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Emerging Markets: The Outlook, and the Role of the Fund 1/

Statement by Mr. Stanley Fischer
First Deputy Managing Director, International Monetary Fund
at the Spring Membership Meeting of the Institute for International Finance
Washington, D.C., April 29, 1997

Thank you. It is a great pleasure to be here and to have the opportunity to talk to the members of this organization, whose growing importance mirrors and is mirrored by the increasing role of international capital flows in the world economy.

1. I was asked to talk about the outlook for emerging markets, and in the course of preparing to do so, I read the excellent letter of April 21 by Charles Dallara to the Managing Director of the IMF and the Chairman of the Interim Committee, copies of which have I believe been made available to you. Charles has provided you with a first-rate summary of the outlook with which it is very difficult to disagree -- and if you had expected me to disagree, I shall have to disappoint you. Rather than repeat much of what is set out in Charles's letter, I shall briefly summarize the outlook and discuss a few overall risk factors, and then turn to three issues that are also mentioned in Charles's letter: the international effort to improve the functioning of financial--and particularly banking--systems in the emerging markets; recent progress by the Fund in enhancing transparency, both on data and on surveillance; and the ongoing effort to amend the Articles of Agreement of the Fund "to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements" (Interim Committee Communique, April 28, 1997)

2. **Capital flows to emerging markets**: 1996 was a very good year for capital flows to developing and transition countries. Using the IIF's numbers, private flows to emerging markets amounted to about $250 billion, or nearly 3 percent of recipient country GDP. Of this amount, nearly half ($113 billion) took the form of equity, with bonds ($94 billion) the other large category. Asia was the largest recipient, with Latin America second. Maturities lengthened and spreads declined. Net external financing in 1996 is shown as at about the same level as in 1995, with the difference that the net official flows in 1995 amounted to over $40 billion, compared with a net of zero in 1996.

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[1] Presentation to the Spring Membership Meeting of the Institute for International Finance, J.W. Marriott Hotel, Washington DC, April 29, 1997.

The performance of the last two years, including the rapid recovery from the Mexican crisis, is so impressive as to raise the question of whether it's too good to last. The IIF's answer is **no**: it predicts an unchanged level of flows in 1997. But as the IIF recognizes, there are risks to the forecast.

To analyze those risks, it is useful to ask why private capital flows to emerging markets have increased so rapidly in the 1990s. Let me mention six factors: (1) an increase in expected returns in emerging markets, due to structural reforms, increases in the supply of assets via privatization, and enhanced macroeconomic stability; (2) improvements in emerging market financial markets and banking systems, and other aspects of the economies, have reduced risks and made investment in these countries more attractive; (3) liberalization of capital controls in emerging market countries, removals of restrictions on institutional investors in industrial countries, and technological advances in communications; (4) portfolio diversification by investors in advanced countries, with the number of emerging market mutual funds having increased from 30 to 1500 in a decade, and with the flows to emerging markets fueled in part by the capital gains in advanced country stock markets; (5) improvements in information flows about emerging markets, both in the provision of data by emerging market countries and companies, and in the vastly improved quality of research on emerging markets in recent years; and (6) low interest rates in the advanced economies;

What could go wrong and upset the optimistic IIF forecast, a forecast whose optimism we in the IMF share? Most of the six factors I mentioned represent structural changes in emerging market countries or in advanced country capital markets that are unlikely to be reversed. But there are at least three elements that do present risks. First, there are emerging market countries where large current account deficits have to be watched, and some in which banking sector problems need to be dealt with rapidly. Second, capital flows to emerging markets show some signs of the exuberance that has been detected in other asset markets. In particular, spreads have become remarkably low. Third, interest rates in the United States have begun to rise.

I am sure that all these factors have been taken into account in the IIF's forecast, which is based on a country-by-country analysis. That would enable the IIF to take into account the fact that the macroeconomic situation in some countries is less good than in others. Presumably, those differences are already reflected in differential rates of capital flows to these countries in the IIF forecast. There is some evidence supporting the view that the capital markets are discriminating much better among emerging markets than they did in the past. Examples of such improved discrimination can be seen for instance in the differential spreads among yields seen in Charts 4 and 5; and in the very different behavior of stock markets seen in Charts 7, 8, and 9.

Still, it is hard looking at some of the spreads, to avoid the impression that while the markets might have **ranked** spreads correctly, the overall **level** of spreads could be low. And it is also not easy to forget that empirical work has found a strong impact of increases in U.S. interest rates on flows to developing countries.

In brief, the prospects are good, but there are real downside--and of course upside too--risks. Some of these risks originate in the situations of individual countries, and discriminating investors paying careful attention to those individual situations should be able to deal with them. Other risks are more general, in particular the risk that the overall rate of flow to emerging

markets may be significantly affected by conditions in advanced country capital and money markets.

3. **The financial market initiative**: The last ten months have seen a remarkable international effort to begin work to improve the quality of banking and financial systems in emerging market and developing countries more generally. The impetus for this effort came from the growing realization that banking sector crises had played an important role in the propagation of macroeconomic crises, and that their resolution had placed a heavy toll on fiscal resources. The 1996 IMF paper on this topic, Bank Soundness and Macroeconomic Policy, found that there had been banking sector problems in no less than 130 countries--many of them advanced countries. Morris Goldstein of the IIE, who this month published a book, The Case for an International Banking Standard on the topic, played an important role in generating the momentum behind the banking sector initiative.

The G-10 deputies have just completed a major report, Financial Stability in Emerging Market Economies that sets out a comprehensive coordinated strategy for dealing with these problems. The Basle Committee on Banking Supervision has produced an important paper, "Core principles for effective banking supervision", that sets out 25 principles that apply to bank supervision in emerging markets. (The draft version of this paper is available on the Internet.)

Some attention has focused on the roles of the Fund and the World Bank in this effort, and on coordination between the two institutions. This is not a complicated problem, and the Managing Director of the Fund and the President of the World Bank have set out the principles of our cooperation in a statement sent to the Boards of the two institutions. The IMF in its surveillance activities is paying increasing attention to the quality of banking systems, and in its technical assistance in central banking will also focus on this topic and on supervision. In advising on banking standards, we shall use the Basle Committee's new core principles wherever possible. The World Bank in both its lending and technical assistance activities will focus on the microeconomic aspects of banking systems, supervision, and financial systems more generally. In cases where Fund programs require attention to banking sector problems, we will to the maximum extent possible draw on the World Bank for advice. In some countries in which the Fund is active and the Bank is not, we may have to undertake some technical assistance on our own.

Now we have to get on with our work in this area, as we have been doing with increasing intensity for the last few years.

4. **Transparency**: The Fund makes a great deal of its analysis public, with the **World Economic Outlook (WEO)** and the **International Capital Markets** report as our flagship publications. We also publish the reports on Recent Economic Developments in individual countries that are prepared as part of the Article IV consultation process, unless the country concerned objects -- and the great majority do not.

