BANK FOR INTERNATIONAL SETTLEMENTS

Restricted

XXXVII Annual Monetary Studies Conference
Regional Economic Integration: Issues and Challenges

Changing Links Between Mature and Emerging Financial Markets

Serge Jeanneau
Senior Economist
BIS Representative Office for the Americas

Nassau, 1- 4 November 2005

Recent BIS work on international banking and financial markets

- Hawkins and Mihaljek (2001): „The banking industry in the emerging market economies: competition, consolidation and systemic stability“, *BIS Papers, No 4*
- McCauley et al (2002): „Globalising international banking“, *BIS Quarterly Review*, March
- Domanski et al (2003): „Changing links between mature and emerging financial markets“, *BIS Quarterly Review*, September
- McGuire and Schrijvers (2003): „Common factors in emerging market spreads“, *BIS Quarterly Review*, December
- Committee on the Global Financial System (2004): „*Foreign Direct Investment in the Financial Sector of Emerging Market Economies*“, March
- McGuire and Wooldridge (2005): „The BIS consolidated banking statistics: structure, uses and recent enhancements“, *BIS Quarterly Review*, September
- Domanski (2005): “FDI in the financial sectors of emerging market economies: a regional story with global implications”, *BIS Quarterly Review*, forthcoming December

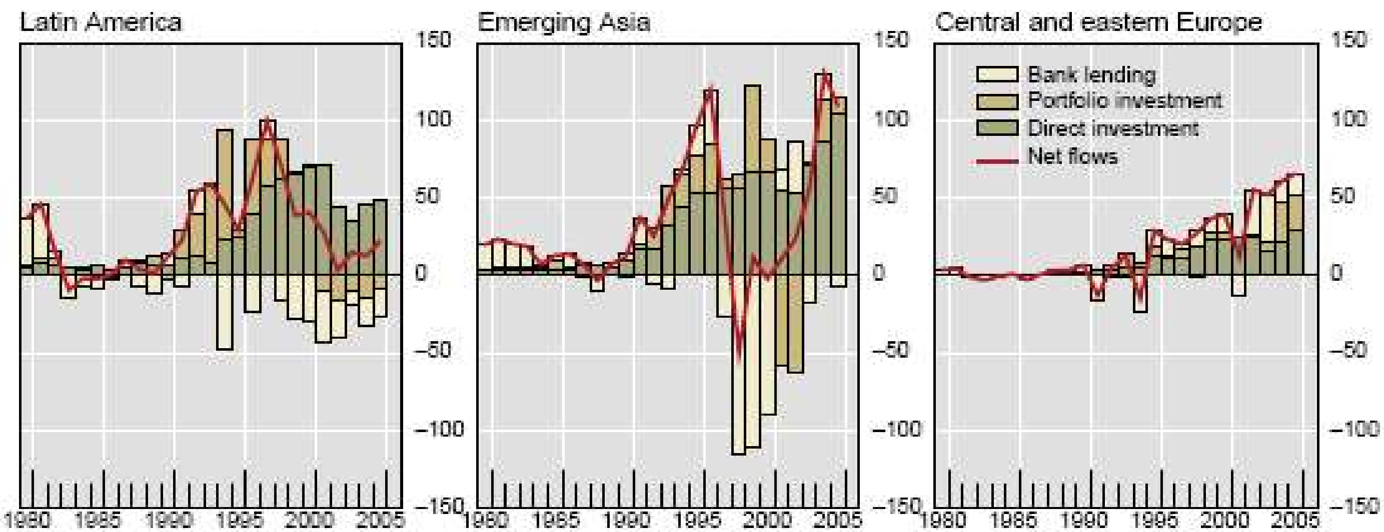
Main points

- Net capital flows to EMEs have yet to return to the level of the mid-1990s
- This does not mean that the process of global financial integration has come to a stop
- In fact, there is evidence that emerging and mature financial markets are more integrated today than at any time since the 19th century
- A simple look at cross-border flows does not provide a complete picture of the breadth and depth of financial links
  - Broader range of investors
  - Increasingly important role of local operations
  - Growing involvement of emerging market residents in global financial system, both as borrowers and investors
- Changing nature of financial links between emerging and mature markets
- Challenges resulting from this evolution and issues for public policy

Recent evolution of net private capital flows

Net private capital flows to emerging markets[1]

In billions of US dollars



[1] For 2005, IMF forecast.

Source: IMF, *World Economic Outlook*.

- Net private capital flows are now dominated by FDI
- In Asia, portfolio flows are recovering
- In Latin America, bank lending and portfolio flows are still negative

