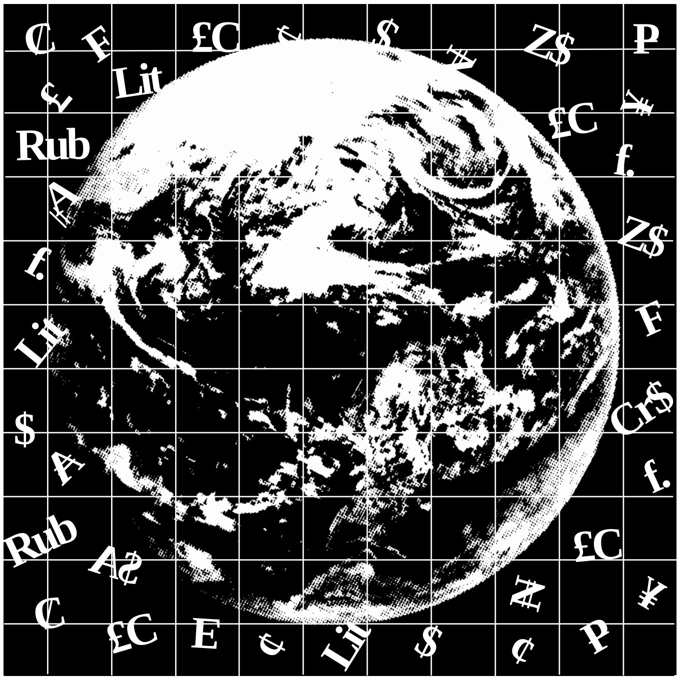
Emerging Market Financing

Quarterly Report on Developments and Prospects



August 8, 2001

By a Staff Team led by Bankim Chadha

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The quarterly *Emerging Market Financing* report is an integral element of the IMF's surveillance over developments in international capital markets. The report draws, in part, on a series of regular informal discussions with a broad set of private financial market participants.

The report was prepared in the IMF's Research Department. The project is directed by Bankim Chadha, Chief, Global Markets Unit. Co-authors of the report are Gabrielle Lipworth and Christopher Morris, Senior Economists; Anna Ilyina, Subir Lall, and Jens Nystedt, all Economists; Martin Edmonds, Senior Financial Systems Officer; Anne Jansen, Senior Research Officer; and Christian Carrillo and Peter Tran, Research Assistants. Sheila Kinsella provided expert drafting assistance.

The report reflects developments and data available through July 24, 2001, unless specifically noted otherwise. The report has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors (following their discussion of the Emerging Market Financing report on August 2, 2001). The analysis and views are those of the contributing staff and should not be attributed to Executive Directors, their national authorities, or the IMF.

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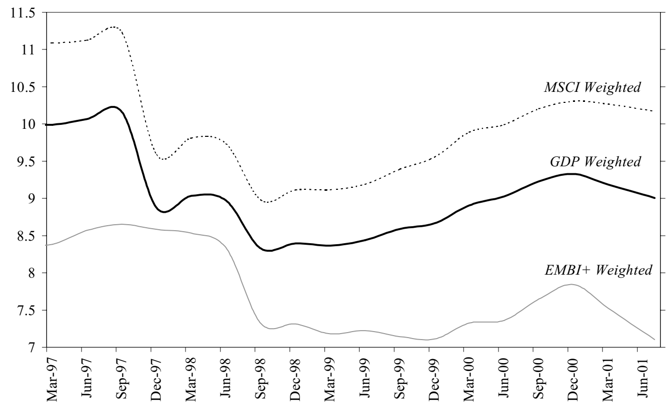
I. Overview

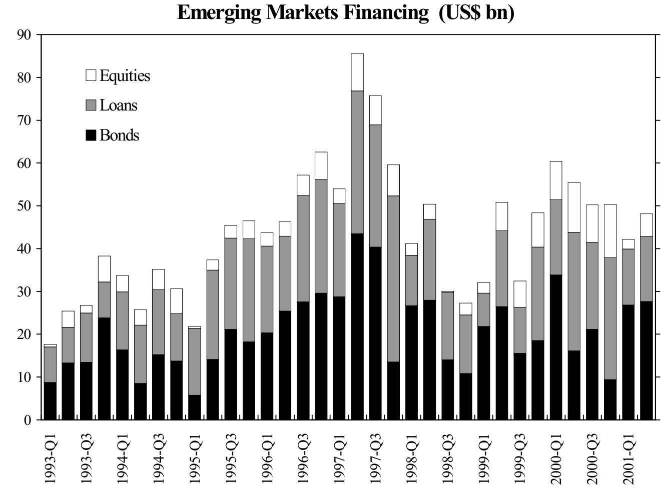
Emerging market assets and financing continued broadly to follow global markets during the second quarter, buoyed in April and May by US interest rate cuts, then succumbing in June to a growing consensus on the global slowdown. Against the backdrop of global slowing, perceived emerging market fundamentals and credit quality continued to weaken, with average credit quality in the emerging debt markets falling back to its post Russian crisis lows (see chart). Concerns about Argentina and Turkey erupted once again in July, and sovereign spreads for the former, which represents over 20 percent of the benchmark EMBI+ index, reached distressed debt levels.

Emerging Markets Credit Quality Indices



Sources: Bloomberg, Reuters, IMF Staff estimates.

Emerging Markets Financing (US$ bn)



Despite the heightened credit concerns, overall emerging market financing held up relatively well during the second quarter. The volume of bond issuance picked up modestly from the first quarter, as did syndicated lending though the latter remained, as in the first quarter, at much lower levels than last year. Reflecting the poor conditions in global equity markets and low valuations in emerging equity markets, international equity placements remained at depressed levels.

Though there were clear spillovers from emerging market countries where credit concerns heightened, they remained contained to particular emerging markets. Broader measures of spillover or contagion across the emerging markets remained well below levels seen in other major historical episodes of stress. Similarly, the pickup in overall market volatility was relatively modest.

Recent Emerging Debt Market Spread Correlations with Argentina

Brazil	0.94
Mexico	-0.12
Russia	-0.07
Non-Latin	-0.27

Average Correlation and Volatility Peaks in Emerging Debt Markets 1/

	Average Correlation	Volatility of EMBI+ Returns (annualized, in %)
Past Crises		
Mexican crisis	0.80	47
Attack on the Thai Bhat	0.73	11
Asian crisis	0.92	30
Russian default	0.80	49
Brazilian devaluation	0.62	29
Recent Spikes		
Turkey devaluation	0.44	9
Argentina's July sell-off	0.50	17

1/ For a definition see p. 18, footnote 3.

Following a record number of bond exchanges on international capital markets by emerging market sovereigns in 2000, the pace of exchanges has accelerated again this year. We characterize three different types of bond exchanges carried out by emerging market sovereigns: Brady-eurobond swaps; liability profile management (eurobond to eurobond) exchanges; and distressed bond exchanges. We discuss the broad motivations for each of these types of exchanges, recent experience with them, ongoing trends in such operations, and the potential implications for emerging debt markets.

Increasing confirmation of the global slowdown and heightened concerns about the potential for credit events within the emerging markets since the last quarter have both increased the downside risks and rendered the outlook for emerging market assets and financing subject to more than the usual amount of uncertainty. Our baseline outlook for emerging market financing continues to see moderate bond financing flows, prospects for only very selective equity issuance, and syndicated lending continuing at its current pace, that is at levels well below those of last year. The baseline outlook is subject to a variety of sources of event risk. On the well-known list of risks, at this point we would emphasize: a sharper than expected slowing in the global economy; still substantial potential for downside corrections in mature equity markets as valuations remain high by historical standards; and the potential for broad-based contagion across emerging markets from credit concerns in particular markets.

					2000				2001		2001				
	1997	1998	1999	2000	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.	Apr.	May	June	July 1/	YTD 1/
								(in billions of US dollars)							
ISSUANCE	**274.8**	**149.0**	**163.6**	**216.4**	**60.4**	**55.4**	**50.3**	**50.3**	**42.2**	**48.1**	**13.2**	**15.8**	**19.1**	**3.3**	**93.6**
Bonds	126.2	79.5	82.4	80.5	33.8	16.1	21.1	9.4	26.8	27.7	8.1	10.4	9.2	1.4	55.9
Equities	26.2	9.4	23.2	41.8	8.9	11.6	8.8	12.4	2.3	5.3	0.2	0.7	4.5	0.2	7.7
Loans	122.5	60.0	58.1	94.2	17.6	27.7	20.4	28.5	13.1	15.2	5.0	4.7	5.5	1.7	30.0
ISSUANCE BY REGION	**274.8**	**149.0**	**163.6**	**216.4**	**60.4**	**55.4**	**50.3**	**50.3**	**42.2**	**48.1**	**13.2**	**15.8**	**19.1**	**3.3**	**93.6**
Asia	115.7	34.2	56.0	85.9	19.5	26.1	18.3	22.0	19.6	22.1	5.7	6.4	9.9	2.1	43.8
Western Hemisphere	89.2	65.7	61.4	69.1	23.7	13.9	18.8	12.7	15.2	13.9	4.2	6.2	3.4	0.1	29.2
Europe, Middle East, Africa	70.0	49.0	46.3	61.4	17.1	15.4	13.2	15.6	7.4	12.2	3.3	3.2	5.7	1.1	20.7
SECONDARY MARKETS															
Bonds:															
EMBI+ (spread in bps) 2/	510	1,037	703	756	674	712	677	756	784	766	787	751	766	915	915
Merrill Lynch High Yield (spread in bps)	311	555	453	871	584	615	664	871	757	736	740	701	736	753	753
Salomon Broad Inv Grade (spread in bps)	30	58	55	89	81	87	83	95	89	80	80	75	80	77	77
US 10 yr. Treasury Yield (yield in %)	5.75	4.65	6.45	5.12	6.03	6.03	5.80	5.12	4.93	4.93	5.35	5.43	5.42	5.13	5.13
Equity:									*(in percent)*						
DOW	22.6	16.1	25.2	-6.2	-5.0	-4.3	1.9	1.3	-8.4	6.3	8.7	1.6	-3.8	-2.5	-5.1
NASDAQ	21.6	39.6	85.6	-39.3	12.4	-13.3	-7.4	-32.7	-25.5	17.4	15.0	-0.3	2.4	-9.3	-20.7
MSCI Emerging Market Free	-13.4	-27.5	63.7	-31.8	2.0	-10.8	-13.4	-13.5	-6.2	3.1	4.7	0.9	-2.3	-8.5	-11.5
Asia	-49.0	-12.4	67.6	-42.5	4.0	-14.0	-22.3	-17.3	-0.1	-1.6	0.0	0.6	-2.2	-9.0	-10.5
Latin America	28.3	-38.0	55.5	-18.4	3.2	-8.1	-6.0	-8.5	-3.5	7.1	5.7	2.6	-1.2	-6.7	-3.6
Europe/Middle East	42.6	-27.4	76.7	-23.4	3.0	-9.7	-3.9	-14.3	-22.0	4.5	12.8	-3.8	-3.7	-8.7	-25.7

Sources: Bloomberg; and Capital Data Ltd.

1/ Issuance data are as of July 17, 2001 close-of-business London and Secondary markets data are as of July 24, 2001 cob New York.

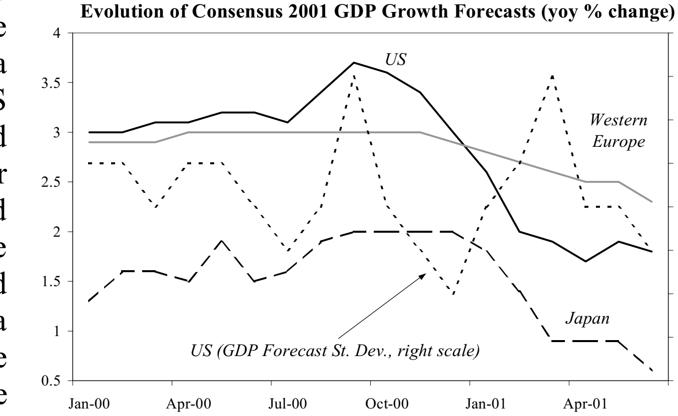
2/ On April 14, 2000 the EMBI+ was adjusted for the London Club agreement for Russia. This resulted in a one-off (131) bps decline in average measured spreac

II. RECENT DEVELOPMENTS

A. The External Environment

Developments in the major financial markets during the second quarter reflected the **tension** between the **deteriorating economic outlook** on the one hand, and the **easing by the major central banks** on the other. Consensus forecasts fell for all three major mature market regions (see chart). Expectations of a possible V-shaped recovery of the US economy gave way to those of a U-shaped trajectory. Though the (average) outlook for 2001 GDP growth in the US was lowered only slightly, to 1.8%, there was a notable reduction in the dispersion of views around lower growth prospects. Japan suffered a particularly sharp downward revision in the consensus growth forecast, to 0.6%, while the forecast for Europe fell to 2.3%.