In the last two years we have made important progress in enhancing transparency. Most of you are familiar with the **Special Data Dissemination Standard (SDDS)** and its bulletin board, the **Dissemination Standards Bulletin Board (DSBB),** which is now on the Internet (http://dsbb.imf.org). Forty two countries have subscribed to the SDDS and are putting comprehensive information about their data--the metadata--out under on the bulletin board under

the aegis of the SDDS. Six countries have so far agreed to electronic hyperlinks from the DSBB to actual country data maintained on country websites. An impressive demonstration of the SDDS Bulletin Board and the hyperlinks has been in place at the Fund for the last few days. We are also making progress on the GDDS, which is both a data **standard** and a data **system**, which applies to countries not ready to subscribe to the special system.

Last week, in another important step forward, the Board of the Fund agreed to allow the publication of **PINs**, Press Information Notices, based on the Executive Board discussion of a country's Article IV consultation report. These will consist of two parts: first, information about the country's economy; and second, a section based on the summing up by the Chairman (who is the Managing Director or one of the Deputy Managing Directors) of the Board's discussion of the Article IV report on the country. The PIN will only be published if the country concerned consents. In addition the summing up will be edited--but only to remove market sensitive information.

This is truly a major advance in making information about IMF consultations with member countries public.

There remains the issue with which we and the IIF have been struggling for some time, of whether there is not a better way of sharing the Fund's assessments of individual countries' prospects with market participants. A session like this of course is a step in that direction. But, beyond the PINs--which should be a major step forward--we have not yet found ways of making these interactions more systematic. In thinking about why it is difficult to go further, we should realize that part of the reason is that the Fund operates as an adviser to member countries. In that capacity, we receive a great deal of confidential information, which the member would be reluctant to reveal if it were not to remain confidential. I have no doubt that our capacity to provide frank and useful advice would be significantly impaired if we were systematically making our assessments of individual countries public.

I hope we can continue to share information and assessments with the IIF and other market participants, and to explore ways of improving information flows, but there are inevitably limits on the extent to which this can be done.

5. **The capital account**: Half a century ago, at Bretton Woods, the great challenge was to restore the volume of international trade in goods and services, which had been decimated by the Great Depression and the War. That challenge has been met, to an extraordinary extent, and we are all the richer for it. By now nearly 140 countries have accepted the Fund's Article VIII, making their currencies convertible on current account. Most remarkably, many of the transition economies are Article VIII members.

Now we are ready to move on to the next stage, the capital account. The globalization of capital markets proceeds apace, but capital controls are still widespread. The IMF Articles of Agreement do not give the Fund jurisdiction over the capital account. Starting from a paper by the UK Treasury, the G-10 deputies have made the case that capital account liberalization should be pursued, and that the Fund should have jurisdiction in this area.

Yesterday's Interim Committee Communique took this suggestion a step further. The

Committee "agreed that the Fund's Articles should be amended to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements; the scope of such jurisdiction would need to be carefully defined and sufficient flexibility should be allowed through transitional provisions and approval policies. The Committee asked the Executive Board to continue its work in this area with a view to making specific recommendations on key elements of an amendment by the time of the Committee's next meeting."

Much work will have to be done. The general strategy is clear. In the case of current account transactions, countries are entitled to impose restrictions on current account transactions. But they have to discuss them with the Fund, and the restrictions are noted in Fund consultations. We will need to develop the equivalents of Article XIV and Article VIII status for the capital account. And we will have to be very careful to specify the circumstances under which countries could impose capital controls in a manner consistent with their obligations under the Articles of Agreement. For instance, there is a general acceptance among Fund staff that market-based controls on capital inflows may at times be useful as temporary measures to deal with surging capital inflows.

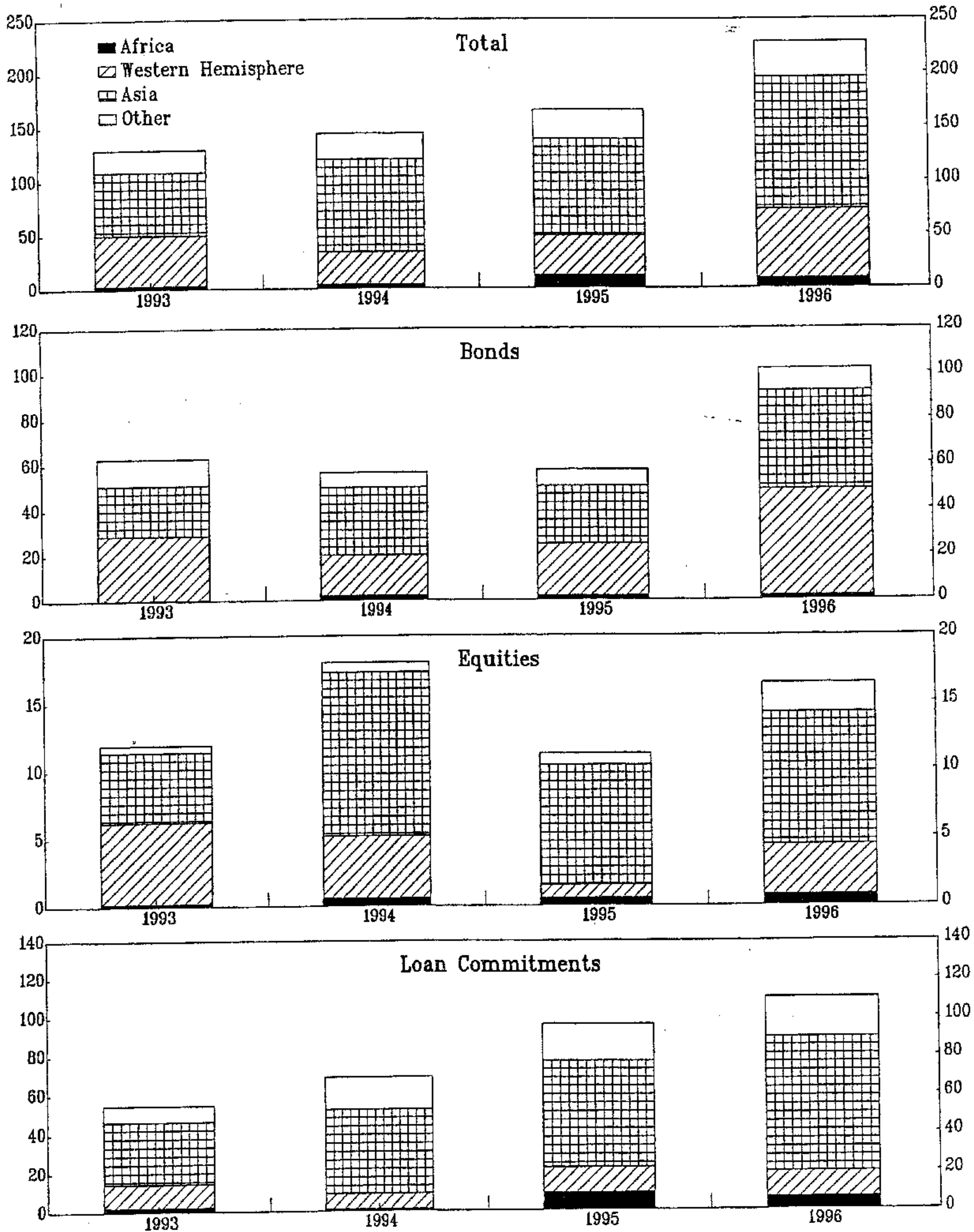
So, as we enter our second half-century, we are being given the authority that will enable us to contribute to completing this critical unfinished chapter in the creation of a global economy. This is another major step for the IMF and for the international economy.

