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Conclusions

The current situation in the international capital markets contains a number of significant risks and uncertainties, as well as the possibility of heightened volatility and large asset price corrections in the period ahead. Most important, the failure of Japan to deal promptly and more forcefully with its banking and financial sector problems is contributing to significant domestic economic weakness and downward pressure on the yen, risking significant spillovers and another round of Asian currency turmoil. Economic activity has been contracting sharply in the Asian crisis countries and the risk is that recovery will be delayed if efforts are not made to speed up financial and corporate sector restructuring or if the external environment faced by these countries weakens further.

In addition, the current reevaluation of emerging market risk—and weakness in commodity prices—may lead to further pressures on the more vulnerable emerging markets outside Asia and a broadening of the crisis. Within the mature markets in North America and Europe, the main risks are related to potential further spillovers from Asia, especially from Japan, and the current high valuations in equity markets. Sharp corrections in mature equity markets, triggered either by domestic or external developments, would risk adversely affecting the advanced economies and spilling over to the international financial markets, further complicating the situation in the Asian emerging markets. More positively, however, much of the immediate uncertainty about the EMU convergence process has been removed by the recent decisions concerning participation in the first round of currency union and the high degree of macroeconomic convergence. Remaining capital market uncertainties are of a more medium-term nature and include the impact of the euro on European financial markets and the adequacy of the new institutional infrastructure for managing systemic risk.

The assessment of vulnerabilities is complicated by the recent rapid pace of structural change in global capital markets, including the closer integration of financial markets, the growing importance of large internationally active financial institutions and international investors, and rapid innovation in financial instruments for managing and trading private risk. These developments are changing the linkages between national financial markets and contributing to uncertainty about how rapidly disturbances are transmitted between countries. This in turn is compounded by an inadequate understanding of whether the growing international use of derivative products is leading to a wider dispersion of private risks or a concentration among a few key financial institutions. The "new" global capital markets have not yet been tested by a major shock simultaneously affecting a large number of countries.

Mature Market Risks

A key risk is that Japan will not move promptly and resolutely to address its financial sector problems while ensuring adequate domestic demand to avoid a sharp and damaging slowdown in growth. The authorities over the past three years have advanced a number of measures that, taken together, constitute important progress toward a workable and potentially viable set of initiatives. Broadly defined, the authorities' package entails the following key elements: public funds for recapitalization and restructuring of the core banking system; reforms to the supervisory and regulatory framework; and Big Bang initiatives to build and develop broad domestic securities markets. Speed is becoming increasingly critical, since Big Bang reforms are accelerating the development of local securities markets and placing additional pressure on the banking system. The priorities should be:

- A rigorous accounting of the size of the bank loan overhang and the size of the problem disclosed as soon as possible. The process of banks' self-assessments should provide a foundation, but until now it has lacked transparency and was weakened by changes in the accounting rules governing banks' prudential ratios.
- Establishment of mechanisms to provide clear incentives for banks to recapitalize and restructure their operations, through the use of both private and public monies. This should involve quickly removing long-standing nonperforming loans from bank balance sheets and their disposal in a transparent, market-oriented way.
- Ensuring that the use of public funds will result in a strong, profitable banking sector, through implementation of the other components of the au-

thorities' approach, including an effective structured mechanism for early intervention and resolution (strengthened Prompt Corrective Action rules), and an independent and adequately staffed supervisory authority that meets the highest international standards.

Until decisive progress is made addressing the banking and financial sector problems, Japan's economy is likely to remain weak, with further downward pressure on the yen. Further sharp depreciation of the yen would put pressure on other Asian currencies—including most importantly those of China and Hong Kong SAR, which have remained closely linked to the U.S. dollar, and could seriously compromise the stability of the Asian region. Moreover, continued weakness in the Japanese banking system could lead to a further pullback from the Asian emerging markets at a time when the external situation of many of these countries has been showing signs of stabilizing. This underscores that Japan's problems have important systemic implications.