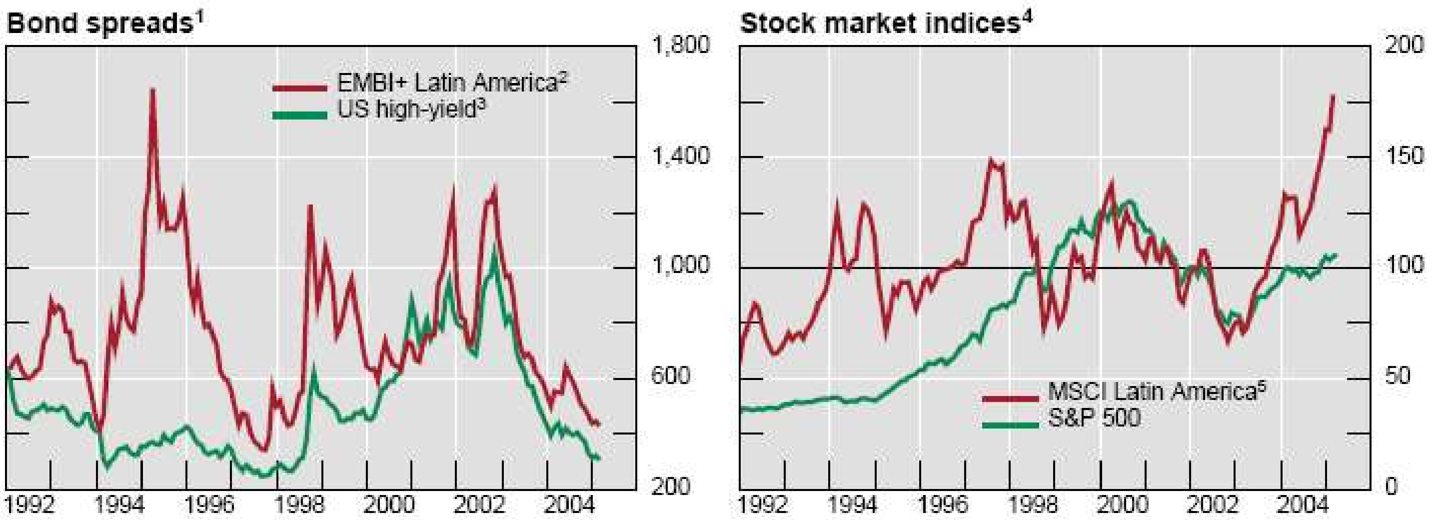
Rapid evolution of links between mature and emerging markets

- In spite of this retrenchment, links between emerging and mature markets have continued to develop rapidly as investors and issuers have taken advantage of new opportunities

- Additional evidence based on asset prices and volumes

Co-movement of mature and Latin American asset prices

Graph 1 **Co-movement of mature and Latin American assets**



[1] Over US treasury yields; in basis points. [2] Stripped spread of emerging market bonds; prior to 1998, EMBI composite. [3] Spread of US high-yield bonds over US Treasury bonds with similar maturity. [4] January 2002 = 100. [5] In US dollar terms.

Sources: Bloomberg; Datastream; JPMorgan Chase; Merrill Lynch.

- Higher correlation between prices and returns of mature country and LAC assets than a decade ago
- Despite significant differences in fundamentals
- Suggests that global factors are probably increasing in importance relative to idiosyncratic factors

Common factors in co-movement of asset prices

- Various econometric studies confirm the growing importance of common factors in the co-movement of equity and bond prices

  – Bekaert and Harvey (1997) demonstrate that global factors explain a large proportion of equity volatility in EMEs that have liberalised

  – Bekaert et al (2003) conclude that EME equity returns were more highly correlated with world returns during the 1990s than the 1980s

McGuire and Schrijvers (2003)

Factor loadings and uniqueness measures

31 March 1997 – 18 June 2003

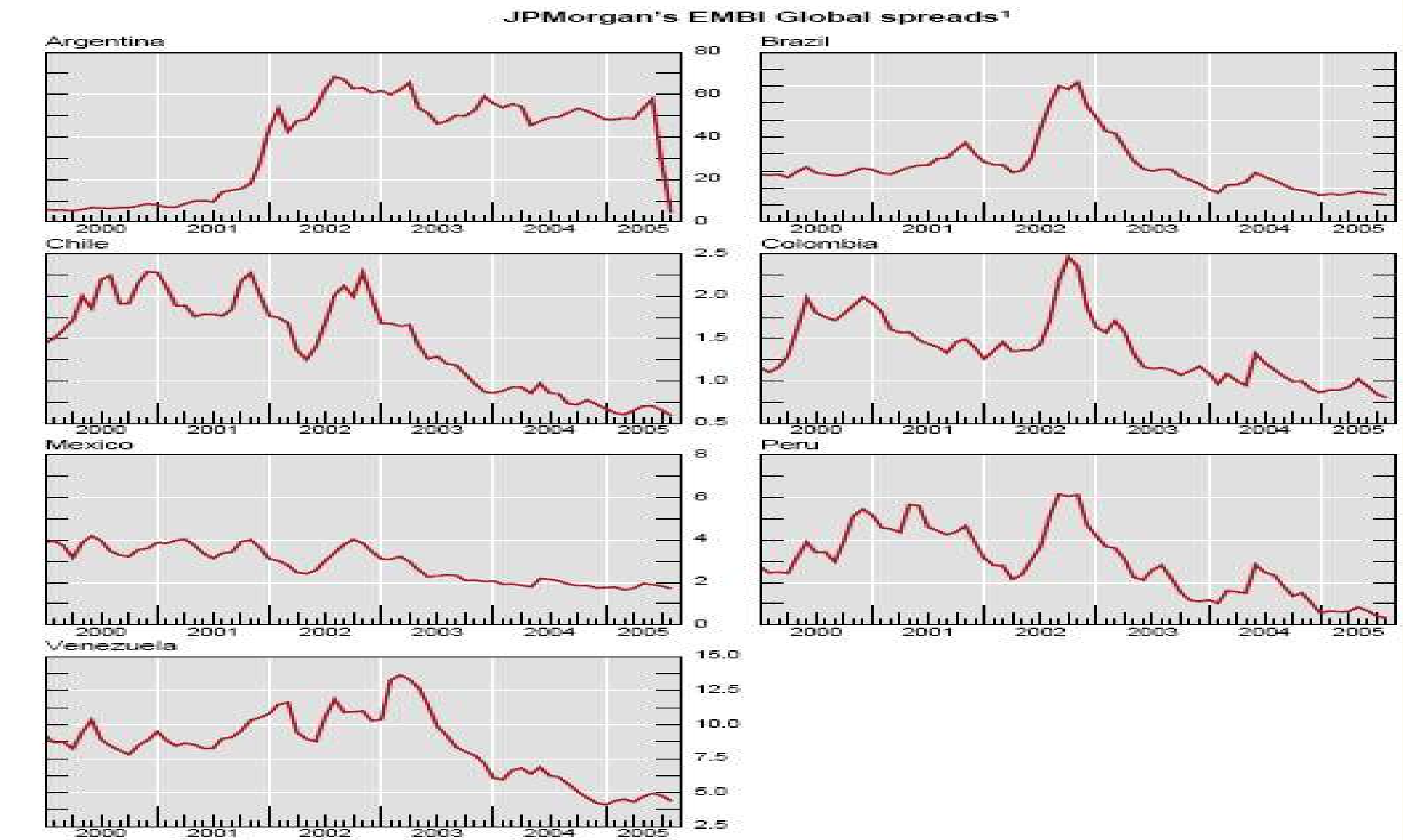
Country	Loading	Uniqueness
Argentina	0.364	0.867
Brazil	0.744	0.446
Bulgaria	0.733	0.462
China	0.258	0.934
Colombia	0.596	0.645
Ecuador	0.403	0.837
Korea	0.590	0.652
Malaysia	0.335	0.888
Mexico	0.860	0.260
Nigeria	0.321	0.897
Panama	0.764	0.417
Peru	0.625	0.609
South Africa	0.418	0.825
Turkey	0.439	0.808
Venezuela	0.655	0.570
Average	*0.540*	*0.674*