Thank you.

Chart 1.

Private Market Financing for Emerging Markets, 1993 to 1996

(In billions of U.S. dollars)

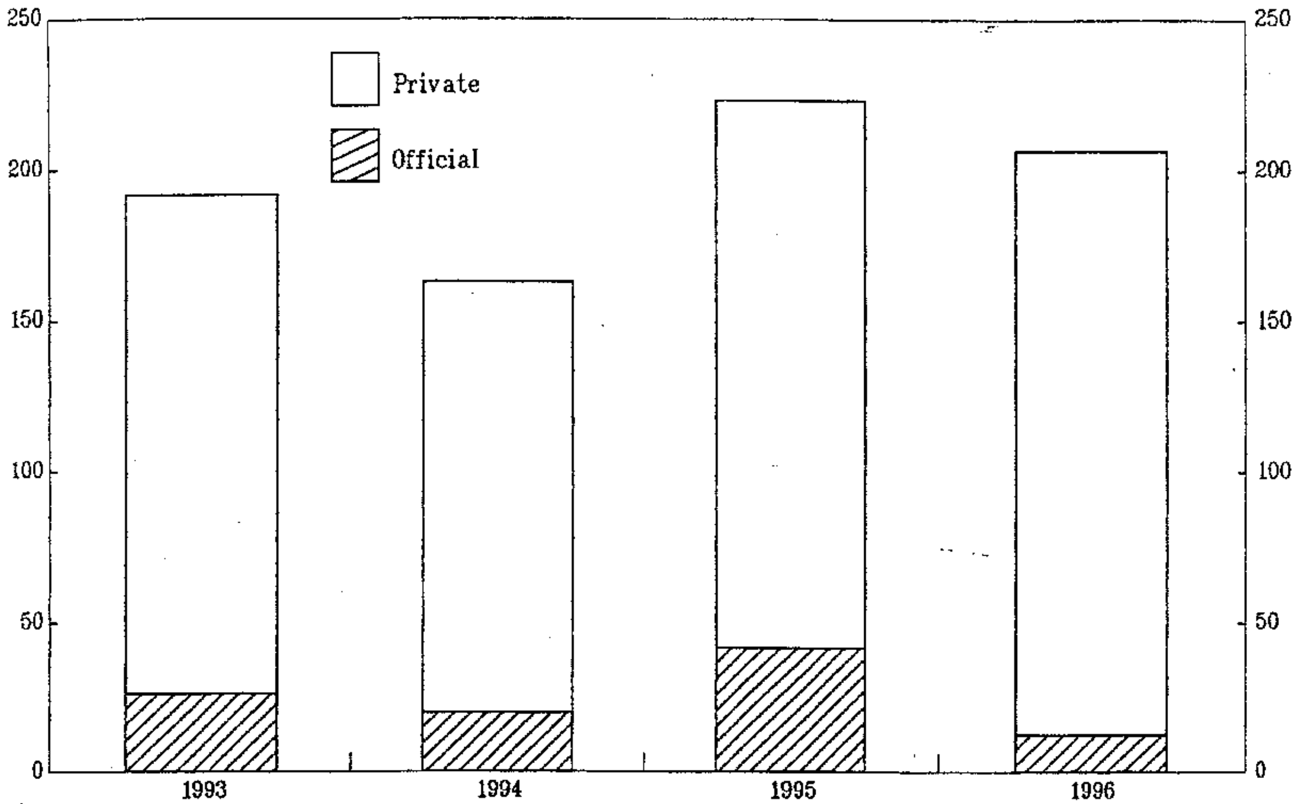


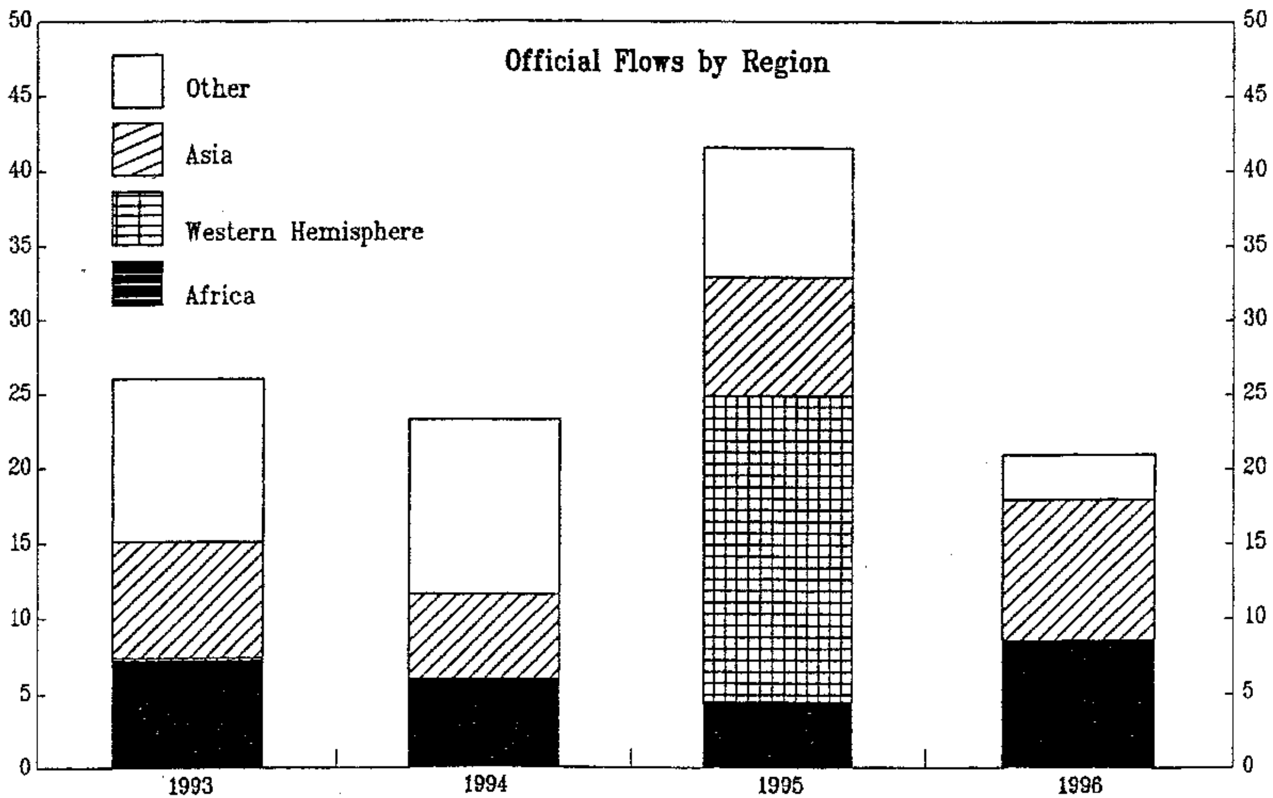
Source: Developing Country Bonds, Equities, and Loans (DCBEL) database.