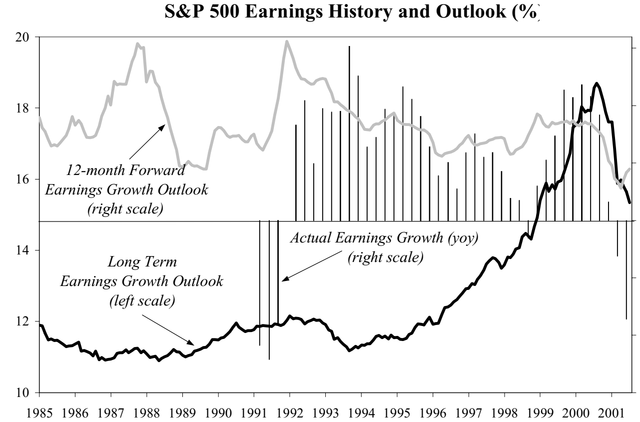
Evolution of Consensus 2001 GDP Growth Forecasts (yoy % change)



Source: Consensus Economics.

The US corporate sector continued to witness sharply **declining profitability** and a **weak earnings outlook** (see chart). **Long term earnings forecasts** continued to be **lowered**, though the decline in the **near term** (12 month) **outlook** since early 2000 appeared to be arrested. The latter, however, may simply reflect low base effects resulting from the sharp decline in the estimates of current earnings. Earnings growth in the third quarter is now also expected to be negative, with the projected rebound postponed to the fourth quarter.

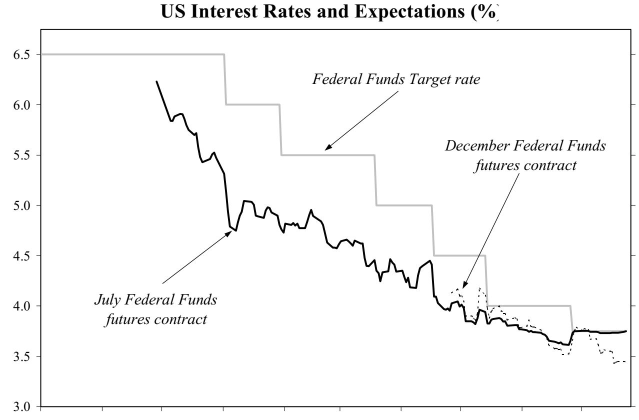
S&P 500 Earnings History and Outlook (%)



Source: Thomson Financial.

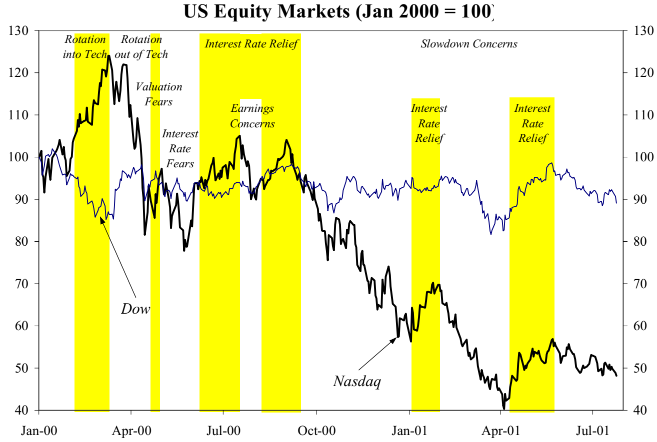
In response to the slowdown, the Federal Reserve **continued to ease monetary policy**, lowering the target Federal Funds rate three times during the second quarter. The first two 50 bps cuts spurred expectations of further cuts, but the consensus expectation following the last cut (25 bps) on June 27 was that the Fed was **nearly done with the easing cycle**, with only a 25 bps further cut now expected (see chart).

US Interest Rates and Expectations (%)



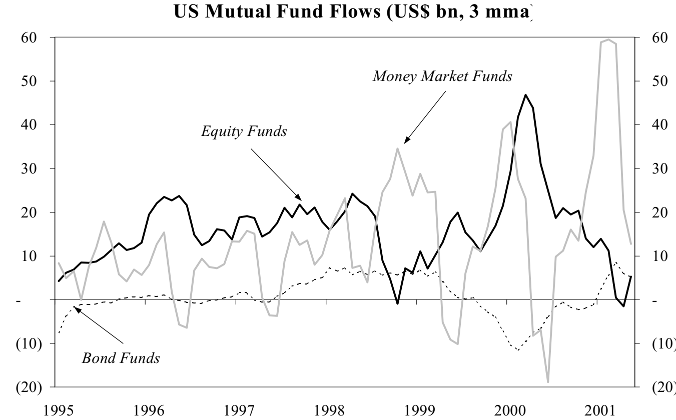
In equity markets, the interest rate cuts and the pricing in of further cuts improved fair values, leading to a **strong rally**, with the Nasdaq rising 41% and the Dow 19% between **early April and late May** (see chart). The deteriorating earnings outlook, however, first tempered, and **then reversed this rise in June**, with the S&P 500 finishing the quarter up only 6.3%, while the Nasdaq ended up 17.4%. Both indices remain down for the year. **Primary markets remained moribund**, reflecting the declines in secondary markets and the increasing attractiveness of raising debt in the lower interest rate environment.

US Equity Markets (Jan 2000 = 100)



Investor unease concerning near-term economic recovery prospects and the continued "richness" of valuations from a longer term perspective was reflected in the **lack of significant inflows into equity market** mutual funds despite the price bounce in the early part of the quarter (see chart). Flows into the money market, which had earlier drawn flows away from equity markets, also continued to fall off, both now having been supplanted by the recent growth in bank deposits.

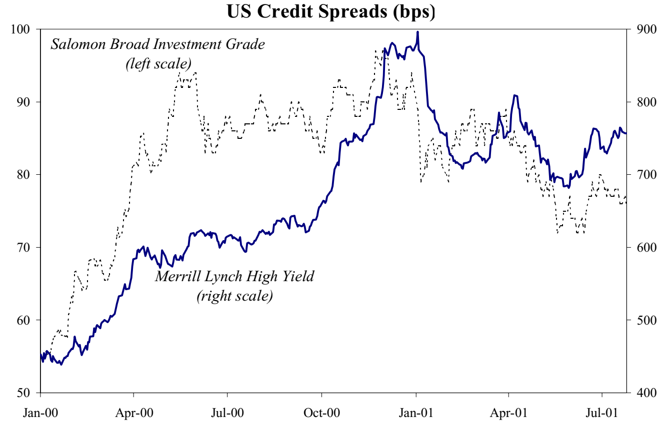
US Mutual Fund Flows (US$ bn, 3 mma)



Source: Investment Company Institute.

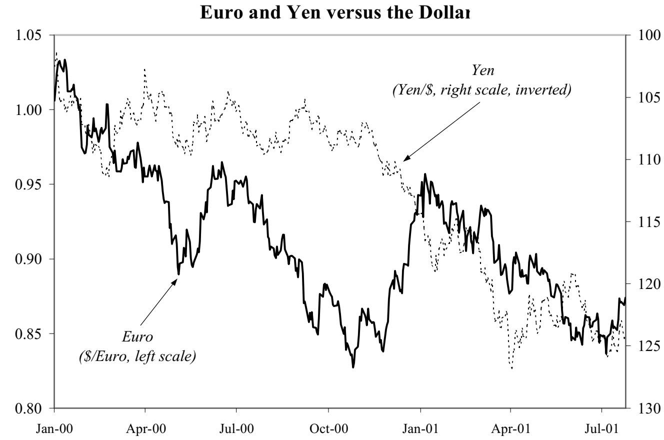
In fixed income markets, nervousness regarding economic prospects translated into a preference for stronger credits, even as monetary easing improved overall market conditions. The US **high grade and high yield markets benefited from the monetary easing**, with spreads narrowing in April and May **before widening again** in June (see chart). Spreads in both markets remain at high levels with, for example, those in the high yield sector some 350 bps wider than they were at the beginning of last year.

US Credit Spreads (bps)



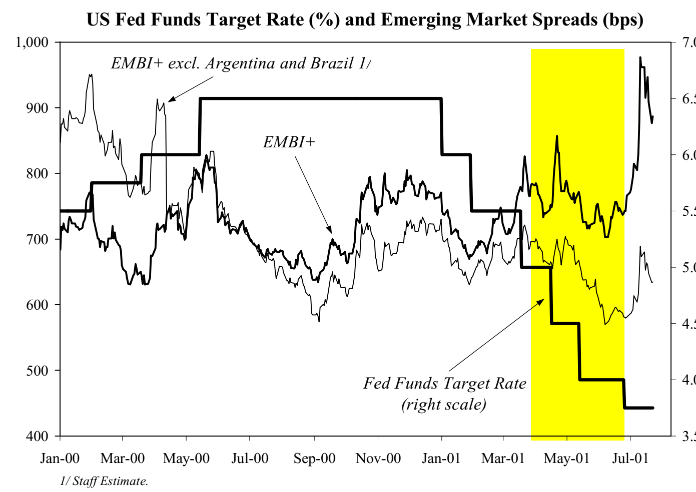
Sources: Merrill Lynch; Salomon Smith Barney.

The second quarter saw **further dollar strength**. Among the major currencies, the euro depreciated by around 7.5% in nominal terms against the dollar from its already low levels. The yen had a turbulent quarter, first weakening as much as 7.5% (nominal), then strengthening for a significant period, before returning to the weakening path many analysts had been predicting would dominate until the economy shows signs of a sustained turnaround.

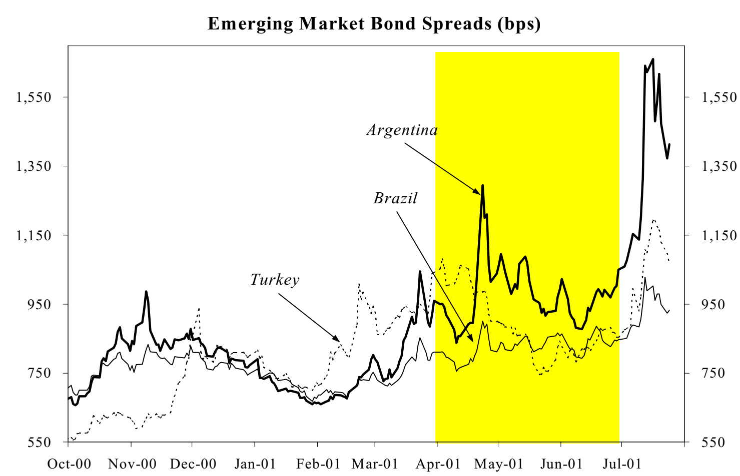


B. Emerging Bond Markets

Developments in **Argentina and Brazil dominated** emerging debt markets in the second quarter (see chart). With the two sovereigns accounting for a substantial 44% of the index, and the **correlation between their movements high** (see second chart), at around 0.9, market concerns about Argentina, reaction to its "mega" bond exchange (see Box 1), and the impact of Brazil's energy crisis and continued political wrangling determined the movement of the EMBI+.



In contrast to the first quarter, these developments overshadowed the potential benefits associated with the further cuts in US interest rates. **Excluding Argentina and Brazil** from the EMBI+, however, reveals a **substantial and persistent tightening in spreads during April and May**. The EMBI+ spread finished the quarter at 743 bps, 18 bps wider. **Excluding Argentina and Brazil, the EMBI+ spread tightened 123 bps**, until renewed tensions in Argentina in July spilled over, though modestly, across emerging markets (see Staff Appraisal for a discussion of recent spillovers and contagion).



Despite the headline risks, emerging market debt posted **a healthy 3.4% return in the second quarter**, **exceeding that of US credit markets**, which suffered from the worsening economic outlook. This aggregate performance, however, masks important country differences: **Russia was the best performer** in the quarter (returning 16.7%), while Turkey (12.4%) was the other sovereign that posted positive double-digit returns. Typically, oil-exporters did well, with Mexico posting an above-average return (5.1%). At the other end of the spectrum, Argentina and Brazil posted negative returns (3.2% and 0.4%, respectively). The **sell-off in early July, however, erased much of the emerging market gains** and the year-to-date return (through July 24) was +1.1%.

Relative Performance of Emerging Market Debt
(Total return in %)

	YTD	Q1	Q2	July 1-24
EMBI+	1.1	2.0	3.4	-4.2
US Govt. Bonds (JP Morgan GBI)	3.9	2.3	-0.5	2.1
US Investment Grade (Salomon's BIG)	5.5	3.1	0.5	1.8
US High Yield (MLHY)	5.6	6.3	-1.3	0.8
Argentina	-20.6	-3.6	-3.2	-14.9
Russia	26.4	10.2	16.7	-1.7

These developments posed important challenges, eliciting the following responses from different segments of the **investor base**:

- **Crossover investors largely remained on the sidelines** or invested in credits with rarity value, sometimes referred to as "exotic" credits such as bonds issued by the Caribbean countries and Egypt.

