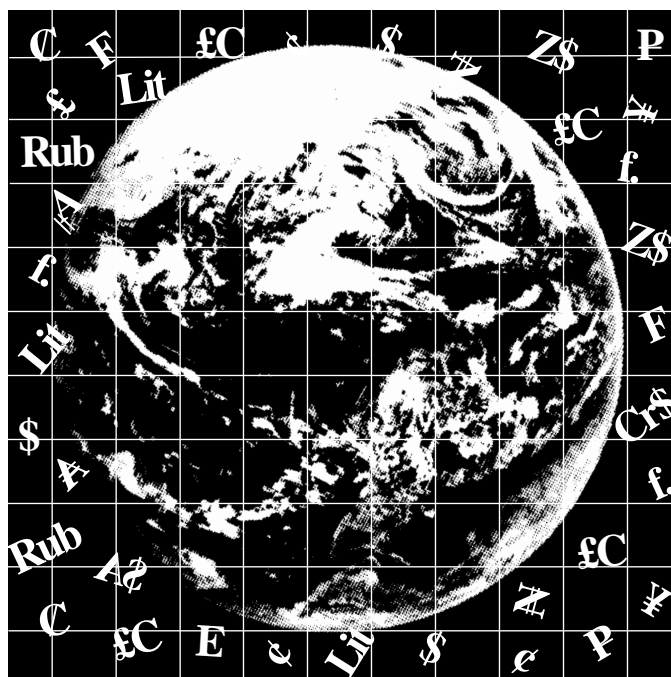


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# Emerging Market Financing

## Quarterly Report on Developments and Prospects

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**November 14, 2001**

**By a Staff Team led by Bankim Chadha**



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INTERNATIONAL MONETARY FUND

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 International Capital Markets Department. The project is directed by Bankim Chadha, Chief, Global Markets Division. 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 Peter Tran, Research Assistant. Sheila Kinsella provided expert drafting assistance.

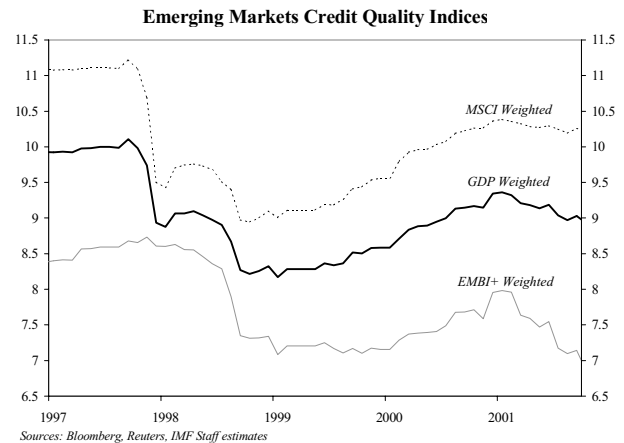
The report reflects developments and data available through October 26, 2001, unless specifically noted otherwise. The report has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors (following their discussion of the *Emerging Market Financing* report on November 7, 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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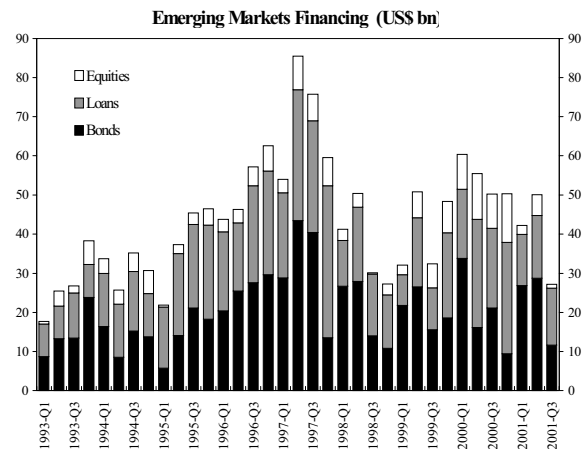
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## I. EXECUTIVE SUMMARY

Events in September increased uncertainty and investor risk aversion at a time when concerns were already high about global slowing, deteriorating emerging market fundamentals, and the potential for credit events in particular emerging markets. In effect, with the benefit of hindsight, we now know that the US economy was losing steam at a faster pace than most observers had anticipated. Against this background, the events prompted an across-the-board sell off of emerging market assets, and a drought in new issuance in the (largest) dollar segment of the primary bond market ensued. While the sell off in emerging market assets was broad-based and the average cross correlation of individual country returns rose, this represented a generalized flight to quality up the credit spectrum in response to heightened investor risk aversion. It was not panic driven, and there were in fact clear indications of investor discrimination between credits and countries, particularly in terms of the severity of the sell-off.



In the event, the gross volume of fundraising by emerging markets on international capital markets fell sharply, with quarterly issuance at levels last seen at the time of the Russia-LTCM crisis. The fall off reflected the drought in emerging bond markets, with bond issuance more than halving from the previous quarter's levels, while syndicated loan commitments were essentially flat, falling slightly from the levels of the previous quarter. Equity placements continued to remain at depressed and negligible levels. With net private market financing for emerging markets set for the worst year since the early 1990s, we examine changes in the composition of these flows and the factors underlying this fall off.



The third quarter saw a deterioration in the near term prospects for emerging market fundraising on international capital markets. Though some markets have rebounded recently, to above their pre-September 11 levels, and global risk aversion measures have fallen back, a durable improvement is predicated on a turnaround in earnings and economic activity in the mature markets next year, and further declines in global risk aversion. The downside risk of a further postponement of recovery in the US remains real, with attendant risks of a

continued flight to quality for emerging markets. Key questions that will shape the outlook for emerging markets are whether global risk aversion subsides, the extent of access for emerging market credits to international bond markets, and the extent of the squeeze generated by refinancing pressures until they do:

- A comparison of the current drought in emerging bond markets to historical episodes suggests parallels with the longest historical episode of 13 weeks at the time of the Russia-LTCM crisis. Then, as now, a surge in global risk aversion was superimposed on an environment where there were already concerns about potential credit events emanating from within the emerging markets.
- Refinancing pressures remain at the forefront of debtor and creditor concerns. Having raised close to the lowest quarterly volume of gross financing since 1995, emerging market debtors as a whole face an increase in amortization payments in the fourth quarter, implying a continued squeeze until capital market access normalizes.
- The consensus outlook is that large segments of the emerging bond markets are expected to remain effectively closed for the remainder of the year, with only small highly opportunistic new issuance favoring “exotic” credits that provide diversification away from a US slowdown, lower oil prices, or those markets where credit event concerns remain high. In addition, certain credits under special circumstances will have access to the markets. If emerging market credit event concerns dissipate, the wider bond market is set to reopen at the beginning of next year, with a surge in issuance given the ample liquidity in the global markets. In the context of the present external environment, the syndicated loan market is expected to broadly continue to maintain its net exposure to emerging markets, i.e., it is unlikely to provide net new financing flows. The prospects for new international equity placements continued to remain very limited.

				2000				2001			2001				
	1998	1999	2000	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.	3rd qtr.	July	Aug	Sep	Oct	YTD 1/
<i>(in billions of US dollars)</i>															
<b>ISSUANCE</b>	<b>149.0</b>	<b>163.6</b>	<b>216.4</b>	<b>60.4</b>	<b>55.4</b>	<b>50.3</b>	<b>50.3</b>	<b>42.2</b>	<b>50.1</b>	<b>27.2</b>	<b>12.8</b>	<b>8.7</b>	<b>5.6</b>	<b>1.5</b>	<b>121.0</b>
Bonds	79.5	82.4	80.5	33.8	16.1	21.1	9.4	26.8	28.7	11.6	5.3	4.8	1.4	0.9	68.0
Equities	9.4	23.2	41.8	8.9	11.6	8.8	12.4	2.3	5.3	1.0	1.0	0.0	0.0	0.1	8.7
Loans	60.0	58.1	94.2	17.6	27.7	20.4	28.5	13.1	16.1	14.6	6.5	3.9	4.2	0.6	44.3
<b>ISSUANCE BY REGION</b>	<b>149.0</b>	<b>163.6</b>	<b>216.4</b>	<b>60.4</b>	<b>55.4</b>	<b>50.3</b>	<b>50.3</b>	<b>42.2</b>	<b>50.1</b>	<b>27.2</b>	<b>12.8</b>	<b>8.7</b>	<b>5.6</b>	<b>1.5</b>	<b>121.0</b>
Asia	34.2	56.0	85.9	19.5	26.1	18.3	22.0	19.6	22.6	7.3	3.4	2.3	1.6	0.5	50.0
Western Hemisphere	65.7	61.4	69.1	23.7	13.9	18.8	12.7	15.2	15.1	9.5	4.3	4.1	1.0	1.0	40.8
Europe, Middle East, Africa	49.0	46.3	61.4	17.1	15.4	13.2	15.6	7.4	12.3	10.4	5.2	2.2	3.0	0.1	30.2
<b>SECONDARY MARKETS</b>															
<b>Bonds:</b>															
EMBI+ (spread in bps) 2/	1,037	703	756	674	712	677	756	784	766	1,005	940	885	1,005	1,013	1,013
Merrill Lynch High Yield (spread in bps)	555	453	871	584	615	664	871	757	736	915	746	732	915	856	856
Salomon Broad Inv Grade (spread in bps)	58	55	89	81	87	83	95	89	80	77	75	75	77	69	69
US 10 yr. Treasury Yield (yield in %)	4.65	6.45	5.12	6.03	6.03	5.80	5.12	4.93	4.93	4.60	5.07	4.85	4.60	4.53	4.53
<b>Equity:</b>															
DOW	16.1	25.2	-6.2	-5.0	-4.3	1.9	1.3	-8.4	6.3	-17.5	0.2	-5.4	-11.1	5.7	-13.3
NASDAQ	39.6	85.6	-39.3	12.4	-13.3	-7.4	-32.7	-25.5	17.4	-30.5	-6.2	-10.9	-17.0	13.2	-31.3
MSCI Emerging Market Free	-27.5	63.7	-31.8	2.0	-10.8	-13.4	-13.5	-6.2	3.1	-23.4	-6.6	-1.2	-15.7	8.0	-18.7
Asia	-12.4	67.6	-42.5	4.0	-14.0	-22.3	-17.3	-0.1	-1.6	-22.1	-5.7	-0.1	-15.2	9.1	-14.4
Latin America	-38.0	55.5	-18.4	3.2	-8.1	-6.0	-8.5	-3.5	7.1	-24.7	-5.9	-3.6	-16.2	5.8	-16.9
Europe/Middle East	-27.4	76.7	-23.4	3.0	-9.7	-3.9	-14.3	-22.0	4.5	-26.1	-6.5	-4.4	-17.0	13.9	-31.2

Sources: Bloomberg; and Capital Data Ltd.

1/ Issuance data are as of October 15, 2001 close-of-business London and secondary markets data are as of October 26, 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 spreads.

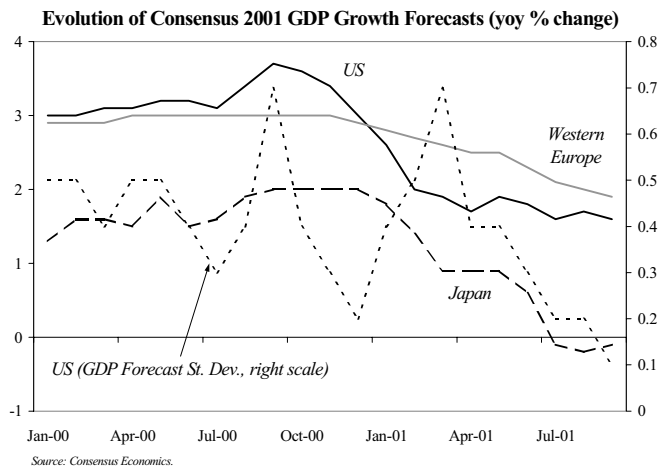
## II. RECENT DEVELOPMENTS

As emphasized in previous quarterly *Emerging Markets Financing* reports, the **external environment once again continued to play a critical role** in determining developments in, and financing for, emerging markets in the third quarter of 2001. In addition to the increasing indications of economic slowdown emphasized in previous reports, the chain of events triggered by the **terrorist attacks of September 11** (the Fall events) introduced an additional source of uncertainty and eroded investor and consumer confidence, impacting global markets. The resultant **rise in global risk aversion and the flight to quality remain key themes** in emerging market financing. Consequently, this report discusses developments in global markets in somewhat greater detail than previous reports before discussing developments in emerging markets.