Chart 2.

Capital Flows to Emerging Markets, 1993-97.

(In billions of U.S. dollars)



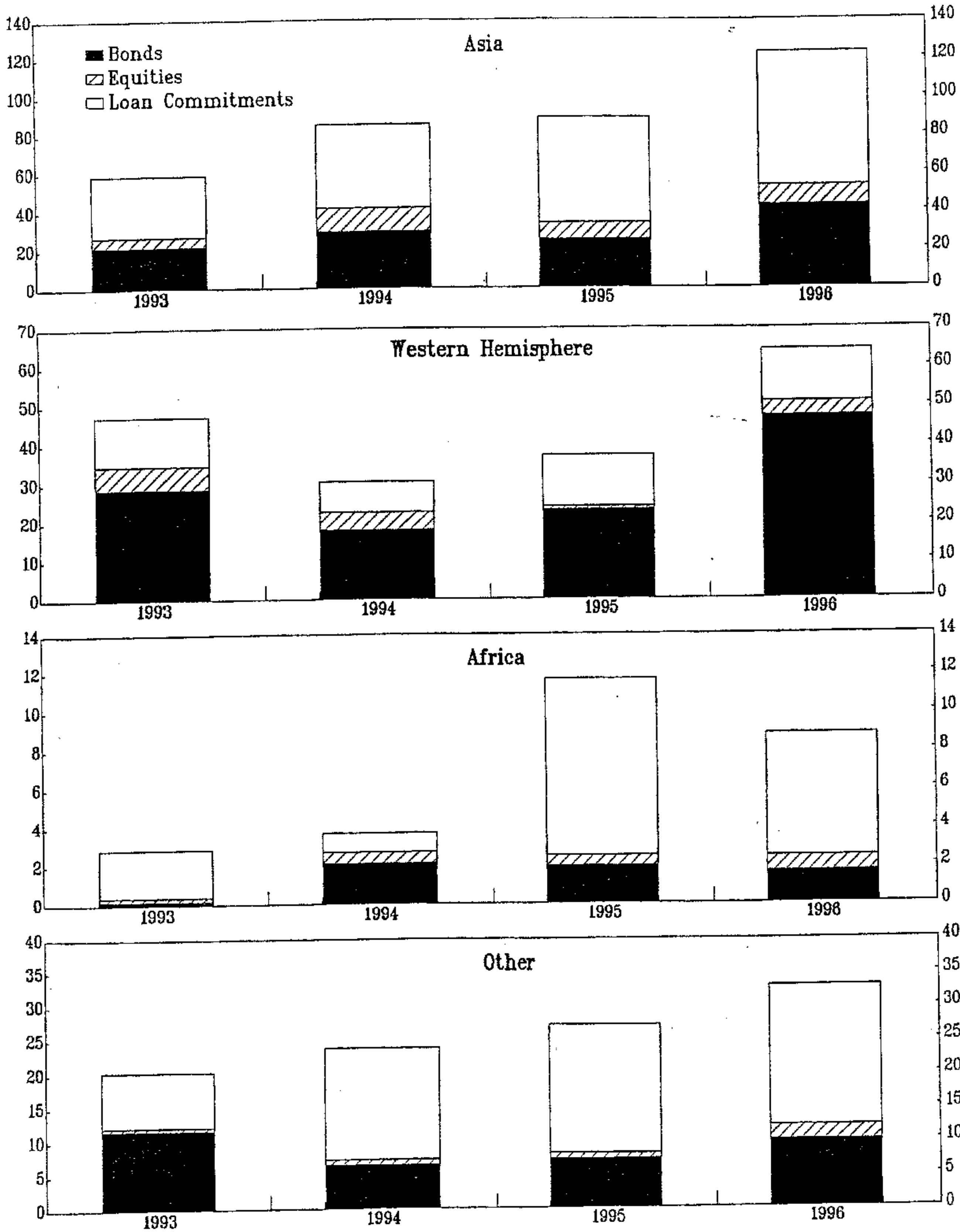


Source: International Monetary Fund, World Economic Outlook database.

Chart 3.

Private Market Financing for Emerging Markets, 1993 to 1996

(In billions of U.S. dollars)