Table 1

* The number of relevant factors is determined using the Kaiser criterion, which drops those factors that account for less variance than at least one underlying spread series.

– McGuire and Schrijvers (2003) find that one third of all variation in EME bond spreads over 1997-2003 can be ascribed to a single common factor

Risk premia on major Latin American bond markets



[1] In percentage points.
Source: Datastream.

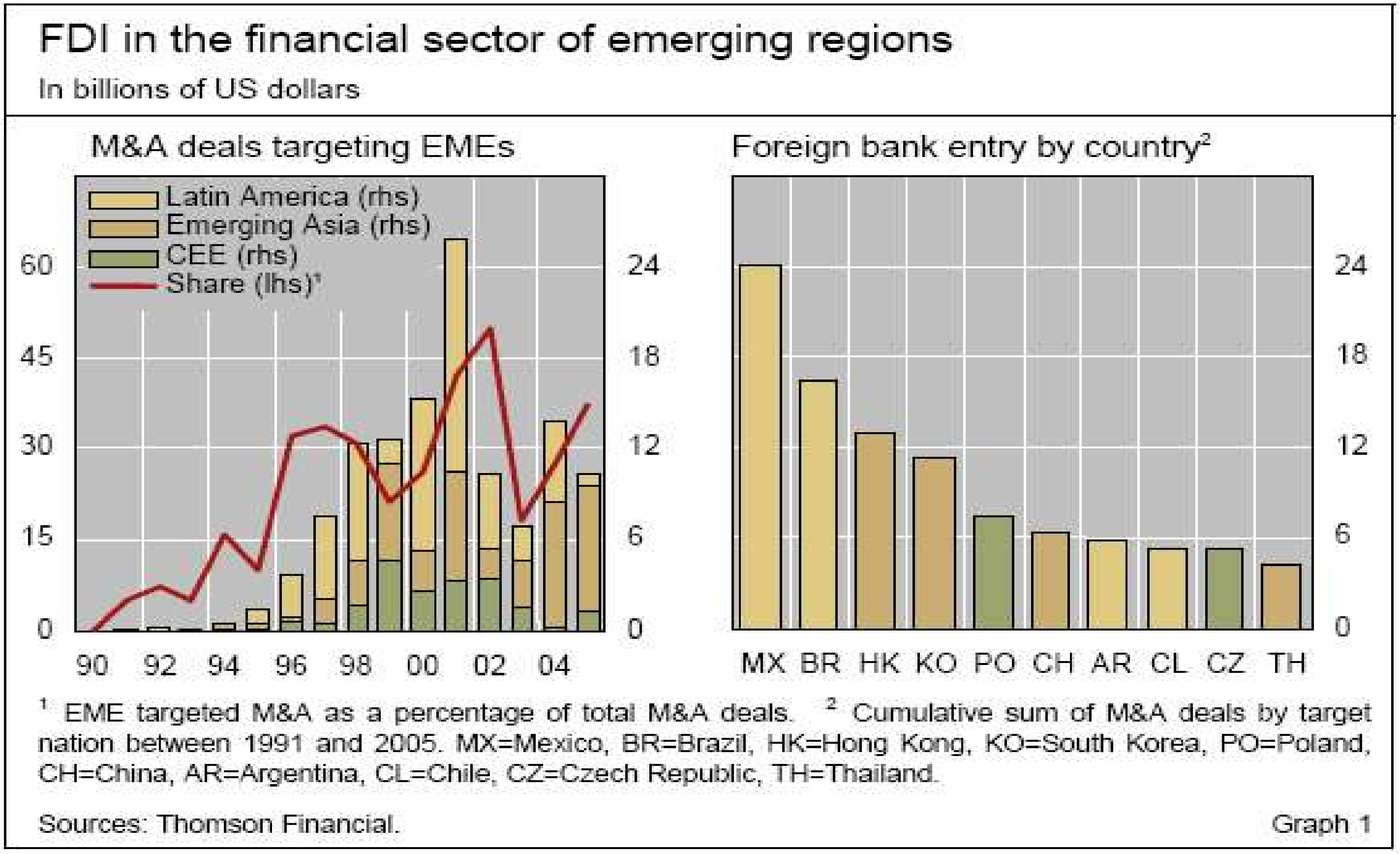
Diversification of investor base in EME assets