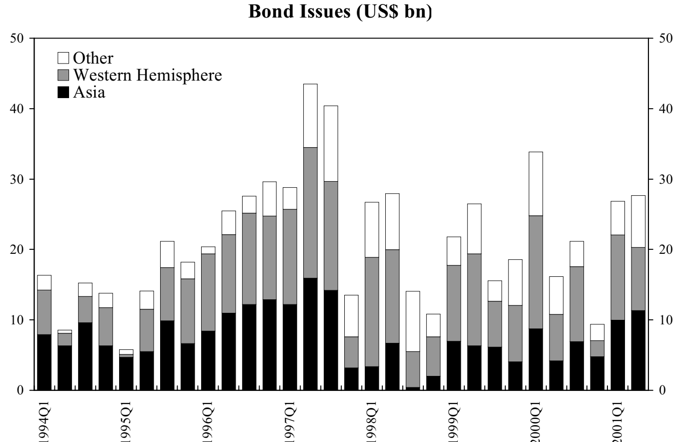
- Dollar-based **dedicated investors maintained their defensive positions** and increased cash cushions. They underweighted Argentina and Brazil, and overweighted **Russia**, on the high yielding end, and **Mexico**, at the lower yielding end of the emerging market credit spectrum. This overweighting at the two ends of the yield spectrum is sometimes referred to as a "**barbell**" strategy. If dedicated fund managers were only concerned with outperforming their benchmarks, they would simply have underweighted Brazil and Argentina and outperformed the index. However, after two quarters of high cash cushions, fund managers were sensitive also to the overall yield, that is, absolute dollar returns, and to the risk of underperformance of their overall portfolios (the beta of their portfolio relative to the EMBI+) from being underweight substantial components of the index in the event of good news. With fundamentals in Mexico and Russia suggesting a greater degree of resilience to potential binary events, the strategy of "barbelling" was one that (ex-ante) seemed to simultaneously hedge event risk and mimic the expected risk profile (beta) of the EMBI+.

- **After Argentine sovereign spreads peaked in mid-April, dedicated investors became slightly less defensive**, reducing modestly their cash holdings and their underweight positions. These underweights were further reduced leading into and after the Argentine "mega" bond exchange, as the ensuing rally squeezed those dedicated investors caught underweight. In the event, the reduction in underweights rendered those dedicated investors particularly susceptible to the sell-off in July, with two large US fund managers having to liquidate overweight positions in a falling market.

- With the crossover investor remaining mostly on the sidelines and dedicated investors following a defensive strategy, the **relative importance of the local investor and hedge funds increased over the quarter**. Notably, the behavior of domestic pension funds and local banks was key to the larger-than-expected Argentine debt swap and they continue to be important drivers of the country's sovereign spread.

Primary markets echoed the sentiment in secondary markets, with a moderation in Latin issuance offset by a pickup in Asian and European issuance. In particular, the barbell investment strategy and crossover interest in good credit stories created investor-driven demand for a string of small Caribbean and Central American countries, and enhanced the appetite for Mexico and Malaysia. Investor appetite for Malaysia's $1 bn bond was driven by its rarity value, the sovereign's investment grade status, and it being seen as immune to any renewed turbulence from Latin America. Egypt's $1.5 bn new issue also met with strong demand. Non-Asian **corporate issuance** continued to **suffer from a lack of investor sponsorship**, with only the occasional US high-yield bond fund considering it worthwhile to invest in emerging market corporates.

Bond Issues (US$ bn)



For the quarter as a whole, emerging market issuance reached $28 bn, slightly higher than volumes in the first quarter, with $5.9 bn in debt issued in the last week of June. The largest sovereign transaction during the quarter was the **Argentine $30 bn "mega" debt swap**, which exceeded market expectations in terms of size and foreign investor participation (see Box 1).

Currency of Issuance
(Shares in %)

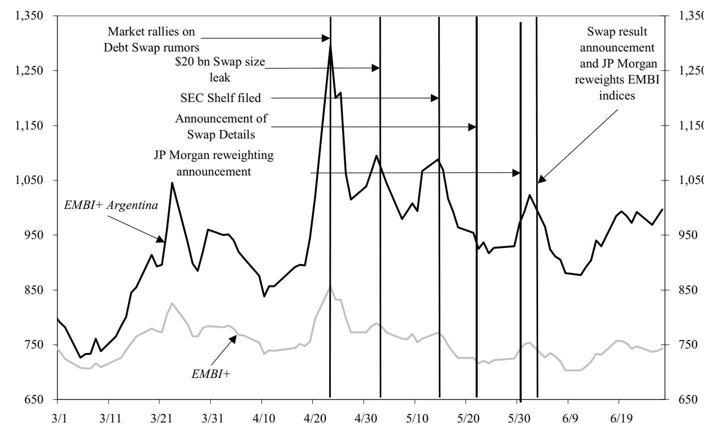
	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	00Q1	00Q2
U.S. dollars	62	76	86	83	62	67	59	53	62	51	65	60	57	71
Euro	8	9	7	0	26	28	36	37	33	28	18	21	31	18
Deutsche mark	15	8	6	14	2	0	2	0	0	0	0	0	0	0
Yen	0	0	0	1	2	1	1	8	3	17	14	13	7	6

In terms of currency of issuance, the increased **importance of Asian issuers was translated into a higher share of dollar issuance** during the quarter. With Latin issuers having reduced market access, the importance of the euro-denominated market almost halved (see Box 2), while yen issuance remained stable.

Box 1. Market Reactions to Argentina's "Mega" Bond Exchange

Facing a debt service "hump" in 2001-2005, in April the Argentine authorities began contemplating a bond exchange that would replace near-term payments with payments in 2006-2030. With roughly $60 bn worth of eligible domestic and external debt targeted, the exchange was potentially the **largest ever non-distressed bond exchange** (in terms of nominal face value exchanged, Russia's distressed exchange was bigger). The exchange had an important market impact at several critical junctures during the quarter.

Chronology of the Debt Swap: EMBI+ and Argentina Spreads (bps)



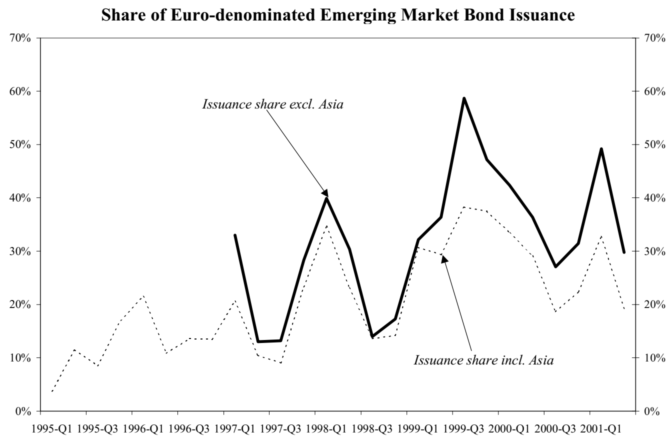
Rumors of the debt swap reversed market sentiment following the sharp April 19-23 sell-off. Confirmation by the authorities that a "mega" debt swap was indeed under consideration triggered a strong rally as market participants rebalanced portfolios, increasing exposures to shorter maturity bonds to take advantage of any exchange "sweetener."

Shortly thereafter, market **rumors suggesting the size of the swap may reach $20 bn further anchored market expectations**, spurring a short-covering rally by underweight investors scrambling to revert their underweight positions to neutral for those bonds most likely to be bought back in the exchange. Other investors, reportedly including hedge funds, also switched into shorter maturity bonds in the belief there would be a scarcity premium on these bonds following the exchange, and leading the Argentine credit yield curve to become distinctly hump shaped. With the local media having already reported the proposal, the May 24 **announcement of the actual details of the swap failed to have any noticeable market impact** Leading into the swap, some nervousness developed, as widening sovereign spreads raised the question of whether, at yields of 15%, the swap would be too costly for the government. In the end, **higher than expected foreign investor participation** ensured a large headline swap number, triggering what some saw as a relief rally, which **lasted slightly over a week** and pushed the Argentine **EMBI+ spread 146 bps lower**.

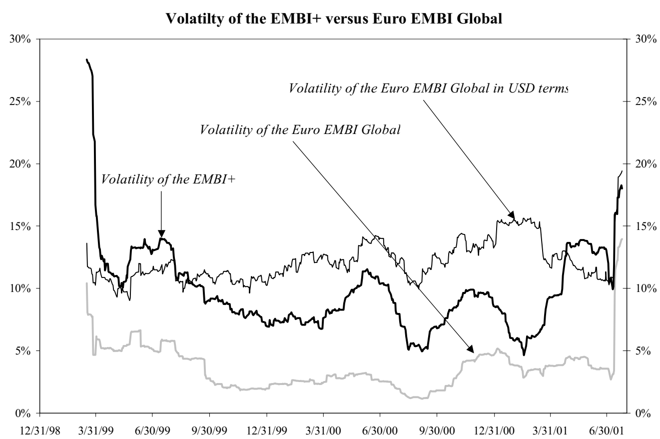
Many market participants, though, saw the subsequent rally largely driven by JP Morgan's decision to undertake an unprecedented **intra-month rebalancing of the widely tracked EMBI** family of indices. The decision took investors by surprise and forced those benchmarked against an EMBI index to sell the old bonds that risked removal from the index as a result of the swap, and switch into the new exchange bonds so as to minimize tracking errors. **Spread gains** from the swap were **reversed by end-June.**

Box 2. Euro-denominated Emerging Market Bonds: New Benchmarks

The rapid growth in **euro-denominated emerging market issuance** has created an important source of investor demand that is **beginning to rival the importance of the dollar-market** (see chart). The euro market's importance for emerging market issuers peaked in the third quarter of 1999 when, excluding Asian issuers, **euro-denominated issuance reached a high of 60%**. This year, the share of euro-denominated issuance has fluctuated. In the first quarter, when the dollar market largely closed for non-Asian issuers, the share briefly touched 50%, before falling back during the second quarter as Turkey and Argentina were shut out also from the euro market.



As discussed in past quarterly reports, the **dominant bondholder is still the retail investor** who generally holds bonds until maturity, thereby limiting the market's volatility. With the beginnings of **growth of an institutional investor base** for emerging market bonds in Euroland, **several investment banks have created benchmark indices of euro-denominated bonds**. JP Morgan, the producer of the widely used EMBI+ in the dollar market, recently launched a Euro EMBI Global index. For US based investors, however, the attractiveness of investing in the limited secondary market volatility of the Euro EMBI Global is more than offset by the volatility introduced through the currency exposure (see chart).



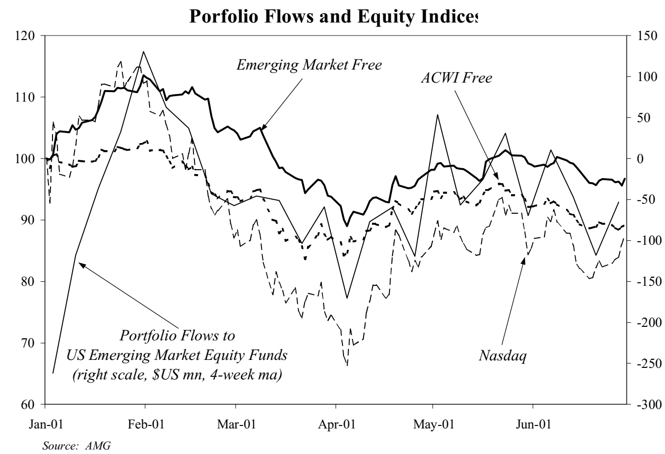
A comparison of the EMBI+ and Euro EMBI Global highlights several common features. **Latin sovereigns dominate both** indices, with their share constituting 60% of the Euro index versus 71% for the EMBI+. Among them, **Argentina has the highest weighting in both**. The **Euro EMBI Global would not, therefore, appear to provide portfolio diversification benefits different from the EMBI+**. A key difference between the two is the **much larger importance of Turkey in the Euro index**. The sum of Turkey and Argentina's weights is 44.2% in the Euro EMBI Global compared to 24.3% for the EMBI+. The **overall market capitalization of the two indices is very different**, reflecting the inclusion of the still respectable stock of largely dollar-denominated Brady bonds in the EMBI+. Over the next couple of years, increased issuance in the euro market, and buy-backs and amortization of Brady bonds **will likely narrow the difference in market capitalization** of the two indices.