### A. Global Markets: Before and Since September 11

The increased uncertainty in financial markets and the bleaker near-term economic outlook generated by the changed environment since September 11 translated into **heightened risk aversion** by investors (see Box 1), generating a further **flight to quality** seen in shifts away from equity and higher risk credit markets to the extent possible. The **damage to trading infrastructure** and associated dislocations in particular markets generated a temporary excess demand for liquidity, increased volatility, and created spillovers across asset markets. **Policy responses** (Box 2) helped stabilize financial markets and meet the demand for liquidity, and **prevented the market disruptions from becoming a systemic concern**. Since then, forceful policy responses, especially from the US authorities, on both the monetary and fiscal fronts, have begun to foster market expectations of an eventual US recovery next year, even though risks of its postponement remain high.

While market anticipation of a slowdown had already been underway in the quarter, **the Fall events were seen as increasing the likelihood of a US recession**, with attention shifting to questions about its depth and duration (see chart). During the quarter, the slowdown in Japan intensified, with business and consumer confidence falling, and Europe was increasingly seen following the US into a downturn.



### Box 1. Global Risk Aversion

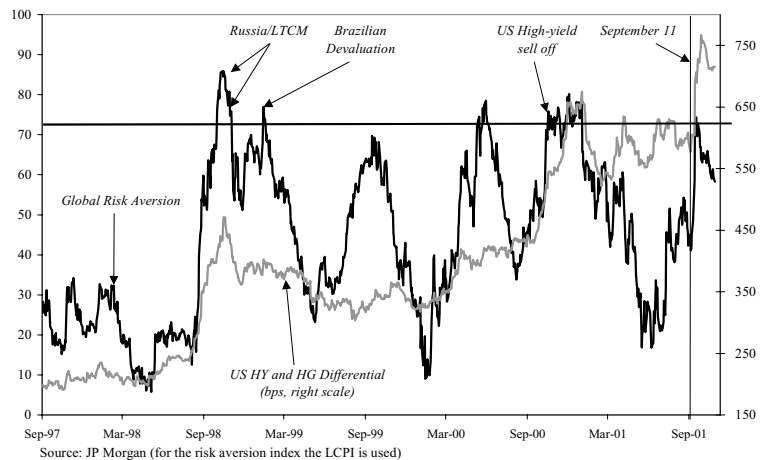
Investor risk aversion is reflected in the premium investors charge to take on a certain amount of risk. This premium varies with changes in market conditions, including changes in liquidity, which represent the risk of being unable to trade at prevailing prices. Risk aversion **measures**, however, remain at best **ambiguous** because an investor with unchanged preferences could charge a higher premium because the underlying risk (or uncertainty) has increased, or because the investor's risk tolerance has changed while underlying risk remained unchanged.

One popular market index that attempts to measure risk aversion is JP Morgan's Liquidity and Credit Premia Index (LCPI). This index attempts to measure risk aversion more broadly and, therefore, captures not only risk appetite but also the liquidity premia demanded in US financial markets (which is itself a measure of risk appetite). The LCPI suggests that periods of **surges in risk aversion have had an important impact on the risk premium charged on high yielding bonds relative to safer investment grade bonds** (see chart). Such surges have been common. Global risk aversion **peaked** during September 1998 in the aftermath of the **LTCM crisis**, but there have been several instances of surges since then largely related to the US economic outlook. More recently, **since early June, risk aversion had been rising** as uncertainty about the global growth outlook increased.

#### A definition of JP Morgan's LCPI

The LCPI has two broad sub-components measuring liquidity and credit premia respectively. The indicators of a liquidity premia consist of the spread between on- and off-the-run US treasuries and US swap spreads. The credit premia indicators consist of US high-yield spreads, an emerging market bond index (the EMBI), JP Morgan's Global Risk Aversion Index, and implied volatilities of the major exchange rates. An overall index is constructed by equally weighting the different sub-components of the indicators.

Global Risk Aversion, US High Yield and High Grade Spread Differential 1



Following **the terrorist attacks, risk aversion rose sharply**, but did

not reach the levels seen last year at the time of concerns about further Fed tightening (May, 2000) and the US high-yield sell off (mid-October, 2000). Reflecting a broad based flight to quality, the differential between high yield and high grade US bonds widened to record levels, even though risk aversion did not. This may partly reflect telecom sector-specific troubles that have kept high-yield spreads high even when risk aversion was low.

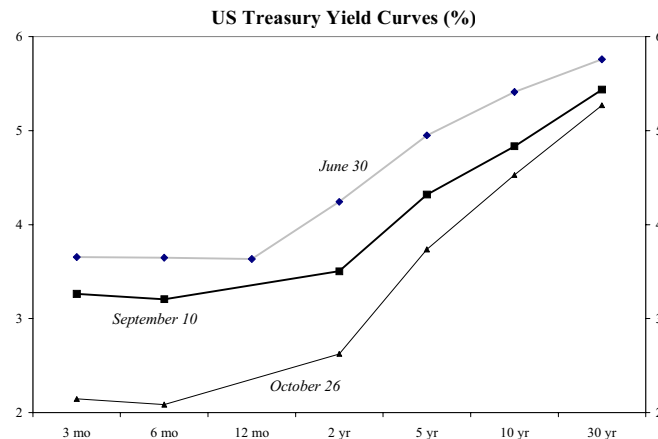
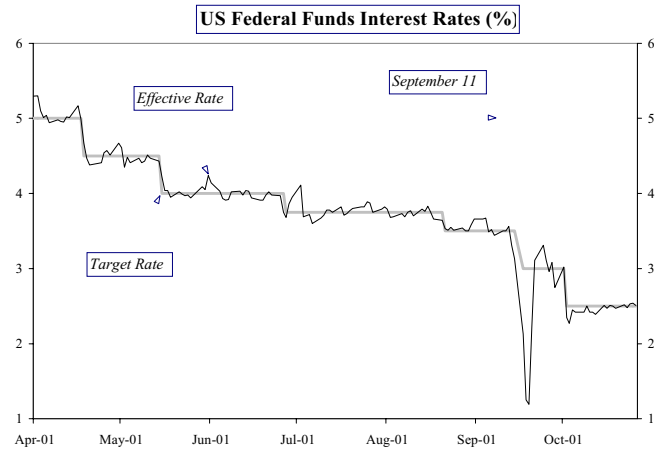
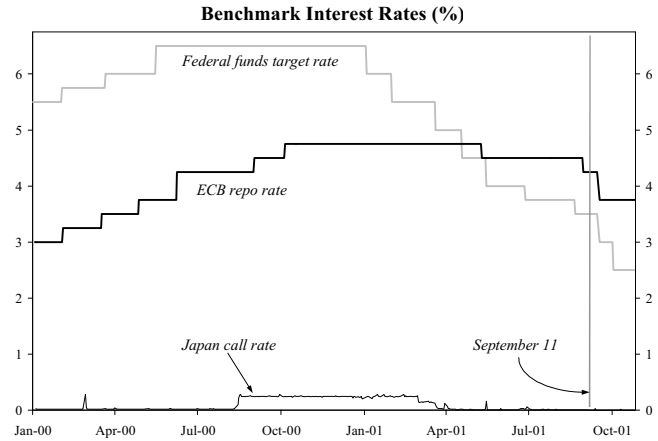
Since late September, **the global risk aversion measure has slowly receded**, reflecting partly a fall in the implied volatility of the major currencies, and partly a recovery in constituent credit spreads, but remains **well above pre-September 11 levels and substantially above early June levels**.

### Box 2. Policy Measures in Support of Markets

The **US Federal Reserve** issued a **statement** within hours of the attacks confirming its readiness to provide liquidity. To facilitate orderly market functioning and manage any shortages of liquidity, the Fed also took **several other measures**: depository institutions used the discount window for record amounts on September 11 and 12; the volume of overnight repos by the Fed rose sharply between Sept 12 and Sept 19; there was a surge in liquidity from the Federal Reserve's "float" due to interruptions in the check clearing process; policy interest rates were reduced through two consecutive 50 bps cuts over the next 3 weeks; an \$80 bn swap arrangement with the ECB and the Bank of England, and an increase from \$2 bn to \$10 bn of the swap arrangement with the Bank of Canada were undertaken; and securities lending rules were eased.

The temporary **expansion in liquidity** was most evident in the deviation of the federal funds effective rate from the federal funds target rate (see chart). Excess reserves of banks for the maintenance period through Sept 19 reached an unprecedented \$39 bn. The US Treasury yield curve reacted to the liquidity injections by falling sharply at the short end. Since late September, the market liquidity situation has normalized.

The **Securities and Exchange Commission** initiated a series of actions, primarily relaxing existing rules, to support market activity and facilitate a return to normalcy by removing some restrictions on share repurchases as well as restrictions on borrowing from, and lending to, related parties by mutual funds. A total of \$47 bn of corporate stock buy-backs were announced during Sept 17-21 but slowed to only \$4.7 bn during Sept 24-28, and to \$1 bn during the week of Oct 1-5. **Bond trading** was suspended September 12, but resumed the following day. Settlements moved to T+3 that week for Treasuries and agencies from T+1. Settlement was extended to T+5 for the week beginning September 17 as equity trading resumed, but returned to normal subsequently. Early market closing characterized several trading sessions during the crisis period.





## Equity Markets

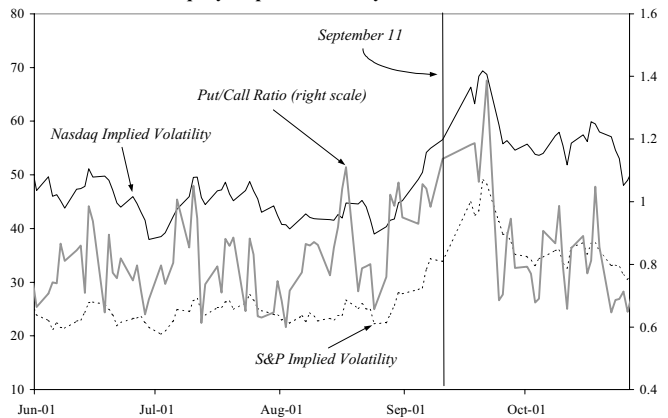
In response to the economic slowdown, mature equity markets had continued to decline during the quarter with cyclical sectors significantly underperforming defensive sectors (perceived to be acyclical and sometimes referred to as “stable growth” sectors such as food, pharmaceuticals, and drugs). Options markets also clearly reflected the market’s bearishness (see chart), well before the Fall events. Immediately following the terrorist attacks, with US stock markets closed for the week, **investors then sought to increase their cash allocations** and establish hedges against the expected fall in US markets when they reopened by closing positions elsewhere. This added to the selling pressures in European and Japanese bourses, which posted losses of 6-12%.