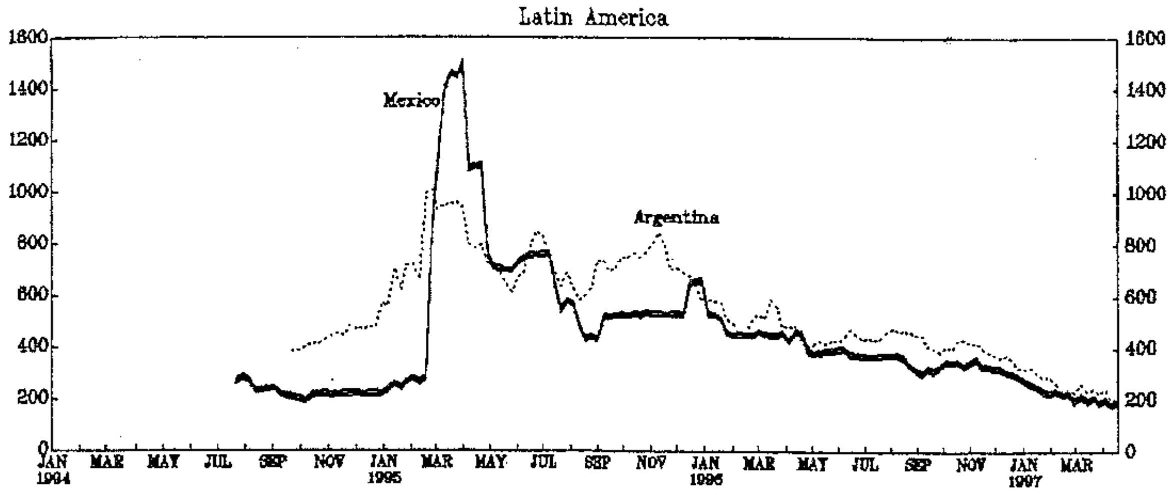


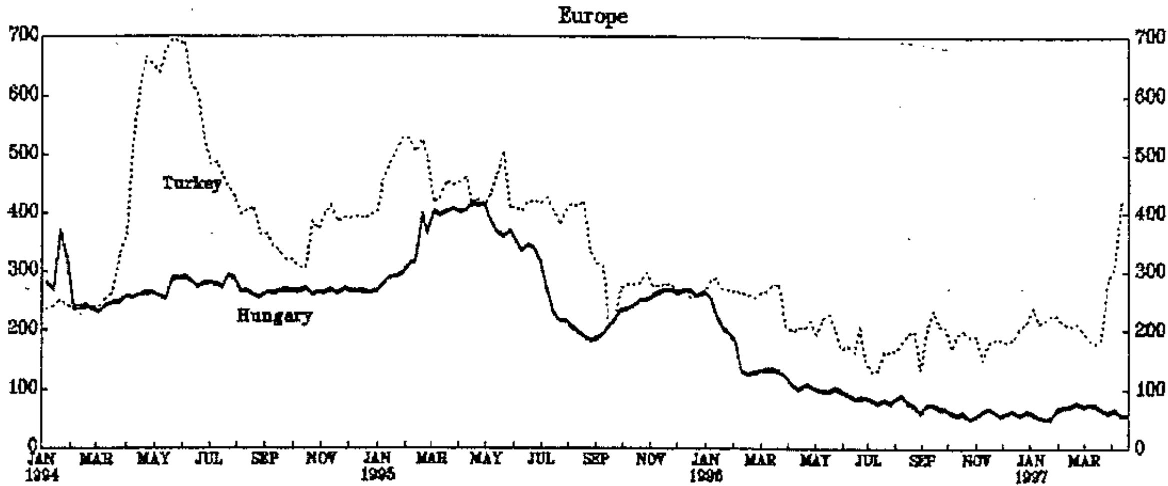
Source: Developing Country Bonds, Equities, and Loans (DCBEL) database.

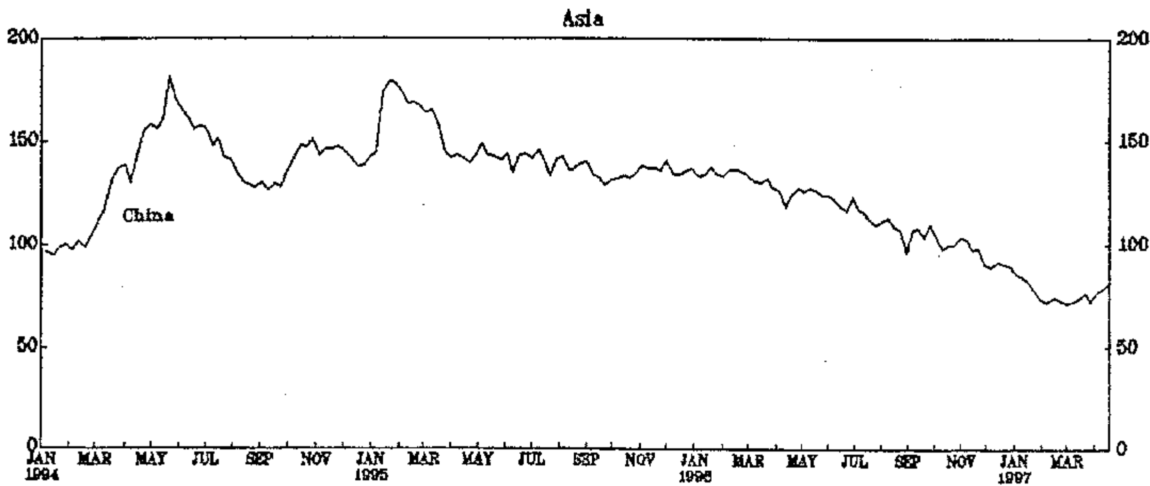
Chart 4

Secondary Market Yield Spreads on U.S. Dollar-Denominated Eurobonds by Selected Emerging Markets 1/

(In basis points)