Comparison EMBI+ and Euro EMBI Global Constituents

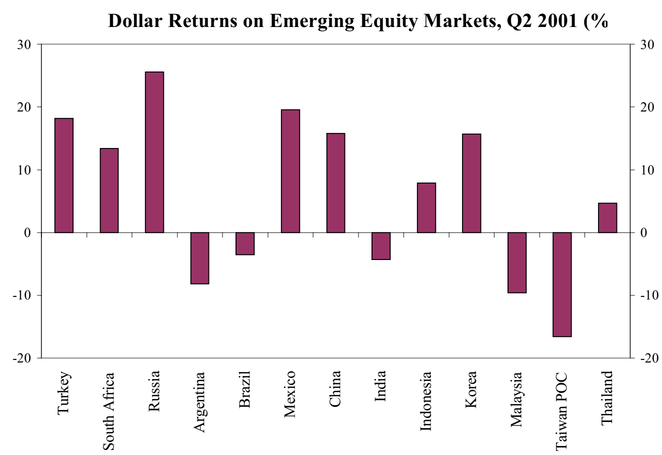
	EMBI+		Euro EMBI Global	
	Share (in %)	Market Cap. (in US$ mn)	Share (in %)	Market Cap. (in US$ mn)
Argentina	21.5	37,210	29.0	11,163
Brazil	21.5	37,180	16.3	6,269
Mexico	16.7	28,936	9.1	3,496
Russia	13.4	23,218	3.8	1,462
Venezuela	4.9	8,425	2.8	1,083
Turkey	2.8	4,820	15.2	5,847
Others	19	32,991	24	9,246
Total	100.0	172,781	100.0	38,566

C. Emerging Equity Markets

Emerging equity markets broadly **reflected the performance of US equity markets** in the second quarter, with a rally in April and May giving way to a sell off in June (see chart). Overall, **emerging equity markets ended up 3.1%**, as measured by MSCI's EMF index, in line with global markets (ACWI up 2.3%), but lagging the major US indices (Dow 6.3%, and Nasdaq 17.4%). Mutual **fund flows** into emerging equity markets during the quarter continued to move broadly in line with the performance of global equity markets, but remained volatile reflecting uncertainty about the timing of a rebound in global economic activity.



This broad pattern of performance masked **considerable dispersion across countries** (see chart). **EMEA** (Emerging Europe, Middle East and Africa) was the best performer, led by strong gains in Russia (25.6%), Turkey (18.1%), and South Africa (13.4%). In **Latin America** (7.1%), Mexico's (19.6%) gains offset losses in Brazil (-3.5%) and Argentina (-8.3%). **Asia** (-1.6%) was the worst performing region, with strong gains in China (15.8%) and Korea (15.7%) contrasting with substantial losses in Taiwan Province of China (-16.6%) and notable losses in Malaysia (-9.6%).



Differences in country and sectoral performances during the quarter reflected several broad themes. Strong energy prices supported the performance of **oil** exporters, Mexico and Russia, the two best performing emerging markets over the quarter. In mid-May, **MSCI announced provisional free-float based index** weights, which would potentially affect a large pool of benchmarked funds that invest in emerging markets[1]. Countries whose

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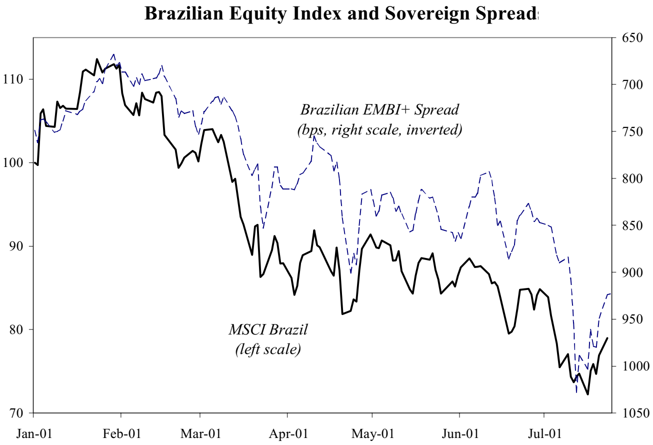
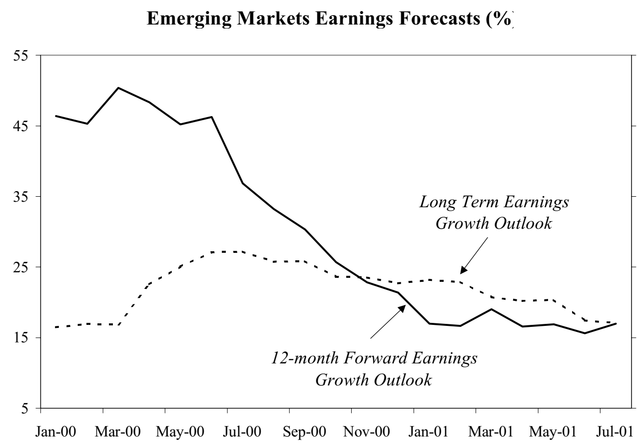
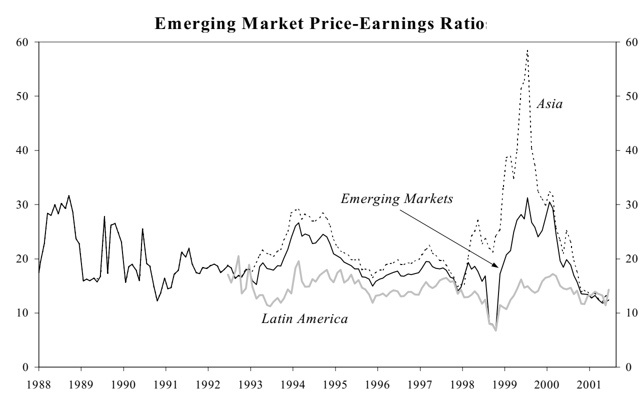
[1] As discussed in a previous quarterly report, on December 10, 2000 MSCI announced its decision to move to free-float based equity indices, in order to factor in the actual availability ('free float') of the underlying shares. New (provisional) inclusion factors for index constituents were published in May 2001 in order to give fund managers benchmarked against the MSCI indices some idea of the potential impact of these changes on the composition of their portfolios. The provisional indices based on the new methodology will be provided by MSCI along with the old indices until the transition is completed on May 31, 2002.



benchmark weights turned out to be lower than expected were among the poorer performers. For example, Taiwan Province of China's weight increased less than expected, while India's weight fell more than expected. In contrast, South Africa's weight rose slightly more than expected. In **Latin America**, equity investors remained focused on developments in **Argentina**. Despite the country's relatively small (1.5%) weight in the EMF index, Argentine developments were one of the key drivers of Brazilian stocks due to the latter's sensitivity to the movements of the *real* and Brazilian sovereign risk (see chart), which in turn were strongly influenced by Argentine sovereign risk. **China**'s strong performance can be attributed to the view it is relatively **immune to the global slowdown** while enjoying robust domestic demand. Asian **"old economy"** stocks benefited from the view the sector **would bottom out before the "new economy" does.**

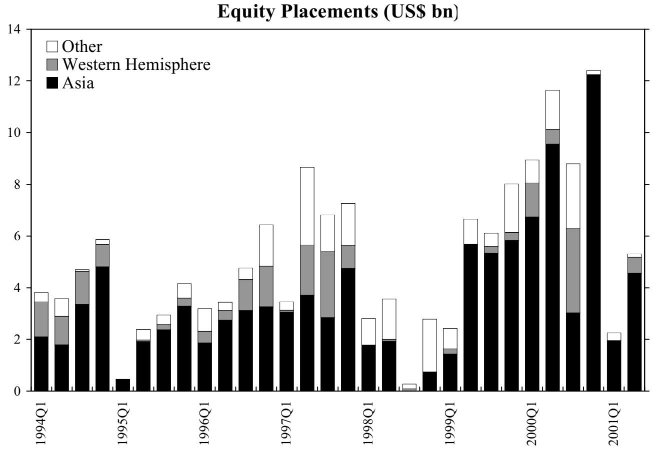


Mirroring the trend in mature markets, **earnings per share (EPS) growth forecasts** for emerging markets were also **revised down** in the second quarter. Intensifying concerns about global growth, the downturn in the technology investment cycle, and country specific risks continued to depress both 12-month and long term earnings forecasts. At the same time, **valuations** (as measured by price-earnings ratios) in all the emerging market regions are **at, or close to, their historical lows**, and well below those in the mature markets.



Source: Thomson Financial.

Equity Placements (US$ bn)

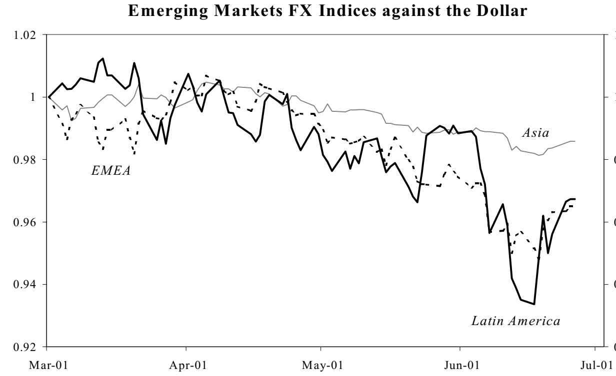


Some emerging market corporates took advantage of the initial rally in equity markets during the second quarter to place $5.3 in primary markets. **Cumulative issuance** through the second quarter, however, remained close to **a 5-year low**. Primary issuance was once again dominated by the Asian technology and telecom sector in spite of generally poor market conditions for these sectors. Asian companies (Korean Hynix Semiconductor Inc. ($1.13 bn), Taiwan Semiconductor ($291 mn) and Korea Telecom ($2.24 bn)) were responsible for the bulk of issuance. The Hynix issue followed the debt rescheduling agreed with its creditors in May, and was priced at a substantial discount to the local share price. Korea Telecom's issue was from the previously planned partial privatization. Outside Asia, there was only one large issue, of (non-voting) ADRs from Latin America by Brazilian aircraft manufacturer Embraer ($577 mn).

D. Emerging Foreign Exchange Markets

Emerging market currencies of **all regions weakened against the dollar** over the quarter. Much of the depreciations occurred in June, and continued into July (see chart). Spillover from adverse developments in Argentina affected Latin American and Emerging European currencies to varying degrees, while emerging Asian currencies overall depreciated more modestly, but with significant differences across countries.

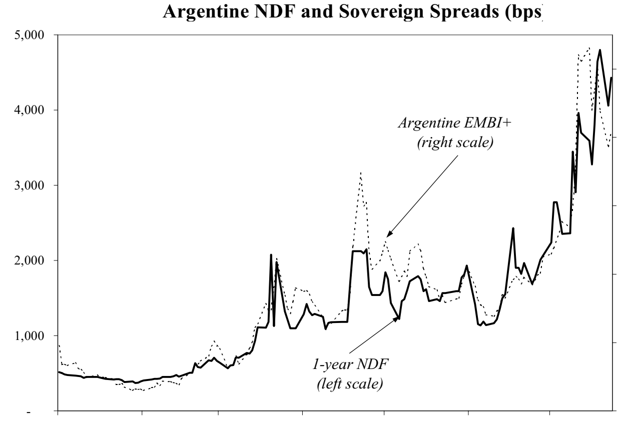
Emerging Markets FX Indices against the Dollar



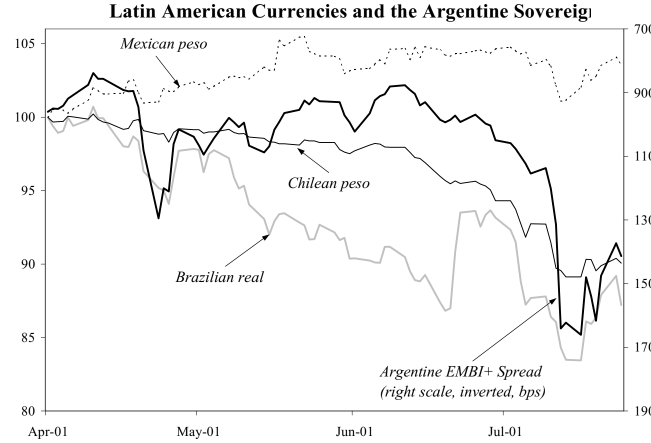
Source: Bloomberg, MSCI,; Staff Calculations.