**Total Return Performance of Mature Equity Markets (in %)**

	Market cap (Sep. 10)	Jul. 1 - Sep. 10	Sep. 10 - Sep. 21	Sep. 21 - Oct 31
<b>MSCI US \$ Index</b>	100%	-10.7	-11.6	9.3
of which due to				
Cyclical sectors	44%	-8.2	-7.1	6.1
Defensive sectors	43%	-1.0	-2.9	2.0
Banks and Financials	13%	-1.5	-1.6	1.3
<b>MSCI EU \$ Index</b>	100%	-10.0	-13.9	15.9
of which due to				
Cyclical sectors	38%	-4.3	-6.6	7.1
Defensive sectors	43%	-4.0	-3.3	5.2
Banks and Financials	19%	-1.6	-3.9	3.6
<b>MSCI Japan \$ Index</b>	100%	-14.5	-4.1	-0.7
of which due to				
Cyclical sectors	61%	-11.5	-5.0	2.2
Defensive sectors	23%	-1.9	1.1	-0.4
Banks and Financials	16%	-1.0	-0.3	-2.5

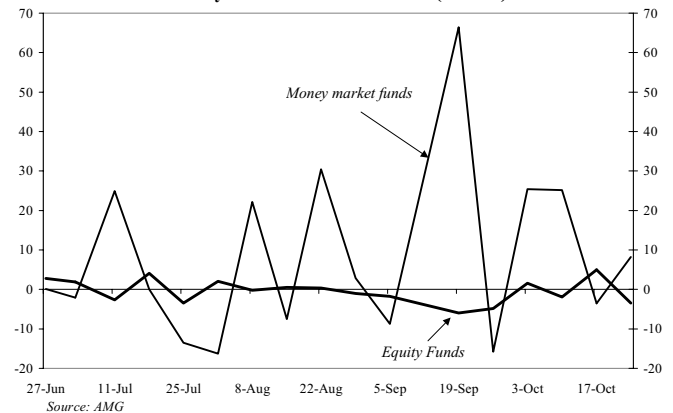
When US stock markets reopened on Sept 17, the flight to the safe haven of money markets (see chart) soon resulted in a sharp sell-off, with **cyclical stocks again leading the decline**. Net cash inflows into money market mutual funds reached a record \$66 bn in the 6 days of market activity between September 6–19, while equity funds reported \$5.9 bn in outflows over the period. In contrast to other markets, equities evidenced much higher than average daily turnover.

**US Equity Implied Volatility and Put/Call Ratio**



Stocks began to **rebound on Sept 24**, as risk aversion began gradually to recede and in response to the interest rate cuts, and expectations of a sizable fiscal stimulus in the US. The rebound was somewhat more pronounced for cyclicals, which had suffered sharper sell-offs previously. Major market indexes, especially in Western Europe, have recovered most if not all of their losses since September 11 with Japan being the

**Weekly US Mutual Fund Flows (in \$ bn)**

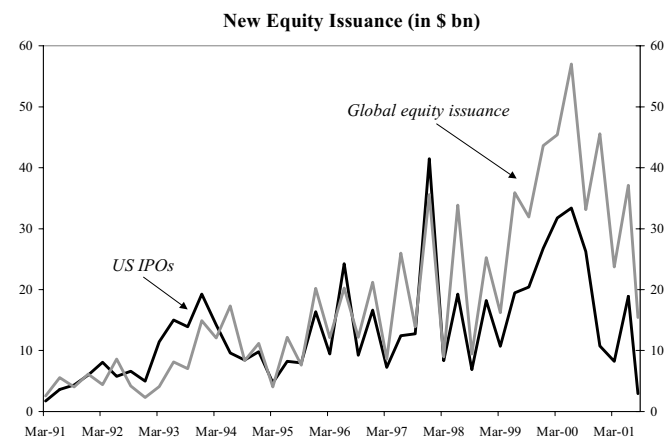
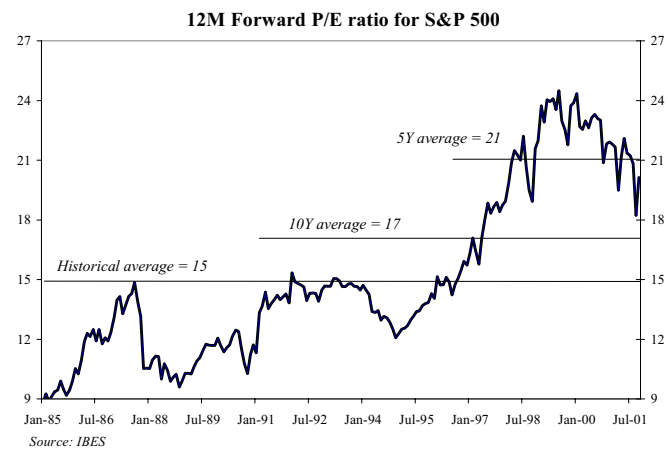
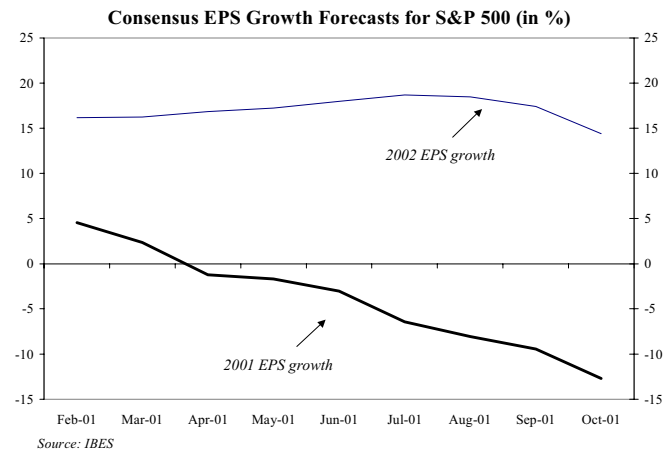


notable exception. “**Program**” trading by some fund managers contributed to the ensuing rally. The cumulative 100 bps cut in the federal funds rate in two weeks, the accompanying rally in bonds and declines in equity markets had increased the proportion of bonds to stocks in these fund managers’ portfolios by as much as 10 percentage points, triggering automatic buying of stocks to reestablish desired asset allocations. Unlike the US high yield corporate bond market which has still traded at extremely wide spreads against high-grade corporates, the equity market rebound reflects expectations of a recovery in the US economy, as also evidenced in the steepening yield curve, although the basic earnings outlook has been revised downward.

Consensus **earnings forecasts**, which were already reflecting deteriorating corporate earnings, **do not yet** include many analysts’ revisions to their forecasts to adjust for the Fall events. The consensus forecast of the S&P 500 average EPS growth rate for 2001 was revised down to  $-12.7\%$  in October from  $-9.5\%$  in September. Consensus 2002 earnings forecasts have also been revised downward from  $+17.4\%$  in September to  $+14.4\%$  in October.

In spite of the fall in share prices during the quarter, **valuations** in US equity markets by several measures continue to remain well above their longer term historical average. While the 12-month forward price-earnings ratio for the S&P 500, for example, is now some 25% below its peak (see chart), it still remains well above historical averages.

In September, **primary equity markets in the US closed for the first time in 25 years** as risk aversion choked off demand for new equities. This followed \$621 mn in issuance in August, and compares with \$10 bn in September of 2000. On the back of strengthening secondary markets, markets reopened in October but many IPOs/additional issues were either delayed or cancelled. The cost of equity



capital, however, relative to debt markets in the current low interest rate environment continues to remain high, and prospects for primary markets remain weak.

### Bond Markets

Heightened risk aversion and the resulting **flight to quality** due to the Fall events were **particularly evident in US credit markets**, with a **sharp differentiation** by investors **between high grade and high yield bonds**. While spreads for both market sectors had been roughly unchanged during the quarter prior to September 11,

the subsequent sell-off triggered a 14 bps widening in high grade spreads, but a 174 bps widening in high yield spreads, leading to the worst monthly performance of high yield bonds in over a decade. Selling was, however,

**US Corporates' Total Return Performance According to Ratings**

	Sep. 10 - Sep. 26	Sep. 27 - Oct. 26	Year-to-date 1/	Third Quarter
AAA	0.9%	1.3%	9.4%	4.8%
AA	0.8%	1.4%	10.4%	4.6%
A	0.5%	1.3%	10.9%	4.4%
BBB	-0.1%	1.4%	10.3%	3.7%
BB	-4.9%	1.5%	6.4%	-1.9%
B	-6.2%	2.1%	-3.3%	-4.9%
C	-9.7%	1.1%	-4.0%	-8.3%

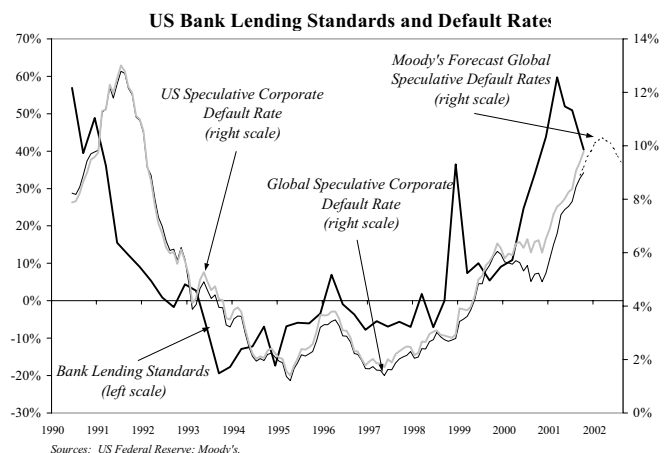
1/ October 26.

**not indiscriminate** across sectors, with defense and consumer noncyclicals benefiting, while airlines, gaming and telecoms sold off. In October, both high grade and high yield sectors gained. High-yield mutual funds suffered three consecutive weeks of outflows totaling \$1.5 bn following September 11 before inflows resumed.

In **primary markets**, the attacks led to a closure of bond markets in the week following the attacks, but high quality corporates regained market access the following week. During October, the normalization of the high grade issuance market continued, and issuance has now returned to recent monthly average levels. Having remained closed, as risk aversion started to dissipate and high yield mutual funds registered their first inflows since early September, the high yield market reopened for issuance during the third week of October with around 3 new issues at a total value of \$900 mn.

### Syndicated Lending

The **third quarter** contributed to 2001 being the **choppiest for syndicated lending in over a decade**, reflecting the impact of increasing perceptions of a global slowdown and the sharp decline in M&A activity. As monetary conditions in the mature markets eased, refinancings have constituted the mainstay of syndicated lending. As the generalized flight to quality intensified, however, borrowers have had to rely heavily on their relationship banks to secure



Sources: US Federal Reserve; Moody's.

financing, a fact particularly evident in the telecom sector.

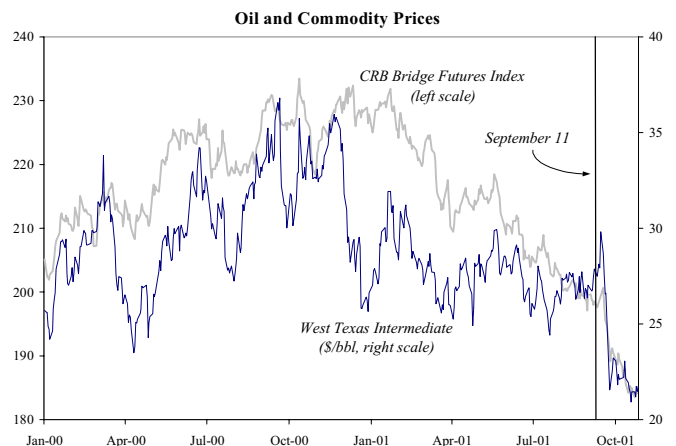
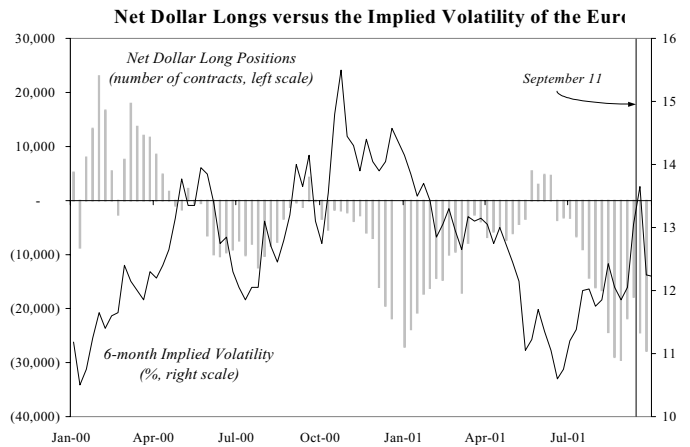
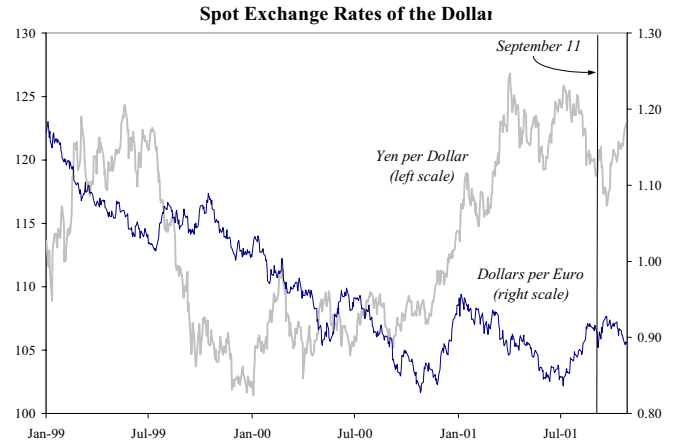
In the context of the flight to quality, US bank lending standards continued to tighten. The Fall events brought an **abrupt halt to airline- and insurance-related lending** but US and European banks are expected to be able to manage their airline, insurance and hotel-related exposures despite losses associated with the Fall events. Preliminary assessments by the ratings agencies suggest the losses incurred by the banks are unlikely to pose a risk to banks' current credit ratings.