A second risk is a large correction in the currently high valuations in the U.S. equity market and spillovers to other markets. By some measures, U.S. stock prices are even more overvalued now than they were one or two years ago, and especially in light of the slowdown in earnings growth that has already taken place, the current phase of the business cycle, and the likelihood of further fallout from Asia. There is the perception, however, that the U.S. economy has entered a "new age," in which more rapid productivity growth can be sustained with low inflation, in which case high corporate earnings growth might be sustainable. The current high valuations may also reflect to some extent the implications of international investors shifting their portfolios to the United States in the wake of the Asian crisis. In any event, it seems unlikely that a sharp and sustained correction (say, 20–25 percent) would occur in the absence of strong evidence of either a sustained rise in U.S. interest rates or a significant revision in the prospects for continued corporate earnings growth, triggered perhaps by a worsening of the situation in Asia. Even if a sharp correction did occur, it is likely that the domestic impact would be manageable, because of the strong economic and financial condition of the U.S. economy and the absence of a direct impact on the commercial banking system.

The effect on international markets is more uncertain and would depend on the factors giving rise to the correction. The risk of severe spillover to European markets is at least partly counterbalanced by structural factors, such as strengthening prospects for corporate efficiency improvements through restructuring within EMU and improved liquidity and investor interest in a pan-European equity market. By contrast, the weaknesses in the Japanese economic and financial system, and the risk of negative knock-on effects to other asset prices (particularly the yen), would make the risk of spillovers more worrisome than usual. There would undoubtedly also be adverse consequences for the emerging equity markets from a sharp correction in the U.S. market.

Emerging Market Risks

A key risk is that the Asian crisis may continue to deepen either as a result of a deterioration in the external situation or a failure of the crisis countries to make substantial further progress in financial and corporate restructuring. Experience from previous crises has illustrated that the key to arresting output declines and restoring growth on a sustained basis is to restart the credit intermediation process through the speedy recognition and writing down of losses in financial institutions and injections of additional capital. Absent substantial progress in these areas, the risk is that financial institutions will continue to refrain from new lending and that both strong and weak domestic firms will suffer as a result. Urgent attention also needs to be paid to the problems of high corporate indebtedness and, where necessary, debts need to be restructured or written down. In countries where a large share of corporate debt is held by domestic banks, corporate restructuring will need to be closely linked to financial sector restructuring and can be speeded up by the judicious injections of public monies into the financial sector that balances the benefits of rapid restructuring with possible adverse moral hazard effects. While more efficient and better implemented bankruptcy procedures are required in many countries, these may need to be complemented by special workout procedures when large-scale problems of corporate insolvency or illiquidity exist.

Another risk is that the current reevaluation of emerging market vulnerabilities has not run its course and that the terms and conditions of external financing will worsen further, leading to a broadening of the crisis to emerging markets outside Asia. A tightening of external financing conditions would place additional pressure on the more vulnerable emerging markets and could lead to renewed currency pressures. As a result of the reforms introduced after the 1994–95 Mexican crisis, many of the Latin American emerging markets have strengthened considerably the resilience of their banking and financial systems. This served these countries well when they suffered contagion from the Asian crisis in the second half of 1997 and enabled the use of aggressive and credible interest rate defenses. Several of these countries have also responded to currency pressures by speeding up or intensifying much-needed policy adjustments, which has added to credibility. Elsewhere, the more vulnerable emerging markets need to accelerate their efforts to address shortcomings in macroeconomic and struc-

tural policies and to strengthen financial sectors as a key defense against external pressures, and be prepared to aggressively use interest rates to maintain exchange market stability.

European Monetary Union

An issue of a medium-term nature concerns the development of efficient crisis management procedures in EMU and the role of the TARGET payments system. The acceleration of financial sector restructuring that is expected to accompany the introduction of the euro will pose unique challenges in view of the fact that responsibilities for banking supervision and lender of last resort may remain at the national level while the supranational European Central Bank (ECB) will have a relatively narrow mandate for price stability and no formal responsibility to ensure financial stability. Ensuring that workable fast-reacting mechanisms are in place to handle systemic risk in the banking system will be critical in view of the additional competitive pressures likely to be placed on banks as a result of the development of pan-European capital markets. Systemic risk can also be reduced by ensuring that most large-value intra-European payments occur through the TARGET payments system. Some European authorities believe there is no reason to concentrate the processing of large-value payments on TARGET because there exist other payments systems that also process large-value payments at very low risk, believed to be comparable to that of TARGET. Based on this view, the full-cost recovery of TARGET should be maintained in order to guarantee a level playing field, and it should be left to market participants to decide whether to use TARGET or some other payments system. Despite such views, should markets decide to route many large-value payments through other channels on account of the high costs of using TARGET, consideration could still be given to abandoning the principle of full-cost recovery or reducing the system's collateral requirements. The rationale would be that a widely used real-time payments system can be of substantial benefit in reducing systemic risk.