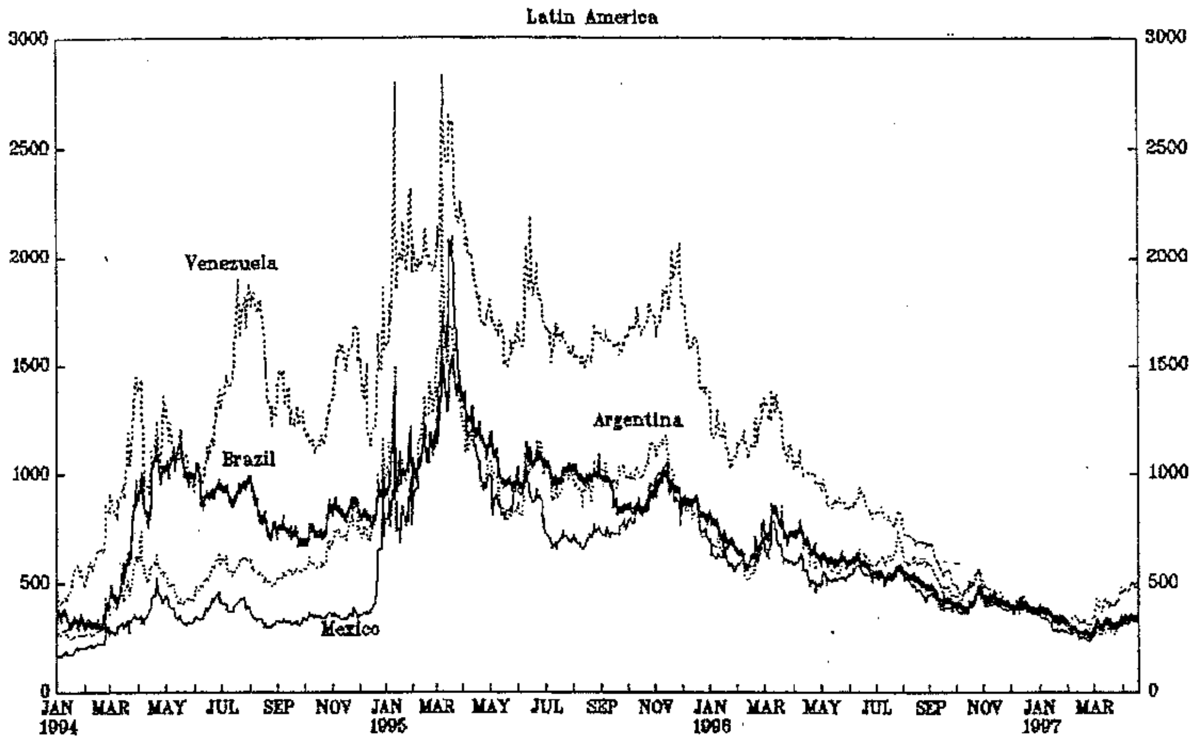


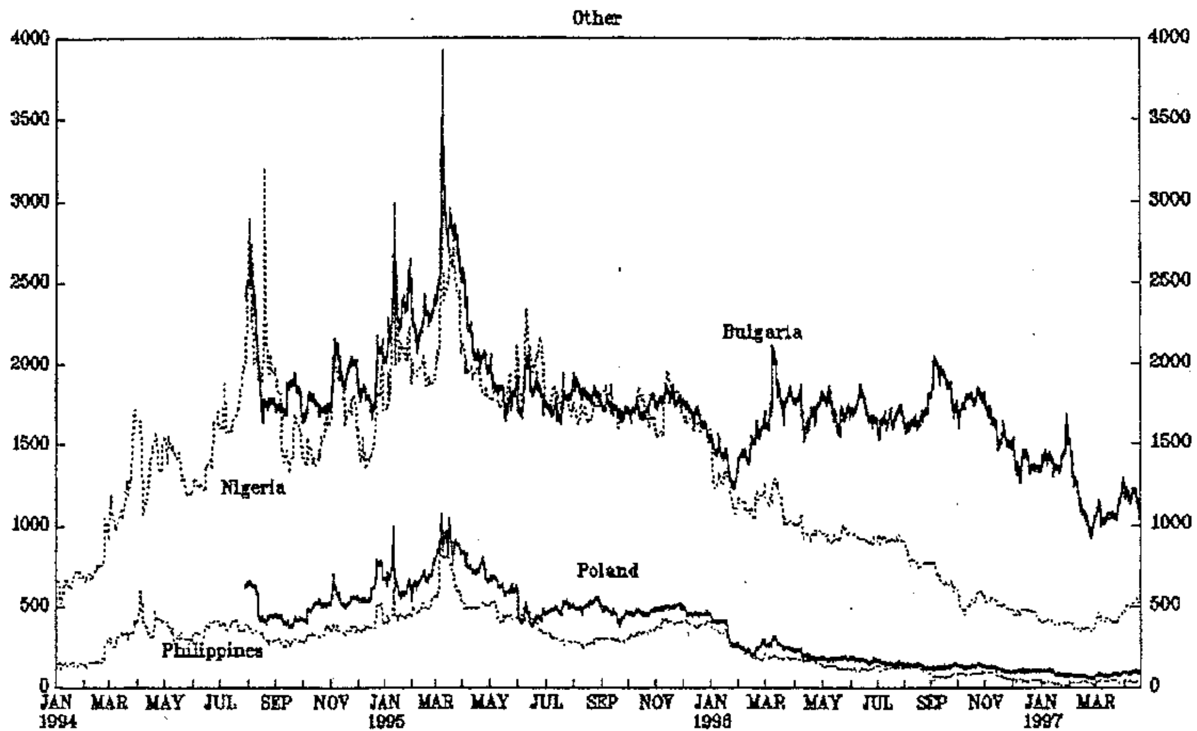


Sources: Bloomberg; and Reuters.

1/ Latin America: Republic of Argentina bond due 12/03 and United Mexican States bond due 9/02.
Europe: National Bank of Hungary bond due 6/95 and Republic of Turkey bond due 5/97.
Asia: People's Republic of China bond due 11/03.

Chart 5
Stripped Yield Spreads for Selected Brady Bonds
(In basis points)



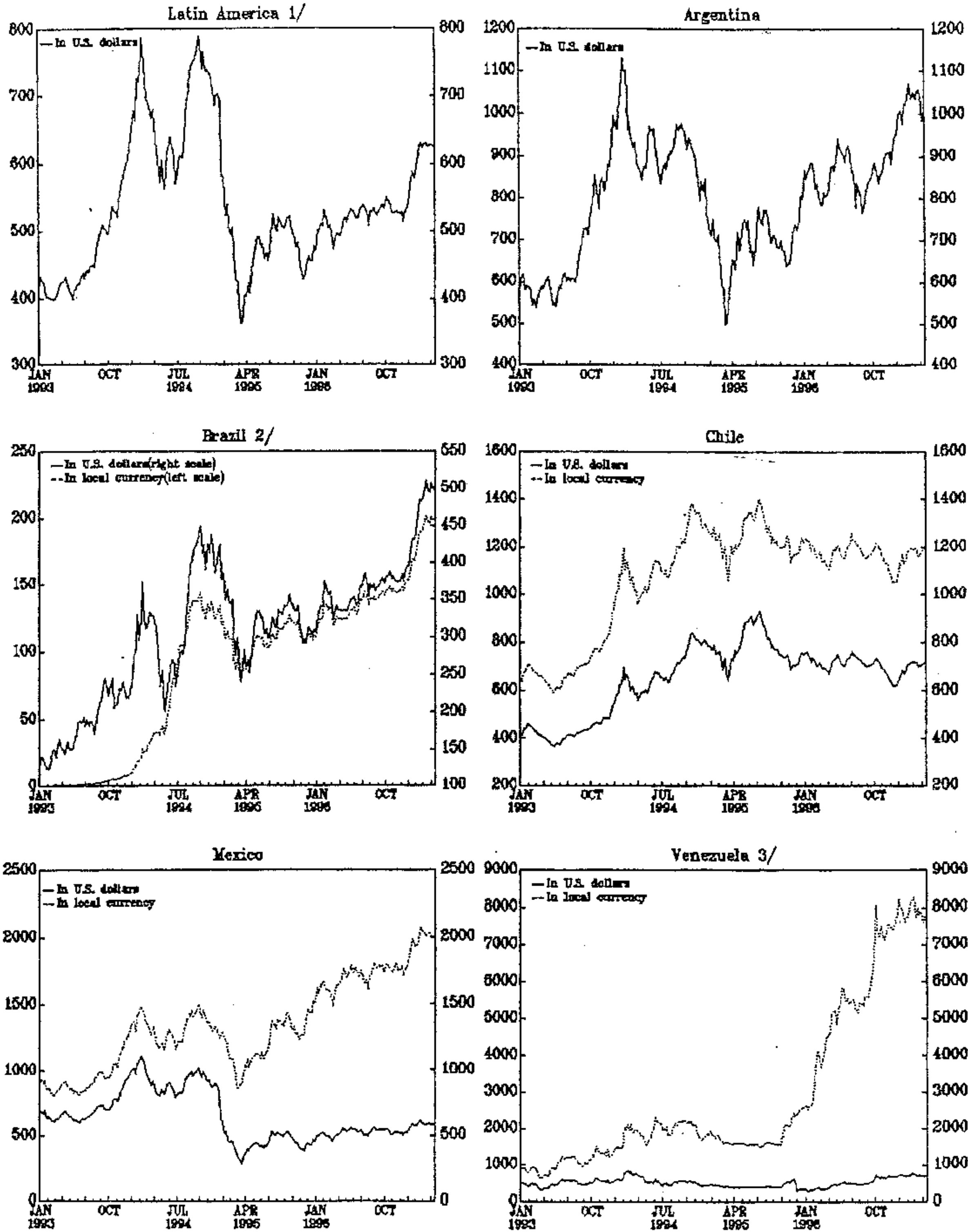


Sources: Reuters; Salomon Brothers; and Fund staff estimates.