In **Latin America**, developments in Argentina dominated movements in key currencies. The Argentine nondeliverable forward (NDF) market closely reflected changing perceptions of sovereign risk (see chart). The **Brazilian *real*** weakened considerably in response to developments in Argentina and the domestic energy crisis, reaching a **new all time low in July**. Exporters began hoarding US dollars overseas from mid-May, and there were notable currency outflow

Argentine NDF and Sovereign Spreads (bps

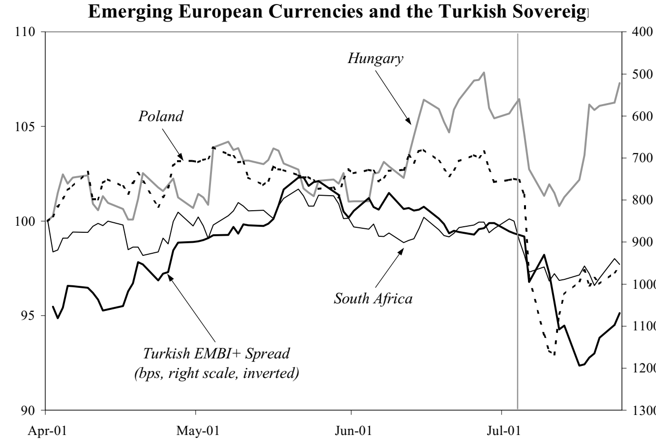


during the quarter. While the surprise decision by BACEN to raise interest rates by 150 bps on June 20 caused a temporary repatriation of export proceeds, and some short covering, the currency's slide resumed in concert with Argentine developments in spite of central bank intervention. In the face of downward pressure from adverse developments in Argentina, and following the central bank's lowering of interest rates in response to domestic weakness and falling copper prices, the **Chilean peso fell to historical lows** against the dollar. The **Mexican peso was notable for its relative immunity** to developments in Argentina. Investors continued to maintain their long local currency positions in view of **Mexico's perceived safe haven status** given its increased integration with the US economy. The currency also received a boost in anticipation of FDI inflows relating to the \$12.5 bn acquisition of Banamex-Accival by Citigroup.



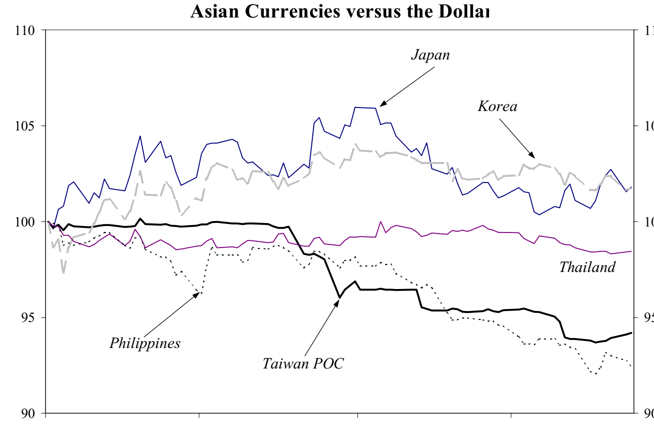
Latin American Currencies and the Argentine Sovereig

Emerging European currencies were volatile in the second quarter. In Turkey, the lira ended the quarter down more than 20% reflecting the ongoing economic turmoil. While the Hungarian forint initially strengthened as restrictions on the capital account were removed, the currency weakened sharply against the dollar along with other regional currencies and the South African rand in July. While domestic factors played some role, in particular in the weakness of the zloty, unwinding of the euro-funded carry trade by international investors in local currency instruments, following the exacerbation of Argentine and Turkey concerns in early July, also contributed to the weakness of these currencies.



Emerging European Currencies and the Turkish Sovereig

Though the Japanese yen fluctuated against the dollar, **Asian currencies** weakened modestly during the quarter. Given the deterioration of the export sector in response to the global slowdown, most Asian currencies did not strengthen with the yen in April and

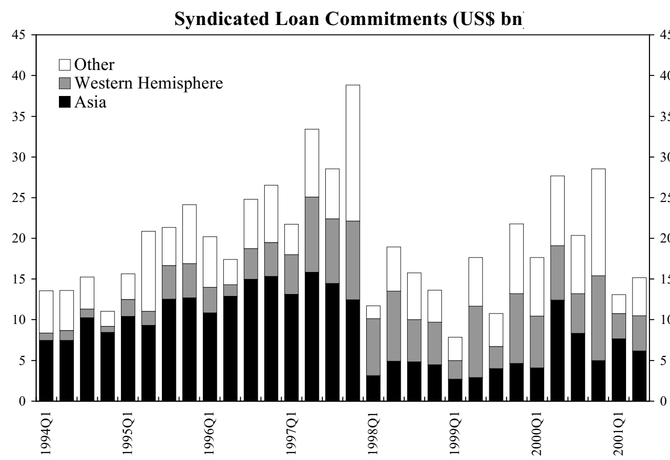


Asian Currencies versus the Dolla

May. The major moves were the more than 5% weakenings of the Philippine peso and of the New Taiwan dollar as monetary policy was relaxed to support domestic demand. Against this broad trend, the Korean *won* actually strengthened around 3.0% during the quarter, reversing much of the depreciation seen earlier in the year, continuing to maintain its close link with the yen.

E. Syndicated Loans

Syndicated lending to emerging markets picked up modestly in the second quarter amid ongoing concern about the global slowdown. The overall volume of lending reached $15.2 bn in the second quarter compared to $13.1 bn in the first. As the **corporate sector scaled back investment, notably in Latin America and Asia, and lenders adopted a more cautious stance towards some of the riskier credits**, the monetary easing in the mature markets facilitated the refinancing of loans.



The composition of **syndicated lending to emerging markets shifted in favor of the Emerging Europe, Middle East and Africa (EMEA) region**, with all regions receiving a roughly equal share of total loan volumes. In the EMEA region, the Turkish government secured funding amounting to $535 mn, while a number of corporates maintained access to international loans, albeit at substantially higher spreads than a year ago, reflecting the sovereign's difficulties. Of note, Bank Zenit became the first Russian bank to brave the syndicated loan market since the 1998 crisis, completing a small $20 mn 6-month loan at Libor+400 bps that was collateralized with Tatneft eurobonds.

Moderate volumes in the second quarter reflected:

- **An ongoing flight to quality**, with lenders demonstrating increased discrimination regarding corporate credit quality. As in the first quarter, **refinancings were a dominant feature** of market activity.

- In Latin America, **Argentina's troubles engendered caution towards the credit**, with banks typically looking to reduce exposure to Argentine corporates, irrespective of the structure of the deals. **Argentine concerns also spilled over into the region**, notably to Brazil, which has also suffered some domestic difficulties. While Brazilian corporates were prominent borrowers in the second quarter, many loans were scaled back or provided for "market flex" (allowance for adjustments of spreads to market conditions) during syndications, and most loans required collateral or political risk insurance. For instance, to lure support, benchmark Brazilian utility Light had to increase the spread on its 3-year $190 mn loan by 50 bps to 264 bps over Libor.

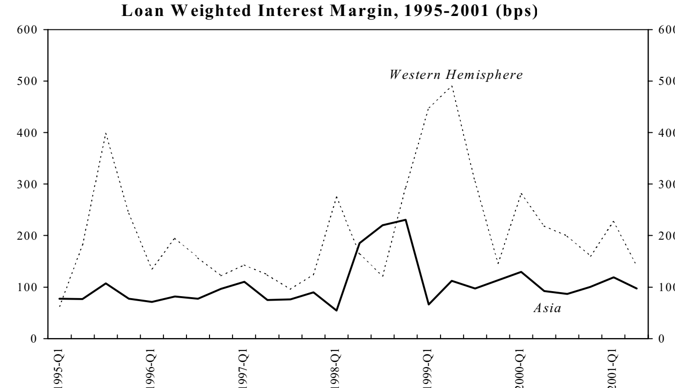
- Without the prospect of rolling over their maturing loans, **second-tier Turkish banks have been paying off their obligations**. Meanwhile, Turkexim Bank mandated a 364-day $120 mn loan to replace a $160 mn facility that matured in May, reportedly paying a 36% premium over the deal being replaced. A number of top-tier banks are hoping to roll over loans maturing in July, and the market's expectation is the deals will be completed by the arrangers of the loan, although lingering nervousness about Turkey may pose difficulties in being able to onsell it to a wider syndicate.

- Significant **liquidity in local markets** continued to support local currency denominated lending, particularly in Asia (e.g., Thailand and Singapore). In addition, corporates are reported to be increasingly seeking to avoid asset/liability mismatches by borrowing in local currency.

- A **number of telecom related deals**, suggesting lenders are increasingly distinguishing the underlying fundamentals of emerging market telecom companies from their mature market counterparts. Typically, emerging market telecoms have healthier balance sheets, not having purchased UMTS licenses, and promising outlooks, with growth being 'subscriber led,' penetration rates in most mobile markets still low, and ongoing management improvements in a number of emerging market telecom companies.

In the context of abundant liquidity in mature market banks, and the continued availability of banks' underutilized internal risk limits to emerging markets, syndicated loan **spreads tightened across the regions** amid intense competition among arrangers to win mandates for well-structured deals with the 'right borrowers.'

Loan Weighted Interest Margin, 1995-2001 (bps)



- In **Asia, pricing has fallen close to pre-crisis levels**:
  - In Hong Kong, blue-chip companies secured deals in the low 50 bps over Libor range, roughly half of what they would have paid a year ago. For red-chips, spread-narrowing has been even more dramatic.
  - In Korea, spreads for top-tier financial institutions declined to about half of last year's margins.

- In **Eastern Europe**, **top tier corporates and financial institutions**, particularly in Hungary and Poland, **witnessed a tightening in loan margins towards Western European levels**, with regional banks clearly pricing deals for relationship reasons during the quarter.

III. Staff Appraisal

Several **themes** dominated emerging markets during the second quarter. The **external environment** witnessed a greater confirmation of slowdown. In spite of the monetary easing in mature markets, the **supply of capital** to emerging markets remained **constrained**. **Domestic fundamentals** and perceived **credit quality** of emerging markets **deteriorated** markedly, with concerns about credit events dominating a few key emerging markets. These factors, along with the **linkages between emerging markets and the scope for contagion** (and fears of future contagion) are likely to be the key determinants that shape the outlook for emerging markets in coming months. Against this background, we examine in depth two issues. First, we revisit the question of investor discrimination or **contagion, and volatility** in emerging debt, equity and foreign exchange markets, providing an update of our measures during the recent July turbulence. We discuss whether there have been changes that can explain the differences in behavior from previous crisis episodes. Second, with the confluence of the poor external environment and country-specific concerns having prompted the **largest ever voluntary debt exchange** by an emerging market issuer during the last quarter, we examine the rationales for the variety of recent debt exchanges that have become common in emerging debt markets. We then discuss the outlook and risks.

A. Contagion and Volatility: An Update

A salient feature of emerging markets have been their proneness to sharp spikes in volatility and "contagion" across countries as well as markets during periods of crisis. Substantial market concerns about the potential for credit events in two of the key emerging markets in July, and poor performance in a variety of other emerging markets once again raised the specter of widespread contagion.

As noted above in discussing recent developments, there were **clear instances where concerns about Argentina were closely mirrored in similar asset price movements in other countries**. This was especially notable in the case of **Brazil**, particularly in the external debt markets, but also in the foreign exchange and equity markets, and to a more limited extent for other countries in the region. Outside Latin America, the extent of the comovement of asset prices with Argentine developments, and whether they represented instead coincident local developments is debatable. **Defining contagion as comovements in asset markets in excess of those that can be explained by movements in fundamentals**, most observers have argued that the **comovement of Brazilian asset prices with those of Argentina** were "excessive," and represented **contagion**.

While it is **clear that there were specific instances of spillover** from particular country credit concerns to others, **how wide was it across the emerging market asset class?** In a past quarterly report,[2] we discussed in depth a measure—the average cross-country correlation of returns—that provides an indication of the extent of comovement of individual country returns, and indicates periods of broad-based selling *or* buying of emerging markets[3]. That report discussed alternative interpretations of the measure, and the historical experience. Before providing an update of the measure for the recent period, it is useful to reiterate some observations from that report:

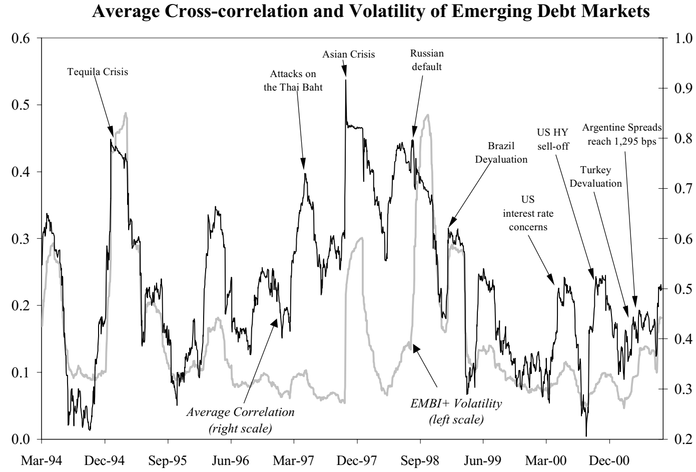
- Contagion can, and indeed does, occur at high frequencies, for example at daily frequencies. It is not generally possible to get high frequency observations on economic fundamentals on similar high frequencies. **Ideal high frequency estimates of contagion**, that is, asset price comovements purged of the influence of fundamentals are, therefore, **not available**.