### Foreign Exchange Markets

Following six quarters of almost unbroken dollar strength, the dollar weakened 5.8% against the euro in the quarter through September 11, and 3.0% against the yen and the market appeared to establish **substantial short positions against the dollar** (see chart). The dollar initially continued to weaken on the poorer growth prospects for the US and the search for alternative safe haven currencies in the immediate aftermath of the terror attacks. This trend was, however, reversed by late September, as the US was again seen leading the eventual global recovery, particularly in comparison to Europe and Japan.

### Oil

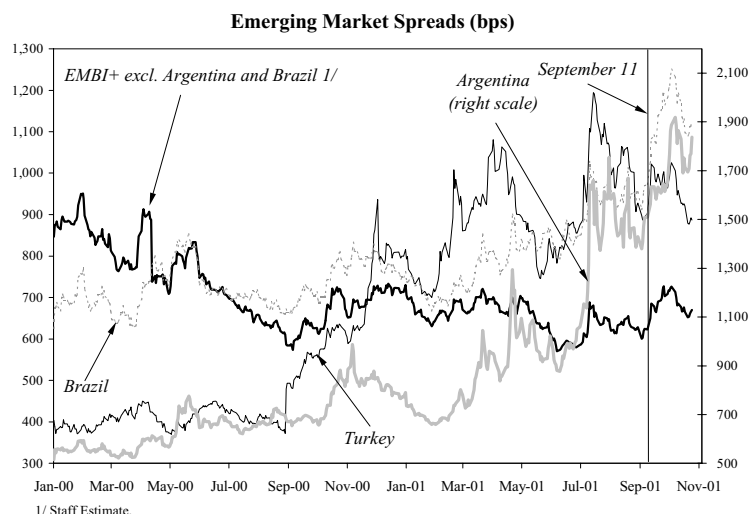
The third quarter saw sharply declining oil and commodity prices in June and July, coinciding with the largest short hedge fund positions on oil on the NYMEX exchange in nearly four years. These positions were testing the lower limit of the OPEC band. Prices recovered somewhat from mid-July as OPEC began discussing production cuts, worries surfaced about Iraq's ability to destabilize markets, and the substantial unwinding of outstanding speculative short positions in early August. **Crude oil prices spiked upward briefly after September 11** to reach (by September 14) \$29.07/bbl, from \$27.30/bbl at the beginning of the week, even though OPEC officials affirmed



their commitment to maintaining market stability in the face of geopolitical uncertainty. Oil prices, however, **fell dramatically between September 14 and 24** (by 29%, including a one-day drop of 15%) as markets reacted with scepticism to the OPEC Vienna meetings, seeing the cartel as constrained by the US from cutting production. Hedge funds were reportedly again at the forefront of challenging OPEC's ability to defend the lower end of its price band. Oil prices since then have continued to hover around \$21-22.

## B. Emerging Bond Markets

During July and August, the **market's main focus was on the Argentine crisis and potential contagion**, and the impact of the slowing in the US on Mexico and Asian emerging markets. Signs of broad-based contagion from Argentina were, however, limited. While the EMBI+ widened 134 bps through September 11, spreads excluding Argentina and Brazil widened a relatively modest 42 bps. After September 11, however, a **generalized flight to quality** ensued leading to a sell off across emerging debt markets.



The sell-off due to the Fall events was nonetheless not as sharp as the sell off in the US high yield sector. **Market reaction was tempered** by the already **defensive positioning** of investors in some key credits, most notably Argentina, **substantial cash holdings**, support from the **local investor base**, and the **perception of likely increased support from the official community** for vulnerable countries. There were **clear signs of investor discrimination** (see table), with the worst performing credits either close to the area of a US military

Total Return Performance of Select Emerging Debt Markets

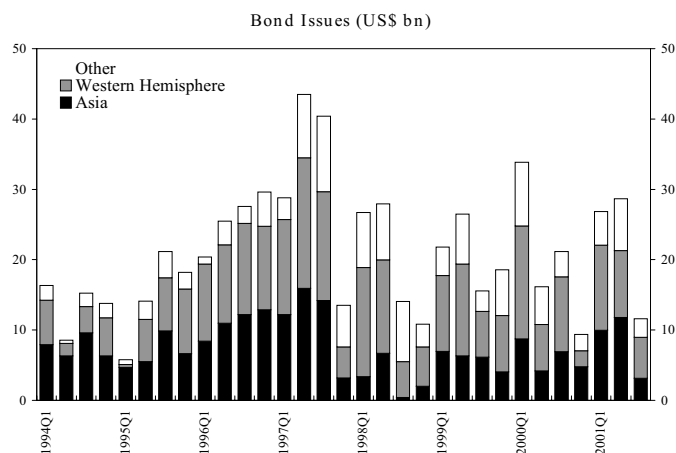
	Year-to-date 1/	Third Quarter	July 1 - Sep. 10	Sep. 10 - Sep. 26	Sep. 27 - Oct. 26	Reaction in Standard Deviations 2/
<b>Emerging Markets</b>						
Argentina	-28.8%	-17.2%	-15.4%	-2.0%	-6.4%	-0.6
Pakistan		-0.7%	9.4%	-9.2%	5.5%	
Brazil	-4.7%	-7.7%	-1.5%	-6.2%	4.7%	-3.1
Egypt				-7.7%	5.7%	
EMBI Plus	-2.8%	-5.2%	-2.0%	-3.2%	2.5%	-1.9
Russia	36.7%	1.7%	5.7%	-3.7%	6.1%	-1.5
Philippines	14.9%	-2.4%	0.9%	-3.3%	5.0%	-2.0
Venezuela	9.7%	-0.6%	1.0%	-1.6%	1.2%	-2.0
Lebanon	4.2%	-5.8%	0.1%	-6.0%	3.2%	-8.7
Turkey	12.0%	2.0%	3.0%	-1.0%	7.4%	-0.5
Mexico	11.6%	-0.1%	2.6%	-2.6%	5.6%	-3.6
Colombia	25.6%	3.6%	3.9%	-0.3%	2.9%	-0.4
Chile	11.3%	3.8%	3.0%	0.8%	2.2%	-0.1
Poland	9.6%	2.5%	1.9%	0.5%	1.0%	-0.1
South Africa	19.8%	3.8%	2.9%	0.9%	0.9%	-0.1
South Korea	14.0%	4.5%	3.6%	0.9%	2.0%	0.7
China	14.2%	5.6%	3.4%	2.1%	2.0%	1.3
Thailand	12.5%	7.7%	2.8%	4.7%	0.7%	3.0

1/ October 26.

2/ Total return over September 11 to September 26, divided by the modified historical standard deviation for this period

response or those seen as the most vulnerable to a sustained closure of international capital markets.

In **primary markets**, issuance in the quarter through September 11 totaled \$9.4 bn, a 40% decline from the average during the same period over the previous 5 years. Sovereign issuance from Latin America dominated, led by Brazil's \$1.6 bn Samurai bond issue in July, and Mexico's \$1.5 bn eurobond in August. Lebanon was the last issuer to tap the market through a \$300 mn reopening on September 10. The sharp drop in issuance reflected the defensive positioning of investors, the fact that many sovereigns had already fulfilled financing needs for 2001, and the high level of spreads due to concerns about the potential for a credit event. International capital **markets were thus effectively closed** for the large traditional emerging market issuers **since mid-August**. Since then, only occasional opportunistic issuances by Asian corporates and "exotic" credits, which were viewed as providing diversification from Argentine and Brazil risk, have been able to tap the market.



There were no dollar issuances from September 22 to October 11. In line with the generalized

	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
U.S. dollars	62	76	86	83	62	67	59	53	62	51	65	60	57	72	62
Euro	23	17	13	14	28	28	38	37	33	28	18	21	31	18	7
Yen	0	0	0	1	2	1	1	8	3	17	14	13	7	6	20

flight to quality and the stability of the US high grade market, single-A rated Chile (not a member of the EMBI+ due to its rating) was able to issue its second eurobond ever. With the exception of an issue by a Romanian oil company, the first euro-denominated bonds since September 11 were City of Moscow on October 16 and Turkey on October 23. There were also no emerging market issues in the Samurai market after September 11.

For the quarter as a whole, the importance of the yen-denominated market rose to an all-time-high share of 20% of the total \$11.2 bn issued. This, while reflective of the overall low bond issuance in the quarter, also owed to the success of the largest ever emerging market Samurai bond issue by Brazil.

Developments with regard to the investor base during the quarter included:

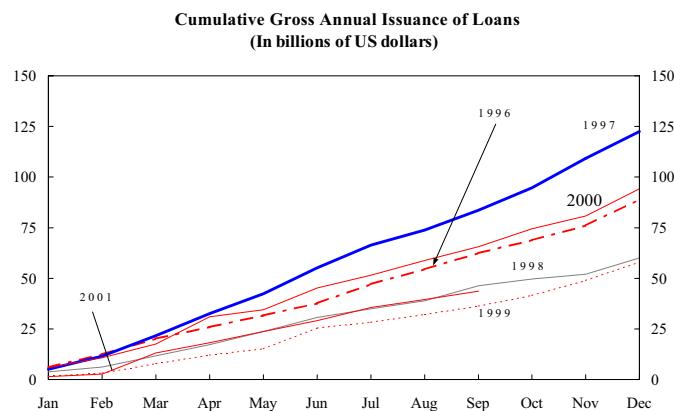
- Facing a slowdown in the global economy, falling oil prices, an increase in global risk aversion, and increased geopolitical uncertainty, **dedicated dollar-based emerging market investors** increased cash and near-cash positions to 10%-15% of their portfolios in light of the Fall events, exceeding the previous high following the Russian crisis. The increased cash cushions partly reflected the lack of any clear investment opportunities

following the attacks, and a fear among fund managers that large redemptions may follow the broad-based flight to quality. So far, however, redemptions have been limited.

- Both **high-grade and high-yield crossover investors** turned their attention towards the US, following the worse-than-expected sell off in the high yield sector and the investment grade airline sector. Adding to pressures on the Mexican sovereign, S&P's announcement that an investment grade upgrade would be postponed, exacerbated the retreat of high-grade investors out of emerging markets, with only a limited recovery in early October.
- **Local investors** continued to play a key role in both primary and secondary markets. The outperformance of Asian credits since September 11 is largely attributed to the strength of local demand, which did not capitulate, and indeed showed signs of continued buying interest given the lack of other investment opportunities in Asia. In Colombia, local pension funds' demand for the sovereign's bonds, coupled with substantial prefinancing, made the country one of the few safe havens of the asset class.
- **Retail investors in the yen and euro** segments confirmed their reputation of "steady hands" during crises with a smaller sell off, but in part this was due to the virtual shutdown of the secondary market, as market makers were unwilling to provide liquidity to an otherwise one-way market.