Chart 6

Share Price Indices for Selected Markets in Latin America

(IFC weekly investable price indices, December 1988=100)

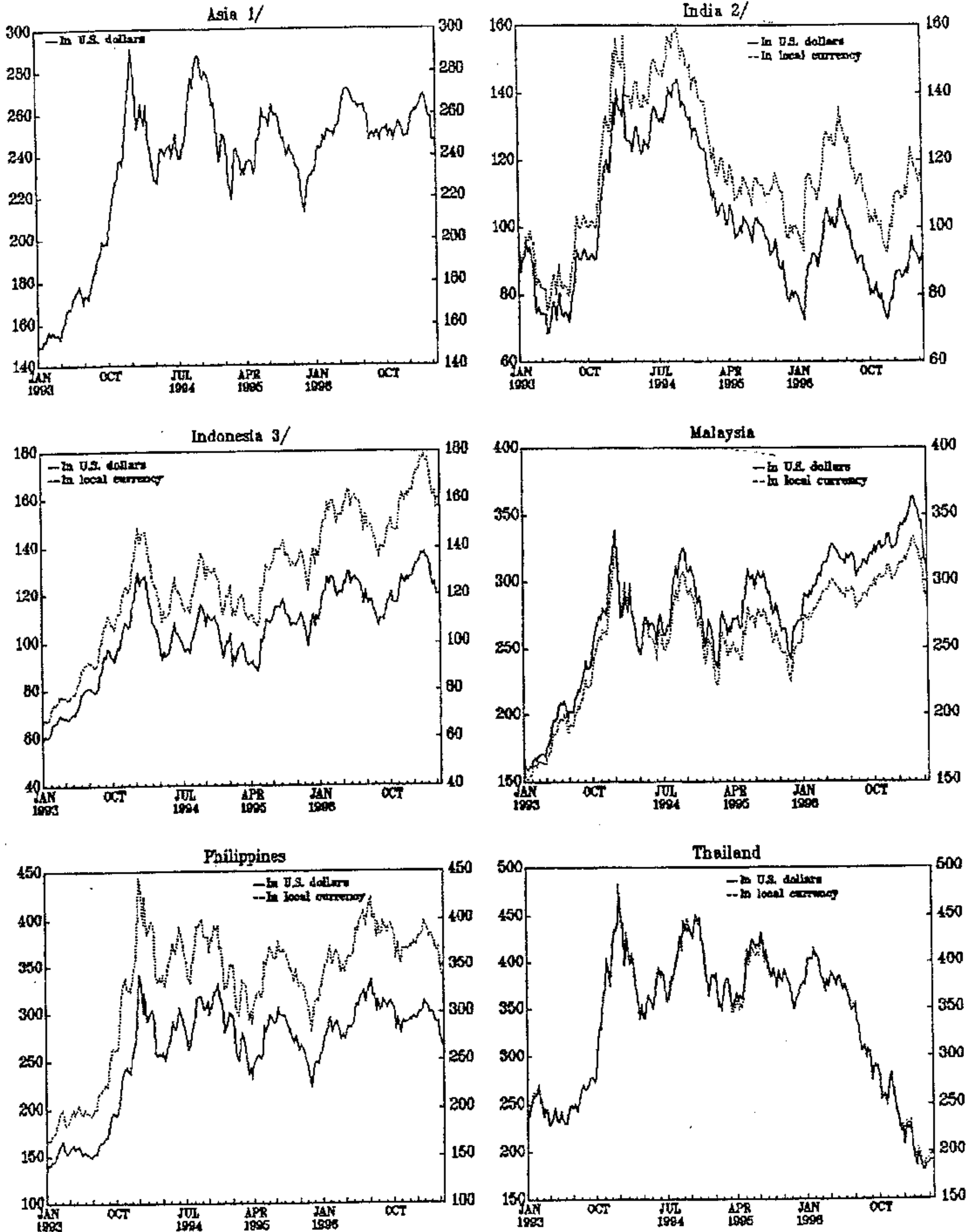


Source: International Finance Corporation (IFC), Emerging Markets Data Base.
1/ Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
2/ The Brazilian local currency index has been divided by ten million.
3/ January 1990=100.

Chart 7

Share Price Indices for Selected Markets in Asia

(IFC weekly investable price indices, December 1988=100)

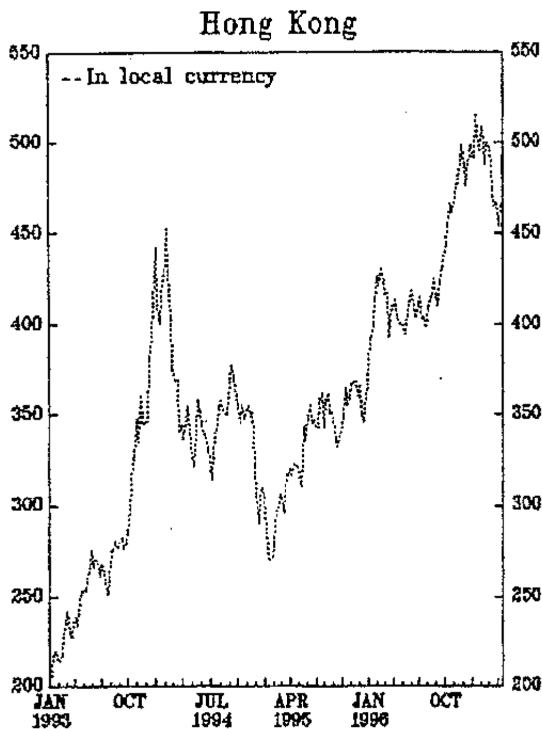


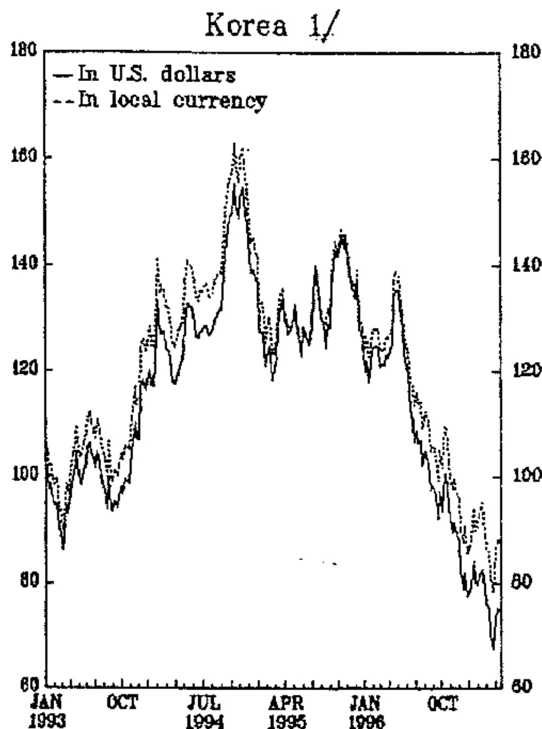
Source: International Finance Corporation (IFC), Emerging Markets Data Base.
1/ China, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Sri Lanka, Taiwan Province of China, and Thailand.
2/ November 1992=100.
3/ September 1990=100.