- Broad range of participants from mature countries now active in EMEs
- Bank lending was the dominant source of financing in the 1970s but portfolio investment now tends to exceed bank lending
- The range of investors has also widened
  - Specialised investors, such as hedge funds and mutual funds focusing on EMEs, accounted for the bulk of portfolio flows in the early 1990s (See WB (2003))
  - More recently other institutional investors have also added EME assets to their portfolios
- Introduction of EME assets into global bond indices underline this diversification (eg. Lehman Brothers' Global Aggregate Index)

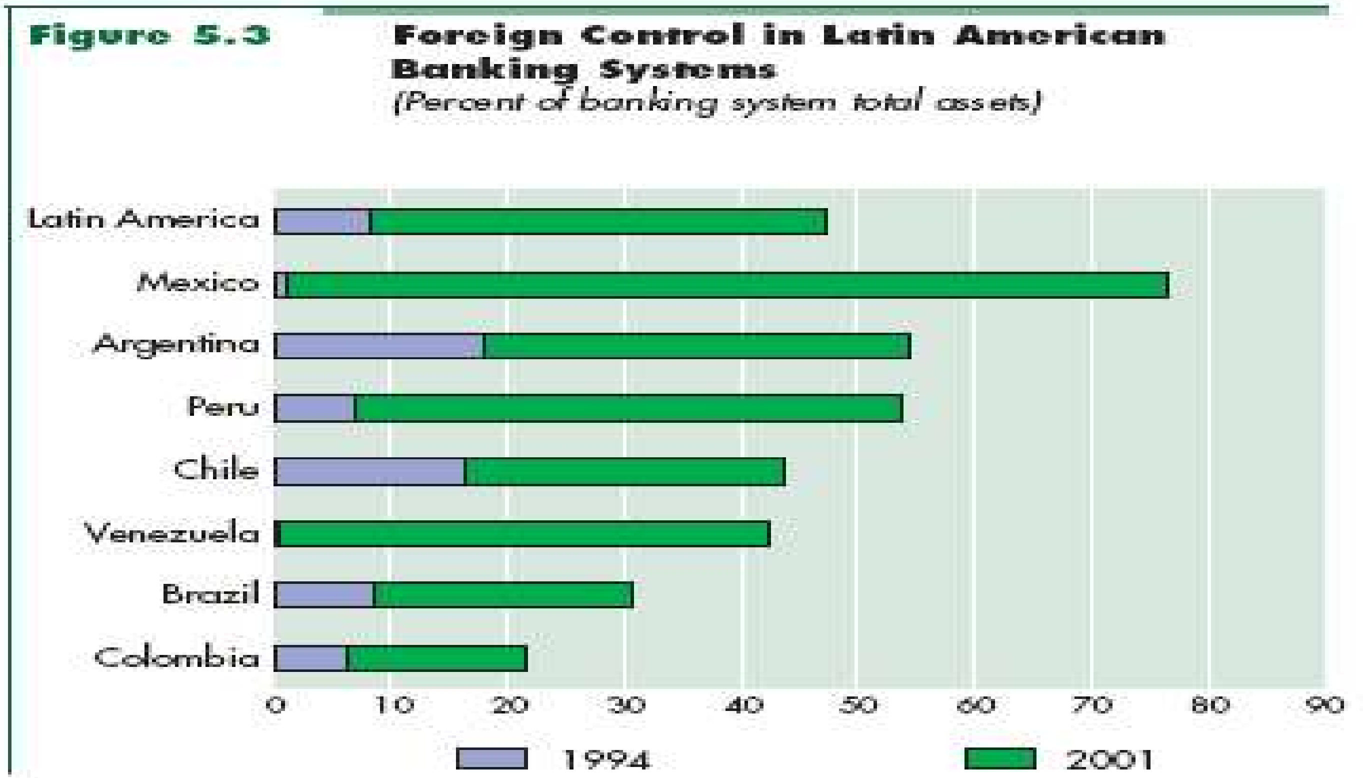
Growing presence of global banks in EMEs

- Foreign participation in the financial sector of EMEs increased sharply in the second half of the 1990s
- Strong competition in traditional markets led international banks to search for new profit opportunities
- This participation expanded largely through FDI, a ready means of accessing EMEs
- Wave of financial crises created a need to re-establish functioning banking systems
- Governments responded by accelerating financial liberalisation and privatising or recapitalising local banks through foreign participation

Bank mergers in EMEs



Foreign control in Latin American banking systems



Source: Galindo, Micco and Serra (2002).

Foreign control in banking systems of EMEs: more recent data

Share of bank assets held by foreign banks[1]

Country	1990	2002	2004[2]
Asia			
China	0	2	[3]
Hong Kong SAR	89	72	[70]
India	5	8	[8]
Korea	4	8	[30]
Malaysia	...	18	[18]
Singapore	89	76	[75]
Thailand	5	18	[17]
Central and Eastern Europe			
Bulgaria	0	67	[76]
Czech Republic	10	82	[80]
Estonia	...	99	99
Hungary	10	62	[60]
Poland	3	63	[67]
Latin America			
Argentina	10	48	[40]
Brazil	6	27	[31]
Chile	19	42	[42]
Mexico	2	82	[86]
Peru	4	46	[46]
Venezuela	1	34	[30]