### C. Syndicated Loans

Syndicated lending to emerging markets remained **broadly flat** in the third quarter amid ongoing concern about the global slowdown. Despite **abundant liquidity**, lenders showed **increased discrimination** regarding credit quality, with the overall volume of lending registering \$14.6 in the third quarter against \$16.1 bn in the second. Year-to-date syndicated loan commitments are running sharply lower than last year, and close to 1998 levels. A number of launches for emerging market borrowers scheduled for late September were pushed back, while foreign banks remain hesitant to proceed with Middle Eastern deals.

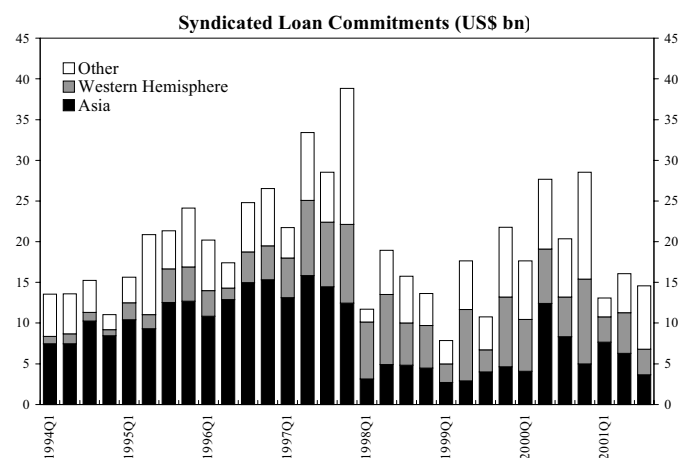


Moderate volumes in the third quarter were attributable to a number of factors:

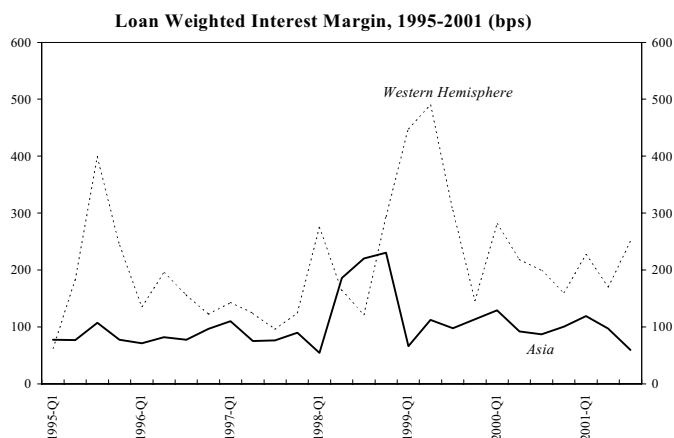
- **Concerns about the slowdown** in the world economy and a dearth of M&A activity reduced the demand for new money, with **refinancings remaining the dominant theme** of 2001.

- The ongoing **flight to quality** led lenders to provide substantial **over subscriptions for top-tier corporates** at competitive pricing and, in some instances imposed less restrictive covenants, while lower tier borrowers experienced greater difficulty obtaining credits.
- **Increased local currency lending** by regional financial institutions reduced the demand for international syndications. In Central and Eastern Europe, foreign ownership of strategic stakes in the region's financial institutions has strengthened the latter's funding and expertise. Middle Eastern financial institutions, flush with oil-related liquidity, and less constrained by return-on-equity requirements than their international counterparts, have been willing to lend on more favorable terms, including longer tenors and more competitive pricing. After the Fall events, deals for **Middle Eastern entities** that included foreign banks' participation have essentially been on hold.
- In **Asia**, in addition to local banks' abundant liquidity, **pressure on a number of currencies deterred corporates from borrowing** in foreign currencies

In the third quarter, the **composition of syndicated lending to emerging markets** shifted further in favor of the Emerging Europe, Middle East and Africa (EMEA) region, as has been the trend through 2001. Notably, South Africa's Reserve Bank signed a \$1.5 bn facility to be made available to the Treasury should privatization receipts fail to meet expectations. Meanwhile, **Turkish financial institutions returned in force** to the euroloan market, with deals amounting to \$1.7 bn. Strong support from their relationship banks enabled them to refinance their deals, albeit at substantially higher margins. **Latin America suffered** a sharp reduction in lending amid heightened concerns about Argentina and its knock-on effects on Brazil.



Reflecting increased risk aversion and this quarter's distribution of lending among Latin corporates, syndicated loan **spreads were sharply higher**. In Asia, the 'North-South divide' remained clear, with Hong Kong and Korean corporates enjoying ample access to funds at highly competitive rates. In contrast, of the few loans received by Philippine and Thai corporates, most were secured or required sovereign or foreign agency participation.





## D. Emerging Equity Markets

**Emerging equity markets followed their mature market counterparts down** during the July to September 11 period, on pessimism about near term global growth prospects, with defensive sectors again outperforming cyclicals. Of note, China reverted from being the best performing Asian bourse in the second quarter to the worst during this period amid regulatory investigations and privatization related oversupply fears. Malaysia, in contrast, surprised on the upside on reduced political risk and diminished concerns about the ringgit's peg.

Total Dollar Return Performance of Emerging Equity Markets (in %)

	Jul. 1 - Sep. 10	Sep. 10 - Sep. 21	Sep. 21 - Oct. 26	Third Quarter	Year-to-date 1/
<b>Regions:</b>					
EMF	-10.9	-14.6	10.5	-22.1	-18.7
Asia	-8.0	-14.4	10.5	-20.1	-14.4
LatAm	-14.8	-13.8	9.4	-24.0	-16.9
EMEA	-13.0	-15.0	14.3	-25.8	-31.2
<b>Major Emerging Markets:</b>					
Korea	-4.9	-15.3	17.1	-19.7	9.8
Taiwan Province of China	-11.7	-17.6	14.6	-27.8	-17.9
China	-38.7	-0.5	10.4	-35.0	-32.1
Malaysia	20.2	-13.2	0.5	5.5	-9.0
India	-7.0	-19.0	15.5	-18.8	-28.2
Argentina	-27.7	-15.7	-5.5	-39.6	-43.7
Brazil	-20.3	-15.2	10.7	-29.9	-36.5
Mexico	-14.0	-13.2	15.3	-20.7	6.0
South Africa	-12.3	-17.4	9.9	-22.7	-18.3
Turkey	-24.1	-29.3	24.5	-44.1	-56.2
Russia	-5.8	-12.8	7.7	-19.4	20.6
<b>Mature Market Comparators:</b>					
Dow	-8.5	-14.3	15.9	-15.8	-11.5
Nasdaq	-21.6	-16.1	24.3	-30.7	-28.4
S&P 500	-10.8	-11.6	14.4	-15.0	-16.3
ACWIF	-10.8	-11.7	13.8	-15.0	-20.0

1/ October 26

Source: Morgan Stanley Capital International

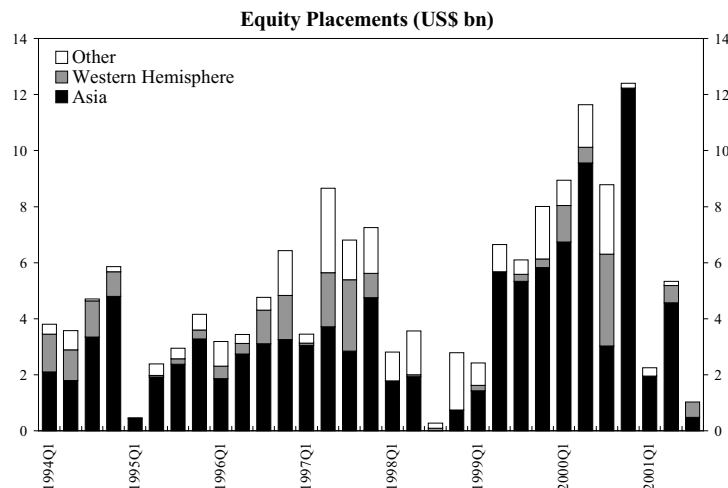
After September 11, emerging markets sold off sharply consistent with their “high beta” character relative to mature equity markets.<sup>1</sup> **Comovements across markets rose sharply** (see chart). Emerging equity markets ended the quarter sharply lower, with Malaysia again being the notable exception. China, on the other hand, regained its safe haven status, returning 6% between September 10-28. Russia, Mexico and Malaysia proved to be more resilient than other emerging equity markets to the initial sell off as it coincided with the initial surge in oil prices. Across sectors, net exporters and cyclicals led declines post-September 11.

Average Correlations of the Returns on Major Emerging Equity Indices



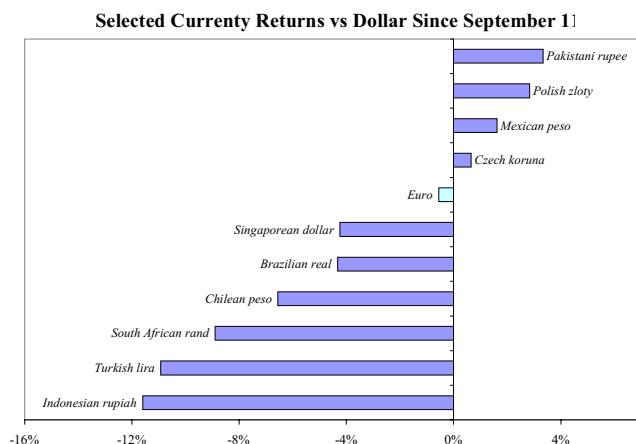
<sup>1</sup> See *Emerging Market Financing*, May 10, 2001 for an explanation of the “high beta” characteristics of emerging equity markets.

Total **primary issuance** by emerging market corporates in Q3 2001 barely reached \$1 bn, close to historical lows. Only in two other quarters was international issuance by emerging markets as a share of global equity issuance lower. The largest issue this quarter was the privatization ADR issue by Brazil's Petrobras (\$545.7 mn), accounting for about half of total emerging market issuance. The rest was accounted for by small issues from Taiwan Province of China, China and India, concentrated mainly in electronics, computers and banking sectors. In light of the fall events, many IPOs/additional issues have been either delayed or cancelled.



### E. Emerging Foreign Exchange Markets

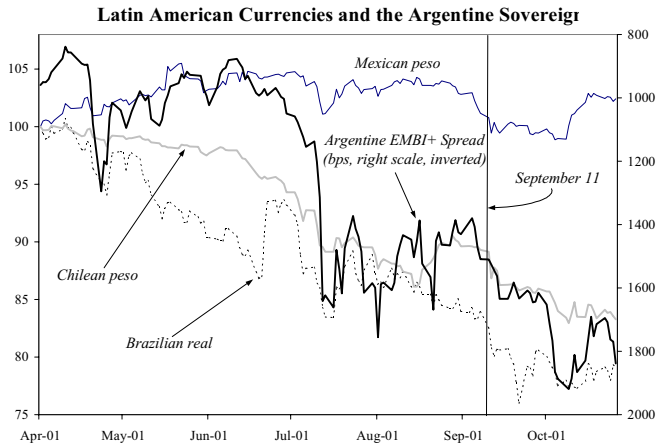
**Emerging market currencies continued to weaken** against the dollar during the third quarter, at a pace similar to that of recent years, in spite of the dollar's weakness. The global slowdown that was one of the elements undermining the strength of the dollar was seen as even more negative for emerging economies heavily dependent on exports to the US than for the US itself. Increased risk aversion in light of Fall events was viewed as negative for emerging markets with high external financing requirements, and emerging market currencies were hard hit. In line with other markets, there were clear signs of investor discrimination, with those economies relatively well insulated from the events and the growth slowdown remaining stable, while others sold off. In countries with pegged currencies such as Malaysia, the selling pressure was transferred to other markets. While domestic factors complicated the picture, economies reliant on private market financing for a substantial part of their external financing (or which can be sold as proxies for such countries) came under pressure. Some currencies for commodity-based countries also sold off in the expectation slower world growth will put downward pressure on prices.