Asian Crisis

The severity and fallout from the Asian financial crisis is leading to attempts to better understand the dynamics of the rapidly evolving global financial markets. Coming only three years after Mexico's problems, the Asian crisis has raised fundamental questions about the risks of premature capital account liberalization and underscored the difficulties faced by the emerging markets in absorbing large international capital flows. In addition to prompting large-scale international financial support, the crisis is stimulating a major reevaluation of the international architecture for crisis prevention and resolution. The reevaluation is intended to help identify and address weaknesses in the international financial system, and find means to increase the participation of the private sector in resolving cross-border financial crises.

Many lessons have been drawn from the Asian financial crisis but three are of particular significance from a capital markets perspective.

First, and most important, severe financial sector weaknesses and fragilities can themselves be an important cause of cross-border financial crises and can overwhelm apparently strong macroeconomic policies. In a situation where financial markets are intermediating increasing volumes of cross-border private capital flows, the crisis has underscored the importance of market participants appropriately managing the associated exchange rate and liquidity risks and ensuring that funds are invested to generate adequate returns. Especially important in this regard are well-functioning supervisory and regulatory regimes, strong credit and market risk management practices, and sound corporate governance. These factors will only be effective, however, if market discipline is allowed to play a greater role through scaling back excessively broad national safety nets and ensuring that financial institutions do not exploit these safety nets by undertaking excessive risk.

Second, the dynamics and spillovers from private sector financial crises are becoming increasingly complex in view of the closer financial integration between the advanced and the emerging markets, the proliferation of new financial instruments for managing and trading risk, and the role of some emerging markets as important investors in other emerging markets. In these circumstances, the potential for spillovers across countries is increasing and disturbances in one market may be transmitted to other countries more rapidly.

Third, the Asian crisis has underscored that large exchange rate changes accompanying financial crises can themselves lead to a significant deepening of crises when there are large unhedged currency exposures. This is not to say that the private sector in Asia should have foreseen the massive exchange rate changes that occurred. Rather, the point is that financial sector fragility can be significantly reduced by the hedging of exchange rate risk, the costs of which should be taken into account in borrowing and lending decisions. More than in previous crises, the Asian currency turmoil has underscored the extreme fragilities associated with the interaction between unhedged currency exposures and weaknesses in the financial and corporate sectors.

National authorities in the advanced and emerging market economies are currently addressing two important aspects of recent financial crises. The first is that supervisory and regulatory frameworks need in-

creasingly to be more proactive in ensuring that financial institutions (many of them judged too big to fail) do not exploit the financial safety net. Greater attention in supervision to internal risk management and control systems, and the ability and involvement of senior management in these processes, are fruitfully being pursued in many advanced economies. The second is the recognition of the need to make earlier and more effective use of market discipline. An important feature of having strong financial infrastructures—including payments systems—is that the threat of financial institutions being forced to close down gains credibility, since the associated collateral damage can be reduced. In practice, the key to more effective market discipline is prompt action to ensure that losses in financial institutions are promptly recognized and borne by shareholders, and are not allowed to become a bigger problem. The main message is that an appropriate combination of greater transparency and disclosure, effective supervision, and timely market discipline will go a long way in safeguarding national financial systems and avoiding crises.

The large swings in private capital flows to the emerging markets have created enormous difficulties for policymakers and placed severe strain on countries' financial systems. During periods of large inflows, the accompanying easier credit conditions and upward pressure on domestic asset prices—especially in situations of inadequate financial sector supervision and market discipline—frequently lead to large deteriorations in asset quality in the banking sector and inappropriate management of credit, foreign exchange, and liquidity risk. Conversely, the sudden pullback of private capital tends to produce large downward adjustments in domestic asset prices and exchange rates, creating severe balance sheet problems in the financial and corporate sectors when risks have not been adequately hedged. Even though the swings in capital flows may reflect rational choices by many individuals, the aggregate outcomes appear anything but rational and well-informed.