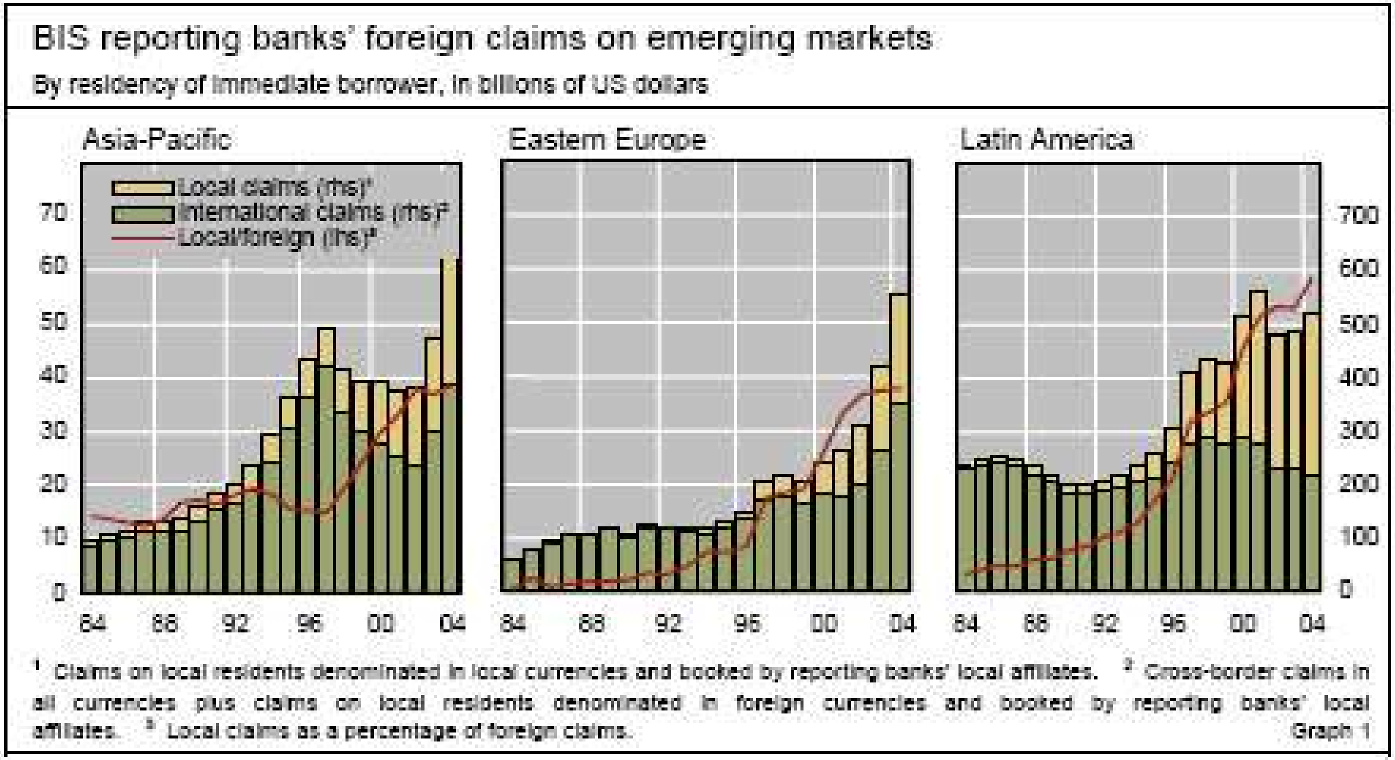
1 Percentage share of total bank assets. 2002 figures for central and eastern Europe: percentage share of regulatory capital. 2 Or latest available year.

Sources: CGFS (2004), national central banks, BIS calculations. Table 1

Changing character of global banking intermediation

- Internationally active banks have turned their focus from cross-border lending to locally funded lending
  - Greater awareness of risks resulting from cross-border lending, such as transfer risk and currency mismatches
  - Locally funded assets do not involve a foreign exchange drain
- Internationally active banks have also shifted to local capital market activities
  - Reflects a broader strategic shift from interest-earning to fee-based business
  - Contributes to balanced growth of local assets and liabilities