- **In Latin America the currencies of Brazil and Chile fell sharply during the third quarter.** The Brazilian real remained under pressure, influenced by events in Argentina,

and despite substantial sales of dollar-linked debt, pressures on the currency remained. The Mexican peso maintained its reputation as delinked from events further south but it came under selling pressure on the stock market sell off but reversed sharply as equity markets began to recover.

- **Currencies in Europe, the Middle East, and Africa also fell in the third quarter.** A very sharp drop of several central European currencies at the start of the quarter had raised concerns they might be vulnerable to contagion from developments in Argentina and Turkey, but more important factors were the broader external environment, domestic factors, and investor positioning and financing.



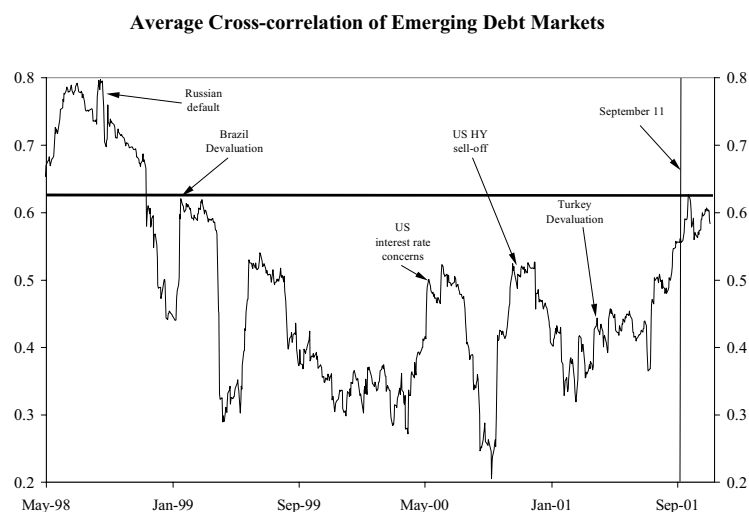
- Unlike other regions, emerging **market currencies in Asia continued their trend of relative strength** during the quarter. North Asian currencies were broadly stable against the dollar, even as the yen strengthened. South East Asian currencies strengthened significantly late in the quarter. In part this reflected equity flows as some investors repositioned themselves away from North Asia after revising their views on a US-led recovery. Other factors were positive political developments, particularly in Indonesia, and a continued tightening of regulations.

### III. STAFF APPRAISAL

The events in September increased uncertainty and investor **risk aversion** at a time when concerns were already high about **global slowing**, deteriorating **emerging market fundamentals**, and the potential for **credit events** in particular emerging markets. In the response of emerging markets to the events of the last quarter, several salient, and by now **classic, features of the asset class**' behavior were once again evident. Their "**high beta**" nature made them prone to sharper sell offs than global markets. **Volatility** surged. There was broad based selling or "**contagion**" across countries comparable to that in many past crisis episodes. Finally, there was a drought in **the (largest) dollar primary bond market**. These features of emerging markets have been analyzed in depth in past quarterly reports and remain key determinants that will shape the outlook for emerging markets in coming months. Against this background, we examine two issues in depth. First, we revisit the question of **investor discrimination** and place the recent drought in emerging bond markets in the historical context. Second, with **net financing on primary markets** by emerging markets set for the **worst year since the early 1990s**, we examine changes in the composition of these flows and the factors underlying this fall off. We then discuss the outlook and risks.

#### A. Investor Discrimination, Market Closures, and Risk Aversion: An Update

The quarter saw a steady increase in the average cross-correlation of individual country returns in emerging debt markets (see chart). That is to say, **individual country returns moved together**, with the average cross-correlation reaching **levels last seen at the time of the Brazilian devaluation**, but has fallen off modestly since. In developing our measure of "contagion" and investor discrimination in past quarterly reports, we have pointed out that spikes in average cross-correlation indicate periods of either broad-based selling *or* broad-based buying. We have also argued that, for a variety of reasons, while a high value is consistent with a number of factors, **common external factors and lack of investor discrimination are the more likely explanators**.



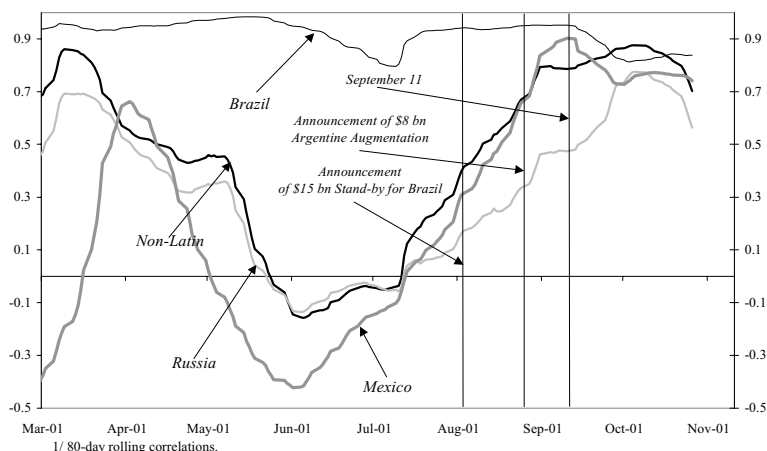
At the time of writing of the last quarterly report, we noted that while the average cross-correlation had clearly increased by end-July due to developments in Argentina, it had yet to reach the levels seen during the Brazilian devaluation or the Russian default. This absence of substantial contagion was attributed to several changes in the market structure and investor

holdings, but also to the fact no credit event had actually taken place. The subsequent increase to levels last seen at the time of the Brazilian devaluation occurred as:

- There was **another sell off in Argentina during August**, with continued spillovers to Brazil and those countries seen as having large (gross) external financing requirements.
- There was a **broad-based sell off in the aftermath of September 11** as heightened risk aversion prompted dedicated emerging market investors to move into cash, broadly selling all EMBI+ constituents.

Unlike the previous quarter, when investors had reallocated portfolios towards Mexico and Russia to exploit differences in country fundamentals, the **lack of “safe havens”** within the asset class was evident in increased pair-wise correlations during the third quarter (see chart). Unfortunately, the increase in co-movements after September 11 called further into question the value of the safe havens within the emerging markets of the previous quarter.

Emerging Market Spread Correlations with Argentina 1.



US Dollar Market Droughts for Emerging Market Debt, 1993-2001

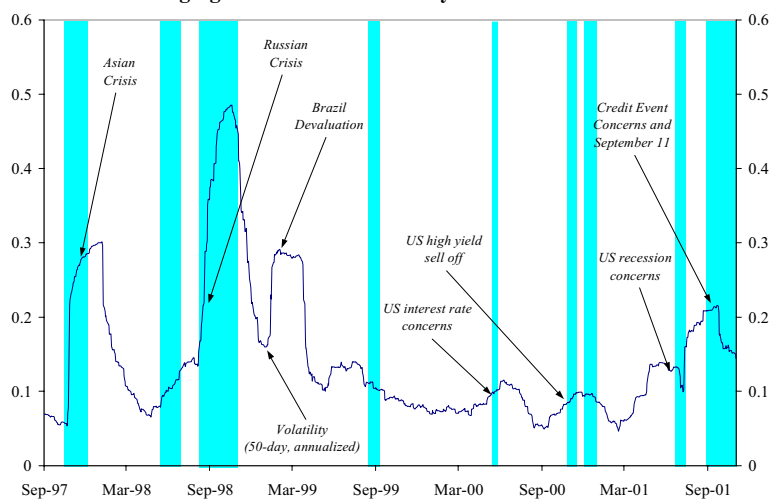
Event	Start	End	Duration (weeks)	EMBI/EMBI+ Spreads (weekly in bps)		
				Min	Max	Average
Mexico Crisis	1/9/95	2/10/95	5	1,131	1,266	1,195
Tequila Crisis	3/20/95	3/24/95	1	1,627	1,752	1,690
Asia Crisis	10/13/97	12/5/97	8	341	640	500
Pre-Russia Crisis	5/18/98	7/3/98	7	497	666	559
Russia/LTCM Crisis	8/10/98	10/30/98	13	662	1,524	1,143
Argentine Debt Relief Concern	8/9/99	9/3/99	4	1,014	1,067	1,044
US Interest Rate Uncertainty	5/8/00	5/19/00	2	752	806	788
US High-Yield Crisis	10/9/00	10/20/00	2	678	766	725
Argentina and Turkey Sell-Offs	11/13/00	12/15/00	5	763	790	776
US Recession Concerns	6/2/01	6/22/01	3	703	747	731
Credit Event Concerns and Sep 11	8/27/01	10/19/01	8	900	1,080	975

The broad-based sell off in secondary markets was reflected in a drought in the primary dollar market, effectively being closed to the main non-investment grade borrowers since mid-August. We have discussed such droughts in emerging debt markets in depth in a past quarterly report. Excluding seasonal slowdowns, such as at year-end, and employing our previous methodology, we **identify eleven droughts since 1993** including the current ongoing episode (see table).<sup>2</sup> **Key features** of droughts are:

<sup>2</sup> For a discussion of the methodology and definitions of droughts see Emerging Market Financing, Quarterly Report on Developments and Prospects, Fourth Quarter, 1999.

- Their **duration has varied** substantially, from one relatively brief period of 1 week (at the time of the Tequila crisis) to the most severe and prolonged drought of 13 weeks (at the time of the Russian crisis). The current episode has so far lasted 8 weeks.
- They have occurred due to both **emerging market crises**, or uncertainties in the periods building up to them (such as the drought that preceded the Russian crisis), and **developments in the external environment**. As discussed in past quarterlies,<sup>3</sup> uncertainties with respect to US growth or inflation have led to market closures in emerging markets.
- There is a surprising **lack of a clear relationship between the average level of emerging market spreads and droughts in emerging markets issuance**, with the spread on the EMBI+ varying between 341 bps and 1752 bps during droughts (see table).

Emerging Debt Market Volatility and Market Closures

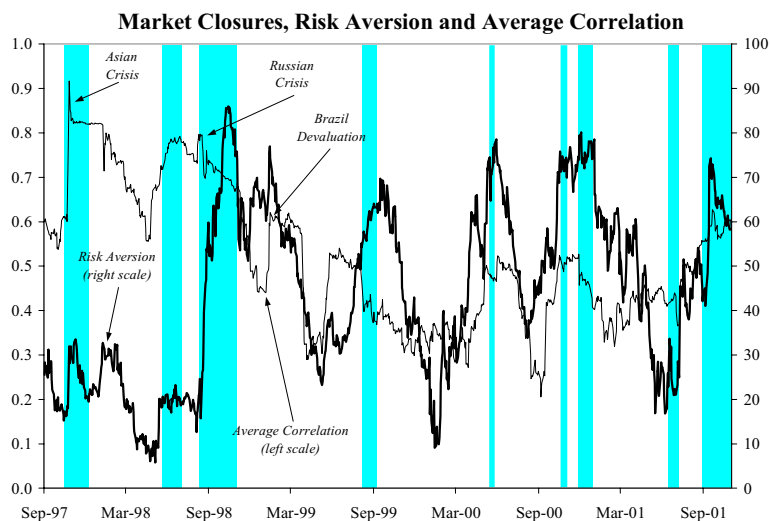


- However, droughts **during or following periods of rapid spread widening, and market volatility** has been a key factor in market closures (see chart), with markets having a **tendency to reopen when spreads stabilize or narrow**.
- While there has **typically been a key discrete event that closes the markets**, there has typically **not been a clearly identifiable discrete event that reopens them**.
- The last two characteristics are consistent with the following **dynamic**. A discrete event, such as a crisis in a major emerging market or a change in the external environment, that causes **a sharp change in spreads, prompts issuers and investors to wait before issuing**. While issuers are loathe to lock in higher rates, investors are concerned about taking mark-to-market losses on new issues if spreads widen further. Whether or not the outlook is worse, a resolution of the uncertainty about that outlook appears key for reopening the market. That is, issuers tend to accept higher borrowing rates with time, and once investors become convinced things will not worsen, they become willing to

<sup>3</sup> For example, Emerging Market Financing, Quarter Report on Developments and Prospects, February 2001.

buy. **Volatility of the secondary markets is, therefore, key to market closures, and its dissipation key to reopenings.**

- Surges in **global risk aversion** (measured using the LCPI index introduced in Box 1) have **had a clear impact in creating droughts**, as investors sold off risky assets and moved higher up the credit spectrum (see chart). Examining the behavior of global risk aversion along with the incidence of droughts in emerging bond markets suggests clear instances when droughts were triggered by external developments and, by implication, when they were not. The drought and contagion during the Asian crisis, for example, did not occur against a backdrop of heightened global risk aversion. The droughts at the end of 2000 on the other hand coincided with sharp increases in risk aversion and can be attributed to a weakening in the external environment. We noted above that the longest recorded drought so far of 13 weeks occurred at the time of the **Russia/LTCM** crisis. As the chart shows, this episode was **unique** in that the drought began with an **emerging market crisis** but was **followed soon after by heightened global risk aversion** in response to LTCM's crash. The confluence of shocks—they were, of course, related—explains the severity of that drought.