- High values for our average cross-correlation measure are consistent with a number of factors: common country fundamentals; real and financial linkages across countries; common external shocks; and lack of investor discrimination. For a variety of reasons discussed in the previous report, in our view **common external factors and lack of investor discrimination are the more likely key explanators** of spikes in observed correlations.

Looking first at the emerging debt markets (see chart):

- It is evident that there were **large spikes in the average cross-correlation associated with the major emerging market crises**: the Tequila in early 1995 (when the average cross correlation reached 0.8); the attacks on the Thai baht in early May 1997 (0.72); the October 1997 Asian crisis

Average Cross-correlation and Volatility of Emerging Debt Markets



[2] Emerging Market Financing in the Fourth Quarter of 2000: Developments and Prospects. Forbes and Rigobon (2000), in “Measuring Contagion: Conceptual and Empirical Issues,” (mimeo. MIT), point out that in measuring contagion, increases in volatility during crisis periods can bias correlations upwards. However, Baig and Goldfajn, in “The Russian Default and the Contagion to Brazil,” (IMF WP/00/160, 2000), argue that it is unclear the Forbes and Rigobon correction should be made, as the same factors that result in increased volatility (thin markets, panic, margin calls) are precisely the factors responsible for contagion and controlling for one, causes a loss of power for the other.

[3] The measure uses the average cross-correlation of spreads for a rolling 50-day window on the external debt of nine emerging markets (Argentina, Brazil, Ecuador, Mexico, Panama, Peru, Poland, Russia and Venezuela).

(0.92); and the Russian default (0.82). These very high correlations are not only consistent with, but **highly suggestive of contagion**.

- The **Turkish devaluation** in February led to a **modest rise** in the average cross correlation to 0.43. During the April Argentina sell-off, which saw sovereign spreads reach nearly 1,300 bps, the average correlation was 0.45. Similarly, the most **recent sell off in Argentina** during July, which saw sovereign spreads peak over 1600 bps resulted in an increase in average correlations, but ***so far*** **only to a relatively modest** 0.47 (see chart). **In all three of the recent episodes** of heightened credit concerns, therefore, the **average cross-correlation across the emerging debt markets has been much lower than in past crisis episodes**. This suggests emerging market debt investors have been discriminating more between various sovereign credits than during the major emerging market crises of the past.

- The **volatility of EMBI+ total returns**, which has also **spiked at times of crisis, has also remained remarkably subdued** recently, not approaching anywhere near the levels seen during the Tequila, Russian or Brazilian crises.

From the **point of view of broad-based contagion and volatility**, therefore, the most **recent period of turbulence has still been, from a historical perspective, a period of relative stability** in emerging debt markets. We see several **factors** as having played a role:

- So far **there has not been a credit event or a "full-blown" crisis in a major emerging market**. It remains an open question (see below) as to how much contagion and volatility there would be if such an event were to actually take place.

- The heightened credit concerns have **come at a time of much lower exuberance** in global markets in general, and emerging markets in particular. Net emerging markets fundraising on international capital markets, for example, totaled $140 bn in 1996 and $196 bn in 1997, with **flows falling off sharply in the aftermath of the Asian crisis**. Though flows recovered from a low of $56 bn in 1998, **in 2000 at $98 bn they were still at only half their previous peak**.

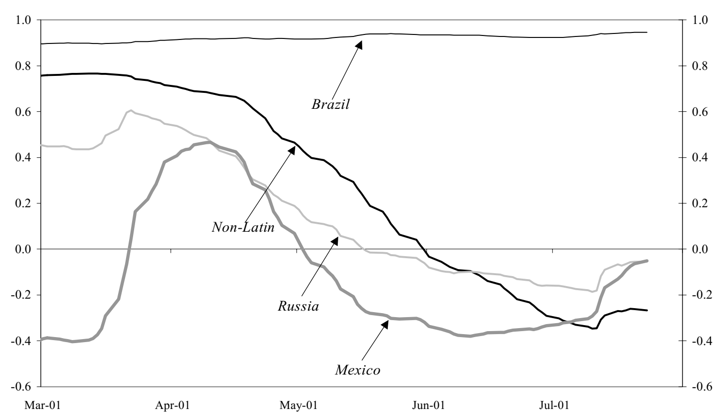
- The poor external environment, namely the **global slowdown, has long been anticipated**, **drawing capital up the credit spectrum** and away from higher risk asset classes, including emerging markets. This has meant **significantly reduced participation by crossover investors**, i.e., high grade and high yield investors who devote a small proportion of their portfolios to emerging markets, who have traditionally been a substantial and key segment of the investor base.

- A **decline in leverage** in the investor base. The need for across-the-board liquidations in response to margin calls due to losses in the face of bad news have, therefore, been fewer. In contrast to the Russian crisis, hedge funds are broadly seen as benefiting from a deterioration due to their net "short" positions.

- In the case of Argentina, **investor concerns have been building for some time**, thereby:
    - Allowing **remaining crossover investors** to focus on the top credits, becoming largely **non-invested in the riskier credits**.
    - Leading **dedicated investors** to take **underweight** positions in the countries of concern. **Bad news** in these countries has, therefore, actually meant **outperformance** relative to the EMBI+ index, often the benchmark against which their performance is measured.

- **Dedicated investors** have since late last year followed a **strategy** of overweighting Mexico and Russia at the expense of Argentina and Brazil. Observed correlations indicate such a strategy was also followed dynamically, with spreads in Russia, Mexico and other non-Latin credits actually being negatively correlated with returns in Argentina, while Brazilian returns remained highly positively correlated with those in Argentina. These correlations suggest **investors reallocated holdings** away from Argentina and Brazil towards these other credits ***within*** **the emerging market asset class**, with Mexico, Russia, and other non-Latin credits being **"safe havens."** This is in **sharp contrast to previous crisis episodes** where, because of the predominance of crossover investors, we saw a **mass exit out of the asset class**. The safe haven reallocations within the asset class are a welcome positive development. It is important to note, though, that this example of increased investor discrimination is a result of who the current marginal investor in emerging debt markets is—the dedicated and the local investor.

Emerging Market Spread Correlations with Argentina 1/



1/ 50-day rolling correlations.

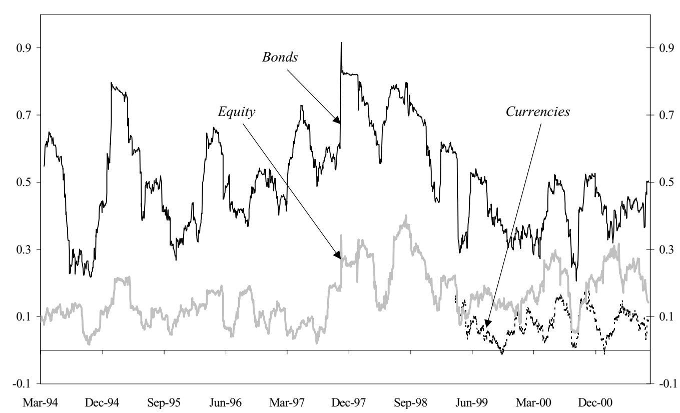
- The **importance of local investors for sovereign external debt has risen** over time. With most local investors typically **holding only their own country's external debt**, for regulatory or home-bias reasons, rather than a broad portfolio of emerging market credits, they are **unlikely to be a channel for spillovers** across emerging markets.

- With **Turkey's share of the EMBI+ index between 2%-3%,** it was to be expected that the devaluation's impact on other emerging debt markets would be limited.

- The **fundamentals** of some of the key emerging market countries have **improved** relative to previous crises, putting them in a better position to absorb, and not exacerbate any contagion. Short-term debt to reserves ratios, especially in Asia, have generally fallen, many more countries have adopted floating exchange rates that can work as shock absorbers, and financial systems in a number of countries have had their vulnerabilities exposed recently and are in the process of being rebuilt. Other policy measures, such as South Africa's sharp reduction in its net open forward position, have also strengthened countries against contagion.

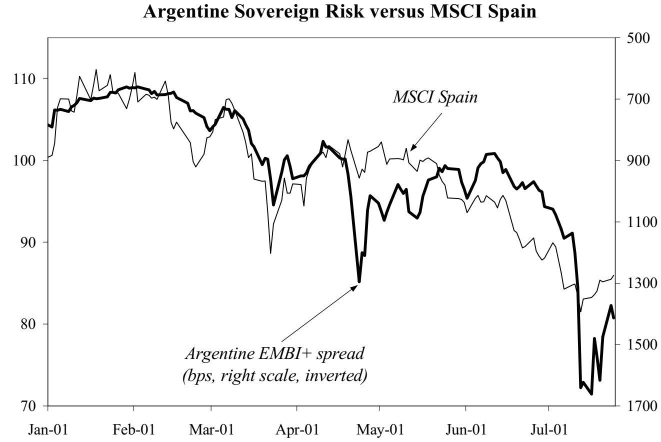
The basic pattern of average cross-correlations between individual country returns in emerging debt markets is also evident in **emerging equity and currency** markets, where average correlations are, however, lower (see chart). We also note that in **equity markets, both Argentina and Turkey have relatively low weights in major indices**, and have therefore had little direct impact on other emerging equity markets, as investors have been **able to reduce their exposures to zero without substantial risk of underperformance** in the face of positive developments in these markets.

Average Correlation for Emerging Bonds, Equities and Currencies Markets



Have there been spillovers or contagion to the mature markets? The significant exposures of some G7 banks and corporates to certain emerging market countries (via direct investments in emerging market companies, portfolio investments, or lending) imply that credit related developments in those emerging markets will affect market valuations of these entities. For example, equity prices of the Spanish banks and corporates, which have the highest overall exposure to Argentina among the mature markets, have been sensitive to any sudden widening of Argentine sovereign spreads.[4] Since these entities have a significant weight in the Spanish equity market, **the**

Argentine Sovereign Risk versus MSCI Spain



[4] Two major Spanish banks, BBVA and Banco Santander (BSCH), own two of Argentina's three biggest lenders, while Spain's Telefonica owns Argentina's biggest phone operator.

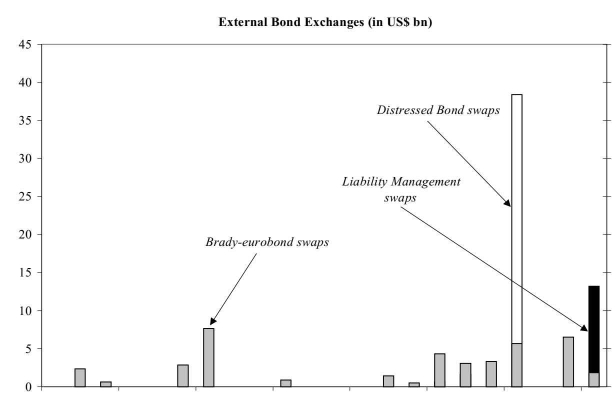
overall Spanish stock market index exhibits fairly high sensitivity to the Argentine EMBI+ spread as well (see chart).

Because of the direct economic links, the **comovement of equity prices of certain western European corporates and banks with emerging market sovereign spreads** (Argentine as well as Turkish) is, **in and of itself, neither surprising nor a cause for concern**. However, they can be a cause for **concern when such movements are exaggerated** because international investors use these more liquid markets as a **"proxy play"** to express negative views on the emerging markets, as they have been doing, thereby exacerbating price movements and causing what would be termed **contagion**.

In conclusion, there are **a number of differences** between the present situation and that prevailing, for example, at the time of the Russian crisis: the current financial environment confronting emerging markets, changes in the investor base, and investor positioning. These differences both **explain the limited broad-based contagion and volatility** in emerging markets so far, and **suggest the potential for future contagion is less than it was in the past**. It is important to note, **however**, that **past episodes of contagion were clearly associated with actual occurrences of discrete events** and, therefore, that the **potential** for contagion, were a credit event to occur in one of the major emerging markets, **remains an open question**. As many observers have noted, were a substantial proportion of the asset class' benchmark index to go into the distressed category, this could seriously **harm the dedicated investor base for emerging market debt**. Moreover, the **euro-denominated and Samurai markets**, which have proved important safety-valves for emerging market issuance, but remain predominantly retail investor bases, could be seriously damaged by a credit event in a major emerging market. The potentially severe impact on both the dollar and non-dollar segments of the emerging bond markets suggests **primary market closure** could be prolonged.