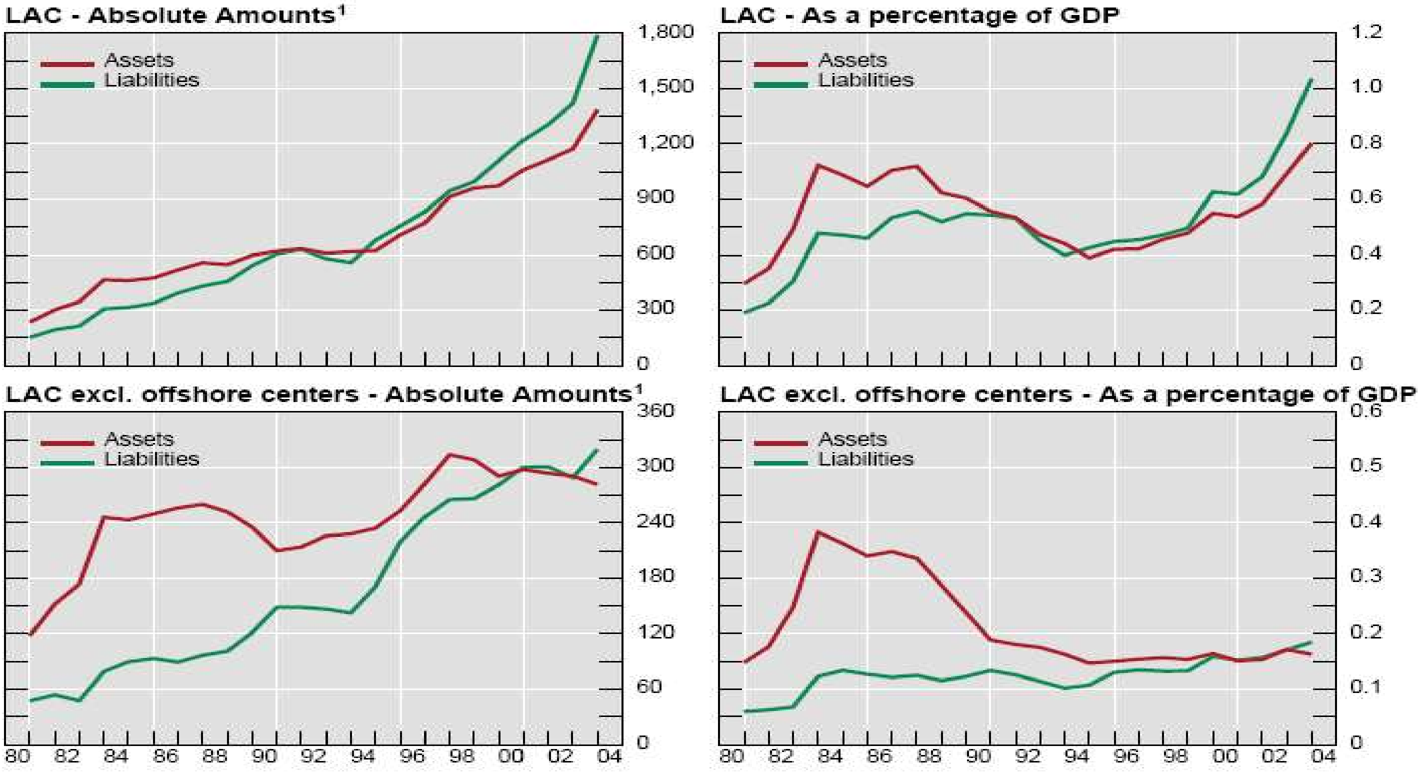
Shift to local lending in EMEs



- Based on BIS international banking statistics
- Evident in all areas but most pronounced in Latin America

Stagnation of international bank intermediation to LAC

Graph 4 **International bank assets and liabilities in Latin American and Caribbean countries (LAC)**



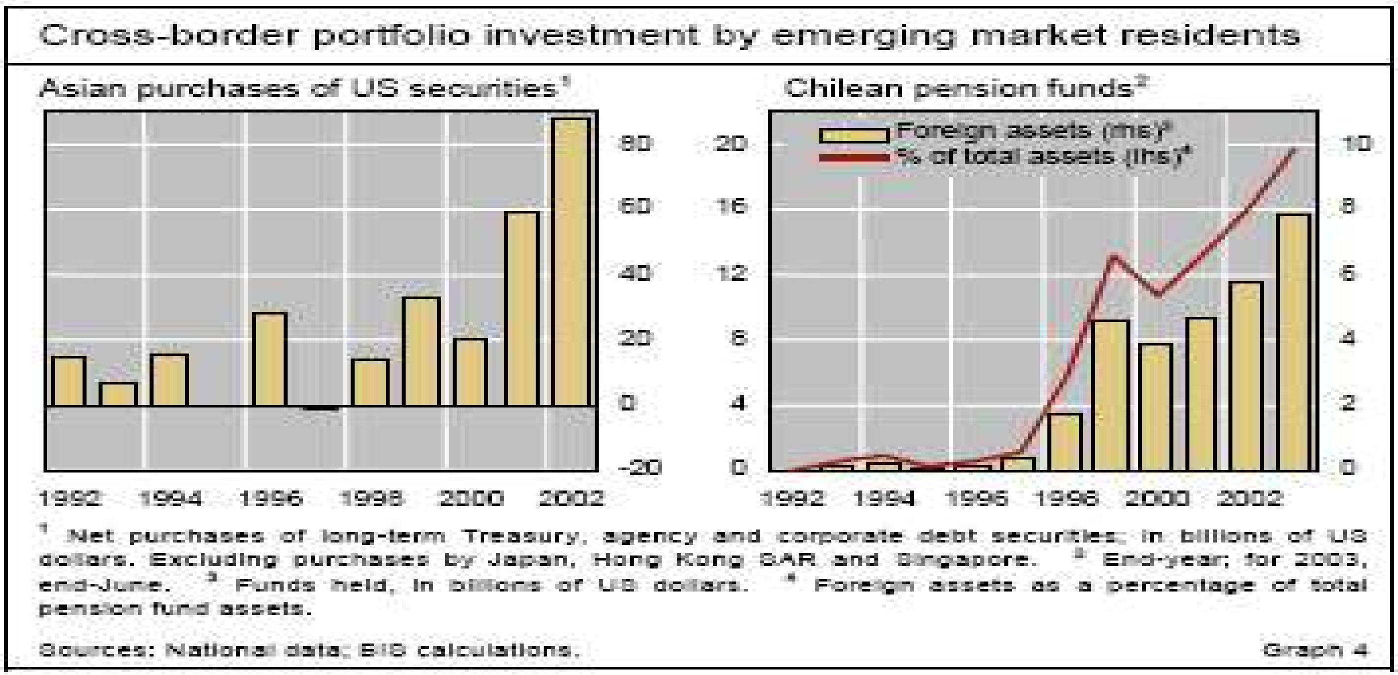
[1] In billions of US dollars.

Source: National data, BIS.