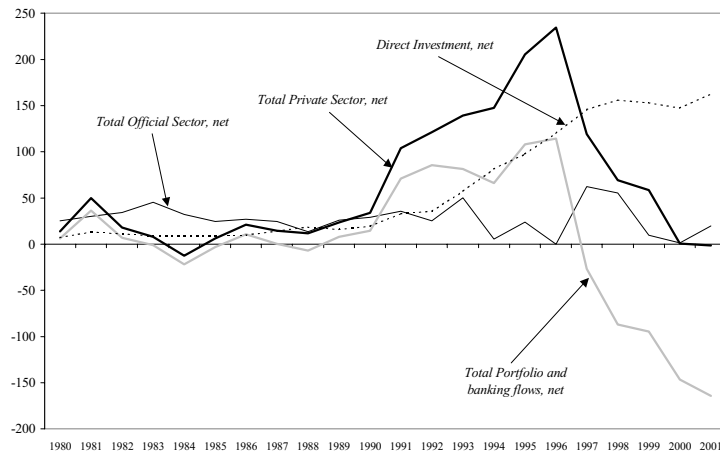
Turning to the **current drought**, bond markets were already effectively closed for noninvestment grade issuers since mid-August, reflecting concerns about the global slowdown and the potential for credit events within the emerging markets. Contagion in secondary markets from Argentina was limited largely to Brazil, and while the average correlation measure showed a steady increase throughout July and August it remained below previous peaks such as at the time of the Brazilian devaluation. The Fall events have now created a situation that has **parallels with the Russian crisis** in that there has been a **surge in global risk aversion** superimposed on an environment where there were **already concerns about potential credit events** emanating from within the emerging markets. This confluence suggests the drought could be prolonged.

## B. The Fall Off in Private Market Financing of Emerging Markets: The End of a Decade of Capital Flows?

For the first time in at least a decade, and so far despite stable FDI flows, **net capital flows to emerging markets are set to turn negative** in 2001 for the year as a whole. This compares with a peak of \$230 bn in 1996. This turnaround raises several questions:

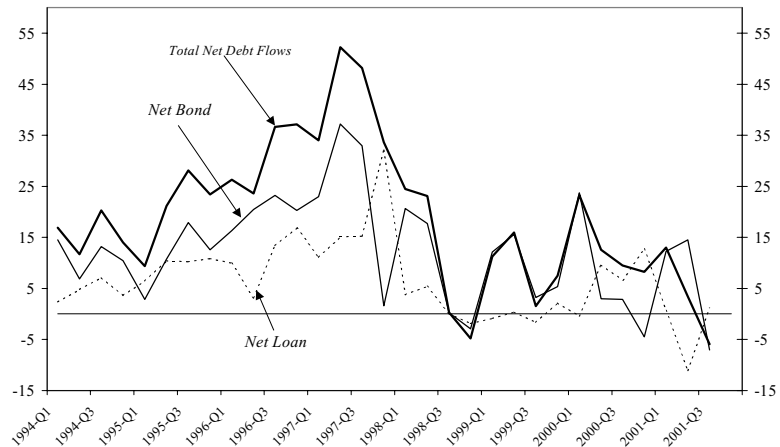
- Does the broad correspondence of the cycle of capital flows to emerging markets with that of economic activity in the mature markets, especially in the US, imply that the substantial **capital inflows to emerging markets during the 1990s merely reflected a cyclical phenomena?**

Capital Flows to Emerging Economies (in US\$ bn)



- Or was the resurgence of **such flows** following the “lost decade” of no flows during the 1980s after the emerging market debt crisis a “one-off” albeit **gradual portfolio stock adjustment that has now run its course?**

Emerging Markets Net Bond and Loan Flows (Public & Private, in US\$ bn)

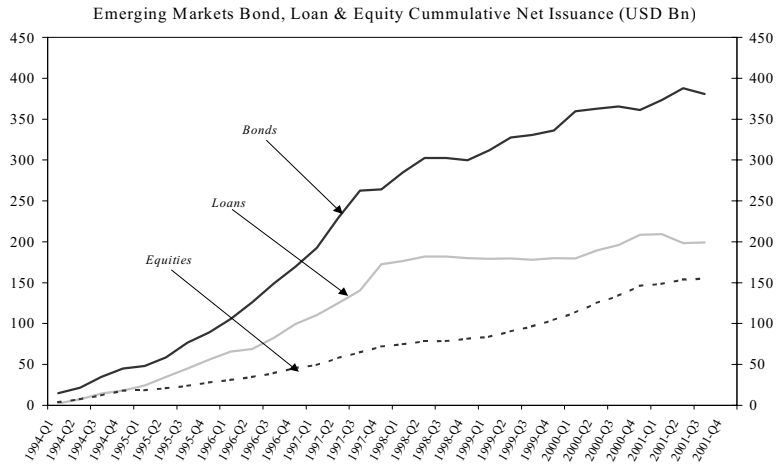


- Many observers have argued the volume of flows to emerging markets was “excessive” in the period leading up to the Asian crisis. **Has the fall off now also been excessive?**
- What has been the **extent of the liquidity squeeze** generated by the falloff in new issuance? And what is the **extent of refinancing risks** on international capital markets for emerging markets?



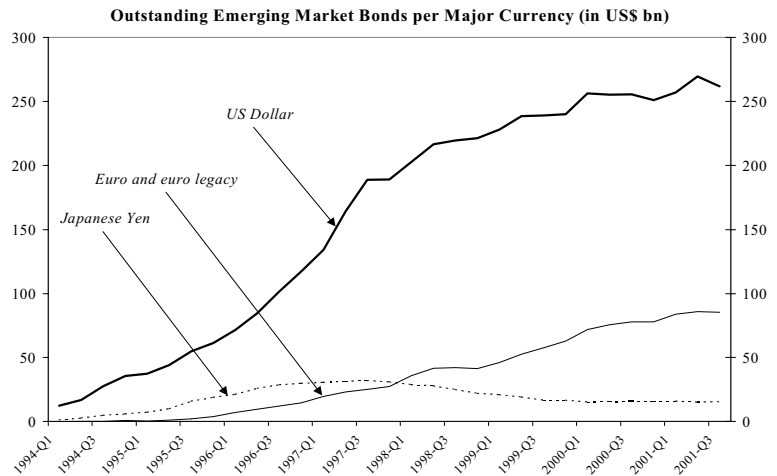
In framing answers to these questions, it is useful to note **key features of net financing flows** to emerging markets on international capital markets in recent years. They include:

- The **recovery** in net debt financing flows to emerging markets **since the Asian and Russian crises** from negative levels in the immediate aftermath of the crises was to decidedly **lower levels** (see chart above). During 1999-2000, net debt flows averaged a little less than \$10 bn a quarter, as compared to \$25-45 bn in 1996-97. The data clearly suggests a **“structural decline”** in the average volume of such flows since the Russian crisis.



- The international **bond market**, by far the **largest provider of net financing** to emerging markets since the 1990s, and the mainstay of external financing for sovereigns has also been the **most volatile provider** of such flows. Nevertheless, net financing flows to emerging markets on international bond markets have been positive in all but three quarters since 1994.
- With the extended drought in bond issuance beginning in mid-August, at negative \$7 bn, the **third quarter** represents the **worst outcome to date** in terms of the net volume of financing provided to emerging markets on international capital markets.

- Net **syndicated loan** flows, the mainstay of external financing for emerging market corporates, **never really recovered** from the Asian and Russian crises. After falling off to around zero by the third quarter of 1998, there were essentially no *net* syndicated loan commitments to emerging markets for a year and a half, that is through the first quarter of 2000. New loan commitments just compensated for maturing loans. This remarkable stability in the cumulative net issuance of syndicated



loans indicates **international banks' tightly limiting, but maintaining, the stock of their exposures**. There were, however, **changes in the composition** of this stock of exposures, with a move **up the credit spectrum** to better quality corporates, to those with **ownership links to multinationals**, an increasing proportion of the stock of exposures covered by **political risk insurance**, and a shift away from Asia, the largest recipient of such loans among the emerging markets, in the aftermath of the crisis. With growth in international banks' balance sheets, the constancy of the nominal stock of exposures to emerging markets indicates a **reduction in the portfolio share** devoted to emerging markets.

- The modest recovery in net syndicated loan flows during the latter part of 2000 which at the time suggested the beginnings of a longer-term recovery, with net new commitments of around \$15 bn during the year, were led by the **TMT sector**.
- Net **syndicated loan flows** during the last quarter were **once again around zero, consistent with the post-Asian crisis norm**.
- Consequently, **net debt** (bond and syndicated loan) **flows were substantially negative** (-\$7 bn) in the last quarter, **exceeding the previous worst** (quarterly) outcome **in the aftermath of the Russian crisis**.
- International **equity placements had grown steadily** through last year, both in absolute terms and as a share of total net new financing to emerging markets. This growth was driven **primarily by issuance from Asia**, while placements from Latin America remained insignificant. Asian issuance was in turn **supported heavily by the TMT sector**, and then **jumbo privatization issues from China**. Along with global markets, new international equity placements by emerging markets **slowed to a trickle** in the first quarter of this year and show **no indications of recovering**.

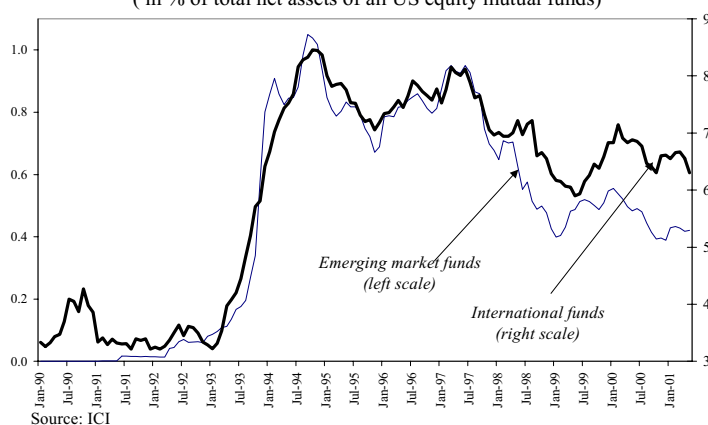
On the fall off in private market financing of emerging markets, we make the following observations:

- Part of the “structural break” in the volume of net emerging market financing following the Asian and Russian crises is explained by the **lower demand** for international financing. External **financing “needs” are lower** now than they were then. Emerging Asia still has current account surpluses compared to deficits then, and Latin current account deficits are smaller. Moreover, flexible exchange rates since the crises, combined in many instances with a painful awareness of exchange rate risk have encouraged domestic entities to look to **financing on domestic markets in local currency**. This shift away from external to domestic markets has been further encouraged by historically low local interest rates (and differentials).
- As noted above, part of the structural break is directly attributable to the **stagnation of net syndicated bank lending**. Some observers would attribute this to more prudent bank

behavior. Clearly some distortions that boosted bank flows have been removed since the crises, and banks have displayed a desire to move steadily up the credit spectrum in their lending. In our reading, however, with some notable exceptions (especially in the Telecom sector and the major emerging markets with credit event concerns) the stagnation reflects in considerable part reduced demand for international syndicated loans from higher quality emerging market corporates.

