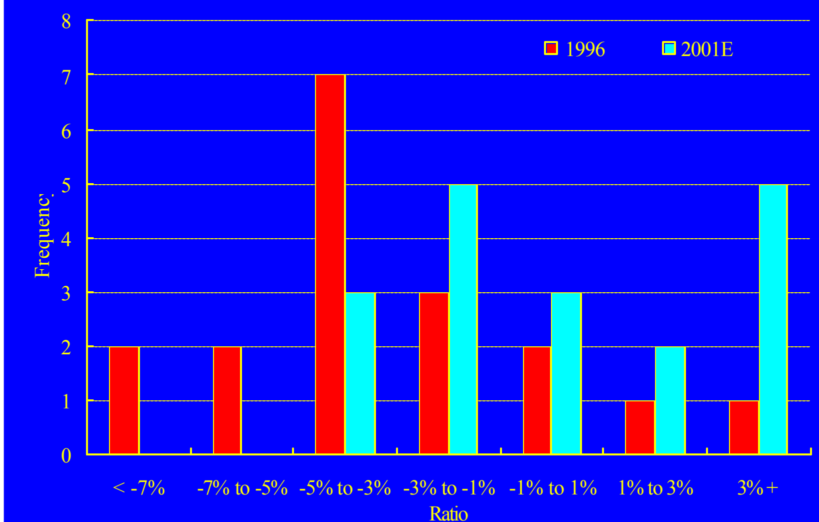
Note: Sample includes 18 emerging market economies, including Argentina, Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland Russia, South Africa, South Korea, Thailand, Turkey, and Venezuela.
Sources: National Sources, IMF, and Salomon Smith Barney.

Improved macroeconomic policies are reflected in key vulnerability indicators. The average ratio of reserves-to-short term debt has risen substantially (Figure 5). In January 1997 this ratio was above 1.25 for only 8 out of the 18 emerging market countries surveyed; at the end of last year, the ratio was above 1.25 for fourteen of the eighteen countries. As you know, the data suggest that a ratio above one is a good indicator of reduced vulnerability to crisis. Current accounts are in better shape than they were in 1997, with much of the improvement coming in Asia, though external debt ratios have not improved much (Figure 6). With exchange rates having become more flexible, they appear also to have become more sustainable.

[5] Such a result is easier to understand in those cases where the markets for currency hedging at relevant horizons are well developed.

Accompanying improved policies, are improvements in institutions, and here the international community has played an important role through the development of codes and standards. The Basel capital adequacy standards were early in the field. The IMF has developed Codes of Good Practices on Transparency in Monetary and Financial Policies, and on Fiscal Transparency, and is working with countries to measure their practices relative to these international standards. The World Bank is taking the lead in assessing corporate governance, accounting, auditing, and insolvency and creditor rights. The Financial Sector Assessment Programs undertaken by the Bank and the Fund are a very useful means for countries to assess the strength of their financial system against international standards.

Figure 6: Emerging Markets: Current Account/GDP



Note: Sample includes 18 emerging market economies, including Argentina, Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland Russia, South Africa, South Korea, Thailand, Turkey, and Venezuela. The 2001 data are Salomon Smith Barney's estimates. Sources: National Sources, IMF, and Salomon Smith Barney.

It is early yet to tell whether spreads are lower for countries that meet relevant standards. However, anecdotal evidence and discussions with some market participants suggest that awareness of these publicly posted reports is growing. If this awareness translates into lower spreads, then the standards initiative will pay off not only for individual countries, but also for the system as a whole.

Finally, moral hazard. There is a growing understanding that the IMF can not, should not, and will not, be able to provide sufficient financing to prevent countries from defaulting if their debt situations are unsustainable.[6] This should have been clear after the Russian default, when a major country was allowed to default despite being in an IMF program; it must be clearer yet after the Argentine default. Some view the perceived reduction of moral hazard as an important contributor to the increasing efficiency of the market.

Recently Anne Krueger has put on the table the question of strengthening the legal framework in which countries and their creditors deal with unsustainable debt burdens. Whether or not that discussion leads to a change in the legal framework, I am

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[6] Sustainability has to be calculated assuming some level of IMF financing. In a recent policy paper, the Bank of Canada and Bank of England have argued that IMF assistance should only in very exceptional cases exceed prespecified access limits, this to provide greater certainty to the market and the country and more precision to the sustainability analysis.

certain that the discussion of this proposal, including alternatives that do not necessarily require a change in the legal framework, will also help increase the efficiency of the international capital markets.

So: we meet at a relatively good moment for emerging country debt markets. Now for the warnings. We cannot yet be sure that what we are seeing is a permanent change in the behavior of these markets. It would be good news indeed if that were true, and there are reasons to believe it could be true. But even if these markets behave better on average from now on, there will from time to time be episodes of excessive optimism or pessimism – in other words, financial markets will be financial markets.

So long as that remains true, countries will have to be careful not to rely excessively on the international capital markets. Borrowing countries need to take the possibility of excessive fluctuations in the markets for their debt into account, both by restraining their overall external borrowing, and by ensuring that they can withstand short periods in which market access is interrupted. The reserves to short-term debt ratio is a good indicator of the ability of the country to withstand temporary market disturbances, with the empirical data suggesting a 100 percent ratio is a good target to aim for. With regard to the level of borrowing, we should not consider the Maastricht 60 percent debt to GDP upper bound as a good guide for emerging market countries, not least because interest rates in the emerging debt markets fluctuate much more than those for the industrial countries.

To paraphrase the U.S. government's dietary guidelines for alcohol consumption, countries that tap the international markets should "do so in moderation … and when consumption does not put you or others at risk."

Finally, consider the future of the emerging debt markets. The emerging market countries will be with us for a long time. Only, they should not always be the same set of countries. Rather, as countries manage their economies and their financing better, and as they develop, we should expect to see the most advanced among them graduate from the ranks of the emerging market countries into those of the industrialized countries. Some of the countries with the lowest spreads are well on the way to graduating, just as Australia, New Zealand, Japan and other nations have graduated in the past. And as they graduate out of the emerging market group, other countries will move into the group, and be able to access the international capital markets, but not yet at spreads that are close to those of the industrialized countries. Through good policies, and careful debt management, and with the help of increasingly efficient markets, they too will one day graduate. And when they do, we will be able to count them as having successfully joined the ranks of the advanced countries.

In that way, the work that all of you do in seeking to strengthen the international capital markets contributes to the goal of helping developing countries grow and mature – and that is the critical challenge we face today.

Thank you very much.