Shift from transfer risk to country risk

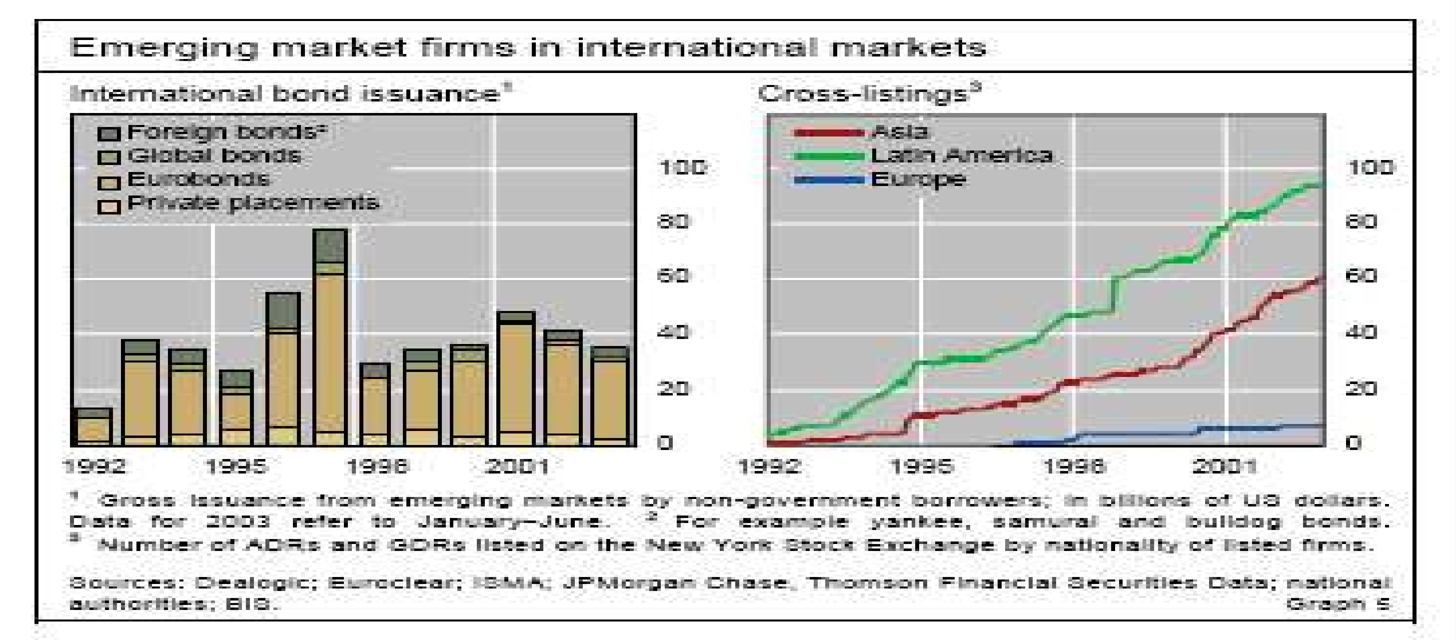
- Growing share of locally funded business is shifting the balance of risk from transfer risk towards country risk
- Transfer risk, **which results from constraints on the transfer of funds from one country to another**, is associated with cross-border claims
- Country risk, **which encompasses the economic and political environment**, is associated with all claims, cross-border and local
- Banks are now focusing on a matching of their customers' debt to local currency cash flow
- This should make the global banking system more robust

Flip side: growing presence of EME investors in mature markets



- Resulting from C/A surpluses but also from changes in portfolio allocation
- Largely from Asia and ME but also from traditional net importers of capital, such as Chile and Mexico

Flip side: growing use by EME issuers of external financial markets



- In the past, EME issuers mainly tapped unregulated markets, such as the eurobond market
- Since the 1990s they have become more active in regulated markets

Mixed evidence concerning macroeconomic benefits

- In principle, financial integration should brings benefits
  - A larger pool of capital potentially available for investment, which should lead to a reduction in funding costs and a use of savings in line with national preferences
  - The spreading of economic risk geographically and intertemporally, which should increase long-term growth and reduce economic volatility
  - However, the empirical evidence concerning the benefits of integration is somewhat disappointing (Rogoff et al (2003))

Stronger evidence concerning microeconomic impact

- Domestic banks are now exposed to international competition, which is promoting improvements in competitiveness and efficiency in the financial industry as well as in its risk management practices (CGFS (2004))
  - Declining costs/higher productivity
  - Business strategies tend to be more focused (specialised expertise is used in specific market segments)
  - Host countries benefit from a transfer of human capital and technology as well as innovation in product and processes
  - Foreign firms play a key role in developing local financial markets

Changing links are creating new challenges

- Economy wide credit allocation
- Organisational changes
- Regulatory/accounting practices
- Availability of market information and prices
- Market liquidity
- Concentration of investment

Challenge: effect on economy-wide credit allocation

- Heavy involvement of foreign banks in domestic lending has special implications
- Foreign banks have tended to focus on household lending
- They tend to use standard credit evaluation models over soft lending criteria or long-term customer relationships
- Lending to SMEs could possibly fall outside of the scope of their activities if such firms are not subject to proper auditing

Challenge: impact of organisational changes

- Possible concentration of decision making at head office
- Change in business strategy at parent level can have a major impact on host country banking and financial markets
  - Especially when local operations form a small share of a global institution's portfolio
- Local operations might become more specialised, raising questions about their ability to operate on their own in the event of a crisis

Challenge: inconsistency of regulatory/accounting practices

- Differences in parent/host country regulations and accounting practices could affect host markets
- Subsidiaries have to comply with both home and host country regulations
- Host country with parent banks from different countries could be subject to different rules
  - Ex: different capital charges for same type of operation
- Could result in an uneven playing field in domestic markets, which would affect the competitive environment and liquidity