Against this background, there is a need to intensify the efforts to improve the functioning of international financial markets on at least two fronts.

First, efforts should be directed at addressing the factors that contribute to surges in capital flows and the waves of excessive "exuberance" and excessive "pessimism" on the part of international investors. The reasons why surges in capital inflows are so frequently followed by sharp outflows and major reevaluations of risk are imperfectly understood. The evidence suggests, however, that an adverse outcome is likely the more important is herding behavior on the part of international investors and the larger the movement down the credit spectrum toward lower-rated borrowers during the boom period. Improved data and information on emerging markets should, in principle, help encourage sounder and more informed investor behavior and reduce the likelihood of subsequent large "corrections" from earlier excesses. The incentives to efficiently use improved information can be undermined, however, unless there are clear expectations on the part of creditors and debtors that they will bear the costs of mistakes. Moreover, it remains to be seen in practice to what degree large swings in capital flows will be significantly reduced by making better information available to investors. Informational asymmetries are a key feature of loan contracts and tend to be especially severe in cross-border lending in "new" markets.

Second, recognizing that it is unrealistic to believe that swings in capital inflows will be eliminated, emerging markets should speed up their programs to strengthen financial systems and improve corporate governance to facilitate the prudent absorption of capital inflows and improve the ability to manage large shifts in investor sentiment and asset flows. The measures required are the same as those in advanced countries and include stronger regulatory and supervisory systems, strengthened market discipline, and improvements in information and transparency. Within the corporate sector, there is a need for strengthened corporate governance mechanisms. As regards exchange rate policy, a number of countries have found that greater exchange rate flexibility—together with the appropriate supporting policies—can play a useful role in managing surges in capital flows. Developments of the securities markets, together with strengthened payments and settlements systems, can over time play an important role in improving financial sector resilience.

Notwithstanding the urgent need for a number of emerging markets to improve the soundness of their financial systems and strengthen corporate governance, the required structural reforms are likely to take time to be implemented and become fully effective. In these circumstances, countries in the process of undertaking these reforms may benefit from a temporary strengthening of prudential safeguards, such as the stricter regulation and control of financial institutions' foreign currency and liquidity management, and closer monitoring of private capital flows. Some countries may, in addition, find it useful to complement the tightening of prudential controls with well-crafted temporary taxes on (short-term) capital inflows to lessen the vulnerabilities associated with short-term foreign currency exposures of the domestic financial and corporate sectors. In particular, a cross-border Chilean-type "tax" on short-term capital inflows would be a way of reducing external vulnerabilities while, at the same time, not discouraging desirable longer-term capital inflows and foreign direct investment. The potential benefits of such taxes should not, however, be exaggerated as their effectiveness will be limited in situations in which there are significant unaddressed weaknesses in financial and corporate sec-

tors. It is also likely that such taxes will be subject to growing circumvention over time.

The Asian crisis has focused attention on the risks associated with the heavy dependence on cross-border short-term interbank funding and the current low capital risk weights applied to such funding. On the one hand, interbank funding can be withdrawn very quickly during a crisis and be an important source of instability; on the other hand, such lending is subject to severe moral hazard problems because national authorities typically will be unable to allow major banks to default on their interbank exposures. In these circumstances, it is entirely appropriate that some members of the Basle Committee are reexamining the capital weights applied to such lending with a view to ensuring that the risks are adequately reflected in banks' capital requirements. In principle, any increase in the amount of capital that banks are required to set aside for short-term interbank funding could be achieved either by raising capital requirements on "debtor" banks according to the size of their interbank borrowing, or through increasing the capital requirements "creditor" banks must meet on such lending. An increase in the capital risk weight would potentially address a number of concerns about the risks associated with interbank lending but would need to be complemented by strengthened supervision of such lending and improvements in banks' internal risk management. Moreover, any increase in the risk weights needs to be considered within the broader context of its implications for the role of the interbank market in intermediating cross-border capital flows and the effects on banks' cost of capital.