B. Recent Experiences with External Bond Exchanges

Following a **record volume of bond exchanges, or swaps,** by emerging market sovereigns on international capital markets last year, **the pace has once again accelerated** this year (see chart). The recent surge has reflected both the increased willingness by sovereigns to engage in traditional Brady-eurobond swaps and new forms of bond exchanges. We identify three distinct types of bond exchanges: Brady-eurobond swaps; liability profile management exchanges; and distressed bond exchanges.



Before discussing the motivations for, and recent experience with these operations, it is useful to note that any **bond exchange can be broken down** into two legs: the **buying back of the old bond**; and the **issuance of a new bond**. This raises two questions:

- **Why buy back the old bond?** Any debt buy back is subject to the Bulow-Rogoff critique that, under certain conditions, it does not make sense for a sovereign to buy back its own debt, as bondholders are likely to reap the benefits, while the sovereign loses[5]. We point out below features of emerging debt markets that render certain types of buybacks (swaps) always beneficial for the sovereign, and what the trade-offs are for other types of swaps.

- **Why issue a new bond simultaneously?** Alternatively, the sovereign could separate the two operations, buying back the old bond at a time when it is trading at a steep discount,[6] for example, and issue a new bond with a long maturity during advantageous conditions. Implementing such a strategy, however, requires the ability to deploy liquid reserves for the buy back leg, and having to forego the use of that liquidity until the new bond is issued. Frequently, however, emerging market sovereigns **lack the necessary liquidity** to be able to follow such a strategy. In addition, executing the two operations simultaneously allows the sovereign to lock-in an already existing investor base for its bonds.

Brady-Eurobond Swaps

These have been **the most popular** of the three types of exchanges. Mexico launched the first such swap in April 1996, retiring $2.3 bn in Bradys, and issuing in exchange $1.8 bn of its longest maturity eurobond at the time. The transaction received considerable attention from other Brady sovereigns as it generated debt service savings, with official estimates placing these at $224 mn in net present value (NPV) terms, and freed up $650 mn of collateral. A number of countries subsequently followed the lead of Mexico (see table). Last year, some $12 bn in Brady bonds were exchanged for $10.5 billion in eurobonds, and in the first quarter of this year another $6.5 bn in Brady bonds were swapped. To date, **Brady-eurobond swaps have retired nearly 27 percent of the total stock of the $150 bn in Brady bonds** outstanding in 1996.

Brady-eurobond Swaps: Top Users (in US$ bn)

	Amount of Bradys retired	Amount of new eurobonds issued	NPV Savings generated	Collateral released	New Money Raised
Brazil	15.6	16.9	0.6	2.2	3.4
Mexico	10.1	8.9	0.5	3.3	0.0
Argentina	8.5	5.3	0.5	2.0	0.5
Venezuela	4.4	4.0	0.4	1.3	0.5
Philippines	1.5	1.7	0.0	0.3	0.4
Panama	0.7	0.7	0.0	0.0	0.1
Uruguay	0.1	0.1	0.0	0.0	0.0
Total	41.0	37.7	2.0	9.1	4.9

Source: Buchanan, Nystedt and Srinivasan (2001).

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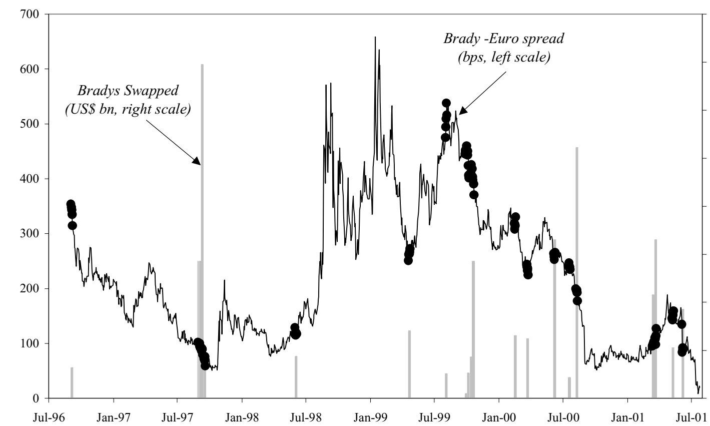
[5] See Bulow, J. and K. Rogoff, 1988, "The Buyback Boondoggle", Brookings Papers on Economic Activity, 2:1988.

[6] Assuming it can do so without raising the price too much.

A **distinguishing feature of emerging debt markets** has been the persistence of **multiple prices for the same sovereign risk**. For a variety of reasons, the Brady segment of the market has persistently traded at a discount to the Eurobond segment, with the average differential peaking at a hefty 650 bps (see chart and Box 3). Sovereign issuers with outstanding Bradys selling at a discount to their eurobonds can, therefore, capture this potential pricing inefficiency by carrying out a swap. Taking advantage of this pricing inefficiency represents a key reason why a **Brady-eurobond swap is attractive** (so long as the inefficiency remains), **since it should always generate debt service savings** if comparable maturity eurobonds are issued. In addition, Brady-Eurobond swaps have been attractive because they can be used to: (i) **release the collateral backing Brady bonds** with many having significant principal collateral and rolling interest guarantees (in total around 35%-40% of principal), thereby turning committed reserves into usable reserves; (ii) raise **new money**; and (iii) **extend duration**.

Brady-Eurobond Spread Differential and Volume of Bradys Swapped



What has been the experience with the **timing of Brady-eurobond swaps?**

- The chart above indicates that the **Brady-eurobond differential** has in fact been a good **indicator of turbulence in emerging debt markets**, with spikes at the time of the Asian crisis, the Russian crisis, and an all-time high following the Brazilian devaluation. These were times when the **highest debt service savings from Brady-eurobond swaps could have been realized**. However, as the chart indicates, **no swaps occurred at these times**. This reflects the fact that **capital markets were basically closed** for emerging market issuers during these periods, making the **second leg of the swap infeasible**.

Box 3. Explaining the Brady-eurobond differential

A variety of reasons for why stripped (of their collateral value) spreads of Brady bonds have persistently exceeded those of comparable eurobonds have been advanced. Among them, key are:

- The stigma associated with Bradys representing previously defaulted debt.
- A premium demanded for the additional complexity introduced in pricing out the collateral in Bradys;
- Uncertainty about their relative seniority to eurobonds in the event of default. Following the Ecuador default (August 1999, see chart) initial market belief that the sovereign would default selectively on its Brady bonds caused the Brady-Eurobond differential to widen across the emerging markets. Several sovereigns quickly took advantage of the widening differential to launched a series of swaps (note the spike in swap volumes in September-October 1999, and the subsequent collapse in the spread differential).

- As noted above (in Box 3), there was a spate of swaps in September-October 1999 following market **concerns about the junior treatment of Bradys** in the event of default stemming from interpretations about developments in Ecuador. Since credit concerns remained localized to Ecuador, however, capital markets remained open to the major Brady sovereigns, creating a favorable environment for the swaps.

- The persistence of the positive Brady-Eurobond differential indicates that, as long as the differential persists, an exchange should generate savings. So, **why has there not been a rush by sovereigns to carry out swaps until they extinguish their Brady bonds?** Note that there is an **option value to waiting**. That is to say, while it pays to do a swap today, it may pay even more to do it at some point in the future. History suggests the restoration of capital markets access following major turbulence are good times to conduct such swaps.

Note that the **current Brady-eurobond spread differential** (at 10-20 bps) is at its historical low, and the **gains from swaps**, therefore, **while positive, are limited**. The **stock of easily retirable Brady bonds is also being extinguished**, and we, therefore, expect the **pace of Brady-eurobond swaps to decline**. In line with this trend, recent Brady-eurobond exchanges have involved new innovations, such as par-to-par exchanges, where the original commercial banks involved in the Brady restructurings still holding some original Brady bonds have been enticed to participate in exchanges where they receive a new bond, which would not create a book value loss.

Liability Profile Management Exchanges

The second quarter saw the **first example of a plain-vanilla eurobond-to-eurobond exchange** as part of Argentina's "mega" bond swap (see Box 1). Following the perceived success of this operation, a number of **other sovereigns have indicated that they may pursue similar liability management operations**. The main purpose of these transactions is to actively manage the issuer's debt service profile thereby avoiding, for example, a near-term bunching of maturities which has the potential of triggering a liquidity crisis for an otherwise solvent issuer. Eurobond-to-eurobond swaps **can be conducted in two general types of situations**:

- **During "normal" times**, executing such a swap will mean weighing the costs of the transaction against the benefits of maturity extension. The sovereign's (credit) yield curve would typically be positively sloped, and a higher yield would, therefore, have to be paid for the longer maturity bonds. As the Bulow-Rogoff critique suggests, the sovereign pays a cost for the transaction. This up front cost in terms of a price concession, however, has to be measured against the benefits of "smoothing" a country's debt service profile, a consideration not part of their framework. The steeper the slope of the sovereign's yield curve, the more costly will be the operation. A swap may, however, still be a cheaper way for the sovereign to re-profile its debt service compared to issuing a stand alone new sovereign bond (which may require a new issue premium).

- **During a near-crisis period of heightened credit concerns**, eurobond-to-eurobond swaps may, as was the recent experience of Argentina, provide up front cash flow relief which could otherwise be unavailable as the capital markets most likely are closed to the sovereign borrower. Maturity extensions in these cases can be especially costly as bondholders may be hesitant to increase the duration of their exposures at such a time.

In general, **eurobond-to-eurobond swaps can be expected to entail costs** in terms of debt service, though in some instances, if, for example, they target investors holding illiquid eurobonds who value the opportunity to swap in to a more liquid benchmark eurobond issue, there could be savings. As some of the easy benefits associated with retiring Bradys comes to an end, it is likely that the **role of liability profile management bond exchanges will become more prominent**. It is likely that these operations **will be focused in the dollar-denominated eurobond segment** of the market. As we have noted in several past reports and above (see Box 2), the euro- and yen-denominated segments of the emerging bond market are dominated by retail investors, who largely "buy-and-hold" emerging market sovereign bonds. It may be difficult to inform and entice these retail investors to participate in these operations. In the dollar market, however, institutional investors dominate, enhancing liquidity and making debt exchanges driven by "mark-to-market sweeteners" feasible.

Distressed Bond Exchanges

In a past report we presented some of the salient features of recent distressed bond exchanges, which have provided a partly voluntary tool for sovereigns to normalize relations with their bondholders.[7] To-date, **these exchanges have involved nearly $40 bn of old bonds** for the following countries: Pakistan, Ukraine, Russia and Ecuador. Russia's bond exchange, completed during the third quarter of last year, was by far the largest and constitutes around 80% of the total of distressed sovereign bonds swapped. We offer the following observations:

- Contrary to widespread market expectations that bond restructurings (especially of dollar-denominated international bonds) would be very difficult and time consuming given the wide distribution of bondholders, the **recent resolutions were relatively smooth and fast**. They took about 2 years in the case of Russia, and about 1 year in the case of Ecuador. This stands in stark contrast to the loan restructuring experiences of the 1980s (the lost decade) and compares well with the US high yield sector (average 2.1 years).

[7] Emerging Market Financing in the Third Quarter of 2000: Developments and Prospects.

- In the absence of much of an empirical basis, market participants had ascribed ad hoc low recovery values, i.e., the value recovered in the event of default, of around 18-20%. For emerging bond markets, the successful resolutions in Russia and Ecuador suggested **recovery values in the event of default may be much higher**. Higher recovery values **should be reflected in lower spreads** for the asset class.

- A potential **consequence** of the relatively smooth and easy resolutions is that they **may have lowered the market's perception of the cost-of-default** for the sovereign, and this can be expected to be reflected in flows and/or spreads in emerging debt markets.

- Following the protracted syndicated loan restructurings after the 1980s debt crisis, many observers attributed the subsequent growth of the emerging bond market as encouraged by the perception they would be much harder to restructure. The experience of relatively easy bond restructurings, therefore, has the potential of sparking **another round of innovation** of **harder to restructure instruments** for lending to sovereigns.

C. Outlook and Risks

Increasing confirmation of the global slowdown and heightened concerns about the potential for credit events within the emerging markets since the last quarter have **increased the downside risks**, but also rendered the **outlook** for emerging market assets and financing **subject to more than the usual amount of uncertainty**. Our **baseline outlook** for overall financing to emerging markets is predicated on the current external environment in financial markets continuing to prevail and the absence of a major credit event in the emerging markets. We continue to see **moderate bond financing flows**, and prospects for only **very selective equity issuance**, while signs of a **slowing in syndicated loan flows** in the previous quarter appear to be confirmed.

On emerging **bond markets**:

- A broad-based return of the **crossover investor** to emerging markets is **unlikely** until the diminution or resolution of the headline credit risks.

- While inflows to emerging market fund managers have so far been remarkably resilient, **dedicated emerging market investors are** likely to continue to **maintain defensive positions**, adjusting their cash cushions to take broader views on the market. The **outlook for oil prices remains key** for the current overweight favorites (Russia and Mexico), with a sharper-than-expected global slowing that is reflected in oil prices likely to make current favorites also less attractive.