Challenge: loss of market information and prices

- M&As often result in a delisting of local financial stocks
- The delisting of subsidiaries leads to a loss of market information and prices
- Impairment of capacity to monitor financial markets in host country
- Loss of benchmarks for domestic financial institutions

Challenge: weakened market liquidity

- Most large firms in the region list abroad, primarily through ADRs. ADRs from LAC are often traded more actively than are local stocks

- Positive impact of foreign listings:
  - Reduction of credit constraints, leading to lower financing costs and vulnerability to local market volatility
  - Pressure on local exchanges and regulatory authorities to modernise their operations and rules, improve disclosure standards and strengthen the rights of small shareholders

- Negative impact of foreign listings:
  - Foreign listings can subtract liquidity from local exchanges, inhibiting their development and increasing costs for firms that do not have access to foreign markets

Impact of foreign listings

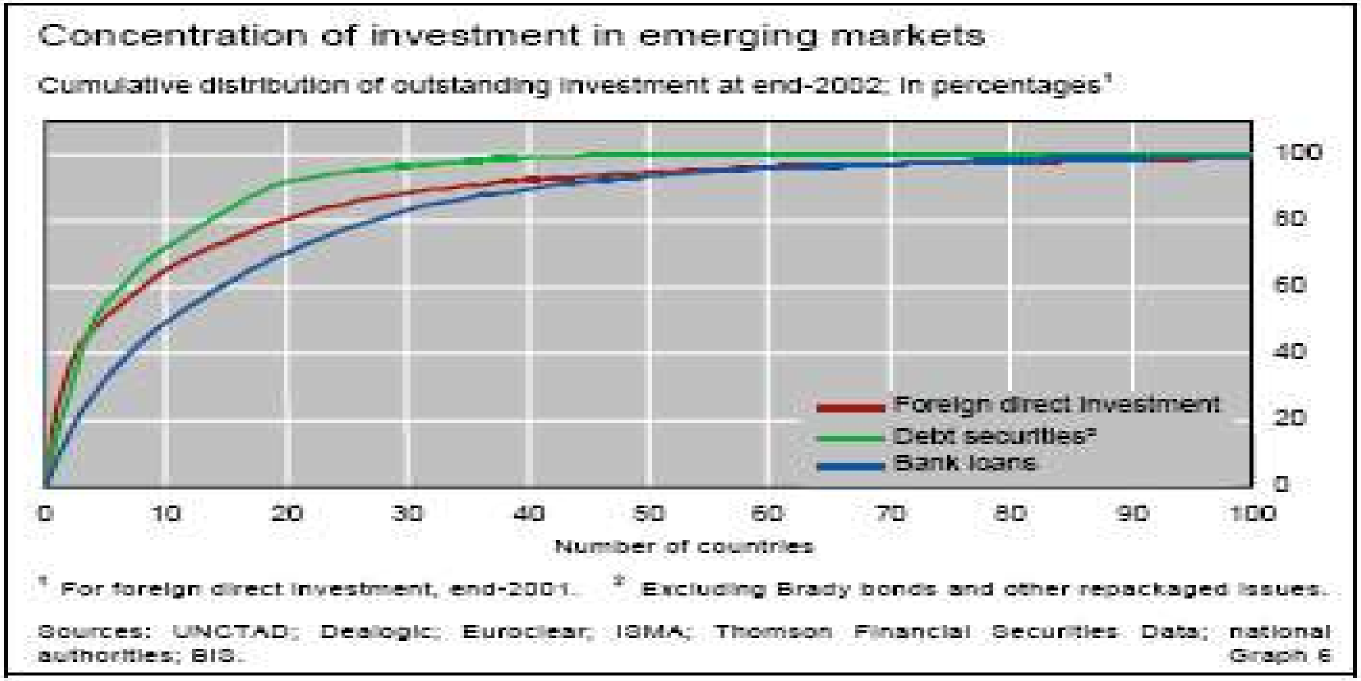
- The number of IPOs in LAC appears to fall when large companies begin to raise capital through ADRs.

Note: Capital raised through ADRs includes Level III and SEC Rule 144A programs.
Source: Moel (2001).

Challenge: concentration of foreign investment

- Market integration facilitates the measurement and management of risks, leading to greater price discrimination
- Benefits of integration more likely to accrue to well managed economies that have strong growth prospects
- Higher risk countries are likely to face high risk premia and be marginalised
- Declining cross-border lending may even add to tiering
  - Banks have traditionally had more diversified portfolios than other investors. They also mitigate risks through collateral and restrictive covenants
  - As institutional investors come to play a larger role, lower rated countries may face more difficult financing conditions

Concentration of investment to EMEs



- Tiering is already evident for most types of capital flows
- Institutional investors face restrictions in investments below investment grade
- Lower-rated borrowers face major difficulties in accessing derivatives markets

Role for public policy

- How can one ensure the proper functioning of increasingly integrated financial markets?
  - Macroeconomic policies ensuring stable financial conditions
  - Adoption of internationally agreed legal, prudential and regulatory standards
  - Better cooperation of authorities in charge of financial supervision and stability
    - coordination mechanisms between home and host county supervisors and central banks (particularly for liquidity crises)
    - Identification of information requirements for authorities responsible for financial stability (both host and home countries)
    - linkages across regulatory agencies

XXXVII Annual Monetary Studies Conference
Regional Economic Integration:
Issues and Challenges

Changing Links Between Mature
and
Emerging Financial Markets

Serge Jeanneau
Senior Economist
BIS Representative Office for the Americas
serge.jeanneau@bis.org