- The **global slowing** has had a direct impact on the flow of capital to emerging markets. With emerging markets remaining an opportunistic asset class lower down the credit spectrum, the historical experience has been one of their being impacted considerably by the **flight to quality up the credit spectrum** that can be **expected at times of notable slowings in economic activity or heightened global risk aversion**. In fact, elevated investor concerns in November last year about what were at the time expected to be the largest sovereign borrowers on international markets—Argentina and Turkey—followed heightened concerns about the US slowdown, a sell off in the US high yield market, and the subsequent closure of (dollar) primary markets for emerging markets.
- The **synchronized** nature of the global slowdown has also meant fewer diversification gains globally and to emerging markets.
- The global TMT bubble, which was highly correlated with the US economic cycle, played a key role in elevating the volume of financing flows to emerging markets. The TMT boom raised not only equity placements, but also syndicated bank loans and bond issues from the sector. The subsequent **unwinding of the TMT bubble** has played a key role in reducing the volume of new flows.
- While precise and comprehensive data on the shares of international investors' portfolios dedicated to emerging markets are not available, an indication in equity markets is provided by the share of assets of US-based emerging market funds in total assets of all US-based mutual funds. Comparing this share with that of "international" funds suggests the following. Both shares have moved hand in hand, suggesting similar considerations driving allocations internationally and those to emerging markets. In our view, this was a rather discrete change in investor awareness and preferences for international diversification. There was a clear **large increase in allocations internationally and to emerging markets during 1993 -94** as investors sought out the

Total net assets of all US-based International and Emerging Market Funds  
( in % of total net assets of all US equity mutual funds)



benefits of international diversification. Both shares have been declining since, though this reflects in part the relative outperformance of US equity markets since that period.

### C. Outlook and Risks

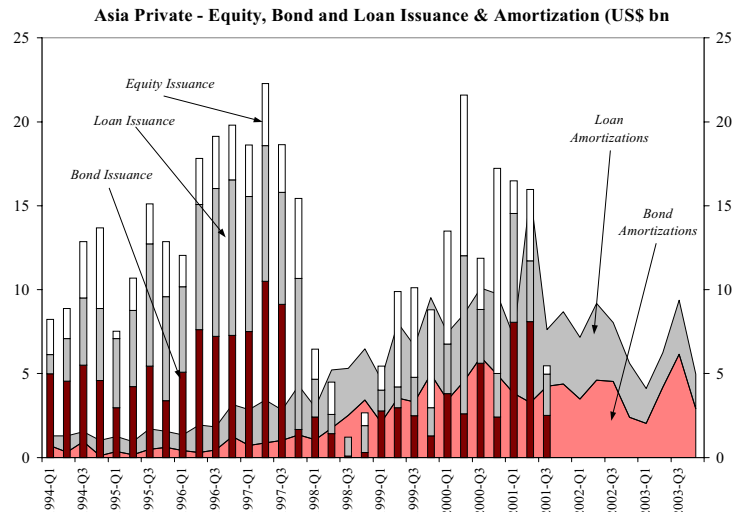
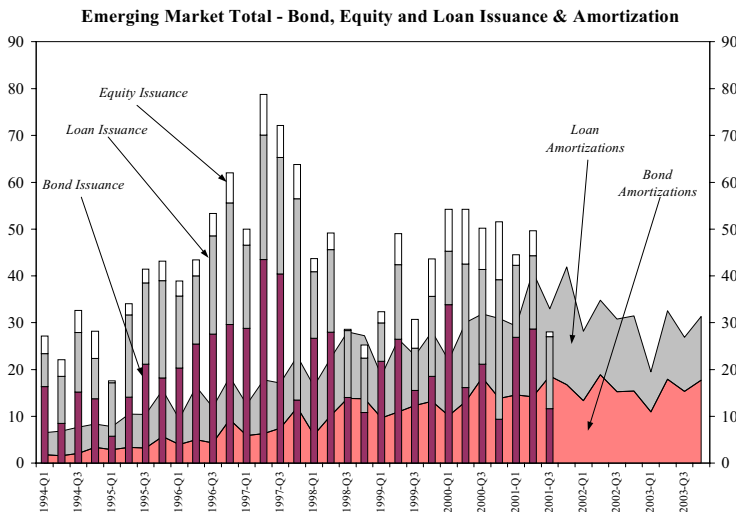
The last quarter saw a **clear deterioration** in the external environment for emerging markets and near term prospects for fundraising on international capital markets. During October, both mature and emerging equity markets have rebounded, in many cases above their pre-September 11 levels. Global risk aversion measures have also fallen back, but remain high. The recent rebound in equity markets is predicated on a turnaround in earnings and economic activity next year. It remains dependent on further declines in global risk aversion and the downside risk of further postponement of recovery remains very real. For emerging markets, the risk of a further flight to quality if such risks materialize, remains.

Key questions that will shape the outlook for emerging markets are whether global risk aversion subsides, **when international bond markets will reopen more widely for emerging market credits**, and the **extent of the squeeze** generated by refinancing pressures until they do. On the other hand, investors remain defensively positioned, with dedicated emerging market debt investors, for example, holding huge cash cushions implying that the technical support for the market is strong, and a rebound, both in secondary markets and in new issuance, when it occurs, could be substantial. The build up of these large cash cushions has been motivated in part by fund managers' potential redemption concerns following the poor performance of emerging debt markets and lingering credit-event concerns in particular systemically important emerging markets. Further declines in global interest rates and liquidity injection by the major central banks have so far proved supportive for fixed-income allocations and there have not been significant redemptions from the asset class yet.

- For the **remainder of the year**, the drought in the (largest) dollar segment of the emerging **bond market is expected continue**, with only small highly opportunistic issuance from those new credits enjoying special circumstances, or which provide investors diversification away from a US slowdown, lower oil prices, or emerging markets where credit event concerns remain high. As the year draws to a close, few investors are willing to take on new risky bets and there are signs that fund managers are already closing their books to lock-in year-to-date profits or limit their downside.
- The consensus outlook is that **if emerging market credit event concerns disappear** from the horizon as a constant cloud of worry over the emerging debt market, and assuming reasonable costs of resolution in the event **primary markets are set for a surge in issuance at the beginning of the year** reminiscent of the post-Y2K issuance spike.
- In the context of the present external environment, we expect the **syndicated loan market to continue to broadly maintain its net exposures** to emerging markets. Over the last several years, the market has continued to move up the credit spectrum and only the top-tier corporates have had access to financing. As loans to these entities mature we

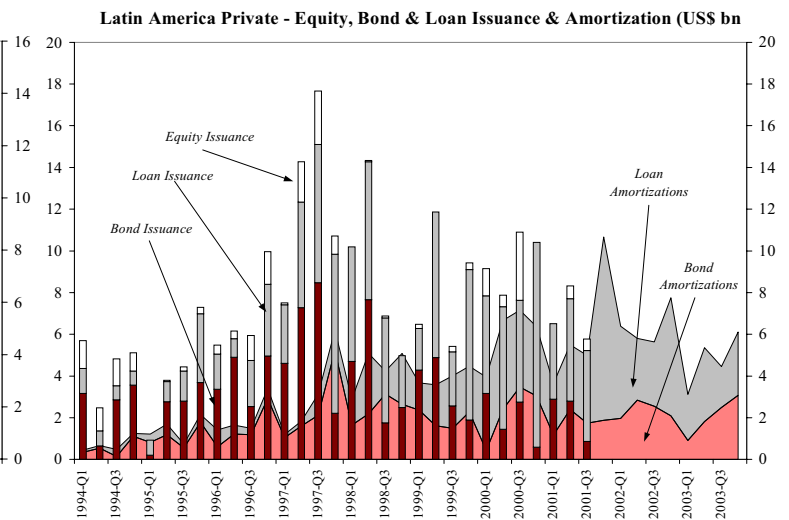
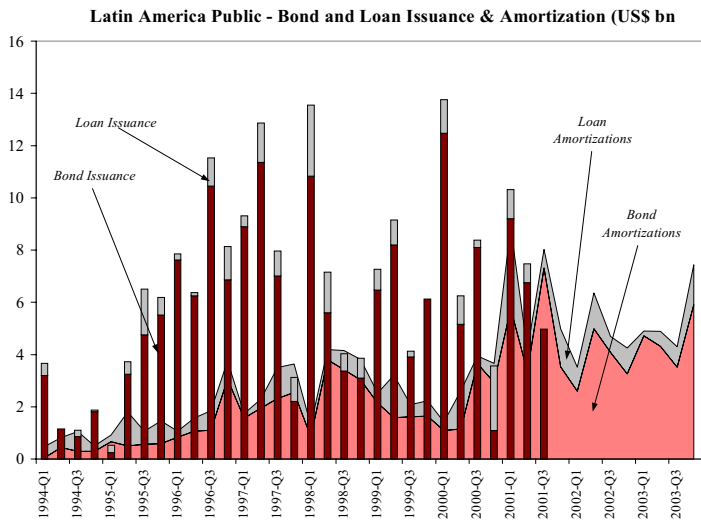
expect they will continue to be rolled over though some further move up the credit spectrum is likely to continue. The impact on pricing remains unclear. Banks have ample liquidity, which should continue to pressure spreads lower, while continued tightenings in lending standards, evident in home markets, should pressure spreads wider.

- The **prospects for new international equity placements continues to remain very limited**. With emerging market **valuations near all time lows**, the cost of raising equity capital remains very high, and placements are likely to await a rebound in secondary markets. While emerging equity markets have followed the recent up tick in mature markets, the jury remains out on the extent to which this has been due to fundamental considerations.
- **Refinancing pressures** remain at the forefront of debtors' and creditors' concerns. Comparing upcoming repayments to recent fundraising experience provides an indication of financing pressure. Having raised one of the lowest volume of gross financing in the last quarter since 1995, **emerging market debtors** as a whole face an **increase in amortization payments in the fourth quarter** of 2001 to over \$40 bn, implying a continued **squeeze** unless capital markets reopen. Thereafter, amortizations fall back, but remain on the order of \$30 bn a quarter.



- A **disaggregation across regions, sectors, and countries**, confirms a similar picture. In **Asia**, the private sector's external amortizations are fairly high for the next four quarters. Local capital markets have, however, developed rapidly since the Asian crisis, and local liquidity is ample suggesting likely increased substitution of domestic for external financing. In **Latin America**, refinancing pressures are evident for both the public and private sector into 2002. For the private sector, amortizations are set to spike next quarter, reaching \$11 bn, well above average fundraising levels in the last two years. The exercise of put options embedded in some eurobonds issued by some corporates may also exacerbate pressures.

- The vulnerability of emerging markets is **not restricted to primary markets** alone. Past episodes of stress—such as at the time of the Russia-LTCM crisis—indicate the **considerable potential for capital outflows** from secondary emerging debt and equity markets as part of broad-based flights to quality (see chart). So far the extent of outflows in September are reassuring. Portfolio flows turned negative, but remained well below levels seen in previous times of stress.



- Even though it has been quite resilient in recent years, **foreign direct investment** into emerging markets may be subject to **downside risks** in the current environment. The cancellation or postponement of a number of cross-border M&A deals is indicative of the global economic slowdown as well as heightened global risk aversion and uncertainty. Furthermore, the currently high cost of equity capital in emerging markets hampers the prospects for privatization.