- With foreign investors in a defensive position, the **importance of the local investor** in emerging bond markets will continue **to increase**. Recent decisions in both Colombia and Mexico allowing local pension funds to invest in the sovereign's international bonds support this trend.

- The **2001 prefinancing cushion** of the major Latin sovereigns, raised during the first six months of the year, **begins to run out** at the end of the third quarter (see table). The desire to complete financing needs for this year and begin prefinancing for 2002 later this year, could create a glut of potential issuance, with poor conditions on international markets squeezing issuers.

Emerging Market Sovereigns' Bond Financing Needs (in US$ bn)

	2001			
Countries	Amort	Financing Needs (excl. prefunding) 1/	Issued YTD 2/	Covered
Turkey	2.6	2.5	0.7	28%
Argentina 3/	5.4	3.3	1.6	49%
Brazil	3.4	7.0	5.1	72%
Mexico	1.4	3.3	2.2	67%
Colombia 4/	0.6	2.3	2.9	128%
Poland	0.2	0.6	0.7	108%
Malaysia	0.2	1.0	1.0	103%
Philippines	0.7	1.0	0.3	33%
Venezuela	0.9	1.5	0.9	57%
Other 5/	1.1	0.5	0.8	150%
Total	16.4	23.0	16.2	70%

1/ Average of market estimates.
2/ July 5, 2001.
3/ Authorities' revised financing program, May 4, 2001.
4/ Strategy of prefinancing 2002.
5/ Includes Chile, Bulgaria, Panama and Russia.

- **Investment grade credits** outside South America, Mexico, and smaller "novelty" credits, are expected **to continue to enjoy fair market access**, with the euro- and yen-denominated segments continuing to be supportive. In addition, the Russian sovereign is expected to return to international capital markets towards the end of the year or during the first quarter of 2002.

- Issuers unconstrained by the need for prefinancing will focus on **liability management operations**. Peru is reportedly considering a Brady-Eurobond swap, while Colombia is considering a swap to lengthen maturities. Panama's decision to launch a buyback for its eurobond maturing in 2002 in return for a warrant represents a creative approach to managing the country's debt service profile.

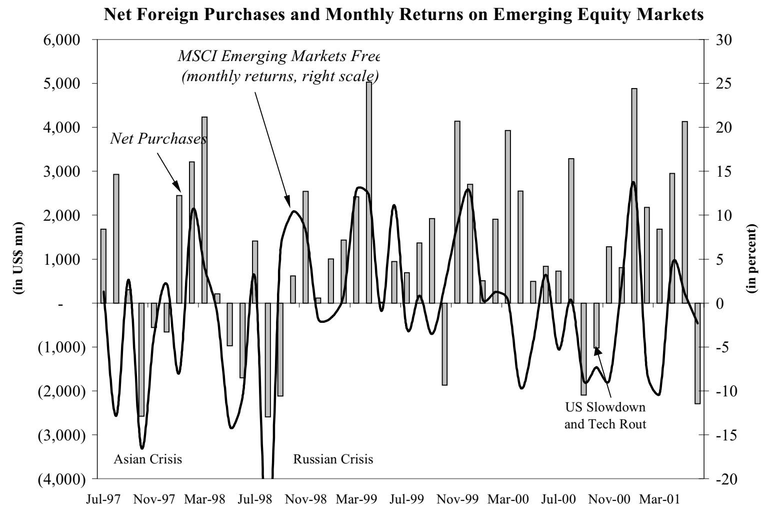
- As regards **corporate issuance**:

  - With the drought in new Asian equity issuance continuing, we expect **Asian corporate convertible bond** issuance to dominate as a funding vehicle for the region's technology and telecom sector.

  - In other regions, we see signs the **bifurcation in market access between the top tier corporate credits and others** will continue. Latin American, corporate bond issuance will probably be limited as those Chilean and Mexican corporates who are likely to have market access also enjoy access to a highly competitive supply of syndicated loans.

On emerging **equity markets**, the outlook for secondary markets remains closely tied to developments in the external environment, while on primary markets both demand and supply factors suggest that, except for specific pockets, the outlook remains weak:

- While extremely **attractive valuations** and positive **market technicals** (international investors' underweight positions) are both favorable for a rally in emerging equity markets, the available evidence indicates foreign investor equity flows to emerging equity markets and their **secondary market performance has continued to reflect considerably changing sentiment on the timing and severity of the global slowdown**. Foreign investor purchases on emerging equity markets were buoyant in April and May along with the wave of optimistic sentiment in the mature markets noted above, but reversed sharply in June as sentiment turned, resulting in the **largest monthly outflows** from emerging equity markets **since the Russian crisis** (see chart).



- **Cheap valuations** for investors in secondary markets have also meant, though, a commensurately **higher cost of raising equity capital** for emerging market firms, thereby reducing their demand to do so.

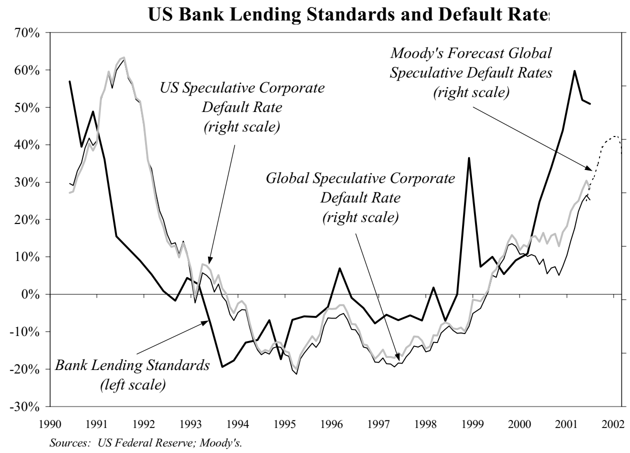
- Given the ongoing global economic slowdown and its knock-on impact on emerging markets, capacity utilization by emerging market companies remains well below its peak, and in some sectors excess capacity is still being worked off. The **need for raising fresh equity capital for investment spending remains limited**.

- To the extent that working capital is needed for operations and for restructuring, in the prevailing low interest rate environment, **domestic debt markets are an attractive alternative source of liquid funds**.

- Except for blue chip and strategic IPOs and SPOs, the TMT sector has been responsible for the overwhelming share of emerging markets' international equity placements since October 1997. While **TMT related companies** in emerging markets may have a need to come to market to fund their ongoing investment plans and roll over debt financing, their ability to do so is hindered by **skepticism globally towards the sector**.

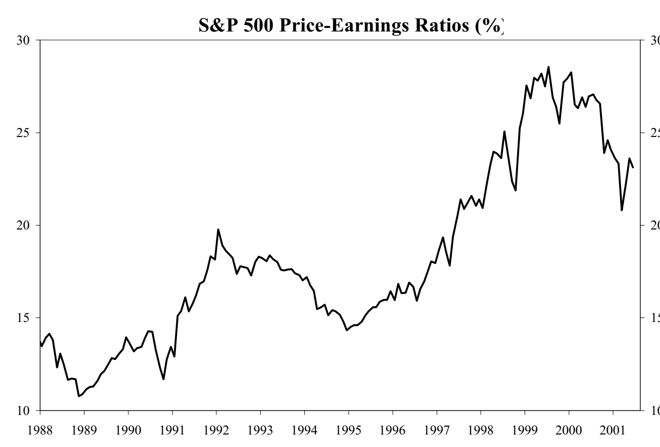
- Looking ahead, the only exceptions in terms of issuance will likely be pockets of demand due to special factors, such as a good restructuring or privatization story, or a strategic positioning story. This suggests **China will remain at the forefront** of whatever emerging market IPOs come to market.

On the **syndicated loan** market, we expect volumes to remain steady at current levels through the remainder of the year. This implies **volumes for the year will be down considerably** from 2000 levels, reflecting both the more difficult external environment and increased wariness about prospects for a credit event in emerging markets. As noted last quarter, and as has been the case since, US bank lending standards have continued to tighten, albeit at a slower pace (see chart). This tightening in an environment of perceptions of heightened credit risks and uncertainties about spillovers and contagion within the emerging markets will inevitably keep banks cautious also about lending to emerging markets, though abundant liquidity indicates selective access for particular countries will likely be maintained.



We are cognizant of a variety of **sources of event risk** to our baseline scenario that could disrupt flows to emerging markets on international capital markets. Of the items on most observers' lists, at this point we would emphasize: a sharper than expected slowing in the global economy; still substantial potential for downside corrections in mature equity markets where valuations remain high by historical standards; and the potential for spillover or contagion across emerging markets from credit concerns or events in particular markets.

- In spite of **US equity markets** being **off their all time highs** of last year (-11.1% for the Dow and -41.3% for the Nasdaq), they **remain "rich"** as measured by a broad set of standard valuation measures such as price-earnings ratios, earnings yield relative to bond yields, price to book and price to sales ratios. Price-earnings ratios, for example, remain well above their historical (1982-1995) average levels (see chart). Given the decline in forward earnings projections, as well as current corporate profitability, the risks of a further downward adjustment of equity valuations more in line with historical levels remain substantial.



- A notable feature of the US equity market bull run of the 1990s was the **large scale shift from fixed income into equities** (see Box 4). These inflows have trailed off sharply, coincident with price movements. There does not, however, as yet appear to have been any sustained selling, i.e., outflows. A **key question, and risk, for global markets is the extent to which the**

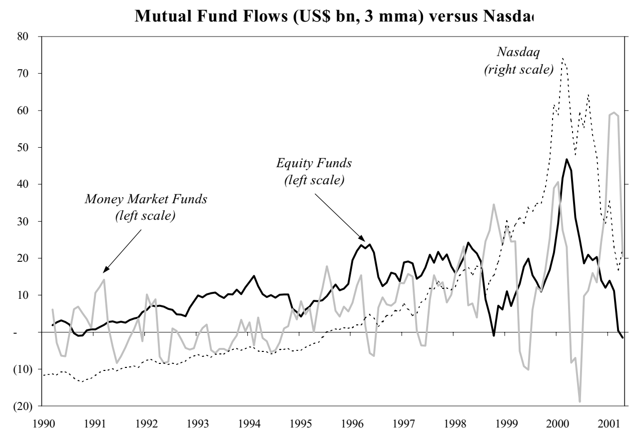
enormous inflows during 1995-2000 were structural and to what extent they were cyclical and, therefore, whether accumulated losses at some point turns the tide of these flows and result in substantial outflows.

- Finally, as already discussed above, though the available evidence indicates that so far the **spillovers and contagion** from credit concerns in particular emerging markets have been limited to one or two regional markets and not broad-based across the emerging markets, the potential for broader-based contagion remains.

Box 4. Equity Flows: Cyclical or Structural?

Coincident with the bull market in equities, the **past decade witnessed large inflows into equity markets** in what appeared to be a shift in investor preferences regarding the risk-return tradeoff. The phenomenon has been global, but the US provides one of the most striking examples. The **recent pull back in equity markets** has been associated with the **first slowdown and modest reversal** (outflows) in the decade long trend. A key question is whether the flows over the past decade represented a structural shift in preferences that will be resilient to the recent downturn, or whether they represented a long cycle that has peaked.

The increased preference for equities in the US can be observed at several levels. At the retail level, inflows into equity mutual fund flows grew at an annual rate of around 33% until their peak in March 2000 at $47 bn (3 month moving average—see chart). Equity mutual funds assets grew from 29% of total mutual fund assets in 1991, to 57% of total mutual fund assets by end-2000. At the institutional level, private pension funds raised their direct equity investments, from 42% of total investments in 1991, to 44% in 2000. Pension funds and mutual funds (excluding holdings of mutual funds by pension funds) account for around 21% of US equity market investment.



Source: Investment Company Institute.

Several structural factors supported the move into equity investments. The growth of employer-sponsored defined contributions plans and shifts away from IRAs and defined benefits plans since 1981 supported institutional flows into equity markets as individuals sought to maximize the potential upside of their investments. Losses in 401(k) plans in the early 1990s related to Guaranteed Investment Contracts also drove many investors away from debt into equities. The substantial reduction in the cost of equity transactions and innovations in financial products also made it easier and cheaper for small investors to diversify away from fixed income into equities. Empirical evidence suggests that many **temporary or cyclical factors also played an important role** in determining net retail inflows into mutual funds. For example, returns on equities, and the cross-sectional volatility of equity funds, have been found to be important determinants of flows into equity mutual funds.

Some observers calculate that despite the declines in US equity markets since last year, because of the substantial prior run up in prices, retail **investors have not yet suffered net losses on their initial investments**. It is only **if and when prices decline further** and they do suffer such losses, will the **resilience be tested**.