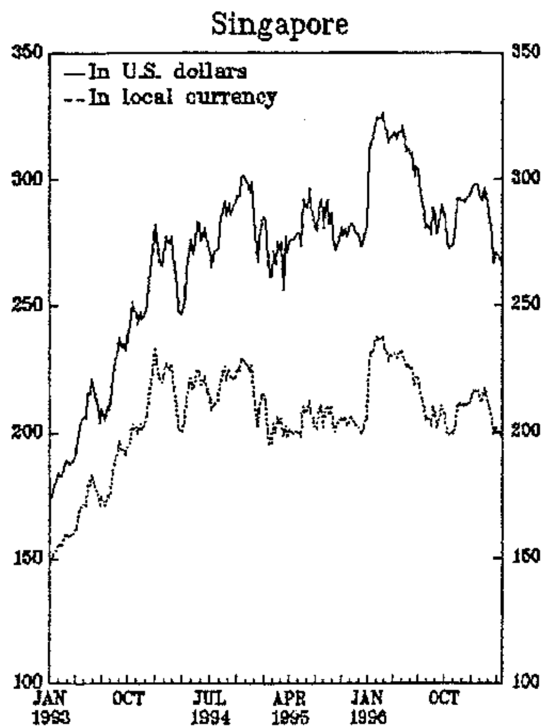
Chart 8

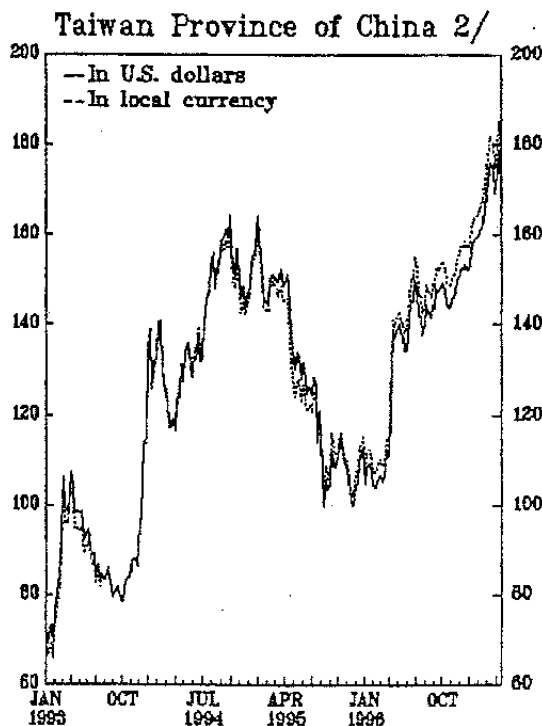
Weekly Share Price Indices for Asian NIEs

(December 1988=100)



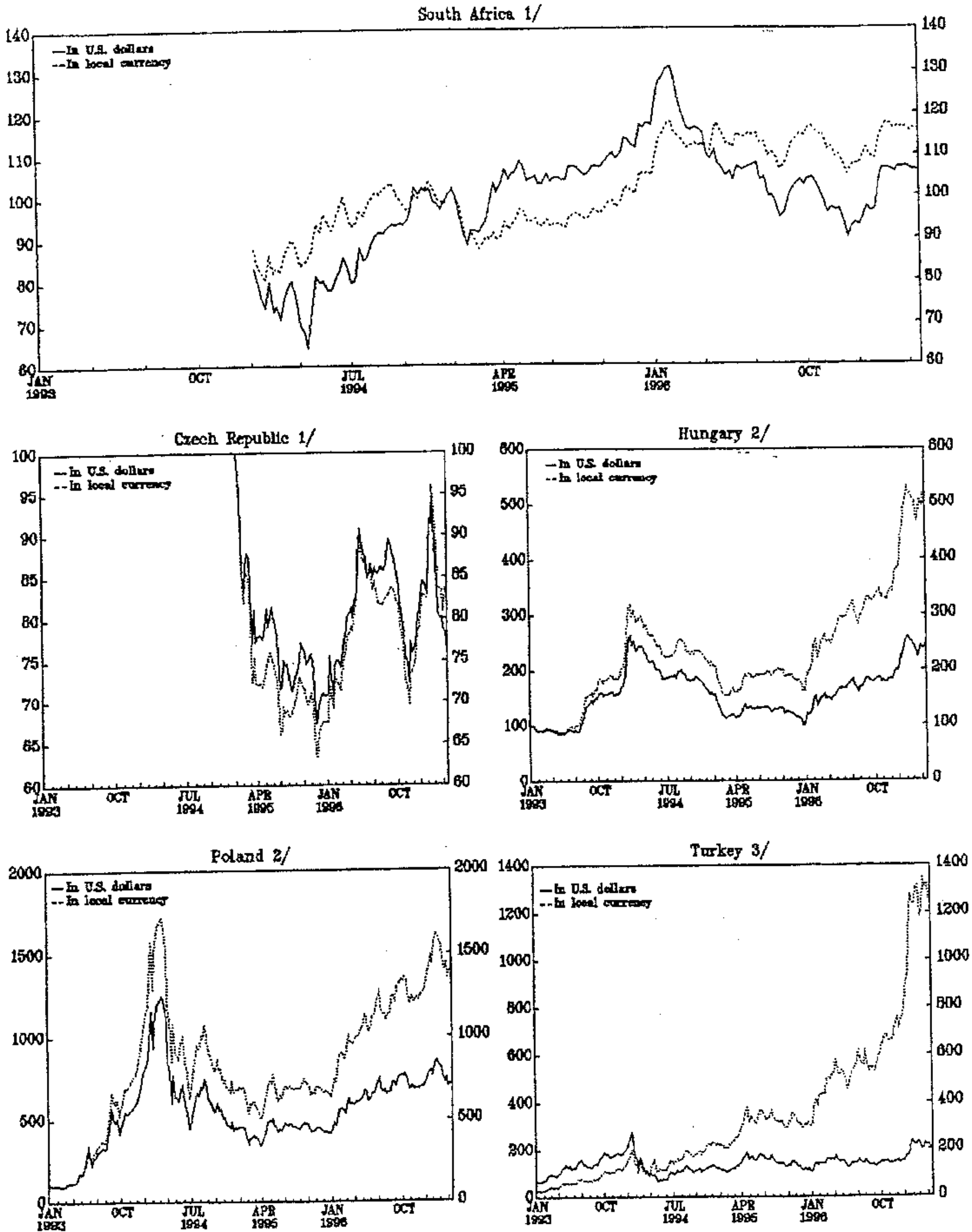






Sources: International Finance Corporation (IFC), Emerging Markets Data Base; Reuters; and WEFA.
1/ IFC weekly investable price index, January 1992=100.
2/ IFC weekly investable price index, January 1991=100.

Chart 9
Share Price Indices for Other Selected Emerging Markets
(IFC weekly investable price indices)



Source: International Finance Corporation (IFC), Emerging Markets Data Base.
1/ January 6, 1995=100.
2/ January 8, 1993=100.
3/ August 4, 1989=100. The Turkish local currency index has been divided by ten.